STATE OF NORTH CAROLINA

BEFORE THE
TAX REVIEW BOARD

COUNTY OF WAKE

IN THE MATTER OF:

The Proposed Assessment of Franchise Tax for the period of August 1, 1997 through July 31, 1998 by the Secretary of Revenue of North Carolina

vs.

Cisco Systems Sales and Services, Inc.

ADMINISTRATIVE DECISION Number: <u>410</u>

This Matter was heard before the Regular Tax Review Board (hereinafter "Board") in the City of Raleigh, Wake County, North Carolina, on Thursday, January 30, 2003, upon a petition filed by Cisco Systems Sales and Services, Inc. (hereinafter "Taxpayer") for administrative review of the Final Decision of the Assistant Secretary of Revenue entered on August 22, 2002, sustaining the franchise tax assessment, plus penalties and interest for the period of August 1, 1997 through July 31, 1998.

Chairman Richard H. Moore, State Treasurer, presided over the hearing with <u>ex officio</u> member Jo Anne Sanford, Chair, Utilities Commission and duly appointed member, Noel L. Allen, Attorney at Law participating.

Michael A. Hannah, Senior Manager with Deloitte & Touche, LLP and John P. Murphy, Manager with Cisco Systems Inc. were present at the hearing on behalf of the Taxpayer. George W. Boylan, Special Deputy Attorney General, appeared at the hearing on behalf of the Secretary of Revenue.

Following the hearing, the Tax Review Board took this matter under review and agreed to render a decision at its next meeting. During the April 22, 2003 Tax Review Board meeting, the members, after considering the Taxpayer's petition, the briefs and record of the proceeding before the Assistant Secretary, rendered the following decision:

STATEMENT OF CASE

Cisco Systems, Inc. (hereinafter "Cisco") is the parent corporation of Cisco Systems Sales and Services, Inc. (hereinafter "Taxpayer'). The two corporations seek review of the Final Decision of the Assistant Secretary of Revenue entered on August 22, 2002 that denied Cisco a tax credit for investment in machinery and equipment made during its 1996 taxable year.

Cisco is an international company that develops, manufactures, sells and supports networking products that connect various devices with computer networks. Cisco is engaged in research and development activities at its Research Triangle Park facility. In 1996, Cisco placed in service machinery and equipment at its Research Triangle Park facility for fiscal year ended July 26, 1997. Thereafter, Cisco submitted requests to the North Carolina Employment Security Commission (NCESC) and North Carolina Department of Commerce (NCDC) for qualification for the William S. Lee Credit Program ("Bill Lee Credits"). Upon receipt of the Certificate of Eligibility from NCDC, Cisco computed the amount of Bill Lee Credits that it was entitled for the purchase of the machinery and equipment at its Research Triangle Park facility for the fiscal year ended 1997.

On May 11, 1999, the Taxpayer filed its North Carolina franchise tax return and claimed an installment of the tax credit for investment in the machinery and equipment that was placed in service at its Research Triangle Park facility. If the credit is available to Cisco, unused installments may also be claimed by the Taxpayer for subsequent tax years.

On March 14, 2001, the Department of Revenue issued a proposed assessment against the Taxpayer for additional franchise tax in the amount of $49,704, plus penalties in the amount of $12,426 and accrued interest for Taxpayer's fiscal year ended July 25, 1998. The proposed assessment was based upon the Department of Revenue's disallowance of the tax credit installment claimed by the Taxpayer on its franchise tax return for fiscal year ended July 1998. Taxpayer objected to proposed assessment and requested a hearing before the Secretary of Revenue. On August 22, 2002, the Assistant Secretary issued the Final Decision that sustained the assessment of tax, penalties and interest imposed in this matter. Thereafter, the Taxpayer filed a petition for administrative review of the Final Decision with the Board pursuant to N.C. Gen. Stat. § 105-241.2.

ISSUE

The issue to be considered by the Board on review of this matter is stated as follows:

Is Cisco entitled to a tax credit for investing in machinery and equipment during its 1996 taxable year, thereby enabling Taxpayer to utilize any remaining installments of a credit that remained after Cisco transferred the property in question to it during the 1997 tax year?

