

State of North Carolina

**FRANCHISE TAX
CORPORATE INCOME TAX
PRIVILEGE TAX
INSURANCE PREMIUM TAX
EXCISE TAX**

2004 SUPPLEMENT

**RULES AND BULLETINS
TAXABLE YEARS
2003 & 2004**

Issued By

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2004 Supplement to Rules and Bulletins for Taxable Years 2003 & 2004

Preface

This publication is a supplement to the Franchise Tax, Corporate Income Tax, Privilege Tax, Insurance Premium Tax, and Excise Tax Rules and Bulletins for Taxable Years 2003 & 2004. This supplement addresses changes to the 2003/2004 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 Statutes, or administrative interpretation by the Department of Revenue.

This supplement includes only those sections of the 2003/2004 Rules and Bulletins that have been changed. With one exception, the changes are indicated by striking through the original material and underlining the new material. The exception is the section titled *Guidelines for Article 3A Tax Credits Tax Year 2004*. The Guidelines are updated each year; therefore, the old material is not struck through and the new material is not underlined.

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I. FRANCHISE TAX (Article 3)

J. Corporate Members of LLCs (G.S. 105-114.1)

Effective January 1, 2002, a corporation that is a member of a limited liability company (LLC) and is entitled to receive at least seventy percent (70%) of the LLC's assets upon dissolution is required to include a percentage of the LLC's income, assets, liabilities, and equity in the corporation's franchise tax calculation. In that case, the corporation's investment in the LLC is not included in the calculation of the corporation's capital stock, surplus and undivided profits base.

Effective January 1, 2003, the LLC's income, assets, liabilities, or equity must be attributed to a corporation if the corporation and its related members together own indirectly seventy percent (70%) or more of the LLC's assets if a corporation or affiliated group of corporations owns, directly or constructively, seventy percent (70%) or more of the capital interests in an LLC, the corporation or group of corporations must include the same percentage of the LLC's assets in its three franchise tax bases. The attribution to the three bases is equal to the same percentage of (1) the LLC's capital stock, surplus and undivided profits, (2) fifty-five (55%) of the LLC's appraised ad valorem tax value of property, and (3) the LLC's actual investment in tangible property in this State.

Exception – if the total book value of the LLC's assets never exceeds one hundred fifty thousand dollars (\$150,000) during its taxable year, no attribution is required.

Effective January 1, 2005, the ownership percentage that requires an attribution of the LLC's assets is reduced from seventy percent (70%) to fifty percent (50%).

When a partnership, trust, LLC, or other entity is placed between a corporation and an LLC, ownership of the capital interests in an LLC is determined under the constructive ownership rules for partnerships, estates, and trusts in IRC §318(a)(2)(A) and (B), modified as follows:

- The term "capital interest" is substituted for "stock" where that term appears in the referenced Code section.
- An LLC and any noncorporate entity other than a partnership, estate or trust is treated as a partnership.
- The operating rule of section 318(a)(5) applies without regard to section 318(a)(5)(C).

Example: A partnership owns one hundred percent (100%) of the capital interests of an LLC. Corporation A is a fifty percent (50%) owner of the partnership. Corporation A constructively owns fifty percent (50%) of the capital interest in the LLC.

The members of an affiliated group must determine the percentage of the LLC's assets to be included in each member's franchise tax bases. If all members of the group are doing business in North Carolina, then the percentage of the LLC's assets included by each member in its franchise tax bases is equal to the member's percentage ownership in the LLC. If some of the members of the group are not doing business in North Carolina, then the percentage of the LLC's assets owned by the group are allocated among the members that are doing business in North Carolina.

The percentage attributed to each member doing business in North Carolina is determined by multiplying the percentage of the LLC owned by the entire group by a fraction. The numerator of the fraction is the percentage of the LLC owned by the member and the denominator is the total percentage of the LLC owned by all members doing business in North Carolina.

Example: An affiliated group of corporations own one hundred percent (100%) of the capital interests in an LLC. The group consists of three corporations. Corporation A is doing business in North Carolina and owns fifty percent (50%) of the LLC. Corporation B is doing business in North Carolina and owns ten percent (10%) of the LLC. Corporation C is not doing business in North Carolina and owns forty percent (40%) of the LLC. The percentage of the LLC's assets required to be included in Corporation A's and Corporation B's franchise tax bases is determined as follows:

Corporation A: $100\% \times 50\% \div (50\% + 10\%) = 83.33\%$

Corporation B: $100\% \times 10\% \div (50\% + 10\%) = 16.67\%$

A corporation that is required to include a percentage of the LLC's assets in its franchise tax bases may exclude its investment in the LLC from its computation of the capital stock base.

Shifting assets back and forth between a corporation and an LLC to avoid franchise tax is prohibited. Ownership of the capital interests in an LLC is determined as of the last day of the LLC's taxable year. The attribution of the LLC's assets and the exclusion of the corporation's investment in the LLC are made to the corporation's next following franchise tax return. However, if the corporation and LLC engage in a pattern of transferring assets between them so that each did not own the assets on the last day of its taxable year, the ownership of the capital interest in the LLC must be determined as of the last day of the corporation's taxable year.

~~The income, assets, liabilities, or equity of an LLC are attributed to a corporation if the corporation and its related members together own indirectly seventy percent (70%) or more of the LLC's assets. A person owns indirectly assets of an LLC if the LLC's governing law provided that seventy percent (70%) or more of its assets, after payments to creditors, must be distributed to the person upon dissolution. The LLC's assets are attributed only to the related members that are corporations. None of the LLC's assets are attributed to the related members that are not corporations. Instead, the amount that would be attributed to that member is also attributed to the corporate members.~~

~~Example: A parent corporation, its subsidiary corporation, and an individual that is a shareholder of the parent corporation form a partnership to own an LLC. The parent and subsidiary transfer assets to the LLC. The LLC's governing law provides that upon dissolution, the assets of the LLC will be distributed as follows:~~

| | |
|-------------------------------------|----------------|
| — Parent Corporation | 20% |
| — Subsidiary Corporation | 45% |
| — Individual | 35% |

~~Because the parent corporation and its related members own directly 100% of the LLC's assets, 100% of the LLC's income, assets, liabilities, and equity must be attributed to the related members that are corporation. The attribution percentage~~

is as follows:

- ~~—Parent Corporation — 31% (its 20% interest/65% total interest of all corporate members)~~
- ~~—Subsidiary Corporation — 69% (its 45% interest/65% total interest of all corporate members).~~

Any taxpayer who, because of fraud with intent to evade tax, underpays the tax under this Article (G.S. Article 3) is guilty of a Class H felony in accordance with G.S. 105-236(7). For additional information on the filing requirements for members of LLCs, see Item 5, Subsection M "Corporations Conditionally or Partially Exempt" in this section.

L. Corporations Conditionally or Partially Exempt (G.S. 105-122 & 125)

5. Limited Liability Company (LLC)

The "North Carolina Limited Liability Company Act" (Chapter 57C of the North Carolina General Statutes) permits the organization and operation of limited liability companies (LLC). A LLC 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 not subject to the franchise tax.

Each corporate member of an LLC doing business in North Carolina has nexus in North Carolina, however, not every corporate member is required to file North Carolina corporate income and franchise tax returns. The determining factors are the LLC's entity classification and each corporate member's other activities in this State.

If an LLC is treated as a partnership for federal income tax purposes, each corporate member is required to file a corporate income and franchise tax return even if there are no other activities in the State since the LLC's income, assets, and activities flow through to the members of the LLC. The treatment of a corporate member of an LLC that is treated as a partnership is identical to the treatment of a corporation that is a partner in a partnership.

If the LLC is treated as a corporation for federal tax purposes and each corporate member's only connection to North Carolina is its ownership interest in the LLC, the corporate member(s) is not required to file a North Carolina corporate income and franchise tax return even though the corporate member(s) has nexus in North Carolina as a result of its membership in the LLC. The corporate member(s) is not required to file in this circumstance because the LLC reports its North Carolina income at the entity level and the apportionment attributes of the LLC do not flow through to the corporate member(s) as is the case when the LLC is disregarded or is treated as a partnership.

If the LLC is treated as a corporation for federal tax purposes and each corporate member has activities in this State, in addition to its ownership interest in the LLC, that make the corporate member subject to the franchise tax, the corporate member(s) is required to file a corporate income and franchise tax return.

Effective for taxes due January 1, 2002, through December 31, 2002, a corporation that is a member of an LLC and is entitled to receive at least seventy percent (70%) of the LLC's assets upon dissolution, must include the LLC's assets in the

corporation's investment in tangible property franchise tax base. The member corporation's investment in the LLC is excludible from the computation of the corporation's capital stock, surplus and undivided profits base. (G.S. 105-114(c)).

~~Effective for any taxes due on or after January 1, 2003, the income, assets, liabilities, or equity of an LLC are attributed to a corporation or affiliated group of corporations if the corporation or affiliated group of corporations owns, directly or constructively, and its related members together own indirectly seventy percent (70%) or more of the LLC's assets. A person owns indirectly assets of an LLC if the LLC's governing law provided that seventy percent (70%) or more of its assets, after payments to creditors, must be distributed to the person upon dissolution. The LLC's assets are attributed to the related members that are corporations. None of the LLC's assets are attributed to the related members that are not corporations. Instead, the amount that would be attributed to that member is also attributed to the corporate members. (G.S. 105-114.1) Constructive ownership can exist when a partnership, trust, LLC, or other entity is placed between a corporation and an LLC. In such situations, ownership of the capital interests in an LLC is determined under the constructive ownership rules for partnerships, estates, and trusts in IRC §318(a)(2)(A) and (B), modified as follows:~~

- ~~• The term "capital interest" is substituted for "stock" where that term appears in the referenced Code section.~~
- ~~• An LLC and any noncorporate entity other than a partnership, estate, or trust is treated as a partnership.~~
- ~~• The operating rule of section 318(a)(5) applies without regard to section 318(a)(5)(C).~~

~~Effective January 1, 2005, the ownership percentage that requires an attribution of the LLC's assets is reduced from seventy percent (70%) to fifty percent (50%).~~

~~An example of the attribution calculation is included in Item 15, Subsection G-J "Capital Stock, Surplus and Undivided Profits Base Corporate Members of LLCs" in this section. The member corporation's actual investment in the LLC is excludible from the member corporation's computation of its capital stock, surplus and undivided profits base.~~

II. CORPORATE INCOME TAX (Article 4)

I. Apportionment Factors (G.S. 105-130.4)

2. Public Utilities, Excluded Corporations and Air or Water Transportation Corporations Apportionment Factors (G.S. 105-130.4)

e. Excluded Corporations, including Construction Contractors, and Other Public Utilities

All apportionable income of an excluded corporation and all other public utilities must be apportioned by multiplying apportionable income by the sales factor as defined in G.S. 105-130.4. "Excluded corporation" means any company engaged in business as a building or construction contractor, a securities dealer, loan company or company which receives more than fifty percent (50%) of its ordinary gross income from intangible property. A building or construction contractor is a business so classified in the Standard Industrial Classification Manual North American Industry Classification System (NAICS) published by the Federal Office of Management and Budget.

Guidelines for Article 3A Tax Credits Tax Year 2004

B. Quality Jobs and Business Expansion Credits (Article 3A of Chapter 105)

1. General Information

a. Purpose

This section sets out guidelines for the tax credits in Article 3A of Chapter 105 of the General Statutes, also known as the William S. Lee Quality Jobs and Business Expansion Act. The section applies to tax years beginning on or after January 1, 2004. Article 3A has been amended each year since its enactment. This section does not attempt to review the law in effect prior to January 1, 2004.

These guidelines are published by the Department on its website at www.dor.state.nc.us and are updated periodically as issues arise that require clarification. The first publication applied to tax years beginning on or after January 1, 2001 and before January 1, 2002. The second publication of the document applied to tax years beginning on or after January 1, 2002 and before January 1, 2003. The third publication of the document applied to tax years beginning on or after January 1, 2003 and before January 1, 2004. The updated guidelines may be accessed through the "Business" portal of the DOR web page.

b. Overview

The Article 3A tax credits are designed to attract certain types of new businesses to North Carolina and to foster expansions of certain types of businesses in North Carolina. The credits are based on a system that divides the State into five enterprise tiers, with tier one being the most economically distressed and tier five being the least economically distressed. Eligibility requirements are easier to meet and credits are increased for business expansion occurring in the lower tiers. Each county is assigned a tier designation by the Secretary of Commerce on or before December 31st of each year. Generally, a designation applies only to the calendar year following the designation. A tier one or tier two area, however, may not be redesignated as a higher-numbered enterprise tier area until it has been in its designated enterprise tier area for at least two consecutive years. The Department of Commerce publishes a list of the counties and their respective tier designations.

