

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE
SECRETARY OF REVENUE

IN THE MATTER OF:)

The Proposed Franchise Tax Assessments)
for the Tax Years ending December 2001)
through December 31, 2002)
by the SECRETARY OF REVENUE)

FINAL DECISION
Docket No. 06-217

vs.)

(Taxpayer))

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 September 21, 2006, regarding franchise tax assessments proposed against (Taxpayer) hereinafter referred to as "Taxpayer", for the tax years ending December 31, 2001 and December 31, 2002. Taxpayer was represented at the hearing by (representatives) of (law firm). The Corporate, Excise, and Insurance Tax Division of the Department of Revenue ("Division") was represented by Gregory B. Radford, Director, Donna P. Powell, Assistant Director, and Diane S. Hucke, Administrative Officer.

ISSUES

The issues to be decided in this matter are as follows:

- I. Whether Taxpayer's primary business was an eligible business type within the meaning of G.S. § 105-129.4(a) so as to be entitled to the tax credit for creating jobs and the tax credit for investing in machinery and equipment as provided by Article 3A?
- II. Were the negligence penalties assessed against Taxpayer lawful and proper?

EVIDENCE

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

Submitted by the Department:

1. Taxpayer's North Carolina Franchise and Income Tax return for tax year 2000.
2. Taxpayer's North Carolina Franchise and Income Tax return for tax year 2001.
3. Taxpayer's North Carolina Franchise and Income Tax return for tax year 2002.
4. Taxpayer's Federal Form 1120S, U.S. Income Tax Return for an S Corporation, for tax year 2000.
5. Taxpayer's Federal Form 1120S, U.S. Income Tax Return for an S Corporation, for tax year 2001.
6. Taxpayer's Federal Form 1120S, U.S. Income Tax Return for an S Corporation, for tax year 2002.
7. Notice of franchise tax assessment, field auditor's report, and audit worksheets for tax year 2001 dated August 31, 2004.
8. Notice of franchise tax assessment, field auditor's report, and audit worksheets for tax year 2002 dated August 31, 2004.
9. Executed Power of Attorney and Declaration of Representative form from Taxpayer dated September 29, 2004 permitting (representatives) of (law firm) to represent Taxpayer for tax years 2000, 2001, and 2002.
10. Correspondence dated September 29, 2004 from (representative) to Gregory B. Radford, Director, Corporate Excise and Insurance Tax Division, protesting the Notices of Franchise Tax Assessment and requesting an administrative tax hearing.
11. Correspondence dated October 29, 2004, from Diane S. Hucke, Administrative Officer, Corporate, Excise, and Insurance Division to (representative) acknowledging the request for an administrative tax hearing and requesting tentative dates for an informal conference with the Division Director.
12. Correspondence dated November 30, 2004, from (representative) to Diane S. Hucke responding to the Department's letter dated October 29, 2004.
13. Correspondence dated December 15, 2004, from Diane S. Hucke to (representative) confirming the date of the informal conference and requesting additional information pertinent to the facts of the protested issue.

14. Correspondence dated January 25, 2005 from Diane S. Hucke to (representative) requesting additional information pertinent to the facts of the protested issue in preparation for an informal conference.
15. Correspondence dated June 28, 2005 from Diane S. Hucke and Gail Beamon, Administrative Officer, Personal Taxes Division, to (representative) requesting additional information pertinent to the facts of the protested issue not received as of June 28, 2005.
16. Correspondence with related attachments dated July 14, 2005 from (representatives) to Diane S. Hucke responding to the Department's request for information.
17. Correspondence dated June 1, 2006 from Diane S. Hucke to (representative) affirming the Department's position on the protested issue.
18. Correspondence dated June 23, 2006 from (representative) to Diane Hucke proposing dates for an Administrative hearing.
19. Correspondence dated July 5, 2006 from (representative) to Gail Beamon agreeing to abide by the ultimate outcome of the administrative tax hearing for both franchise tax and for individual income tax purposes.
20. Correspondence dated July 17, 2006 from Eugene Cella, Assistant Secretary of Revenue, to (representative) scheduling Taxpayer's administrative tax hearing for September 21, 2006.
21. 2002 Instructions for filing Federal Form 1120S.
22. North Carolina Department of Revenue Final Decision Docket Number 2001-294.
23. Session Law 06-252.
24. Copy of note logged into Department of Revenue's Integrated Tax Administration System (ITAS) on March 22, 2006 regarding an approved penalty waiver for Taxpayer based on good compliance.
25. Affidavit of Dr. Peter A. Neenan, Director of the Labor Market Information Division of the Employment Security Commission.
26. North Carolina Department of Revenue Pre-Hearing Brief submitted by the Corporate, Excise, and Insurance Tax Division to Eugene J. Cella, Assistant Secretary of Revenue, on September 21, 2006.
27. Transcript of Administrative Tax Hearing held on September 21, 2006 regarding the proposed assessments against Taxpayer.

