SUMMARY OF 2006 NORTH CAROLINA TAX LEGISLATION

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INTRODUCTION

This Summary provides an overview of legislation enacted during the North Carolina General Assembly's 2006 "short" session, which adjourned on July 28th. As of August 8th, the Governor had yet to act on several ratified bills reviewed below. Under the North Carolina Constitution, these bills will become law unless the Governor vetoes them by August 28th (the thirtieth day after the General Assembly's adjournment).

This Summary provides general information only and should not be construed as legal advice or necessarily applicable to your organization or business. Should you have specific questions about any piece of legislation, please contact a member of Smith Anderson's Tax and Estate Planning practice group.

EXECUTIVE SUMMARY

IRC Update and Federal Conformity Changes

- The IRC reference in Chapter 105 has been updated to January 1, 2006.
- Couples including a spouse with no North Carolina filing obligation have been granted permission to file joint North Carolina returns.
- The filing deadline for nonresident alien individuals and foreign corporations has been extended to conform to the federal filing date.
- The dollar limits on the North Carolina child care tax credit have been increased from $2,400 (for one child) and $4,800 (for two or more children) to $3,000 and $6,000 respectively.
- The time limit for reporting federal changes has been reduced from two years to six months.

Individual Income Tax Changes

- The top individual income tax rate is scheduled to be reduced from 8.25% to 8% beginning in 2007.
- Taxpayers may deduct up to $2,000 ($4,000 for joint filers) in donations to North Carolina's 529 Plan.
- The special rule for computing tax credits for conservation donations by partnerships at the partner level has been extended until 2007.
- All income earned through an S corporation is now subject to individual (rather than corporate) income tax adjustments.

Corporate Income, Franchise and Gross Premiums Tax Changes

- The royalty reporting option for payments of trademark royalties to related foreign corporations has been extended to patent and copyright royalties, and a new exception has been created for payments to certain non-US corporations.

- LLCs that elect to be taxed as C corporations will become subject to the franchise tax in 2007.

- Beginning in 2007, deferred tax assets may be used to reduce deferred tax liabilities (but no other deferred liabilities) for purposes of computing the capital stock franchise tax base.

- The Department of Revenue's administrative practice of allocating premiums on multiple risk policies for purposes of computing the 1.33% gross premiums surtax on fire and lightning policies has been codified.

Changes to Credits and Incentives

- The Lee Act has been completely overhauled for years beginning after 2006. Changes include (1) replacing the existing five enterprise tiers with three development tiers, (2) creating credit enhancements for activities in agrarian growth zones, (3) reducing the number of credits to three (job creation, investment in business property and investment in real estate), (4) increasing the classes of eligible businesses, (5) modifying the wage standard, (6) requiring all eligibility requirements to be satisfied at the facility level (rather than at the taxpayer level), and (7) providing flexibility in allocating the credit among different tax schedules.

- New income and franchise tax credits have enacted for (1) small employer health insurance premiums (beginning in2007), (2) producing biodiesel fuel (beginning in 2008), (3) donating oyster shells (beginning in 2006) and (4) rehabilitating certain historic industrial facilities (beginning in 2006).

- Existing credits for (1) constructing renewable fuel processing facilities, (2) rehabilitating historic structures, and (3) spending money on film and TV productions in North Carolina have been expanded.

Sales and Use Tax Changes

- The general sales tax rate is scheduled to be reduced from 4.50% to 4.25% in December of 2006, and the sales tax rate on electricity sold to manufacturers is scheduled to be reduced to 2.6% in July of 2007.

- Cable TV providers are subject to a 7% state sales tax and exempt from local franchise taxes beginning in 2007.

- New sourcing rules have been provided for railway car lease payments by utilities.

- The rules for taxing bundled telecommunication services have been extended to all bundled services.

- Beginning in October of 2007, large retailers will be required to remit sales taxes on a monthly rather than semimonthly schedule.

- New sales tax refunds have been authorized for the purchase of (1) race car parts by professional racing teams (beginning in July of 2007), (2) certain locomotive and railway cars by utilities (beginning in July of 2006), (3) building materials by financial services companies making large investments in North Carolina (beginning in July of 2006), and (4) electricity and building materials by internet service providers making large investments in North Carolina (beginning in October of 2006).

- The refunds authorized for sales taxes paid on (1) aviation fuel purchased by professional motor sports racing teams and (2) fuel purchased by interstate air carriers have been extended until 2009.

- Refunds for sales taxes on purchases of tangible personal property by government entities and non-profit organizations have been limited to exclude refunds of taxes on purchases of alcoholic beverages.

Property Tax Changes

- Counties have been authorized to (1) permit the electronic listing of non-business personal property, (2) accept late applications for present use valuation inappropriate cases, and (3) deliver receipts for assessments under appeal to the Property Tax Commission to the County Tax Collector, provided no collection action is taken until resolution of the appeal.

- Collection remedies for delinquent taxes are now required to be directed against the property's owner of record on the delinquency date rather than on the lien date.

- Modular homes used for display have been classified as exempt inventory.

Other Tax Changes

- The variable wholesale component of the motor fuels tax has been limited to 12.4¢ per gallon from July 2006 through June 2007.

- Beginning in 2007, motor fuel distributors making exempt purchases of fuel must pay tax at the terminal and seek refunds of the tax paid.
- A new 1% excise tax is imposed on certain equipment purchased by physical engineering and life science research and development companies.
- A retroactive exemption from the entertainment excise tax is provided for certain exhibitions and amusements held on farmland.
- A new exemption from the 1% excise tax on mill machinery has been enacted for logging machinery.

COMPLETE SUMMARY

IRC Update

The Internal Revenue Code ("IRC") reference in Chapter 105 has been updated from January 1, 2005 to January 1, 2006.[1] Four major pieces of federal tax legislation were enacted between January 1, 2005 and January 1, 2006: The Energy Tax Incentive Act of 2005[2], the SAFE Transportation Equity Act of 2005[3], the Katrina Emergency Tax Relief Act of 2005[4], and the Gulf Opportunity Zone Act of 2005.[5] The IRC reference update is effective June 21, 2006, provided that any IRC amendments enacted after January 1, 2005 that increase North Carolina taxable income for the 2005 taxable year become effective for taxable years beginning on or after January 1, 2006.[6]

Other Changes Related to Federal Conformity

Joint Returns for Nonresidents

North Carolina has no jurisdiction over an individual who neither is a North Carolina resident nor has North Carolina income. As a result, under prior law, a married couple could not file a North Carolina joint return if one spouse was a nonresident with no North Carolina income, even if the couple filed a federal joint return. Instead, the North Carolina resident spouse (or the spouse with North Carolina income) had to file a separate return, requiring the couple to recompute their income separately. The Current Operations and Capital Improvements Appropriations Act of 2006 (the "2006 Budget Act") changes this rule to permit a couple, only one of whom is a North Carolina resident or who has North Carolina income, to file a joint return in North Carolina.[7] Some states, such as South Carolina, do not permit couples to file a joint

[1] *See* N.C. Gen. Stat. § 105-228.90(b)(1b); S.L. 2006-18, §§ 1 and 2.
[2] P.L. 109-58.
[3] P.L. 109-59.
[4] P.L. 109-73.
[5] P.L. 109-135.
[6] *See* S.L. 2006-18, §§ 2 and 10.
[7] *See* N.C. Gen. Stat. § 105-152(e); S.L. 2006-66, § 24.11.(a).

return if only one spouse is subject to tax in that state unless the other spouse's state of residence permits the filing of a joint return in similar circumstances.[8] Thus, a couple that previously was required to file separate returns in North and South Carolina may now file joint returns in both states. This change is effective for taxable years beginning on or after January 1, 2006.[9]

