State of North Carolina

INDIVIDUAL INCOME TAX
GIFT TAX
ESTATE TAX

2006 SUPPLEMENT

RULES AND BULLETINS
TAXABLE YEARS
2005 and 2006

Issued by:

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2006 Supplement to Rules and Bulletins for Taxable Years 2005 and 2006

Preface

This publication is a supplement to the Individual Income Tax, Gift Tax, and Estate Tax Rules and Bulletins for Taxable Years 2005 and 2006. The supplement addresses changes to the 2005/2006 Rules and Bulletins resulting from legislative actions, court decisions, Attorney General opinions, rules adopted or amended under the Administrative Procedures Act, Chapter 150B of the General Statues, or administrative interpretation by the Department of Revenue.

This supplement includes only those sections of the 2005/2006 Rules and Bulletins that have been changed. The changes are indicated by striking through the original material and underlining the new material.

CONTENTS

Note: Sections V, X, XVII, XIX, and XX referenced above are not contained in this supplement but may be viewed in the Individual Income Tax Bulletins for Taxable Years 2005 and 2006.

I. Subject: Filing Individual Income Tax Returns

3. Items Requiring Special Attention (Page 2)

f. The same filing status claimed on the federal income tax return must also be claimed on the North Carolina income tax return. However, <u>for taxable years beginning prior to January 1, 2006,</u> 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** must be claimed. <u>For taxable years beginning on or after January 1, 2006, such taxpayers may choose to file a joint State return if they filed a joint federal return. Once a joint return is filed, separate returns may not be filed for that year after the due date of the return.</u>

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~~ <u>Nonresidents</u> and ~~Nonresidents~~ <u>Part-Year Residents</u>" 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 54.)

6. Extensions (Page 3)

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. ~~The penalties will also apply if the extension is not valid.~~

~~An application for extension is considered invalid if the amount entered on the extension form as the tax expected to be due is not properly estimated. In determining whether the amount reflected as tax due on the application is properly estimated, all facts and circumstances, including the amount of tax due in prior years, whether substantial~~

~~underpayments have been made in other years, and whether an individual made a bona fide and reasonable attempt to locate, gather, and consult information, must be considered.~~

~~Individuals living outside the United States or Puerto Rico (including military personnel) are~~ 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 ~~they attach a statement to their return to explain that they were out of the country on the due date of the return.~~ the individual marks the "out of the country" indicator on page 1 of Form D-400. The extension application, Form ~~D-410~~ 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.

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

4. Joint Returns (G.S. 105-152) (Page 9)

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~~ 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.

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.

New Filing Option for 2006: Effective for tax years beginning on or after January 1, 2006, 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, an individual still has the option of filing the State return as married filing separately.

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

2. Additions to Federal Taxable Income (G.S. 105-134.6) (Page 13)

k. 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 $1,600 ($1,700 for tax years beginning on or after January 1, 2006). 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 ~~2005~~ federal taxable income the amount of the child's unearned income in excess of $500 but not exceeding $1,600 ($1,700 for tax years beginning on or after January 1, 2006).

l. The amount of qualifying expenses for which an income tax credit for qualifying expenses of a film or television production company was claimed under G.S. 105-151.29. (Repealed effective for tax years beginning on or after January 1, 2007.)

The following new additions (m, n, and o) are effective for tax years beginning on or after January 1, 2006.

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

n. 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.

o. 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.

3. Deductions from Federal Taxable Income (G.S. 105-134.6) (Page 15)

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 2: If an individual claimed the 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 ~~2005~~ State return.

r. Up to $750 ($1,500 on a joint return) for contributions made on or after January 1, 2006 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. The deduction is allowable only to taxpayers whose adjusted gross incomes are less than the following amounts for their filing status: (Married filing jointly/Qualifying widow(er) - $100,000; Head of Household - $80,000; Single - $60,000; and Married filing separately - $50,000).

~~V.~~IV. Subject: Bailey Settlement

1. Qualifying State or Local Retirement System (Page 23)

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.

