State of North Carolina

INDIVIDUAL INCOME TAX
GIFT TAX
ESTATE TAX

RULES AND BULLETINS
TAXABLE YEARS
2009 and 2010

Issued by:

Personal Taxes Division
Tax Administration
North Carolina Department of Revenue
501 North Wilmington Street
Raleigh, North Carolina 27604

PREFACE

This publication was prepared for the purpose of presenting the administrative interpretation and application of North Carolina income tax laws relating to individuals, partnerships, estates, trusts, and gifts in effect at the time of publication for income years beginning on and after January 1, 2009. This publication does not cover all provisions of the law.

Taxpayers are cautioned that this publication is intended merely as a guide and that consideration must be given to all the facts and circumstances in applying these bulletins to particular situations. Taxpayers using this publication should be aware that additional changes may result from legislative action, court decisions, and rules adopted or amended under the Administrative Procedure Act, Chapter 150B of the General Statutes. In no case should these bulletins be relied upon for years other than the taxable years 2009 and 2010.

Revised December 2009

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TAXPAYERS' BILL OF RIGHTS

The North Carolina Taxpayers' Bill of Rights explains your rights as a taxpayer.

This **Bill of Rights** explains your rights as a taxpayer. It gives information about:

- Protection of Privacy
- Examinations
- Representation
- Penalties and Interest
- Request for Review
- Final Determination after Departmental Review
- Hearings
- Collections
- Refund of Overpaid Tax
- Taxpayer Assistance

As a taxpayer, you are always entitled to fair, professional, prompt, and courteous service. Our goal is to apply the tax laws consistently and fairly so that your rights are protected and that you pay only your fair share of North Carolina tax.

Protection of Privacy: It is your right to have information about your tax history, financial situation, and assessments or reviews kept in strict confidence. Any return information, correspondence, or departmental discussions concerning your tax situation are confidential. Employees or former employees who violate this confidentiality are subject to criminal prosecution and possible fines. An employee who willfully discloses tax information is also subject to dismissal.

Examinations: The Department of Revenue routinely examines returns to ensure that taxpayers comply with tax statutes. If we examine your return, we may ask you to provide information to verify items on your return.

Examinations are done by mail or through personal interviews with auditors. You have the right to ask that the examination be held at a time and place convenient for you and the auditor.

You are entitled to a fair examination and an explanation of any changes we propose to your return. Examinations do not necessarily mean additional taxes. Your case could be closed without any changes or you could receive a refund.

Representation: During any examination or conference, you may have an attorney, accountant, or designated agent present. You can authorize another person to represent you if you execute a written power of attorney. Form Gen. 58, Power of Attorney and Declaration of Representative, is on the Department's website at **http://www.dornc.com/downloads/fillin/Gen58_webfill.pdf**.

If you wish, the Department will suspend the proceedings at any time to permit you to consult with your authorized representative.

You may make an audio recording of the proceedings at your own expense with your own equipment. The Department may also audio record the proceedings. If we do so, you can get a copy of the transcript for a nominal charge.

Penalties and Interest: By law, the Department of Revenue is required to assess penalties for the following:

- Late Filing of Returns
- Late Payment of Tax
- Negligence
- Fraud
- Bad Checks or Bad EFT Payments

You have the right to request that penalties be waived. The Department waives penalties in accordance with its Penalty Waiver Policy, which is on the Department's website at **www.dornc.com/practitioner/waiverpolicy.pdf.** Interest accrues on unpaid taxes from the date the tax was due until the date it is paid. The law does not permit the Department to waive interest that accrues on unpaid taxes. To request penalty waiver, you should pay the tax and interest due and submit **Form NC-5500, Request to Waive Penalties,** located on the Department's website at **www.dornc.com/downloads/penalty.html** or by calling 1-877-252-3052. Your request for penalty waiver should be mailed to North Carolina Department of Revenue, Correspondence Unit, P.O. Box 1168, Raleigh, NC 27602-1168.

Request for Review: **I**f you object to a proposed denial of a refund or a proposed assessment, you may request a Departmental review of the action if the request is made in writing and received by the Department within 45 days after the date the notice was mailed to you. If a request for a Departmental review is not filed in a timely manner, the proposed action is final and is not subject to further administrative or judicial review. An assessment for an amount shown due on the return but not paid or the application of a refund against debts owed to State or local agencies or to the Internal Revenue Service is not subject to review. To request a review, submit **Form NC-242, Objection and Request for Departmental Review**. The form is available at **www.dornc.com/downloads/nc242.pdf** or by calling 1-877-252-3052. Your request for a review should be mailed to North Carolina Department of Revenue, Correspondence Unit, P.O. Box 471, Raleigh, NC 27602-0471.

Upon receipt of a timely request for review, the Department will take one of the following actions: (1) make the refund or cancel the assessment; (2) schedule a conference; or (3) request additional information. A conference is an informal proceeding at which you and the Department attempt to resolve the case. If a conference is necessary, the Department will set the time and date and notify you at least 30 days prior to the date set for the conference. The date set for the conference may be changed by mutual agreement.

Final Determination after Departmental Review: If the issues cannot be resolved, the Department will issue a notice of final determination within nine months of the date that you filed the request for review. The final determination will state the basis of the determination. The final determination issued for a proposed assessment will also show the amount of tax, penalties, and interest you owe and the collection options available to the Department if the amount shown due is not paid and you do not contest the final determination. Final determinations issued for a denied refund or proposed assessment will explain the procedure you must follow to contest the final determination.

Hearings: If you disagree with the notice of final determination regarding a proposed assessment or denied refund, you may file a petition for a contested tax case hearing at the Office of Administrative Hearings. The petition for a contested tax case hearing may be filed only after the Department has issued the notice of final determination. You must file the petition with the Office of Administrative Hearings within 60 days of the date the final determination is mailed to you by the Department. You do not have to pay the tax, penalty, and interest due before proceeding to a hearing at the Office of Administrative Hearings. If you disagree with the final decision in the contested tax case before the Office of Administrative Hearings, you may file a petition in the Superior Court of Wake County for further judicial review of your case. However in the case of a proposed assessment, you must pay the tax, penalty, and interest due before the petition will be considered. **(The appeal information given here is a general description of your appeal rights and does not cover all situations. You should visit the Office of Administrative Hearings website at www.ncoah.com for further information.)**

Collections: You are responsible for the full amount of tax you owe, but we will not take action to collect from you until you have had an opportunity to pay voluntarily. **It is important that you respond promptly if we contact you for payment.** If you do not pay the amount of tax, penalty, and interest you owe within 90 days after a notice of collection was mailed to you, the law requires the Department to add a 20% collection assistance fee to your debt. The fee does not apply if you enter into an installment payment agreement with the Department before the fee is imposed.

If you do not pay in full, the Department of Revenue may garnish your wages, bank account, or other funds, seize and sell personal property, issue a tax warrant to your sheriff, or record a certificate of tax liability against you. If you willfully fail to pay the tax, you may be subject to criminal charges. If we believe that you owe tax and collecting that tax is in jeopardy, the Department can immediately assess and collect the tax. You are entitled to a Departmental review of the actions taken on the jeopardy assessment. If you disagree with the review findings, you have the right to bring civil action in Superior Court.

Refund of Overpaid Tax: If you believe you have overpaid your taxes, you have the right to file a claim for refund. Generally, you can apply for a refund of tax paid at any time within three years after the due date of the return or within two years of paying the tax, whichever is later. When you file a claim for refund, the Department will take one of the following actions within six months after the date the claim is filed: (1) send the requested refund to you; (2) adjust the amount of the refund; (3) deny the refund; or (4) request additional information. If the Department does not take one of the actions within six months, the inaction is considered a proposed denial of the requested refund. If we select your claim for examination, you have the same rights you would have during an examination of your return.

Taxpayer Assistance: You can check the status of your individual income tax refund 24 hours a day, 7 days a week at 1-877-252-4052.

If you need tax forms or other assistance with individual income, withholding, sales and use or corporate and franchise taxes, please call 1-877-252-3052. For assistance with motor fuels, please call 1-877-308-9092. For assistance with all other taxes administered by the Department of Revenue, please call 1-877-308-9103. You may also access the Department's website at **www.dornc.com**, or you may write to the Department at

N. C. Department of Revenue
P. O. Box 1168
Raleigh, NC 27602

Recorded information on commonly asked individual income, withholding, sales and use and corporate and franchise tax questions is also available. You can call us 24 hours a day, 7 days a week at 1-877-252-3052.

The hearing impaired with TDD service can contact Relay North Carolina at 1-800-735-2962 for assistance.

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IMPORTANT TOLL FREE TELEPHONE NUMBERS

TAXPAYER ASSISTANCE AND FORMS	**1-877-252-3052**
AUTOMATED REFUND INQUIRY LINE	**1-877-252-4052** (Available 24 hours a day, 7 days a week.)
FREQUENTLY ASKED QUESTIONS	**1-877-252-3052**
INTERNAL REVENUE SERVICE	**1-800-829-1040** (Toll free within North Carolina.)
TAX FRAUD HOTLINE	**1-800-232-4939** (733-6354 in Wake County. Toll free from 8:00 a.m. to 5:00 p.m., Monday through Friday, except holidays.)

DEPARTMENT OF REVENUE WEBSITE

www.dornc.com

I. Subject: Filing Individual Income Tax Returns

1. Forms

The individual income tax return, Form D-400, is available from the Department of Revenue in Raleigh or from any of the Department's Service Centers located throughout the State. The return and other related schedules are also available from the Department's website at **www.dornc.com.**

2. Electronic Tax Filing

The North Carolina Department of Revenue participates in the Federal/State *e-file* program. This program allows residents, nonresidents, and part-year residents to file their federal and State individual income tax returns in a single electronic transmission or file their State return separately. *E-file* is the fastest, safest, and most accurate way to file income tax returns. Taxpayers who *e-file* can have their refunds direct deposited into a checking or savings account. *E-file* is offered by a rapidly growing number of tax practitioners. A list of tax practitioners that offer electronic filing is on the Department's website, **www.dornc.com**. The State return can be a refund, zero tax due, or balance due return.

To participate in the Federal/State *e-file* Program, a tax practitioner must complete IRS Form 8633, Application to Participate in the *E-file* Program, and submit it to the IRS. The practitioner must have been accepted into the program and received an Electronic Filing Identification Number (EFIN) in order to participate in State *e-file*. The Department will have access to the Federal Applicant Database that enables the Department to reference pertinent information regarding the tax practitioner. The tax practitioner must use computer software that has been approved by the IRS and the Department of Revenue for filing. The Department of Revenue maintains a list of approved software developers on its website.

The Department of Revenue also participates in the Federal/State Online Filing Program. A taxpayer with a personal computer and modem can file their federal and State returns in one transmission or the State return separately. A taxpayer must use approved online software to *e-file* the federal and State returns. A list of approved online software products is on the Department's website.

3. Items Requiring Special Attention

The individual taxpayer or his agent should give special attention to the following items when preparing an individual income tax return:

a. The Form D-400 for the proper year should be used. For example, a 2009 form should be used by a taxpayer whose calendar year ends December 31, 2009. A taxpayer filing on a fiscal year basis whose fiscal year begins in 2009 should also use a 2009 form.

b. The first name, middle initial, last name and the current mailing address of the taxpayer (taxpayers; if joint) should be printed in the applicable boxes on the tax return. Do not use the name or

address shown on a wage and tax statement if incorrect. Enter the social security number(s) in the applicable boxes.

c. When filing an income tax return for an unmarried individual who died during the taxable year, enter the date of death in the applicable box.

d. When filing a separate return of a decedent who was married at the time of death, enter the date of death in the applicable box and enter the address of the surviving spouse or personal representative.

e. The taxpayer is required to furnish his social security number with the return. This number is necessary to verify the identity of the taxpayer, since the Department identifies taxpayers and credits refunds and payments by social security number.

   Separate returns of spouses are often interrelated whether they are living together or apart; therefore, the taxpayer is asked to furnish the name and social security number of the spouse if they file on separate forms, but not if they are divorced. This information can save time, correspondence, and difficulty for the taxpayer and the Department.

f. The same filing status claimed on the federal income tax return must also be claimed on the North Carolina income tax return. However, if either the taxpayer or the taxpayer's spouse is a nonresident and had no North Carolina taxable income for the taxable year, the filing status **Married Filing Separately** may be claimed. Once a joint return is filed, separate returns may not be filed for that year after the due date of the return.

g. The tax must be computed accurately and any penalty and interest prescribed by statute should be included on the return.

h. If additional tax is due on the income tax return, it can be paid by check or money order with the return, or it can be paid online by bank draft or credit or debit card using Visa or MasterCard. Note: The Department will not accept a check, money order, or cashier's check unless it is drawn on a U.S. (domestic) bank and the funds are payable in U.S. dollars.

i. If an individual has moved into or out of North Carolina during the tax year or is a nonresident with income from sources within North Carolina, the section on page 4 of Form D-400, "Computation of North Carolina Taxable Income for Part-Year Residents and Nonresidents" must be completed. Credit for tax paid to another state is not allowed to an individual moving into or out of this state unless the individual has income derived from and taxed by another state or country while a resident of this State. (See Credit for Tax Paid to Another State or Country on page 56.)

j. If a tax credit is claimed for tax paid to another state or country, there must be attached to the return a true copy of the return filed with the other state or country and a cancelled check, receipt, or other proof of payment of tax.

k. Every return must be signed and dated by the taxpayer or the taxpayer's authorized agent, and joint returns should be signed and dated by both spouses. A refund may be delayed by an unsigned return.

l. Where tax has been withheld, the original or copy of the original State wage and tax statement that was received from an employer must be attached to the return. Wage and tax statements or 1099 statements generated by tax software programs cannot be used to verify North Carolina tax withheld.

m. Any additional information that will assist in the processing and auditing of a return should be attached to the return.

n. Anyone who is paid to prepare a return must sign and date the return in the space provided. When more than one person prepares a return, the preparer with primary responsibility for the overall accuracy of the return must sign as the preparer. The preparer must manually sign and date the prepared return. Preparers may use the practitioner ID number (PTIN) in lieu of their social security number. Preparers should also include their phone numbers in the space provided.

o. Nonresident aliens are required to file income tax returns at the same time they are required to file their federal returns.

4. Substitute Returns

Any facsimile or substitute form must be approved by the Department of Revenue prior to its use. The guidelines for producing substitute forms are available in the publication, "Requirements for the Approval of Substitute Tax Forms." The publication is available on the Department's Website, or it can be obtained by contacting the Department's forms coordinator. If you use computer generated returns, the software company is responsible for requesting and receiving an assigned barcode. The Department publishes a list of software developers who have received approval on it's website. Photocopies of the return are not acceptable. Returns that cannot be processed by the Department's imaging and scanning equipment may be returned to the taxpayer with instructions to refile on an acceptable form.

5. Federal Forms

Taxpayers must include a copy of their federal return with the North Carolina return unless their federal return reflects a North Carolina address.

6. Extensions

If an income tax return cannot be filed by the due date, an individual may apply for an automatic six-month extension of time to file the return. To receive the extension, an individual must file Form D-410, Application for Extension for Filing Individual Income Tax Return, by the original due date of the return. A copy of the individual's federal extension is not acceptable. Partnerships, estates, or trusts must file Form D-410P, Application for Extension for Filing Partnership, Estate, or Trust Tax Return, to apply for an extension of time to file a return.

Although a taxpayer is not required to send a payment of the tax estimated to be due, it will benefit the taxpayer to pay as much as possible with the extension request. An extension of time for filing the return does not extend the time for paying the tax. If the tax due is not paid by the original due date, interest will be due on the unpaid amount. The 10 percent late payment penalty will not be due if the taxpayer pays at least 90 percent of the tax liability through withholding, estimated tax payments, or with Form D-410 by the original due date.

A late filing penalty may be assessed if the return is filed after the due date (including extensions). The penalty is 5 percent per month ($5 minimum; 25 percent maximum) on the remaining tax due.

If the application for extension is not filed by the original due date of the return, the taxpayer is subject to both a late filing penalty and a late payment penalty.

An individual who is an U. S. citizen or resident and is "out of the country" on the regular due date of the return (April 15) is granted an automatic 4-month extension for filing a North Carolina income tax return if the individual marks the "out of the country" indicator on page 1 of Form D-400. The extension application, Form D-410, does not have to be filed. The time for payment of the tax is also extended; however, interest is due on any unpaid tax from the original due date of the return until the tax is paid. If an individual is unable to file the return within the automatic 4-month extension period, an additional 2-month extension may be obtained by filing Form D-410 by August 15 and marking the "out of country" indicator on the form.

For this purpose, "Out of the Country" means (1) you live outside the United States and Puerto Rico, and your main place of work is outside the United States and Puerto Rico, or (2) you are in military service outside the United States and Puerto Rico.

A return may be filed at any time within the extension period but it must be filed before the end of the extension period to avoid the late filing penalty.

If the Internal Revenue Service authorizes an extension of time for federal tax-related deadlines for persons determined to be affected by a Presidentially declared disaster, North Carolina will grant a similar extension of time to file a return or report. For North Carolina income tax purposes, the extension of time does not abate the payment of interest.

7. Amended Returns

For tax years prior to 2009: Use From D-400X, Amended North Carolina Income Tax Return, to file an amended return.

For tax years after 2008: Use **Form D-400, Individual Income Tax Return** and instructions for the tax year that is being amended. **Form D-400X-WS, Worksheet for Amending Individual Income Tax Return,** must also be completed and attached to the amended return.

8. Tax Liability

If North Carolina taxable income is less than $68,000, the tax liability must be determined by using the Tax Table in the individual income tax instructions. If taxable income is $68,000 or more, use the Tax Rate Schedule on below to compute the tax.

TAX RATE SCHEDULE

If your filing status is	And your taxable income is more than	But not over	The Tax is
Single	$ 0	$ 12,750	6% of the taxable income
	$ 12,750	$ 60,000	$765 + 7% of the amount over $12,750
	$ 60,000	----------	$4,072.50 + 7.75% of the amount over $60,000
Head of Household	$ 0	$ 17,000	6% of the taxable income
	$ 17,000	$ 80,000	$1,020 + 7% of the amount over $17,000
	$ 80,000	----------	$5,430 + 7.75% of the amount over $80,000
Married filing Jointly or Qualifying Widow(er)	$ 0	$ 21,250	6% of the taxable income
	$ 21,250	$ 100,000	$1,275 + 7% of the amount over $21,250
	$ 100,000	----------	$6,787.50 + 7.75% of the amount over $100,000
Married filing Separately	$ 0	$ 10,625	6% of the taxable income
	$ 10,625	$ 50,000	$637.50 + 7% of the amount over $10,625
	$ 50,000	----------	$3,393.75 + 7.75% of the amount over $50,000

9. Income Tax Surtax

Effective for taxable years beginning on or after January 1, 2009 and before January 1, 2011, a surtax is due if North Carolina taxable income is greater than the amount shown below for the taxpayer's filing status:

Married filing jointly/qualifying widow(er)	$100,000
Head of Household	$80,000
Single	$60,000
Married filing separately	$50,000

The surtax is in addition to the income tax imposed and is computed by multiplying North Carolina income tax by the applicable percentage shown in the table below.

Surtax Percentage Table

Filing Status	NC Taxable Income	Applicable Percentage
Married Filing Jointly/ Qualifying Widow(er)	Greater than $100,000 but does not exceed $250,000	2%
	Greater than $250,000	3%
Head of Household	Greater than $80,000 but does not exceed $200,00	2%
	Greater than $200,000	3%
Single	Greater than $60,000 but does not exceed $150,000	2%
	Greater than $150,000	3%
Married Filing Separately	Greater than $50,000 but does not exceed $125,000	2%
	Greater than $125,000	3%

If additional tax is due because of the surtax, there is no interest on the underpayment of estimated tax on that portion of the tax.

II. Subject: Filing Requirements (G.S. 105-152)

1. General

The minimum gross income filing requirements under North Carolina law are different from the filing requirements under the Internal Revenue Code because North Carolina law does not adjust the standard deduction and personal exemption for inflation as required by the Internal Revenue Code. See pages 11 and 12 for the North Carolina standard deduction and personal exemption amounts. The amounts are reflected in the charts for minimum gross income filing requirements on pages 7 and 8 that follow.

2. Individuals Required to File a North Carolina Individual Income Tax Return

The following individuals are required to file a North Carolina individual income tax return:

a. Every resident of North Carolina whose income for the taxable year equals or exceeds the amount for the individual's filing status shown in Chart A or B which follows.

b. Every part-year resident who received income while a resident of North Carolina or who received income while a nonresident attributable to the ownership of any interest in real or tangible personal property in North Carolina or derived from a business, trade, profession, or occupation carried on in North Carolina, or derived from gambling activities in North Carolina and whose total income for the taxable year exceeds the amount for the individual's filing status shown in Chart A or B which follows.

c. Every nonresident who received income for the taxable year from North Carolina sources that was attributable to the ownership of any interest in real or tangible personal property in North Carolina or derived from a business, trade, profession, or occupation carried on in North Carolina, or derived from gambling activities in North Carolina and whose total income for the taxable year exceeds the amount for the individual's filing status shown in Chart A or B which follows.

3. Minimum Gross Income Filing Requirements

The minimum gross income filing requirements for most people are shown in Chart A, on the following page:

CHART A—FOR MOST TAXPAYERS

	Filing Status	A Return is Required if Federal Gross Income Exceeds
(1)	Single	$5,500
	Single (age 65 or older)	$6,250
(2)	Married—Filing Joint Return	$11,000
	Married—Filing Joint Return, (one age 65 or older)	$11,600
	Married—Filing Joint Return, (both age 65 or older)	$12,200
(3)	Married—Filing Separate Return	$2,500
(4)	Head of Household	$6,900
	Head of Household (age 65 or older)	$7,650
(5)	Qualifying Widow(er) with dependent child	$8,500
	Qualifying Widow(er) (age 65 or older)	$9,100

If an individual was not required to file a federal income tax return but had gross income inside and outside North Carolina that exceeds the amount for the individual's filing status in Chart A, a federal return must be completed and attached to the North Carolina return to show how the negative federal taxable income was determined.

The minimum gross income filing requirements for children and other dependents are shown in Chart B on the following page. The filing requirements in Chart B generally are applicable to those individuals who can be claimed as a dependent by another person (such as a parent).

Note: **Earned income** includes salaries, wages, tips, professional fees, scholarships that must be included in income, and other compensation received for personal services.

Unearned income includes taxable interest, dividends, capital gains, pensions, annuities, and social security benefits.

Chart B—FOR CHILDREN AND OTHER DEPENDENTS

Single dependents. Were you **either** age 65 or older **or** blind?

☐ **No.** You must file a return if **any** of the following apply to you.
- Unearned income was over $500
- Earned income was over $3,000
- Gross income was more than the **larger** of-
  - $500, or
  - Earned income (up to $2,750) plus $250

☐ **Yes.** You must file a return if **any** of the following apply to you.
- Earned income was over $3,750 ($4,500 if 65 or older **and** blind)
- Unearned income was over $1,250 ($2,000 if 65 or older **and** blind)
- Gross income was more than-

The larger of-	Plus	This amount:
• $500, **or** • Earned income (up to $2,750) plus $250		**$750 ($1,500 if 65** or older **and** blind)

Married dependents. Were you **either** age 65 or older **or** blind?

☐ **No.** You must file a return if **any** of the following apply to you.
- Gross income was at least $10 and your spouse files a separate return and itemizes deductions.
- Unearned income was over $500
- Earned income was over $3,000
- Gross income was more than the **larger** of-
  - $500, or
  - Earned income up to $2,750 plus $250

☐ **Yes.** You must file a return if **any** of the following apply.
- Earned income was over $3,600 ($4,200 if 65 or older **and** blind)
- Unearned income was over $1,100 ($1,700 if 65 or older **and** blind)
- Gross income was at least $10 and your spouse files a separate return and itemizes deductions
- Gross income was more than-

The larger of-	Plus	This amount:
• $500, **or** • Earned income up to 2,750 plus $250		**$600 ($1,200 if 65** or older **and** blind)

Unearned income includes taxable interest, dividends, capital gains, pensions, annuities, and social security benefits. **Earned Income** includes salaries, wages, tips, professional fees, scholarships that must be included in income, and other compensation received for personal services.

4. Joint Returns (G.S. 105-152)

G.S. 105-152 requires that a husband and wife file a joint State return if:

a. They file a joint federal income tax return and

b. Both spouses are residents of North Carolina or both spouses had North Carolina taxable income.

Generally, all other individuals must file separate returns.

On joint returns, both spouses are jointly and severally liable for the tax due. However, if a spouse has been relieved of any liability for federal income tax under Internal Revenue Code Section 6015, that spouse would not be liable for the corresponding State income tax liability.

A husband and wife who file a joint federal income tax return may file a joint State return even if one spouse is a nonresident and had no North Carolina income. However, the spouse required to file a North Carolina return has the option of filing the State return as married filing separately. If an individual files a joint federal return but files a separate North Carolina return, the individual must complete a separate federal return and attach it to the North Carolina income tax return to show how the federal taxable income would be determined on a separate federal return. In lieu of completing a separate federal return, an individual may submit a schedule showing the computation of the separate federal taxable income. In this case, an individual must attach a copy of the joint federal return unless the federal return reflects a North Carolina address.

In determining the federal taxable income on the separate federal return, deductions are allowable only to the spouse responsible for payment of the item and who actually paid the amount during the tax year. In the case of a joint obligation, nonbusiness deductions (except for medical expenses) are allowable to the spouse who actually paid the item; or if a joint obligation is paid from a joint checking account, the deductions must be allocated between the spouses according to their respective adjusted gross income. In determining the amount of medical expenses paid by each spouse from a joint checking account, each spouse is considered to have paid their own medical expenses.

III. Subject: Computation of Taxable Income (G.S. 105-134.2 - G.S. 105-134.5)

1. General

The starting point in determining North Carolina taxable income is taxable income for federal income tax purposes, subject to the following additions, deductions and transitional adjustments. These adjustments do not apply to all individuals. Each individual should determine if any of the adjustments apply to his or her return.

2. Additions to Federal Taxable Income (G.S. 105-134.6)

Federal taxable income must be increased by the following additions to the extent the amounts are not included in federal taxable income:

a. Interest received upon obligations of states other than North Carolina and their political subdivisions;

   This addition includes that portion of an exempt interest dividend from a regulated investment company (mutual fund) that represents interest on direct obligations of states and their political subdivisions other than North Carolina. (See page 54 for additional information on regulated investment companies.)

b. Any amount allowed as a deduction from gross income that is taxed by a separate tax under the Internal Revenue Code. This includes lump-sum distributions from certain employees' retirement plans which a taxpayer may elect to exclude from taxable income in the regular tax computation and compute the tax separately.

c. State and local taxes and any foreign income taxes deducted on the federal return.

d. The amount claimed for domestic production activities income. The federal Jobs Creation Act of 2004 allows a deduction equal to a portion of the qualified production activities income. North Carolina did not adopt the federal provision allowing the deduction for domestic production activities income.

e. Real property taxes claimed as an addition to the federal standard deduction and deducted on the federal return.

f. New motor vehicle taxes claimed as an addition to the federal standard deduction or as an itemized deduction and deducted on the federal return.

g. An amount equal to 85 percent of the first-year bonus depreciation deducted on the 2009 federal return. The federal Economic Stimulus Act of 2008 allowed the 50 percent bonus depreciation to certain property acquired and placed in service on or after January 1, 2008, and before January 1, 2009. The federal American Recovery and Reinvestment Act of 2009 extended the 50 percent bonus depreciation available to certain prorperty an additional year, through December 31, 2009. North Carolina law did not adopt the bonus depreciation provisions under IRC sections 168(k) and 168(n). Therefore, if the 50 percent bonus depreciation under these

sections was deducted on the 2009 federal return, an individual must add to federal taxable income 85 percent of the amount deducted. This adjustment does not result in a difference in basis of the affected assets for State and federal income tax purposes.

Note: Any amount of bonus depreciation added to federal taxable income on the 2009 State return may be deducted in five equal installments over the first five taxable years beginning with the tax return for taxable year 2010.

h. The market price of donated gleaned crops for which a tax credit was claimed on the North Carolina individual income tax return.

i. The difference in the standard deduction for federal and State income tax purposes and the difference in the personal exemption for federal and State income tax purposes. These adjustments are necessary because the federal standard deduction amounts and personal exemption amounts will be adjusted each year, if necessary, for inflation. North Carolina does not have a similar provision.

The charts that follow show the North Carolina standard deduction for individuals who are not claimed as dependents by another taxpayer.

Standard Deduction Chart for Most People

Do Not use this chart if you or your spouse were 65 or older or blind, **Or** if someone can claim you as a dependent.

If your filing status is:	Your standard deduction is:
Single	$3,000
Married filing jointly/Qualifying widow(er)	$6,000
Married filing separately	
If spouse does not claim itemized deductions	$3,000
If spouse claims itemized deductions	0
Head of household	$4,400

[See **Standard Deduction Chart for People Age 65 or Older or Blind** on the following page.]