Filing Deadlines for Nonresident Aliens and Foreign Corporations

For federal income tax purposes, nonresident aliens of the United States and foreign corporations have until the 15th day of the sixth month following the close of the taxable year (June 15th for calendar year taxpayers) to file their federal returns.[10] Under prior North Carolina law, nonresident aliens and foreign corporations were required to file their North Carolina income tax returns at the same time as domestic taxpayers, *i.e.,* by the 15th day of the third month following the close of the taxable year for foreign corporations and by the 15th day of the fourth month following the close of the taxable year for nonresident aliens. Since North Carolina taxable income is based on federal taxable income, the North Carolina filing deadlines effectively accelerated the preparation of federal returns for foreign taxpayers. The North Carolina filing deadlines for foreign taxpayers have been amended to conform to the federal deadlines.[11] These changes are effective for taxable years beginning on or after January 1, 2006.[12]

Child Care Credit Limits

For federal income tax purposes, an individual is entitled to a credit equal to a percentage of certain child and dependent care expenses. The amount of the credit is limited to $3,000 (for one dependent) or $6,000 (for two or more dependents).[13] North Carolina offers a similar credit, but with lower dollar limitations of $2,400 and $4,800. The North Carolina credit dollar limitations have now been increased match the federal limitations. The North Carolina credit has also been amended to provide that the expenses for which a credit may be claimed must be reduced by the amount of any employer-provided dependent care assistance that is excluded from income (such as amounts excluded under IRC § 129).[14] A similar rule applies in calculating the amount of the federal credit, except that the amount excluded from income is used to reduce the dollar limitation rather than the amount of creditable expenses.[15] These changes are effective for taxable years beginning on or after January 1, 2006.[16]

Time for Reporting Federal Changes

Under prior law, if a taxpayer's federal corporate income, individual income, gift or estate tax was redetermined by the IRS, the taxpayer had two years to report the federal changes

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[8] *See, e.g.,* S.C. Code § 12-6-5000(C)(2).
[9] *See* S.L. 2006-66, § 24.11.(b).
[10] *See* IRC § 6072(c).
[11] *See* N.C. Gen. Stat. §§ 105-130.17 and 105-155(a); S.L. 2006-18 §§ 7 and 8.
[12] *See* S.L. 2006-18, § 10.
[13] *See* IRC § 21.
[14] *See* N.C. Gen. Stat. § 105-151.11(b); S.L. 2006-18, § 9.
[15] *See* IRC § 21(c).
[16] *See* S.L. 2006-18, § 10.

to the Department of Revenue by filing a corrected state return. The period for reporting these federal changes has been reduced to six months.[17] This change conforms North Carolina law to the Multistate Tax Commission model uniform statute for reporting federal changes.[18] These changes are effective July 1, 2006 and apply to federal determinations made on or after that date.[19]

Other Personal Income Tax Changes

Rate Reduction

In 2001, the General Assembly enacted a temporary individual income tax rate of 8.25% applicable to taxable income over $200,000 for joint filers (with lower thresholds for other filers). The 8.25% rate was scheduled to expire in 2004.[20] In 2003, the General Assembly extended the 8.25% rate until 2006.[21] In 2005, the General Assembly again extended the 8.25% rate until 2008.[22] The 2006 Budget Act lowers the top rate to 8% for taxable years beginning on or after January 1, 2007. In 2008, the top rate will return to the 7.75% rate in effect before 2001.[23] The North Carolina Supreme Court recently upheld the 2001 rate increase against a challenge that it was unconstitutionally retroactive.[24]

Deductible Contributions to NC 529 Plan

In 1996, the General Assembly established the Parental Savings Trust Fund to hold contributions made under the North Carolina National College Savings Plan, the State's 529 plan. Under IRC § 529 and conforming North Carolina law, earnings on 529 plan contributions and qualified withdrawals from 529 plans are not subject to federal or North Carolina tax. The 2006 Budget Act creates a North Carolina income tax deduction for contributions of up to $2,000 ($4,000 for joint filers) to North Carolina's 529 plan. No deduction is permitted for contributions to 529 plans maintained by other states. The deduction is permitted only for taxpayers with federal adjusted gross income of $100,000 or less (for married couples filing jointly), $80,000 or less (for heads of households), $60,000 or less (for single taxpayers) or $50,000 or less (for married individuals filing separately). If a taxpayer claims the deduction and later makes a nonqualified withdrawal from the plan, the amount of the nonqualified withdrawal must be added to federal taxable income except in the case of the death or permanent disability of the plan beneficiary. This provision is effective for taxable years beginning on or after January 1, 2006 and sunsets for taxable years beginning on or after January 1, 2011.[25]

Extension of Special Rule for Conservation Donations

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[17] *See* N.C. Gen. Stat. §§ 105-32.8, 105-130.20, 105-159 and 105-197.1; S.L. 2006-18, §§ 3, 4, 5 and 6.
[18] *See* Multistate Tax Commission, *Model Uniform Statute For Reporting Federal Tax Adjustments With Accompanying Model Regulations* (adopted August 31, 2003).
[19] *See* S.L. 2006-18, § 10.
[20] *See* S.L. 2001-424, § 34.18.
[21] *See* S.L. 2003-284, § 39.1.
[22] *See* S.L. 2005-276, § 36.1.
[23] *See* N.C. Gen. Stat. § 105-134.2(a); S.L. 2006-66, § 24.2.
[24] *See Coley v. State*, 360 N.C. 493 (2006).
[25] *See* N.C. Gen. Stat. §105-134.6(d)(4) and (5); S.L. 2006-66, § 24.12; S.L. 2006-__ (S198), § 27.(a).

Individuals are entitled to an income tax credit equal to 25% of the fair market value of real property donated for public beach access and similar conservation purposes. The maximum credit is $250,000.[26] Where a partnership engages in creditable activities, any maximum dollar limit on the credit is typically applied at the partnership level rather than at the partner level.[27] Legislation enacted in 2001, however, provides that, for purposes of the real property donation credit, the maximum dollar limit applies at the partner level. This special rule was scheduled to expire for taxable years beginning on or after January 1, 2005.[28] In 2004, the sunset on this special rule was extended to January 1, 2006.[29] The 2006 Budget Act extends the sunset to January 1, 2007.[30]

Adjustments Related to S Corporation Income

Under prior law, if an S corporation shareholder earned income from the S corporation that was attributable to North Carolina, that income was subject to the adjustments required to be made to federal taxable income for North Carolina corporate income tax purposes. If a resident shareholder of an S corporation earned income through the S corporation that was not attributable to North Carolina, such income was subject to the adjustments required to be made to federal taxable income for North Carolina individual income tax purposes.

The theory behind these rules, which are based on the Model S Corporation Income Tax Act drafted by the ABA Tax Section's Subcommittee on the State Taxation of S Corporations, is that a shareholder's share of the S corporation's income attributable to the state should be subject to corporate adjustments, because the corporation's activities generate the income allocable to or apportioned to the state. On the other hand, a shareholder's share of the S corporation's income not attributable to the state should be subject to individual adjustments, because such income is subject to tax only because it belongs to residents who are taxable in their individual capacities and not because of the corporation's activities.