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

4. Taxable Income of Nonresidents and Part-Year Residents (Page 33)

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.

An individual who files a joint federal income tax return but cannot qualify to file a joint North Carolina income tax return because the individual's spouse is a nonresident and had no North Carolina taxable income must calculate federal taxable income on a federal income tax form as a married person filing a separate federal income tax return and attach it to the North Carolina return to show how the separate federal taxable income was determined. The separate federal return should reflect only the individual's income, exemptions, and deductions. In lieu of making the calculation on a federal form, an individual may submit a schedule showing the computation of the separate federal taxable income. In this case, the individual must attach a copy of the joint federal return unless the federal return reflects a North Carolina address.

<u>**New Filing Option for 2006:** Effective for tax years beginning on or after January 1, 2006, 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, an individual still has the option of filing the State return as married filing separately.</u>

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.

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

4. Tax Credits (Page 37)

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.

Pursuant to North Carolina General Statutes 105-134.6(a) and 105-130.5(a)(10), an addition to federal taxable income is required on a shareholder's return for the amount of all tax credits claimed by the S corporation and passed through to the individual shareholders, with the exception of the credit for tax paid to another state or country and the credit for donation of real property under G.S. 105-130.9(4).

Example:

> S corporation claims the tax credit for creating jobs (G.S. 105-129.8). The installment for the tax year 2005 is $1,000 and the S corporation elects to claim this credit against the income tax rather than the franchise tax. There are two (50%) shareholders. Each shareholder claims the jobs tax credit of $500 on his or her individual income tax return. Therefore, each individual taxpayer must add to federal taxable income the tax credit of $500 claimed on his or her individual income tax return.

<u>(Effective for taxable years beginning on or after January 1, 2006, a shareholder is subject only to the adjustments under G. S. 105-134.6 regardless of the shareholder's residency status or whether the income is attributable to North Carolina.)</u>

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

7. Tax Credits (Page 46)

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, ~~and~~

e. Tax credit for charitable contributions by nonitemizers, <u>and</u>

f. <u>Tax credit for recycling oyster shells.</u>

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

10. Income Tax Credits of Partnerships (Page 50)

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. Effective for taxable years beginning on or after January 1, 2002, 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.

Notwithstanding the above provisions, with respect to the allocation by the partnership of the tax credit for certain real property donations, the specific dollar limitations apply separately to each partner instead of to the partnership as a whole. This provision is effective for taxable years beginning on or after January 1, 2002 and expires for taxable years beginning on or after January 1, ~~2006~~ 2007.

XI. Subject: Tax Credits

4. Child and Dependent Care Expenses (G.S. 105-151.11) (Page 58)

A tax credit is allowable for the employment-related expenses for child and dependent care. The credit is calculated on the net qualified federal employment-related expenses ~~(not to exceed $2,400 for one qualifying dependent or $4,800 for two or more qualifying dependents)~~ after reduction for any employer-paid dependent care assistance that is excluded from federal gross income.

~~The maximum amount of qualifying expenses for federal purposes is $3,000 for one qualifying dependent and $6,000 for two or more qualifying dependents. Under North Carolina law, the maximum qualifying expenses on which the credit is based is $2,400 for one dependent and $4,800 for two or more dependents. If an employer pays dependent care benefits of $2,400 or more for one dependent or $4,800 or more for two or more dependents, no tax credit is allowed on the State return.~~

For tax year 2005, the maximum employment-related expenses on which the credit is based is $2,400 for one qualifying dependent and $4,800 for two or more qualifying dependents. For the tax year 2006, 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.

5. Real Property Donated for Public Purposes (G.S. 105-151.12) (Page 59)

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 or other similar land conservation purposes. The credit is allowed for 25 percent of the fair market value of the interest donated but may not exceed $250,000. A taxpayer 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. 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, 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.