EVIDENCE

The Tax Review Board reviewed the following evidence presented by the parties at the hearing before the Assistant Secretary of Revenue:

Submitted by the Division

1. Taxpayer's 1997 North Carolina Franchise and Income Tax Return, designated as CD-1.

2. Taxpayer's 1998 North Carolina Franchise and Income Tax Return, designated as CD-2.

3. Notice Of Corporate Franchise Tax Assessment dated March 14, 2001, designated as CD-3.

4. Field Auditor's Report dated December 5, 2000, designated as CD-4.

5. Letter from M. W. Massey, Administrative Officer, to Taxpayer dated June 20, 2000, designated as CD-5.

6. Letter from Taxpayer to the Department of Revenue dated April 11, 2001, designated as CD-6.

7. Letter from Jonathan K. Tart, Administrative Officer, to Taxpayer dated May 15, 2001, designated as CD-7.

8. Letter from Taxpayer to William M. Daniel, former Director of the Corporate, Excise and Insurance Tax Division, dated June 7, 2001, designated as CD-8.

9. Letter from Taxpayer to Jonathan K. Tart dated June 18, 2001, designated as CD-9.

10. Letter from Eugene J. Cella, Assistant Secretary of Revenue, to Taxpayer dated December 14, 2001, designated as CD-10.

11. Letter from Taxpayer to Eugene J. Cella dated January 3, 2002, designated as CD-11.

12. Section 1(a) and Section 1(c) of Senate Bill 748; 2001 General Assembly, designated as CD-12.

13. Section 3.3 of Chapter 13, House Bill 18; 1996 General Assembly, designated as CD-13.

14. Company Overview of Cisco, designated as CD-14.

15. Pages 584 and 585 of North American Industry Classification Manual, 1997 edition, designated as CD-15.

16. Certificates of Eligibility issued by the North Carolina Department of Commerce to Parent, designated as CD-16.

17. Schedule K from Taxpayer's 1997 Federal Income Tax Return, designated as CD-17.

18. Page 370 of Standard Industrial Classification Manual, designated as CD-18.

19. Pages 993 and 994 of North American Industry Classification Manual, 1997 edition, designated as CD-19.

Submitted by the Taxpayer

1. Fax Cover Sheet from Employment Security Commission of North Carolina to Taxpayer and Pages 298 and 299 from Standard Industrial Classification Manual, designated as TP-1.

2. Page 961 of North American Industry Classification Manual, 1997 edition, designated as TP-2.

3. Page 316 of North American Industry Classification Manual, 1997 edition, designated as TP-3.

4. Page 975 of North American Industry Classification Manual, 1997 edition, designated as TP-4.

5. Letter dated March 11, 1998 from Parent to the Department of Commerce with Attachments, designated as TP-5.

6. Taxable Year 1996 Certification Issued by Department of Commerce to Parent, designated as TP-6.

7. Taxable Years 1997 and 1998 Certifications Issued by Department of Commerce to Parent, designated as TP-7.

8. Letter from Julie R. Stiles, Interstate Examination Division, to Taxpayer dated December 5, 2000, with related attachments, designated as TP-8.

9. Document titled *Information on Tax Incentives Under the William S. Lee Quality Jobs and Business Expansion Act* published by the North Carolina Department of Revenue, designated as TP-9.

10. Document titled *Credit for Investing in Machinery and Equipment* from Department of Revenue Web Page, designated as TP-10.

Submitted by the Assistant Secretary of Revenue:

1. *Brief for Tax Hearing* submitted by the Corporate, Excise and Insurance Tax Division, designated as S-1.

2. *Objection to Proposed Assessment of Corporate Franchise Tax* submitted by Taxpayer, designated as S-2.

3. *Supplemental Brief in Support of Objection to Proposed Assessment of Corporate Franchise Tax* dated March 21, 2002 submitted by Taxpayer, designated as S-3.

4. Letter from Michael A. Hannah to Eugene J. Cella dated March 29, 2002, designated as S-4.

5. Letter from Eugene J. Cella to Michael A. Hannah dated April 11, 2002, designated as S-5.

6. Post-Hearing Brief submitted by the Corporate, Excise and Insurance Tax Division, designated as S-6.

7. Cross-Brief in Reply in Support of Objection to Proposed Assessment of Corporate Franchise Tax dated May 24, 2002 submitted by Taxpayer, designated as S-7.