Within each tier, there may be designated development zones. These designations recognize defined areas of economic need within a tier. For purposes of the wage standard requirement, the credit for investing in machinery and equipment, and the credit for worker training, a development zone is considered an enterprise tier one area. Additionally, credits for creating jobs are increased by \$4,000 per job for jobs located within a development zone. Upon the request of a taxpayer or a local government, the Secretary of Commerce will determine whether an area is in a development zone. The determination is based on various economic factors. If an area is designated as a development zone, the designation is effective for 24 months following the date of the designation. The Department of Commerce publishes annually a list of all development zones with a description of their boundaries.

A parcel of property that is partially in a development zone is considered to be entirely within the development zone if all of the following conditions are met:

- At least fifty percent of the parcel is located within the development zone.
- The parcel was in existence and under common ownership prior to the most recent federal decennial census.
- The parcel is a portion of land made up of one or more tracts or tax parcels of land that is surrounded by a continuous perimeter boundary.

c. Credits Available

For tax years beginning on or after January 1, 2004, credits are available for:

- Creating jobs
- Investing in machinery and equipment
- Technology commercialization
- Research and development
- Worker training
- Investing in central office or aircraft facility property
- Development zone projects
- Substantial investment in other property

d. Substantiation (G.S. 105-129.7)

To claim a credit, the taxpayer must provide any information considered necessary by the Secretary of Revenue to determine and verify the amount of the credit to which the taxpayer is entitled. The burden of proving eligibility for the credit and the amount of the credit rests upon the taxpayer. The taxpayer must submit a portion of the qualifying information with the tax return. That information is reported on the Department of Revenue NC-478 form series. The taxpayer must maintain additional documentation needed to substantiate the credit and make it available for inspection by the Secretary of Revenue.

2. General Eligibility Requirements (G.S. 105-129.4)

The taxpayer must satisfy all general eligibility requirements in order to qualify for any of the credits listed in Section III, except the credit for development zone projects. If a taxpayer is uncertain about its eligibility for a credit, the taxpayer may request specific advice in writing from the Secretary of Revenue.

The general eligibility requirements are listed below, followed by a description of each specific requirement:

- Be an eligible business type
- Meet the wage standard specified for the credit
- Provide health insurance for employees as specified for the credit
- Have a good environmental record
- Have a good Occupational Safety and Health Act (OSHA) record
- Have no overdue tax debts

a. Eligible Business Types

(1) Types

Article 3A allows tax credits only to certain types of businesses. Under the Article, the taxpayer must meet one of the following descriptions to be eligible for a credit. For definitions of the business types described below, see G.S.

105-129.2.

(a) Central Office or Aircraft Facility

The taxpayer operates a central office or aircraft facility that creates at least 40 new jobs and the jobs, investment, and activity with respect to which a credit is claimed are used in that office or facility. Generally, 40 new jobs are created if the taxpayer hires at least 40 additional full-time employees to fill new positions at the office within 12 months after the taxpayer first uses the property as a central office or aircraft facility. If a taxpayer uses temporary space, however, for the central office or aircraft facility functions during completion of the central office or aircraft facility property, the jobs must be created during the period starting 24 months before and ending 12 months after the completion of the property.

(b) Air Courier Services or Data Processing

The primary business of the taxpayer is one of the following and the jobs, investment, and activity with respect to which a credit is claimed are used in that business:

- Air courier services
- Data processing

(c) Manufacturing, Warehousing, or Wholesale Trade

The primary business of the taxpayer is one of the following and the jobs, investment, and activity with respect to which a credit is claimed are used in any of the listed businesses:

- Manufacturing
- Warehousing
- Wholesale trade

(d) Computer Services or Electronic Mail Order House

The primary business of the taxpayer or the primary activity of an establishment of the taxpayer is one of the following and the jobs, investment, and activity with respect to which a credit is claimed are used in that business:

- Computer services
- An electronic mail order house that creates at least 250 new jobs and is located in an enterprise tier one, tier two, or tier three area.

(e) Customer Service Center

The taxpayer operates a customer service center and meets all of the following conditions:

- The taxpayer's primary business is a telecommunications or financial services company as defined by NAICS.
- The primary activity of an establishment of the taxpayer is a customer service center located in an enterprise tier one, tier two, or tier three area.
- The jobs, investment, and activity with respect to which a credit is claimed are used in the operation of the customer service center.

(f) Warehousing at Establishment

The primary activity of an establishment of the taxpayer is warehousing and the taxpayer meets both of the following conditions:

- The warehousing establishment is located in an enterprise tier one, tier two, or tier three area and serves 25 or more establishments of the taxpayer in at least five different counties in one or more states.
- The jobs, investment, and activity with respect to which a credit is claimed are used in the warehousing establishment.

(g) Research and Development

For the purpose of determining eligibility under this subsection for the credit for research and development in G.S. 105-129.10, the following special rules apply:

- If the primary activity of an establishment of the taxpayer in this State is computer services, the taxpayer's qualified research expenditures in this State are considered to be computer services.
- For all other taxpayers, the taxpayer's qualified research expenditures in this State are considered to be used in the primary business of the taxpayer.

(2) Determining Primary Business

For most of the eligible business types, the law specifies that the taxpayer's primary business must be a designated business. To claim a credit as a taxpayer that provides air courier services or data processing services, for example, the provision of these services must be the primary business of the taxpayer and not just the taxpayer's primary activity at one establishment. Similarly, to claim a credit as a customer service center, the taxpayer's primary business must be telecommunications or financial services.

The determination of whether an activity of a company is its primary business is based on the principal product or group of products the taxpayer produces or distributes or the principal services the taxpayer provides. The principal product or service is determined based on the NAICS guidelines for determining industry classification. The activities at all the taxpayer's establishments are considered in determining the taxpayer's primary business.

(3) Determining Primary Activity at an Establishment

For a few of the eligible business types, the law only requires the taxpayer's primary activity at an establishment to be a designated business. The eligible business types for providing computer services, operating an electronic mail order house, and engaging in warehousing, for example, set requirements for the taxpayer's primary business activity at an establishment but not the taxpayer's primary business taken overall. The credit for a customer service center sets requirements for the taxpayer's primary business activity at an establishment and sets a different requirement for the taxpayer's primary business.

The determination of whether an activity at an establishment is the primary business activity is based on the proper classification of the establishment

under the NAICS Code. If more than one activity is conducted at the same establishment, the primary activity of the establishment is determined based on the NAICS guidelines for determining industry classification.

(4) Determining What Jobs, Investment, and Activity Qualify for Credits

All the eligible business types require jobs, investment, and activity to be used in a specified aspect of the taxpayer's business. To satisfy this requirement, that aspect must be the primary activity of the taxpayer at the establishment where the credits are claimed.

For some eligible business types, the jobs, investment, and activity that qualify for the credit must be used in the taxpayer's primary business. For these eligible business types, the taxpayer's primary business must be one of the eligible business types and, if the taxpayer has more than one business establishment, the primary activity at the taxpayer's establishment where the credits are claimed must be the same as the taxpayer's primary business. When these conditions are met, the jobs, investment, and activity at the establishment are considered to be part of the taxpayer's primary business and to satisfy the requirement of being used in that business. The eligible business types for air courier services, data processing, manufacturing, warehousing, wholesale trade, computer services, and electronic mail order house fall into this category. The last five of these also fall into other categories due to alternative ways to qualify for the credits.

Some eligible business types have different requirements for primary business and primary business activity at an establishment. For these eligible business types, the taxpayer's primary business must be the specified type of business, the taxpayer must have more than one business establishment, the taxpayer's primary activity at the establishment where the credits are claimed must be the specified type of activity, and the taxpayer's primary business and the primary business activity at the establishment must be different. When these conditions are met, the jobs, investment, and activity at the establishment are considered to be part of the taxpayer's primary business activity at the establishment and to satisfy the requirement of being used in that specified business activity. The eligible business types for manufacturing, warehousing, wholesale trade, computer services, electronic mail order house, and customer service center fall into this category. The first five of these also fall into other categories due to alternative ways to qualify for the credits.

Some eligible business types set no requirements on the taxpayer's primary business and, instead, set requirements only on the primary business activity at an establishment. For these credits, the primary business activity at the establishment where the credits are claimed must be the specified type of activity. This activity may also be the taxpayer's primary business, but it does not matter if the primary business activity at the establishment and the taxpayer's primary business are the same or are different. If they are different, however, the taxpayer must have more than one establishment. At the establishment, if the primary business activity is the specified type of activity, then the jobs, investment, and activity at the establishment are considered to be part of the primary business activity and to satisfy the requirement of being

used in that primary business activity. The eligible business types for computer services, electronic mail order house, and warehousing at an establishment fall into this category. The eligible business types for computer services and electronic mail order house also fall into another category due to alternative ways to qualify for the credits.

Two eligible business types set requirements for a business function of the taxpayer rather than for primary business or primary business activity at an establishment. These two eligible business types are for a central office or an aircraft facility. For these eligible business types, the jobs, investment, and activity must be used in the central office function or the aircraft facility function. In most cases, the establishment where the central office or the aircraft facility is located will have a NAICS Code reflecting a central office or aircraft facility, but a central office or aircraft facility can be located in a building that includes various functions.

In summary, except for the eligible business types for a central office or an aircraft facility, the determination of whether jobs, investment, and activity qualify turns on the primary business activity at an establishment plus, for some eligible business types, the primary business of the taxpayer. When these conditions are met, all the jobs, investment, and activity at the establishment are considered to be used in the qualifying business, even though they may be part of a support function at the establishment.

The following examples illustrate when jobs, investment, and activity satisfy the requirement of being used in a business:

> ABC Manufacturing Company

ABC's primary business is manufacturing. In the 2004 tax year, ABC constructs and begins operating a North Carolina manufacturing facility. The new jobs, investment, and activity at the North Carolina manufacturing facility are eligible for credits, subject to the other requirements of Article 3A. This is because ABC's primary business of manufacturing is an eligible business type and its primary business activity at the North Carolina facility is the same as its primary business. The jobs, investment, and activity at the North Carolina establishment therefore satisfy the requirement of being used in the manufacturing business.

> EFG Manufacturing Company

EFG's primary business is manufacturing. All of EFG's manufacturing plants are located outside North Carolina. In the 2004 tax year, EFG constructs and begins operating a North Carolina warehouse facility. The new jobs, investment, and activity at the North Carolina warehouse facility are eligible for credits, subject to the other requirements of the Act. This is because EFG's primary business is manufacturing, and the jobs, investment, and activity are used in the warehousing business.

> XYZ Manufacturing Company

XYZ's primary business is manufacturing. XYZ has one manufacturing

plant located in the State. XYZ has previously qualified for credits for new jobs, investment, and activity used in the manufacturing business. During the 2004 tax year, XYZ purchases a facility in North Carolina that conducts marketing, customer service, and product repairs. Additionally, a retail outlet is on site at the newly purchased facility. The new jobs investment, and activity at the newly purchased facility are not eligible for credits. This is because the primary business activity at the facility is not manufacturing, wholesale trade, or warehousing.

b. Wage Standard (G.S. 105-129.4(b))

(1) Wage Standard Test

The taxpayer must satisfy a wage standard test with respect to each potential credit except the worker training credit and the credit for substantial investment in other property. The test is performed by comparing the applicable wage standard for the taxpayer to the wage standard for the relevant county. The county wage standard is obtained from the Department of Commerce. If the taxpayer's tax year is other than a calendar year, the taxpayer must use the wage standard for the calendar year in which the taxpayer's tax year begins. The taxpayer's wage standard must equal or exceed 110% of the county wage standard. The wage standard test does not apply to any credit in a tier one or tier two area or in a development zone.

The wage standard test that applies depends on the credit, as explained below.