With respect to a credit claimed by a partnership, the $250,000 limitation applies to each partner instead of to the partnership as a whole. The $250,000 limitation at the partner level expires for tax years beginning on or after January 1, ~~2006~~ 2007. After that date, the limitation will apply to the partnership as a whole.

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.

13. Credit for Charitable Contributions by Nonitemizers (G.S. 105-151.26) (Page 62)

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 ~~the credit~~ credits for certain real property ~~donations~~ donations, ~~or the credit for~~ gleaned crops, or recycling oyster shells ~~is~~ 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 Qualifying Expenses of a Film or Television Production Company (G.S. 105-151.29) (Page 62)

Effective for taxable years beginning on or after January 1, 2005 for qualifying expenses incurred on or after July 1, 2005, 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.

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.~~ 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)~~(10)~~(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, 2010.

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

Effective for taxable years beginning on or after January 1, 2006, 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.

~~15.~~ 16. Qualified Business Investments (G.S. 105-163.010 through ~~G.S. 105-163.014)~~ G. S. 105-163.015) (Page 64)

~~16.~~ 17. Credit for Investing in Renewable Energy Property (G.S. 105-129.16A) (Page 66)

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, and wind 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 $250,000 per installation ($2,500,000 per installation for tax years beginning on or after January 1, 2006). 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 effective for tax years beginning on or after January 1, 2006);
- $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.

The credit is repealed effective for renewable energy property placed in service ~~taxable years beginning~~ on or after January 1, ~~2006.~~ 2011.

~~17.~~ 18. Credit for Rehabilitating Income-Producing Historic Structure (G.S. 105-129.35) (Page 66)

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. Effective for taxable years beginning on or after January 1, 2006 for eligible sites placed in service on or after July 1, 2006, the tax credit is 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. 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.

~~18.~~19. Credit for Rehabilitating Nonincome-Producing Historic Structure (G.S. 105-129.36) (Page 67)

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. Effective for taxable years beginning on or after January 1, 2006 for eligible sites placed in service on or after July 1, 2006, the tax credit is 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.

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

Effective for taxable years beginning on or after January 1, 2006, a taxpayer that places eligible rehabilitated mill property into service on or after July 1, 2006 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.

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

Effective for taxable years beginning on or after January 1, 2006, a taxpayer that places eligible rehabilitated mill property into service on or after July 1, 2006 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.

~~19~~ 22. Business Targeted Tax Credits (Page 67)

XII. Subject: Statute of Limitations and Federal Changes

3. Federal Changes (Page 68)

(a) ~~If the amount of net income reported or reportable by any taxpayer for any year is changed, corrected, or otherwise determined by the U.S. Government, the taxpayer must file a North Carolina return or amended return reporting that change or determination of net income within two years after receipt of the Internal Revenue Agent's Report.~~ If the amount of a taxpayer's federal taxable income for any year is changed, corrected, or otherwise determined by the federal government and the report of those changes is received by the taxpayer prior to July 1, 2006, the taxpayer must file a North Carolina return or amended return to report the changes within two years after receipt of the Internal Revenue Agent's Report. If the report of the changes is received on or after July 1, 2006, 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.

(b) If an individual files a return or amended return reflecting the corrected or determined net income, an assessment of additional tax or a refund may be made within one year from the date this return is actually filed. ~~If the individual does not file a return reflecting the federal changes or determination of net income within two years after receipt of the Internal Revenue Agent's Report,~~ If the individual does not file a return reflecting the federal changes or determination of net income within the applicable time period required by law, and a report is received from the ~~U.S Governmen~~t federal government reflecting the corrected net income, an assessment may be made within three years from the date of receipt by the Department of Revenue of the report from the ~~U.S. Government~~ federal government. The individual forfeits the right to any refund which might be due by reason of the changes, provided the statute of limitations has otherwise expired. Even though an individual has ~~two years~~ a specified period of time following receipt of ~~the~~ a ~~Internal~~ Revenue Agent's Report in which to report the federal changes, an assessment can be proposed by the Department immediately following the receipt from any source of information concerning the correction, change in, or determination of the net income of the taxpayer by the ~~U.S. Government~~ federal government. If no return reflecting the changes made is received from the individual and no report is received from the ~~U.S. Government~~ federal government, no statute of limitations applies, and an assessment for income tax may be made at any time based on the information acquired.