FINDINGS OF FACTS

Based upon the record, the Tax Review Board makes the following findings of fact:

1. Cisco is the Parent Corporation of Taxpayer.

2. During its 1996 taxable year, Cisco placed certain business property in service at a facility located in North Carolina's Research Triangle Park. This facility was part of Cisco's research and development operations.

3. Subsequent to its 1996 investment in business property placed in service at Research Triangle Park, Cisco submitted a form entitled "Request for Department of Commerce Certification for Participation in the William S. Lee Tax Credit Incentives," hereinafter referred to as the "Participation Request," to the Secretary of Commerce for its 1996 taxable year. Cisco indicated on the form that it had placed $13,065,707 of machinery and equipment into service during the 1996 taxable year.

4. Cisco formed Taxpayer as a subsidiary and transferred ownership of the business property at the research and development facility in Research Triangle Park to Taxpayer in 1997.

5. The Taxpayer was engaged in research and development at its Research Triangle Park facility during its 1997 taxable year. The new machinery and equipment at the Research Triangle Park facility was used in Cisco's primary business of developing, manufacturing and selling computer network equipment.

6. The Taxpayer timely filed its franchise tax return for the tax period ending July 31, 1998, on May 11, 1999, under an approved extension of time to file.

7. The Taxpayer claimed an installment of a tax credit for investing in machinery and equipment on its 1997 North Carolina Franchise and Income Tax Return for business property used at its Research Triangle Park facility during that tax year.

8. The Division disallowed the installment of the machinery and equipment credit taken by Taxpayer against its franchise tax liability.

9. A proposed assessment of additional franchise tax, a twenty-five percent late-filing penalty, a twenty-five percent negligence penalty, and accrued interest was mailed to Taxpayer on March 14, 2001.

10. The Taxpayer timely filed an objection to the proposed assessment and timely requested a administrative tax hearing pursuant to N.C. Gen. Stat. § 105-241.1.

11. On February 19, 2002, Eugene Cella, the Assistant Secretary of Revenue conducted an administrative tax hearing regarding the proposed assessment. On August 22, 2002, Assistant Secretary Cella issued a Final Decision sustaining the assessment of tax, penalties and interest against the Taxpayer for the period at issue.

12. Pursuant N.C. Gen. Stat. § 105-241.2, the Taxpayer filed a petition with the Tax Review Board requesting administrative review of the Final Decision entered by Assistant Secretary Cella on August 22, 2002.

CONCLUSIONS OF LAW

Based upon the record in this matter, the Tax Review Board concludes as a matter of law:

1. The Tax Review has jurisdiction to review this matter on Taxpayer's petition and to determine if Cisco is entitled to a tax credit for investing in machinery and equipment during its 1996 tax year, thereby enabling Taxpayer to utilize any remaining installments of credit that remained after Cisco transferred the property at issue to the Taxpayer during the 1997 tax year.

2. Article 3A of Chapter 105 of the General Statutes, as effective for the 1996 tax year and hereinafter referred to as "the Act", encourages taxpayers in certain types of businesses to either move their business into the State or to expand their business activities in the State by offering tax credits for investments in the businesses. Qualifying businesses when the Act was first enacted included manufacturing and processing, warehousing and distribution, and data processing. To be eligible for the credits, the taxpayer had to be primarily engaged in a qualifying business and conducting that business activity in this State.

3. The Act allows a machinery and equipment tax credit for investing in business property in the State that is used in manufacturing and processing, warehousing and distribution, or data processing.

4. Cisco is an international company that develops, manufactures, sells and supports networking products that connect various devices with computer networks. Cisco is engaged in research and development activities at its Research Triangle Park facility. The machinery and equipment acquired by Cisco and transferred to the Taxpayer are used in an eligible business activity as defined in N.C. Gen. Stat. § 105-129.4(a) and therefore qualify for the tax credit.

5. The Secretary of Revenue is responsible for enforcing the Revenue Laws of this State, inclusive of the tax credits provided under the Act, by determining the correctness of a tax return and determining the proper liability of any person for a tax imposed.