(a) Credit for Creating Jobs

The test is a two-part test. The first part requires the combined average weekly wage of the jobs for which the credit is claimed to meet the wage standard. The second part requires the combined average weekly wage of all jobs at the location with respect to which a credit is claimed to meet the wage standard. The average wage for both parts of the test is determined for the tax year in which the activity that qualifies for the credit occurs, even if the taxpayer's tax year is not a calendar year. For part-time employees, a full-time equivalency factor must be used. However, all part-time jobs for which the taxpayer provides health insurance, as described in G.S. 105-129.4(b2), are considered to meet the wage standard, regardless of the actual wages for the job. If there are potential credits at more than one location, both tests must be applied separately at each location. No credits are allowed with respect to jobs at a location unless both tests are met.

The following example demonstrates the calculation of the wage standard test when new jobs are created during the year at multiple locations. Assume that the taxpayer meets all the other eligibility requirements in Article 3A.

Taxpayer creates 75 new jobs at a tier four location during the year and 50 new jobs at a tier five location. The combined average weekly wage of the 75 jobs created at the tier four location meets the wage standard, and the combined average weekly wage of the 50 jobs created at the tier five location meets the wage standard. The jobs at both locations therefore meet the first part of the test.

The combined average weekly wage of all the jobs at the tier four location

meets the wage standard. However, the combined average weekly wage of all the jobs at the tier five location does not meet the wage standard. Consequently, the taxpayer is eligible to claim a credit for the 75 jobs created at the tier four location, but not the 50 jobs created at the tier five location. This is because the jobs at the tier four location meet the second part of the test and the jobs at the tier five location do not.

(b) Credit for Worker Training

The credit for worker training is not subject to a wage standard test.

(c) Credit for Substantial Investment in Other Property

The credit for substantial investment in other property is not subject to a wage standard test.

(d) All Other Credits

Only the second part of the wage standard test for the jobs credit and the worker training credit apply to the other credits. The other credits are the credit for investing in machinery and equipment, the credit for research and development and the credit for investing in real property for a central office or an aircraft facility. The taxpayer is eligible for these credits if the combined average weekly wage of all jobs at the location with respect to which the credit is claimed meets the wage standard. The average wages of the jobs at the location are determined for the tax year in which the activity that qualifies for the credit occurs, even if the taxpayer's tax year is not a calendar year. For part-time employees, a full-time equivalency factor must be used.

(2) Wage Standard Calculations

- (a) One of the wage tests is to determine if the average wage of all jobs at a business location meets the wage standard. To make that determination, complete the following steps:
 - (i) For each month in the tax year, identify the number of employees for the location who were included on line 1 of the Employer's Quarterly Tax and Wage Report (NCUI 101) as filed with the Employment Security Commission.
 - (ii) Add the number of employees identified in (a)(i) above for each month and divide that amount by 12.
 - (iii) Divide the total wages include on line 2 of Form NCUI 101 for each month for this location for the tax year by the number calculated in (a)(ii) above.
 - (iv) Divide the amount calculated in (a)(iii) above by 52.
 - (v) Compare the amount calculated in (a)(iv) above to the applicable wage standard for the county where the jobs were located.
- (b) The other wage test is to determine if the average wage of jobs for which a potential credit may be claimed meets the wage standard. To make that determination, complete the following steps:
 - (i) For each employee, divide the number of hours worked, not including overtime, by 2080. Hours worked included all regular hours for which the employee received pay including vacation and sick time.

- (ii) Divide each employee's total wages for the tax year by the amount calculated in *(b)(i)* above.
- (iii) Divide each amount calculated in *(b)(ii)* above by 52.
- (iv) Sum the amounts calculated in *(b)(iii)* for each employee and divide by the number of employees.
- (v) Compare the amount calculated in *(b)(iv)* above to the applicable wage standard for the county where the jobs were located.

The above calculations are to be used if the taxpayer is in business at the location with respect to which credits are claimed for its entire tax year. If the taxpayer is in business at the location for only a portion of the year, the calculations must be adjusted accordingly. For example, Company X is an existing North Carolina taxpayer that files on a calendar year basis. On April 1, 2004, it expands its operations by opening a new manufacturing plant in North Carolina. Subsection 3 below shows how Company X would determine if the average wage of all jobs at the new location meets the wage standard. Subsection 4 below shows how Company X would determine if the average wage of jobs at the new location for which a potential credit may be claimed meets the wage standard.

- (c) To determine if jobs at the Company X New Location meet the wage standard in the 2004 tax year, complete the following steps:
 - (i) For the months April through December, identify the number of employees for the location who were included on Line 1 of the Employer's Quarterly Tax and Wage Report (NCUI 101) as filed with the Employment Security Commission.
 - (ii) Add the number of employees identified in *(c)(i)* for each month and divide that amount by 9.
 - (iii) Divide the total wages included on Line 2 of form NCUI 101 for this location for April through December by the number calculated in *(c)(ii)*.
 - (iv) Divide the amount calculated in *(c)(iii)* by 39.
 - (v) Compare the amount calculated in *(c)(iv)* to the applicable wage standard for the county where the jobs are located.

- (d) To determine if jobs at the Company X New Location for which a potential credit may be claimed meet the wage standard in the 2004 tax year, complete the following steps:
 - (i) For each employee, divide the number of hours worked, not including overtime, by 1,560 (2,080 times .75). Hours worked includes all regular hours for which the employee received pay including vacation and sick time.
 - (ii) Divide each employee's total wages for the months April through December by the amount calculated in *(d)(i)*.
 - (iii) Divide each amount calculated in *(d)(ii)* by 39.
 - (iv) Sum the amounts calculated in *(d)(iii)* for each employee and divide by the number of employees.
 - (v) Compare the amount calculated in *(d)(iv)* to the applicable wage standard for the count where the jobs are located.

c. Health Insurance (G.S. 105-129.4(b2))

Article 3A makes the provision of health insurance a condition for qualifying for the credits. The reason for this is to ensure that the credits are allowed only for quality jobs.

A taxpayer provides health insurance if it 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. The specific health insurance requirements for each credit are described below.

(1) Credit for Creating Jobs and Credit for Worker Training

A taxpayer is eligible for a credit for creating jobs or for worker training if the taxpayer provides health insurance for the jobs for which a credit is claimed. The insurance must be provided at the time the jobs are created or the workers are trained and must be maintained in each year the taxpayer claims an installment or a carryforward of the credit. To ensure that a taxpayer satisfies this requirement, the taxpayer must provide with the tax return a certification that the taxpayer provides health insurance for the affected jobs. This applies to the return on which the taxpayer qualifies for the credit, a return claiming an installment of the credit, and a return claiming a carryforward of the credit.

(2) All Other Credits

The health insurance requirement for the jobs credit and the worker training credit differs from the requirement for all the other credits. The other credits are the credit for investing in machinery and equipment, the credit for research and development, the credit for investing in real property for a central office or an aircraft facility, and the credit for substantial investment in other property. The taxpayer is eligible for these credits if the taxpayer provides health insurance for all of the full-time positions at the location with respect to which a credit is claimed. The insurance must be provided at the time of the activity that qualifies for the credit and must be maintained. The taxpayer must provide with the tax return a certification that the taxpayer provides health insurance for all the full-time positions at the location. This applies to the return on which a taxpayer qualifies for the credit and a return claiming an installment or carryforward of the credit.

d. Environmental Impact (G.S. 105-129.4(b3))

Article 3A requires recipients of credits to have good environmental records. The environmental requirements are the same for all credits. A taxpayer is eligible for a credit only if the taxpayer certifies that, at the time the taxpayer first claims the credit, the taxpayer has no pending administrative, civil, or criminal enforcement action based on alleged significant violations of any program implemented by an agency of the Department of Environment and Natural Resources, and has had no final determination of responsibility for any significant administrative, civil, or criminal violation of any program implemented by an agency of the Department of Environment and Natural Resources within the last five years. A significant violation is a violation or an alleged violation that does not satisfy any of the conditions of G.S. 143-215.6B(d).

The Department of Revenue receives notification from the Department of Environment and Natural Resources annually of every person that currently has any of these pending actions and every person that has had any of these final determinations within the last five years. The Department of Revenue uses this information when reviewing eligibility for the credits.

The time the taxpayer first claims a credit is the date the taxpayer first files a tax return concerning the credit. The first tax return concerning the credit is the tax return for the year in which the taxpayer engaged in the qualifying activity.

e. Occupational Safety and Health Programs (OSHA) (G.S. 105-129.4(b4))

Article 3A requires recipients of credits to have good occupational safety and health (OSHA) records. The OSHA requirements are the same for all credits. A taxpayer is eligible for a credit only if the taxpayer certifies that, at the business location with respect to which the credit is claimed, the taxpayer has had no citations under the Occupational Safety and Health Act that have become a final order within the past three years for willful serious violations or for failing to abate serious violations. The certification must be made at the time the taxpayer first claims the credit. A "serious violation" is defined in G.S. 95-127.

The Department of Revenue receives notification from the Department of Labor annually of all employers with citations that have become final orders within the past three years. The Department of Revenue uses this information when reviewing eligibility for the credits.

The time the taxpayer first claims a credit is the date the taxpayer first files a tax return concerning the credit. The first tax return concerning the credit is the tax return for the year in which the taxpayer engaged in the qualifying activity.

f. Large Investment Enhancements (G.S. 105-129.4(b1))

A taxpayer who is otherwise eligible for a tax credit under this Article becomes eligible for the large investment enhancements provided for credits under this Article if the Secretary of Commerce makes a written determination that the taxpayer is expected to purchase or lease, and place in service in connection with the eligible business within a two-year period, at least one hundred fifty million dollars (\$150,000,000) worth of one or more of the following: real property, machinery and equipment, or central office or aircraft facility property. In the case of an interstate air courier that has or is constructing a hub in this State and in the case of an eligible major industry, this investment may be placed in service in connection with the eligible business within a seven-year period. To be an eligible major industry, the taxpayer must be primarily engaged in one of the industries defined in G.S. 105-164.14(j)(3), and be certified by the Secretary of Commerce as planning to invest at least one hundred million dollars (\$100,000,000) of private funds to construct a facility in this State to engage in one or more of those industries.

g. No Overdue Tax

A taxpayer is ineligible for an Article 3A tax credit if the taxpayer has an overdue tax debt at the time the taxpayer claims a credit or an installment or carryforward of a credit. An overdue tax debt is defined in G.S. 105-243.1(a)(1) as "[a]ny part of a tax debit that remains unpaid 90 days or more after the notice of final

assessment was mailed to the taxpayer. The term does not include a tax debt, however, if the taxpayer entered into an installment agreement for the tax debt under G.S. 105-237 within 90 days after the notice of final assessment was mailed and has not failed to make any payments due under the installment agreement."

3. General Administration

a. Sunset (G.S. 105-129.2A(a), (a1), and (a2))

Article 3A is repealed for business activities that occur on or after January 1, 2006, with these exceptions:

- In the case of an interstate air courier that enters into a real estate lease on or before January 1, 2006, with an airport authority that provides for the lease of at least 100 acres of real property with a lease term in excess of 15 years, this Article is repealed effective for business activities that occur on or after January 1, 2010.
- In the case of a taxpayer that qualifies as an eligible major industry on or before January 1, 2006, this Article is repealed effective for business activities that occur on or after January 1, 2010.

b. Expiration (G.S. 105-129.4(a2) and (b2))

This section addresses general expiration provisions applying to all credits based on failure to continue to meet general eligibility requirements. In addition, there are expiration provisions that apply specifically to each credit. The specific provisions are discussed in the sections devoted to each credit. The general expiration provisions are listed below. When a credit expires, the taxpayer may not take any remaining installments of the credit.

The expiration of a credit may also affect the taxpayer's ability to take carryforwards of a credit. Under the first two circumstances described below, the taxpayer may continue to claim carryforwards of previous installments when a credit expires. Under the third circumstance, the carryforwards as well as the installments expire. See the section on Carryforwards of Unused Credits for additional information.

The following are circumstances that result in expiration of a credit:

- During the period that installments of a credit accrue, the taxpayer no longer meets one of the conditions for an eligible business type.
- During the period that installments of a credit accrue, the number of jobs of an eligible business falls below the minimum number required. When this happens, any credit associated with that business expires; the expiration is not limited to the jobs tax credit.
- The taxpayer ceases to provide health insurance for its employees.

c. Forfeiture (G.S. 105-129.4(d))

A taxpayer that forfeits a credit is liable for all past taxes avoided as a result of 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 30 days after the date the credit is forfeited. A taxpayer that fails to pay the past taxes and interest by the due date is subject to the penalties provided in G.S. 105-236. Forfeiture provisions are listed below.

