

STATE OF NORTH CAROLINA
COUNTY OF WAKE

IN THE OFFICE OF
ADMINISTRATIVE HEARINGS
FILE NO. 08 REV 2665

THE FIDELITY BANK)
[FEIN],)
Petitioner)
v.)
N.C. DEPARTMENT OF REVENUE,)
Respondent)

**SECOND AMENDED
FINAL AGENCY DECISION**

THIS MATTER came before the North Carolina Department of Revenue ("Department") for final agency decision pursuant to former N.C. Gen. Stat. § 150B-36. This matter was heard by Administrative Law Judge Robin Adams Anderson ("ALJ") on February 26, 2009, in the Office of Administrative Hearings ("OAH") in Raleigh, North Carolina, upon the Parties' cross-Motions for Summary Judgment on the issues of North Carolina corporate income tax and accrued interest assessed by the Department, as Respondent, against Petitioner. The ALJ's Decision Granting Partial Summary Judgment to Respondent on the issue of the deductibility of Market Discount Income for purposes of North Carolina corporate income tax was filed on June 30, 2009 ("ALJ Deductibility Decision"). The ALJ's Decision Granting Partial Summary Judgment for Petitioner on Petitioner's request for the abatement of accrued interest on the corporate income tax assessment for the period beginning July 2002 and ending on May 16, 2006 ("Interest Abatement Issue") was filed on November 16, 2009 ("ALJ Interest Abatement Decision"). The official administrative record was transmitted by OAH to the Department on November 25, 2009.

The Department issued a Final Agency Decision on January 22, 2010, which adopted the ALJ Deductibility Decision and which remanded the case to the ALJ for a hearing to determine whether the requirements of N.C. Gen. Stat. § 105-237.1 had been met to allow a reduction of the accrued interest as a tax debt liability compromise. Prior to the Interest Abatement Issue

being heard on remand at OAH, Petitioner sought immediate judicial review of the Final Agency Decision pursuant to former N.C. Gen. Stat. § 150B-36(d).

By Opinion and Order on Petition for Judicial Review of Final Agency Decision in a Contested Tax Case entered May 3, 2013 ("Business Court Order"), the Honorable John R. Jolly, Jr., Chief Special Superior Court Judge for Complex Business Cases, affirmed the Final Agency Decision upholding the ALJ Deductibility Decision. Judge Jolly remanded the Interest Abatement Issue to the Department to comply with the requirements of former N.C. Gen. Stat. § 150B-36(b1) and (b2) with regard to Findings of Fact 15, 16, 17, and 18.

The Department issued an *Amended* Final Agency Decision, in Part, and Remanded, in Part, on December 10, 2013, which adopted the ALJ Deductibility Decision and remanded the Interest Abatement Issue to the ALJ for hearing and decision, as required by former N.C. Gen. Stat. § 150B-36(d). On April 23, 2015, the ALJ issued an Amended Decision which rejected application of the theory of abatement in the context of avoiding interest on a tax assessment and concluded that any interest on any tax assessed against Petitioner for 2001 Market Discount Income during the period beginning July 2002 and ending on May 16, 2006 did not abate ("ALJ Amended Interest Abatement Decision").

ISSUES

1. Whether income from the disposition of United States bonds that Petitioner purchased at a market discount is deductible for purposes of North Carolina corporate income tax where market discount is the difference between the amount received by Petitioner upon the disposition of such investment, exclusive of any coupon interest, and the amount Petitioner actually paid for the bond ("Market Discount Income").
2. Whether interest that accrued during the period beginning in July 2002 and ending on May 16, 2006 on the assessment of North Carolina corporate income tax on Petitioner's 2001 Market Discount Income is properly assessed; and, if so, should a recommendation be made that Respondent, in its discretion, consider reducing or waiving the accrued interest during this time period to prevent an unjust result based on the particular facts and circumstances of this case.