Standard Deduction Chart for People Age 65 or Older or Blind

If someone can claim you as a dependent, use the worksheet for dependents instead.

Check if: You were **65** or **Older** ☐ **Blind** ☐

Your spouse was **65** or **Older** ☐ **Blind** ☐

Enter the number of boxes checked above ☐

Note: If married filing separately, include the number of boxes checked for your spouse in the total number only if your spouse had no gross income and was not claimed as a dependent by another taxpayer.

If your filing status is:	**And the total number of boxes you have checked is:**	**Your standard deduction is**:
Single	1	$3,750
	2	$4,500
Married filing jointly/ Qualifying widow(er)	1	$6,600
	2	$7,200
	3	$7,800
	4	$8,400
Married filing separately	1	$3,600
	2	$4,200
	3	$4,800
	4	$5,400
Head of household	1	$5,150
	2	$5,900

The worksheet on the following page is used to calculate the North Carolina standard deduction for individuals who can be claimed as dependents by another taxpayer.

Standard Deduction Worksheet for Dependents

Use this worksheet **only** if someone can claim you as a dependent

1. Enter amount of earned income ➔ _____
   (Earned income defined below) + **$250** Enter total ➔ 1. _____

2. Minimum amount..... 2. **$500**

3. Enter the larger of line 1 or line 2. ..... 3. _____

4. Enter on line 4 the amount shown for your filing status

   - Single, enter $3,000
   - Married filing jointly/
     Qualifying widow(er), enter $6,000
   - Married filing separately, enter $3,000
   - Head of household, enter $4,400 .....4. _____

5. Enter the smaller of lines 3 or 4. **If under 65 and not blind, Stop Here** and enter this amount on the appropriate line of Form D-400 .....5. _____

6. a. Check if: You were **65** or **Older** ☐ **Blind** ☐

   Your spouse was **65** or **Older** ☐ **Blind** ☐

   b. Enter the number of boxes you have checked ☐

   Note: If married filing separately, include the number of boxes checked for your spouse in the total number checked only if your spouse had no gross income and was not claimed as a dependent by another taxpayer.

   c. Multiply $750 ($600 if married filing jointly or separately, or qualifying widow(er)) by the number of boxes you entered on line 6b above and enter the result..... 6c. _____

7. Add lines 5 and 6c. Enter the total here and on the appropriate line of Form D-400 .....7. _____

Earned income includes salaries, wages, tips, professional fees, and other compensation received for personal services you performed. It also includes any amount received as a scholarship that you must report in income.

The standard deduction is zero for a married individual filing separately for federal income tax purposes whose spouse claims itemized deductions.

The standard deduction for nonresident aliens and individuals filing a short year return due to a change of accounting period is zero.

The personal exemption for North Carolina purposes is $2,500 for a taxpayer whose federal adjusted gross income is less than the amount shown for his filing status in the chart that follows. For a taxpayer with federal adjusted gross income equal to or more than the threshold amount, the personal exemption is $2,000.

Filing Status	Adjusted Gross Income
Married filing jointly	$100,000
Head of household	$80,000
Single	$60,000
Married filing separately	$50,000

j. The amount of federal estate tax that is attributable to income in respect of a decedent and that is deducted under Section 691 (c) of the Internal Revenue Code.

k. The amount by which the basis of property for federal purposes exceeds the basis for State purposes upon disposition of the property.

l. The amount of net operating loss carried over to a taxable year to the extent the loss is not absorbed and will be carried forward to subsequent years.

m. With respect to a child's unearned income reported by a parent, the amount of the child's unearned income in excess of $500 but not exceeding $1,900. When a parent elects to report a child's unearned income, the child is treated as having no gross income for the year and is not required to file a federal income tax return. A parent electing to report a child's unearned income for federal tax purposes must add to federal taxable income the amount of the child's unearned income in excess of $500 but not exceeding $1,900.

n. The market price of oyster shells for which a tax credit was claimed on the North Carolina individual income tax return.

o. The amount of a shareholder's share of an S-corporation's built-in gains tax deducted by the shareholder in determining federal taxable income. A shareholder of an S corporation is required to make an addition to federal taxable income for the shareholder's share of built-in gains tax that the S corporation paid for federal income tax purposes. Because the income subject to the built-in gains tax is taxed at both the S corporation and shareholder level for federal income tax purposes, federal law allows the shareholder to deduct his pro rata share of the built-in gains tax to provide relief from double taxation. North Carolina does not impose a built-in gains tax; therefore, there is no double taxation for State income tax purposes.

p. Any amount that was contributed to the Parental Savings Trust Fund (North Carolina's 529 college savings plan) of the State Education Assistance Authority and deducted in a prior year that was later withdrawn and used for purposes other than the qualified higher education expenses of the designated beneficiary unless the withdrawal was due to the death or permanent disability of the designated beneficiary.

q. Effective for tax years beginning on or after January 1, 2008, the amount of a donation made to a nonprofit organization or a unit of state and local government to enable the nonprofit or governmental unit to acquire renewable energy property. G.S. 105-129.16H provides tax credits to taxpayers who donate money to a tax-exempt nonprofit organization or governmental unit for the purpose of providing funds for the organization to construct, purchase, or lease renewable energy property.

r. The amount of income deferred under IRC section 108(i)(I) from the discharge of indebtedness in connection with a reacquisition of an applicable debt instrument.

s. The amount allowed as a deduction on the federal return under IRC section 163(e)(5)(F) for an original issue discount on an applicable high yield discount obligation.

3. Deductions from Federal Taxable Income (G.S. 105-134.6)

Federal taxable income must be decreased by the following deductions to the extent the amounts are included in federal taxable income:

a. Interest upon direct obligations of the United States or its possessions;

Interest earned from obligations that are merely backed or guaranteed by the United States Government will not qualify for deduction from an individual's income. The deduction from income will not apply to distributions which represent gain from the sale or other disposition of the securities, nor to interest paid in connection with repurchase agreements issued by banks and savings and loan associations. The deduction will not apply to any portion of a distribution from an individual retirement account (IRA).

The following are examples of interest on bonds, notes, or other obligations that must be deducted from federal taxable income, if such bonds, notes, or other obligations are direct obligations of:

(1) Puerto Rico, the Virgin Islands and Guam
(2) A Federal Land Bank
(3) A Federal Home Loan Bank
(4) A Federal Intermediate Bank
(5) Farm Home Administration
(6) Export-Import Bank of the United States
(7) Tennessee Valley Authority
(8) Banks for Cooperatives
(9) U.S. Treasury bonds, notes, bills, certificates and savings bonds
(10) Production Credit Association
(11) Student Loan Marketing Association
(12) Commodity Credit Corporation
(13) Federal Deposit Insurance Corporation
(14) A Federal Farm Credit Bank
(15) Federal Financing Bank
(16) Federal Savings and Loan Insurance Corporation
(17) General Insurance Fund
(18) United States Postal Service
(19) Resolution Funding Corporation
(20) Financing Corporation (chartered by the Federal Housing Finance Board — 12 USCS 12-1441)

b. Interest on bonds, notes, and other obligations of the State of North Carolina or any of its political subdivisions;

c. Interest on obligations and gain from the sale or disposition of obligations issued before July 1, 1995 if North Carolina law under which the obligations were issued specifically exempts the interest or

gain (With respect to North Carolina obligations issued after July 1, 1995, the income tax treatment of gains from the sale or disposition of such obligations is the same for federal and State purposes.);

***Examples*:**

(1) Interest on bonds, notes, debentures, or other evidence of the indebtedness issued under G.S. 131E-28 by the North Carolina Hospital Authorities, including gain from the sale or exchange of these obligations.

(2) Interest on bonds, notes, debentures, or other evidence of indebtedness issued by the North Carolina Medical Care Commission under the Health Care Facilities Finance Act under the provisions of G.S. 131A-21. Gain from the sale or exchange of these obligations may also be deducted.

(3) Interest and gain derived from obligations issued by the North Carolina Housing Finance Agency under G.S. 122A-19.

(4) Interest and gain on bonds issued by the North Carolina State Ports Authority under G.S. 143B-456(g).

(5) Interest on bonds, notes, debentures, and any other evidence of indebtedness issued by a North Carolina Housing Authority (including any corporate agent authorized by Article 1 of Chapter 157 of the General Statutes to exercise the powers of the authority) under the provisions of G.S. 157-26. Gain from the sale or exchange of these obligations is not deductible.

(6) Interest and gain derived from bonds issued under the Joint Municipal Electric Power and Energy Act under G.S. 159B-26.

(7) Income from bonds issued by boards of trustees of State supported colleges and universities in North Carolina including any gain from the sale or exchange of them under G.S. 116-183 and 116-196.

(8) Interest and gain received from bonds and notes issued under the provision of the Higher Education Facilities Finance Act by the North Carolina Educational Facilities Finance Agency under G.S. 159D-55.

(9) Interest and gain received on obligations issued under Chapter 122D (The North Carolina Agriculture Finance Act) by the North Carolina Agriculture Finance Authority under G.S. 122D-14.

d. Taxable portion of social security benefits received under Title II of the Social Security Act and any Tier I or Tier II Railroad Retirement benefits received under the Railroad Retirement Act of 1937;

e. An amount by which any federal income tax deduction is disallowed because of the allowance of a federal income tax credit for part or all of the expense comprising the deduction to the extent that a similar State income tax credit is not allowed;

Example 1: If an individual itemizes deductions and claims the mortgage interest tax credit on the federal tax return because of participating in the mortgage credit certificate program (MCC), the individual may reduce North Carolina taxable income by the amount that the mortgage interest deduction was reduced due to claiming the mortgage interest credit on the federal tax return.

Example 2: If an individual claimed the American Opportunity, Hope, or Lifetime Learning tax credit on the federal return in lieu of the deduction for higher education expenses allowed under Section 222 of the Internal Revenue Code, the individual may claim a deduction of up to $4,000 for such expenses on the State return.

f. Refunds of state, local, and foreign income taxes;

g. Up to $4,000 in retirement benefits from one or more federal, state, or local government retirement plans (See IV. Bailey Settlement on page 24 to determine if more than $4,000 of government retirement benefits may be deducted.)

h. Up to $2,000 in retirement benefits from one or more private retirement plans; If an individual receives federal, state, or local government retirement benefits and also receives other qualified retirement benefits, the total deduction is limited to $4,000. For married couples filing a joint return, the maximum dollar amount of retirement benefits that may be deducted from federal taxable income applies separately to the benefits received by each spouse, so that the maximum deduction on a joint return is $8,000.

The $4,000 deduction is applicable to retirement benefits received from the governments of territories and possessions of the United States.

If an individual received retirement benefits during the year from one or more private retirement plans *other than* state, local, or federal government retirement plans, the individual may deduct the amount received or $2,000, *whichever is less*. Married individuals filing a joint return where both received such retirement benefits may each deduct up to $2,000 for a potential total deduction of $4,000.

"Retirement benefits" are amounts paid to a former employee or to a beneficiary of a former employee under a written retirement plan established by the employer to provide payments to an employee or beneficiary after the end of the employee's employment with the employer where the right to receive the payment is based upon the employment relationship. For self-employed individuals, retirement benefits are amounts paid to an individual, or beneficiary under a written retirement plan established by the individual to provide payments after self-employment ends. Retirement benefits also include amounts received from an individual retirement account or from an individual retirement annuity (IRA).

An individual is not required to have ceased employment to qualify for the $2,000 deduction for distributions from an individual retirement account or an individual retirement annuity.

The deduction for retirement benefits is allowed only to the extent the benefits are included in federal taxable income. If an individual elects to roll-over the distribution from an employer's plan or from an individual retirement account, no deduction is allowed since the amount rolled over is not included in taxable income.

A change in the structure of a corporate employer which causes a distribution to be paid to the employee from the employer's retirement plan does not entitle the employee to claim the deduction for retirement benefits from such distribution. For example, Company A is merged with Company B. An employee of A continues to work for the merged company. During the tax year, the employee received a distribution of $5,000 representing the employee's total credit in the non-contributory retirement plan of Company A. The employee would not be entitled to the $2,000 deduction since the employee had not ceased employment.

Since short-term disability benefits from the Disability Income Plan of North Carolina administered for the benefit of North Carolina teachers and state employees are not paid to a former employee under a retirement plan after the end of the employee's employment, the benefits are not subject to the $4,000 deduction from federal taxable income. Long-term disability benefits are payable after the conclusion of the short-term disability period or after salary continuation payments cease, whichever is later. Recipients of long-term disability benefits under the Disability Income Plan of North Carolina are former employees and they are entitled to the $4,000 deduction from federal taxable income.

Benefits paid to federal civil service employees who become disabled prior to becoming age 60 upon separation from service are paid to a former employee under a retirement plan after the end of the employee's employment and are subject to the $4,000 deduction from federal taxable income.

Survivors of a member of the armed forces who receive benefits from the Retired Serviceman's Family Protection Plan or the Survivor's Benefits Plan as the result of taking a reduction in retirement pay are subject to the deduction of up to $4,000 from federal taxable income.

i. The amount of North Carolina inheritance or estate tax paid that is attributable to an item of income in respect of a decedent;

The deduction from federal taxable income is determined by multiplying the amount of North Carolina inheritance or estate tax paid on all property transferred to the particular beneficiary, less the North Carolina inheritance or estate tax which would have been paid if the item of income in respect of a decedent had not been included, by a fraction, the numerator of which is the income in respect of a decedent the beneficiary included in federal taxable

income, as adjusted, and the denominator of which is the total income in respect of a decedent transferred to the beneficiary. The deduction is allowable in the year the item of income is included in federal taxable income.

j. Income earned or received by an enrolled member of a federally recognized Indian tribe if such income is derived from activities on a federally recognized Indian reservation while the member resided on the reservation. Intangible income having a situs on the reservation and retirement income associated with activities on the reservation are considered income derived from activities on the reservation.

k. Repayments of items of income included in gross income in a prior year under the claim-of-right doctrine for which the taxpayer reduces his tax under Section 1341 of the Internal Revenue Code in the year of repayment;

For federal income tax purposes, if the repayment claimed under a claim of right is substantial (more than $3,000) and there is insufficient income in the later year to offset the deduction, an individual may claim a credit if the benefit received by claiming the credit is greater than that received by claiming a deduction for the repayment. A taxpayer who qualifies for the credit on the federal return is still entitled to the deduction for the amount repaid on the State return. The taxpayer is also considered to have made a payment of North Carolina income tax on the repayment. The payment, which is applied against the tax liability for the year in which the repayment was made, is the amount the tax was increased in the earlier year because the income was included in gross income minus the amount the tax for the current year was decreased because the repayment was deductible. Individuals may claim the payment on the individual income tax return by including the payment on the same line as S corporation payments.

Example: In 2008, a single taxpayer reported North Carolina taxable income of $25,000 on which he paid tax of $1,624. The taxpayer's only income was sales commissions. In 2009, it is determined that the commissions were erroneously computed for 2008. Accordingly, the taxpayer pays back $8,000 of the commissions. The North Carolina taxable income for 2009 without regard to the $8,000 repayment is $4,000. The taxpayer qualifies for a credit on the federal return for the amount repaid. The tax payment to be claimed on the 2009 North Carolina return is determined as follows:

2008			
Tax on $25,000	=	$ 1,624	
Tax on $17,000 ($25,000-$8,000)	=	1,064	
			$ 560
2009			
Tax on $4,000	=	$ 242	
Tax after deducting $8,000 payment	=	0	
			$ 242
Payment to be claimed on the 2009 North Carolina return			$ 318

l. The amount by which the basis of property for State purposes exceeds the basis for federal purposes upon disposition of the property. The deduction can be claimed only in the year in which the property is disposed.

m. Up to $35,000 of any severance wages received as a result of a taxpayer's permanent, involuntary termination from employment through no fault of the employee is deductible from federal taxable income. The severance wages deducted as a result of the same termination may not exceed $35,000 for all taxable years in which the wages were received. "Stay on pay" does not qualify for the deduction.

Severance wages do not include payments that represent compensation for past or future services. Compensation for past or future services includes payment for any of the following:

(1) Accumulated sick leave, vacation time, or other unused benefits;

(2) Bonuses based on job performance; and

(3) Payments in consideration of any agreement not to compete with the employer or in consideration of a contractual or legal claim.

n. See IV. Bailey Settlement.

o. Interest, investment earnings, and gains of a trust established by two or more manufacturers that signed a settlement agreement with the State to settle claims for damages attributable to a product of the manufacturers.

p. The amount paid to an individual from the Disaster Relief Reserve Fund in the Office of State Budget, Planning, and Management for hurricane relief or assistance, but not including payments received for goods or services.

q. An amount equal to 20 percent of the total additional first-year depreciation an individual added back on the 2002, 2003, and 2004 State returns. North Carolina did not adopt the additional first-year depreciation provisions in the federal Jobs Creation and Worker Assistance Act of 2002 or the federal Jobs and Growth Tax Relief Reconciliation Act of 2003. Instead, an adjustment was required on the 2002, 2003, and 2004 returns for a certain percentage of the first-year depreciation claimed on the federal return for the applicable year. Any amount of additional

first-year depreciation that an individual added to federal taxable income on the 2002, 2003, or 2004 State returns may be deducted in five equal installments beginning with the State tax return for 2005. The final 20 percent installment must be claimed on the 2009 State return.

If a taxpayer disposes of an asset on which additional first-year depreciation was added back on the 2002, 2003, or 2004 State return, the taxpayer is entitled to claim the 20 percent deduction over the five year period even though the taxpayer no longer owns the asset.

If a taxpaying entity that added back additional first-year depreciation on the State return merges with another entity, the new entity is not entitled to claim the 20 percent deduction.

r. An amount equal to 20 percent of the additional first-year bonus depreciation deduction that was added to federal taxable income on the 2008 State return. North Carolina did not adopt the 50 percent bonus depreciation provisions in IRC section 168(k) for tax year 2008. Therefore, any amount added to federal taxable income on the 2008 State return may be deducted in five equal installments beginning with the 2009 State return.

s. A deduction up to $2,500 ($5,000 on a joint return) is allowed for contributions made to an account in the Parental Savings Trust Fund (North Carolina's 529 college savings plan) of the State Education Assistance Authority.

   Amounts rolled over to North Carolina's 529 plan from another state's 529 plan are considered contributions to the North Carolina plan.

t. A $250 deduction is allowed to a taxpayer who is an eligible firefighter or rescue squad worker. An eligible firefighter is defined as an unpaid member of a volunteer fire department who attended at least 36 hours of fire department drills and meetings during the taxable year. An eligible rescue squad worker is defined as an unpaid member of a volunteer rescue or emergency medical services squad who attended at least 36 hours of rescue squad training and meetings during the taxable year. An individual may not claim a deduction as both a volunteer firefighter and a volunteer rescue squad worker. In the case of a married couple filing a joint return, each spouse may qualify separately for the deduction.

4. Transitional Adjustments (G.S. 105-134.7)

The following transitional adjustments are required because of differences in the way State and federal law treated certain tax transactions prior to January 1, 1989.

a. Amounts that were included in the basis of property under federal law but not under State law prior to January 1, 1989, must be added to taxable income in the year of disposition of the property. These adjustments include the increase in basis for federal gift tax paid on property received as a gift and in certain cases where the

individual was permitted under federal law to capitalize certain expenditures for interest and taxes.

b. Amounts that were included in the basis of property under State law but not under federal law prior to January 1, 1989, must be deducted from an individual's taxable income in the year of disposition of the property. Deductions of this type include the increase in basis for State gift tax paid on property received as a gift and certain business expenditures that an individual elected to expense under Section 179 of the Internal Revenue Code but which were required to be capitalized for State income tax purposes.

c. A loss or deduction that was incurred or paid and deducted in full for North Carolina income tax purposes under prior State law in a taxable year beginning before January 1, 1989, but was carried forward and deducted from federal taxable income in a taxable year beginning on or after January 1, 1989, must be added to taxable income.

Example: The full amount of a capital loss incurred in 1988 would have been deductible on an individual's 1988 State income tax return but on his federal income tax return the amount of the deductible loss would have been limited to his capital gains plus $3,000 ($1,500 if married and filing a separate return). Any remaining loss could be carried forward to subsequent tax years and deducted on his federal income tax return in computing his federal taxable income. In this instance, the individual must add back each year that portion of the 1988 loss deducted from his federal taxable income in arriving at the amount of his North Carolina taxable income.

In determining the amount of a capital loss to add back, short-term capital losses from taxable years beginning prior to January 1, 1989, must be applied before applying short-term capital losses incurred in taxable years beginning on or after January 1, 1989, and before applying long-term capital losses from any year. Long-term capital losses from taxable years beginning prior to January 1, 1989, must be applied before applying long-term capital losses incurred in taxable years beginning on or after January 1, 1989.

Example: An individual carries over $6,000 of capital losses from years beginning prior to January 1, 1989, consisting of $4,000 of short-term losses and $2,000 of long-term losses. In 1989, the individual incurs additional capital losses of $2,500, consisting of $1,500 of short-term losses and $1,000 of long-term losses. The individual claims a capital loss deduction of $3,000 on his federal income tax return. In 1990 and 1991 the individual has no additional capital gains or losses and claims a $3,000 capital loss carry-over on his 1990 federal income tax return and the balance of $2,500 capital loss carry-over on his 1991 federal income tax return. The taxpayer would be required to add back the following amounts as transitional adjustments: 1989 — $3,000 (a portion of the short-term capital loss from 1988); 1990 — $1,500 consisting of the $1,000 balance of the 1988 short-term loss and $500 of the

1988 long-term loss; 1991 — $1,500 consisting of the remaining 1988 long-term loss carry-over.

Example: Generally, for federal income tax purposes for tax years beginning on or after January 1, 1987, to the extent that the total deductions from passive activities exceed the total income from such activities for the tax year, the excess (passive activity loss) is not allowed as a deduction for that year. A disallowed passive loss is allowed to be carried forward as a deduction from passive activity income in the next succeeding tax year. Generally, losses from passive activities may not be deducted from other types of income (e.g. wages, interest, or dividends). A passive activity is one that involves the conduct of any trade or business in which the taxpayer does not materially participate. Any rental activity is a passive activity regardless of whether the taxpayer materially participates. Special rules apply to rental activities. Under State law, a passive loss carried forward from a tax year beginning prior to January 1, 1989, must be added back to federal taxable income since the entire loss was deductible on the taxpayer's return for the year the loss was incurred.

d. Amounts deducted on an individual's federal income tax return as net operating losses brought forward from tax years beginning prior to January 1, 1989, must be added to federal taxable income. For tax years prior to January 1, 1989, State law allowed a net economic loss to be carried forward to subsequent years but was computed differently from the federal net operating loss. Prior State law did not permit the loss to be carried back to prior tax years as did federal law. See V. Net Operating Losses for additional information.

   Example: An individual sustains a business loss of $100,000 in 1988, had no other business income or business expenses for that year, and received interest income of $82,000 from City of Raleigh bonds during the taxable year. For federal income tax purposes, the individual would have sustained a net operating loss of $100,000. If the individual had no income in the prior three tax years to offset the net operating loss, he could carry the $100,000 loss forward for up to 15 years and deduct it as a net operating loss on his subsequent federal income tax returns. Under prior State law, the individual would have incurred a net economic loss of $18,000 (business loss of $100,000 less nontaxable income of $82,000) that could be carried forward to up to five years after reducing it by both taxable and nontaxable income. In this situation, the individual must add back the net operating loss deduction claimed on his federal income tax return.

e. Adjustments must also be made in the taxable income of a shareholder of an S corporation. For a discussion of the tax status of distributions from S corporations to shareholders in tax years beginning on or after January 1, 1989, see VII. S Corporations.

f. Under the "tax benefit rule," the recovery of an amount deducted or credited in an earlier year is included in federal taxable income in the current (recovery) year, except to the extent the earlier year's

deduction or credit did not reduce federal income tax imposed in that year. Income attributable to such recovery items which did not provide a tax benefit for federal income tax purposes but did provide a tax benefit for State purposes for taxable years beginning prior to January 1, 1989, must be added to federal taxable income.

Other additions and deductions to federal taxable income may be required to ensure that the transition to the tax changes effective January 1, 1989, does not result in the double taxation of income, the exemption of otherwise taxable income or double allowance of deductions.

IV. Subject: Bailey Settlement

As a result of the North Carolina Supreme Court's decision in Bailey v. State of North Carolina and the settlement subsequently reached in that case, North Carolina may not tax retirement benefits received by a retiree (or by a beneficiary of a retiree) from qualifying State, local, or federal retirement systems if the retiree was vested in the retirement system as of August 12, 1989. For most government retirement systems, a person is vested if the person had five or more years of creditable service in a qualifying State, local or federal retirement system as of August 12, 1989. For certain retirement systems, the vesting period is less.

1. Qualifying State or Local Retirement System

The following retirement systems were designated as a North Carolina state or local governmental retirement system:

System	Law Creating the System
North Carolina Teachers' and State Employees' Retirement System (TSERS)	G.S. 135, Article 1
Optional Retirement Program available to administrators and faculty of the University of North Carolina system in lieu of TSERS	G.S. 105-135-5.1
North Carolina Local Governmental Employees' Retirement System	G.S. 128, Article 3
North Carolina Consolidated Judicial Retirement System	G.S. 135, Article 4
North Carolina Legislative Retirement System	G.S. 120, Article 1A
North Carolina Disability Income Plan (both short-term and long-term disability benefits)	G.S. 135, Article 6
North Carolina Supplemental Retirement Income Plan	G.S. 135, Article 5
North Carolina Supplemental Retirement Income Plan for State Law Enforcement Officers	G.S. 143-166.30(d)
North Carolina Deferred Compensation Plan	G.S. 143B, Article 9
North Carolina National Guard Pension Fund	G.S. 127A-40
North Carolina Sheriffs' Supplemental Pension Fund	G.S. 143, Article 12H
North Carolina Registers of Deeds' Supplemental Pension Fund	G.S. 161, Article 3
North Carolina Supplemental Retirement Plan for Local Governmental Law Enforcement Officers Separate Insurance Benefits Plan for State and Local	G.S. 143-166.50(e)
Governmental Law Enforcement Officers	G.S. 143-166.60
North Carolina Firemen's and Rescue Squad Workers' Pension Fund	G.S. 58, Article 86

Charlotte Firefighters' Retirement System	Session Laws 1947, Chapter 926, § 6(c)
Firemen's Supplemental Fund of Hickory	Session Laws 1971, Chapter 65
Winston-Salem Police Officers' Retirement System	Session Laws 1939, Chapter 296
Separate Insurance Benefits Plan for State and Local Government Law Enforcement Officers	G. S. 143-166.60
New Hanover County School Employees' Retirement Plan	1979 Session Laws, Chapter 1307

No local government optional contribution plans, similar to the State's Supplemental Retirement Income Plan and Deferred Compensation Plan, were afforded tax exemption prior to August 12, 1989. Therefore, retirement benefits from local government optional contribution plans (such as local government 457 plans) are not subject to future tax exemption.

Teachers and other employees of North Carolina's public schools have the option of contributing to optional contribution plans established pursuant to section 403(b) of the Code. Distributions from these plans may not be excluded from taxable income under the settlement.

The "special separation allowance" paid to retired law enforcement officers pursuant to G.S. 143-166.41 and reported on Form W-2 does not qualify for exclusion under *Bailey*. However, the special separation allowance is subject to the $4,000 retirement benefits deduction.

2. Vesting Period for Qualifying State or Local Retirement Systems

The general rule is that a participant in a qualifying State or local retirement system is vested if the participant had five or more years of creditable service as of August 12, 1989. The general rule does not apply to qualifying optional contribution plans, however, or to certain other qualifying plans.

Participants in the State's Supplemental Retirement Income Plan (Internal Revenue Code § 401(k)) or the State's Deferred Compensation Plan (Code § 457) are vested in the plan as of August 12, 1989, if they contributed or contracted to contribute to the plan by August 12, 1989. If the participant contributed any money to a plan before August 12, 1989, all future withdrawals from that plan are excludable from tax. Contributions to one plan prior to August 12, 1989, do not qualify contributions to the other plan as vested. If a State employee began contributing to the §401(k) plan in June 1989, and to the §457 plan in October 1989, the employee is vested only in the §401(k) plan. Participants in the State's Supplemental Retirement Income Plan or the State's Deferred Compensation Plan may have chosen an annuity as an investment option. In some cases, they receive the annuity payments and the subsequent tax information statement from the annuity company instead of the plan administrator. These amounts also qualify for future tax exemption if the retiree was vested.

Participants in the North Carolina Firemen's and Rescue Workers'

Pension Plan are vested as of August 12, 1989, only if the individual had both five years of service and had paid five years of contributions to the plan by August 12, 1989. Sheriffs receiving benefits from the North Carolina Sheriffs' Supplemental Pension Fund and Registers of Deeds receiving benefits from the North Carolina Registers of Deeds' Supplemental Pension Fund are vested as of August 12, 1989, only if the sheriff or the register of deeds (not a deputy or assistant) had five years of service as a sheriff or a register of deeds and five years of participation in the Local Government Employees' Retirement System (or equivalent local plan) by August 12, 1989.