These rules have been amended to provide that all income earned through an S corporation should be subject to the individual rather than the corporate adjustments. The theory behind the change is that since corporations are not eligible S corporation shareholders, corporate adjustments should not apply to any income earned through the S corporation.[31]

For federal income tax purposes, S corporations that previously were C corporations are subject to entity-level taxes on built-in gains and excess passive income.[32] These corporate level taxes reduce the amount of S corporation income passed-through to the S corporation's shareholders.[33] North Carolina does not subject S corporations to these entity-level taxes and previously had not required any adjustment to the shareholders' income earned through the S

[26] *See* N.C. Gen. Stat. § 105-151.12.
[27] *See* N.C. Gen. Stat. § 105-269.15(a).
[28] *See* N.C. Gen. Stat. § 105-151.12(f); S.L. 2001-335, § 3.
[29] *See* S.L. 2004-134, § 1.
[30] *See* S.L. 2006-66, § 24.15.(a).
[31] *See* N.C. Gen. Stat. §§ 105-131.2(a) and 105-134.6(a); S.L. 2006-17, §§ 1 and 2.
[32] IRC §§ 1374 and 1375.
[33] *See* IRC § 1366(f)(2) and (3).

corporation to unwind the effect of IRC § 1366(f) (2) and (3). New legislation, however, includes a new addition to federal taxable income for an individual taxpayer equal to the individual's share of the IRC § 1366(f)(2) reduction in S corporation income for the corporate-level federal built-in gains tax.[34] However, the new legislation does not require any adjustment with respect to the IRC § 1366(f)(3) reduction with respect to the tax on excess passive income.

These changes are effective for taxable years beginning on or after January 1, 2006.[35]

Other Corporate Income and Franchise Tax Changes

Modification of Royalty Reporting Option

In 2001, the General Assembly enacted a royalty reporting option for trademark and tradename licensing companies. Under the royalty reporting option, where a foreign corporation (such as a *Geoffrey*-type Delaware holding company) receives royalties from licensing trademarks or tradenames to a related North Carolina corporation, the payor can deduct the royalty payments on its North Carolina return and the recipient can include them on its North Carolina return or the payor can add them back to its North Carolina income and the recipient can exclude them on its North Carolina return.[36]

The 2006 Budget Act expands the royalty reporting option to cover royalties for the use of copyrights and patents as well as trademarks and tradenames.[37] This change is effective for taxable years beginning on or after January 1, 2006.[38]

In addition, new legislation provides that the payor can deduct the royalty payments if it can establish that the payee is organized under the laws of a jurisdiction outside the United States that has a comprehensive income tax treaty with the United States and that taxes the royalty income at a rate at least equal to the North Carolina corporate income tax rate.[39] This change is effective for taxable years beginning on or after January 1, 2006.[40]

Expansion of LLC Franchise Tax

Under prior law, LLCs were specifically excluded from the definition of a "corporation" for franchise tax purposes and so were not subject to the tax. An LLC's assets are indirectly subject to the franchise tax, however, if more than 50% of the capital interests in the LLC are owned by a corporation or affiliated group of corporations, in which case, the corporate owners must include a proportionate amount of the LLC's assets in calculating their own franchise tax liabilities.

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[34] *See* S.L. 2006-17, § 3.
[35] *See* S.L. 2006-17, § 4.
[36] *See* N.C. Gen. Stat. § 105-130.7A.
[37] *See* N.C. Gen. Stat. § 105-130.7A; S.L. 2006-66, § 24A.3.(a).
[38] *See* S.L. 2006-66, § 24A.3.(b).
[39] *See* N.C. Gen. Stat. § 105-130.7A(c); S.L. 2006-196, § 10.
[40] *See* S.L. 2006-196, § 14.

The 2006 Budget Act provides that any LLC that elects to be taxed as a C corporation for federal income tax purposes is treated as a corporation for franchise tax purposes and so becomes directly liable for the franchise tax. An LLC that elects to be taxed as a corporation is also entitled to a non-refundable credit for the difference between the annual report fee for corporations ($20) and the annual report fee for LLCs ($200).[41] These changes are effective for taxable years beginning on or after January 1, 2007.[42]

The legislature was apparently concerned that a corporation operating in North Carolina but owned by a parent corporation not doing business in North Carolina could avoid the franchise tax by converting to an LLC and checking the box to be taxed as a corporation for federal income tax purposes. In such a case, the subsidiary would no longer be subject to the franchise tax, because check-the-box elections had no effect on the LLC's status for franchise tax purposes, while the foreign parent would not be required to include the subsidiary's assets in its franchise tax calculations, because it had no nexus with North Carolina. (If the subsidiary corporation simply converted to an LLC without checking the box, it would be treated as a division of the parent, creating nexus between the parent and North Carolina.)

A corresponding change was made to the special franchise tax applicable to holding companies. A holding company for franchise tax purposes is defined as a corporation that derives more than 80% of its gross income from controlled corporations. A corporation is controlled if the holding company owns more than 50% of its voting stock. Because a corporation for purposes of the franchise tax can now include an LLC that has checked the box, this definition has been amended so that a corporation will be considered to be controlled by a holding company if the holding company owns more than 50% of its voting stock or "voting capital interests."[43] This change is effective for taxable years beginning on or after January 1, 2007.[44]

Franchise Tax Treatment of Deferred Tax Assets

A corporation may reduce its capital stock base for franchise tax purposes by the amount of a liability only if the liability is a "definite and accrued legal liability."[45] For financial accounting purposes, however, a corporation may have to accrue a liability that is not yet "definite and accrued." These liabilities must be added back to the capital stock base in computing the corporation's franchise tax liability. These deferred liabilities may include liabilities for deferred taxes. For financial accounting purposes, a corporation may also carry on its books a deferred tax asset, representing the benefit of future deductions associated with a particular deferred liability.[46]

For a number of years, the Department of Revenue had taken the position that deferred liabilities required to be added back to the capital stock base could not be reduced by the amount

[41] *See* N.C. Gen. Stat. §§ 105-144(b)(2), 105-114.1 and 105-122.1; S.L. 2006-66, § 24A.2.(a), (b) and (c).
[42] *See* S.L. 2006-66, § 24A.2.(d).
[43] *See* N.C. Gen. Stat. §105-120.2(c); S.L. 2006-196, § 9.
[44] *See* S.L. 2006-196, § 14.
[45] *See* N.C. Gen. Stat. § 105-122(b).
[46] *See* Financial Accounting Standards Board Statement No. 109 (February 1992).

of the related deferred tax asset carried on the taxpayer's books. However, in a 1996 Technical Advice Memorandum, the Department concluded that "upon further review" adding back the total amount of a deferred liability without a netting adjustment for the related deferred tax asset resulted in an inaccurate calculation of the capital stock base. As a result, the Department announced that for tax years ending on or after July 31, 1996, deferred liabilities required to be added back to the capital stock base could be reduced (but not below zero) by the amount of any corresponding deferred tax asset.[47]

New legislation alters the treatment of deferred tax liabilities by permitting a taxpayer to reduce (but not below zero) the amount of its deferred tax liabilities required to be added back to the capital stock base by the amount of its deferred tax assets. Thus, the taxpayer's deferred tax assets are not to be netted against their corresponding deferred liabilities but against the taxpayer's deferred tax liabilities.[48] This provision is effective for taxable years beginning on or after January 1, 2007.[49] The Department will presumably revoke or modify its 1996 Technical Advice Memorandum.