(1) All Credits

A taxpayer forfeits a credit allowed if the taxpayer was not eligible for the credit for the calendar year in which the taxpayer engaged in the activity for which the credit was claimed.

(2) Worker Training

If a taxpayer forfeits the credit for creating jobs, the technology commercialization credit, or the credit for investing in machinery and equipment, it also forfeits any credit for worker training claimed for the jobs for which the credit for creating jobs was claimed or the jobs at the location with respect to which the technology commercialization credit or the credit for investing in machinery and equipment was claimed.

(3) Substantial Investment in Other Property

A taxpayer forfeits the credit for substantial investment in other property if it fails to timely make the required level of investment or fails to timely create the required number of new jobs.

(4) Technology Commercialization Credit

A taxpayer forfeits the technology commercialization credit if it fails to timely make the required level of investment or if it fails to meet the terms of its licensing agreement with a research university. If a taxpayer claimed a 20% technology commercialization credit and fails to make the required level of investment for the 20% credit, but does make the required level of investment for the 15% credit, the taxpayer forfeits one-fourth of the 20% credit.

(5) Large Investment Enhancements

A taxpayer forfeits a large investment enhancement of a tax credit if it fails to timely make the required level of investment.

(6) Eligible Major Industry Enhancements

A taxpayer forfeits the eligible major industry enhancements, including a delayed sunset of the Article 3A credits and an extended time to make sufficient investments to qualify for the large investment enhancements, if the taxpayer fails to timely make the required level of investment.

d. Change in Ownership of Business (G.S. 105-129.4(e))

The sale, merger, consolidation, conversion, acquisition, or bankruptcy of a business, or any transaction by which an existing business reformulates itself as another business does not create new eligibility in a succeeding business with respect to credits for which the predecessor was not eligible. A successor business may, however, take any installment of or carried-over portion of a credit that its predecessor could have taken if it had a tax liability. The acquisition of a business is a new investment that creates new eligibility in the acquiring taxpayer under Article 3A if any of the following conditions are met:

- The business closed before it was acquired.
- The business was required to file a notice of plant closing or mass layoff under the federal Worker Adjustment and Retraining Notification Act, 29 U.S.C. §2102, before it was acquired.
- The business was acquired by its employees through an employee stock

option transaction or another similar transaction.

The term "business" means a taxpayer or an establishment. For example, a taxpayer that purchases one of five plants from an unrelated entity has acquired a business, and must meet one of the three conditions described above in order to create new eligibility for its investment.

e. Tax Election (G.S. 105-129.5)

The credits are allowed against the franchise tax, the income tax, or the gross premiums tax. The taxpayer elects the tax against which a credit will be claimed when filing the return on which the first installment of the credit is claimed. This election is binding on all future installments and carryforwards of that credit. A special election is provided for the technology commercialization credit. A general election applies to all other credits.

(1) Technology Commercialization Credit

The technology commercialization credit may be divided between the taxes against which it is allowed. The taxpayer elects the percentage of the credit that will be taken against each tax when filing the return on which the credit is first taken. This election is binding. The percentage of the credit elected to be taken against each tax may be carried forward only against the same tax.

(2) All Other Credits

The taxpayer must take a credit against only one of the taxes against which it is allowed.

f. Fifty Percent (50%) Cap on Credits (G.S. 105-129.5(b))

The total of all credits may not exceed 50% of the tax against which they are claimed for the taxable year, reduced by the sum of all other credits allowed against that tax, except tax payments made by or on behalf of the taxpayer.

g. Carryforward of Unused Credit (G.S. 105-129.5(c))

Generally, any unused portion of a credit may be carried forward for the succeeding five years. Several credits have longer carryforward periods, however. Those credits and their carryforward periods are listed below.

(1) 20-Year Carryforward

Any unused portion of the following credits may be carried forward for 20 years:

- Technology commercialization.
- Substantial investment in other property.
- Credits concerning a "large investment" (\$150,000,000). A taxpayer is eligible for the large investment enhancement if the Secretary of Commerce makes a written determination that the taxpayer is expected to purchase or lease, and place in service in connection with the eligible business within a two-year period (seven years for interstate air couriers and eligible major industries), at least \$150,000,000 worth of one or more of the following: real property, machinery and equipment, or central office or aircraft facility property. If the taxpayer fails to make the required level of investment within the two-year period (seven years for interstate air couriers and eligible major industries), the taxpayer

forfeits the longer carryforward period.

(2) 15-Year Carryforward for Research and Development

Any unused portion of a research and development credit may be carried forward for the succeeding 15 years.

(3) 10-Year Carryforward for \$50,000,000 Investment

Any unused portion of a credit may be carried forward for the succeeding 10 years if the taxpayer is expected to purchase or lease, and place in service in connection with the eligible business within a two-year period (seven years for interstate air couriers and eligible major industries), at least \$50,000,000 worth of one or more of the following: real property, machinery and equipment, or central office or aircraft facility property. The Secretary of Commerce must issue a written determination that the required investment is expected to be made in order for this extended carryforward period to apply. If the taxpayer fails to make the required level of investment within the two-year period (seven years for interstate air couriers and eligible major industries), the taxpayer forfeits the longer carryforward period.

h. Advisory Ruling (G.S. 105-129.4(g))

A taxpayer may request in writing from the Secretary of Revenue specific advice regarding eligibility for a credit. G.S. 105-264 governs the effect of this advice.

i. Statute of Limitations (G.S. 105-129.5(d))

A taxpayer must claim a credit within six months after the date set by statute for the filing of the return that coincides with the year that the taxpayer qualified for the credit, including any extensions of that date. The following example illustrates this requirement:

A calendar year taxpayer creates 10 new qualifying jobs in 2004. The taxpayer files a timely extension on March 15, 2005, which extends the due date of the tax return to October 15, 2005. Applying the six-month statute of limitations, the taxpayer has until April 15, 2006 to file the NC-478A and report the 2004 credit for creating jobs. If the taxpayer had not filed a timely extension by March 15, 2005, the NC-478A would have had to be filed by September 15, 2005.

j. Fees (G.S. 105-129.6)

A fee of \$500.00 is required for each credit the taxpayer intends to claim with respect to a location that is in an enterprise tier three, four, or five area, subject to a maximum fee of \$1,500.00. There is no fee for a credit in an enterprise tier one or tier two area. There is also no fee for a credit with respect to a location that is in a development zone. If the taxpayer intends to claim a credit that relates to locations in more than one enterprise tier area, the fee is based on the highest-numbered enterprise tier area. The fee is due at the same time as the tax return and the credit will not be allowed until the fee is paid.

k. Forms

The Form NC-478 series is used to calculate and report tax credits, including the Article 3A tax credits, that are limited to 50% of the taxpayer's tax less the sum of all other credits that the taxpayer claims. Forms NC-478A through NC-478I are

used to calculate the specific credits without regard to the 50% limitation. Form NC-478 is used to total the specific credits, to determine if the 50% limitation applies, and, if so, to allocate the limited total credit among the specific credits. Form NC-478V is used to report the fee that is due.

The table below lists the tax credits that are subject to the 50%-of-tax limitation and the NC-478 series form on which the credit is reported. The table also indicates if the credit is an Article 3A credit.

| Credit | File Form NC-478 plus Form: | Article 3A? |
|---|---|--------------------|
| Creating Jobs | NC-478A | Yes |
| Investing in Machinery and Equipment | NC-478B | Yes |
| Research and Development (Article 3A) | NC-478C | Yes |
| Worker Training | NC-478D | Yes |
| Investing in Central Office or Aircraft Facility Property | NC-478E | Yes |
| Investing in Business Property (SEE NOTE BELOW) | NC-478F | No; in Art. 3B |
| Investing in Renewable Energy Property | NC-478G | No; in Art. 3B |
| Low-income Housing | NC-478H | No; in Art. 3E |
| Research and Development (Article 3F) | NC-478I | No; in Art. 3F |
| Contributing to Development Zone Projects | No additional form. Use NC-478, line 11 | Yes |
| Technology Commercialization | No additional form. Use NC-478, line 9 | Yes |
| Investing in Non-hazardous Dry-cleaning Equipment | No additional form. Use NC-478, line 10 | No; in Art. 3B |
| Use of North Carolina Ports | No additional form. Use NC-478, line 11 | No; in Art. 4 |
| Renewable Energy Equipment Facility - Article 4 | No additional form. Use NC-478, line 11 | No; in Art. 4 |
| Manufacturing Cigarettes for Export | No additional form. Use NC-478, line 11 | No; in Art. 4 |
| Substantial Investment in Other Property | No additional form. Use NC-478, line 11 | Yes |

Note: The Investing in Business Property credit expired for investments made after December 31, 2001; remaining installments and carryforwards may still be taken.

Both Form NC-478 and any applicable Form NC-478 series form must be filed for any taxable year in which the taxpayer is eligible to claim a credit or an installment of a credit against the taxpayer's tax liability for that year. This requirement

applies even if the taxpayer's tax liability for that year is not large enough for the taxpayer to benefit from the credit. If the taxpayer engages in activities that qualify for the credit for creating jobs, the credit for investing in machinery and equipment, or the credit for investing in central office or aircraft facility property, the taxpayer must complete Part 1 of Form NC-478A, Form NC-478B, or Form NC-478E and file the form with the taxpayer's return for the taxable year in which the taxpayer engages in the activity, even though the first installment of the credit will not be claimed until the following year.

For further information about the Form NC-478 series, see Form NC-478 INST, *Instructions for 2003 Form NC-478 Series*.

I. Overdue Tax Debts (G.S. 105-129.4(b6))

A taxpayer is ineligible for an Article 3A tax credit if the taxpayer has an overdue tax debt at the time the taxpayer claims an installment or carryforward of a credit. An overdue tax debt is defined in G.S. 105-243.1(a)(1) as "[a]ny part of a tax debit that remains unpaid 90 days or more after the notice of final assessment was mailed to the taxpayer. The term does not include a tax debt, however, if the taxpayer entered into an installment agreement for the tax debt under G.S. 105-237 within 90 days after the notice of final assessment was mailed and has not failed to make any payments due under the installment agreement."

4. Credit for Creating Jobs (G.S. 105-129.8)

a. Eligibility

To be eligible for a credit for creating jobs, a taxpayer must meet the following conditions:

- Meet all general eligibility requirements described in Section V.
- Have five or more full-time employees.
- Hire an additional full-time employee during the year to fill a position located in this State.

b. Terms Used

(1) Creating a New Full-time Job

To determine the number of new jobs filled, the taxpayer subtracts the highest number of full-time employees the taxpayer had in the State at any time during the twelve-month period preceding the beginning of the taxable year from the number of full-time employees the taxpayer has in the State at the end of the taxable year.

(2) Full-time Job

A position that requires at least 1,600 hours of work per year and is intended to be held by one employee during the entire year.

(3) Location of a Job

A job is located in an area if more than fifty percent of the employee's duties are performed in the area.

c. Credit Amount

The amount of credit allowed is based upon the enterprise tier of the area in which the position is located as shown below:

| Area Enterprise Tier | Amount of Credit for Each Job |
|------------------------------|--------------------------------------|
| Tier One | \$12, 500 |
| Tier Two | 4,000 |
| Tier Three | 3,000 |
| Tier Four | 1,000 |
| Tier Five | 500 |
| Development Zone in Any Tier | \$4,000 plus the amount for the Tier |

d. Taking the Credit

The credit is taken in four equal installments over the four-year period beginning the year after the taxpayer qualifies for the credit. If a taxpayer is required to file more than one tax return during a year, each return constitutes a year for purposes of taking installments of the credit.

e. Expiration

If, in one of the four years in which an installment accrues, the number of the taxpayer's full-time employees falls below the number of full-time employees the taxpayer had in the year in which the taxpayer qualified for the credit, the credit expires and the taxpayer may not take any remaining installments of the credit. This calculation is illustrated by the following example:

Taxpayer is claiming a credit for forty jobs in tier four at \$1,000 per job. The installments are \$10,000 each over four years. During the year that the third installment of the credit accrues, the taxpayer loses twelve jobs. The third and fourth installments must be recalculated to recognize the loss of the jobs. After the recalculation, the third and fourth installments that remain to be taken are \$7,000 each, rather than \$10,000 each, computed as follows:

$$\frac{(40 - 12) \times \$1,000}{4}$$

If the taxpayer has carryforwards from the first and second installments attributable to the 12 lost jobs, the taxpayer can continue to take the carryforwards for these even though the installments have expired. When a credit expires, the taxpayer can still take the portion of an installment that accrued in a previous year and was carried forward.

f. Movement of Jobs

Jobs transferred from one area in the State to another area are not considered new jobs. If a job qualifies for the credit in one tier, but is moved to another enterprise tier, the credit is recomputed as if the job had been created initially in the area to which it was moved.

g. Planned Expansion

A taxpayer that signs a letter of commitment with the Department of Commerce to create at least 20 new full-time jobs in a specific area within two years (seven years for interstate air couriers and eligible major industries) of the date the letter is signed qualifies for the credit in the amount allowed based on the area's enterprise tier and development zone designation for that year even though the employees are not hired that year. The credit is available in the taxable year after

at least 20 employees have been hired if the hirings are within the two-year (seven years for interstate air couriers and eligible major industries) commitment period. If the taxpayer does not hire the employees within the two-year (seven years for interstate air couriers and eligible major industries) period, the taxpayer does not get the benefit of the letter of commitment.