An employee in a qualifying State or local government retirement system who was vested prior to August 12, 1989, and who leaves employment remains vested if the employee later returns to work, provided the employee did not withdraw his or her contributions to the retirement system. If the employee withdrew his or her contributions, the employee is no longer vested in the retirement system, even if the employee subsequently buys back the service time, unless the employee returned to employment in time to become vested again before August 12, 1989.

3. Qualifying Federal Retirement Systems

The following retirement systems were designated as a federal governmental retirement system:

- Federal Civil Service Retirement System
- Federal Employees' Retirement System
- Lighthouse Retirement System
- Thrift Savings Plan
- Foreign Service Retirement and Disability System and Pension System
- Military Retirement System
- Coast Guard Retirement System
- Central Intelligence Agency Retirement System
- Commissioned Corps of the Public Health Service Retirement System
- Comptrollers' General Retirement Plan
- Judicial Plans & Pay for Federal Judges Treated as Retirement Pay by Federal Law, including:
  - Judicial Retirement System
  - Judicial Survivors' Annuities System
  - Court of Federal Claims Judges' Retirement System
  - Court of Veterans Appeals Judges' Retirement Plan
  - Judicial Officers' Retirement System (for Bankruptcy Judges and Magistrates)
  - United States Tax Court Retirement Plan
  - United States Tax Court Survivors' Annuity Plan
  - Retirement Plans for District Court Judges for the Northern Mariana Islands, the Virgin Islands, and Guam
  - Court of Appeals for the Armed Forces Judges Retirement System
- National Oceanic and Atmospheric Administration Retirement System
- Tennessee Valley Authority Retirement System and TVA Savings and Deferral Retirement Plan
- Financial Institutions Retirement Fund (Office of Thrift Supervision Employees)
- Federal Home Loan Bank Board Retirement Systems
- Federal Home Loan Mortgage Corporation Plan
- Federal Reserve Employees Retirement Plans and Thrift Plan
- Nonappropriated fund plans, including:
  - Retirement Annuity Plan for Employees of Army and Air Force Exchange Service
  - Supplemental Deferred Compensation Plan for Members of the Executive Management Program (Army and Air Force Exchange Service)
  - Nonappropriated Fund Retirement Plan for Civilian Employees
  - United States Army Nonappropriated Fund Retirement Plan
  - Retirement Plan for Civilian Employees of United States Marine Corps Morale, Welfare, and Recreation Activities and Miscellaneous Nonappropriated Fund Instrumentalities

- Navy Exchange Service Command Retirement Plan
- Navy Nonappropriated Fund Retirement Plan for Employees of Civilian Morale, Welfare, and Recreation Activities
- Norfolk Naval Shipyard Pension Plan
- Retirement Savings Plan and Trust for Employees of the Army and Air Force Exchange Service
- Coast Guard Nonappropriated Fund Retirement Plan

- District of Columbia Police Officers and Fire Fighters' Retirement Fund and Related Funds (including payments to Secret Service and U.S. Park Police covered by the Fund)
- District of Columbia Teachers' Retirement Fund and Related Funds
- District of Columbia Judges' Retirement Fund and Related Funds
- Uniformed Services University of the Health Sciences Plan
- Smithsonian Institution Defined Contribution Retirement Plan
- USDA Graduate School Plan

4. Vesting Period for Qualifying Federal Retirement Systems

Generally, participants in the qualifying federal retirement systems listed above, including military retirees, are vested for purposes of the settlement if they had five or more years of creditable service as of August 12, 1989. The general rule, however, does not apply to the Thrift Savings Plan.

The Thrift Savings Plan has both an employee and an employer component. The employee component is similar to the State's § 401(k) and § 457 plans and allows the employee to voluntarily contribute to the Plan. The employee is vested in the employee component if the employee first made a contribution to the plan prior to August 12, 1989. The employer component includes both contributions by the employer of a fixed percentage of the employee's salary and contributions by the employer that match the employee's voluntary contributions. The employee is also vested in the employer matching contributions if the employer first made a matching contribution prior to August 12, 1989. An employee is vested in the employer fixed component only if the employee had three years of service (two years of service for certain highly ranked employees) as of August 12, 1989. One exception to the three-year rule is that an employee who died prior to completing the mandatory three years is still considered vested if the date of death was on or before August 12, 1989.

As explained above, it is possible for a participant in the Federal Thrift Savings Plan to be vested as of August 12, 1989, in some components of the plan while at the same time not being vested in other components. The annual tax information statement (Form 1099-R) does not distinguish between the various components when reporting the amount distributed during the year; therefore, the recipient cannot readily determine the amount to exclude from North Carolina income tax. When a participant in the plan ceases employment, the recipient is provided a Form TSP-8, Thrift Savings Plan Participant Statement, that identifies the cash balances in the various components. To determine the proper amount to exclude, the recipient should multiply the annual distribution by a fraction, the numerator of which is the balance of the components in which the recipient is vested as of August 12, 1989. The denominator of the fraction is the total cash balance of all components. That same fraction will be used for each year the recipient receives distributions from the plan.

5. Rollover Distributions with Respect to Bailey Retirement Plans

The Economic Growth and Tax Relief Reconciliation Act of 2001 made numerous changes with respect of pension portability. Beginning in 2002, distributions from most types of retirement plans may be rolled over into another retirement plan or into an IRA. Because rollover distributions lose their character upon rollover, all distributions from a qualifying *Bailey* retirement account in which the employee/retiree was "vested" as of August 12, 1989, are exempt from State income tax regardless of the source of the funds contained in the account. Conversely, qualifying tax-exempt *Bailey* benefits rolled over into another retirement plan lose their character and would not be exempt upon distribution from the other plan unless that plan is a qualifying *Bailey* retirement account in which the employee was vested as of August 12, 1989. (Rollovers to IRAs will always result in a loss of tax-exempt status since IRAs do not qualify under the *Bailey* settlement.)

6. Benefits from Other Retirement Plans

Retirees receiving benefits from government retirement plans of other states or territories were not class members in *Bailey* and are not entitled to recovery of taxes paid in earlier years or to tax exemption in future years, except for the $4,000 deduction provided by G.S. 105-134.6(b)(6). Private retirement benefits remain taxable except for the $2,000 deduction.

V. Subject: Net Operating Losses (G.S. 105-134.7)

Prior to 1989, North Carolina law provided a measure of relief to individual income taxpayers who incurred economic misfortune by allowing losses qualifying as net economic losses as defined by G.S. 105-147(9)(d)(2) to be carried forward and deducted from future gross income. With the adoption of federal taxable income as the starting point in determining North Carolina taxable income in 1989, net operating losses were recognized for State individual income tax purposes. The primary differences between net operating losses and net economic losses are (1) nontaxable income is used to reduce the amount of a net economic loss but is not used to reduce the amount of net operating loss, and (2) net economic losses can only be carried forward while net operating losses can be carried back and/or forward.

1. Determining Net Operating Losses

Since federal taxable income is the starting point for determining North Carolina taxable income, the amount of net operating loss determined for federal income tax purposes is also the net operating loss for State income tax purposes. Although adjustments to federal taxable income may be required which cause North Carolina taxable income to be different than federal taxable income in the year the loss is incurred, the law does not require or permit a separate calculation of a net operating loss for State purposes. The amount of net operating loss is the same for State and federal purposes. However, a nonresident or part-year resident must make an additional calculation to determine the portion of the total net operating loss that is from North Carolina sources.

2. Net Operating Loss Carryovers

a. Since federal taxable income is the starting point for determining North Carolina taxable income, the amount of net operating loss carried over and absorbed for federal purposes is the same amount carried over and deducted for State purposes. "Absorbed" means the amount of net operating loss carried to a year less the amount of net operating loss carried forward from that year. If, in the year to which the loss is carried, adjustments are required to the State return which result in the taxpayer not receiving full benefit of the carryover, no additional carryover of the portion of the loss not resulting in a benefit is permitted.

b. For any year in which a net operating loss is carried over but not completely absorbed for federal purposes, an addition to federal taxable income is required on the State return for the amount of net operating loss carried forward from that year.

> ***Example:*** A taxpayer incurs a net operating loss of $75,000 in 2009. The taxpayer amends his 2007 federal return to carry back the net operating loss and deducts the entire loss in arriving at federal taxable income. Only $50,000 of the loss is absorbed and $25,000 is carried forward to the 2008

federal return. To determine North Carolina taxable income, the taxpayer must make an addition to federal taxable income, as amended, of $25,000 on his amended 2007 State return.

c. Because North Carolina did not recognize net operating losses before 1989, a taxpayer may not carry forward a loss incurred prior to 1989. G.S. 105-134.7(a)(6) requires an addition to federal taxable income for the amount of net operating loss carried forward from a tax year prior to 1989 and deducted in arriving at federal taxable income.

3. Effect of Residency Status on Net Operating Losses

As stated earlier, the amount of net operating loss carried over and absorbed for federal tax purposes is also the amount carried over and deducted for State tax purposes. If the taxpayer is a nonresident or a part-year resident in the year the net operating loss is incurred and a resident in the year to which the loss is carried, the taxpayer receives the full benefit of the deduction, regardless of whether the net operating loss resulted from North Carolina source activities. If the taxpayer is a resident in the year the net operating loss is incurred and a nonresident or part-year resident in the year to which the loss is carried, the taxpayer may subtract the entire portion of the net operating loss carried over and absorbed for federal purposes that year from North Carolina source income in the numerator of the fraction used to calculate North Carolina taxable income for nonresidents and part-year residents. If the taxpayer is a nonresident or a part-year resident in both the year the net operating loss is incurred and the year to which the loss is carried, the taxpayer must determine the portion of the net operating loss that was from North Carolina sources. The numerator of the fraction is reduced by the attributable portion of the North Carolina source net operating loss while the denominator is reduced by the portion of the total net operating loss carried over and absorbed in that year for federal purposes.

> ***Example:*** A nonresident taxpayer incurs a net operating loss of $10,000 in 2009, $7,000 of which is from North Carolina sources. The portion of the net operating loss that is from North Carolina sources is .70 ($7,000 divided by $10,000). If the taxpayer carries the loss back to 2007 and deducts $4,000 in that year, the portion of that loss deemed to be from North Carolina sources and subtracted in determining the numerator of the fraction is $2,800 ($4,000 multiplied by .70). The denominator is reduced by the entire $4,000.

The North Carolina source net operating loss is apportioned to all years to which the total net operating loss is carried even if the taxpayer has no other North Carolina source income in those years to which the net operating loss may be applied.

4. Claiming a Net Operating Loss

a. Carrying back a net operating loss. – For federal tax purposes, a taxpayer carrying back a net operating loss may use Federal Form 1040X or, if a refund is due, Federal Form 1045. North Carolina does not have a form similar to Federal Form 1045; therefore, the

taxpayer must use Form D-400X to carry back the loss. A copy of Federal Form 1045, including Schedule A, must be provided for each year to which the loss is carried back. For any year in which the loss is carried back but not completely absorbed, a copy of Schedule B of Federal Form 1045 must also be provided. In lieu of Federal Form 1045, a worksheet containing the same information as Federal Form 1045 is acceptable.

b. Carrying a net operating loss forward. – For federal tax purposes, a taxpayer carrying a net operating loss forward reports the loss as "Other Income" on the federal return. A copy of Federal Form 1045, Schedule A, or similar worksheet identifying the year in which the net operating loss was incurred and showing how the net operating loss was calculated must be attached to each State return to which the loss is carried forward. For any year in which the loss is carried forward but not completely absorbed, a copy of the Worksheet for NOL Carryover included in Federal Publication 536 or a similar worksheet must also be provided.

c. Nonresidents and part-year residents. – A taxpayer who is a nonresident or part-year resident in the year to which a net operating loss is carried over must include a schedule showing the calculation of the amount subtracted in arriving at the numerator of the fraction used to determine North Carolina taxable income.

5. Statute of Limitations

For both State and federal tax purposes, the period of time in which a taxpayer may claim a refund resulting from the carryback of a net operating loss is extended beyond the general period of limitations for claiming a refund. The period of time for claiming a refund from the carryback of a net operating loss expires three years after the date the return is due, including extensions, for the year in which the loss is incurred, not the year to which the loss is carried. For example, a calendar year taxpayer who incurs a net operating loss in tax year 2009 and files the 2009 return by April 15, 2010, has until April 15, 2013 to file a claim for refund of taxes paid for the tax year 2007 because of the carryback of the net operating loss.

6. Calculation of Interest on Overpayments

Interest accrues on an overpayment of individual income tax from a date 45 days after the latest of the following dates: (1) the date the final return is filed; (2) the original due date of the return; or (3) the date of the overpayment, until the refund is paid. An overpayment resulting from the carryback of a net operating loss is considered to have occurred on the date the income tax return for the year in which the loss was incurred is filed or due to be filed, whichever is the later. Therefore, no interest accrues on the overpayment if refunded within 45 days of the date the tax return for the loss year is filed.

VI. Subject: Nonresidents and Part-Year Residents (G.S. 105-134.5(b)(c)(d))

1. Definition of Resident

G.S. 105-134.1(12) defines a resident as "an individual who is domiciled in this State at any time during the taxable year or who resides in this State during the taxable year for other than a temporary or transitory purpose."

Domicile is the place where an individual has a true, fixed permanent home and principal establishment, and to which place, whenever he is absent, he has the intention of returning. There are other definitions of domicile, and this definition is presented solely to be used as a guide in determining residency.

If an individual lives in North Carolina for more than 183 days of a tax year, he is presumed to be a resident for income tax purposes in the absence of factual proof to the contrary; but the absence of an individual from the State for more than 183 days raises no presumption that he is not a resident.

In many cases, a determination must be made as to when or whether a domicile has been abandoned. A long standing principle in tax administration, repeatedly upheld by the courts, is that an individual can have but one domicile; and, once established, it is not legally abandoned until a new one is established. A taxpayer may have several places of abode in a year, but at no time can an individual have more than one domicile. A mere intent or desire to make a change in domicile is not enough; voluntary and positive action must be taken.

Listed below are some of the tests or factors to be considered in determining the legal residence of an individual for income tax purposes. Some factors are more important than others, and fulfilling a few does not necessarily mean a change in domicile has occurred. As implied by the list of factors below, an individual's legal state of residence is reflected more by the routine events of life rather than events such as voting or obtaining a driver's license which may occur every four or five years.

a. Place of birth of the taxpayer, the taxpayer's spouse, and the taxpayer's children.
b. Permanent residence of the taxpayer's parents.
c. Family connections and close friends.
d. Address used for federal tax returns, military purposes, passports, driver's license, vehicle registrations, insurance policies, professional licenses or certificates, subscriptions for newspapers, magazines, and other publications, and monthly statements for credit cards, utilities, bank accounts, loans, insurance, or any other bill or item that requires a response.
e. Civic ties, such as church membership, club membership, or lodge membership.

f. Professional ties, such as licensure by a licensing agency or membership in a business association.
g. Payment of state income taxes.
h. Place of employment or, if self-employed, place where business is conducted.
i. Location of healthcare providers, such as doctors, dentists, veterinarians, and pharmacists.
j. Voter registration and ballots cast, whether in person or by absentee ballot.
k. Occasional visits or spending one's leave "at home" if a member of the armed services.
l. Ownership of a home, insuring a home as a primary residence, or deferring gain on the sale of a home as a primary residence.
m. Location of pets.
n. Attendance of the taxpayer or the taxpayer's children at State supported colleges or universities on a basis of residence–taking advantage of lower tuition fees.
o. Location of activities for everyday "hometown" living, such as grocery shopping, haircuts, video rentals, dry cleaning, fueling vehicles, and automated banking transactions.
p. Utility usage, including electricity, gas, telecommunications, and cable television.

Listed below are some of the events indicating when residency may have changed:

1. Selling a house and buying a new one.
2. Directing U.S. Postal Service to forward mail to a new address.
3. Transferring family medical records to a new health care provider.
4. Notifying senders of statements, bills, subscriptions, and similar items of new address.
5. Registering a vehicle in a new jurisdiction.
6. Transferring memberships for church, health club, lodge, or similar activity.
7. Applying for professional certifications in a jurisdiction.

A legal resident of North Carolina serving in the United States Armed Forces is liable for North Carolina income tax and North Carolina income tax should be withheld from his military pay whether he is stationed in this State or in some other state or country.

An individual who enters military service while a resident of North Carolina is presumed to be a resident of this State for income tax purposes. Residency in this State is not abandoned until a definite residence is established elsewhere.

To change residency, the serviceman must not only be present in the new location with the intention of making it his domicile, but must also factually establish that he has done so.

2. Nonresidents

The term "nonresident" includes an individual:

a. Who resides in North Carolina for a temporary or transitory purpose and is, in fact, a domiciliary resident of another state or country; or

b. Who does not reside in North Carolina but has income from sources within North Carolina and is, in fact, a domiciliary resident of another state or country.

Under the Servicemembers Civil Relief Act, a member of the Armed Services who is a legal resident of another state stationed in North Carolina by virtue of military orders, is not subject to North Carolina income tax on service pay but other income from employment, a business, or tangible property in North Carolina is subject to North Carolina income tax.

Military Spouses. The Military Spouses Residency Relief Act of 2009 amended the Servicemembers Civil Relief Act to provide that a spouse shall neither lose nor acquire domicile or residence in a state when the spouse is present in the state solely to be with the servicemember in compliance with the servicemember's military orders if the residence or domicile is the same for both the servicemember and the spouse.

Therefore, effective for tax years beginning on or after January 1, 2009, the income earned for services performed in North Carolina by a spouse of a servicemember who is legally domiciled in a state other than North Carolina is not subject to North Carolina income tax if (1) the servicemember is present in North Carolina solely in compliance with military orders; (2) the spouse is in North Carolina solely to be with the servicemember; and (3) the spouse is domiciled in the same state as the servicemember. All three of the conditions must be met to qualify for the exemption.

There is no presumption as to the residence of a spouse of a member of the armed forces because of marriage. Legal residence will be determined based on the facts in each case.

3. Part-Year Residents

An individual who moves his domicile (legal residence) into or out of North Carolina during the tax year, is a part-year resident.

4. Taxable Income of Nonresidents and Part-Year Residents

Nonresidents and part-year residents are required to prorate their federal taxable income to determine the portion that is subject to North Carolina tax.

The taxable income of a nonresident subject to North Carolina income tax is determined by multiplying federal taxable income as calculated under the Internal Revenue Code, as adjusted, by the percentage obtained when dividing the portion of total federal gross income, as adjusted, derived from North Carolina sources, by the total federal gross income, as adjusted.

The taxable income of a part-year resident subject to North Carolina tax is determined by multiplying the total federal taxable income as calculated under the Internal Revenue Code, as adjusted, by the percentage obtained when dividing the portion of total federal gross income received from all sources during the period the individual was a resident of North Carolina, plus any gross income received from North Carolina sources while a nonresident, by the total federal gross income, as adjusted.

A husband and wife who file a joint federal income tax return may file a joint State return even if one spouse is a nonresident and had no North Carolina income. However, the spouse required to file a North Carolina return has the option of filing the State return as married filing separately. If an individual chooses to file a separate North Carolina return, they must complete either a federal return as married filing separately reporting only their income, deductions, and exemptions, or a schedule showing the computation of their separate federal taxable income and attach it to their North Carolina return. In addition, a copy of the complete joint federal return must be included unless the federal return reflects a North Carolina address.

If an individual has income from sources within another state or country while a resident of North Carolina and the other state or country taxes the individual on such income, the individual may be eligible to claim a tax credit on the North Carolina income tax return.

A nonresident is not entitled to the tax credit for tax paid to another state or country.

5. Nonresident Members of Professional Athletic Teams

The North Carolina source income of a nonresident individual who is a member of a professional athletic team is determined by multiplying the individual's total compensation for services rendered as a member of a professional athletic team during the taxable year by a fraction, the numerator of which is the number of duty days spent in North Carolina rendering services for the team in any manner during the taxable year. The denominator is the total number of duty days spent both within and without North Carolina during the taxable year.

Travel days that do not involve either a game, practice, team meeting, promotional caravan or other similar team event are not considered duty days spent in North Carolina. However, such travel days are considered duty days spent within and without North Carolina.

In determining the North Carolina source income of a nonresident member of a professional athletic team, the following definitions apply:

a. The term "professional athletic team" includes, but is not limited to, any professional baseball, basketball, football, soccer or hockey team.

b. The term "member of a professional athletic team" includes those employees who are active players, players on the disabled list and any other persons required to travel and who do travel with and

perform services on behalf of a professional athletic team on a regular basis. This includes, but is not limited to, coaches, managers and trainers.

c. The term "duty days" means all days during the taxable year from the beginning of the professional athletic team's official preseason training period through the last game in which the team competes or is scheduled to compete.

Duty days also include days on which a member of a professional athletic team renders a service for a team on a date which does not fall within the aforementioned period. Such services include participation in instructional leagues, the "Pro Bowl" or promotional caravans. This includes days during the member's off-season where the member conducts training activities at the facilities of the team.

Duty days include game days, practice days, days spent at team meetings, promotional caravans and preseason training camps, and days served with the team through all post-season games in which the team competes or is scheduled to compete.

Duty days for any person who joins a team during the season begins on the day the person joins the team, and for any person who leaves a team ends on the day the person leaves the team. Where a person switches teams during the taxable year, a separate duty day calculation will be made for the period the person was with each team.

Days for which a member of a professional athletic team is not compensated and is not rendering services for the team in any manner, including days when the person has been suspended without pay and prohibited from performing any services for the team, are not treated as duty days.

Days for which a player is on the disabled list are presumed not to be duty days spent in North Carolina. However, such days are considered to be included in total duty days spent within and without North Carolina.

d. The term "total compensation for services rendered as a member of a professional athletic team" means the total compensation received during the taxable year for services rendered:

(1) from the beginning of the official preseason training period through the last game in which the team competes or is scheduled to compete during that taxable year; and

(2) for an event during the taxable year which occurs on a date which does not fall within the aforementioned period such as participation in instructional leagues, the "Pro Bowl" or promotional "caravans."

Such compensation includes, but is not limited to, salaries, wages, bonuses, and any other type of compensation paid during the taxable year for services performed in that year. Such compensation does not

include strike benefits, severance pay, termination pay, contract or option year buy-out payments, expansion or relocation payments, or any other payments not related to services rendered to the team.

e. "Bonuses" are included in "total compensation for services rendered as a member of a professional athletic team" and subject to allocation if they are:

   (1) earned as a result of play, such as performance bonuses, during the season, including bonuses paid for championship, playoff or "bowl" games played by a team, or for selection to all-star league or other honorary positions; and

   (2) paid for signing a contract, unless all of the following conditions are met:

      a. the payment of the signing bonus is not conditional upon the signee playing any games for the team, or performing any subsequent services for the team, or even making the team;

      b. the signing bonus is payable separately from the salary and any other compensation; and

      c. the signing bonus in nonrefundable.

Where the method for determining North Carolina source income does not fairly and equitably apportion and allocate the compensation of a nonresident member of a professional athletic team for services rendered in North Carolina, the Secretary of Revenue may require the person to apportion and allocate the compensation under another method prescribed by the Secretary as long as the prescribed method results in a fair and equitable apportionment and allocation. A nonresident member of a professional athletic team may submit a proposal for an alternative method to apportion and allocate the compensation, demonstrating that the method provided under this section does not fairly and equitably apportion and allocate the compensation. If approved, the proposed method must be fully explained in the North Carolina income tax return filed by the nonresident member.

See page 99 for the withholding requirements of professional athletic teams.

VII. Subject: S Corporations (G.S. 105-131 - G.S. 105-131.8)

1. Reporting Income – In General

An individual shareholder of an S corporation is required to take into account his pro rata share of an S corporation's net income in the manner provided under Section 1366 of the Internal Revenue Code subject to certain adjustments.

2. Resident Shareholders

Since 100 percent of the S corporation's income is included in the federal taxable income starting point, no adjustment because of doing business outside of North Carolina is required by a resident.

3. Nonresident Shareholders

A nonresident shareholder of an S corporation takes into account only his share of the S corporation's income attributable to North Carolina in the numerator of the fraction in determining that portion of federal taxable income that is taxable to North Carolina. If an S corporation does business in North Carolina and one or more other states, the income attributable to North Carolina is determined by the same apportionment formula as used for other corporations.

All nonresident shareholders must include an agreement with the first S corporation return filed with North Carolina agreeing to be liable and subject to the laws of North Carolina for individual income tax purposes; otherwise, the S corporation becomes liable for the tax on the income attributable to such nonresident shareholders at the rate for single individuals.

A nonresident shareholder in an S corporation may claim the proportionate share of the tax paid on his behalf by the S corporation to North Carolina on his share of the S corporation income.

4. Tax Credits

If part of the S corporation's income is earned within and taxed by another state or country, either to the individual or to the corporation, a resident shareholder is entitled to a tax credit on his individual income tax return for his share of the tax paid to the other state or country. A shareholder claiming the tax credit must attach a schedule to his income tax return reflecting the total amount of tax paid to the other state or country by the S corporation, and explaining how his pro rata share of the tax was determined. A separate tax credit must be calculated for each state or country to which the S corporation paid tax. Nonresident shareholders are not allowed credit for tax paid to another state or country.

A shareholder is subject to adjustments under G.S. 105-134.6 rather than being subject to both individual and corporate income tax adjustments, regardless of the shareholder's residency status or whether the income is attributable to North Carolina.

5. Basis in Stock

Due to different tax treatment of an S corporation's income for State and federal purposes for taxable years beginning before January 1, 1989, a shareholder's basis in the stock of an S corporation for State tax purposes may be different than for federal tax purposes; thereby requiring transitional adjustments in determining North Carolina taxable income upon receipt by the shareholder of distributions from the S corporation and upon disposition of the S corporation stock.

The initial basis of the stock in an S corporation to a nonresident of North Carolina is zero, and the nonresident shareholder is not taxed on distributions from the corporation and recognizes no income or loss upon disposition of the stock. A nonresident shareholder's basis in the S corporation stock is adjusted for his pro rata share of the income or loss of the corporation.

A resident shareholder's initial basis in the stock of an S corporation is determined as of the later of the date the stock is acquired, the effective date of the S corporation election, or the date the shareholder became a resident of North Carolina. A resident shareholder's basis in the stock is increased by his pro rata share of the corporation's income adjusted pursuant to G.S. 105-131.2 except for income exempt from federal or State income taxes and deductions for depletion in excess of the basis of the property being depleted. The basis is decreased by distributions to the extent deemed a return of basis; a pro rata share of the losses of the corporation as adjusted; nondeductible expenses of the corporation; and the amount of the shareholder's deduction for depletion of oil and gas wells to the extent the deduction does not exceed the proportionate share of the adjusted basis of that property allocated to the shareholder. The adjustments to the basis do not apply to tax periods beginning prior to January 1, 1989.

The aggregate amount of losses taken into account by the shareholder of an S corporation may not exceed the combined adjusted basis of the shareholder's stock and indebtedness of the corporation to the shareholder.

Example:

> A is a resident of North Carolina and his share of the loss of an S corporation for the tax year 1989 is $50,000. On January 1, 1989, A's basis in the S corporation stock for federal income tax purposes was $110,000, comprised of $40,000 initial cost plus his share of the undistributed income of the S corporation of $70,000. Since for federal tax purposes the loss does not exceed his basis, the $50,000 is allowed as a deduction in computing federal taxable income. For State tax purposes, his basis is the $40,000 initial cost since the prior year undistributed income is not included in his basis due to being for tax years prior to January 1, 1989. Therefore, the loss that A may take into account in determining his North Carolina taxable income is $40,000 and he is required to adjust federal taxable income by $10,000 ($50,000 total loss less $40,000 basis).

6. Distributions

A resident shareholder must take into account distributions from an S corporation in computing North Carolina taxable income to the extent the distributions are characterized as dividends or as gains pursuant to Section 1368 of the Internal Revenue Code. Section 1368 of the Code provides that if the S corporation has no accumulated earnings and profits, the amount distributed to a shareholder reduces the adjusted basis in his stock. If the distribution exceeds his basis, the excess is treated as a capital gain. If the S corporation has earnings and profits, the distribution is applied in the following order:

(1) To the Accumulated Adjustments Account (AAA) which basically includes the income during the period the corporation has been an S corporation reduced by its losses and distributions during that period. The AAA for State income tax purposes *does not* include the federal AAA for tax years beginning prior to January 1, 1989. The shareholder does not take into account distributions from the AAA in determining taxable income but such distributions reduce the adjusted basis of his stock.