7. Protective Refund Claim (Page 70)

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.

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 ~~two years to file an amended return to report federal changes~~ either six months or two years to file an amended return to report federal changes, depending upon when the report was received. (See 3. Federal Changes)

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

4. Failure To Report Federal Changes (Page 72)

When a taxpayer fails to report federal changes within ~~two years from the date of receipt of a the federal revenue agent's report or other final determination of corrected net income,~~ the time required by law (within two years in the case of an Internal Revenue Agent's Report received before July 1, 2006 and within six months of a report received on or after July 1, 2006), 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 ~~two-year period.~~ six month or two year period, depending upon when the report of federal changes was received.

XIV. Subject: Miscellaneous Rules (Page 74)

5. 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 campaign money to nonpartisan candidates for the North Carolina Supreme Court and Court of Appeals who ~~voluntarily~~ accept strict campaign spending and ~~strict~~ fund-raising limits. The Fund also helps finance educational materials about voter registration, the role of the appellate courts, and the candidates seeking election as appellate judges in North Carolina.

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

7. Reporting and Paying the Withheld Tax (Page 80)

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 AS/RP1, Registration for Income Tax Withholding, Sales and Use Tax, and Machinery, Equipment and Manufacturing Fuel Tax.~~ 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 AS/ RP1~~ Form NC-BR to receive a separate account identification number. They will receive separate forms for paying the tax withheld from pensions.

XVI. Subject: Withholding From Nonresidents for Certain Personal Services (G.S. 105-163.1 through G.S. 105-163.24)

6. Reporting and Paying the Withheld Tax (Page 84)

A payer who withholds tax from personal services income but who is not already registered with the Department of Revenue for wage withholding must register by completing ~~Form AS/RP1, Registration for Income Tax Withholding, Sales and Use Tax, and Machinery, Equipment and Manufacturing Fuel Tax~~, 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 from personal services income, and will pay the tax on a quarterly basis.

XVIII. Subject: Reporting and Paying Tax Withheld

1. New Employers (Page 96)

Each new employer required to withhold North Carolina income tax must complete and file ~~FormAS/RP 1, RegistrationApplication for Income Tax Withholding, Sales and Use Tax, and Machinery, Equipment, and Manufacturing Fuel Tax,~~ 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 ~~the AS/RP 1~~ Form NC-BR. Do not use the number of another employer from whom a business was acquired.

XXI. Subject: Gift Tax (G.S. 105-188 - G.S. 105-197.1)

11. Federal Corrections (Page 107)

If the federal government corrects the amount of net ~~gifts,~~ gifts a taxpayer must ~~report~~ report, ~~the corrected amount by filing~~ a corrected North Carolina gift tax return must be filed. ~~two years after being notified of the correction.~~ If the report of changes from the federal government is received on or after July 1, 2006, the amended return must be filed within six months of the date the report was received (within two years if the report was received before July 1, 2006). The Department may use all available evidence to determine the correct tax liability. The term “all available evidence” means evidence of any kind that becomes available from any source, whether or not the evidence was considered in the federal correction or determination. 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.

XXII. Subject: Estate Tax (G.S. 105-32.1 - G.S. 105-32.8)

8. Federal Changes (Page 111)

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. If the report of changes from the federal government is received on or after July 1, 2006, the amended return must be filed within six months of the date the report was received (within two years if the report was received before July 1, 2006). ~~If the amended return and payment of any additional tax due is not received by the Department within two years of receipt of the report of federal changes, a~~ 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~~ percent). ~~is due~~. A person who fails to report a federal correction or determination forfeits the right to any refund due by reason of the determination.