

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE
SECRETARY OF REVENUE

IN THE MATTER OF:

The Proposed Assessment of Franchise)
Tax for the period August 1, 1997)
through July 31, 1998 by the Secretary)
of Revenue of the State of North)
Carolina)
vs.)
[Taxpayer])

FINAL DECISION
Docket No. 2001-294

This matter was heard before Eugene J. Cella, Assistant Secretary for Administrative Tax Hearings, at the North Carolina Department of Revenue in the City of Raleigh on February 19, 2002 regarding the franchise tax assessment proposed against [Taxpayer] for the tax period August 1, 1997 through July 31, 1998. Taxpayer was represented at the Hearing by [its Manager for State & Local Taxes] and by [a Senior Manager of an accounting firm]. The Corporate, Excise, and Insurance Tax Division of the Department of Revenue ("Division") was represented by Gregory B. Radford, Director, and Jonathan K. Tart, Administrative Officer.

ISSUE

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

EVIDENCE

The following items were introduced by the parties at or subsequent to the hearing as exhibits and made part of the record:

Submitted by the Division

- CD-1 Taxpayer's 1997 North Carolina Franchise and Income Tax Return
- CD-2 Taxpayer's 1998 North Carolina Franchise and Income Tax Return
- CD-3 Notice Of Corporate Franchise Tax Assessment dated March 14, 2001
- CD-4 Field Auditor's Report dated December 5, 2000

- CD-5 Letter from M. W. Massey, Administrative Officer, to Taxpayer dated June 20, 2000
- CD-6 Letter from Taxpayer to the Department of Revenue dated April 11, 2001
- CD-7 Letter from Jonathan K. Tart, Administrative Officer, to Taxpayer dated May 15, 2001
- CD-8 Letter from Taxpayer to William M. Daniel, former Director of the Corporate, Excise, and Insurance Tax Division, dated June 7, 2001
- CD-9 Letter from Taxpayer to Jonathan K. Tart dated June 18, 2001
- CD-10 Letter from Eugene J. Cella, Assistant Secretary of Revenue, to Taxpayer dated December 14, 2001
- CD-11 Letter from Taxpayer to Eugene J. Cella dated January 3, 2002
- CD-12 Section 1(a) and Section 1(c) of Senate Bill 748; 2001 General Assembly
- CD-13 Section 3.3 of Chapter 13, House Bill 18; 1996 General Assembly
- CD-14 [Company] Overview
- CD-15 [Pages] of North American Industry Classification Manual, 1997 edition
- CD-16 Certificates of Eligibility issued by the North Carolina Department of Commerce to Parent
- CD-17 Schedule K from Taxpayer's 1997 Federal Income Tax Return
- CD-18 [Page] of Standard Industrial Classification Manual
- CD-19 [Pages] of North American Industry Classification Manual, 1997 edition

Submitted by the Taxpayer

- TP-1 Fax Cover Sheet from Employment Security Commission of North Carolina to Taxpayer and [Pages] from Standard Industrial Classification Manual
- TP-2 [Page] of North American Industry Classification Manual, 1997 edition
- TP-3 [Page] of North American Industry Classification Manual, 1997 edition
- TP-4 [Page] of North American Industry Classification Manual, 1997 edition
- TP-5 Letter dated March 11, 1998 from Parent to the Department of Commerce with Attachments
- TP-6 Taxable Year 1996 Certification Issued by Department of Commerce to Parent

- TP-7 Taxable Years 1997 and 1998 Certifications Issued by Department of Commerce to Parent
- TP-8 Letter from Julie R. Stiles, Interstate Examination Division, to Taxpayer dated December 5, 2000, with related attachments
- TP-9 Document titled *Information on Tax Incentives Under the William S. Lee Quality Jobs and Business Expansion Act* published by the North Carolina Department of Revenue
- TP-10 Document titled *Credit for Investing in Machinery and Equipment* from Department of Revenue Web Page

Submitted by the Assistant Secretary of Revenue

- S-1 *Brief for Tax Hearing* submitted by the Corporate, Excise, and Insurance Tax Division
- S-2 *Objection to Proposed Assessment of Corporate Franchise Tax* submitted by Taxpayer
- S-3 *Supplemental Brief in Support of Objection to Proposed Assessment of Corporate Franchise Tax* dated March 21, 2002 submitted by Taxpayer
- S-4 Letter from [Senior Manager of an accounting firm] to Eugene J. Cella dated March 29, 2002
- S-5 Letter from Eugene J. Cella to [Senior Manager of the accounting firm] dated April 11, 2002
- S-6 Post-Hearing Brief submitted by the Corporate, Excise, and Insurance Tax Division
- S-7 Cross-Brief in Reply in Support of Objection to Proposed Assessment of Corporate Franchise Tax dated May 24, 2002 submitted by Taxpayer