(2) To Earnings and Profits (E and P): An S corporation is not considered to have earnings and profits for State tax purposes for years in which it operates as an S corporation after January 1, 1989. The E and P account basically includes the earnings and profits on hand from the period the corporation was a C corporation; and for State tax purposes, the E and P account also includes the undistributed earnings and profits of the S corporation from tax years beginning before January 1, 1989, (the federal AAA that existed on the day North Carolina began to measure the S corporation shareholder's income by reference to the income of the S corporation). The amount distributed to the shareholder from the E and P account is taxed to the shareholder as a dividend. Since the State E and P account includes the federal AAA that existed prior to the change in State law taxing the S corporation income to the shareholders, federal taxable income must be increased for any distributions from the federal AAA that existed prior to the law change.

(3) To the basis of the shareholder's stock. Any excess over the shareholder's basis is taxed as a capital gain.

A shareholder who makes an election for federal tax purposes to treat distributions from the S corporation as being paid first from earnings and profits may not make a different election for State purposes.

The following examples illustrate transitional adjustments required in determining North Carolina taxable income of a shareholder from distributions of S corporations:

(1) A North Carolina corporation chartered on January 1, 1986, elected to be taxed as an S corporation for federal income tax purposes. Taxpayer A invested $100,000 in the corporation; and at the end of the tax year 1988, A's pro rata share of the S corporation's

accumulated adjustments account for federal income tax purposes was $50,000. A's pro rata share of the S corporation's net income for the tax year 1989 was $20,000. The S corporation distributed $100,000 to A during the tax year 1989. In this case, A would include his $20,000 share of the S corporation's net income in his federal taxable income. For federal income tax purposes, A would not be taxed on any part of the $100,000 distribution since it is considered to have been paid from his accumulated adjustments account and reduces the basis of his stock.

Original investment	$100,000
Accumulated adjustments account at the end of 1989 ($50,000 plus $20,000)	70,000
Adjusted basis of stock at end of year	$170,000
Less: Distribution	100,000
Adjusted basis of stock as of January 1, 1990	$ 70,000

For State income tax purposes, the $50,000 accumulated adjustments account balance on December 31, 1988, is treated as additional earnings and profits and A's federal taxable income must be increased for any part of the distribution attributable to earnings and profits in determining North Carolina taxable income. The amount is determined as follows:

Investment in the corporation		$100,000
Pro rata share of 1989 earnings — accumulated adjustments account		20,000
Adjusted basis in stock at end of tax year		$120,000
Distributions	$100,000	
Applied to accumulated adjustments account	(20,000)	(20,000)
Balance of distribution	$ 80,000	
Earnings and profits	(50,000)	
Balance of distribution	$ 30,000	(30,000)
Basis in stock as of January 1, 1990		$ 70,000

The $50,000 from earnings and profits is a transitional adjustment and represents a dividend to the shareholder.

(2) Shareholders of a North Carolina C corporation elect to be taxed as an S corporation effective for the tax year beginning January 1, 1989. Taxpayer B, a resident of North Carolina, owned 4,000 shares of the corporate stock with a basis of $500,000 at the time of the election. At that time, B's pro rata share of the C corporation's undistributed earnings and profits was $800,000. During the tax year 1989, his pro rata share of the S corporation's earnings was

$50,000 and the corporation distributed $1,000,000 to B in 1989. In this case, B would include in federal taxable income his $50,000 pro rata share of the S corporation's net income and dividends of $800,000 representing his share of the undistributed earnings and profits accumulated during the period the corporation operated as a C corporation. His basis in the corporate stock for federal tax purposes would be reduced to $350,000 determined as follows:

Cost of stock		$500,000
1989 earnings — added to accumulated adjustments account		50,000
Basis before deductions		$550,000
Distributions	$1,000,000	
Applied to accumulated adjustments account	(50,000)	(50,000)
Balance	$ 950,000	
Applied to earnings and profits	(800,000)	
Balance of distribution	$ 150,000	(150,000)
Basis in stock as adjusted as of January 1, 1990		$350,000

No adjustment would be necessary in determining North Carolina taxable income since the State and federal accumulated adjustment account and the accumulated earnings and profit account are the same.

(3) Shareholders of a North Carolina C corporation elected to be taxed as an S corporation for federal income tax purposes effective January 1, 1986. At that time, taxpayer X owned 200 shares of the stock with a cost basis of $50,000. X's pro rata share of the C corporation's undistributed earnings and profits on January 1, 1986, was $20,000. His pro rata share of the earnings of the S corporation was $10,000; $5,000; ($10,000); and $15,000, respectively, for the tax years 1986, 1987, 1988 and 1989. No distributions were made to X in the tax years 1986 and 1988. Distributions were made to X of $10,000 in 1987 and $35,000 in 1989. In this case, X must include his pro rata share of the 1989 earnings of $15,000 in his 1989 federal taxable income. The part of the $35,000 distribution that is included in federal taxable income as a dividend is determined as follows:

Distributions in 1989		$35,000
Accumulated adjustments account —		
1986 share of income	$10,000	
1987 share of income	5,000	
1987 distribution	(10,000)	
1988 share of income (loss)	(10,000)	
Balance as of 12/31/88	(5,000)	
1989 share of income	15,000	
Total		10,000
Balance of distribution		$25,000
Applied to undistributed earnings while a C corporation (dividend)		20,000
Excess distribution applied to reduce basis		$ 5,000

For federal tax purposes, X must include the $20,000 distribution of earnings and profits in his federal taxable income as dividends. The adjustment required in computing his North Carolina taxable income is determined as follows:

Distributions in 1989		$35,000
Applied to accumulated adjustments account — (1989 share of income)		15,000
Balance of distribution		$20,000
Undistributed earnings and profits:		
Balance January 1, 1986	$20,000	
Federal accumulated adjustments account as of December 31, 1988	(5,000)	
Earnings and profits as adjusted for State tax purposes (treated as dividend)	15,000	(15,000)
Excess distribution applied to reduce basis		$ 5,000

X would be entitled to deduct $5,000 ($20,000 less $15,000) from his federal taxable income as a transitional adjustment in computing his North Carolina taxable income.

7. Losses

The amount of loss a shareholder may deduct is limited to the adjusted basis of the shareholder's stock, plus the adjusted basis of any loans owed to the shareholder by the corporation. The amount of the loss for the taxable period is figured before the shareholder's basis in the stock is adjusted for any distributions during the tax year. If the amount of the loss of a shareholder is limited because it exceeds the adjusted basis, the excess is treated as incurred by the corporation in the next tax year.

8. Foreign S Corporations

North Carolina income tax is required to be withheld from compensation paid to foreign S corporations for certain personal services performed in North Carolina. **(See XVI. Withholding From Nonresidents for Certain Personal Services.)** If the S corporation has obtained a certificate of authority from the Secretary of State, no tax is required to be withheld if the S corporation provides to the payer the S corporation's corporate identification number issued by the Secretary of State.

S Corporations may claim credit on the S corporation franchise and income tax return, Form CD-401S, for the portion of the tax withheld attributable to shareholders on whose behalf the corporation files a composite return. The portion of the tax withheld attributable to shareholders who are not part of a composite return must be allocated to those shareholders on Schedule K of the S corporation return.

VIII. Subject: Estates and Trusts (G.S. 105-160 - G.S. 105-160.8)

1. General

All income of an estate or trust is taxed to the fiduciary or the beneficiary. The conduit rules for taxing estates and trusts are applicable for North Carolina income tax purposes. Under the conduit rules, regardless of who is taxed, the income retains its same character as when received by the estate or trust.

A trust is neither a resident nor a nonresident. A trust's North Carolina income tax liability is determined based, in part, on the situs of the income beneficiaries, not where the trust was established or where the trustee lives. North Carolina law requires the tax to be computed on the taxable income of the estate or trust that is for the benefit of a resident of this State, or for the benefit of a nonresident to the extent that the income (1) is derived from North Carolina sources and is attributable to the ownership of any interest in real or tangible personal property in this State or (2) is derived from a business, trade, profession, or occupation carried on in this State.

2. Estates and Trusts Returns

The federal taxable income of the fiduciary is the starting point for preparing a North Carolina Income Tax Return for Estates and Trusts, Form D-407 and requires the same additions, deductions, and transitional adjustments to federal taxable income as required for individuals.

The fiduciary responsible for administering the estate or trust is responsible for filing the return and paying the tax. The fiduciary must file an income tax return for the estate or trust for which he acts if he is required to file a federal return for estates and trusts and (1) the estate or trust derives income from North Carolina sources or (2) the estate or trust derives any income which is for the benefit of a resident of North Carolina. **Exception:** With respect to grantor trust returns, North Carolina has access to the federal information contained in the federal grantor trust returns. Therefore, a State grantor trust return is not required to be filed when the entire trust is treated as a grantor trust for federal tax purposes.

The return is required to be filed on or before April 15 if on a calendar year basis and on or before the 15th day of the fourth month following the end of the fiscal year if on a fiscal year basis. If the return cannot be filed by the due date, the fiduciary may apply for an automatic six month extension of time to file the return. To receive the extension, the fiduciary must file Form D-410P, Application for Extension for Filing Partnership, Estate, or Trust Return, by the original due date of the return.

3. Payment of Tax

The tax rate for estates and trusts is the same as the tax rates for single individuals. (See the Tax Rate Schedule on page 5.)

The tax due on the estate and trust return is payable in full by the due date of the return.

4. Penalties

The penalty for failure to file an estate or trust return by the due date is 5 percent of the tax per month with a minimum of $5.00 and a maximum of 25 percent of the tax.

The penalty for failure to pay the tax by the due date is 10 percent of the tax with a minimum penalty of $5.00.

Other penalties for fraud, negligence, and criminal penalties for willful failure to comply with the income tax laws are similar to those applicable to individuals.

5. Allocation of Adjustments

The additions and deductions to federal taxable income of an estate or trust must be apportioned between the estate or trust and the beneficiaries based on the distributions of income made during the taxable year. Unless the trust instrument or will that created the estate or trust specifically provides for the distribution of certain classes of income to different beneficiaries, the apportionment of additions and deductions to the beneficiaries is determined on the basis that each beneficiary's share of the income for regular tax purposes from Schedule K-1, Federal Form 1041 relates to adjusted total income from Federal Form 1041. If the trust instrument or will specifically provides for the distribution of certain classes of income to different beneficiaries, any addition or deduction directly attributable to a particular class of income must be apportioned to the beneficiary to which that class of income is distributed. In allocating the adjustments, for State purposes the amount of income for regular tax purposes on Federal Schedule K-1 must be adjusted for distributions to the beneficiary which are not reflected in income for regular tax purposes. The adjusted total income on Federal Form 1041 must be adjusted (1) to exclude classes of income that are not part of the distribution to the beneficiary; (2) to include classes of income that are a part of the distribution to the beneficiary which are not included in adjusted total income; and (3) by any deduction treated differently for State and federal tax purposes that adjust federal taxable income pursuant to G.S. 105-134.6 and G.S. 105-134.7. After apportioning the additions and deductions to the beneficiaries, the balance is apportioned to the fiduciary.

6. Allocation of Income Attributable to Nonresidents

If the estate or trust has income from sources outside of North Carolina and if any of the beneficiaries are nonresidents of North Carolina, the portion of federal taxable income of the fiduciary that is subject to North Carolina tax must be determined. If there is no gross income from dividends, interest, other intangibles or from sources outside North Carolina for the benefit of a nonresident beneficiary, the total income of the estate or trust is taxable to the fiduciary.

The determination of the amount of undistributed income from intangible property which is for the benefit of a resident is based on the beneficiary's state of residence on the last day of the taxable year of the trust. In the

case of both resident and nonresident beneficiaries, the determination of the amount of undistributed income from intangible property which is for the benefit of a resident is made on the basis that the resident beneficiary's interest for the taxable year relates to the interest of both resident and nonresident income beneficiaries for the taxable year.

7. Tax Credits

Estates and trusts are allowed all tax credits allowed to individuals except for:

a. Tax credit for income taxes paid by individuals to other states or countries,
b. Tax credit for child and dependent care,
c. Tax credit for the disabled,
d. Tax credit for children,
e. Tax credit for charitable contributions by nonitemizers,
f. Tax credit for recycling oyster shells,
g. Tax credit for premiums paid on long-term care insurance contracts,
h. Tax credit for adoption expenses, and
i. Refundable earned income tax credit

Form D-407TC is used to report any tax credits claimed on an estate or trust return. The amounts reflected on Form D-407TC are the portions of the tax credits allocated to the trust or estate. A fiduciary required to pay an income tax to North Carolina for a trust for which he acts may claim a credit for tax imposed and paid to another state or country on income from sources within that state or country under the provisions of G.S. 105-160.4(a).

A resident beneficiary of an estate or trust, the fiduciary of which pays an income tax to another state or country on distributable income reportable to North Carolina which is derived from sources in the other state or country may claim a credit against his North Carolina income tax for his share of tax paid the other state or country under the provisions of G.S. 105-160.4(e).

Part 5 of Form D-407TC is to be used in computing the tax credit allowable to the estate or trust. Before this schedule may be completed however, there must be an allocation between the estate or trust and its beneficiaries of the tax paid and the gross income on which such tax was paid to the other state or country.

The fiduciary's share and each beneficiary's share of the gross income on which tax has been paid to another state or country is determined by the governing instrument and should be entered in the appropriate schedule on the return. The fiduciary's share of total gross income to be used in the tax credit computation schedule is the total gross income from Federal Form 1041.

IX. Subject: Partnerships (G.S. 105-154)

1. General

The partnership's taxable income determined under the Internal Revenue Code is the starting point for preparing the North Carolina partnership income tax returns. The same additions, deductions, and transitional adjustments to federal taxable income required for individuals apply to partnerships.

2. Partnership Returns

A North Carolina partnership return (Form D-403), must be filed by every partnership doing business in North Carolina if a federal partnership return was required to be filed. The return of a partnership on a calendar year basis is due on or before April 15 following the close of the calendar year. If on a fiscal year basis, the return must be filed on or before the 15th day of the fourth month following the close of the fiscal year. If the partnership return cannot be filed by the due date, the partnership may apply for an automatic six month extension of time to file the return. To receive the extension, the partnership must file Form D-410P, Application for Extension for Filing Partnership, Estate, or Trust Tax Return, by the original due date of the return.

The return should include the names and addresses of the individuals entitled to share in the net income of the partnership and should be signed by the managing partner and the individual preparing the return. For individual income tax purposes, the term "business carried on in this State" means the operation of any activity within North Carolina regularly, continuously, and systematically for the purpose of income or profit. A sporadic activity, a hobby, or an amusement diversion does not come within the definition of a business operation in this State. Income from an intangible source which is received in the course of a business operation in this State so as to have a taxable situs here (including such income which is included in the distributive share of partnership income, whether distributed or not) is included in the numerator of the fraction used in determining the portion of federal taxable income that is taxable to North Carolina by a nonresident.

3. Schedule NC K-1

Schedule NC K-1 is used by the partnership to report each partner's share of the partnership's income, adjustments, tax credits, tax paid, etc. The NC K-1 must reflect the net tax paid by the partnership. The partnership must provide a completed Schedule NC K-1, or other schedule containing the same information, to each entity or person who was a partner in the partnership at any time during the year. This schedule must be provided to each partner on or before the day on which the partnership return is required to be filed. When reporting the distributive share of tax credits, a list of the amount and type of tax credits should be provided each partner.

4. Penalties

The penalty for failure to file a partnership return on which tax is due on or before the due date is 5 percent of the tax for each month, or part of a month, the return is late. The minimum penalty is $5.00; the maximum penalty is 25 percent of the unpaid tax. If a partnership does not pay the tax due on or before the original due date of the return, a late payment penalty of 10 percent of the unpaid tax (minimum $5.00) is due. If the partnership has a valid extension of time for filing the return, a 10 percent late payment penalty will apply on the remaining balance due if the tax paid by the original due date is less than 90 percent of the total tax due. In addition, penalties are provided by law for willful failure to file a return on time and for willful attempt to evade or defeat the tax.

5. Nonresident Partners

When an established business in North Carolina is owned by a partnership having one or more nonresident members, the managing partner is responsible for reporting the share of the income of each nonresident partner and is required to compute and pay the tax due, including any surtax due, on behalf of those partners. If the nonresident partner is a corporation, partnership, trust or estate, the managing partner is not required to pay the tax on that partner's share of the partnership income provided the partner files **Form NC-NPA, Nonresident Partner Affirmation.** Form NC-NPA affirms that the partner will pay the tax with its corporation, partnership, trust or estate income tax return. In such cases, a copy of Form NC-NPA must be attached to the partnership return when it is filed. (Note: This provision does not extend to grantor trusts because no tax is paid on grantor trust returns.) The tax rate is the same as the tax rate for single individuals. (See the Tax Rate Schedule on page 5.) Payment of the tax due by the managing partner on behalf of corporations, partnerships, trusts and estates that are partners does not relieve the partner from filing a North Carolina income tax return; however, credit for the tax paid by the managing partner may be claimed on the income tax return. Although a partnership may treat guaranteed payments to a partner for services or for use of capital as if they were paid to a person who is not a partner, such treatment is only for purposes of determining its gross income and deductible business expenses. For other tax purposes, such guaranteed payments are treated as a partner's distributive share of ordinary income. In determining the allowable North Carolina deductions from federal taxable income, do not include a partner's salary, interest on a partner's capital account, partner relocation and mortgage interest differential payments, or payments to a retired partner regardless of whether they were determined without regard to current profits. These types of payments are treated as part of the partner's share of the partnership income.

A nonresident individual partner is not required to file a North Carolina individual income tax return when the only income from North Carolina sources is the nonresident's share of income from a partnership doing business in North Carolina and the manager of the partnership has paid the tax due for the nonresident individual partner. A nonresident individual

partner may file an individual income tax return and claim credit for the tax paid by the manager of the partnership if the payment is properly identified on the individual income tax return.

In determining the tax due for nonresident partners, a partnership must apportion to North Carolina the income derived from its activities carried on within and outside North Carolina that are not segregated from its other business activities. A partnership's business activities are not segregated if it does not employ a method of accounting that clearly reflects the income or loss of its separate activities. A partnership must allocate to North Carolina the income derived from business activities in North Carolina that are segregated from its other business activities. Income derived from a partnership's business activities outside of North Carolina that are segregated from its other business activities are not includable in determining the tax due for nonresident partners. This allocation of income does not affect the partnership income of a resident partner because each partner is taxed on the share of the net income of the partnership whether or not any portion of it is attributable to another state or country.

Publicly Traded Partnerships: Effective for tax years beginning on or after January 1, 2008, a publicly traded partnership as described in Section 7704 of the Internal Revenue Code is required to file an information return only for those nonresident partners whose distributive share of the partnership net income for the tax year is more $500. The return should list the partner's name, address, taxpayer identification number, and the partner's share of income from the partnership for the tax year. A publicly traded partnership is not required to pay the tax on behalf of the nonresident partners.

6. Disposition of Partner's Interest

An interest in a partnership is intangible personal property. Nonresident partners do not include the gain from the sale of their interest in a partnership in the numerator of the fraction unless the sale of the partnership interest conveys title to specific partnership property. If a partnership owning an interest in another partnership sells its interest in that partnership, the nonresident partners do not include their distributive shares of the gain realized by the partnership from the sale of its partnership interest in the numerator unless the partnership selling its interest is carrying on a trade or business in this State.

Nonresident partners must include their distributive shares of the gains or losses from the sale or other disposition of the partnership's assets in the numerator of the fraction in determining North Carolina taxable income. If the sale of partnership interests conveys title to specific partnership property instead of to limited interests in the partnership, the transaction will be considered as a sale of partnership assets for purposes of determining North Carolina taxable income.

7. Part-Year Residents

Part-year residents with distributive income from a partnership doing business in North Carolina and in one or more other states must prorate

their shares of the partnership's income attributable and not attributable to North Carolina between their periods of residence and nonresidence in accordance with the number of days in each period. The amount required to be included in the numerator of the fraction for determining taxable income is the taxpayer's share of partnership income determined for the period of residence plus the taxpayer's share of the partnership income attributable to North Carolina during the period of nonresidence.

8. Estimated Income Tax

No estimated income tax is required of a partnership. Resident individual partners who meet statutory requirements must pay estimated income tax on Form NC-40. Nonresident individual partners are not required to pay estimated tax on their distributive share of partnership income.

9. Interest Income Passed Through to Partners

Although the interest income passed through to a partner in a partnership retains its same character as when received by the partnership, the expenses incurred in earning such income are deductible by the partnership and net interest income after expenses is reflected in the partner's pro rata share of the income of the partnership. For interest income subject to federal income tax, the partner's federal gross income reflects the net interest income after expenses incurred in earning the income. Interest income not subject to federal income tax is not reflected in the partner's federal taxable income. In these cases, a partner must adjust federal taxable income as required by G.S. 105-134.6(b) or G.S. 105-134.6(c), for the net amount of interest attributable to the partnership.

10. Income Tax Credits of Partnerships

A partnership may pass through to each of its partners the partner's distributive share of an income tax credit for which the partnership qualifies. Any dollar limit on the amount of a tax credit applies to the partnership as a whole instead of to the individual partners. The maximum dollar limits and other limitations that apply in determining the amount of tax credit available to a taxpayer apply to the same extent in determining the amount of tax credit for which the partnership qualifies, except the limitation that the tax credit cannot exceed the tax liability of the taxpayer.

11. Limited Liability Companies

The "North Carolina Limited Liability Company Act" (Chapter 57C of the North Carolina General Statutes) permits the organization and operation of limited liability companies. A limited liability company is a business entity that combines the S corporation characteristic of limited liability with the flow-through features of a partnership. Limited liability companies are subject to State taxation according to their classification for federal income tax purposes; therefore, if a limited liability company is classified as a partnership for federal income tax purposes, the company and its members are subject to tax to the same extent as a partnership and

its partners and is required to file a North Carolina partnership return.

A limited liability company may be organized by a single member by delivering executed articles of organization to the Secretary of State.

12. Foreign Partnerships

North Carolina income tax is required to be withheld from compensation paid to foreign partnerships for certain personal services performed in North Carolina. **(See XVI. Withholding From Nonresidents for Certain Personal Services.)** If the partnership has a permanent place of business in North Carolina, no tax is required to be withheld if the partnership provides to the payer the partnership's address and taxpayer identification number.

Partnerships may claim credit on the partnership income tax return, Form D-403, for the portion of the tax withheld attributable to nonresident partners on whose behalf the managing partner pays tax. The portion of the tax withheld attributable to resident partners or nonresident partners that have provided an affirmation to the managing partner (see Nonresident Partners on page 49) must be allocated to those partners on Schedule NC K-1.

13. Investment Partnerships

A partnership whose only activity is as an investment partnership is not considered to be doing business in North Carolina. An investment partnership is a partnership that is not a dealer in securities, as defined in section 475(c)(1) of the Internal Revenue Code, and that derives income exclusively from buying, holding, and selling securities for its own account. If any of the partnership's income consists of ordinary operating income whether from direct activities or flowing through from other partnerships, the partnership is not considered an investment partnership for North Carolina tax purposes.

An investment partnership is not required to file an income tax return in North Carolina or pay income tax to North Carolina on behalf of its nonresident partners.

X. Subject: Taxable Status of Distributions from Regulated Investment Companies

1. General

Distributions received from regulated investment companies (mutual funds) by a shareholder who was a North Carolina resident must be included in North Carolina taxable income to the same extent included in the shareholder's federal taxable income; except that (1) an amount not included in federal gross income which was determined to be an "exempt interest dividend" for federal income tax purposes, must be added to federal taxable income to the extent it represents interest on obligations of states other than North Carolina and their political subdivisions, and (2) an amount included in federal gross income which represents interest received from direct obligations of the United States or its possessions must be deducted from federal taxable income.

Distributions from a regulated investment company other than "capital gain distributions" and "exempt interest dividends" are included in federal taxable income in the same manner as distributions of other corporations. Distributions from earnings and profits are ordinary dividends (taxable dividends) unless the mutual fund notifies the taxpayer to the contrary.

Capital gain distributions are paid by mutual funds from their net realized long-term capital gains. Individuals receiving a capital gain distribution must report the distribution as a long-term capital gain on their federal income tax return.

2. Exempt Interest Dividends

A mutual fund is qualified to pay exempt interest dividends only if at the close of each quarter of its taxable year at least 50 percent of the value of the total assets of the company consisted of state and local bonds, the interest from which is exempt from federal income tax and certain other obligations on which the interest is exempt from federal income tax under provisions of federal law other than the Internal Revenue Code, as those provisions of the law were in effect on January 6, 1983. A mutual fund paying exempt interest dividends to its shareholders must send its shareholders a statement within 60 days after the close of the taxable year showing the amount of exempt interest dividends. The exempt interest dividends are not required to be included in federal taxable income.

Since interest from states other than North Carolina and their political subdivisions is required to be added to federal taxable income in calculating North Carolina taxable income, the exempt interest dividends received from mutual funds must be added to federal taxable income to the extent such dividends *do not* represent interest from bonds issued by North Carolina and political subdivisions of North Carolina, Guam, Puerto Rico, and the United States Virgin Islands, including the governments thereof and their agencies, instrumentalities and authorities, provided the mutual fund furnishes a supporting statement to the taxpayer. In the

absence of such statement, the total amount designated as exempt interest must be added to federal taxable income in computing the taxpayer's North Carolina taxable income.

3. Ordinary Dividends

Interest in the form of dividends from regulated investment companies (mutual funds, investments, etc.) is deductible from an individual's federal taxable income to the extent the distributions represent interest on direct obligations of the United States Government. The fund must furnish the taxpayer a statement verifying the amount of interest paid to him which accrued from direct obligations of the United States Government. Interest earned on obligations that are merely backed or guaranteed by the United States Government will not qualify for the deduction. Further, this deduction does not apply to distributions which represent gain from the sale or other disposition of the securities nor to interest paid in connection with repurchase agreements issued by banks and savings and loan associations.

The taxpayer may not deduct mutual fund dividends on the basis of a percentage of investments held by the fund (i.e., a fund has 75 percent of its investments in United States Treasury Notes). The statement to support the deduction must specify the amount received by the taxpayer which represents interest on direct obligations of the United States Government.

This procedure will also apply with respect to interest on obligations of the State of North Carolina and any of its political subdivisions to the extent included in federal taxable income.

4. Capital Gain Distributions

The portion of distributions from a regulated investment company that represents capital gain is reportable on the federal income tax return as capital gain income and not dividend income. Therefore, under G.S. 105-134.6(b)(2) capital gain distributable to a shareholder who is a resident of North Carolina and attributable to the sale of an obligation issued before July 1, 1995, the profit from which is exempt by North Carolina statute is deductible from federal taxable income in determining the North Carolina taxable income of an individual, trust or estate.

XI. Subject: Tax Credits

1. Credit for Corporate Tax Paid by S Corporation to Another State or Country (G.S. 105-131.8)

Credit is allowed to a resident shareholder for his share of the corporate tax paid by an S corporation to another state or country that taxes the corporation rather than the shareholder on the S corporation's income, or the computed credit, whichever is less.

If credit is claimed for the shareholder's part of the corporate tax paid, a schedule must be attached to the North Carolina return showing the total tax paid by the S corporation and how the pro rata share of the tax was determined. A separate tax credit must be calculated for each state or country to which the S corporation paid tax.

2. Credit for Income Tax Paid to Another State or Country (G.S. 105-151)

A tax credit is allowed to an individual who is a resident of North Carolina for tax imposed by and paid to another state or country on income that is also taxed by North Carolina, subject to the following conditions:

a. The income must have been derived from sources in the other state or country and must have been taxed under the laws of that state or country, regardless of the legal residence of the taxpayer.

b. The credit allowable is the smaller of either the net tax paid the other state or country on income also taxed by North Carolina or the product obtained by multiplying the North Carolina tax computed before credit by a fraction in which the numerator is the part of the North Carolina income, as adjusted, which is taxed in the other state or country and the denominator is the total income as adjusted, received while a resident of North Carolina. If credits are claimed for taxes paid to more than one state or country, a separate computation must be made for each state or country and the separate credits combined to determine the total credit.

c. Receipt or other proof showing payment of income tax to the other state or country and a true copy of the return filed with the other state or country must be submitted with the North Carolina return. No credit is allowed for income taxes paid to a city, county, or other political subdivision of a state or country or to the federal government.

d. If any tax for which a resident has claimed a tax credit on the North Carolina income tax return is refunded at any time by the other state or country, a tax equal to that portion of the credit allowed for the taxes credited or refunded must be paid to North Carolina within thirty days of the date of receipt of this refund or notice of the credit.

The tax credit allowed to a North Carolina resident is determined as follows:

$$\frac{\text{Portion of total federal income while a resident of N.C., as adjusted, that was taxed by another state or country}}{\text{Total federal income while a resident of N.C., as adjusted}} \times \text{N.C. income tax} = \text{Tax credit}$$

After making the computation by use of this formula, the tax credit allowed is either the credit obtained by use of the formula or the actual amount of net income tax paid to the other state or country, whichever is the smaller.