6. The Secretary of Revenue has the authority to determine the correctness of tax credits claimed under the Act by reviewing any records considered necessary. In addition to being given this authority as part of his responsibility to enforce the Revenue Laws in general, this authority is specifically declared with respect to the Act in G.S. 105-129.7.

7. The Act requires a taxpayer to meet two general eligibility requirements pertaining to the primary business industry that it belongs to and the average wage it pays to its employees before it is eligible to participate in the Act.

8. Before claiming a tax credit under the Act on its tax return, a taxpayer submits the Participation Request to the Secretary of Commerce. The Participation Request is used to provide statistical reports to the General Assembly and to the Department of Revenue based on the number of Participation Request(s) received.

9. The Participation Request asks a taxpayer to provide information about the business industry that it belongs to and the average wage paid.

10. The Department of Commerce endorses a taxpayer's participation in the Act by certifying that a taxpayer's representations on the Participation Request are consistent with a type of business industry recognized under the Act, and that the average wage as reported meets or exceeds the applicable county wage standard.

11. The Department of Commerce does not have the authority to conduct an audit to verify that all representations made by the taxpayer on the Participation Request are true and accurate.

12. The Cisco was entitled to the tax credit for investing in machinery and equipment at the North Carolina facility during its 1996 year.

13. The Act contains a provision for a change in ownership that allows a successor business to take any installment of a credit that its predecessor could have taken if it had a tax liability.

14. The Taxpayer, as a successor corporation, was entitled to the installment of credit that was claimed against its 1997 franchise tax liability.

15. The Secretary of Revenue may, upon making a record of the reasons thereof, reduce or waive any penalties.

16. The Department of Revenue was created under the provisions of the Executive Organization Act of 1973. The Secretary of Revenue's duties include administering the laws enacted by the General Assembly relating to the assessment and collection of corporate income taxes. As an official of the Executive branch of the government, the Secretary lacks the authority to determine the constitutionality of legislative acts. The question of constitutionality of a statute is for the judicial branch. *(Insurance Co. v. Gold*, 254 NC 168). The constitutionality of the income tax statutes is not within the Secretary's jurisdiction.

DECISION

The scope of administrative review for petitions filed with the Tax Review Board is governed by N.C. Gen. Stat. § 105-241.2(b2). After the Tax Review Board conducts an administrative hearing, this statute provides in pertinent part:

> (b2). "The Board shall confirm, modify, reverse, reduce or increase the assessment or decision of the Secretary."

In sustaining the proposed assessment of franchise tax, penalties and interest assessment against the Taxpayer, the Assistant Secretary concluded that the Taxpayer was not entitled to claim the Bill Lee Credits on the machinery and equipment that Cisco had placed into service at the Research Triangle Park facility. The Assistant Secretary held that the Taxpayer was not engaged in a qualified activity at the Research Triangle

Park facility and that the certification of eligibility issued by Secretary of Commerce does not entitle the Taxpayer to utilize Bill Lee Tax Credits.

The record shows that Cisco, the Parent Corporation of the Taxpayer, is an international company that develops, manufactures, sells and supports networking products that connect various devices with computer networks. Cisco's primary business is the development, manufacture and sale of computer networking equipment. Cisco placed in service certain business property at that the Research Triangle Park facility. In 1997, Cisco transferred ownership of the business property at the North Carolina facility to the Taxpayer.

The Board, upon review the record, concludes that there is sufficient evidence to show that the property used at Research Triangle Park facility qualified for the Bill Lee Tax Credits because the research and development that occurs at the Research Triangle Park facility is a necessary, inseparable and integral part of the primary business of manufacturing. Thus, the property is used for an eligible business activity as defined in the applicable statute and qualifies for the tax credit.

The Board having conducted an administrative hearing in this matter, and having considered the petition, the briefs, the whole record and the Assistant Secretary's final decision, concludes that the Assistant Secretary erred in sustaining the proposed assessment of additional franchise tax, penalty and interest in this matter.

WHEREFORE, THE TAX REVIEW BOARD ORDERS AND DECREES that the Final Decision entered by the Assistant Secretary on August 22, 2002 be **Reversed.**