FINDINGS OF FACT

Based on the foregoing evidence of record, the Assistant Secretary makes the following findings of fact:

1. Parent is the parent corporation of Taxpayer.
2. Parent is not engaged in manufacturing in North Carolina.
3. During its 1996 taxable year, Parent conducted research and development at an establishment located in [North Carolina], and placed business property in service at that location in its research and development operations.
4. Subsequent to its 1996 investment in business property placed in service [in North Carolina], Parent submitted a form entitled "Request for Department of Commerce Certification for Participation in the William S. Lee Tax Credit Incentives," hereafter

referred to as the "Participation Request," to the Secretary of Commerce for its 1996 taxable year. Parent indicated on the form that it had placed \$13,065,707 of machinery and equipment into service during the 1996 taxable year.

5. Parent formed Taxpayer as a subsidiary and transferred ownership of the business property at the research and development establishment in [North Carolina] to Taxpayer in 1997.
6. Taxpayer engaged in research and development at its [North Carolina] establishment during its 1997 taxable year.
7. Taxpayer does not engage in manufacturing.
8. Taxpayer timely filed its franchise tax return for the tax period ending July 31, 1998, on May 11, 1999, under an approved extension of time to file.
9. Taxpayer claimed an installment of a tax credit for investing in machinery and equipment on its 1997 North Carolina Franchise and Income Tax Return for business property used in the research and development activity at its [North Carolina] establishment during that tax year.
10. The Division disallowed the installment of the machinery and equipment credit taken by Taxpayer against its franchise tax liability.
11. Taxpayer understated its franchise tax liability by 50% by claiming the installment of the machinery and equipment tax credit.
12. A proposed assessment of additional franchise tax, a twenty-five percent late-filing penalty, a twenty-five percent negligence penalty, and accrued interest was mailed to Taxpayer on March 14, 2001.
13. Taxpayer objected to the proposed assessment and timely requested a hearing pursuant to G.S. 105-241.1.

CONCLUSIONS OF LAW

Based on the foregoing findings of fact, the Assistant Secretary makes the following conclusions of law:

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

2. The Act allows a machinery and equipment tax credit for investing in business property in the State that is used in manufacturing and processing, warehousing and distribution, or data processing.
3. Machinery and equipment is defined under the Act in part as “Engines, machinery, tools, and implements that are capitalized by the taxpayer for tax purposes under the Code and are used or designed to be used in manufacturing and processing, warehousing and distribution, or data processing.”
4. The burden of proof for eligibility to claim a tax credit under the Act rests upon the taxpayer.
5. The Secretary of Revenue is responsible for enforcing the Revenue Laws of this State, inclusive of the tax credits provided under the Act, by determining the correctness of a tax return and determining the proper liability of any person for a tax imposed.
6. The Secretary of Revenue has the authority to determine the correctness of tax credits claimed under the Act by reviewing any records considered necessary. In addition to being given this authority as part of his responsibility to enforce the Revenue Laws in general, this authority is specifically declared with respect to the Act in G.S. 105-129.7.
7. The Act requires a taxpayer to meet two general eligibility requirements pertaining to the primary business industry to which it belongs and the average wage it pays to its employees before it is eligible to participate in the Act.
8. Before claiming a tax credit under the Act on its tax return, a taxpayer submits the Participation Request to the Secretary of Commerce. The Participation Request is used to provide statistical reports to the General Assembly and to the Department of Revenue based on the number of Participation Requests received.
9. The Participation Request asks a taxpayer to provide information about the business industry to which it belongs and the average wage paid.
10. The Department of Commerce endorses a taxpayer’s participation in the Act by certifying that a taxpayer’s representations on the Participation Request are consistent with a type of business industry recognized under the Act, and that the average wage as reported meets or exceeds the applicable county wage standard.
11. The Department of Commerce does not have the authority to conduct an audit to verify that all representations made by the taxpayer on the Participation Request are true and accurate.
12. Being primarily engaged in a certain industry and meeting a wage standard does not independently entitle a taxpayer to a tax credit under the Act for any investment it makes in capitalized business property placed in service in this State.
13. Although the Participation Request does not request information about how business property is used, no credit is available under the Act for an investment in business property unless it is specifically used in manufacturing and processing, warehousing and distribution, or data processing.