Example 1: A full-year resident of North Carolina files a 2009 North Carolina return as a single individual. His total income is $37,000. He worked temporarily in South Carolina, earning $5,000 on which he paid tax of $131 to South Carolina. The taxpayer claimed the standard deduction in computing his federal taxable income of $27,650. The credit against his North Carolina income tax is determined as follows:

Federal taxable income	$	27,650
State standard deduction and personal exemption adjustment.....		3,850
North Carolina taxable income	$	31,500
North Carolina tax due	$	2,079

Less tax credit:

$$\frac{\text{Portion of total federal income, while a resident of N.C., as adjusted, taxed by another state } \$\ 5{,}000}{\text{Total federal income, as adjusted, while a resident of N.C. } \$37{,}000} \times 2{,}079 = \$\ 281$$

Since the $131 tax paid to South Carolina is less than the computed tax credit of $281, the allowable tax credit is the actual tax paid to South Carolina.....	$	131
N.C. tax due.....	$	1,948

Example 2: A husband and wife are both residents of North Carolina and file a joint 2009 North Carolina income tax return. Their total income is $40,000, $5,500 of which was received from rental property, owned jointly, in Virginia. A total of $2,000

was received by the husband for temporary employment in South Carolina. The taxpayers claimed the standard deduction in computing their federal taxable income of $21,300. They paid tax of $290 on the income earned in Virginia and the husband paid tax of $102 on the income reported to South Carolina. The credit against their North Carolina income tax is determined as follows:

Federal taxable income		$21,300
State standard deduction and personal exemption adjustment.....		7,700
North Carolina taxable income		$29,000
North Carolina tax due		$1,819
Less tax credit:		
Portion of total federal income while a resident of N.C., as adjusted, taxed by Virginia	$5,500 x 1,819 = $ 250	
Total federal income, as adjusted, while a resident of N.C.	$40,000	
Portion of total federal income while a resident of N.C., as adjusted, taxed by South Carolina	$2,000 x 1,819 = $ 91	
Total federal income, while a resident of N.C., as adjusted	$40,000	
Total credit.....		$ 341
Net North Carolina tax due		$ 1,478

The computed credits are allowed since each is less than the amount paid to the other state.

Example 3: Taxpayer, a single man, became a North Carolina resident on June 1. Prior to moving to North Carolina, he earned $4,000 in South Carolina. From June 1 through December 31, he earned $6,000 in South Carolina and $10,000 in North Carolina. He paid income tax to South Carolina of $400 on the $10,000 South Carolina income. The taxpayer claimed the standard deduction in computing his 2009 federal taxable income of $10,650. His tax credit is determined as follows:

Federal taxable income				$ 10,650
State standard deduction and personal exemption adjustment.....				3,850
North Carolina taxable income before part-year resident adjustment.....				$ 14,500
Total federal income, as adjusted, while a N.C. resident plus total income from N.C. sources while a nonresident as adjusted	$16,000	x	$14,500 =	$11,600
Total federal income from all sources, as adjusted	$20,000			N.C. taxable income
North Carolina taxable income.....				$ 11,600
North Carolina tax on $11,600 taxable income.....				$ 698
Less tax credit:				
Portion of total federal income, while a N.C. resident, as adjusted, taxed by S.C.	$ 6,000	x	$698 =	$262*
Total federal income while a N.C. resident, as adjusted	$16,000			N.C. tax

(*The computed credit is determined only with respect to income while taxpayer is a resident of North Carolina.)

S.C. income taxed by N.C.	$ 6,000	x	$400 =	$240**
Total S.C. income	$10,000			S.C. tax

Since the $240 tax paid to South Carolina on income also taxed by North Carolina is less than the $262 computed credit, the allowable credit is	$ 240
Net tax due North Carolina	$ 458

(**Since a part of the tax paid South Carolina was on income not taxed by North Carolina, this computation is necessary to determine that portion of the South Carolina tax that was paid on income also taxed by North Carolina.)

3. Handicapped Dwelling Units (G.S. 105-151.1)

A tax credit of $550.00 for each dwelling unit completed during the taxable year is allowable to an owner who constructs multi-family rental units located in North Carolina which conform to Volume I-C of the North Carolina Building Code. To receive the credit the taxpayer must

attach a copy of the occupancy permit on which the building inspector has recorded the number of units completed during the year. If the credit exceeds the tax liability for the year reduced by all other credits, the excess may be carried over only to the succeeding tax year.

4. Child and Dependent Care Expenses (G.S. 105-151.11)

A tax credit is allowable for the employment-related expenses for child and dependent care if an individual is entitled to claim an income tax credit for child and dependent care expense on their federal return. The credit is calculated on the net qualified federal employment-related expenses after reduction for any employer-paid dependent care assistance that is excluded from federal gross income. The maximum employment related expenses on which the credit is based is equal to the expenses allowed for federal purposes: $3,000 for one dependent and $6,000 for two or more dependents.

In the case of a married couple that file a joint federal return when only one spouse files a North Carolina return, that spouse calculates the amount of expenses used to determine the credit by multiplying total qualified expenses by the ratio of that spouse's total income to the total income of both spouses. For dependents who were seven years old or older and not physically or mentally incapable of caring for themselves, the credit is from 7 percent to 9 percent of the net qualified federal employment-related expenses depending on filing status and federal adjusted gross income as shown in the following table.

For dependents who were under the age of seven and dependents who were physically or mentally incapable of caring for themselves, the credit is from 10 percent to 13 percent of the net qualified federal employment-related expenses depending on filing status and federal adjusted gross income as shown in the following table. An individual who is not able to dress, clean, or feed himself because of a physical or mental condition is not able to care for himself. Individuals with mental conditions who require constant attention to prevent them from injuring themselves or others are considered to be unable to care for themselves.

For a dependent who reaches age 7 during the taxable year and who is *not* physically or mentally incapable of caring for himself, the tax credit for employment-related expenses incurred prior to the dependent's 7th birthday will be calculated by using the applicable percentage in column A, and the tax credit for employment-related expenses incurred after the dependent becomes age 7 will be calculated by using the applicable percentage in column B.

A nonresident or part-year resident is allowed a prorated credit based on the percentage of the taxpayer's total income that is taxable for North Carolina income tax purposes.

Filing Status	Federal AGI	Column A	Column B
Head of Household	Up to $20,000	13%	9%
	Over $20,000 up to $32,000	11.5%	8%
	Over $32,000	10%	7%
Married Filing Jointly or Qualifying Widow(er)	Up to $25,000	13%	9%
	Over $25,000 up to $40,000	11.5%	8%
	Over $40,000	10%	7%
Single	Up to $15,000	13%	9%
	Over $15,000 up to $24,000	11.5%	8%
	Over $24,000	10%	7%
Married Filing Separately	Up to $12,500	13%	9%
	Over $12,500 up to $20,000	11.5%	8%
	Over $20,000	10%	7%

5. Real Property Donated for Public Purposes (G.S. 105-151.12)

A credit is allowed for donating interests in real property located in North Carolina to the State, local government, or other qualified organization. To qualify for the credit the property must be certified by the Department of Environment and Natural Resources as useful for public beach access or use, public access to public waters or trails, fish and wildlife conservation, forestland or farmland conservation, watershed protection, conservation of natural areas, conservation of natural and scenic river areas, conservation of predominately natural parkland, or historic landscape conservation. An individual is allowed a credit of 25 percent of the fair market value of the interest donated but may not exceed $250,000. In the case of property owned by a married couple filing a joint return, the maximum credit for real property donations is $500,000. An individual who donates multiple properties in the same year is entitled to a separate credit for each donation. However, all donations in one year are combined into one credit calculation for that tax year and may not exceed $250,000 ($500,000 in the case of property owned by a married couple filing a joint return). The tax credit may not exceed the tax liability for the tax year, reduced by other tax credits. Any unused credit can be carried forward for the next succeeding five years. Although $250,000 is the maximum credit allowable for all donations in one year ($500,000 in the case of property owned by a married couple filing a joint return), an individual may claim more than $250,000 if the amount in excess of $250,000 is an unused credit carried over from a previous year. For example, an individual is entitled to the maximum credit of $250,000 and is also entitled to carry over an unused credit of $30,000 from the previous year. Therefore, the allowable credit for the current tax year is $280,000.

To be eligible for the credit, the interest in the property must be donated in perpetuity to and accepted by the State, a local government, or a body that is both organized to receive and administer lands for conservation

purposes and qualified to receive charitable contributions under the Internal Revenue Code. To support the credit, a certification by the Department of Environment and Natural Resources that the donated property is suitable for one or more of the valid public benefits described above and a self-contained or summary appraisal report must be filed with the individual income tax return. For fee simple absolute donations of real property, the taxpayer may provide documentation of the county's appraised value of the property, as adjusted by the sales assessment ratio, in lieu of an appraisal report.

Effective for tax years beginning on or after January 1, 2007, with respect to a credit claimed by a partnership, a $500,000 maximum credit limitation applies to the partnership as a whole instead of each partner. Consequently, each partner is allowed a credit equal to the partner's allocated share of the credit, not to exceed $250,000. Prior to January 1, 2007, the $250,000 limitation applied to each partner instead of the partnership as a whole.

If an owner's share of pass-through entities credit is limited due to the maximum allowable credit for a taxable year, the pass-through and its owners may not reallocate the unused credit among the owners.

Example: In 2007, a partnership consisting of five partners (each a 20% partner) donated qualifying North Carolina real property to the State with a fair market value of $6,000,000. The total credit allowed to the partnership is allocated as follows:

Total tax credit before limitation	$1,500,000 ($6,000,000 x 25%)
Maximum total tax credit	$ 500,000
Tax credit allocated to each partner	$ 100,000 ($500,000 x 20%)

Marshland for which a claim has been filed pursuant to G.S. 113-205 pertaining to grants in navigable waters of coastal counties of North Carolina, will not qualify for this credit unless the offer of donation was made before December 31, 2003.

In the case of property owned by a married couple where both spouses are required to file North Carolina income tax returns, the credit is allowed only if the couple files a joint return. If only one spouse is required to file a North Carolina return, that spouse may claim the credit on a separate return.

6. Conservation Tillage Equipment (G.S. 105-151.13)

A credit is allowable for the purchase of certain conservation tillage equipment for use in a farming business, including tree farming, for 25 percent of the cost of the equipment up to a maximum credit of $2,500 for any income year. Qualifying conservation tillage equipment is (1) a planter designed to minimize disturbance of the soil in planting crops or trees, including equipment that may be attached to equipment already owned by the taxpayer, or (2) equipment designed to minimize disturbance of the soil in reforestation site preparation, including equipment that may be attached to equipment already owned by the taxpayer; provided, however, this shall include only those items of equipment generally known as a 'KG-Blade', and 'drumchopper', or a 'V-Blade'.

The credit may be claimed only by the first purchaser of the equipment and may not be claimed by a person who purchases the equipment for use outside of North Carolina. Any excess credit may be carried forward for the next succeeding five years. The basis in any equipment for which a credit is allowed must be reduced by the amount of credit.

7. Gleaned Crops (G.S. 105-151.14)

A credit is allowable for unharvested crops which are donated by a grower to a qualified charitable organization. The credit is 10 percent of the season average price of the crop as determined by the North Carolina Crop and Livestock Reporting Service in the North Carolina Department of Agriculture and Consumer Services or the average price of the crop in the nearest local market for the month in which the crop is gleaned if the Crop and Livestock Reporting Service does not determine the season average price. Any unused portion of the credit can be carried forward to the next succeeding five years.

If the tax credit is claimed, the amount of the market price of the donated crops must be added to federal taxable income in determining North Carolina taxable income.

8. Credit for Disabled Taxpayer, Dependent or Spouse (G.S. 105-151.18)

A tax credit equal to one-third of the amount of the federal tax credit allowed under the Internal Revenue Code is allowed to an individual who is permanently and totally disabled. Although the federal tax credit is allowed for being 65 or older, no portion of the tax credit is allowed on the North Carolina return for being 65 or older.

A tax credit is also allowed to a taxpayer who is allowed an exemption under the Internal Revenue Code for a totally and permanently disabled dependent or spouse. To claim the credit, a statement from a physician or local health department must be attached to the return certifying that the dependent was unable to engage in any substantial gainful activity by reason of a physical or mental impairment that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not less than 12 months. The allowable credit is determined by completing Form D-429, "Worksheet for Determining the Credit for the Disabled Taxpayer, Dependent, or Spouse."

A taxpayer who claims the tax credit for being permanently and totally disabled may also be eligible to claim the tax credit for a permanently and totally disabled dependent or spouse for whom the taxpayer claimed an exemption under the Internal Revenue Code.

A nonresident or part-year resident is allowed the tax credit for a disabled taxpayer and the tax credit for a disabled dependent or spouse in the proportion that federal taxable income (as adjusted) is taxable to North Carolina.

9. Farm Machinery (G.S. 105-151.21)

A credit of up to $1,000 is allowable to an individual engaged in the business of farming for the amount of property tax paid during the

taxable year on farm machinery or attachments and repair parts for farm machinery. Farm machinery is defined as machinery that is exempt from State sales tax under G.S. 105-164.13(1b). The credit may not exceed the tax liability for the year, reduced by other tax credits. To support the credit, you must attach a copy of the tax receipt for the property taxes for which the credit is claimed.

10. Credit for the Use of North Carolina Ports (G.S. 105-151.22)

A tax credit is allowed for a portion of the wharfage, handling, and throughput charges for importing goods to and exporting goods from the North Carolina ports of Morehead City and/or Wilmington. The credit is equal to the amount of increase in charges in the current year over the average of charges paid in the current and previous two years without consideration of the free-on-board cargo terms under which the cargo is moved. The credit is limited to 50 percent of the current year's tax and any unused credit can be carried over for the next five years. A taxpayer's maximum accumulated credit is $2,000,000. To obtain the credit, the taxpayer must include with the return a statement from the State Ports Authority certifying the amount of charges paid by the taxpayer for which the credit is claimed. The credit expires for taxable years beginning on or after January 1, 2014.

11. Credit for Children (G.S. 105-151.24)

A tax credit of $100 for each dependent child is allowable to an individual who is entitled to claim a child tax credit on the federal return if the individual's federal adjusted gross income is less than the amount shown in the chart below.

Filing Status	Adjusted Gross Income
Married filing jointly	$100,000
Head of household	$ 80,000
Single	$ 60,000
Married filing separately	$ 50,000

The credit for children can be claimed only for a child who was under 17 years of age on the last day of the tax year.

A nonresident or part-year resident is allowed the tax credit for children in the proportion that federal taxable income (as adjusted) is taxable to North Carolina.

12. Credit for Construction of a Poultry Composting Facility (G.S. 105-151.25)

A tax credit is allowed to a taxpayer for constructing a poultry composting facility in North Carolina for the composting of poultry carcasses from commercial poultry operations. The credit is equal to 25 percent of the installation, materials, and equipment costs of construction paid during the taxable year, not to exceed $1,000 for any single installation. That portion of construction costs represented by State or federal agency provided funds cannot be used in determining the credit.

The credit may not exceed the tax liability for the year, reduced by

other credits and any unused credit may not be carried over to another tax year.

13. Credit for Charitable Contributions by Nonitemizers (G.S. 105-151.26)

A tax credit for charitable contributions is allowed to an individual who elects the standard deduction on the federal income tax return. The credit is not allowed to an individual who claims itemized deductions on the federal return. The credit equals 7 percent of the contributions for the taxable year which exceed 2 percent of the individual's federal adjusted gross income. The credit may not be claimed for contributions for which credits for certain real property donations, gleaned crops, or recycling oyster shells are claimed. Nonresidents and part-year residents may claim a prorated credit equal to the percentage of income that is subject to North Carolina tax.

The credit may not exceed the tax liability for the year, reduced by other credits. Any unused credit may not be carried over to another tax year.

14. Credit for Premiums Paid on Long-Term Care Insurance Contracts (G.S. 105-151.28)

A credit for premiums paid on long-term care insurance contracts was originally effective for taxable years beginning on or after January 1, 1999 and was repealed for tax years beginning on or after January 1, 2004. As originally enacted, there were no income limitations with respect to who could claim the credit. The tax credit has been reenacted for tax years beginning on or after January 1, 2007, and income limitations have been added with respect to who can claim the credit.

Effective for the tax years beginning on or after January 1, 2007, a tax credit is allowed for the qualifying premiums paid during the taxable year on a qualified long-term care insurance contract (s) (as defined in section 7702B of the Internal Revenue Code) that provides insurance coverage for an individual, the individual's spouse, or a dependent for whom the individual was allowed to claim a personal exemption on the federal return if the individual's federal adjusted gross income is less than the amount shown for the individual's filing status in the chart below.

Filing Status	Adjusted Gross Income
Married filing jointly/ Qualifying widow(er)	$100,000
Head of household	80,000
Single	60,000
Married filing separately	50,000

The credit is 15 percent of the premiums paid but may not exceed $350 for each qualified long-term care insurance contract for which a credit is claimed. Medical insurance premiums that an individual pays for general health care, hospitalization, or disability insurance do not qualify as premiums paid for a long-term care insurance contract. A long-term care insurance contract is any insurance contract under which

the only insurance protection provided is for coverage of qualified long-term care services as defined in section 7702B of the Internal Revenue Code. Qualified long-term care services are those services required by a chronically ill individual and provided under a plan of care prescribed by a licensed health care practitioner.

No credit is allowed for payments that are deducted from, or not included in, federal gross income for the taxable year. For example, payments that are not included in federal gross income are premiums paid through an employer-sponsored plan in which the payments are excluded from taxable wages (pre-taxed dollars). Individuals who claim a deduction for medical expenses on Federal Schedule A, or individuals who claim a deduction for self-employed health insurance premiums on the federal return are not entitled to claim this credit. However, individuals may claim this credit for any premiums paid for long-term care insurance that are not deductible on the federal return because of the age limitations contained in section 213(d)(10) of the Internal Revenue Code.

A part-year resident or nonresident is allowed a prorated tax credit based on the percentage of the individual's total income that is taxable for North Carolina income tax purposes. The credit many not exceed the individual's tax for the year reduced by the sum of all other credits allowed. Any unused portion of the credit may not be carried over to subsequent years. The credit expires for taxable years beginning on or after January 1, 2013.

15. Credit for Qualifying Expenses of a Film or Television Production Company (G.S. 105-151.29)

A taxpayer that is a production company and has qualifying expenses of at least $250,000 with respect to a production is allowed a credit against individual income taxes. The credit is equal to fifteen percent (15%) of the production company's qualifying expenses. The credit is claimed for the taxable year in which the production activities are completed but includes all of the taxpayer's qualifying expenses incurred with respect to the production, including qualifying expenses incurred in earlier years. In the case of an episodic television series, an entire season of episodes is one production.

(**Note:** In lieu of the existing 15% credit, a production company may choose to compute the credit at 25%. However, the company must forfeit the benefit of the special sales tax rate imposed on mill machinery under G.S. 105-187.51 by subtracting from the amount of credit computed at 25% the difference between the amount of tax paid on purchases subject to the mill machinery rate of 1% and the amount of sales or use tax that would have been due had the purchases been subject to the combined sales tax rate. The credit is based on all expenses incurred for the production, not just those incurred during the taxable year. The election is binding.)

The maximum credit for a production that is a feature film is limited to $7,500,000. There is no maximum credit for other types of productions. The following productions do not qualify for the credit: political advertisements; television productions of a news program or live sporting event; productions that contain obscene material; or radio productions.

Qualifying expenses includes the total amount spent in North Carolina for goods and services leased or purchased by the production company and compensation and wages paid by the production company, other than amounts paid to a highly compensated individual, on which the production company remitted North Carolina withholding payments. A highly compensated individual is an individual who receives compensation in excess of one million dollars for personal services with respect to a single production, regardless of whether the individual receives compensation directly from the production company or indirectly from a personal services company or an employee leasing company and regardless of whether the compensation is considered wages or nonemployee compensation. Qualifying expenses for compensation and wages paid to employees for services performed in North Carolina includes payments for per diem, living allowances, and fringe benefits to the extent they are included in the recipient's taxable wages subject to federal income tax withholding. The amount paid to an individual through a personal services corporation or through an employee-leasing organization is considered compensation and is subject to the "highly compensated individual" limitations in calculating the allowable credit.

For goods with a purchase price of $25,000 or more, the amount included in qualifying expenses is the purchase price less the fair market value of the good at the time the production is completed. Spending for goods purchased or leased from a North Carolina business is eligible for the tax credit. This includes fuel, food, airline tickets and other goods if purchased or leased from a business located in North Carolina. Spending for services is eligible for the credit regardless of whether paid to residents or nonresidents, as long as the services are performed in North Carolina.

A pass-through entity that qualifies for the credit does not allocate the credit among any of its owners. Instead, the pass-through entity is considered the taxpayer for purposes of claiming this credit. If the return filed by a pass-through entity indicates that the entity is paying tax on behalf of the owners of the entity, the credit allowed does not affect the entity's payment of tax on behalf of its owners and cannot be applied against that liability.

The tax credit must be claimed on Form NC-415 for the taxable year in which the production activities are completed. Processing of the credit cannot begin until after the income tax return for the taxable year in which the production activities are completed is filed. A taxpayer must satisfy any tax liability for the tax year in which the tax credit is claimed before the credit will be refunded. If the amount of credit exceeds the taxpayer's income tax liability for the taxable year less the sum of all other credits, then the excess is refundable. Nonrefundable credits are credited against the taxpayer's tax liability before this refundable credit.

A taxpayer allowed the credit must maintain and make available for inspection any information or records required by the Secretary of Revenue. The taxpayer has the burden of proving eligibility for a credit and the amount of the credit. The Secretary may consult with the North Carolina Film Office of the Department of Commerce and the regional film commissions to determine the amount of qualifying expenses.

A taxpayer cannot claim both a tax credit and a deduction for the same expenses. A taxpayer claiming the credit must add to federal taxable income the amount of the qualifying expenses used to calculate the credit as provided in G.S. 105-134.6(c)(9). For example, a taxpayer that has $10,000,000 in qualifying expenses is eligible for a tax credit of $1,500,000. Federal taxable income must be increased by $10,000,000 in determining income taxable to North Carolina.

This credit is repealed for qualifying expenses occurring on or after January 1, 2014.

16. Credit for Recycling Oyster Shells (G.S. 105-151.30)

A tax credit is allowed to a taxpayer who donates oyster shells for recycling to the Division of Marine Fisheries of the Department of Environment and Natural Resources. The credit is $1.00 per bushel of oyster shells donated. The credit is limited to the tax liability and any unused portion of the credit can be carried forward for the succeeding five years.

To support the credit, a taxpayer must obtain a certification by the Department of Environment and Natural Resources stating the number of bushels of oyster shells that were donated. A taxpayer who claims the credit must add back to taxable income any amount deducted under the Code for the donation of the oyster shells. The credit expires for taxable years beginning on or after January 1, 2011.

17. Refundable Earned Income Tax Credit (G.S. 105-151.31)

A refundable earned income tax credit is allowed to an individual who claimed an earned income tax credit under section 32 of the Internal Revenue Code. The credit is 5% of the amount of the earned income tax credit the individual qualified for on the federal return.

If the credit exceeds the tax liability reduced by the sum of all credits allowable, the excess is refunded to the individual. Section 3507 of the Internal Revenue Code, Advanced Payment of Earned Income Credit, does not apply to the State earned income tax credit.

A part-year resident or nonresident is allowed a prorated tax credit based on the percentage of the individual's total income that is taxable for North Carolina income tax purposes. The credit expires for taxable years beginning on or after January 1, 2013.

18. Tax Credit for Adoption Expenses (G.S. 105-151.32)

A tax credit is allowed to an individual who claimed an adoption tax credit on the federal income tax return. The tax credit is equal to 50% of the allowable tax credit claimed under section 23 of the Internal Revenue Code.

A part-year resident or nonresident is allowed a prorated tax credit based on the percentage of the individual's total income that is taxable for North Carolina income tax purposes. The credit may not exceed the taxpayer's tax for the year reduced by the sum of all other credits allowed. Any unused credit may be carried forward for the next succeeding five years.

19. Qualified Business Investments (G.S. 105-163.010 through G.S. 105-163.015)

A tax credit is allowed to individuals, estates, and trusts that make qualified investments directly in equity securities or subordinated debt of a qualified business. These organizations are defined in G.S. 105-163.010 and are required to register with the Secretary of State. The credit is also allowable to partnerships, S corporations, limited liability companies, and other pass-through entities that make qualifying investments. However, the credit is not allowed to a pass-through entity that has committed capital under management in excess of $5,000,000. Nor is the credit allowed if a broker's fee or commission or other similar remuneration is paid or given directly or indirectly for soliciting the investment in a qualified business. A pass-through entity that is itself a qualified business is not entitled to the credit for an investment in another qualified business.

The aggregate amount of credit allowed a taxpayer for one or more investments made in a single tax year is 25 percent of the amount invested or $50,000, whichever is less, regardless of whether the investments were made directly by the taxpayer or indirectly though a pass-through entity. The credit allowed a pass-through entity is 25 percent or $750,000, whichever is less. The $50,000 limitation for individuals does not apply to unused amounts carried forward from previous years. If the owner's share of the pass-through entity's credit is limited due to the maximum allowable credit, the pass-through entity and its owners may not reallocate the unused credit among the other owners.

A taxpayer's basis in the equity securities or subordinated debt acquired as a result of an investment in a qualified business must be reduced by the amount of allowable credit. To be eligible for the credit a taxpayer must file an application (Form D-499) for the credit with the Secretary of Revenue. The application should be filed on or before April 15 and no later than October 15 of the calendar year in which the investment was made and must include (1) copies of canceled check(s) or other documents which verify the investment, (2) copies of stock certificates or subordinated debt instrument(s) issued by the qualified business, and (3) the Certificate of Qualified Status for each organization for which credit is claimed. If an investment shown on an application was paid for other than in money (real estate, personal property, etc.), a taxpayer must include with the application a certified appraisal of the value of the property used to pay for the investment. The application for a credit for an investment made by a pass-through entity must be filed by the pass-through entity. An application filed after October 15 will not be accepted.

The credit is allowable for the taxable year beginning during the calendar year following the calendar year in which the investment was made and any unused credit can be carried forward for the next succeeding five years. A taxpayer must attach a copy of the qualified business tax credit approval letter from the Department of Revenue to verify the credit claimed on the return.

The total amount of the credits allowable to all taxpayers for each calendar year may not exceed $7,500,000. If the total credits for which applications are received exceeds the threshold amount, the credits claimed will be allocated in proportion to the size of the credit claimed by each taxpayer.

If the credit is reduced, the taxpayer will be notified by the Department of Revenue of the amount of reduction of the credit on or before December 31 of the year following the calendar year in which the investment was made.

A taxpayer will forfeit the credit if:

(1) Within three years after the investment was made, the taxpayer participates in the operation of the qualified business. A taxpayer participates in the operation of the qualified business if the taxpayer, the taxpayer's spouse, parent, brother or sister, child, or an employee of any of these individuals or of a business controlled by any of these individuals provides services of any nature to the qualified business for compensation, whether as an employee, a contractor, or otherwise.

(2) The registration of the qualified business is revoked because the qualified business provided false information to the Secretary of State on its registration application.

(3) The taxpayer transfers the securities received in the investment to another person or entity within one year except in the case of (a) the death of the taxpayer, (b) a final distribution in liquidation, or (c) a merger, conversion, consolidation, or other similar transaction in which no cash or tangible property is received.

(4) The organization in which the investment was made makes a redemption of the securities within five years. Forfeiture does not occur if a redemption is made by a qualified business that engages primarily in motion picture film production if (1) the redemption occurred because the qualified business completed production of a film, sold the film, and was liquidated and (2) neither the qualified business nor a related person as described in Code section 267(b) or 707(b), continues to engage in business with respect to that film.

A taxpayer who forfeits any credit must repay the credit plus interest 30 days after the date the credit is forfeited. The credit is repealed effective for investments made on or after January 1, 2011.

20. Credit for Investing in Renewable Energy Property (G.S. 105-129.16A)

A tax credit is allowed for 35% of the cost of renewable energy property constructed, purchased, or leased and placed into service in the State during the taxable year. Renewable energy property includes biomass equipment, hydroelectric generators, solar energy equipment, wind equipment, geothermal heat pumps and geothermal equipment. The credit is not allowable for renewable energy property leased from another person unless

the taxpayer has written certification from the lessor that he will not claim a credit with respect to the leased property.

If the renewable energy property serves a single-family dwelling, the credit is taken in the taxable year in which the property is placed in service. For all other property, the credit is taken in five equal installments beginning with the year the property is placed in service. The credit may not exceed 50% of the tax for the year, reduced by the sum of all other tax credits. This limitation applies to the cumulative amount of credit, including carryforwards. Any unused portion of the credit may be carried forward for the succeeding five years. If the property is disposed of, taken out of service, or moved out of the State during the five-year installment period, the credit expires and any remaining installments of the credit may not be taken.