5. Credit for Investing in Machinery and Equipment (G.S. 105-129.9)

a. Eligibility

To be eligible for a credit for investing in machinery and equipment, a taxpayer must:

- Meet all general eligibility requirements described in "General Eligibility Requirements."
- Purchase or lease eligible machinery and equipment.
- Place the eligible machinery and equipment in service during the taxable year.

b. Terms Used

(1) Cost

In the case of property owned by the taxpayer, cost is determined pursuant to regulations adopted under section 1012 of the Internal Revenue Code. In the case of property the taxpayer leases from another, cost is valued at eight times the net annual rental rate as described in G.S. 105-130.4(j)(2).

(2) Eligible Machinery and Equipment (G.S. 105-129.2(10))

Machinery and equipment are eligible if they are capitalized by the taxpayer for tax purposes under the Internal Revenue Code and are not leased to another party. Property expensed under Section 179 of the Code is not eligible. In the case of a qualifying large investment, machinery and equipment that are not capitalized by the taxpayer are eligible if the taxpayer leases them from another party.

(3) Machinery and Equipment

Engines, machinery, equipment, tools, and implements used or designed to be used in the business for which the credit is claimed. The term does not include real property as defined in G.S. 105-273 or rolling stock as defined in G.S. 105-333.

c. Credit Amount

The credit is 7% of the excess of the eligible investment amount over the applicable threshold if the investment is placed in service in a tier one or tier two area, 6% for tier three, 5% for tier four, and 4% for tier five. Business activities subject to a letter of commitment applied for before January 1, 2003, qualify for a 7% credit regardless of the tier in which the investment is placed in service.

The eligible investment amount is the lesser of the following:

- The cost of the machinery and equipment.
- The amount by which the cost of all of the taxpayer's machinery and equipment that is in service in North Carolina on the last day of the taxable year exceeds the cost of all of the taxpayer's machinery and equipment that was in service in North Carolina on the last day of the base year. The base

year is that year, of the three immediately preceding taxable years, in which the taxpayer had the most machinery and equipment in service in North Carolina.

The threshold is based on the enterprise tier of the area where the machinery and equipment are placed in service during the taxable year. Thresholds for tier one through tier five are as follows:

| Enterprise Tier Area | Threshold |
|-----------------------------|------------------|
| Tier One | \$ -0- |
| Tier Two | 100,000 |
| Tier Three | 200,000 |
| Tier Four | 1,000,000 |
| Tier Five | 2,000,000 |

(Note: For business activities subject to a letter of commitment applied for before January 1, 2003, the threshold in tier four is \$500,000 and the threshold in tier five is \$1,000,000.)

If the taxpayer places eligible machinery and equipment in service in an area over the course of a two-year period, the applicable threshold for the second taxable year is reduced by the eligible investment amount for the previous taxable year.

If machinery and equipment are placed in service at two or more establishments within the same tier during the taxable year, the threshold must be applied to each establishment.

d. Taking the Credit

The credit is taken in seven equal installments beginning the year after the taxpayer qualifies for the credit. If a taxpayer is required to file more than one tax return during a year, each return constitutes a year for purposes of taking installments of the credit.

e. Expiration

Generally, if machinery and equipment are disposed of, taken out of service, or moved out of North Carolina prior to the end of the seven-year period in which the credit is claimed, the amount of credit that relates to the machinery and equipment no longer in service expires and a taxpayer may not take any remaining installment related to this machinery and equipment. However, a taxpayer that replaces or otherwise disposes of machinery and equipment for which a credit was claimed can continue to take the remaining installments of the credit that relate to the machinery and equipment no longer in service if the net reduction in the cost of the taxpayer's eligible machinery and equipment in the enterprise tier does not exceed 20% of the cost of the disposed property. If the net reduction exceeds 20%, the remaining installments of the credit expire. If during a single tax year the taxpayer disposes of machinery and equipment with respect to two or more credits in the same tier, costs are calculated based on all credits affected.

The "net investment reduction" calculation is illustrated by the following example:

- Taxpayer has \$10,000,000 of eligible machinery and equipment in service in

tier one.

- During the tax year, a piece of equipment with a cost of \$2,500,000 is taken out of service.
- There are remaining installments of a credit related to the equipment taken out of service.
- Replacement equipment is placed into service during the same tax year at a cost of \$1,500,000.
- Total cost of eligible equipment at the end of the tax year is \$9,000,000.

The net investment reduction in tier one is \$1,000,000 (\$10 million - \$9 million). Twenty percent of the cost of the equipment taken out of service is \$500,000 (\$2,500,000 x .20). The net reduction in total eligible equipment (\$1 million) is greater than 20% of the cost of the equipment taken out of service (\$500,000). Therefore, the installments related to the \$2,500,000 piece of equipment expire.

If a taxpayer disposes of a portion of the machinery and equipment for which a credit is claimed, and the taxpayer is not entitled to continue taking the installments of the credit in accordance with the "net investment reduction" calculation illustrated above, the amount of the credit associated with the machinery and equipment no longer in service expires. This calculation is illustrated by the following example:

- Taxpayer has \$10,000,000 of eligible machinery and equipment in service in tier one where the threshold is \$0.
- Taxpayer is claiming a credit of \$700,000 at \$100,000 per installment based on its \$10,000,000 investment.
- During the year that the third installment of the credit accrues, a piece of equipment for which the credit is claimed with a cost of \$2,500,000 is taken out of service.

The remaining installments beginning in year three are \$75,000 each, computed as follows:

$$\frac{\$10,000,000 - \$2,500,000 \times .07}{7}$$

When a credit expires, a taxpayer can still take a portion of an installment that is related to the machinery and equipment no longer in service and accrued in a previous year and was carried forward.

f. Movement to Higher Tier (G.S. 105-129.9(d))

If machinery and equipment for which a credit has been claimed is later moved to a higher-numbered tier, the credit is recomputed as if the machinery and equipment had been placed originally in the area to which it was moved.

g. Planned Expansion (G.S. 105-129.9(e))

A taxpayer that signs a letter of commitment with the Department of Commerce to place specific eligible machinery and equipment in service in an area within two years (seven years for interstate air couriers and eligible major industries) after the date the letter is signed may, in the year the eligible machinery and equipment are placed in service in that area, calculate the credit for which the taxpayer

qualifies based on the area's enterprise tier and development zone designation for the year the letter was signed. If the taxpayer does not place part or all of the specified eligible machinery and equipment in service within the two-year period (seven years for interstate air couriers and eligible major industries) the taxpayer does not qualify for the benefit of the letter of commitment with respect to the machinery and equipment not placed in service within the two-year period (seven years for interstate air couriers and eligible major industries).

6. Credit for Technology Commercialization (G.S. 105-129.9A)

The credit for technology commercialization is similar to the credit for investing in machinery and equipment, but with higher rates of credit, and with more difficult eligibility requirements. Consequently, except as provided in this section, the provisions that apply to the credit for investing in machinery and equipment also apply to the technology commercialization credit. A taxpayer cannot take the machinery and equipment credit and the technology commercialization credit with respect to the same asset.

a. Eligibility

To be eligible for a technology commercialization credit, the taxpayer must meet all of the requirements for the credit for investing in machinery and equipment. In addition, the taxpayer must meet all of the conditions listed below:

- The eligible machinery and equipment must be directly related to production based on technology developed by and licensed from a research university; or be used to produce resources essential to the taxpayer's production based on technology developed by and licensed from a research university.
- The eligible machinery and equipment must be placed in service in a tier one, two, or three enterprise area.
- The eligible investment amount must be at least \$10,000,000 for the taxable year.
- If qualifying for a 20% credit, the taxpayer must invest at least \$150 million in eligible machinery and equipment by the end of the fourth year after the year in which eligible machinery and equipment are first placed in service in the area.
- If qualifying for a 15% credit, the taxpayer must invest at least \$100 million in eligible machinery and equipment by the end of the fourth year after the year in which eligible machinery and equipment are first placed in service in the area.
- No more than nine years has passed since the first taxable year the taxpayer claimed a technology commercialization credit with respect to the same location.

b. Terms Used

(1) Eligible Machinery and Equipment

Unlike the requirement for the credit for investing in machinery and equipment, a leased piece of machinery and equipment does not have to be capitalized in order to be "eligible" for this credit.

(2) Research University

An institution of higher education classified as a Research I university or a

Research II university in the most recent edition of "A Classification of Institutions of Higher Education," the official report of The Carnegie Foundation for the Advancement of Teaching.

c. Credit Amount

The credit is a percentage of the excess of the eligible investment amount over the applicable threshold for the tax year. For a taxpayer whose level of investment is at least \$100 million, the percentage is 15%. If the level of investment is at least \$150 million, the percentage is 20%.

In calculating the eligible investment amount, machinery and equipment that were transferred to another taxpayer or were taken out of service during the three years preceding the tax year may be considered the taxpayer's machinery and equipment if certain conditions are met. See G.S. 105-129.9A(b) for the conditions. If the taxpayer wants to include machinery and equipment under the exception in G.S. 105-129.9A(b)(2), the taxpayer must first request a ruling by the Department of Revenue as to whether the taxpayer meets the conditions.

d. Taking the Credit

The credit is taken for the taxable year in which the machinery and equipment are placed in service. The credit is not taken in installments.

7. Credit for Research and Development (G.S. 105-129.10)

a. Eligibility

To be eligible for a credit for research and development, a taxpayer must:

- Meet all general eligibility requirements described in "General Eligibility Requirements."
- Claim for the taxable year the federal income tax credit for research and development under section 41(a) or section 41(c)(4) of the Internal Revenue Code.

Special Rules:

- If the primary activity of an establishment of the taxpayer in this State is computer services, the taxpayer's qualified research expenditures in this State are considered to be used in computer services.
- For all other taxpayers, the taxpayer's qualified research expenditures in this State are considered to be used in the primary business of the taxpayer.

b. Terms Used

(1) Base Amount and Qualified Research Expenses

Defined under section 41 of the Code.

(2) Code

The Internal Revenue Code enacted as of January 1, 1999.

c. Credit Amount

(1) General Research and Development Credit

A taxpayer that claims for the taxable year a federal income tax credit under section 41(a) of the Code for increasing research activities is allowed a credit of 5% of the State's apportioned share of the taxpayer's expenditures for increasing research activities. The State's apportioned share of a taxpayer's

expenditures for increasing research activities is the excess of the taxpayer's qualified research expenses for the taxable year over the base amount, multiplied by a percentage equal to the ratio of the taxpayer's qualified research expenses in this State for the taxable year to the taxpayer's total qualified research expenses for the taxable year.

(2) Alternative Research and Development Credit

A taxpayer that claims the alternative incremental credit under section 41(c)(4) of the Code for increasing research activities is allowed a credit equal to 25% of the State's apportioned share of the federal credit claimed. The State's apportioned share of the federal credit claimed is the amount of the alternative incremental credit the taxpayer claimed under section 41(c)(4) of the Code for the taxable year multiplied by a percentage equal to the ratio of the taxpayer's qualified research expenses in this State for the taxable year to the taxpayer's total qualified research expenses for the taxable year. The amount of the alternative incremental credit claimed by a taxpayer is determined without regard to any reduction elected under section 280C(c) of the Code.

d. Taking the Credit

The credit is taken for the taxable year in which the taxpayer qualifies for the credit. The credit is not taken in installments. Effective for research activities occurring on or after May 1, 2005, the credits allowed under this section and the credit allowed under Article 3F are exclusive. A taxpayer can elect to take only one of the three credits with respect to its research activities in a taxable year.