14. Article 3B of Chapter 105 of the General Statutes provides a tax credit outside of the Act for investing in business property.
15. The Article 3B tax credit for investing in business property only requires that the property be placed in service in this State, as opposed to the credit for investing in machinery and equipment, which requires that business property be used in either manufacturing and processing, warehousing and distribution, or data processing.
16. For purposes of the Article 3B credit, business property is defined in G.S. 105-129.15 in part as “Tangible personal property that is used by the taxpayer in connection with a business or for the production of income and is capitalized by the taxpayer for tax purposes under the Code.”
17. The definition of machinery and equipment under the Act is more restrictive than the definition of business property for the Article 3B credit because it requires the property to be “used or designed to be used in manufacturing and processing, warehousing and distribution, or data processing,” as opposed to the definition of business property, which only requires the property to be “used by the taxpayer in connection with a business or for the production of income.”
18. Business property that is used in connection with a business but not used in manufacturing and processing, warehousing and distribution, or data processing can qualify for the tax credit for investing in business property, but it cannot qualify for a tax credit for investing in machinery and equipment.
19. The credit for investing in machinery and equipment is taken in equal installments over the seven years following the taxable year in which the equipment is placed in service.
20. The Article 3B credit for investing in business property is equal to 4.5% of the cost of the property placed in service in a taxable year with a maximum credit of \$4,500. The credit is taken in five equal installments beginning with the tax year in which the property is placed in service.
21. The Act contains a provision for a change in ownership that allows a successor business to take any installment of a credit that its predecessor could have taken if it had a tax liability.
22. A late-filing penalty is imposed if a taxpayer does not file its return by the statutory due date, including extensions.
23. For taxes other than the individual income tax, a twenty-five percent negligence penalty is imposed if a taxpayer understates tax liability by twenty-five percent or more.
24. The Secretary of Revenue may, upon making a record of the reasons therefor, reduce or waive any penalties.
25. The Department of Revenue was created under the provisions of the Executive Organization Act of 1973. The Secretary of Revenue’s duties include administering the laws enacted by the General Assembly relating to the assessment and collection of corporate income taxes. As an official of the Executive branch of the government, the Secretary lacks the authority to determine the constitutionality of legislative acts. The

question of constitutionality of a statute is for the judicial branch. (*Insurance Co. v. Gold*, 254 NC 168). The constitutionality of the income tax statutes is not within the Secretary's jurisdiction.

DECISION

Based on the aforementioned findings of fact and conclusions of law, I find that Parent was not entitled to a tax credit for investing in machinery and equipment during its 1996 taxable year. Consequently, the auditor correctly disallowed the installment of the credit claimed by Taxpayer against its 1997 franchise tax liability, which it claimed as a result of the change in ownership of the research and development operation. The provision in G.S. 105-129.4(e) regarding change in ownership does not entitle Taxpayer, as a successor corporation to the business unit of Parent that operated a research and development establishment in [North Carolina], to claim an installment of a machinery and equipment credit if Parent was not eligible to have taken it.

Parent was not eligible to claim the credit for its investments during its 1996 taxable year because the business property was not used in an eligible activity, and additionally because the business property did not meet the definition of machinery and equipment. For a taxpayer that is primarily engaged in manufacturing, G.S. 105-129.4 requires property to be used in manufacturing in order for it to qualify for the machinery and equipment credit. G.S. 105-129.2(5) (Exhibit CD-13) defined machinery and equipment as property used or designed for use specifically in manufacturing and processing, warehousing and distribution, or data processing. Thus Parent, which asserted that it is primarily engaged in manufacturing, cannot receive a machinery and equipment credit for property that is used in research and development. The Act would not contain the strict requirements for how property has to be used if the intent were for a manufacturer to receive a machinery and equipment credit for any business property investment placed in service in this State. Additionally, these restrictions are repeated in the definition of machinery and equipment. Moreover, if a machinery and equipment credit only required the property's use to be in connection with an overall business,

the definition of machinery and equipment would resemble the definition of business property in G.S. 105-129.15, which allows a more comprehensive but less beneficial credit for investing in business property.