Submitted by the Taxpayer:

- TP-1 Brief of Taxpayer submitted to the Hearing Officer on September 21, 2006.
- TP-2 Segments from North American Industry Classification System relating to race car manufacturing.
- TP-3 Affidavit For (Taxpayer's Controller).
- TP-3A Sample Quality Control Checklist.
- TP-3B Application to North Carolina Department of Commerce for Participation in the William S. Lee Credits for 2000, 2001, 2002.
- TP-3C Certificate of Eligibility from the Secretary of the North Carolina Department of Commerce for years 2000 and 2001.
- TP-3D List of Machinery and Equipment for years 2000, 2001 and 2002.
- TP-3E List of Employees for years 1999, 2000, 2001 and 2002.
- TP-3F List of Taxpayer's expenses for years 2001 and 2002.
- TP-3G List of Taxpayer's Capital Investment for years 2000, 2001, 2002.
- TP-3H Listing of other companies using SIC code 3711.
- TP-3I Letter dated June 16, 2000 from (attorney) of (law firm) to Phillip Smith, Chief of Employer Compliance, Employment Security Commission of North Carolina.
- TP-3J Response dated June 21, 2000 from Myrdis O. Tart with the Employment Security Commission of North Carolina, to Taxpayer.
- TP-3K Photographs of Taxpayer's (city in North Carolina) facility.

FINDINGS OF FACT

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

1. Taxpayer is a North Carolina S Corporation with facilities located in the State at (city) and (city).
2. During tax years 2000, 2001 and 2002, Taxpayer owned and operated three NASCAR racing teams.

3. During tax years 2000, 2001, and 2002, Taxpayer manufactured competitive cars, car bodies, and engines at its North Carolina facilities for its own use in NASCAR racing events.
4. During tax years 2000, 2001 and 2002, Taxpayer did not manufacture any vehicles for sale to third parties.
5. During tax years 2000, 2001 and 2002, Taxpayer employed approximately 133 employees and purchased machinery and equipment totaling more than \$1.8 million for use at its North Carolina facilities.
6. During tax years 2000, 2001 and 2002, Taxpayer earned total revenue in the amount of \$85,778,485, the majority of which was from NASCAR sponsorships, winnings, and royalties.
7. In or around June 2000, Taxpayer began investigating tax credits under the William S. Lee Quality Jobs and Expansion Act ("Lee Act").
8. On June 16, 2000, Taxpayer requested the North Carolina Employment Security Commission to reclassify its Standard Industrial Classification code (now the North American Industry Classification System code) from 7948, a code that describes businesses engaged in the promotional and managerial aspects of automobile racing teams, to 3711, a code that relates to automobile manufacturing.
9. Upon receiving the requested SIC code reclassification, Taxpayer 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 taxable year 1999.
10. Based on the information supplied to the Department of Commerce by Taxpayer, the Secretary of Commerce issued a "Certification of Eligibility" to Taxpayer on August 9, 2000.
11. Upon receipt of the certification, Taxpayer filed an amended 1999 S Corporation tax return with the Department, reporting eligible tax credits of \$49,500.00 for creating jobs and \$10,570.00 for investing in machinery and equipment.
12. Taxpayer subsequently submitted Participation Requests to the Secretary of Commerce for qualification for the William S. Lee Tax Credits for calendar years 2000 and 2001 and was issued certifications of eligibility by the Secretary of Commerce.
13. On its 2000 North Carolina S Corporation Franchise and Income Tax Return, Taxpayer elected to claim the 1999 eligible credit amounts for creating jobs and for investing in machinery and equipment against income tax and allocated the income tax credits to its shareholders. Taxpayer also reported eligible tax credits

of \$184,500.00 for creating jobs and \$46,280.00 for investing in machinery and equipment during 2000.