8. Credit for Worker Training (G.S. 105-129.11)

a. Eligibility

To be eligible for a credit for worker training, a taxpayer must:

- Meet all general eligibility requirements described in "General Eligibility Requirements" except for the wage standard test.
- Provide worker training for five or more of its eligible employees during the taxable year.

b. Terms Used

(1) Eligible Employee

An employee who is in a full-time position classified as non-exempt under the Fair Labor Standards Act and who meets one or more of the following conditions:

- The employee occupies a job for which the taxpayer is eligible to claim an installment of the credit for creating jobs.
- The employee is being trained to operate machinery and equipment for which the taxpayer is eligible to claim an installment of the credit for investing in machinery and equipment.

(2) Location of a Job

A job is located in an area if more than 50% of the employee's duties are performed in the area.

c. Credit Amount

The credit is equal to the wages paid to the eligible employees during the training. Wages paid to an employee performing his or her job while being trained are not eligible for the credit. For positions located in an enterprise tier one area, the credit may not exceed \$1,000 per employee trained during the taxable year. For positions located in other tiers, the credit may not exceed \$500 per employee trained during the taxable year.

d. Taking the Credit

The credit is taken during the taxable year the wages are paid to the eligible employees during training. The credit is not taken in installments.

9. Credit for Investing in Central Office or Aircraft Facility Property (G.S. 105-129.12)

a. Eligibility

To be eligible for the credit, a taxpayer must:

- Meet all of the general eligibility requirements described in "General Eligibility Requirements."
- Purchase or lease real property in North Carolina.
- Begin to use the property as a central office or an aircraft facility during the taxable year.

b. Cost Defined

In the case of property owned by the taxpayer, cost is determined pursuant to regulations adopted under section 1012 of the Code. In the case of leased property, cost is considered to be the taxpayer's lease payments over a seven-year period, plus any expenditures made by the taxpayer to improve the property before it is used as the taxpayer's central office or aircraft facility if the expenditures are not reimbursed or credited by the lessor.

c. Credit Amount

The credit is 7% of the eligible investment amount. The eligible investment amount is the lesser of the following:

- The cost of the property.
- The amount by which the cost of all the property the taxpayer is using in North Carolina as central offices or aircraft facilities on the last day of the taxable year exceeds the cost of all the property the taxpayer was using in North Carolina as central offices or aircraft facilities on the last day of the base year. The base year is that year, of the three immediately preceding taxable years, in which the taxpayer was using the most property in North Carolina as central offices or aircraft facilities.

The maximum credit is \$500,000 per taxpayer. The basis in any real property for which a credit is allowed must be reduced by the amount of credit allowable.

d. Mixed Use Property

If the property is used for more than one purpose, the credit is allowed only with respect to the portion of the property that is used as a central office or aircraft facility. This determination is made using the following fraction:

square footage of the property used as central office or aircraft facility
total square footage of the property

e. Taking the Credit

The credit is taken in seven equal installments beginning the year after the taxpayer qualifies for the credit. If a taxpayer is required to file more than one tax return during a year, each return constitutes a year for purposes of taking installments of the credit.

f. Expiration

The credit expires in the following circumstances:

- When the property for which the credit is claimed is no longer used as a central office or an aircraft facility.
- When the total number of employees the taxpayer employs at all of its central offices or aircraft facilities in North Carolina drops below 40.
- When a portion of the property for which the credit is claimed is no longer used as a central office or an aircraft facility. In this circumstance, the amount of the credit associated with the portion no longer used as a central office or an aircraft facility expires. The remaining installments are computed by multiplying the total credit times the fraction described above for mixed-use property.

When a credit expires, the taxpayer can still take the portion of an installment that accrued in a previous year and was carried forward.

10. Credit for Substantial Investment in Other Property (G.S. 105-129.12A)

a. Eligibility

To be eligible for the credit, the taxpayer must receive a written determination from the Secretary of Commerce that the Secretary expects the taxpayer to purchase or lease and use in an eligible business at a specific location within a three-year period at least \$10,000,000 of real property, and to create 200 new jobs at that location within two years of the time that the property is first used in an eligible business. This requirement is set out in G.S. 105-129.4(b5). Additionally, the taxpayer must meet all of the eligibility requirements listed below:

- Meet all of the general eligibility requirements described in "General Eligibility Requirements."
- Purchase or lease real property in an enterprise tier one or two area.
- Begin to use the property in an eligible business during the taxable year.

b. Terms Used

(1) Cost

In the case of property owned by the taxpayer, cost is determined pursuant to regulations adopted under section 1012 of the Internal Revenue Code. In the case of leased property, cost is considered to be the taxpayer's lease payments over a seven-year period, plus any expenditures made by the taxpayer to improve the property before the taxpayer uses it if the expenditures are not reimbursed or credited by the lessor.

(2) Property Located in an Enterprise Tier One or Two Area

Property is located in an enterprise tier one or two area if the area is designated as tier one or two at the time the taxpayer requests the required written determination from the Secretary of Commerce regarding its expected investment.

c. Credit Amount

The credit is 30% of the eligible investment amount. The eligible investment amount is the lesser of the following:

- The cost of the property.
- The amount by which the cost of all of the real property the taxpayer is using in this State in an eligible business on the last day of the taxable year exceeds the cost of all of the real property the taxpayer was using in this State in an eligible business on the last day of the base year. The base year is that year, of the three immediately preceding taxable years, in which the taxpayer was using the most real property in this State in an eligible business.

When an investment is phased in over the course of more than one tax year, the taxpayer may claim a credit in each year based on the eligible investment amount of the property that is first used in an eligible business for the current tax year. The basis in any real property for which a credit is allowed must be reduced by the amount of credit allowable.

d. Mixed Use Property

If the property is used for more than one purpose, the credit is allowed only with respect to the portion of the property that is used as a central office or aircraft facility. This determination is made using the following fraction:

$$\frac{\text{square footage of the property used as central office or aircraft facility}}{\text{total square footage of the property}}$$

e. Taking the Credit

The credit is taken in seven equal installments beginning the year after the taxpayer qualifies for the credit. If a taxpayer is required to file more than one tax return during a year, each return constitutes a year for purposes of taking installments of the credit.

f. Expiration

The credit expires in the following circumstances:

- When the property for which the credit is claimed is no longer used in an eligible business.
- When the total number of employees at the property with respect to which the credit is claimed drops below 200.
- When a portion of the property for which the credit is claimed is no longer used in an eligible business. In this circumstance, only the amount of the credit associated with the portion no longer used in an eligible business expires. The remaining installments are computed by multiplying the total credit times the fraction described above for mixed-use property.

When a credit expires, the taxpayer may not take any remaining installments of the credit. The taxpayer can still take the portion of an installment that accrued in a previous year and was carried forward.

11. Credit for Development Zone Projects (G.S. 105-129.13)

a. Eligibility

The general eligibility requirements do not apply to this credit. To be eligible for a credit for a development zone project, the taxpayer must meet the following requirements:

- Contribute cash or property to a development zone agency for an improvement project in a development zone.
- Not control, be controlled by, or be under common control with an affiliate of the development zone agency. The taxpayer may not have one of the relationships defined in section 267(b) of the Internal Revenue Code with the development zone agency.
- File an application with the Department of Revenue on or before April 15 of the year following the calendar year in which the contribution was made. The Secretary may grant an extension for filing the application if a taxpayer makes a timely request for an extension. An extension allows the taxpayer to file the application by the following September 15.
- Include with an application submitted a certified appraisal of the value of the property contributed, if the contribution was of property rather than cash.

b. Terms Used

(1) Control

A person controls an entity if the person owns, directly or indirectly, more than 10% of the voting securities of that entity. The term "voting security" means a security that confers upon the holder the right to vote for the election of members of the board of directors or similar governing body of the business or is convertible into, or entitles the holder to receive upon its exercise, a security that confers such a right to vote. A general partnership interest is a voting security.

(2) Development Zone Agency

Any of the following agencies that the Department of Commerce certifies will undertake an improvement project in a development zone will qualify:

- A community-based development organization qualified under 24 C.F.R. section 570.204.
- A community action agency that has been officially designated as such pursuant to section 210 of the Economic Act of 1964, Public Law 88-452, 78 Stat. 508.
- A community development corporation.
- A community development financial institution certified by the United States Department of the Treasury under the Community Development Banking and Financial Institutions Act of 1994, 12 U.S.C. section 4701.
- A community housing development organization qualified under the HOME Investment Partnerships Act, 42 U.S.C. section 12701 and 12704, and 24 C.F.R. section 92.2.

- A local housing authority created under Article 1 of Chapter 157 of the General Statutes.

(3) Improvement Project

A project to construct or improve real property for community development purposes or to acquire real property and convert it for community development purposes. Construction or improvement includes services provided by a development zone agency directly related to the construction or improvement, and project development fees charged by a developer for the construction or improvement.

c. Credit Amount

The credit is equal to 25% of the value of the contribution of cash or property to a development zone agency for an improvement project in a development zone. A contribution is for an improvement project if the agency receiving the contribution contracts in writing to use the contribution for the project and agrees in the contract to repay to the taxpayer, with interest, any part of the contribution not used for the project.

d. Taking the Credit

The credit may not be taken in the year in which the contribution is made. Instead, the credit must be taken for the taxable year beginning during the calendar year in which the application to the Department of Revenue for the credit becomes effective.

e. Ceiling

The total amount of all credits for contributions made in a calendar year may not exceed \$4,000,000. If the total amount of credits claimed exceeds \$4,000,000, the Secretary of Revenue must allocate the \$4,000,000 in tax credits in proportion to the size of the credit claimed by each taxpayer. If a credit is reduced because of this ceiling, the Secretary must notify the taxpayer of the amount of the reduction of the credit on or before December 31 of the year the application was filed.

f. Forfeiture

A taxpayer forfeits the credit to the extent the development zone agency uses the taxpayer's contribution for any purpose other than an improvement project.

III. TAX CREDITS
(Articles 3A, 3B, 3C, 3D, 3E, 3F, and 4)

F. Low-Income Housing Tax Credits (Article 3E of Chapter 105)

2. Credit for Low-income Housing Awarded a Federal Credit Allocation on or after January 1, 2003 (G.S. 105-129.42)

a. Credit (G.S. 105-129.42(b))

A taxpayer who is allocated a federal income tax credit under Section 42 of the Code to construct or substantially rehabilitate a qualified North Carolina low-income housing development is allowed a credit equal to a percentage of the development's ~~eligible-qualified~~ basis, as determined pursuant to Section 42(d) of the Code. For the purpose of this section, ~~eligible-qualified~~ basis is calculated based on the information contained in the carryover allocation and is not recalculated to reflect subsequent increases or decreases. No credit is allowed for a development that uses tax-exempt bond financing.

c. Developments and Amounts (G.S. 105-129.42(c))

The housing developments that are qualified North Carolina low-income housing developments and the percentage of the development's eligible basis for which a credit is allowed are:

- If forty percent (40%) of the qualified residential units are affordable to households whose income is fifty percent (50%) or less of area median income and the units are in a Low-Income county or city, the percentage of the basis for which a credit is allowed is thirty percent (30%).
- If fifty percent (50%) of the qualified residential units are affordable to households whose income is fifty percent (50%) or less of the area median income and the units are in a Moderate-Income county or city, the percentage of the basis for which a credit is allowed is twenty percent (20%).
- If fifty percent (50%) of the qualified residential units are affordable to households whose income is forty percent (40%) or less of the area median income and ten percent (10%) of the units are in High-Income county or city, the percentage of the basis for which a credit is allowed is ten percent (10%).
- If twenty-five percent (25%) of the qualified residential units are affordable to households whose income is thirty percent (30%) or less of the area median income and ten percent (10%) of the units are in a High-Income county or city, the percentage of the basis for which a credit is allowed is ten percent (10%).

The designation of a county or city as Low-Income, Moderate-Income, or High-Income and determinations of affordability are made by the Housing Finance Agency in accordance with the Qualified Allocation Plan in effect as of the time the federal credit is allowed. A change in the income designation of a county or city after a federal credit is allocated does not affect the percentage of the developer's eligible basis for which the credit is allowed. The affordability requirements apply for the duration of the federal tax credit compliance period.