Gross Premiums Tax Changes

North Carolina imposes a 1.33% surtax on gross premiums derived from most contracts of insurance that provide fire and lightning coverage. The Department of Revenue has administered this surtax by permitting insurers writing policies that cover fire and lightning as well as other risks to pay the surtax on only a percentage of the premiums paid on such multiple risk policies. The Attorney General had informally advised the Department that the surtax was in fact due on the entire gross premiums received on such policies. New legislation codifies the Department's past practice, effective for taxable years beginning on or after January 1, 2006.[50]

Changes to Credits and Incentives

<u>Overhaul of William S. Lee Act</u>

Effective for taxable years beginning on or after January 1, 2007, the existing William S. Lee Act credits are replaced with an entirely new and simplified incentive regime. Under the new regime, the existing Lee Act credits are replaced with three credits: a credit for creating jobs, a credit for investing in business property and a credit for investing in real property. Like the existing Lee Act credits, the amount of the new credits depends on the location of the creditable activity, but the existing five enterprise tiers are replaced with three development tiers. A county's tier designation is based on its relative unemployment, household income, population growth and per capita property tax value. Credit enhancements are available if the creditable activity takes place in an "urban progress zone" (replacing existing development zones) or an "agrarian growth zone." The number of eligible business categories has been revised and expanded. Specifically, eligible businesses include: aircraft maintenance and repair businesses,

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[47] *See* TAM-CF 96-1.
[48] *See* N.C. Gen. State § 105-122(b); S.L. 2006-95, § 1.1.
[49] *See* S.L. 2006-95, § 1.2.
[50] *See* N.C. Gen. Stat. §105-228.5(d)(3); S.L. 2006-196, § 1-5 and 14.

air courier service hubs, company headquarters, company service call centers, electronic shopping and mail order houses, information technology and services, manufacturing businesses, motor sports racing teams and facilities, research and development businesses, warehousing businesses and businesses engaged in wholesale trade. As under existing law, taxpayers must satisfy wage, health insurance, worker safety and environmental compliance standards and must have no overdue tax debts, though these requirements have been modified in some respects. The eligibility standards are applied to the specific facility or location where the creditable activity occurs, whereas under the existing Lee Act regime, some eligibility requirements were applied to the taxpayer generally. In a departure from existing law, the taxpayer may divide the credits among the income tax, franchise tax and gross receipts tax (rather than having to make an irrevocable election to apply the credit against one of the three), and the 50% cap on the amount of the credit that may be taken in any year is applied on the basis of the taxpayer's aggregate liability under all three taxes. Moreover, credit carryforwards can be divided in a manner different from the taxpayer's original allocation.[51]

Other Lee Act Changes

The 2006 Budget Act makes several other changes to the Lee Act, some of them retroactive, that apply to credits claimed under existing incentive programs. First, the 2006 Budget Act includes a retroactive expansion of the definition of a development zone to include an "economic development and training district."[52] An "economic development and training district" is defined in section 153A-317.12 of the General Statutes, which was enacted in 2003 and intended to apply to a portion of Johnston County.[53] This change is effective for taxable years beginning on or after January 1, 2004.[54]

Second, the 2006 Budget Act includes a retroactive relaxation of the wage standard for certain taxpayers. Under the existing Lee Act provisions, a taxpayer may claim the credits for investing in machinery and equipment, engaging in research and development and investing in central office and aircraft facilities only if the wages paid by the taxpayer at the location with respect to which the credit is claimed satisfy the wage standard. The 2006 Budget Act includes a special provision for applying the wage standard under the Lee Act to a fiber, yarn, or a thread mill that uses a sequential manufacturing process in which several parts of the process are performed in different facilities within the same county. Under this special provision, the wage standard will be considered satisfied if it is satisfied either with respect to the specific facility in question or with respect to all facilities in the same county in which parts of the process are performed.[55] This change is effective retroactively for taxable years beginning on or after January 1, 1996.[56]

Third, the 2006 Budget Act accelerates the agrarian growth zone concept of the new incentive regime into the existing Lee Act. An "agrarian growth zone" is defined, generally, as a

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[51] *See generally* S.L. 2006-__ (H2170).
[52] *See* N.C. Gen. Stat. §105-129.3A(a); S.L. 2006-66, § 24.5.(a).
[53] *See* S.L. 2003-418.
[54] *See* S.L. 2006-66, § 24.5.(b).
[55] *See* N.C. Gen. Stat. § 105-129.4(b); S.L. 2006, § 24.14.(a).
[56] *See* S.L. 2006, § 24.14.(b).

contiguous area located within a single county and comprising not more than 5% of the total area of the county, in which more than 20% of the population is below the poverty level. In addition, the county in which the area is located must not have any town with a population over 10,000. (According to the most recent North Carolina Municipal Population report prepared by the Office of State Management and Budget, there were fifty-seven such counties in North Carolina in 2004.) A county may not have more than one agrarian growth zone. A local government may request the Secretary of Commerce to certify that an area constitutes an agrarian growth zone. If the Secretary makes this determination, the determination is effective until December 31 of the year following the year of the determination. The Department of Commerce is to publish an annual list of all agrarian growth zones. Special rules are included for parcels that are partially within and partially without an agrarian growth zone. Taxpayers creating jobs in agrarian growth zones are entitled to enhanced job creation credits. In addition, for purposes of the wage standard requirement, the credit for investing in machinery and equipment and the credit for worker training, an agrarian growth zone is considered an enterprise tier one area (most distressed).[57] This provision is effective for taxable years beginning on or after January 1, 2006.[58]

New Health Insurance Premium Credit

The 2006 Budget Act provides a new credit for small employers who provide health insurance for employees. The credit is available only to employers with 25 or fewer full-time employees that pay at least 50% of the premiums for health care coverage for all of their full-time employees (other than employees with qualifying existing coverage). The health care coverage provided must equal or exceed the minimum provisions of the basic healthcare plan of coverage recommended by the Small Employer Carrier Committee established by the North Carolina Insurance Commissioner. Although the employer must provide coverage to all full-time employees to be eligible for the credit, the credit is equal to the employer's actual cost (not to exceed $250) of providing coverage only for full-time employees whose total annual wages do not exceed $40,000. The amount of the credit is reduced for multistate taxpayers that apportion their business income.[59] The credit is to be codified in Article 3B of Chapter 105 and so may be taken against either the franchise tax or the income tax at the taxpayer's election but may not exceed 50% of the tax against which it is claimed, reduced by the sum of all other credits allowed (other than tax payment credits).[60] The credit is effective for tax years beginning on or after January 1, 2007 and expires for taxable years beginning on or after January 1, 2009.[61]

Expansion of Renewable Fuel Production Credit

In 2004 the General Assembly enacted a credit for constructing and placing in service a commercial facility for processing renewable fuel. The credit is equal to 25% of the cost of constructing and equipping the facility. The credit was to sunset effective for facilities placed in

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[57] *See* N.C. Gen. Stat. §§ 105-129.3B, 105-129.2, 105-129.6(a1), 105-129.7(b)(1), 105-129.8, 105-129.9; S.L. 2006-66, § 24.16(a).
[58] *See* S.L. 2006-66, § 24.16.(g).
[59] *See* N.C. Gen. Stat. §105-129.16E; S.L. 2006-66, § 24.4.(a).
[60] *See* N.C. Gen. Stat. §105-129.17.
[61] *See* S.L. 2006-66, § 24.4.(b) and N.C. Gen. Stat. §105-129.16E(d).