The credit is subject to various ceilings. For nonresidential property, the credit may not exceed $2,500,000 per installation. For renewable energy property placed in service for residential purposes, the following ceilings apply:

- $1,400 per dwelling unit for solar energy equipment for domestic water heating, including pool heating;
- $3,500 per dwelling unit for solar energy equipment for active space heating, combined active space and domestic hot water systems, and passive space heating; and
- $10,500 per installation for any other renewable energy property placed in service.
- $8,400 per installation for geothermal heat pump and geothermal equipment.

The credit is repealed effective for renewable energy property placed in service on or after January 1, 2016.

21. Credit for Small Business Employee Health Insurance (G.S. 105-129.16E)

A tax credit is allowable to a small business that provides health insurance for all of its eligible employees during the taxable year. A taxpayer that employs no more that 25 eligible employees at any one time during the taxable year is considered a small business.

A taxpayer provides health benefits if the taxpayer pays at least 50% of the premiums for health care coverage that equals or exceeds the minimum provisions of the basic health care plan of coverage recommended by the Small Employer Carrier Committee pursuant to G.S. 58-50-125 or its employees have qualifying existing coverage. The amount of credit per eligible employee is the lesser of $250 or the taxpayer's actual cost of providing health benefits for the taxable year. The credit is limited to insurance paid for an eligible employee whose wages or salary from the business does not exceed $40,000 on an annual basis.

A part-year resident or nonresident is allowed a prorated credit based on the percentage of the taxpayer's total income that is taxable for North Carolina income tax purposes. The credit expires for taxable years beginning on or after January 1, 2010.

22. Credit for Rehabilitating Income-Producing Historic Structure (G.S. 105-129.35)

Generally, a taxpayer who is allowed a federal income tax credit under section 47 of the Internal Revenue Code for making rehabilitation expenditures for a certified historic structure located in North Carolina is allowed a credit equal to 20% of the expenditures that qualify for the federal credit (40% of expenditures if the facility at one time served as a State training school for juvenile offenders). A pass-through entity that qualifies for the credit may allocate the credit among any of its owners in its discretion as long as an owner's adjusted basis is at least 40% of the amount of the credit allocated to that owner.

To claim the credit, the taxpayer must provide a copy of the certification obtained from the State Historic Preservation Officer verifying that the historic structure has been rehabilitated in accordance with the Secretary of the Interior's Standards for Rehabilitation.

The credit for rehabilitating an income-producing historic structure must be claimed in five equal installments beginning with the taxable year in which the property is placed in service. Any unused portion of the credit may be carried forward for the succeeding five years.

23. Credit for Rehabilitating Nonincome-Producing Historic Structure (G.S. 105-129.36)

Generally, a taxpayer who is not allowed a federal income tax credit under section 47 of the Internal Revenue Code and who makes rehabilitation expenses for a State-certified historic structure located in North Carolina is allowed a credit equal to 30% of the rehabilitation expenses (40% of qualifying expenditures if the certified historic structure is a facility that at one time served as a State training school for juvenile offenders). To qualify for the credit, the rehabilitation expenses must exceed $25,000 within a 24-month period. Rehabilitation expenses do not include the cost of acquiring the property, site work, personal property or cost attributable to the enlargement of the existing property. To claim the credit the taxpayer must attach to the return a copy of the certification obtained from the State Historic Preservation Officer verifying that the historic structure has been rehabilitated in accordance with the Secretary of the Interior's Standards for Rehabilitation.

The credit for rehabilitating an historic structure must be claimed in five equal installments beginning with the taxable year in which the property is placed in service. Any unused portion of the credit may be carried forward for the succeeding five years.

24. Credit for Income-Producing Rehabilitated Mill Property (G.S. 105-129.71)

A taxpayer that places eligible rehabilitated mill property into service and is allowed a federal income tax credit under Code section 47 for making qualified rehabilitation expenditures with respect to an eligible site is allowed a State credit equal to a percentage of the expenditures that

qualify for the federal credit. The credit may be claimed in the year the eligible site is placed in service. If the eligible site is placed in service in phases in different years, the credit may be claimed for each year based on the qualified expenditures associated with the phase placed in service during that year. Any unused credit may be carried forward for the succeeding nine years.

To be eligible for the credit, the taxpayer must attach to the return a copy of the eligibility certification and the cost certification from the State Historic Preservation Officer. The amount of the credit is 40% of the qualified expenditures if the eligible site is located in a tier one, two, or three area on the date of certification or 30% of the qualified expenditures if the eligible site is located in a tier four or five area.

A pass-through entity that qualifies for the credit is allowed to allocate the credit among any of its owners in its discretion as long as an owner's adjusted basis in the pass-through entity at the end of the taxable year in which the eligible site is placed in service is at least 40% of the amount of credit allocated to that owner. This differs from the allocation principles in G.S. 105-131.8 and G.S. 105-269.15 that apply to all other tax credits. Under the general allocations provisions in G.S. 105-131.8 and G.S. 105-269.15, tax credits are allocated among S corporation shareholders in accordance with their pro rata share of the corporation, which is determined on the basis of stock ownership, and tax credits are allocated among partners in a partnership in accordance with the partnership agreement. The allocation made by the partnership must have a substantial economic effect, which means that the allocation agreement must reflect the economic interests of the partners in the partnership and cannot be based solely on tax consequences. A statement of the allocation made under the special provision for this credit and the allocation that would have been required if this provision were not law must be included with the tax returns filed by the pass-through entity and the owners for each year in which the allocated credit is claimed.

The owner of a pass-through entity must forfeit a portion of the credit for rehabilitating income-producing mill property if the owner disposes of more than one-third of the owner's interest in the pass-through entity within five years from the date the eligible site is placed in service. The forfeiture amount is determined by multiplying the amount of the credit by the percentage reduction in ownership and then multiplying that product by the federal recapture percentage found in Code section 50(a)(1)(B).

Forfeiture is not required if the change in ownership is the result of a death of the owner, or a merger, consolidation, or similar transaction requiring approval by the shareholders, partners or members of the taxpayer under applicable State law, to the extent the taxpayer does not receive cash or tangible property in the merger, consolidation, or other similar transaction.

An owner of a pass-through entity that forfeits a credit for change in ownership is liable for all past taxes avoided as the result of claiming the credit, plus interest at the rate established under G.S. 105-241.1(i) computed from the date the taxes would have been due if the credit had

not been allowed. The past taxes and interest are due thirty days after the date the credit is forfeited. If the taxes and interest are not paid by the due date, the taxpayer is subject to the penalties in G.S. 105-236.

25. Credit for Nonincome-Producing Rehabilitated Mill Property (G.S. 105-129.72)

A taxpayer that places eligible rehabilitated mill property into service and is not allowed a federal income tax credit under Code section 47 and that makes qualified rehabilitation expenses with respect to an eligible site is allowed a State tax credit equal to a percentage of the rehabilitation expenses. The credit may be claimed in five equal installments beginning in the year the eligible site is placed in service. If the eligible site is placed in service in phases in different years, the credit may be claimed for each year based on the qualified expenses associated with the phase placed in service during that year. Any unused credit may be carried forward for the succeeding nine years.

To be eligible for the credit, the taxpayer must attach to the return a copy of the eligibility certification and the cost certification from the State Historic Preservation Officer. The amount of the credit is 40% of qualified expenditures if the eligible site is located in a tier one, two, or three area on the date of certification. No credit is allowed if the eligible site is in a tier four or five area.

A pass-through entity that qualifies for the credit is allowed to allocate the credit among any of its owners in its discretion as long as an owner's adjusted basis in the pass-through entity at the end of the taxable year in which the eligible site is placed in service is at least 40% of the amount of credit allocated to that owner. This differs from the allocation principles in G.S. 105-131.8 and G.S. 105-269.15 that apply to all other tax credits. Under the general allocation provisions, tax credits are allocated among S corporation shareholders in accordance with their pro rata share of the corporation, which is determined on the basis of stock ownership, and tax credits are allocated among partners in a partnership in accordance with the partnership agreement. The allocation made by the partnership must have a substantial economic effect, which means that the allocation agreement must reflect the economic interests of the partners in the partnership and cannot be based solely on tax consequences. A statement of the allocation made under the special provision for this credit and the allocation that would have been required if this provision were not law must be included with the tax returns filed by the pass-through entity and the owners for each year in which the allocated credit is claimed.

A taxpayer will forfeit the credit if an owner of a pass-through entity disposes of more than one-third of the owner's interest in the pass-through entity within five years from the date the eligible site is placed in service, the owner must forfeit a portion of the credit for rehabilitating nonincome-producing mill property. The forfeiture amount is determined by multiplying the amount of the credit by the percentage reduction in ownership and then multiplying that product by the federal recapture percentage found in Code

section 50(a)(1)(B). The remaining allowable credit is allocated equally among the five years in which the credit is claimed.

Forfeiture is not required if the change in ownership is the result of a death of the owner, or a merger, consolidation, or similar transaction requiring approval by the shareholders, partners or members of the taxpayer under applicable State law, to the extent the taxpayer does not receive cash or tangible property in the merger, consolidation, or other similar transaction.

An owner of a pass-through entity that forfeits a credit for change in ownership is liable for all past taxes avoided as the result of claiming the credit, plus interest at the rate established under G.S. 105-241.1(i) computed from the date the taxes would have been due if the credit had not been allowed. The past taxes and interest are due thirty days after the date the credit is forfeited. If the taxes and interest are not paid by the due date, the taxpayer is subject to the penalties provided in G.S. 105-236.

26. Business Targeted Tax Credits

Individuals, partnerships, trusts, and estates may be eligible to claim business targeted tax credits for:

- Creating Jobs
- Investing in Machinery and Equipment
- Research and Development
- Worker Training
- Investing in Central Office or Aircraft Facility Property
- Contributions to Development Zone Projects
- Technology Commercialization
- Investing in Low-Income Housing
- Nonhazardous Dry-Cleaning Equipment
- Work Opportunity
- Constructing a Railroad Intermodal
- Biodiesel Producers

For information about these credits, see the Tax Credits subsection in the Corporate Income Tax section of the Franchise Tax and Corporate Tax Rules and Bulletins.

XII. Subject: Statute of Limitations and Federal Determinations

1. General

The law contains certain time limitations, generally referred to as the "statute of limitations."

An income tax return from which information required to calculate the taxpayer's income tax liability has been omitted is not a return for the purpose of determining the applicable statute of limitations. The date the return is filed which contains sufficient information upon which to determine the tax liability is the determining date.

2. Federal Determinations

If the amount of a taxpayer's federal taxable income for any year is changed, corrected, or otherwise determined by the federal government, the taxpayer must file a North Carolina return or amended return to report the changes within six months from the date the report was received.

Under G.S. 105-241.10, the Department may assess additional tax that results only from adjustments related to the federal determination if the tax year is otherwise barred by statute.

3. Statue of Limitations for Refunds

The Department of Revenue will refund an overpayment of $1.00 or more if the statute of limitations has not expired. A refund of less than $1.00 will not be made unless the taxpayer files a written request for a refund. The general statute of limitations for filing a claim for refund of overpayment of taxes is three years after the due date of the return or two years after payment of the tax, whichever is later. The following exceptions apply:

(a) If a taxpayer files a timely return reflecting a federal determination, the period of time for requesting a refund is one year after the return reflecting the federal determination is filed or three years after the original return was filed or due to be filed, whichever is later.

(b) A taxpayer's waiver of the statute of limitations for making a proposed assessment extends the period in which the taxpayer can obtain a refund to the end of the period extended by the waiver.

(c) For overpayments attributable to worthless debts or securities, the period of time for demanding a refund is seven years.

(d) For overpayments attributable to capital loss and net operating loss carrybacks, the period of time for demanding a refund is three years from the due date of the return for the year in which the loss was incurred rather than three years from the due date of the return for the year to which the loss is carried back.

4. Statute of Limitations for Assessments

The general statute of limitations for proposing an assessment is three years after the due date of the return or three years after the return was filed, whichever is later. The following exceptions apply:

(a) If a taxpayer files a timely return reflecting a federal determination, the period of time for proposing an assessment of any tax due is one year after the return is filed or three years after the original return was filed or due to be filed, whichever is later. If there is a federal determination and a timely return is not filed, the proposed assessment must be made within three years after the date the Department received the final report of the federal determination.

(b) If a taxpayer did not file a return, filed a fraudulent return, or attempted to fraudulently evade or defeat the tax, there is no statute of limitations and an assessment may be proposed at any time.

(c) If a taxpayer forfeits a tax credit or tax benefit, the period of time for proposing an assessment of any tax due resulting from the forfeiture is three years after the date of the forfeiture.

There is no statutory provision prohibiting an assessment for a given year after an assessment has already been proposed for that year. Subsequent assessments can be made upon the discovery of new facts.

5. Limit on Refunds and Assessments After a Federal Determination

When a taxpayer files a timely return reflecting a federal determination that affects the amount of State tax payable and the general statute of limitations for requesting a refund or proposing an assessment of the State tax has expired, the taxpayer is entitled to a refund or is liable for additional tax only if the refund or additional tax is the result of adjustments related to the federal determination. A federal determination is a correction or final determination by the federal government of the amount of a federal tax due.

6. Appeals Process

For details regarding the appeals process for a proposed assessment or denial of a refund, please refer to the **Taxpayers' Bill of Rights** which is located near the beginning of this publication. In addition, please refer to the **2007 Tax Law Changes**, Section 6, beginning on page 70 for additional information on the appeals process.

7. Federal Determinations and Fraud

When there is a federal determination and a fraud penalty is assessed by the federal government, the State may open the year on the basis of either fraud or the federal assessment; and if a State return has not been filed, the 50 percent fraud penalty and the 5 percent per month ($5.00 minimum; 25 percent maximum) delinquency penalty may be assessed.

8. Collection of Tax

The Department may collect a tax in the following circumstances:

(1) When a taxpayer files a return showing an amount due with the return and does not pay the amount shown due.

(2) When the Department sends a notice of collection after a taxpayer does not file a timely request for a Department review of a proposed assessment of tax.

(3) When a taxpayer and the Department agree on a settlement concerning the amount of tax due.

(4) When the Department sends a notice of final determination concerning an assessment of tax and the taxpayer does not file a timely petition for a contested case hearing on the assessment.

(5) When a final decision is issued on a proposed assessment of tax after a contested case hearing.

(6) When the Office of Administrative Hearing dismisses a petition for a contested case for lack of jurisdiction because the sole issue is the constitutionality of a statute and not the application of a statute.

9. Protective Refund Claim

A protective refund claim is a claim filed to protect a taxpayer's right to a potential refund based on a contingent event for a taxable period for which the statute of limitations is about to expire. A protective claim is usually based on contingencies such as pending litigation or a tax determination in another state.

The Department of Revenue will accept a protective claim for refund provided it (1) is filed before the expiration of the usual refund claim period; (2) identifies and describes the contingencies affecting the claim; (3) is sufficiently clear and definite to alert the Department of Revenue as to the essential nature of the claim; and (4) identifies a specific year or years for which a refund is claimed.

There is no special form for filing a protective claim. The Department of Revenue will accept any written submission provided it contains all the required elements. Upon conclusion of the contingency, a taxpayer may perfect the claim for refund by filing an amended return for the tax year at issue. The six-month period within which the Department must take action on a claim for refund does not begin on a protective claim until the amended return perfecting the claim is filed.

It is not necessary for a taxpayer to file a protective refund claim for a year under examination by the Internal Revenue Service because, under North Carolina law, a taxpayer has six months to file an amended return to report federal changes. (See 2. Federal Determinations)

10. Servicemembers Civil Relief Act

Certain sections of the Servicemembers Civil Relief Act (formerly the Soldiers' and Sailors' Civil Relief Act of 1940) are pertinent to matters of federal and state taxation. With respect to payment of income tax, the act provides for the deferment of payment of income tax for a period of 180 days after military service ends if the servicemember's inability to pay the tax was caused by military service. No penalty or interest shall accrue during the period of deferment.

11. Combat Zone

An individual serving in the Armed Forces, or serving in support of the Armed Forces, in an area designated by the President as a combat

zone who receives an extension of time to file his or her federal income tax return and receives relief from the accrual of penalty and interest as a result of serving in a combat zone or for being hospitalized as a result of wounds, disease, or injury sustained while serving in a combat zone, will receive the same extension of time for filing and the same relief from the accrual of penalty and interest for State income tax purposes.

The compensation of a military or civilian employee of the United States who dies as a result of terroristic or military action is exempt from State income tax for the same periods for which his income is exempt for federal income tax purposes.

12. Waiver of Time Limitation

A taxpayer may make a written waiver of the limitations of time specified by law for assessing any tax or additional tax, for either a definite or indefinite period of time, and if such waiver is accepted, the Secretary of Revenue may propose an assessment at any time within the extended period. An agreement by a taxpayer to extend the time in which the Secretary of Revenue can assess the taxpayer automatically extends the period of time for refunds of overpayments by the taxpayer.

XIII. Subject: Penalties, Interest, and Required Filing of Information Returns

1. General

The North Carolina Statutes provide both civil and criminal penalties for failure to comply with the income tax laws.

In addition to any applicable penalty, all assessments of taxes or additional taxes bear interest at the applicable rate from the due date until date of payment.

2. Failure To File and Failure To Pay Penalties

Under the provisions of G.S. 105-236, both the late filing and late payment penalties can be applied for the same month. If the return is filed late without payment of the tax shown due, both the late filing and late payment penalties will be assessed at the same time.

If the return is filed under an extension, the late filing penalty will be assessed from the extended filing date rather than from the original due date. The late payment penalty is 10 percent of the tax not paid by the original due date of the return and will apply on any remaining balance due if the tax paid by the original due date of the return is less than 90 percent of the total amount of tax due. If the 90 percent rule is met, any remaining balance due, including interest, must be paid with the income tax return on or before the expiration of the extension period to avoid the late payment penalty. Interest is due from the original due date to the date paid.

The late-payment penalty will not be assessed if the amount shown due on an amended return is paid with the return. Proposed assessments of additional tax due are subject to the 10 percent late-payment penalty if payment of the tax is not received within 45 days of the assessment.

3. Negligence Penalties

When there is an understatement of taxable income equal to 25 percent or more of gross income, the 25 percent negligence penalty will be assessed. When the percentage of understatement of taxable income is less than 25 percent, the 10 percent negligence penalty may be applied. The application of the 10 percent negligence penalty is based on the understatement of tax and will be made on the basis of the facts in each case. When the accuracy penalty has been assessed for federal income tax purposes, the 10 percent negligence penalty will be assessed for State income tax purposes, unless the 25 percent negligence penalty applies.

A negligence penalty cannot be assessed when the fraud penalty has been assessed with respect to the same deficiency. There is no minimum dollar amount of negligence penalty.

4. Failure To Report Federal Changes

When a taxpayer fails to report federal changes within six months from the date the Internal Revenue Agent's report was received, the taxpayer is subject to the failure to file penalty and forfeits the right to any refund as the result of the federal changes. The failure to file penalty begins at the expiration of the six month period.

5. Fraud

When an examination of an income tax return is based on a federal audit report and the fraud penalty has been assessed for federal purposes, the 50 percent fraud penalty will be assessed for State purposes. When the fraud penalty is assessed, no penalty for negligence or failure to pay shall be assessed with respect to the same deficiency; however, other penalties that apply, such as failure to file, will be assessed.

6. Collection Assistance Fee

Any tax, penalty, and interest not paid within 90 days after the tax debt becomes collectible is subject to a 20 percent collection assistance fee. The fee will not apply if payments are being made pursuant to an installment agreement that became effective within 90 days after the debt became collectible.

7. Interest

Interest accrues on tax not paid by the original due date even though a taxpayer may have an extension of time for filing the return. Interest accrues on overpayments beginning 45 days after the latest of (1) the date the final return was filed, (2) the date the final return was due to be filed, or (3) the date of the overpayment. The law requires the Secretary of Revenue to establish the interest rate on or before June 1 for the following six-month period beginning on July 1, and on or before December 1 for the following six-month period beginning on January 1. The rate set by the Secretary may not be less than 5 percent per year or greater than 16 percent per year. The current rate of interest may be obtained by calling the Department of Revenue or from the Department's website.

8. Underpayment of Estimated Income Tax

Interest on the underpayment of estimated income tax is computed on Form D-422, Underpayment of Estimated Income Tax by Individuals. If interest on the underpayment is applicable, add the amount of the interest to the tax due and include the full payment with the return. (See **XX. Interest on Underpayment of Estimated Income Tax** for explanation.)

9. Waiver of Penalty

Any penalty may be waived by the Secretary of Revenue pursuant to the Department of Revenue penalty policy. A request for waiver or reduction of penalty must be in writing and must include an explanation for the request. Interest cannot be waived or reduced.

XIV. Subject: Miscellaneous Rules

1. When a payment is received by the Department of Revenue for less than the correct tax, penalty, and interest due under the law and the facts and the payment includes the statement, "paid in full" or other similar statements, the payment will be deposited as required by G.S. 147-77. The endorsement and deposit of the payment with such statement will not make the statement binding on the Department of Revenue and will not prevent the collection of the correct balance due.

2. The Department of Revenue is authorized by law to photograph, photocopy, or microphotocopy all records of the Department, including tax returns, and such copies, when certified by the Department as true and correct copies, shall be admissible in evidence in all actions, proceedings, and matters as the original would have been. (G.S. 8-45.3)

3. In some cases debts owed to certain State, local, and county agencies will be collected from an individual's income tax refund. If the agency files a claim with the Department for a debt of at least $50.00 and the refund is at least $50.00, the debt will be set off and paid from the refund. The Department will notify the debtor of the set-off and will refund any balance which may be due. The agency receiving the amount set-off will also notify the debtor and give the debtor an opportunity to contest the debt. If an individual has an outstanding federal income tax liability of at least $50.00, the Internal Revenue Service may claim the individual's North Carolina income tax refund.

4. An individual may elect to contribute all or any portion of an income tax refund (at least $1.00 or more) to the North Carolina Nongame and Endangered Wildlife Fund. Once the election is made to contribute, the election cannot be revoked after the return has been filed.

   Your tax deductible contributions are essential to match private and federal grants to pay for conservation projects for sea turtles to songbirds, from native fish to bats. Conserving these species and their habitat is made possible by your contributions. If you are not due a refund, you may still contribute to the Fund by mailing your donation directly to the North Carolina Wildlife Resources Commission, 1722 Mail Service Center, Raleigh, North Carolina. Checks may be made payable to the Nongame and Endangered Wildlife Fund.

5. A taxpayer may designate $3.00 of the tax paid for use by the Democratic or Republican Parties. If the taxpayer does not specify a party, the amount designated will be distributed to political parties in North Carolina on a pro rata basis according to voter registrations. No political party with less than one percent of the total number of registered voters in the State will receive any of the designated funds. Married couples filing a joint return may make a designation only if their income tax liability is $6.00 or more. The designation will neither increase the tax nor reduce the refund.

6. A taxpayer may designate $3.00 of the tax paid to the North Carolina Public Campaign Fund. On a joint return, each spouse may designate $3.00 to the Fund. The designation will neither increase the tax nor reduce the refund. The Fund provides an alternative source of campaign money to qualified candidates who accept strict campaign spending and fund-raising limits. The Fund also helps finance a Voter Guide with educational materials about voter registration, the role of the appellate courts, and the candidates seeking election as appellate judges in North Carolina.

7. Tenancy by the Entirety: When filing separate returns, a determination must be made as to that portion of the income or loss from real property that must be reported by each spouse. Under G.S. 39-13.6, a husband and wife have equal right to the control, use, possession, rents, income, and profit from real property held as tenants by the entirety and each spouse is taxed on one-half of the income or loss from such property located in North Carolina.

   When real property conveyed jointly in the name of husband and wife is located in another state and the share of ownership of each is not fixed in the deed or other instrument creating the co-tenancy, each spouse is considered as having received one-half of the income or loss from the real property unless they can demonstrate that the laws of that particular state with respect to the right to the income from the property allocate the income or losses in a different manner.

8. An individual may elect to have an income tax refund applied to estimated income tax for the following year. For example, an individual due a refund on the 2009 income tax return may have all or any portion of the refund applied to his estimated tax for 2010. The individual may not, however, file a 2009 tax return in 2011 and request the refund be applied to 2011 estimated tax since the refund can only be applied to the tax year which follows the year for which the request for refund is made. The last allowable date for making a 2008 estimated tax payment is January 15, 2011; therefore, you must file your 2009 income tax return by January 15, 2011, to elect to apply a portion of your refund to 2010 estimated tax.

   If an individual makes a valid election, that individual may not revoke the election in order to have the amount refunded or applied in any other manner, such as an offset against any subsequently determined tax liability.

9. Cancelled checks, receipts, or other evidence to substantiate deductions on the tax return should be kept for a period of at least three years from the due date of the return or three years from the date the return is filed, whichever is later. Lack of adequate records could result in the disallowance of all or part of the deductions claimed.

   A cancelled check, money order stub, or Departmental receipt showing payment of tax should be kept for at least five years from the due date of the tax return.

10. In determining North Carolina taxable income, G.S. 105-134.6(b) allows an individual to deduct from federal taxable income interest received from obligations of the United States or its possessions, the State of North Carolina or its political subdivisions, and nonprofit educational institutions located in North Carolina, to the extent the interest is included in the individual's federal gross income. Under this statute, an individual is allowed to deduct the total of such interest included in federal gross income even though certain expenses incurred in earning the interest are allowed as deductions on the federal income tax return.

    G.S. 105-134.6(c) requires an individual to add interest income received from obligations of states other than North Carolina and their political subdivisions to federal taxable income in calculating North Carolina taxable income, to the extent the interest is not included in federal gross income. Under this statute, an individual is required to add the total of such interest to federal taxable income even though the individual may have incurred expenses in earning the interest.

11. Every individual, fiduciary, partnership, corporation, or unit of government buying real property located in North Carolina from a nonresident individual, partnership, estate or trust is required to complete Form NC-1099NRS, Report of Sale of Real Property by Nonresidents, reporting the seller's name, address, and social security number, or federal employer identification number; the location of the property; the date of closing; and the gross sales price of the real property and its associated tangible personal property. Within fifteen days of the closing date of the sale, the buyer must file the report with the Department of Revenue and furnish a copy of the report to the seller.

12. Like all states that have a sales tax, North Carolina has a use tax on out-of-state purchases. The use tax applies to purchases made outside the State for use inside the State. North Carolina residents are responsible for paying use tax on their out-of-state purchases. The use tax should be reported on the individual income tax return.

    A North Carolina resident owes use tax on an out-of-state purchase when the item purchased is subject to the North Carolina sales tax and the retailer making the sale does not collect sales tax on the sale or the state and local sales tax imposed by the other state is less than the state and local sales tax imposed by North Carolina. Items that are subject to sales tax include computers and other electronic equipment, software, books, audio and video tapes, compact discs, records, clothing, appliances, furniture and other home furnishings, sporting goods, and jewelry. Out-of-state retailers include mail-order companies, television shopping networks, firms selling over the internet, and retailers located outside North Carolina. When an out-of-state retailer does not collect sales tax, or the tax collected is less than the state and local sales tax imposed

by North Carolina, the responsibility of paying the tax falls on the purchaser. North Carolina residents are responsible for paying use tax on the following purchases when the applicable sales tax is not collected and the purchases are for use in this State:

- Catalog, internet, or mail-order purchases from out-of-state vendors.
- Purchases from other states or countries.
- Purchases from television shopping networks or clubs.
- Vacation or other travel purchases, whether delivered to you in another state or shipped to you in North Carolina.
- Any other purchases subject to tax on which the applicable tax was not paid.

The use tax is calculated at the same rate as the sales tax. Taxpayers who paid another state's sales or use tax on out-of-state purchases may credit that amount against the North Carolina use tax due. Taxpayers may not claim a credit for sales tax or value-added tax paid to another country.

Worksheets for determining the North Carolina use tax are available in the individual income tax instructions.

XV. Subject: Withholding from Pensions, Annuities, and Deferred Compensation (G.S. 105-163.2A)

1. General

A pension payer required to withhold federal tax under section 3405 of the Code on a pension payment to a North Carolina resident must also withhold State income tax from the pension payment. If a payee has provided a North Carolina address to a pension payer, the payee is presumed to be a North Carolina resident and the payer is required to withhold State tax unless the payee elects no withholding. A pension payer that either fails to withhold or to remit tax that is withheld is liable for the tax.

A pension payer must treat a pension payment paid to an individual as if it were an employer's payment of wages to an employee. If the pension payer has more than one arrangement under which distributions may be made to an individual, each arrangement must be treated separately.

2. Definitions.

Unless otherwise specified below, the definitions, provisions, and requirements of section 3405 of the Internal Revenue Code with respect to federal withholding on pensions are applicable to State withholding on pensions.

a. Pension payer – A payer or a plan administrator with respect to a pension payment under section 3405 of the Code.

b. Pension payment – A periodic payment or a nonperiodic distribution, as those terms are defined in section 3405 of the Code.