FINDINGS OF FACT

With regard to the ALJ's Findings of Fact in the ALJ Amended Interest Abatement Decision, and based upon the pleadings, Stipulations of Fact, Exhibits, Affidavits, Briefs, and other evidence in the Record, the Department decides as follows:

1. Petitioner is a C corporation and a wholly-owned subsidiary of Fidelity Bancshares (N.C.), Inc. [Stip. Fact 1.]

2. Petitioner is headquartered in Fuquay-Varina, North Carolina, and has offices throughout North Carolina. [Stip. Fact 2.]

3. Petitioner timely filed its 2001 North Carolina income tax return for the 2001 tax year. Petitioner timely paid the corporate income taxes due on the amount reported to Respondent. [Stip. Fact 3; Stipulations of Fact, Ex. V.]

4. During the 2001 tax year, Petitioner held U.S. government securities that were acquired at a discount to face value and held until the securities' maturity date ("Bonds"). [Stip. Fact 4.]

5. Petitioner earned income on the Bonds held until maturity. The portion of the income on the Bonds that represents the difference between the amount Petitioner paid for the Bonds and the amount Petitioner receives at maturity is referred to as "Market Discount Income."

6. In 2001, Petitioner reported the stated coupon interest on the securities as taxable interest income when received, and reported the Market Discount Income on the securities as taxable other income (accretion on bonds sold) on its federal and North Carolina income tax returns. [Stip. Fact 5.]

7. Petitioner deducted the amount of its U.S. government bond Market Discount Income from its federal taxable income in determining its North Carolina net taxable income. That deduction was included as part of the amount claimed on Schedule H, line 3(a), of its 2001 North Carolina tax return. That line is listed as "U.S. obligation interest (not expenses)." [Stip. Fact 6.]

8. The amount of U.S. government bond Market Discount Income deducted by Petitioner in 2001 was \$724,098, as reflected on Petitioner's 2001 North Carolina income tax return. [Stip. Fact 7.]

9. On July 8, 2002, Respondent issued a Notice of Corporate Income Tax Assessment ("Notice of Assessment") to Petitioner regarding the 2001 tax year. Therein, Respondent proposed an assessment of additional North Carolina income tax of \$49,963.00 and interest of \$1,132.63 on \$724,098.00 of the "gain on disposition of discounted bonds" for 2001 based on the Auditor's Report dated May 10, 2002. [Stip. Fact 8; Stipulations of Fact, Ex. A.]

10. By letter dated July 31, 2002, Petitioner responded to Respondent's Notice of Assessment. [Stip. Fact 9; Stipulations of Fact, Ex. B.]

11. By letter dated August 29, 2002, Respondent acknowledged receipt of Petitioner's protest letter and provided to Petitioner its standard Conference Request Form for execution. [Stip. Fact 10; Stipulations of Fact, Ex. C.]

12. On September 23, 2002, Petitioner completed and submitted to Respondent the Conference Request Form. [Stip. Fact 11; Stipulations of Fact, Ex. D.]

13. No conference was held between Petitioner and Respondent in 2002. [Stip. Fact 12.]

14. On May 17, 2006, Respondent wrote to Petitioner, indicating that Respondent intended to impose income tax on Petitioner's 2001 Market Discount Income. [Stip. Fact 13; Stipulations of Fact, Ex. E.]

15. Respondent cannot explain the inactivity by Respondent during the four-year gap.

16. On May 30, 2006, representatives of Petitioner and Respondent discussed by telephone the disputed income tax assessment. [Stip. Fact 14.]

17. By letter dated May 31, 2006, Respondent provided to Petitioner a Conference Request Form for execution. [Stip. Fact 15; Stipulations of Fact, Ex. F.]

18. On June 12, 2006, Petitioner responded by letter requesting postponement of an informal conference and offering a protest letter in the interim. [Stip. Fact 16; Stipulations of Fact, Ex. G.]

19. On July 31, 2006, Petitioner submitted its protest letter to Respondent. [Stip. Fact 17; Stipulations of Fact, Ex. H.]

20. On August 14, 2006, representatives of Petitioner and Respondent discussed by telephone the disputed income tax assessment. [Stip. Fact 18.]