service on or after January 1, 2008. The 2006 Budget Act extends the sunset to January 1, 2011. In addition, the 2006 Budget Act provides that a taxpayer that constructs and places in service three or more renewable fuel processing facilities and invests at least $400 million in the facilities is entitled to an enhanced credit of 35% of the cost of constructing and equipping the facilities. To claim the credit, the taxpayer must obtain a written determination from the Secretary of Commerce that the taxpayer is expected to invest at least $400 million over a five-year period in three or more facilities. The credit is taken in seven equal annual installments beginning with the taxable year in which the first facility is placed in service. If the taxpayer disposes of a facility or takes it out of service and ceases to satisfy the investment requirements before all the credit installments are taken, the credit expires and any remaining installments (but not unused credit carryforwards) are forfeited. While the 25% production credit is available against the franchise or the income tax, at the taxpayer's election, the 35% production credit is available only against the income tax. A taxpayer may not claim the 25% and the 35% credit with respect to the same facility.[62] Both the 25% credit and the 35% credit are subject to a cap equal to 50% of the tax against which they are claimed. While any unused 25% credit may be carried forward for five years, any unused 35% credit may be carried forward for ten years.[63] These changes are effective for taxable years beginning on or after January 1, 2006.[64]

New Biodiesel Fuel Credit

The 2006 Budget Act creates a new credit for taxpayers that produce at least 100,000 gallons of biodiesel fuel during the taxable year. Biodiesel fuel is liquid derived entirely from agricultural products, animal fats, or wastes from agricultural products or animal fats. The credit is equal to the per-gallon motor fuels tax the taxpayer paid on the biodiesel fuel. The credit may not exceed $500,000. The credit does not apply to tax paid on diesel fuel included in a biodiesel blend. The credit is effective for taxable years beginning on or after January 1, 2008 and sunsets for taxable years beginning on or after January 1, 2010.[65]

New Oyster Shell Donation Credit

The 2006 Budget Act creates a new income tax credit designed to encourage restaurants to recycle oyster shells. The recycled shells will be used by the Department of Environmental and Natural Resources to create oyster reefs to encourage a natural increase in the oyster population. The credit is available to individuals and corporations (but not for estates or trusts) that donate oyster shells to the DENR's Division of Marine Fisheries. The amount of the credit is equal to $1 for each bushel of donated oyster shells. The credit is limited to the amount of tax due for the taxable year reduced by the sum of all credits allowable other than tax payment credits. Any unused credit may be carried forward for five years. Other special rules provide that a taxpayer claiming the credit may not also claim a deduction with respect to the same donation, that individuals claiming the credit may not take such donations into account for purposes of the credit for charitable contributions by non-itemizers, and that individuals claiming the credit must add the market price of the donated oyster shells to federal taxable income in

[62] *See* N.C. Gen. Stat. § 105-129.16D(b1); S.L. 2006-66, § 24.7.(a).
[63] *See* N.C. Gen. Stat. §105-129.16D(b1); S.L. 2006-__ (S1523), § 19.5.(a).
[64] *See* S.L. 2006-66, § 24.7.(b).
[65] *See* N.C. Gen. Stat. §105-129.16F; S.L. 2006-66, § 24.8.(a) and (b).

calculating North Carolina taxable income. To claim the credit, the taxpayer must obtain a certification by the Department of Environment and Natural Resources stating the number of bushels of shells donated by the taxpayer and attach a copy of the certification to its income tax return for the taxable year in which the credit is claimed.[66] The new credit is effective for taxable years beginning on or after January 1, 2006 and sunsets for taxable years beginning on or after January 1, 2011.[67]

Expansion of Historic Rehabilitation Credits

Article 3D of Chapter 105 provides a 20% credit for the rehabilitation of income producing historic properties and a 30% credit for the rehabilitation of non-income producing historic properties. The credits may be taken in five equal annual installments beginning in the year after the property is placed in service. New legislation increases the credit to 40% for the rehabilitation of a former juvenile offender training school, regardless of whether the property is income- or nonincome-producing.[68] This change is effective for taxable years beginning on or after January 1, 2006.[69]

New legislation also creates new Article 3H, which provides an alternative, more generous, credit for the rehabilitation of qualified historic mill properties, particularly those located in distressed counties. A taxpayer claiming the new credit under Article 3H may not claim a credit under Article 3D with respect to the same property. The term "mill" is somewhat misleading, since eligible properties include certified historic structures or state-certified historic structures that were used for manufacturing, for purposes ancillary to manufacturing, for warehousing, for selling agricultural properties or as public or private utilities, provided in each case that the property has been at least 80% vacant for two years. A taxpayer spending more than $3 million to restore an eligible property as income-producing property is entitled to a credit equal to 30% of its qualified rehabilitation expenditures. If the property is located in a development tier one or two area, the credit is increased to 40%. In addition, a taxpayer spending more than $3 million to restore an eligible property located in a development tier one or two area as nonincome-producing property is entitled to a credit equal to 40% of its qualified rehabilitation expenditures. No credit is allowed for the rehabilitation of an eligible property located in a development tier three area as nonincome-producing property.

If the property is income-producing property, the entire credit is taken in the year the property is placed in service. If the property is nonincome-producing, the credit is to be taken in five equal annual installments beginning with the taxable year in which the property is placed in service.

The credit is allowed against the income, franchise or gross premiums taxes at the taxpayer's election and the amount of the credit taken may not exceed the tax against which it is

[66] *See* N.C. Gen. Stat. §§ 105-130.48, 105-151.30, 105-130.9(4), 105-151.26, 105-134.6(c)(5a), 105-160.3(b)(8); S.L. 2006-66, § 24.18.(a)-(f).
[67] *See* S.L. 2006-66, § 24.18.(g).
[68] *See* N.C. Gen. Stat. §105-129.35(a), 105-129.36(a); S.L. 2006-40, §§ 2 and 3.
[69] *See* S.L. 2006-40, § 5.

claimed, reduced by all other credits allowed, other than tax payment credits. Any unused portion of the credit may be carried forward for nine years. These provisions are effective for taxable years beginning on or after January 1, 2006 and apply to eligible sites placed into service on or after July 1, 2006.[70] Qualified rehabilitation expenditures incurred on or after July 1, 2011 are not eligible for these credits.[71]

Expansion of Production Company Expenditure Credit

In 2005, the General Assembly enacted an income tax credit for 15% of the qualifying production expenses of film and TV production companies that spend at least $250,000 on a production in North Carolina. Taxpayers claiming the credit were required to add back to federal taxable income the amount of any expenses with respect to which the credit was claimed in order to avoid a double tax benefit. New legislation eliminates the expense add-back, effective for taxable years beginning on or after January 1, 2007, thus permitting the same expenses to generate both a deduction and a credit.[72]

Sales and Use Tax Changes

Rate Reductions

In 2001 the General Assembly increased the general state sales tax rate from 4% to 4½%.[73] This rate increase was originally scheduled to sunset on July 1, 2003.[74] This sunset was extended first to July 1, 2005[75], then to December 31, 2005[76] and finally to July 1, 2007.[77] The 2006 Budget Act provides for an interim rate reduction to 4¼ % effective December 1, 2006 before returning to the 4% rate in July of 2007.[78]

The 2006 Budget Act also reduces the sales tax rate on electricity separately measured and sold to manufacturing industries and manufacturing plants for use in their operations from 2.83% to 2.6% effective July 1, 2007 and applicable to sales of electricity made on or after that date.[79]

Video Programming Services

Under prior law, cable TV providers negotiated franchise agreements with cities and counties and were subject to local franchise taxes. They were also subject to a 7% state sales tax on the cost of cable service, with an offset for any local franchise tax paid. New legislation replaces the local franchise regime with a state-level franchise system and repeals the authority

[70] *See* S.L. 2006-40, §5.
[71] *See* N.C. Gen. Stat. §105-129.75.
[72] *See* S.L. 2006-__ (H1522), § 1-5.
[73] *See* S.L. 2001-424, § 34.13.(a).
[74] *See* S.L. 2001-424, § 34.13.(c).
[75] *See* S.L. 2003-284, § 38.1.
[76] *See* S.L. 2005-144, § 9.1.
[77] *See* S.L. 2005-276, § 33.1.
[78] *See* S.L. 2006-66, §§ 24.1.(a), (b), (c) and (j).
[79] *See* N.C. Gen. Stat. § 105-164.4(a)(1i); S.L. 2006-66, § 24.19.