14. On its 2001 North Carolina S Corporation Franchise and Income Tax Return Taxpayer elected to claim the 2000 eligible credit amount for investing in machinery and equipment against its franchise tax and claimed the first installment of that credit against its franchise tax liability. Taxpayer elected to claim the 2000 eligible credit amount for creating jobs against its income tax and allocated the income tax credit to its shareholders. Taxpayer also reported eligible tax credits of \$36,000.00 for creating jobs and \$54,245.00 for investing in machinery and equipment during 2001.
15. On its 2002 North Carolina S Corporation Franchise and Income Tax Return, Taxpayer elected to claim the 2001 eligible credit amount for creating jobs against its franchise tax and claimed the first installment of that credit and the second installment of the 2000 credit for investing in machinery and equipment against its franchise tax liability. Taxpayer elected to claim the 2001 eligible credit amount for investing in machinery and equipment against its income tax and allocated the income tax credit to its shareholders.
16. Upon examination, the Department determined that Taxpayer did not satisfy all of the general eligibility requirements needed to qualify for Article 3A credits and disallowed the installments of the credits for creating jobs and for investing in machinery and equipment claimed by Taxpayer against its franchise tax liability for tax years 2001 and 2002 and the credits for creating new jobs and investing in machinery and equipment that Taxpayer had allocated to its shareholders to claim against income tax for tax years 2000 through 2002.
17. Specifically, the Department determined that Taxpayer's primary business was not an eligible business type.
18. The Department's disallowance of the installments of the Lee Act credits claimed by Taxpayer against its franchise tax liability resulted in an understatement of Taxpayer's franchise tax liability by 25% or more.
19. On August 31, 2004, the Department issued Notices of Franchise Tax Assessment for tax years 2001 and 2002 assessing additional tax, interest, and negligence penalties under the authority of G.S. § 105-241.1 in the amounts of \$9,191.31 and \$15,412.30, respectively. In addition, the Department issued Notices of Tax Assessment against Taxpayer's shareholders for calendar years 2000 through 2002.
20. On September 29, 2004, Taxpayer objected to the proposed franchise tax assessments and requested a hearing before the Secretary of Revenue pursuant to G.S. § 105-241.1(c).
21. On July 5, 2006, the Department and Taxpayer mutually agreed that since the disallowance of the Article 3A credits affected both Taxpayer's franchise tax return

- and its shareholders' individual income tax returns, the Department, Taxpayer and its shareholders would abide by the ultimate outcome of Taxpayer's administrative tax hearing regarding whether Taxpayer and its shareholders were eligible to claim Article 3A credits for both franchise tax and for individual income tax purposes.
22. Taxpayer contends that the law requires the Department to make its determination regarding a taxpayer's primary business by looking at the facility at issue and determining the establishment's principal product or service.
 23. Taxpayer argues that, according to the Department's own guidelines, if an establishment is engaged in more than one activity, the "primary" business is the activity which comprises the largest share of the production cost and capital investment of the business. Taxpayer believes that Article 3A credits are site-specific. Taxpayer believes its overall business does not matter as long as Taxpayer is engaged in a qualifying business at the site of the activity.
 24. The Department contends that the determination of whether an activity of a service based company, such as Taxpayer, is its primary business is best measured by the value of the company's receipts or revenues generated from that activity.
 25. The Department contends that the reclassified NAICS code from ESC as requested by Taxpayer does not accurately reflect Taxpayer's primary business.
 26. Article 3I of Chapter 105 of the General Statutes, as enacted for tax years beginning on or after January 1, 2007, now known as Article 3J, increased the number of eligible business types that qualify for enhanced business tax credits. This new Article, which generally replaces the credits found under the Lee Act, adds motorsports facilities and motorsports racing teams as eligible business types.
 27. Taxpayer argues that their decision to claim the Lee Act credits was not negligent and they should not be assessed a negligence penalty.
 28. Taxpayer argues that since it believed it was entitled to claim the Lee Act credits, the Secretary should waive any penalties based on Taxpayer's good faith compliance.
 29. The Secretary exercises his authority to waive or reduce penalties through the established policies and procedures of the Department, including the Department's penalty waiver policy.
 30. The Department's penalty waiver policy includes automatic reasons for waiver, waivers based on a taxpayer's good compliance record, and waivers based on special circumstances.
 31. The good compliance provision provides that a taxpayer may be granted a penalty waiver by the Secretary if the taxpayer has filed all tax returns due, has paid all tax and interest due on the returns filed, has received no penalty waivers over the past

three years, and the penalty imposed was not the result of a repeated mistake made by the taxpayer.

32. If a taxpayer has had one 100% waiver within 3 years, that taxpayer is allowed one more penalty waiver at 50%.
33. Taxpayer received a 100% waiver of penalties assessed on another tax schedule on March 22, 2006 from the Department.