4. Sunset (G.S. 105-129.45)

Article 3E is repealed effective January 1, ~~2006~~2010. The repeal applies to developments to which federal credits are allocated on or after January 1, ~~2006~~2010.

III. TAX CREDITS
(Articles 3A, 3B, 3C, 3D, 3E, 3F, and 4)

G. Research and Development Tax Credit (Article 3F of Chapter 105)

1. General Information

a. Administration (G.S. 105-129.51)

Effective for business activities occurring on or after May 1, 2005, any taxpayer, regardless of its type of business, is allowed a tax credit for qualified North Carolina research expenses, if the taxpayer meets the eligibility requirements relating to wage standard, health insurance, environmental impact, and safety and health programs found in G.S. 105-129.4(b), (b2), (b3), and (b4), respectively.

The credit allowed under this section and the credits allowed in G.S. 105-129.10 are exclusive. A taxpayer can elect to take only one of the three credits with respect to its research activities in a taxable year. A taxpayer may elect to take a different credit for different expenses in a subsequent year.

b. Tax election (G.S. 105-129.52)

A taxpayer may claim the credit allowed in Article 3F against either franchise or income tax. The taxpayer must elect the tax against which the credit will be claimed when filing the return on which the credit is first claimed. The election is binding and applies to both the credit and any carryforwards of the credit.

c. Cap (G.S. 105-129.52)

The credit allowed in Article 3F cannot exceed fifty percent (50%) of the amount of tax against which it is claimed, reduced by the sum of all other tax credits allowed against that tax. This limitation applies to the cumulative amount of credit, including carryforwards. Any unused portion of this credit may be carried forward for the succeeding 15 taxable years.

d. Substantiation (G.S. 105-129.53)

Each taxpayer that claims a credit under Article 3F must maintain and make available for inspection any information or records required by the Secretary. The burden of proof for a credit and the amount of the credit rests upon the taxpayer.

e. Forms

The Form NC-478 series is used to calculate and report tax credits, including the Article 3F credits, that are limited to fifty percent (50%) of the taxpayer's tax less the sum of all other credits that the taxpayer claims. Form NC-478I is used to calculate the research and development tax credits without regard to the fifty percent (50%) limitation. Form NC-478 is used to total the specific credits, to determine if the fifty percent (50%) applies, and, if so, to allocate the limited total credit among the specific credits.

f. Sunset (G.S. 105-129.51)

Article 3F is repealed for taxable years beginning on or after January 1, 2009.

2. Definitions (G.S. 105-129.50)

The definitions in section 41 of the Code apply in this Article. Additionally, the following definitions apply also:

a. North Carolina university research expenses

Any amount the taxpayer paid or incurred to a research university for qualified research performed in this State or basic research performed in this State.

b. Period of measurement

Defined in the Small Business Size Regulations of the federal Small Business Administration. Pursuant to those regulations (13CFR121.104), the period of measurement is used to determine the entity's annual receipts and is determined by how long an entity has been in business.

If the entity has been in business for less than three years, the annual receipts for the period of measurement are the receipts for the period of time for which the entity has been in business divided by the number of weeks in business and multiplied by 52.

If the entity has been in business for three full fiscal years and has not filed a short-period income tax return for any of those three years, the annual receipts for the period of measurement are the total receipts over the last three years divided by three.

If one of the three years' returns is a short-period return, the annual receipts for the period of measurement are the receipts for the short year and the two full years divided by the total number of weeks in the short year and two full years divided by 52.

c. Qualified North Carolina research expenses

Qualified research expenses, other than North Carolina university research expenses, for research performed in this State.

d. Receipts

Defined in the Small Business Size Regulations of the federal Small Business Administration. Pursuant to those regulations (13CFR121.104), receipts means total income, gross income plus cost of goods sold as reported for federal income tax purposes, less net capital gains or losses and taxes collected for and remitted to a taxing authority to the extent included in gross or total income, proceeds from transactions between the entity and its domestic or foreign affiliates if also excluded from gross or total income on a federal consolidated return, and amounts collected for another by a travel agent, real estate agent, advertising agent, conference management service provider, freight forwarder or customs broker.

e. Related person

Defined in G.S. 105-163.010 and IRC sections 267(b) or 707(b).

f. Research university

An institution of higher education that:

- Is classified in the most recent edition of 'A Classification of Institutions of Higher Education', the official report of The Carnegie Foundation for the Advancement of Teaching as one of the following:
 - Doctoral/Research Universities, Extensive or Intensive.
 - Masters Colleges and Universities, I or II.

- Baccalaureate Colleges, Liberal Arts or General.
- Is a constituent institution of The University of North Carolina.

g. Small business

A business whose annual receipts, combined with the annual receipts of all related persons, for the applicable period of measurement did not exceed one million dollars (\$1,000,000).

3. Credit for North Carolina Research and Development (G.S. 105-129.55)

The credit allowed in this article consists of two parts:

a. Credit for qualified North Carolina research expenses

The credit is equal to a percentage of the expenses based on whether the expenses qualify as small business, low tier research, or other research. Only one credit is allowed with respect to the same expenses. If the expenses qualify in more than one category, then the credit is equal to the higher percentage, not both percentages combined. If part of the taxpayer's expenses qualify as low-tier and part of the expenses qualify as other research, the applicable percentages apply separately to each part of the expenses.

If the taxpayer was a small business as of the last day of the taxable year, the applicable percentage is three percent (3%). Research performed in a tier one, tier two, or tier three area is considered low-tier research and the applicable percentage is three percent (3%). Research expenses that do not qualify as small business or low-tier are considered other research.

If other research expenses are greater than zero but not greater than fifty million dollars (\$50,000,000), the applicable percentage is one percent (1%). If other research expenses are greater than fifty million dollars (\$50,000,000), but not greater than two hundred million dollars (\$200,000,000), the applicable percentage is two percent (2%). If other research expenses are greater than two hundred million dollars (\$200,000,000), the applicable percentage is three percent (3%).

b. Credit for North Carolina university research expenses

A taxpayer that has expenses for research performed by an institution within the North Carolina university system is allowed a credit equal to fifteen percent (15%) of the expenses.

V. EXCISE TAX
(Articles 2A, 2C, and 5E)

A. Tobacco Products Excise Tax (G.S. 105-113.2 - G.S. 105-113.40)

5. Tax on Cigarettes (G.S. 105-113.5)

An excise tax is levied on the sale or possession for sale in this State, by a distributor, of all cigarettes at the rate of two and one-half mills (.0025) per individual cigarette. Distributors are responsible for the tax on all packages of cigarettes received by them and should consider the desirability of insuring their cigarette inventories against loss by theft or otherwise, since distributors are liable for the tax upon any non-tax-paid cigarettes which are stolen or otherwise unaccounted for.

It is the responsibility of each wholesale cigarette dealer and retail dealer who purchases cigarettes from a distributor to determine that the tax is indicated as paid by the wording "North Carolina Cigarette Excise Tax Paid" on each invoice for cigarettes. If non-tax-paid cigarettes are received, such wholesale cigarette dealer or retail dealer must immediately notify the distributor from whom said cigarettes are purchased, with a copy to the Department. Upon such notification, the distributor from whom said cigarettes were purchased must immediately determine if the tax has been paid and make the necessary invoice changes to their customer as well as make any payment corrections to the Department with applicable penalty and interest.

~~The excise tax does not apply to sample cigarettes distributed without charge in packages containing five or fewer cigarettes or to cigarettes in a package of cigarettes given without charge by the manufacturer of the cigarettes to an employee of the manufacturer who works in a factory where cigarettes are made, if he cigarettes are not taxed by the federal government. Such complimentary packages of cigarettes containing over five cigarettes given to factory employees must be so marked by the manufacturer.~~

~~Exemption from the cigarette tax does not apply to packages of cigarettes given to employees of such cigarette manufacturer working in office buildings; nor does such exemption extend to employees in warehouses, or in plants manufacturing only cigars or pipe tobacco, if such packages contain more than five cigarettes.~~

16. Discount; Refund (G.S. 105-113.21)

Effective for reporting periods beginning on or after August 1, 2004, a distributor is allowed to deduct a discount equal to two percent (2%) of the tax due *if* the report is filed and the tax due is paid by the due date. The discount covers expenses incurred in preparing the records and reports required by this Part and the expense of furnishing a bond.

A distributor in possession of packages of stale or otherwise unsalable cigarettes upon which the tax has been paid may return the cigarettes to the manufacturer and apply to the Secretary for refund of the tax, less the discount allowed. The application shall be in the form prescribed by the Secretary and shall be accompanied by an affidavit from the manufacturer stating the number of cigarettes returned to the manufacturer by the applicant.

Any spoiled packages of tax-paid cigarettes in the hands of a retailer or wholesaler should be returned to its respective distributors, as refunds of the cigarette excise tax will ~~only~~ be made only to the distributor.

24. Tax on Tobacco Products Other Than Cigarettes (G.S. 105-113.35)

An excise tax is levied on tobacco products other than cigarettes at the rate of two percent (2%) of the cost price of the products. "Cost price" means the actual gross purchase price of the other tobacco products before any discounts, rebates, or allowances and before the excise tax is applied. Additional charges which are included and are not set out separately on the invoice, such as freight charges that are not separately stated, are considered part of the cost price and the tax is applied to the total invoice amount before any deductions.

This tax does not apply to the following:

- A tobacco product sold outside the State.
- A tobacco product sold to the federal government.
- A sample tobacco product distributed without charge.

The wholesale dealer or retail dealer who first acquires or otherwise handles other tobacco products subject to the tax imposed by this section is liable for the tax imposed by this section. A wholesale dealer or retail dealer who brings into this State a tobacco product made outside the State is the first person to handle the tobacco product in this State. A wholesale dealer or retail dealer who is the original consignee of a tobacco product that is made outside the State and is shipped into the State is the first person to handle the tobacco product in this State.

Examples are:

- The out-of-state wholesale dealer or retail dealer who brings such products into the State on its own truck.
- The in-state wholesale dealer or retail dealer who brings such products into the State on its own truck.
- The in-state wholesale dealer or retail dealer who first receives such products from outside the State by common carrier or contract carrier.

A retail dealer who acquires non-tax-paid other tobacco products subject to the tax imposed by this section from a wholesale dealer is liable for any tax due on the tobacco products. A retail dealer who is liable for tax under this subsection may not deduct a discount from the amount of tax due when reporting the tax.

A manufacturer who is not a retail dealer and who ships tobacco products other than cigarettes to either a wholesale dealer or retail dealer licensed under this Part may apply to the Secretary to be relieved of paying the tax imposed by this section on the tobacco products. Once granted permission, a manufacturer may choose not to pay the tax until otherwise notified by the Secretary. To be relieved of payment of the tax imposed by this section, a manufacturer must comply with the requirements set by the Secretary.

Other tobacco products sold to the federal government and its instrumentalities, such as the Armed Forces Exchange Services, are exempt from the excise tax. However, to qualify for exemption, sales of other tobacco products by such services must be limited to members of the armed forces and their dependents who hold

identification cards entitling them to make purchases through armed forces exchange services.

Whenever tax-exempt deliveries of other tobacco products are made by dealers to armed forces exchange services, the dealer must require a duly receipted invoice or copy thereof from the governmental agent designated to accept delivery.

If a person engages in the sale of any other tobacco products on a military reservation, regardless of the fact that he may have a contract with the federal government, whereby the federal government will receive a commission, flat fee, or some other type of compensation on such sales, same does not exempt the sale of such products from the excise tax. In such instances, such sales would not be made by the federal government or an instrumentality thereof. Instead, all such sales are subject to the excise tax.

29. Discount (G.S. 105-113.39)

Effective for reporting periods beginning on or after August 1, 2004, a wholesale dealer or a retail dealer who is primarily liable for the taxes imposed by this Part is allowed to deduct a discount equal to two percent (2%) of the tax due *if* the report is filed and the tax due is paid by the due date. The discount covers losses due to damage to tobacco products, expenses incurred in preparing the records and reports required by this Part, and the expense of furnishing a bond.

30. Records (G.S. 105-113.40)

Every wholesale dealer, every retail dealer and their customers must keep accurate records of inventories, purchases, and sales of tobacco products for at least three years. These records and inventories must be maintained separately in such a manner as can be inspected and audited by the Secretary or duly authorized representative at any time without having to go through and separate or segregate all sales of the taxpayer to arrive at the amount of exempt sales or inventories.