of local governments to impose franchise taxes on cable companies. Cable companies and others providing "video programming services" remain subject to the state-level 7% sales tax. Transition rules are provided for taxpayers with existing franchise agreements with local governments.[80] These changes are effective January 1, 2007.[81]

Bundled Transactions

If a telecommunications provider bundles taxable and nontaxable telecommunication services, the taxpayer's gross receipts are to be allocated between taxable and nontaxable services based on the unbundled price of the taxable services or, if all the bundled services are not offered on an unbundled basis, based on some other "reasonable" allocation method. New legislation expands these allocation requirements to all transaction involving taxable bundled services, not just telecommunications services.[82] This change is effective January 1, 2007.[83]

Expansion of Refunds for Motor Sports Racing Teams

In 2005, the General Assembly enacted legislation to permit motor sports racing teams to claim a refund of sales taxes paid on aviation fuel used to travel to or from motor sports events.[84] The 2006 Budget Act clarifies that this refund provision only applies to "professional" motor sports racing teams (defined as a for-profit team a majority of the revenues of which is derived from sponsorship and prize money and which competes in at least 66% of the races sponsored in a single season by a motor sports sanctioning body) and extends the sunset on the credit from January 1, 2007 to January 1, 2009.[85]

The 2006 Budget Act further provides that a professional sports racing team is entitled to a refund of one-half of the sales and use tax paid by it in North Carolina on tangible personal property (other than tires or accessories) that comprises any part of a professional motor racing vehicle. Accessories for this purpose include instrumentation, telemetry, consumables and paint. A written request for refund must be made within six months after the end of the state's fiscal year.[86] This new refund provision becomes effective July 1, 2007 and applies to purchases made on or after that date.[87]

Extension of Sunset on Passenger Air Carrier Refunds

In 2005, the General Assembly enacted legislation to permit interstate passenger air carriers to obtain refunds of the net amount of sales and use taxes in excess of $2,500,000 they paid to North Carolina on fuel during a calendar year. This provision was scheduled to sunset effective for purchases made on or after January 1, 2007.[88] This sunset has been extended until

[80] *See* N.C. Gen. Stat. §105-164.3(50c) and 105-164.4(a)(6); S.L. 2006-151, § 2, 3, 9 – 12.
[81] *See* S.L. 2006-151, § 22.
[82] *See* N.C. Gen. Stat. § 105-164.4D; S.L. 2006-151, §§ 4 and 5.
[83] *See* S.L. 2006-151, § 22.
[84] *See* N.C. Gen. Stat. § 105-164.14(l).
[85] *See* N.C. Gen. Stat. §§ 105-164.3 and 105-164.14(l); S.L. 2006-66, §§ 24.6.(a) and 24.10.(a).
[86] *See* N.C. Gen. Stat. §105-164.14(m); S.L. 2006-66, § 24.10.(b).
[87] *See* N.C. Gen. Stat. § 105-164.14; S.L. 2006-66, § 2006-66, § 24.10.(c).
[88] *See* S.L. 2005-435, § 61 and 62.

January 1, 2009.[89]

New Refund for Utilities

The 2006 Budget Act includes a provision that permits utility companies to obtain refunds of part of the sales and use tax paid on the purchase in North Carolina of railway cars and locomotives (and their accessories). The amount of the refund is calculated by applying the North Carolina sales tax rate to the purchase price of all the taxpayer's purchases of railway cars, locomotives, and accessories for a given refund period, whether purchased inside or outside of North Carolina, and then multiplying that number by the ratio of the number of miles the taxpayer's railway cars and locomotives were operated in North Carolina to the total number of miles the taxpayer's cars and locomotives were operated. If the resulting product is more than the sales tax the taxpayer paid on its North Carolina purchases, the excess is refundable to the taxpayer. This formula appears to be designed to ensure that the taxpayer does not suffer if it buys proportionately more of its locomotives, cars and accessories in North Carolina. The Secretary is authorized to prescribe the periods with respect to which refunds may be claimed and the periods within which an application for refund may be made.[90] This provision became effective for purchases made on or after July 1, 2006.[91]

Sourcing Rules for Utility Rents

For sales tax purposes, sales are generally sourced to where the property was delivered to the purchaser. With respect to leased property, however, a rental payment may be sourced to the primary location where the property was used during the period covered by the payment, so that multiple payments may have multiple sources.[92] The 2006 Budget Act includes a special rule providing that all lease payments made by a utility company with respect to railway cars are sourced under the general sourcing rules based on the place of delivery.[93] This section is effective for lease or rental payments made on or after July 1, 2006.[94]

New Refund for Financial Services Facilities

A taxpayer that owns a facility primarily engaged in providing financial services, securities operations and related systems development is entitled to a refund of sales and use taxes paid on materials that become a part of the facility's real property, provided the taxpayer has committed to invest at least $50 million to construct the facility (if the facility is in a development tier one area) or $100 million (if the facility is in a development tier two or three area) and provided the financial, security or development services performed at the facility are performed for the taxpayer or a related party and no part of the facility is leased to an unrelated party.[95] This change is effective for sales made on or after July 1, 2006 and sunsets for sales

[89] *See* S.L. 2006-66, § 24.6.(b).
[90] *See* N.C. Gen. Stat. § 105-164.14(a2); S.L. 2006-66, § 24.13.(b).
[91] *See* S.L. 2006-66, § 24.13.(c).
[92] *See* N.C. Gen. Stat. § 105-164.4B.
[93] *See* N.C. Gen. Stat. 105-164.4B(b)(4); S.L. 2006-66, § 24.13.(a).
[94] *See* S.L. 2006-66, § 24.13.(c).
[95] *See* N.C. Gen. Stat. §105-164.14(j); S.L. 2006-168, § 3.1.

made on or after January 1, 2013.[96]

New Internet Data Center Exemptions

The 2006 Budget Act creates a sales tax exemption for sales of electricity and eligible business property to an internet service provider or web search portal business that undertakes to invest at least $250 million in private funds within five years in a facility on one or more contiguous parcels located in a an enterprise tier one, two, or three area (or in a development tier one or two area). Eligible business property entitled to the exemption includes electrical equipment, engineering or computer science research equipment and equipment used to provide internet service or web search portal services, provided in each case that such equipment is capitalized for income tax purposes. Forfeiture rules are provided if the required investment is not timely made, if specific eligible business property is not located and used at the facility or if any portion of the electricity subject to the credit is not in fact used at the facility. If the credit is forfeited, the taxpayer is liable for all past taxes avoided as a result of the forfeited exemption computed from the date the taxes would have been due if the exemption had not been allowed, plus interest. If the forfeiture is triggered because of a failure to make the required investment, interest is computed from the date the taxes would have been due if the exemption had not been allowed. For all other forfeitures, interest is computed from the time as of which the eligible business property or electricity was put to a disqualifying use. The past taxes and interest are due 30 days after the date the exemption was forfeited.[97] The exemption is effective for sales made on or after October 1, 2006.[98]

No Refunds for Alcoholic Beverage Purchases

Certain taxpayers are entitled to refunds of sales and use taxes paid on the purchase of certain items of specified property. The 2006 Budget Act provides that refunds are not authorized for purchases of alcoholic beverages.[99] This change is effective for purchases made on or after July 1, 2006.[100] Most of the authorized refunds are limited to specific types of property and would not apply to alcoholic beverages in any event. However, non-profit hospitals, educational institutions, certain qualified retirement facilities, and churches, orphanages and other charitable or religious institutions not operated for profit and certain governmental entities were entitled to refunds on purchases of any tangible personal property.[101] Thus, this change is likely to apply only to these charities and government entities.