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 enacted by the North Carolina General Assembly in 1996, hereinafter referred to as the "William S. Lee Act" or "Lee 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, including credits for creating jobs and for investing in machinery and equipment.
2. G.S. § 105-129.4 sets forth the eligibility requirements and forfeiture provisions of the Lee Act. Before a business is eligible to participate in the Lee Act, it must be primarily engaged in a qualifying business and conduct that business activity in this State.
3. Manufacturing is one of the qualifying businesses included in G.S. § 105-129.4(a).
4. Manufacturing is defined under the Lee Act as "[a]n industry in manufacturing sectors 31 through 33, as defined by NAICS, but not including quick printing or retail bakeries.
5. The Lee Act allows a taxpayer that meets the eligibility requirements set out in G.S. § 105-129.4 to claim a tax credit for creating jobs if the taxpayer has five or more full-time employees, and hires an additional full-time employee during the tax year to fill a position located in this State.
6. The Lee Act allows a taxpayer that meets the eligibility requirements set out in G.S. § 105-129.4 to claim a machinery and equipment tax credit if the taxpayer purchases or leases eligible machinery and equipment and places the equipment in service in this State during the taxable year.
7. The law requires that before a taxpayer is eligible to claim Article 3A credits under the provisions of G.S. 105-129.4(a)(3), it must satisfy two tests. First, the taxpayer must be primarily engaged in a qualifying business overall, and second, the

taxpayer must be conducting that business at the location of the activity where the credit is claimed.

8. Eligible machinery and equipment is defined in G.S. § 105-129.2(15) as “[e]ngines, machinery and equipment, tools, and implements used or designed to be used in the business for which the credit is claimed.”
9. The burden of proof for eligibility to claim a tax credit under the Lee Act rests upon the taxpayer.
10. The Secretary of Revenue is responsible for enforcing the Revenue laws of this State, inclusive of the tax credits provided under the Lee Act, by determining the correctness of a tax return and determining the proper liability of any person for a tax imposed.
11. The Secretary of Revenue has the authority to determine the correctness of tax credits claimed under the Lee 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 Lee Act in G.S. § 105-129.7.
12. Prior to 2002, a taxpayer was required to obtain certification for a credit under the Lee Act from the Secretary of Commerce before claiming the tax credit on its tax return. To obtain the certification, the taxpayer would submit a Participation Request to the Secretary of Commerce. The Participation Request was used to provide statistical reports to the General Assembly and to the Department of Revenue based on the number of Participation Request(s) received.
13. The Department of Commerce endorsed a taxpayer’s participation in the Lee Act by certifying that a taxpayer’s representations on the Participation Request were consistent with an eligible business type recognized under the Lee Act.
14. The Participation Request asked the taxpayer to provide information about the business industry that it belonged to, including its type of eligible business and its North American Industry Classification System (“NAICS”) code as recorded by the North Carolina Employment Security Commission (“ESC”) from information provided by Taxpayer.
15. The Department of Commerce did not have the authority to conduct an audit to verify that all representations made by the taxpayer on the Participation Request were true and accurate.
16. The North Carolina Employment Security Commission is responsible for the maintenance and updating of the industrial classification system used by the state and federal government for various purposes including the creation of accurate experience rating information used in connection with the assessment of unemployment tax rates.

17. NAICS is a self-identification system. Each business must decide for itself whether its NAICS code is accurate.
18. The North Carolina Employment Security Commission encourages North Carolina businesses to assign themselves true and accurate industrial classification codes but cannot enforce the accurate assignments of the particular codes.
19. Since the North Carolina Employment Security Commission is not an enforcement agency, it has no authority to compel any business to accept certain industrial classification codes as true.
20. There are no state or federal regulatory or administrative agencies with any authority to require business entities to change or adjust the industrial code classifications which businesses assign themselves.
21. The determination of whether an activity of a service based company is its primary business is best measured by the value of the company's receipts or revenues generated from that activity.
22. The reclassified NAICS code from ESC as requested by Taxpayer does not accurately reflect Taxpayer's primary business.
23. Taxpayer's primary business is the owning and operating of NASCAR race teams.
24. Motorsports facilities and motorsports racing teams became eligible business types for purposes of North Carolina's tax credits for growing businesses for the first time with the enactment of Article 3J, effective for tax years beginning on or after January 1, 2007.
25. For the years at issue, Taxpayer was not engaged in an eligible business within the meaning of G.S. § 105-129.4.
26. 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 pursuant to G.S. 105-236(5)c. No finding of negligence is required for this penalty to be imposed. Whether the penalty is imposed is determined by the percentage of the tax liability understated by the taxpayer.
27. The penalties were properly assessed because the Department's disallowance of the installments of the Lee Act credits claimed by Taxpayer against its franchise tax liability resulted in an understatement of Taxpayer's franchise tax liability by 25% or more in each year.
28. The Secretary of Revenue may, upon making a record of the reason therefore, reduce or waive any penalties.
29. Taxpayer does not qualify for waiver or reduction under the automatic or special circumstances provisions of the Department's penalty waiver policy.