31. Other Tobacco Products Vending Machines

No other tobacco products dispensing machine will be allowed to operate in this State that does not have affixed thereto the identification required under the Tobacco Products Tax Article.

Wholesale dealers or retail dealers owning, leasing, furnishing or operating other tobacco products vending machines must affix to each machine in a conspicuous place an identification sticker or device, which shows the name, address and telephone number of the operator owning and placing such machine on location. The owner of the business wherein such machine is located is also responsible for seeing that such vending machine is so identified.

It is the duty of any person, firm or corporation operating other tobacco products vending machines to have available for the Department information as to the location of any and all vending machines so operated by such operator, and make such information available at any time to the Secretary or his authorized agent.

32. Refund of Overpaid Tax

A wholesale dealer or a retail dealer who pays tax to the Department on other tobacco products that are exempt from the excise tax may obtain a refund for the net amount of tax paid by filing an application for refund form provided by the

Secretary. Applications for refund must be submitted within the time allowed by G.S. 105-266 or G.S. 105-266.1.

33. Interest and Penalties (G.S. 105-236, G.S. 105-241.1(i))

Interest, at the rate set by the Secretary, is applicable to all late payments of the tobacco products excise tax and to all assessments of additional tax due.

The North Carolina Statutes provide both civil and criminal penalties for failure to comply with the tax laws. See Section VIII General Administration for additional information. Also, see Item ~~24~~23 above for information on penalties specific to this Article.

V. EXCISE TAX
(Articles 2A, 2C, and 5E)

B. Alcoholic Beverage License and Excise Tax (G.S. 105-113.68 – G.S. 105-113.89)

6. Payment of Excise Tax (G.S. 105-113.83)

a. Beer and Wine (G.S. 105-113.83(b))

The excise taxes on malt beverages and wine are payable to the Secretary by the resident wholesaler or importer who first handles the beverages in this State. The taxes on malt beverages and wine are levied only once on the same beverages.

The excise tax ~~on wine~~ levied under G.S. 105-113.80(b)) on wine shipper-shipped directly to consumers pursuant to G.S. 18B-1001.1 must be paid by the wine shipper permittee.

The tax must be paid on or before the 15th day of the month following the month in which the beverage is first sold or otherwise disposed of in this State by the wholesaler, importer, or wine shipper permittee.

When excise taxes are paid on wine or malt beverages, the wholesaler, importer, or wine shipper permittee must submit to the Secretary verified reports on forms provided by the Secretary detailing sales records for the month for which the taxes are paid. The report must indicate the amount of excise tax due, indicate separately any transactions to which the excise tax does not apply, and include all the information required by the Secretary.

b. Liquor (G.S. 105-113.83(b))

The excise tax on liquor is payable monthly by the local ABC board to the Secretary. The tax is due on or before the 15th day of the month following the month in which the tax was collected.

c. Railroad Sales (G.S. 105-113.83(c))

Each person operating a railroad train in this State on which alcoholic beverages are sold must submit monthly reports of the amount of alcoholic beverages sold in this State and must remit the applicable excise tax due on the sale of these beverages when the report is submitted. The report is due on or before the 15th day of the month following the month in which the beverages are sold. The report must be made on a form prescribed by the Secretary.

d. Wholesaler Buying From Wholesaler (17 NCAC 04E.0206)

When a resident wholesaler or importer purchases beer or wine from another wholesaler or importer in this ~~state~~State, the beverages must be reported separately as tax-paid beverages in the space provided on the monthly report filed by the purchasing resident wholesaler or importer since the selling resident wholesaler or importer, being the first in the State to receive or handle the product, is liable for the tax and must include the same product in their monthly report and pay the tax due.

8. Discount (G.S. 105-113.85)

Effective for reporting periods beginning on or after August 1, 2004, each wholesaler or importer is allowed to deduct a discount equal to two percent (2%) of

the tax due *if* the report is filed and the tax due is paid by the due date. The discount covers losses due to spoilage and breakage, expenses incurred in preparing the records and reports required by this Article, and the expenses of furnishing a bond.

9. Bonds (G.S. 106-113.86)

a. Wholesalers and Importers (G.S. 105-113.86(a)) (17 NCAC 04E.0601)

A resident wholesaler and importer must furnish a bond in an amount of at least five thousand dollars (\$5,000) and not more than fifty thousand (\$50,000). The bond must be payable to the State, must be in a form acceptable to the Secretary, and must be secured by a corporate surety or by a pledge of obligations of the federal government, the State, or a political subdivision of the State. The bond amount is in proportion to the anticipated tax liability of the wholesaler or importer and may vary yearly, based upon a review by the Alcoholic Beverages Excise Tax Unit of the previous twelve-month period. Bond requirements are as follows:

- Where the combined tax due for any three months of the previous twelve months exceeds forty thousand dollars (\$40,000), the amount of the bond will be fifty thousand dollars (\$50,000).
- Where the combined tax due for any three months of the previous twelve months exceeds twenty-five thousand dollars (\$25,000), but does not exceed forty thousand dollars (\$40,000), the amount of the bond will be forty thousand dollars (\$40,000).
- Where the combined tax due for any three months of the previous twelve months exceeds twelve thousand five hundred dollars (\$12,500), but does not exceed twenty-five thousand dollars (\$25,000), the amount of the bond will be twenty-five thousand dollars (\$25,000).
- Where the combined tax due for any three months of the previous twelve months exceeds five thousand (\$5,000), but does not exceed twelve thousand five hundred dollars (\$12,500), the amount of the bond will be twelve thousand five hundred dollars (\$12,500).
- Where the combined tax due for any three months of the previous twelve months does not exceed five thousand (\$5,000), the amount of the bond will be five thousand (\$5,000).

b. New Wholesaler or Importer Bond (17 NCAC 04E.0602)

In the case of a new wholesaler subject to the excise tax, or where operation has been conducted for less than twelve months prior to January 1, the amount of the bond is determined by the Secretary for the remainder of the calendar year or the ensuing calendar year based upon the wholesaler's anticipated business volume as evident by inventory, but will not be less than five thousand dollars (\$5,000).

c. Nonresident Vendors (G.S. 105-113.86(b))

The Secretary may require the holder of a nonresident vendor ABC permit to furnish a bond in an amount not to exceed two thousand dollars (\$2,000). The bond must be payable to the State, must be in a form acceptable to the Secretary, and must be secured by a corporate surety or by a pledge of obligations of the federal government, the State, or a political subdivision of the State.

10. Refund of Excise Tax Paid on Sacramental Wine (G.S. 105-113.87)

A person who purchases unfortified or fortified wine for the purpose stated in G.S.

18B-103(8) may obtain a refund from the Secretary for the amount of the excise tax levied under this Article. An applicant for a refund must file a written request for the refund due for the prior calendar year on or before April 15. Refunds are made annually. No refund will be made if the application is filed more than three years after the date it is due.

11. Records (G.S. 105-113.88)

A person who is required to file a report or return under this Article must keep a record of all documents used to determine information the person provides in a report or return. The records must be kept for three years from the due date of the report or return to which the records apply.

12. Other Applicable Administrative Provisions (G.S. 105-113.89)

The administrative provisions of Article 9 of Chapter 105 apply to this Article. See the section, "General Administration" for additional information.

VI. PRIVILEGE TAXES (Article 2)

D. Amusements – Certain Exhibitions, Performances, and Entertainment Exempt (G.S. 105-40)

The following forms of amusements are exempt from the taxes imposed under Article 2 of Chapter 105 of the General Statutes:

1. All exhibitions, performances, and entertainments, except those expressly mentioned in Article 2 as not exempt, produced by local talent exclusively, for the benefit of religious, charitable, benevolent or educational purposes, as long as no compensation is paid to the local talent.
2. The North Carolina Symphony Society, Incorporated, as specified in G.S. 140-10.1.
3. All exhibits, shows, attractions, and amusements operated by a society or association organized under the provisions of Chapter 106 of the General Statutes where the society or association has obtained a permit from the Secretary to operate without the payment of taxes under Article 2.
4. All outdoor historical dramas, as specified in Article 19C of Chapter 142 of the General Statutes.
5. All elementary and secondary school athletic contests, dances, and other amusements.
6. The first one thousand dollars (\$1,000) of gross receipts derived from dances and other amusements *actually promoted and managed* by civic organizations when the entire proceeds of the dances or other amusements are used exclusively for civic and charitable purposes of the organizations and not to defray the expenses of the organization conducting the dance or amusement. The exemption applies separately to each dance or other amusement (17NCAC 04B.0306). The mere sponsorship of a dance or another amusement by a civic or fraternal organization does not exempt the dance or other amusement, because the exemption applies only when the dance or amusement is actually *managed and conducted* by the civic or fraternal organization.
7. A youth athletic contest with an admissions price that does not exceed ten dollars (\$10.00) sponsored by a person exempt from income tax under Article 4 of this Chapter. For the purpose of this subdivision, a youth athletic contest means a contest in which each participating athlete is less than 20 years of age.
8. All dances, motion picture shows, and other amusements promoted and managed by a qualifying corporation that operates a center for the performing and visual arts if the dance or other amusement is held at the center. "Qualifying corporation" means a corporation that is exempt from income tax under G.S. 105-130.11(a)(3). "Center for the performing and visual arts" means a facility, having a fixed location, that provides space for dramatic performances, studios, classrooms, and similar accommodations to organized arts groups and individual artists. This exemption does not apply to athletic events.
9. All exhibitions, performances, and entertainments promoted and managed by a nonprofit arts organization that is exempt from income tax under G.S. 105-130.11(a)(3). This exemption does not apply to athletic events.

10. A person that is exempt from income tax under Article 4 of Chapter 105 and is engaged in the business of operating a teen center. A "teen center" is a fixed facility whose primary purpose is to provide recreational activities, dramatic performances, dances, and other amusements exclusively for teenagers.
11. All entertainment or amusements offered or given on the Cherokee Indian reservation when the person giving, offering, or managing the entertainment or amusement is authorized to do business on the reservation and pays the tribal gross receipts levy to the tribal council.
12. Arts festivals held by a person that is exempt from income tax under Article 4 of Chapter 105 and that meets the following conditions:
 - The person holds no more than two arts festivals during a calendar year.
 - Each of the person's arts festivals last no more than seven days.
 - The arts festivals are held outdoors on public property and involve a variety of exhibitions, entertainments, and activities.
13. Community festivals held by a person who is exempt from income tax under Article 4 of Chapter 105 and that meets all of the following conditions:
 - The person holds no more than one community festival during a calendar year.
 - The community festival lasts no more than seven days.
 - The community festival involves a variety of exhibitions, entertainments, and activities, the majority of which are held outdoors and are open to the public.
14. An admission charge to a fishing pier is not subject to the tax if the charge is for fishing on the pier. (17 NCAC 04B.0310)

**VII. INSURANCE PREMIUM TAX
(Article 8B)**

E. Tax Rates and Charges (G.S. 105-228.5, G.S. 58-6-25)

Tax rates and charges are as follows:

| | |
|--|------------------|
| Workers' Compensation | 2.50% |
| Other taxable contracts | 1.90% |
| Additional Statewide Fire and Lightning (excluding auto and marine) | 1.33% |
| Additional Local Fire and Lightning | .50% |
| Article 65 Corporations (2003) | 1.10% |
| Article 65 Corporations (2004) | 1.90% |
| Health Maintenance Organizations (2003) | 1.10% |
| Health Maintenance Organizations (2004) | 1.00% |
| Insurance Regulatory Charge (2003 2004) | 5.00%* |

*Subject to change each year and is established by the General Assembly based on a proposed percentage rate submitted by the NC Department of Insurance sufficient to defray the estimated cost of the operations of the NC Department of Insurance for each upcoming fiscal year.

VIII. GENERAL ADMINISTRATION
(Article 9)

C. Penalties and Interest (G.S. 105-228.90 - G.S. 105-236, G.S. 105-241.1, G.S. 105-253)

13. 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. The Department's Penalty Waiver Policy and form to request waiver (Form NC-5500) are available on the Department's website, www.dor.state.nc.us. Interest on the tax cannot be waived or reduced.

Exception: Penalties assessed as the result of a taxpayer engaging in tax strategies whereby income that would otherwise be taxable in North Carolina is shifted out-of-state or in other tax shelter activities that reduce or eliminate North Carolina state taxes will not be waived for any reason.