New Exemption for Logging Machinery

Before 2006, mill machinery was subject to the sales tax but was entitled to the benefits of a special rate of 1% and a maximum tax of $80 per article. In order to comply with the Streamlined Sales and Use Tax Agreement, North Carolina was required to, and did, eliminate

[96] *See* S.L. 2006-168, § 3.2.
[97] *See* N.C. Gen. Stat. § 105-164.13(55) and 105-164.3(8e); S.L. 2006-66, § 24.17(a); S.L. 2006-__ (H2170), § 2.25.(a1).
[98] *See* S.L. 2006-66, § 24.17.(c) and S.L. 2006-168, § 4.3.
[99] *See* N.C. Gen. Stat. § 105-164.14(d1); S.L. 2006-66, § 24A.1.(a).
[100] *See* S.L. 2006-66, § 24A.1.(b).
[101] *See* N.C. Gen. Stat. § 105-164.14(b) and (c).

the special rate and cap on sales of mill machinery. However, in order not to change the economics of mill machinery purchases, the General Assembly exempted mill machinery from the sales tax altogether and created a new privilege tax on mill machinery with a 1% rate and $80 per article cap.[102] The Department of Revenue had historically treated logging firms that had contracts with wood product manufacturers to cut timber as manufacturers entitled to the 1% rate and $80 cap under the sales tax. Under this interpretation, sales of logging machinery to such logging firms would be subject to the mill machinery tax rather than the sales tax. New Legislation specifically exempts logging machinery (together with attachments and repair parts, lubricants and fuel) from both the sales tax and the mill machinery tax.[103] This change is effective July 1, 2006 and applies to items purchased on or after that date.[104]

Telecommunications Services

New Legislation makes a number of changes to the sales tax definitions relating to telecommunications services to conform to the definitions related to such services contained in the Streamlined Sales Tax Agreement. The major changes relate to the definitions of "ancillary service," "prepaid telephone calling service," "prepaid wireless calling service," "prepaid wireline calling service," and "telecommunications service."[105] These changes become effective January 1, 2007.[106]

Sales Tax Payment Schedules

Under prior law, taxpayers that were liable for at least $10,000 a month in sales tax, electric utility tax, or piped gas excise tax were required to pay tax twice a month within ten days after the end of each semimonthly period. This semimonthly payment schedule has been replaced with a single monthly payment due on the 20th for the prior month's liability. The taxpayer is also required to make a partial prepayment on the 20th of the following month's estimated liability. The new law also eliminates provisions providing for relief from penalties for small underpayments, because taxpayers now have more time to calculate payments.[107] These changes become effective October 1, 2007.[108]

Modular Home Sales

New legislation provides that a person who sells a modular home at retail is allowed a credit against the sales or use tax due with respect to such sale for sales or use taxes paid to another state on tangible personal property incorporated in the modular home. The bill makes it clear that a retail sale of a modular home occurs when a modular home manufacturer sells a modular home to a modular homebuilder or directly to the end user of the modular home.[109]

[102] *See* N.C. Gen. Stat. §§105-164.13(5a) and 105-187.51.
[103] *See* N.C. Gen. Stat. §§105-164.13(4f) and 105-187.53; S.L. 2006-19, §§ 1 and 2.
[104] *See* S.L. 2006-19, § 4.
[105] *See* N.C. Gen. Stat. § 105-164.3; S.L. 2006-33, § 1
[106] *See* S.L. 2006-33, § 14.
[107] *See* N.C. Gen. Stat. §§ 105-164.16, 105-113(b) and 105-187.43; S.L. 2006-33, §§ 9, 10 and 13.
[108] *See* S.L. 2006-33, §14.
[109] *See* N.C. Gen. Stat. §105-164.4(a)(8); S.L. 2006-33, § 11.

This change is effective July 1, 2006.[110]

This change was necessary because legislation enacted in 2003 and a related Department of Revenue Directive[111] had eliminated the distinction between the sale of modular homes and the installation of modular homes pursuant to performance contracts. Under prior law, a taxpayer who installed a modular home pursuant to a performance contract was treated as the consumer of the articles incorporated into the home and was therefore subject to a use tax on the value of such articles purchased in another state, with a credit for the other state's sales tax paid on the purchase of such articles. By treating such installations as sales, the 2003 legislation subjected modular home manufacturers to the sales tax rather than the use tax with respect to installations and, accordingly, denied them the ability to credit sales taxes paid to another state on the articles incorporated into the home. The new law restores this credit.

Property Tax Changes

Electronic Listing of Non-Business Personal Property

Under prior law, counties were permitted to allow taxpayers to list their business personal property electronically and to extend the listing period for electronically listed property to June 1. New legislation provides that counties may now also authorize the electronic listing of non-business personal property. However, non-business personal property listed electronically would still have to be listed by January 31.[112] This provision became effective June 29, 2006.[113]

Late Applications for Present Use Valuation

County boards of equalization and review are permitted to consider late applications of property tax exemptions or exclusions but formerly were not authorized to consider late applications for present use valuation. Present use valuation applications generally must be filed during the regular listing period of the year for which the present use value classification is first claimed. New legislation permits county boards of equalization and review to review and accept a late application for present use valuation if the applicant demonstrates good cause for the delay. A decision of the county board denying late application may be appealed to the Property Tax Commission.[114] This provision became effective June 29, 2006.[115]

Collection Activity Pending Appeal

Under prior law, county commissioners were prohibited from delivering to the county tax collector any receipt for an assessment that had been appealed to the Property Tax Commission until the appeal was finally adjudicated. New legislation repeals this prohibition, permitting receipts for assessments under appeal to be delivered to the tax collector, but prohibits the tax

[110] *See* S.L. 2006-33, § 14.
[111] *See* S.L. 2004-400 and Directive SD-03-01.
[112] *See* N.C. Gen. Stat. §§ 105-304(a1) and 105-307; S.L. 2006-30, §§ 1 and 2.
[113] *See* S.L. 2006-30, § 8.
[114] *See* N.C. Gen. Stat. § 105-277.4; S.L. 2006-30, § 4.
[115] *See* S.L. 2006-30, § 8.

collector from collecting the tax or enforcing a tax lien resulting from the assessment until the appeal has been finally adjudicated. The tax collector may, however, send an initial tax bill or notice to the taxpayer pending appeal so that the taxpayer may, if he chooses, pay the amount due and stop the running of interest on the amount in dispute.[116] These provisions became effective June 29, 2006.[117]

Collection Against Purchasers of Real Property

Under prior law, tax collectors were permitted to enforce collection remedies for delinquent real property taxes against the person who owned the property on the lien date (January 1). This created the potential for anomalous results where the property was sold after the lien date. For instance, where property is sold after the lien date, property taxes are typically prorated, with the purchaser assuming responsibility for paying the taxes for the full year and crediting against the purchase price the taxes attributable to the months before the closing. If the purchaser does not pay the taxes by January 6th of the following year, the taxes become delinquent and the tax collector may enforce collection remedies. Under prior law, the tax collector would send a notice of delinquent taxes to the seller, because the seller was the owner of the property on the lien date. If the seller disregarded the notice, the tax collector was entitled to, among other remedies, garnish the seller's wages. New legislation provides that the "taxpayer" against whom collection remedies for delinquent real property taxes can be enforced, means the record owner of the real property on the date the taxes become delinquent and any subsequent record owner of the real property who takes title after the delinquent date.[118] These provisions became effective for taxes imposed for taxable years beginning on or after July 1, 2006.[119]