21. By letter dated August 16, 2006, Respondent provided to Petitioner a Conference Request Form for execution. [Stip. Fact 19; Stipulations of Fact, Ex. I.]

22. On August 17, 2006, Petitioner completed and submitted to Respondent the Conference Request Form for an informal conference with Respondent. [Stip. Fact 20; [Stipulations of Fact, Ex. J.]

23. By letter dated August 24, 2006, Respondent responded to Petitioner, confirming the date and time for the informal conference. [Stip. Fact 21; Stipulations of Fact, Ex. K.]

24. On October 24, 2006, representatives for Petitioner and Respondent participated in an informal conference to address the disputed income tax assessment. [Stip. Fact 22.]

25. By letter dated November 15, 2006, a representative for Petitioner provided supplemental information to Respondent. [Stip. Fact 23; Stipulations of Fact, Ex. L.]

26. By letter dated February 8, 2007, Respondent responded to Petitioner's supplemental information. [Stip. Fact 24; Stipulations of Fact, Ex. M.]

27. By letter dated February 26, 2007, a representative of Petitioner provided a response to Respondent. [Stip. Fact 25; Stipulations of Fact, Ex. N.]

28. By letter dated March 16, 2007, Respondent provided a response to Petitioner. [Stip. Fact 26; Stipulations of Fact, Ex. O.]

29. By letter to Respondent dated April 13, 2007, counsel for Petitioner requested a hearing on the disputed income tax assessment. [Stip. Fact 27; Stipulations of Fact, Ex. P.]

30. A hearing on the disputed income tax assessment was scheduled for August 8, 2007, at 1:00 p.m. [Stip. Fact 28.]

31. On August 3, 2007, counsel for Petitioner and representatives of Respondent discussed by telephone the pending hearing on the disputed income tax assessment. [Stip. Fact 29.]

32. By letter dated August 7, 2007 to counsel for Petitioner, Respondent confirmed cancellation of the scheduled hearing. [Stip. Fact 30; Stipulations of Fact, Ex. Q.]

33. By letter dated September 7, 2007, Respondent notified Petitioner of changes enacted into law and effective January 1, 2008, affecting hearing procedures for contested tax matters. [Stip. Fact 31; Stipulations of Fact, Ex. R.]

34. On September 20, 2007, Petitioner completed and submitted to Respondent the form provided by Respondent requesting application of the new procedures. [Stip. Fact 32; Stipulations of Fact, Ex. S.]

35. On June 23, 2008, counsel for Petitioner and a representative of Respondent discussed by telephone the scheduling of an informal conference. [Stip. Fact 33.]

36. By letter dated June 26, 2008, Respondent confirmed with Petitioner that the June 23, 2008 telephone conference qualified as an informal conference. [Stip. Fact 34; Stipulations of Fact, Ex. T.]

37. On September 12, 2008, Respondent issued its Notice of Final Determination on the disputed income tax assessment [Stip. Fact 35; Stipulations of Fact, Ex. U] and made the following assessment:

- a. Tax: \$49,963.00
- b. Interest: \$19,870.00
- c. Total: \$69,743.00

38. On November 11, 2008, Petitioner filed its Petition for Contested Case Hearing wherein it (a) challenged Respondent's disallowance of Petitioner's deduction of its Market Discount Income earned on the Bonds, and (b) requested relief from assessment of interest on the alleged tax owed for Respondent's inaction during the period from July 2002 through May 16, 2006. [Stip. Fact 36.]

39. On December 17, 2008, Petitioner and Respondent filed their respective Prehearing Statements.

40. On February 13, 2009, Petitioner and Respondent filed Stipulations of Fact.

41. On February 17, 2009, Respondent filed its Motion for Summary Judgment and, on February 23, 2009, submitted a supporting Brief.

42. On February 18, 2009, Petitioner filed its Motion for Summary Judgment and, on February 26, 2009, submitted a supporting Memorandum of Law.

43. On February 26, 2009, the Court heard oral argument from Petitioner and Respondent on the Parties' cross-Motions for Summary Judgment. In open court, the Parties

agreed to modify their respective Motions for Summary Judgment to Motions for Partial Summary Judgment.