30. Taxpayer qualifies for a reduction of 50% of the penalty imposed in accordance with the good compliance provisions of the Department's penalty policy upon payment in full of the tax, interest and 50% of the penalties assessed.

DECISION

This case presents two issues for resolution. The first issue to be addressed is whether Taxpayer's primary business is an eligible business type within the meaning of G.S. § 105-129.4(a) so as to be entitled to the tax credits for creating jobs and for investing in machinery and equipment provided in Article 3A of Chapter 105. The second issue is whether the Department, on the facts of this case, properly imposed negligence penalties against Taxpayer.

1. Is Taxpayer's Primary Business an Eligible Business

The Department assessed Taxpayer additional franchise tax for tax years 2001 and 2002 based upon the State's disallowance of Article 3A credits that Taxpayer claimed against its franchise tax liability for those years because Taxpayer's primary business was not an eligible business type within the meaning of G.S. 105-129.4(a)(3). The law requires that a taxpayer satisfy two tests to be eligible to claim Article 3A tax credits. First, the taxpayer must be primarily engaged in a qualifying business. Second, the taxpayer must be conducting that business at the location of the activity for which the credit is claimed.

I agree with the Department that the determination of whether an activity of a service based company is its primary business is best measured by the value of the company's receipts or revenues generated from that activity. During the tax years at issue, Taxpayer owned and operated three NASCAR racing teams. It manufactured competitive cars, car bodies, and engines at its North Carolina facilities for its own use in

NASCAR racing events. It did not manufacture any vehicles for sale to third parties.

Taxpayer earned total revenue in the amount of \$85,778,485 during those tax years, the majority of which was from NASCAR sponsorships, winnings, and royalties.

The reclassified NAICS code from ESC as requested by Taxpayer does not accurately reflect Taxpayer's primary business. Taxpayer's primary business is NASCAR racing. Taxpayer's primary business is not a qualifying business as described in G.S. § 105-129.4. Consequently, the Department was correct to propose assessments against Taxpayer based on the disallowance of the installments of the Lee Act credits.

2. Were the Negligence Penalties Imposed Against Taxpayer Properly Assessed

The Department imposed a 25% penalty pursuant to G.S. 105-236(5)c against Taxpayer for each tax year in which tax credits were disallowed. I agree with the Department that the application of the 25% penalty is required by statute and is simply a mathematical calculation; no finding of negligence is required. The penalties were properly assessed because the Department's disallowance of the installments of the Lee Act credits claimed by Taxpayer against its franchise tax liability resulted in an understatement of Taxpayer's franchise tax liability by 25% or more in each year.

The law does grant the Secretary of Revenue the discretion to waive or reduce all penalties imposed, including the negligence penalty. Pursuant to the Department's penalty waiver policy, Taxpayer qualifies for a reduction of 50% of the penalty imposed in accordance with the good compliance provisions of the Department's penalty policy since Taxpayer received a 100% waiver of other penalties on March 22, 2006 and has not had any other penalty waivers or reductions in the past three years. I will therefore apply the Department's waiver policy and waive one-half of the assessed negligence penalty upon

payment of the total tax, interest, and one-half of the penalty imposed as a result of this Final Decision.

CONCLUSION

After considering the arguments presented at the hearing and the briefs filed by both parties, I find based on the findings of fact and conclusions of law stated herein, that Taxpayer's primary business is not an eligible business type within the meaning of the Lee Act. Therefore, Taxpayer is not entitled to the claimed tax credits for creating jobs and for investing in machinery and equipment. I further find that the negligence penalty as assessed was proper. However, I will waive half of the negligence penalty in accordance with the Department's penalty policy under the conditions stated above.

The proposed assessments of additional franchise tax, interest and penalties, as modified to waive one half of the penalties, are correct under the law and are hereby sustained and determined to be final and collectible, together with interest as allowed by law.

This the _____ day of _____, 2006.

Signature _____

Eugene J. Cella
Assistant Secretary of Revenue