Modular Home Display Models

Session Law 2006-106 clarifies that a modular home used exclusively by a retail merchant as a display model on the retail merchant's place of business and held for eventual sale is nontaxable inventory.[120] This provision became effective for taxable years beginning on or after July 1, 2006.[121]

Motor Fuels Tax Changes

The excise tax on suppliers or importers of motor fuels is imposed at a flat rate of 17½ ¢ per gallon plus a variable wholesale component equal to the greater of 3½ ¢ per gallon or 7% of the average wholesale price of motor fuel for the applicable base period.[122] The 2006 Budget Act provides that for the twelve-month period from July 1, 2006 to June 30, 2007, the variable

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[116] *See* N.C. Gen. Stat. §§ 105-321(d) (repealed) and 105-378; S.L. 2006-30, §§ 5 and 6.
[117] *See* S.L. 2006-30, § 8.
[118] *See* N.C. Gen. Stat. §§ 105-273(17), 105-369, 105-374(c), 105-375(b), 105-375(c) and 105-375(i); S.L. 2006-106, §§ 1-6.
[119] *See* S.L. 2006-106, § 10.
[120] *See* N.C. Gen. Stat. § 105-273(8a); S.L. 2006-106, § 8.
[121] *See* S.L. 2006-106, § 10.
[122] *See* N.C. Gen. Stat. § 105-449.80(a).

wholesale component may not exceed 12.4¢ per gallon.[123] This change is effective July 1, 2006.[124]

In addition, new legislation (1) eliminates the requirement of prior law that a distributor or blender of motor fuel transporting fuel for its own use obtain a separate transporter license, applicable to fuel transported on or after July 1, 2007[125]; (2) requires motor fuel transporters transporting fuel within the state (and not just in interstate movements) to file monthly returns, applicable to fuel transported on or after July 1, 2007[126]; (3) requires distributors holding an exempt card or code to pay tax when fuel is removed from the terminal and seek a refund, effective for fuel purchased on or after January 1, 2007[127]; and (4) establishes a common due date (the 25th of the month) for all motor fuel returns, effective for motor fuel purchased on or after January 1, 2007.[128]

Excise Tax on R&D Purchases

The 2006 Budget Act imposes a 1% excise tax on the price of certain equipment purchased by physical engineering or life sciences research and development companies. The tax applies to equipment (including attachments and repair parts) that is capitalized by the company for federal income tax purposes, is used in research and development of tangible personal property and which would be considered mill machinery if it were purchased by a manufacturing industry or plant and used in the research and development of tangible personal property manufactured by the industry or plant. Like the 1% excise tax on mill machinery the tax is capped at $80 per article.[129] This provision becomes effective January 1, 2007.[130]

Privilege Tax Changes

A new exemption from the 3% privilege tax on gross receipts derived from entertainment events is provided for farm-related exhibitions or amusements conducted on farmland.[131] This new exemption is effective retroactively to 1999.[132]

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[123] *See* S.L. 2006-66, § 24.3.(a).
[124] *See* S.L. 2006-66, § 28.7.
[125] S*ee* N.C. Gen. Stat. § 105-449.65(b); S.L. 2006-162, §§ 13.(a) and 33.
[126] S*ee* N.C. Gen. Stat. § 105-449.101; S.L. 2006-162, §§ 13.(b) and 33.
[127] S*ee* N.C. Gen. Stat. §§ 105-449.88A, 105-449.90, 105-449.93, 105-94, 105-449.97(d) and 105-449.105A(a); S.L. 2006-162, §§ 14 and 33.
[128] S*ee* N.C. Gen. Stat. §§ 105-449.100, 105-449.101, 105-449.102(a), 105-449.137(b), and 119-18(a); S.L. 2006-162, §§ 13.(b), 15 and 33.
[129] *See* N.C. Gen. Stat. 105-187.51B; S.L. 2006-66, § 24.9.(a).
[130] *See* S.L. 2006-66, § 24.9.(b).
[131] *See* N.C. Gen. Stat. §105-40(12); S.L. 2006-__ (H143), § 1.
[132] *See* S.L. 2006-__ (H143), § 2.

Tax and Estate Planning

Like it or not, the IRS is your business partner. If you are a wealthy individual, the IRS is also one of your heirs. The share of your profits or your estate going to the IRS and its state and local counterparts depends in large part on the effectiveness of your tax planning and, in some cases, the effectiveness of your representation in tax controversies. Smith Anderson's Tax and Estate Planning group provides experienced, effective counsel in planning to reduce the burden of taxation and in defending taxpayers against claims of federal, state and local tax authorities. We use our experience in the complex world of taxation to save our clients money for their businesses, their philanthropies and their families.

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Advice on tax, corporate and trust law issues to charitable and other tax-exempt organizations

Business Tax Planning: Our work involves planning for the tax consequences of business transactions, including the formation of business entities of all types; taxable and tax-free corporate acquisitions and divestitures; public securities offerings; joint ventures, entity conversions; and transactions involving partnerships, limited liability companies and S corporations.

Tax Controversies: We regularly represent taxpayers in adversarial proceedings before the Internal Revenue Service. We have considerable experience in working with local revenue agents and appeals officers as well as Regional Service Centers and the IRS National Office. Our National Office practice includes obtaining private letter rulings and various forms of technical advice for our clients in controversy and planning matters. On the state level, we have handled income, franchise, sales and use and property tax disputes for local and multi-state clients before the North Carolina Department of Revenue and various state and local tax authorities.

Estate Planning and Administration: We regularly assist individuals and families in reducing income, estate, gift and generation-skipping taxes, as well as counseling on specific wealth transfer issues such as transfers of family businesses, charitable gifts, the use of insurance products and tax planning for retirement distributions. We have significant experience in planning and administering large, complex estates and regularly advise executors, trustees and beneficiaries on tax and fiduciary law matters.

Tax and Estate Planning

Tax-exempt Organizations: We often advise tax-exempt organizations concerning tax, nonprofit corporation law and trust law issues. We represent numerous charitable and other exempt organizations including large grant-making foundations and a number of large tax-exempt retirement communities. We have significant expertise in representing exempt organizations in challenges to their exempt status before the IRS.

Additional Services: Since our inception in 1912, Smith Anderson has grown to become the largest Triangle-based, full-service law firm and one of the largest in North Carolina. Representing diverse organizations with local, state, national and international interests, our lawyers focus on building and strengthening relationships by understanding our clients' businesses and customizing our legal solutions accordingly. Our commitment to our clients also extends to our community and profession. We invite you to learn more about us at www.smithlaw.com.

Many of our tax clients have the need for legal counsel in corporate, commercial, real estate, employment law and other legal matters. As a full-service law firm, we can provide a full range of legal experience to our tax clients as needed. For example, we often work with lawyers in our employee benefits practice on profit sharing, pension and 401(k) plans and executive compensation arrangements.

Our Clients: Our tax clients include Fortune 500 companies, closely held businesses, entrepreneurs and other individuals, real estate developers, and specialized taxpayers such as venture capital funds, private foundations, public charities, REIT investors and international joint ventures.

Our Lawyers: Our lawyers have significant prior experience in major national and international law firms and national accounting firms. All our lawyers are active in the organized tax bar, and the team includes two former chairs of the Tax Section of the North Carolina Bar Association, and the co-author of Guidebook to North Carolina Taxes (CCH).

Tax and Estate Planning Group:

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