44. On March 3, 2009, Petitioner and Respondent submitted Stipulations on Motions for Partial Summary Judgment whereby the Parties agreed that their respective Motions for Summary Judgment would be recharacterized as Motions for Partial Summary Judgment, and the Parties thereby submitted the issue of the deductibility of Market Discount Income for North Carolina tax purposes to the Court for decision based on the pleadings, Stipulations of Fact, Exhibits, Affidavits, the Court's file, and arguments presented by counsel at the hearing.

45. On June 30, 2009, the ALJ issued the ALJ Deductibility Decision, holding that as to the deductibility of Market Discount Income, Market Discount Income earned on the Bonds was not deductible as interest for North Carolina corporate income tax purposes.

46. By letter dated July 10, 2009, Petitioner transmitted to Respondent a check in the amount of \$49,963.00, under protest and with a full reservation of rights, as payment of the Market Discount Income. That payment did not include interest.

47. Respondent's Brief on Petitioner's Request for Abatement of Interest was filed on July 20, 2009.

48. Petitioner's Reply to Brief of Respondent on the Interest Abatement Issue was filed on August 3, 2009.

49. On November 16, 2009, the ALJ issued the ALJ Interest Abatement Decision, ruling that the interest that accrued from July 2002 through May 16, 2006 on the corporate income tax owed on Petitioner's Market Discount Income earned on the Bonds was abated.

50. On November 26, 2009, the ALJ Deductibility Decision and the ALJ Interest Abatement Decision were submitted to the Department for final decision pursuant to former N.C. Gen. Stat. § 150B-36.

51. On January 22, 2010, the Department issued a "Final Agency Decision, in part, and Remanded, in part" ("Final Agency Decision"), which adopted the ALJ Deductibility Decision and remanded the Interest Abatement Issue to the ALJ for rehearing.

52. In rendering the Final Agency Decision, the Department altered the findings of fact, conclusions of law, and determinations on the Interest Abatement Issue.

53. On or about February 17, 2010, Petitioner, acting in accordance with the Final Agency Decision, but under protest and with a full reservation of rights, paid interest to Respondent in the amount of \$22,628.05 for the period of March 15, 2002 through July 11, 2009 ("Interest Payment").

54. On February 24, 2010, Petitioner filed its "Petition for Judicial Review of Final Agency Decision in a Contested Tax Case" under Article 4 of the North Carolina Administrative Procedure Act and, pursuant to statute, the matter was submitted to the North Carolina Business Court for review.

55. On May 3, 2013, the North Carolina Business Court entered an "Opinion and Order on Petition for Judicial Review of Final Agency Decision in a Contested Tax Case" ("Business Court Order") wherein the Business Court affirmed the Final Agency Decision upholding the ALJ Deductibility Decision and found and concluded that, in modifying the ALJ Interest Abatement Decision, the Department failed to comply with the applicable provisions of the North Carolina Administrative Procedure Act; directed that the Final Agency Decision denying summary judgment in favor of Petitioner with regard to the Interest Abatement Issue be remanded to the Department for compliance with such provisions; and directed that, after doing so, the Department remand the Interest Abatement Issue to the ALJ for a recommendation as to whether the accrued interest should be abated.

56. On December 10, 2013, the Department issued an "Amended Final Agency Decision, in part, and Remanded, in part" which adopted the ALJ Deductibility Decision and remanded the Interest Abatement Issue to the ALJ for hearing and decision.

57. On April 23, 2015, the ALJ issued the ALJ Amended Interest Abatement Decision which rejected application of the theory of abatement in the context of avoiding interest on a tax assessment and concluded that any interest on any tax assessed against Petitioner for 2001 Market Discount Income during the period beginning July 2002 and ending on May 16, 2006 did not abate.

58. The Department adopts Findings of Fact numbers 1 through 55 of the ALJ's Amended Decision Denying Partial Summary Judgment for Petitioner which was issued on April 23, 2015.