3. Amount to Withhold

In the case of a **periodic payment,** as defined in Code section 3405(e)(2), the payer must withhold as if the recipient were a married person with three allowances unless the recipient provides an exemption certificate (Form NC-4P) reflecting a different filing status or number of allowances. Form NC-4P, Withholding Certificate for Pension or Annuity Payments, is used by a recipient of pension payments who is a North Carolina resident to report the correct filing status, number of allowances, and any additional amount the recipient wants withheld from the pension payment. It may also be used to elect not to have State income tax withheld. In lieu of Form NC-4P, payers may use a substitute form if it contains all the provisions included on Form NC-4P.

For a **nonperiodic distribution**, as defined in Code section 3405(e)(3), four percent (4%) of the distribution must be withheld. A nonperiodic distribution includes an eligible rollover distribution as defined in Code section 3405(c)(3). State law differs from federal law with respect to eligible rollover distributions. Federal law imposes a higher rate of withholding on eligible rollover distributions than on other nonperiodic distributions. State law imposes the same rate of withholding on all nonperiodic distributions.

4. Election Not to Have Income Tax Withheld

A recipient may elect not to have income tax withheld from a pension payment unless the pension payment is an eligible rollover distribution. A recipient of a pension payment that is an eligible rollover distribution does not have the option of electing not to have State tax withheld from the distribution.

Except for eligible rollovers, a recipient of a pension payment who has federal income tax withheld can elect not to have State income tax withheld. Conversely, a recipient who has State income tax withheld can elect not to have federal income tax withheld.

An election not to have tax withheld from a pension payment remains in effect until revoked by the recipient. An election not to have tax withheld is void if the recipient does not furnish the recipient's tax identification number to the payer or furnishes an incorrect identification number. In such cases, the payer will withhold on periodic payments as if the recipient is married claiming three allowances and on nonperiodic distributions at the rate of 4 percent.

A nonresident with a North Carolina address should also use Form NC-4P to elect not to have State income tax withheld. Completing Form NC-4P and electing not to have State tax withheld does not infer that the recipient is a resident of North Carolina.

5. Exceptions to Withholding

Tax is not required to be withheld from the following pension payments:

a. A pension payment that is wages.

b. Any portion of a pension payment that meets both of the following conditions:

   (1) It is not a distribution or payment from an individual retirement plan as defined in section 7701 of the Code.

   (2) The pension payer reasonably believes it is not taxable to the recipient.

c. A distribution described in section 404(k)(2) of the Code, relating to dividends on corporate securities.

d. A pension payment that consists only of securities of the recipient's employer corporation plus cash not in excess of $200 in lieu of securities of the employer corporation.

e. Distributions of retirement benefits received from North Carolina State and local government retirement systems and federal retirement systems identified as qualifying retirement systems under the terms of the *Bailey/Emory/Patton* settlement that are paid to retirees who were vested in the retirement systems as of August 12, 1989.

6. Notification Procedures for Pension Payers

A pension payer is required to provide each recipient with notice of the right not to have State withholding apply and of the right to revoke

the election. The notice requirements for North Carolina purposes are the same as the federal notice requirements, which are provided in section 3405(e)(10) of the Code. Section D of Federal Regulation 35.3405-1 contains sample notices that may be modified for State purposes to satisfy the notice and election requirements for periodic payments and nonperiodic distributions.

Instead of notification that tax will be withheld unless the recipient chooses not to have tax withheld, pension payers may notify recipients whose annual payments are less than $10,560 that no State tax will be withheld unless the recipient chooses to have State withholding apply. Such notice may be provided when making the first payment.

7. Reporting and Paying the Withheld Tax

A pension payer required to withhold State tax from a pension payment but is not already registered with the Department of Revenue for wage withholding must register by completing Form NC-BR, Business Registration Application for Income Tax Withholding, Sales and Use Tax, and Machinery, Equipment, and Manufacturing Fuel Tax. The completed form should be mailed to the N.C. Department of Revenue, Business Registration Unit, P.O. Box 25000, Raleigh, North Carolina 27640-0100. The payer will be assigned an account identification number and will receive forms for paying the State tax withheld. The payer will initially be classified as a quarterly filer. The filing frequency may change after the first year depending on the amount of tax withheld during the first year.

A payer that withholds tax from pensions and also withholds tax from wages must report the withholding from pensions with the wage withholding unless the payer chooses to report the withholding from pensions separately. For those payers that do not choose to report the two types of withholding separately, the payment of tax withheld from pensions is due at the time the withholding from wages is due and the payer will be subject to penalties and interest on both types of withholding based on that due date. Payers that also withhold from wages but choose to report the withholding from pensions separately must file Form NC-BR to receive a separate account identification number. They will receive separate forms for paying the tax withheld from pensions.

A payer that initially chooses to report withholding from pensions separately may, at any time, begin reporting the two types of withholding together. If combined reporting is preferred, a payer should report the combined withholding under the account number for reporting wages. The payer should complete the Out of Business Notification for the separate pension withholding account and file it with the Department. The separate withholding account will be closed. A payer that initially reports the two types of withholding at the same time may choose to begin reporting the withholding on pensions separately by notifying the Business Registration Unit. The payer must continue to report the two types of withholding together until the payer receives the separate account identification number and remittance forms from the Department.

In either case, the payer must file separate annual reconciliations for the year in which the choice is changed.

8. Annual Statements

Payers must report pension income and State tax withheld on Federal Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-sharing Plans, IRAs, Insurance Contracts, etc. Form 1099-R must be given to the recipient on or before January 31 following the calendar year in which the pension payments were made. The payer must file an annual reconciliation with the Department of Revenue that reconciles the amounts withheld from each recipient. Payers choosing to report pension withholding with wage withholding must file one annual reconciliation report that includes the two types of withholding. Payers subject to both wage withholding and pension withholding that report the two types of withholding separately must file separate annual reconciliations for each type of withholding. The annual reconciliation for withholding from pensions is due on or before February 28.

XVI. Subject: Withholding From Nonresidents for Certain Personal Services and Withholding on Contractors Identified by an Individual Taxpayer Identification Number (ITIN) (G.S. 105-163.1 through G.S. 105-163.24)

1. General

North Carolina income tax is required to be withheld from non-wage compensation paid to nonresidents for certain personal services rendered in this State. Effective January 1, 2010, North Carolina tax is also required to be withheld from non-wage compensation paid to an ITIN holder for services performed in this State. The requirement to withhold applies to payers who, in the course of a trade or business, pay more than $1,500 of non-wage compensation to:

a. A nonresident individual or to a nonresident entity for services performed in this State in connection with a performance, an entertainment or athletic event, a speech, or the creation of a film, radio, or television program, or

b. An ITIN holder for services performed in this State.

These payers must withhold North Carolina income tax at the rate of four percent (4%) from the compensation.

2. Definitions

a. Compensation - Consideration a payer pays to any of the following:

   (1) A nonresident individual or nonresident entity for personal services performed in this State.

   (2) An ITIN holder who is a contractor and not an employee for services performed in this State.

b. ITIN contractor - An ITIN holder who performs services in this State for compensation other than wages.

c. ITIN holder - A person whose taxpayer identification number is an Individual Taxpayer Identification Number (ITIN). An ITIN is issued by the IRS to a person who is required to have a taxpayer identification number but does not have and is not eligible to obtain a social security number.

d. Nonresident Contractor - Either of the following:

   (1) A nonresident individual who performs in this State for compensation other than wages any personal services in connection with a performance, an entertainment or athletic event, a speech, or the creation of a film, radio, or television program.

   (2) A nonresident entity that provides for the performance in this State for compensation of any personal services in connection with a performance, an entertainment or athletic event, a speech, or the creation of a film, radio, or television program.

e. Nonresident entity - Any of the following:

(1) A foreign limited liability company that has not obtained a certificate of authority from the Secretary of State pursuant to Article 7 of Chapter 57C of the General Statutes.
(2) A foreign limited partnership or a general partnership formed under the laws of any jurisdiction other than this State, unless the partnership maintains a permanent place of business in this State.
(3) A foreign corporation that has not obtained a certificate of authority from the Secretary of State pursuant to Article 15 of Chapter 55 of the General Statutes.

f. Payer - A person who, in the course of a trade or business, pays compensation to any of the following:
(1) A nonresident individual or a nonresident entity compensation for personal services performed in this State.
(2) An ITIN holder who is a contractor and not an employee for services performed in this State.

3. Exceptions to Withholding

Tax is not required to be withheld from compensation paid to a nonresident entity if the entity meets certain requirements. No tax is required to be withheld if the entity is a corporation or a limited liability company that has obtained a certificate of authority from the Secretary of State. The payer must obtain from the entity and retain in its records the entity's identification number issued by the Secretary of State.

If the entity is a partnership, no tax is required to be withheld if the partnership has a permanent place of business in this State. The payer must obtain from the partnership and retain in its records the partnership's address and taxpayer identification number.

No tax is required to be withheld from an entity that is exempt from North Carolina corporate income tax under G.S. 105-130.11. This includes any organization that is exempt from federal income tax under the Internal Revenue Code. The entity must provide documentation of its tax exemption to the payer, such as a copy of the organization's federal determination letter of tax exemption or a copy of a letter of tax exemption from the Department of Revenue.

Tax is not required to be withheld from personal services income paid to an individual who is an ordained or licensed member of the clergy or who is a resident of North Carolina. The payer must obtain from any individual from whom the payer does not withhold because the individual is a resident of this State the individual's address and social security number and retain this information in its records.

4. Threshold

Withholding is required only if the nonresident contractor or ITIN contractor is paid or is expected to be paid more than $1,500 during the calendar year. Tax is not required to be withheld from a payment of compensation to a contractor if the payment is $1,500 or less and, at

the time the payment is made, the payer does not believe that the total compensation to be paid to the contractor during the year will exceed $1,500. If additional compensation paid to the contractor later in the year causes total compensation for the year to exceed $1,500, the payer is not required to withhold tax from the additional compensation to make up for the compensation from which no tax was withheld. **For example,** the payer pays a nonresident contractor $900 in January, 2010. Since the compensation is $1,500 or less, no tax is withheld. Later in 2010, the same nonresident is paid an additional $800. The payer must withhold $32 from the $800 compensation ($800 x 4%) because the total compensation paid to the contractor for the year now exceeds $1,500. If the payer makes regular payments to the contractor during the year, the total of which is expected to exceed $1,500, tax must be withheld from each payment.

5. Reporting and Paying the Withheld Tax

A payer who withholds tax from personal services income, or from income paid to an ITIN contractor, but who is not already registered with the Department of Revenue for wage withholding, must register by completing Form NC-BR, Business Registration Application for Income Tax Withholding, Sales and Use Tax, and Machinery, Equipment, and Manufacturing Fuel Tax, and returning the form to the North Carolina Department of Revenue at Post Office Box 25000, Raleigh, North Carolina 27640. The payer will be assigned an account identification number, will receive forms for paying the tax withheld.

A payer who withholds tax from non-wage compensation paid to a nonresident contractor or an ITIN contractor and who also withholds tax from wages must report the non-wage withholding with the wage withholding. The withheld tax must be reported and paid on a quarterly, monthly, or semiweekly basis depending on the average amount withheld during the month. **See XVIII. Reporting and Paying Tax Withheld** to determine when to report and pay the withholding.

6. Annual Statements

A payer must give each contractor from whom tax was withheld duplicate copies of a written statement containing the following information:

- the names, addresses, and taxpayer identification numbers of the payer and the contractor;
- the total amount of compensation paid to the contractor during the calendar year;
- the total amount withheld from the amount paid to that contractor during the year.

Payers must report personal services income and the tax withheld on Form NC-1099PS. Payers must report ITIN contractor compensation and the tax withheld on Form NC-1099-ITIN. The payer may complete federal Form 1099-MISC in lieu of Forms NC-1099PS or NC-1099-ITIN. The statement must be given to the contractor on or before January 31

following the calendar year in which the compensation is paid. If the services are completed before the end of the year, the statement must be given within 45 days of the last payment of compensation only if the contractor requests the statement at that time. The payer must file an annual report (Form NC-3 or NC-3M) with the Department of Revenue reconciling the amounts withheld from each contractor. The annual reconciliation for withholding is due on or before February 28.

7. Claiming Credit for Tax Withheld

Individuals having tax withheld from personal services income or from income paid to an ITIN holder should claim credit for the tax withheld on the same line on the individual income tax return, Form D-400, as credit is claimed for wage withholding. Partnerships (including limited liability companies filing as partnerships) may claim credit on the partnership income tax return, Form D-403, for the portion of the tax withheld that is attributable to nonresident partners on whose behalf the managing partner is required to pay tax. The portion of the tax withheld that is attributable to resident partners must be allocated to those partners on Schedule NC K-1. S corporations may claim credit on the S corporation franchise and income tax return, Form CD-401S, for the portion of the tax withheld that is attributable to shareholders on whose behalf the corporation files a composite income tax return. The portion of the tax withheld that is attributable to shareholders who are not part of a composite return must be allocated to those shareholders on Schedule K of the S corporation return.

8. Refund of Tax Withheld in Error

A payer who improperly withholds tax from a nonresident contractor or an ITIN contractor may refund the contractor the amount withheld in error if the refund is made before the end of the calendar year and before the payer furnishes the person the annual statement of tax withheld. A payer who makes a refund should not report the amount refunded on the annual statement nor remit the amount refunded to the Department. If the amount refunded has already been remitted, the payer must reduce the next payment of tax withheld from compensation paid to that person by the amount refunded. If no additional compensation is due to be paid to that person, and the amount withheld in error has already been remitted, the payer may not refund the tax withheld in error. The contractor must file an income tax return and claim credit for the tax withheld.

9. Examples of Required Withholding

Following are examples of when State taxes should be withheld from compensation paid of nonresidents for personal services performed in North Carolina.

Example 1: A nightclub owner enters into a contract with a nonresident agent to provide entertainment at the owner's club. Compensation is paid directly to the agent.

Requirement: If the agent is an individual, tax is required to be withheld from the payment only to the extent the agent performed services

in North Carolina. If the agent is a nonresident entity (LLC, partnership, corporation, etc.), tax must be withheld because the entity is deemed to be doing business in North Carolina through the entertainer. In either case, the agent is responsible for withholding four percent from the compensation paid to the entertainer because the entertainer is providing a personal service for the agent.

Example 2: The same nightclub owner enters into a contract with an agent to locate an entertainer and also enters into a separate contract with the entertainer.

Requirement: The compensation paid to the agent is not subject to withholding unless the agent performs services in North Carolina. However, the club owner must withhold from the compensation paid to the entertainer.

Example 3: A coliseum rents its facility to a resident promoter who has contracted with a nonresident performer for a concert at the coliseum. The coliseum deducts rent and other fees and expenses from the gross ticket proceeds before payment to the promoter. The promoter compensates the nonresident performer for the performance.

Requirement: No withholding is required from the ticket proceeds paid to the promoter because the promoter has not provided a personal service to the coliseum. The promoter is required to withhold the tax from the compensation paid to the nonresident performer because the entertainer is providing a personal service for the promoter.

XVII. Subject: Withholding of Income Tax (G.S. 105-163.1 - 105-163.24)

1. General

G.S. 105-163.1 through G.S. 105-163.10 and G.S. 105-163.22 through G.S. 105-163.24 require employers to withhold income tax from compensation paid to their employees.

2. Withholding From Wages

Income tax must be withheld according to tables prepared by the North Carolina Department of Revenue or by using an acceptable alternate method and employers must pay over the amount withheld to the Department. These requirements are explained in the booklet, "Income Tax Withholding Tables and Instructions for Employers," Form NC-30, which is available on the Department of Revenue website **www.dornc.com**.

3. Withholding from Pensions, Annuities, and Deferred Compensation (See page 86.)

4. Withholding from Nonresidents for Certain Personal Services and Withholding on Contractors Identified by an Individual Taxpayer Identification Number (ITIN) (See page 90.)

5. Wages

For North Carolina income tax purposes, the term wages has the same meaning as in Section 3401 of the Internal Revenue Code, except that it does not include the amount of severance wages paid to an employee during the taxable year that is exempt from State income tax for that taxable year under G.S. 105-134.6(b)(11).

If an employer enters into a voluntary agreement to withhold North Carolina tax on income not requiring withholding, the amount withheld will be accepted and the employee will receive credit on the annual income tax return provided the rules which apply to withholding are followed. Since the agreement to withhold is voluntary between the employer and the employee and is not required by law, the employee cannot receive credit for any amount withheld that is not properly paid to the Department of Revenue.

6. Employee's Withholding Allowance Certificate

Each new employee, before beginning employment, must give the employer a signed North Carolina Employee's Withholding Allowance Certificate, Form NC-4. A certificate filed by a new employee is effective upon the first payment of wages thereafter and remains in effect until a new certificate is furnished unless the employee claimed total exemption from withholding during the prior year. An employee claiming exemption from withholding must provide the employer a new NC-4 by December 1 for the following year. State and federal definitions of dependent, single person, married, head of household, and qualifying widow(er) are the same;

however, the number of allowances an individual is entitled to will differ. **Federal Exemption Certificates are not acceptable**. If an employee fails to furnish an exemption certificate, Form NC-4, the employer must withhold tax as if the employee is single with zero allowances.

The employer is not required to ascertain whether or not the total amount of allowances claimed is greater than the total number to which the employee is entitled. If, however, the employer has reason to believe that the number of allowances claimed by an employee is greater than the number to which such employee is entitled, the employer must notify the Department of Revenue immediately.

If an employee's allowances should decrease, requiring more tax to be withheld, the employee must provide an amended certificate to the employer within 10 days after the change. Should the allowances increase, requiring less tax to be withheld, the employee may provide an amended certificate to the employer at any time after the change occurs.

7. Additional Withholding Allowances

Additional withholding allowances may be claimed by taxpayers expecting to have allowable itemized deductions exceeding the standard deduction or allowable adjustments to income. One additional allowance may be claimed for each $2,500 that the itemized deductions are expected to exceed the standard deduction and for each $2,500 of adjustments reducing income ($2,000 if the annual income equals or exceeds the following amounts for the employee's filing status: single — $60,000; head of household — $80,000; or married or qualifying widow(er) — $50,000). If an employee will be entitled to a tax credit, he may claim one additional allowance for each $175 of tax credit ($140 if the annual income equals or exceeds the following amounts for the employee's filing status: single — $60,000; head of household — $80,000; or married or qualifying widow(er) — $50,000).

8. Penalty

G.S. 105-163.5 provides a civil penalty against an employee who gives an employer an allowance certificate that contains information which has no reasonable basis and results in a lesser amount of tax being withheld than would have been withheld had the employee provided reasonable information. The penalty is 50 percent of the amount not properly withheld.

9. Submission of Certain Withholding Allowance Certificates

An employer is required to submit copies of any withholding allowance certificates on which the employee claims more than 10 withholding allowances or claims exemption from withholding and the employee's wages would normally exceed $200 per week.

An employer filing a quarterly withholding report is required to submit copies of the certificates received during the quarter when the quarterly report if filed. An employer filing monthly withholding reports is required to submit copies of the certificates received during the quarter at the time for filing the monthly report for the third month of the calendar quarter. Copies may be submitted earlier and for shorter reporting periods.

Copies of the certificates, along with a letter showing the employer's name, address, withholding identification number, and the number of certificates submitted, should be mailed to: North Carolina Department of Revenue, Tax Compliance -Withholding Tax, P.O. Box 25000, Raleigh, North Carolina 27640-0001.

The employer shall withhold on the basis of the certificate until written notice is received from the Department that the certificate is defective. As part of that written notice, the Department will advise the employer to ignore the allowance certificate filed and to withhold on a number specified. The employer shall promptly furnish the employee a copy of the written notice.

If the employee files a new certificate, the employer shall honor that certificate only if the employee does not claim exempt and claims a number smaller than the number allowed in the Department's written notice. If the new certificate claims a number larger than the employee has been allowed and the employee specifies, in writing, any circumstances as justification to support the claims, the employer must forward a copy of the certificate and the employee's written statement to the Department for review. The employer shall continue to withhold as specified in the Department's written notice until written notice is received from the Department advising the employer to withhold on the basis of the new certificate.

To increase withholding, an employee may claim less than the employee's allowable allowances or may enter into an agreement with the employer and request that an additional amount be withheld by entering the desired amount on Form NC-4.

An employee working for two or more employers should claim the employee's allowable allowance with only one employer and claim zero allowances with the other employers.

10. Employers

An employer is any person or organization for whom an individual performs any service as an employee. The term includes federal, state, and local governmental agencies as well as religious, charitable, educational, and other nonprofit organizations even though they may be exempt for other tax purposes. **Note:** Compliance with any of the provisions of North Carolina withholding by a nonresident employer will not be deemed to be evidence that the nonresident is doing business in this state. (G.S. 105-163.4).

11. Employees

For North Carolina income tax withholding purposes, an employee is either a resident individual legally domiciled in this State who performs services within or outside North Carolina for wages, or a nonresident of this State who performs services within the State for wages. To prevent double withholding and to anticipate any tax credits allowable to a North Carolina resident, withholding of North Carolina tax is not required from

wages paid to a resident for services performed in another state if that state requires withholding. This relief from double withholding does not relieve the resident of the obligation to file a North Carolina individual income tax return and pay any balance due after tax credit.

All wages received by a nonresident for services performed in this State are subject to withholding of North Carolina income tax. Any relief from double withholding must be granted by the nonresident's state of residence.

12. Employer-Employee Relationship

Everyone who performs services subject to the will and control of an employer, both as to what shall be done and how it shall be done, is an employee. An employer-employee relationship exists when the person for whom the services are performed has the right to control and direct the individual performing the services. Managers and other supervisory personnel, officers of corporations, and elected public officials are employees. Whether the employer actually controls and directs the manner in which the services are performed does not matter if the employer has the right to do so, and it does not matter that the employee is called by some other name such as partner, agent, or independent contractor; nor whether the individual works full or part time; nor how the payments are measured, paid, or what they are called.

Lawyers, physicians, contractors, and others who follow an independent trade, business, or profession in which they offer their services to the public, generally are not employees. If an individual is subject to the control and direction of another only as to the results of the individual's work and not as to the methods of accomplishing the results, the individual is generally an independent contractor and not an employee.

13. Ministers

An ordained or licensed clergyman who performs services for a church of any religious denomination may file an election with the Secretary of Revenue and the church he serves to be considered an employee of the church instead of self-employed. Until a clergyman files the election, amounts paid by a church to a clergyman are not subject to withholding.

14. Common Carriers

The Amtrak Reauthorization and Improvement Act of 1990 provides that no part of the compensation paid to an employee of an interstate railroad subject to the jurisdiction of the Surface Transportation Board (STB) may be subject to income tax, or income tax withholding, in any state except the state of the employee's residence when such employee performs regular assigned duties in more than one state. The Act also precludes the taxation of compensation paid by an interstate motor carrier subject to the jurisdiction of the STB or to an employee of a private motor carrier performing services in two or more states except by the state of the employee's residence. Therefore, the compensation received by such nonresident employees for services performed in this State will not be subject to North Carolina income tax or income tax withholding.

Under the Federal Aviation Act (49 USCS-40116), a nonresident airline employee rendering service on an aircraft would not be liable for North Carolina income tax unless the scheduled flight time in North Carolina is more than 50 percent of the total scheduled flight time during the calendar year. If the employee's flight logs show that more than 50 percent of the scheduled flight time is in North Carolina, the amount of income reportable to this state would be based on the percentage that the North Carolina flight time is to the total flight time for the year.

15. Federal Employees

Under an agreement with this State, federal agencies withhold North Carolina income tax from the military pay of members of the Armed Forces designated as legal residents of North Carolina, and from the pay of civilian federal employees whose regular place of employment is in North Carolina.

16. Military Spouses

Under the Servicemembers Civil Relief Act, as amended by the Military Spouses Residency Relief Act of 2009, the wages of a spouse of a military servicemember who is legally domiciled in a state other than North Carolina are exempt from North Carolina income tax if (1) the servicemember is present in North Carolina solely in compliance with military orders; (2) the spouse is in North Carolina solely to be with the servicemember; and (3) the spouse is domiciled in the same state as the servicemember. Therefore, if a military spouse meets all three of the preceding conditions, an employer is not required to withhold North Carolina tax from wages paid to such military spouses. The Act does not apply to military spouses who are domiciled in North Carolina. Withholding from wages paid to military spouses domiciled in North Carolina is still required.

17. Seamen

The Vessel Worker Tax Fairness Act, 46 U.S.C. § 11108, prohibits withholding of state income tax from the wages of a seaman on a vessel engaged in foreign, coastwise, intercoastal, interstate, or noncontiguous trade or an individual employed on a fishing vessel or any fish processing vessel. Vessels engaged in other activity do not come under the restriction; however, any seaman who is employed in coastwide trade between ports in this State may have tax withheld if such withholding is pursuant to a voluntary agreement between such seaman and his employer.

With respect to income obtained while: (1) engaged as a pilot (licensed under section 7101 of Title 46 of the Code or under the laws of a state) on a vessel performing duties in more than one state; or (2) performing regularly assigned duties as a master, officer or crewman on a vessel operating on the navigable waters of more than one state, an individual is subject to income tax only in the state and political subdivision in which the individual resides.

Seamen who are exempt from withholding as specified above, should determine whether they meet the requirements for making payments of estimated income tax.

18. Professional Athletes

Professional athletic teams must withhold income tax from the North Carolina source income of a nonresident member of the team at the highest rate for individuals with no allowance for any withholding exemption. (The highest rate in effect for 2009 is 7.75 percent.) Taxes shall be withheld from the income of a resident member of the team in the same manner as taxes are withheld from other residents.

Professional athletic teams not domiciled in this State are classified as quarterly employers and must file returns reporting the amount of taxes withheld and pay the amounts withheld on a quarterly basis.

Professional athletic teams that are domiciled in this State shall determine their filing and paying requirements in the same manner as all employers domiciled in this State.

A professional athletic team must include with its annual reconciliation a list of all employees who received North Carolina source income during the year. The list must include the following information:

a. The name, social security number, and mailing address of each employee;
b. Whether the employee is a resident of this State;
c. The total amount of income;
d. The amount of North Carolina source income;
e. The total amount deducted and withheld.

A nonresident member of a professional athletic team is not required to file a North Carolina individual income tax return when the only income from North Carolina sources is the compensation received for services rendered as a member of the team and the team has met the withholding requirements above. The individual may file an individual income tax return and claim credit for the tax withheld.

An individual is liable for any additional tax, penalty, or interest due if the team does not properly determine the individual's North Carolina source income or properly withhold tax from that income.

19. Domestic Employees

Employers are not required to withhold State income tax from the wages of domestic employees; however, the employer and employee may enter into a voluntary agreement to withhold from the employee's wages. The amount to withhold is based on the employee information shown on Form NC-4. Employers may wish to contact the Employment Security Commission regarding any employment insurance liability.

20. Farm Labor

Compensation paid by a farmer for services performed on the farmer's farm in producing or harvesting agricultural products or in transporting the agricultural products to market is subject to North Carolina withholding if the compensation is subject to withholding of federal income taxes. Generally, wages paid to agricultural workers are subject

to federal income tax withholding if the worker is paid $150 or more during the year or the employer pays $2,500 or more to all agricultural workers during the year.

21. North Carolina State Lottery Winnings

Winnings of $600 or more paid by the North Carolina State Lottery Commission are subject to State withholding at the rate of 7 percent.

22. Severance Wages

The first $35,000 of severance wages paid to an employee (whether paid in one year or over several years) as a result of the employee's permanent, involuntary termination from employment through no fault of the employee is exempt from withholding. "Stay on pay" does not qualify as severance wages; therefore, "stay on pay" is subject to withholding.

23. Supplemental Wage Payments

If an employer pays supplemental wages separately (or combines them in a single payment and specifies the amount of each), the income tax withholding method depends partly on whether the employer withholds income tax from the employee's regular wages.

If tax has been withheld on the regular wages and the supplemental amount is not paid in a single payment together with regular wages, the employer may treat the supplemental wages as wholly separate from the regular wages and apply a flat rate of 6 percent to the supplemental wage payment without making any allowance for exemptions. Otherwise, the supplemental wages are added to the regular wages for the most recent payroll period. The income tax is figured as if the regular wages and supplemental wages constitute a single payment. The tax already withheld from the regular wages is subtracted from this amount. The remaining tax is then withheld from the supplemental wages. If the employer did not withhold income tax from the employee's regular wages, the employer must add the supplemental wages to the employee's regular wages paid for the current or last preceding payroll period and withhold tax as though the supplemental wages and regular wages were one payment.

Tips treated as supplemental wages. The employer withholds the income tax on tips from wages or from funds the employee makes available. If an employee receives regular wages and reports tips, the employer figures income tax as if the tips were supplemental wages. If the employer has not withheld income tax from the regular wages, the employer adds the tips to the regular wages and withholds income tax on the total. If the employer withheld income tax from the regular wages, the employer can withhold on the tips as explained above.

24. Wage and Tax Statements

An employer should use the six-part Federal Form W-2 or any other alternate forms which have been designed for payroll equipment if they provide the same information and the same number of copies as the

official form. When completed, the state copies must show the employer's North Carolina withholding identification number and must clearly designate the state tax as North Carolina tax. Statements which do not meet the above requirements will not be accepted and employees cannot be given credit for the tax withheld.