An amendment to the Act effective for taxable years beginning on or after January 1, 2001 amends the requirement for how property must be used in order to qualify for a machinery and equipment credit. Under the amended statute, a taxpayer that is primarily engaged in manufacturing can take a machinery and equipment credit for property used not only in manufacturing, but also in warehousing or wholesale trade as well. Consequently, if Parent, for example, is primarily engaged in manufacturing and invests in machinery and equipment in this State used in the wholesale distribution of its products, it may qualify for a machinery and equipment credit even though the property is not used in manufacturing. However, a manufacturer remains prohibited from taking a credit for investing in machinery and equipment if the machinery and equipment is used only in research and development. Taxpayer contends, however, that the amendment rejected the Department's interpretation of the statute. I find Taxpayer's argument unpersuasive. The changes to G.S. 105-129.2, and the uncodified legislative commentary explaining the amendments establish that for tax years prior to 2001 a taxpayer had to be both primarily engaged in a qualifying business and be conducting that business at the site of the activity in order to qualify for any of the Article 3A credits except for the credit for investing in central office or aircraft facility property, or the credit for contributing to a development zone project. This clarification was consistent with the Department's long-standing administrative interpretation (Exhibit CD-12, ss. 1(a) and 1(c)).

Taxpayer argues that disallowance of the credit violates the Contract Clause of the United States Constitution. While questions of constitutionality are for the courts and outside my authority, it is my opinion that the certification issued by the Department of Commerce in response to Parent's Participation Request is not a contractual agreement within the meaning of the Contract Clause that somehow constitutionally guarantees a machinery and equipment tax

credit to Parent, nor did it purport to be. The Secretary of Commerce declared that the certification was issued based on unverified information represented by Parent on the Participation Request. The disclaimer included as part of the certification so documents (TP Exhibit 6). The certification does not absolve Parent from the requirement to satisfy its burden of proof that it is entitled to the machinery and equipment credit, including substantiating that the property at issue was used directly in manufacturing and that it met the definition of machinery and equipment. The certification does not even satisfy Parent's burden of proof for meeting the general eligibility requirements specifically addressed on the Participation Request related to its business industry and its average wage. Representations made by a taxpayer on the Participation Request are made with knowledge of significant but conditional tax savings at stake, and are unverified. Additionally, taxpayer representations made to the Employment Security Commission regarding its primary business activity are made under the same circumstances, and are likewise unverified. Consequently, in determining whether a taxpayer has satisfied its burden of proof for a machinery and equipment credit, the Secretary of Revenue is directed by statute to not only examine all records necessary to verify that requirements not listed on the Participation Request have been satisfied, including how the property is used and whether or not it meets the definition of machinery and equipment, but he must also substantiate that the taxpayer is primarily engaged in an eligible business, and that it has met the wage standard. Taxpayer has shown no error in the Division's disallowance of Taxpayer's claimed credit for investment in machinery and equipment.

Although Taxpayer is not entitled to the tax credit for investing in machinery and equipment, it is entitled to the credit for investing in business property as provided by G.S. 105-129.16. The qualifying installment is \$900. Allowing this credit results in a corrected understatement of tax liability of 49.5%. Therefore, the 25% negligence penalty still applies.

The law grants the Department the authority to waive or reduce penalties. The Department's Penalty Waiver Policy includes automatic reasons for waiver; waiver based on a

taxpayer's good compliance record, and waiver because of special circumstances. Special circumstances are unusual in nature and limited in application. They include such circumstances as action or inaction by the Department that results in an increased liability for the taxpayer, a gray area of the law, or a recent change in Departmental policy. Taxpayer may believe that its right to a tax credit under the facts of this case is a gray area. However, I do not agree. For the same reasons cited in sustaining the disallowance of the credit, I decline to waive the penalty for special circumstances. The automatic reasons do not apply to Taxpayer. The good compliance provision does not currently apply because Taxpayer has an outstanding tax liability for another tax schedule. If that liability is resolved, Taxpayer may qualify for the waiver of the negligence penalty upon payment of the total tax and interest due as a result of this Final Decision. Taxpayer may then renew its request for waiver of the penalty based on its good compliance record.

CONCLUSION

The proposed assessment of additional franchise tax, penalty, and interest resulting from the disallowance of the installment of a tax credit for investing in machinery and equipment, modified to allow Taxpayer an appropriate installment for the credit for investing in business property and to delete the late-filing penalty, is hereby sustained in its entirety and is determined to be final and collectible, together with interest as allowed by law.

This the 22nd day of August, 2002.

Signature _____

Eugene J. Cella
Assistant Secretary of Revenue