CONCLUSIONS OF LAW

With regard to the ALJ's Conclusions of Law and based upon the foregoing Findings of Fact, the Department concludes as follows:

1. There is no genuine issue as to any material fact on the matter of the deductibility of United States bond Market Discount Income for purposes of North Carolina corporate income tax against Petitioner.

2. Respondent is entitled to judgment as a matter of law that Petitioner's United States bond Market Discount Income is not deductible for North Carolina corporate income tax purposes.

3. The statutory requirements of N.C. Gen. Stat. § 105-130.5(b)(1) to receive a deduction from North Carolina taxable income for United States bond Market Discount Income have not been met.

4. For Market Discount Income to be deductible from North Carolina taxable income as United States bond interest, N.C. Gen. Stat. § 105-130.5(b)(1) requires that: (1) the income must be interest upon the obligations of the United States; and (2) interest on North Carolina bonds must be exempt from federal income taxes.

5. Market Discount Income on North Carolina bonds is included in federal taxable income and, therefore, Market Discount Income on United States bonds is taxable for North Carolina purposes under N.C. Gen. Stat. § 105-130.5(b)(1).

6. United States bond Market Discount Income is not deductible as interest under N.C. Gen. Stat. § 105-130.5(b)(1).

7. There is no genuine issue as to any material fact on the matter of the interest assessed on the corporate income tax due on Petitioner's Market Discount Income earned on the disposition of the Bonds.

8. N.C. Gen. Stat. § 105-241.21(b) provides that "interest accrues on an underpayment of tax from the date set by statute for payment of the tax until the tax is paid. Interest accrues only on the principal of the tax and does not accrue on any penalty."

9. Interest was properly assessed pursuant to N.C. Gen. Stat. § 105-241.21(b).

10. "Abatement," as applied to taxation, "presupposes some error or mistake in the assessment." Gulf States Steel Co. v. United States, 56 F.2d 43, 46, (5th Cir. 1932), aff'd, 287 U.S. 32 (1932).

11. Accrued interest was properly assessed and cannot be abated as there has been no error or mistake in the assessment by Respondent.

12. The theory of abatement does not apply in the context of avoiding interest on a tax assessment.

13. Any interest on any tax assessed against Petitioner for 2001 Market Discount Income during the period beginning July 2002 and ending on May 16, 2006 did not abate.

14. Respondent is entitled to judgment as a matter of law that the interest assessed on Petitioner's 2001 Market Discount Income for the period beginning July 2002 and ending on May 16, 2006, did not abate.

15. The Department adopts Conclusions of Law numbers 1 through 9 of the ALJ's Amended Decision Denying Partial Summary Judgment for Petitioner which was issued on April 23, 2015.

DECISION

The Department hereby decides that Respondent was entitled to summary judgment as a matter of law with regard to the first issue concerning Market Discount Income. The Department therefore adopts the ALJ Deductibility Decision which was filed on June 30, 2009.

The Final Determination dated September 12, 2008 issued by Respondent to Petitioner is sustained as to the tax.

The Department hereby decides that Respondent was entitled to summary judgment as a matter of law with regard to the second issue concerning Interest Abatement. The Department therefore adopts the ALJ Amended Interest Abatement Decision which was filed on April 23, 2015.

APPEAL

Pursuant to N.C. Gen. Stat. §150B-45 a party wishing to appeal the final decision of the Department in a contested tax case arising under N.C. Gen. Stat. § 150-241.15 may commence such an appeal by filing a Petition for Judicial Review in the Superior Court of Wake County

pursuant to N.C. Gen. Stat. § 150-241.16 and in accordance with the procedures for a mandatory business case set forth in N.C. Gen. Stat. § 7A-45.4(b) through (f) within 30 days after being served with a written copy of this Second Amended Final Agency Decision.

This Second Amended Final Agency Decision is made this 24th day of July, 2015.

NORTH CAROLINA DEPARTMENT OF REVENUE

/s/ Janice W. Davidson

Janice W. Davidson, Assistant Director
Sales and Use Tax Division
North Carolina Department of Revenue