25. Reciprocity Of Tax Credits

North Carolina does not allow income tax credit to nonresidents; therefore, any relief from double taxation must be granted by the state of residence. North Carolina provides such relief to its residents as explained in number 11.

26. Credit For Income Tax Withheld

G.S. 105-163.10 provides that the amount deducted and withheld during any calendar year from the compensation of any individual shall be allowed as a credit to that individual against the tax imposed under G.S. 105-134.2 for taxable years beginning in such calendar year. For example, a taxpayer filing his return for a fiscal year ending September 30, 2009, will be allowed credit for tax withheld from wages for the calendar year ending December 31, 2008. This is the case even though the taxpayer must report the income on the return for the fiscal year ending September 30, 2009.

XVIII. Subject: Reporting and Paying Tax Withheld

1. New Employers

Each new employer required to withhold North Carolina income tax must complete and file Form NC-BR, Business Registration Application for Income Tax Withholding, Sales and Use Tax, and Machinery, Equipment, and Manufacturing Fuel Tax, with the Department. The Department will assign a State withholding identification number which should be recorded in a permanent place and used on all reports, returns, and correspondence concerning withholding. In most cases, the identification number will be assigned within four weeks of filing Form NC-BR. Do not use the number of another employer from whom a business was acquired.

2. Reports and Payments

North Carolina does not use a deposit system for income tax withheld similar to the federal system. Withheld taxes are paid quarterly, monthly, or semiweekly. Employers who withhold an average of less than $250 from wages each month must file a quarterly return and pay the withheld taxes on a quarterly basis. The quarterly return and payment are due by the last day of the month following the end of the calendar quarter.

Employers who withhold an average of at least $250 but less than $2,000 from wages each month must file a monthly return and pay the withheld taxes on a monthly basis. All monthly returns and payments are due by the fifteenth day of the month following the month in which the tax was withheld; except the return and payment for the month of December are due by the thirty-first day of January.

Employers who withhold an average of at least $2,000 from wages each month must file a report and pay the withheld taxes at the same times they are required to file reports and pay the tax withheld on the same wages for federal income tax purposes. The due dates for reporting and paying North Carolina income tax withheld is determined by the due dates for depositing federal employment taxes (income tax withheld and FICA). Each time an employer is required to deposit federal employment taxes, the employer must remit the North Carolina income tax withheld on those same wages, regardless of the amount of State tax withheld.

Exception: For federal tax purposes, if an employer withholds $100,000 or more, the deposit is required on the next banking day. North Carolina law does not adopt this provision of federal law, and the State income tax withholding on the same wages is due on or before the normal federal semiweekly due date for those wages. The employer must mail or deliver payment of the North Carolina income tax withheld by the due date.

Semiweekly filers are required to reconcile the tax paid with the tax withheld for the quarter on Form NC-5Q, North Carolina Income Tax Withholding Return. The due dates for Form NC-5Q are the same as for the federal quarterly return (Federal Form 941); on or before the last day of the month following the close of the quarter. An employer has 10 additional days to file the return if all required payments were made during

the quarter and no additional tax is due. Quarterly and semiweekly filers also reconcile the tax paid and the tax withheld for the year by filing Form NC-3, Annual Withholding Reconciliation. Monthly filers reconcile the tax paid and the tax withheld for the year by filing Form NC-3M, Annual Withholding Reconciliation. Forms NC-3 and NC-3M are due to be filed on or before February 28 following the end of the tax year.

(**Important:** The Department of Revenue is currently developing a new electronic process for submitting the annual withholding reconciliation (Form NC-3 and Form NC-3M) information. The new process will affect the annual reconciliation information that is due on February 28, 2011. Please review our website after January 1, 2011 for further information regarding the new electronic submission process.)

3. E-File

Employers can file their North Carolina withholding returns and pay their taxes online by using the Department's E-file system at **www.dornc.com**. The E-file system is available 24 hours a day, 7 days a week. Payments can be made by bank draft or credit or debit card using Visa or MasterCard.

4. Electronic Funds Transfer

The Department of Revenue requires certain employers remitting an average of $20,000 per month per tax type to pay taxes by electronic funds transfer (EFT). Employers required to remit payments by this method will be notified in writing at least 60 days prior to the first month that an EFT payment is due. Voluntary participation is offered for all filing frequencies for nonmandated employers who are interested in paying electronically. For questions concerning electronic funds transfer, contact the EFT Section at (919)733-7307.

5. Reporting and Paying Tax Withheld from Pensions, Annuities, and Deferred Compensation **(See page 86.)**

6. Reporting and Paying Tax Withheld from Nonresidents for Certain Personal Services and on Contractors Identified by an Individual Taxpayer Identification Number (ITIN) **(See page 90.)**

7. Amounts Withheld Are Held In Trust For The Secretary Of Revenue.

Any amount withheld by an employer is deemed to be held in trust for the Secretary of Revenue.

A penalty of 10 percent of the amount due is imposed for failure to withhold or to pay the tax when due. The penalty for failure to timely file a withholding return is 5 percent of the tax due per month (maximum 25 percent). In addition, criminal penalties are provided for willful failure to comply with the withholding statutes.

An employer who fails to withhold or pay the amount required to be withheld is personally and individually liable for the tax. If an employer has

failed to withhold or to pay over income tax withheld or required to have been withheld, the tax not deducted or paid may be assessed against the responsible officers. The liability includes the tax not deducted or paid and any penalties and interest previously assessed against the employer. More than one person may be liable as an officer responsible for the payment of withholding taxes; however, the amount of the income tax withheld or required to have been withheld will be collected only once, whether from the employer or one or more responsible officers. The term "responsible officer" means the president and the treasurer of a corporation, the manager of a limited liability company, and any officer of a corporation or member of a limited liability company who has a duty to deduct, account for, or pay over income tax withheld. It is not necessary that the failure to collect and pay the withholding amounts was willful; it is only necessary that the responsible officer failed to pay the tax withheld or required to have been withheld to the Secretary of Revenue.

When the Department of Revenue determines that collection of the tax is in jeopardy, an employer may be required to report and pay the tax at any time after payment of the wages.

8. Annual Reports

At the end of each calendar year employers are required to furnish wage and tax statements to employees. Two copies must be furnished to the employee and one copy must be furnished to the Department. The Internal Revenue Service supplies a six-part Form W-2 which will produce the required federal and North Carolina statements in one packet.

The copies of the wage and tax statements for the Department of Revenue must be filed with the Annual Withholding Reconciliation, Form NC-3 or NC-3M. (See Number 2 regarding future submissions of annual withholding reconciliation information.)

A payer who withholds from compensation paid to a nonresident contractor or ITIN contractor must provide the contractor a statement showing the total compensation paid and the amount withheld during the calendar year. The payer must give **Form NC-1099PS, Personal Services Income Paid To A Nonresident**, or **Form NC-1099-ITIN, Compensation Paid to an ITIN Contractor**, to the contractor on or before January 31 following the calendar year, or if the contractor requests the statement before then, within 45 days after the last payment of compensation to the contractor. Federal Form 1099-MISC may be filed in lieu of Form NC-1099PS or Form NC-1099-ITIN.

Form NC-1099NRS, **Report of Sale of Real Property by Nonresidents**, is required to be filed by any person buying real property located in North Carolina from a nonresident. The form must be filed within 15 days of the closing date of the sale.

A payer who withholds from pension income must give the recipient Federal Form 1099-R, showing the pension amount paid and the North Carolina tax withheld on or before January 31 following the year in which the pension payments were made.

Forms NC-1099PS, NC-1099-ITIN, NC-1099NRS, and Federal Form 1099-R must be filed with North Carolina; however, other reports of 1099 information (interest, rents, premium, dividends, etc.) are not required to be reported to North Carolina unless the payments have not been reported to the Internal Revenue Service.

XIX. Subject: Estimated Income Tax (G.S. 105-163.15)

1. Forms

The form for payment of estimated individual income tax, Form NC-40, is available from the Department of Revenue in the form of personalized payment vouchers or a four-part nonpersonalized payment form. Both types of forms include the necessary vouchers and instructions for making payments. An individual can also pay estimated tax online at **www.dornc.com**.

2. Requirements for Filing

An individual is required to pay estimated income tax if the tax shown due on the income tax return for the taxable year, reduced by the North Carolina tax withheld and allowable tax credits, is $1,000 or more regardless of the amount of income the individual has that is not subject to withholding. Married individuals can make joint payments of estimated income tax even if they are not living together; however, they are not entitled to make joint estimated tax payments if they are separated under a decree of divorce or of separate maintenance. Also, they may not make joint estimated tax payments if either of them is a nonresident alien or if either of them have different tax years.

Whether a husband and wife make joint estimated tax payments or separate payments will not affect their choice of filing a joint income tax return or separate return. If they make joint payments and then file separate returns, they may divide the estimated tax payments between them.

A taxpayer filing a short period return because of changing his income year is required to make estimated income tax payments on the installment dates which fall within the short period and 15 days after the close of the short period which would have been due had he not changed his income year. Interest on the underpayment of estimated income tax for a short period will be computed for the period of underpayment based on the tax shown due on the short period return and computed in the same manner as it would have been computed had the taxpayer not changed his income year.

3. Applying Prior Year's Income Tax Refund to Current Year's Estimated Income Tax

An individual may elect to have his income tax refund applied to estimated income tax for the following year. For example, an individual due a refund on his 2009 income tax return may have all or any portion of the refund applied to his estimated tax for 2010. The individual may not however, file a 2009 tax return in 2011 and request the refund be applied to his 2011 estimated tax since the refund can only be applied to the tax year which follows the year for which the request for refund is made. The last allowable date for making a 2010 estimated tax payment is January 15, 2011; therefore, you must file your 2009 income tax return

by January 15, 2011, to elect to apply a portion of your refund to 2010 estimated tax. If an individual makes a valid election, that individual may not revoke the election after the return has been filed in order to have the amount refunded or applied in any other manner, such as an offset against any subsequent determined tax liability.

XX. Subject: Interest on the Underpayment of Estimated Income Tax (G.S. 105-163.15)

1. General

Interest may be due on the underpayment of estimated income tax. The interest is computed separately for each payment period, therefore an individual may owe interest for an early period even if that individual later paid enough to make up the underpayment. An individual who did not pay enough tax by the due date of each of the payment periods may owe interest even if a refund is due when the return is filed.

2. Avoiding Interest on the Underpayment

Interest on the underpayment of estimated income tax will not apply if the individual makes payments of estimated income tax on each installment date for 25 percent of the lesser of (1) 90 percent (66.67 percent for farmers and fishermen) of the tax (after tax credits) on the current year's return, (2) 100 percent of the tax on the preceding year's return (provided it was a taxable year of 12 months and the individual filed a return for that year), or (3) 90 percent (66.67 percent for farmers and fishermen) of the tax determined by annualizing the income received during the year up to the month in which the installment is due. Also, no interest on an underpayment will be due if an individual had no tax liability for the preceding year or if the total tax shown on the current year return minus tax credits and the amount paid through withholding is less than $1,000.

3. Underpayments

An underpayment is the excess of the required installment (or, if lower, the annualized income installment) for a payment period over the portion of the amount paid by the due date that is not applied to an underpayment for an earlier payment period.

Payments include income tax withheld and are considered payments of estimated tax in equal installments on the required installment dates (usually four), unless the individual can prove otherwise. A payment of estimated tax is credited against unpaid installments in the order in which the installments are required to be paid.

4. Overpayments

An overpayment for any period occurs when the withholding and estimated tax payments are more than the total of any underpayments for an earlier period plus the lesser of the required installment or the annualized income installment for the period. If there is an overpayment for a period, it should be carried to the next period and added to the withholding and estimated tax paid for that later period to determine any underpayment or overpayment for that later period.

5. Determining An Underpayment

No interest will be due if the estimated tax payments were made on

time and the payment for each period was at least as much as either the required installment or the annualized income installment for the period. Use Form D-422, Underpayment of Estimated Tax by Individuals, to determine any underpayment.

The required installment for any payment period is the lesser of 22.5 percent of the tax shown on the current year return or 25 percent of the tax shown on the prior-year return (if the prior-year return covered all 12 months of the year). However, if the annualized income installment for any period is less than the required installment for the same period and the annualized income installment is used in determining the underpayment, add the difference between the annualized income installment and the required installment to the required installment for the next period. If the annualized income installment for the next payment period is used, add the difference between the annualized income installment for that period and the required installment (as increased) for that period to the required installment for the following payment period.

There will be no underpayment for any payment period in which the estimated tax payments, reduced by any amounts applied to underpayments in earlier periods, were paid by the due date for the period and were at least as much as the annualized income installment for the period.

6. Period of Underpayment

Underpayment interest is applied to the number of days that the installment was not paid. For tax year 2009, for example, determine the period of the underpayment by counting the number of days after the due date of the installment to and including the date of payment, or April 15, 2010, whichever is earlier. Fiscal year taxpayers use the 15th day of the 4th month following the close of the fiscal year instead of April 15, 2010.

Calendar year taxpayers' payments were due on April 15, June 15, and September 15, and January 15 of the following year. If the 15th of the month is on a weekend or holiday, the payment is due on the next business day.

Payments for fiscal year taxpayers were due on the 15th day of the 4th month, the 15th day of the 6th month, and the 15th day of the 9th month of the fiscal year, and the 15th day of the 1st month after the end of the fiscal year.

Periods and amounts of underpayment are determined by applying estimated tax payments to any underpayments of earlier installments in the order in which such installments were required to be paid.

If a payment of estimated tax is applied to an underpayment for an earlier period, but the payment is less than the underpayment, there will be more than one period of underpayment for the earlier period.

The first period of underpayment for any payment period will be from the day after the due date for the payment period to the date of the

first applied payment. Later periods of underpayment for that payment period will be from the day after the due date for the payment period to the date of the next applied payment or April 15 of the following year, whichever is earlier.

To determine the interest for a payment period with more than one period of underpayment, compute interest separately for each of the periods of underpayment using the number of days in each period of underpayment, the correct underpayment balance, and the appropriate interest rates.

7. Farmers and Fishermen

The following special rules for underpayment of estimated tax apply to farmers and fishermen:

a. Interest for underpaying 2009 estimated tax will not apply if the return was filed and all tax was paid by March 1, 2010. For fiscal year taxpayers, interest will not apply if the return is filed and tax due is paid by the first day of the third month after the end of the tax year.

b. Any interest owed for underpaying 2009 estimated tax will be determined from one payment due date, January 15, 2010.

c. Underpayment interest for 2009 is computed on the difference between the amount of estimated tax paid by the due date and the lesser of 100 percent of the tax shown on the 2008 return or 66 $^{2}/_{3}$ percent of the 2009 tax.

In addition to the special rules, farmers and fishermen will not have to pay underpayment interest if the tax due (less withholding and tax credits) is less than $1,000 or if there was no tax liability for the prior year.

XXI. Subject: Gift Tax (G.S. 105-188 - G.S. 105-197.1)

(Important: The gift tax is repealed effective for gifts made on or after January 1, 2009. Gifts made prior to the January 1, 2009 are subject to the provisions below.)

1. General

North Carolina gift tax is imposed on all transfers of North Carolina property by gift and is imposed on the fair market value of net gifts. If property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift. The tax rates are graduated and depend on the relationship of the donee to the donor.

2. Exempt Transfers

North Carolina gift tax does not apply to the following transfers:

a. Gifts for state, county, or municipal purposes within North Carolina;

b. Gifts for the exclusive benefit of charitable, educational, or religious organizations located in North Carolina if no part of the earnings benefit any private shareholder or individual;

c. Gifts to or for the exclusive benefit of charitable, religious and educational corporations, foundations and trusts, not conducted for profit, incorporated or created or administered under the laws of any other state (i) when such other state levies no gift taxes upon property similarly passing from its residents to charitable, educational, or religious corporations, foundations, and trusts incorporated or created or administered under the laws of North Carolina, or (ii) when the corporation, foundation, or trust receives and disburses funds donated in North Carolina for religious, charitable, and educational purposes;

d. Gifts to one spouse from another spouse, including property exempt from federal estate and gift taxes because it is considered qualified terminable interest property under Section 2523(f) of the Internal Revenue Code;

e. Tuition payments made on behalf of an individual to an educational institution. The term "educational institution" includes only those institutions that normally maintain a regular faculty and curriculum and normally have a regularly organized body of students in attendance where the educational activities are conducted. (With respect to qualified tuition programs, if a donor elects to take a contribution to a qualified tuition program into account ratably over a five-year period as provided under Section 529 of the Internal Revenue Code, the contribution is not considered a taxable gift for North Carolina gift tax purposes.);

f. Medical payments made on behalf of an individual to a provider of medical care as defined in the Internal Revenue Code; and

g. Gifts of property located outside the jurisdiction of North Carolina.

3. Imposition of Tax

Gift tax is imposed on all transfers of property by gift, whether the gift is in trust or otherwise and whether the gift is direct or indirect. The tax applies to all property (real, personal, or mixed) and property interests within the jurisdiction of North Carolina. With respect to gifts made by a nonresident, the gift taxes apply only if the property has a tax situs in North Carolina.

Gift tax does not apply to the transfer of property in trust where the donor has the power to revest in the donor title to the property. However, the relinquishment or termination of such power (other than the donor's death) is considered a transfer by gift from the donor, and any payment of income from the property to a beneficiary other than the donor is considered a transfer by gift from the donor.

4. Rates of Tax

The rates of tax are based on the relationship between the donor and the donee as follows:

a. *Class A donees:* Lineal issue, lineal ancestor, adopted child, or stepchild of the donor. Although a stepchild is a class A donee, a stepparent is not.

b. *Class B donees:* Brother, sister, descendant of brother or sister, or uncle or aunt by blood of donor.

c. *Class C donees:* An individual in any other degree of relationship to the donor than those individuals in Classes A and B.

5. Basis of Tax

North Carolina gift tax is based on the aggregate sum of the net gifts made by a donor to the same donee. The term "net gifts" means the sum of the gifts made by a donor to the same donee during any stated period of time in excess of the annual exclusion and the applicable specific exemption.

6. Annual Exclusion

The North Carolina annual exclusion amount is equal to the federal inflation-adjusted amount provided in section 2503(b) of the Internal Revenue Code. The annual exclusion amount is $12,000. Gifts not exceeding the total value of the annual exclusion made to any one donee in a calendar year are not subject to North Carolina gift tax. Gifts to any one donee in a calendar year that exceed the total value of the annual exclusion are subject to gift tax.

Joint Gifts: When a gift is made by one spouse to a person other than the donor's spouse, the donor may elect to claim both the donor's annual exclusion and the spouse's annual exclusion provided both spouses consent to the election and both spouses are residents of North Carolina when the gift is made. Consent to share annual gift tax exclusions must be made in writing on a timely filed gift tax return. The election to share

gift tax exclusions is irrevocable. The consent of both spouses must be shown on the return where the exclusions are claimed.

The personal representative for the estate of a deceased spouse, or the guardian of a legally incompetent spouse, may sign the consent.

Gift-splitting: For federal gift tax purposes, a husband and wife may elect gift-splitting. Consequently, if both spouses consent to gift-splitting, a gift made by a husband or wife to a third party is treated as made one-half by each. If gift-splitting is elected, the donor spouse must file a federal gift tax return if any gifts to any one donee exceed the amount of the annual gift tax exclusion. However, the consenting spouse must file a federal return only if the spouse made gifts to any one donee in excess of the annual gift tax exclusion. There is no provision in North Carolina gift tax law for a husband and wife to elect gift-splitting. Therefore, the donor spouse must file a State gift tax return if the gift exceeds the donor's annual exclusion pursuant to the provisions under *Joint Gifts* above.

Gifts of Future Interest in Property: The annual exclusion does not apply to gifts of future interest where the donee's use, possession, enjoyment, or income of the property will not begin until some future time.

Remainder Interests: The annual exclusion also does not apply to a gift of a remainder interest which is considered a gift of future interest. This is the case even when the donee holds a life estate in the same property and thus has immediate enjoyment of the donated remainder interest.

7. Specific Exemption

A donor is entitled to a total lifetime exemption of $100,000 to be deducted from gifts made to Class A donees. The exemption does not apply to Class B or Class C donees. The exemption may, at the option of the donor, be taken in its entirety in a single year or may be spread over a number of years and, when it is exhausted, no further exemption is allowable.

When the exemption or any part of the exemption is applied to gifts to more than one donee in any one calendar year, it must be apportioned among the donees in the same ratio as the gross gifts after exclusion to each donee is to the total value of all gifts made in the calendar year.

8. Valuation of Property

If a gift is made in property, the amount of the gift is the fair market value of the property on the date of the gift. When a gift of real estate is made to a husband and wife, creating an estate by the entirety, the value of the transfer is equally divided between the donees.

If property is transferred for less than an adequate and full consideration, the amount by which the value of the property exceeds the value of the consideration is considered a gift and must be included in computing the amounts of gifts made during the calendar year.

The value of donated property that is encumbered by a mortgage is measured by the equity in the property remaining after deducting the mortgage indebtedness.

9. Gift Tax Returns and Payment of Tax

The donor is responsible for filing a gift tax return and paying the gift tax. A donor who gives a donee a gift of future interest or one or more taxable gifts whose total value exceeds the amount of the annual exclusion is required to file a gift tax return and pay the tax due by April 15 following the end of the calendar year in which the gift was made.

If a gift tax return cannot be filed by April 15, a donor may apply for an automatic six-month extension of time to file the return by filing Form D-410G, Application for Extension for Filing Gift Tax Return. Form D-410G must be filed by April 15.

Donors (including military personnel) who live outside the United States and Puerto Rico are granted an automatic four-month extension for filing a North Carolina gift tax return. No extension application is required to receive the extension. However, a statement must be attached to the donor's gift tax return explaining that the donor was out of the country on the due date of the return. If an additional two months is needed to file the gift tax return, the donor should fill in the circle located at the bottom right of Form D-410G and file the form on or before August 15.

Gift tax returns not filed by April 15 are subject to a late filing penalty of 5 percent per month (maximum 25 percent). If the full amount of gift tax is not paid by April 15, a late payment penalty of 10 percent of the unpaid tax is due (minimum $5.00). An extension of time to file the return does not extend the time for payment of the tax. Tax not paid by the original due date is subject to the 10 percent late payment penalty. Interest on unpaid tax begins to accrue on April 16 of the year the return is due.

10. Period of Limitation on Assessments

If a donor dies within three years after filing a return, gift taxes may be assessed at any time within those three years, or on or before the date of final settlement of the donor's North Carolina estates taxes, whichever is later.

11. Federal Corrections

If the federal government corrects the amount of net gifts a taxpayer must report, a corrected North Carolina gift tax return must be filed within six months of the date the report was received. Taxpayers who do not comply with these requirements are subject to the penalties provided in G.S. 105-236 and forfeit the right to any refund by reason of the determination.

12. Qualified Personal Residence Trust

Federal and State gift tax provisions differ in determining the value of

gifts of remainder interests in a personal residence through the use of a Qualified Personal Residence Trust (QPRT). With a QPRT, the grantor transfers ownership of a residence to an irrevocable trust, retaining the right to live rent-free in the residence for a term of years. Upon the expiration of the term period, the residence generally is either transferred to the remainder beneficiaries, or retained in trust and rented (perhaps to the grantor), or retained for the rent-free-use of the grantor's spouse.

For federal gift tax purposes, the fair market value of the donated property is reduced by both the present value of the grantor's retained income interest and the grantor's retained contingent reversion interest in the property. The value of the contingent reversion interest is determined based on the donor surviving a certain number of years and is calculated using a table based on national actuarial statistics. For State gift tax purposes, the fair market value of the donated property is not reduced by the grantor's retained contingent reversion interest.

XXII. Subject: Estate Tax (G.S. 105-32.1 - G.S. 105-32.8)

1. General

North Carolina estate tax is imposed when federal estate tax is imposed on the transfer of the taxable estate of a decedent under Section 2001 of the Internal Revenue Code and any of the following apply:

a. The decedent was a resident of North Carolina at death.

b. The decedent was not a resident of North Carolina at death and owned real property or tangible personal property that is located in North Carolina or intangible personal property that has a tax situs in North Carolina.

"Situs" means place or location. For tax purposes, it is the place where something is held to be legally located and therefore where it is taxable. In general, tangible property has a tax situs where it is physically located, and intangible property has a tax situs at the domicile of the owner. However, when intangible property is used by a business at a location other than the domicile of the owner, it acquires a business situs where it is used and becomes taxable in the jurisdiction in which it is used.

2. Amount of Tax

North Carolina estate tax is due on the estate when a federal estate tax would be payable if the federal estate tax was determined **without** regard to the deduction for state death taxes. The North Carolina estate tax is equal to the state death tax credit that was allowable under section 2011 of the Internal Revenue Code as it existed prior to 2002. The amount of the North Carolina estate tax is limited to the federal estate tax that would be payable if the federal estate tax was computed without regard to the deduction for state death taxes.

Determination of tax for resident decedent: If the decedent was a North Carolina resident at death and owned property in another state, the tax due is reduced by the lesser of (a) the amount of the state death tax credit that would have been allowed against the federal taxable estate as of December 31, 2001 or (b) an amount computed by multiplying the credit by a fraction, the numerator of which is the gross value of the estate that has a tax situs in another state and the denominator of which is the value of the decedent's gross estate.

Determination of tax for nonresident decedents: If the decedent was not a resident of North Carolina at the time of death and owned property in North Carolina, the amount of North Carolina estate tax is an amount computed by multiplying the credit by a fraction, the numerator of which is the gross value of real property that is located in North Carolina plus the gross value of any personal property that has a tax situs in North Carolina and the denominator of which is the value of the decedent's gross estate.

3. Liability for Tax

Primary liability: The estate tax is payable from the assets of the estate. A person who receives property from an estate is liable for the amount of tax attributable to that property.

Personal representative: A personal representative is the person appointed by the clerk of superior court to administer a decedent's estate. If no one is appointed personal representative, the personal representative is the person required to file a federal estate tax return for the decedent's estate. The personal representative of an estate is liable for any estate tax that is not paid within two years after it was due. This liability is limited to the value of the assets of the estate that were under the control of the personal representative.

Clerk of Court: A clerk of court who allows a personal representative to make a final settlement of an estate without presenting required proof of payment of the estate tax is liable on the clerk's bond for any estate tax due. The personal representative must provide (a) an affirmation certifying that no tax is due because an estate tax return was not required to be filed or (b) a certificate issued by the Secretary of Revenue that the estate's tax liability has been satisfied.

4. Return and Payment of Tax

Filing requirement: The North Carolina Estate Tax Return (Form A-101) is required to be filed by the personal representative if a federal estate tax return is required to be filed and the decedent was domiciled in North Carolina at death or the decedent owned real property or tangible personal property located in North Carolina. The return is due at the same time the federal return is due which is nine months from the date of death.

If the North Carolina estate return cannot be filed by the due date, and extension of time for filing the return and paying the tax may be granted. A request for an extension must be submitted in writing to the Department of Revenue on or before the due date of the return. In lieu of requesting an extension, proof of a federal extension may be submitted when the return is filed.

Paying the tax: Payment of the tax, including any penalty and interest, is due at the same time the estate tax return is due. The personal representative of an estate may sell estate assets to obtain money to pay the estate tax.

5. Penalties and Interest

If Form A-101 cannot be filed by the due date, a late filing penalty of five percent of the tax (maximum 25 percent) is due for each month, or part of a month, the return is late. If the full amount of tax is not paid by the due date, a late payment penalty of ten percent of the unpaid tax (minimum $5.00) is due. Interest accrues from the due date of the return and continues to accrue until the tax is paid.

6. Installment Payment of Tax

The personal representative of an estate may elect to make installment payments of North Carolina estate tax in the same manner as elected for federal estate tax payments under section 6166 of the Internal Revenue Code. Acceleration of the federal payments also accelerates the State

payments. If the personal representative elects the same North Carolina installment payments, attach supporting documentation of the IRS acceptance of the election.

7. Estate Tax is a Lien on Real Property in the Estate

The North Carolina estate tax imposed on an estate is a lien on the real property. An estate tax lien may be extinguished when one of the following occurs:

a. The personal representative certifies to the clerk of court that no tax is due because an estate return was not required to be filed.

b. The Department issues a certificate stating that the lax liability has been satisfied.

c. For specific property, when the Secretary issues a tax waiver for that property.

d. Ten years have elapsed since the date of the decedent's death.

8. Federal Changes

If the Internal Revenue Service makes changes to the federal estate tax return, the personal representative must report the changes to the State by filing an amended North Carolina estate return with a copy of the changes. The amended return must be filed within six months of the date the report was received. Amended returns not filed within the applicable time period are subject to a penalty of five percent of the additional tax for each month or part of a month that the return is late (minimum $5.00; maximum 25 percent). A person who fails to report a federal correction or determination forfeits the right to any refund due by reason of the determination.

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