

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE NORTH CAROLINA
DEPARTMENT OF REVENUE
OAH NO: 08 REV 2665

The Fidelity Bank,)
) Petitioner,)
))
v.)
))
N. C. Department of Revenue,)
) Respondent.)

) **AMENDED**
) **FINAL AGENCY DECISION, In Part,**
) **and**
) **REMANDED, In Part**

THIS MATTER comes before the North Carolina Department of Revenue (“Department”) for final agency decision pursuant to N.C. Gen. Stat. § 150B-36. This matter was heard by Temporary 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 Respondent against Petitioner. The ALJ’s Decision Granting Partial Summary Judgment for Respondent on the issue of the deductibility of Market Discount income for purposes of North Carolina corporate income tax (“Decision on Market Discount”) was filed on June 30, 2009. The ALJ’s Decision Granting Partial Summary Judgment for Petitioner on Petitioner’s request for the reduction of accrued interest on the corporate income tax assessment (“Decision on Interest Reduction”) was filed on November 16, 2009. 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’s decision to grant summary judgment for Respondent on the issue of taxability of Market Discount Income 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 accrued interest issue being heard on remand at OAH, Petitioner sought immediate judicial review of the Final Agency Decision pursuant to 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, the Honorable John R. Jolly, Jr., Chief Special Superior Court Judge for Complex Business Cases, affirmed the Final Agency Decision upholding the ALJ’s decision to grant summary judgment for Respondent on the issue of taxability of Market Discount Income. Judge Jolly remanded the second issue concerning accrued interest to the Department to comply with the requirements of N.C. Gen. Stat. 150B-36(b1) and (b2) with regard to Findings of Fact 15, 16, 17, and 18. Upon amendment of the Final Agency Decision herein, the issue concerning accrued interest is to be remanded to the ALJ for a hearing and decision, as required by N.C. Gen. Stat. § 150B-36(d), as to whether the accrued interest for the period beginning in July 2002 and ending May 16, 2006 should be reduced pursuant to the standard set forth in N.C. Gen. Stat. § 105-237.1.

Prior to the Final Agency Decision being amended pursuant to Judge Jolly's Opinion and Order, Petitioner appealed this case to the North Carolina Court of Appeals. Respondent-Appellee's Motion to Dismiss Appeal was allowed and the appeal was dismissed by order of the Court on September 26, 2013.

This amendment of the Final Agency Decision is made [a]fter a full review of the entire record of this matter, including the official record as defined in N.C. Gen. Stat. § 150B-37(a), and upon consideration of the cross motions for summary judgment by the parties, the briefs, exceptions, written arguments, proposed orders, and other documents filed or submitted by the parties, the Department makes this consolidated final agency decision as follows:

Deletions from the Findings of Fact, Conclusions of Law, and the issues of the ALJ are marked with ~~strikethroughs~~ and additions/modifications are in **bold**. *Deletions from the original Final Agency Decision are marked with ~~strikethroughs~~ and additions/modifications are in italicized bold print.*

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").
2. Whether interest that accrued during the period beginning in July 2002 and ending ~~in~~ **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 Decision on Market Discount and in the Decision on Interest Reduction, and based upon the pleadings, stipulations of fact, exhibits, affidavits, briefs, and other evidence in the Record, the Department decides as follows:

The Department adopts Findings of Fact #'s 1-13 of the ALJ's Decision on Market Discount and Findings of Fact #'s 1 and 2 of the ALJ's Decision on Interest Reduction which are denoted as Findings of Fact #'s 1-14 in this consolidated final agency decision 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 North Carolina income tax return for 2001. Petitioner timely paid the corporate income taxes due on the income reported thereon to Respondent. (Stip. Fact 3; Exhibit V of the Stipulations of Fact).
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. (Stip. Fact 4).
5. In 2001, Petitioner reported the stated coupon interest on the securities as taxable interest income when received, and reported the Market Discount portion of the income on the securities as taxable other income (accretion on bonds sold) on its federal and North Carolina income tax returns. (Stip. Fact 5).
6. 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 return. That line is listed as "U.S. obligation interest (not expenses)." (Stip. Fact 6).
7. 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).
8. 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 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; Exhibit A of the Stipulations of Fact).
9. By letter dated July 31, 2002, Petitioner responded to Respondent's Notice of Assessment. (Stip. Fact 9; Exhibit B of the Stipulations of Fact).
10. On August 29, 2002, Respondent acknowledged by letter receipt of Petitioner's protest letter and provided to Petitioner its standard Conference Request Form for execution. (Stip. Fact 10; Exhibit C of the Stipulations of Fact).
11. On September 23, 2002, Petitioner completed and submitted to Respondent the Conference Request Form. (Stip. Fact 11; Exhibit D of the Stipulations of Fact).
12. No conference was held between Petitioner and Respondent in 2002. (Stip. Fact 12).
13. On May 17, 2006, Respondent wrote to Petitioner. (Stip. Fact 13; Exhibit E of the Stipulations of Fact).

14. On May 17, 2006, Respondent issued a letter to Petitioner indicating that Respondent intended to impose tax on Petitioner's 2001 Market Discount income. (Exhibit E of the Stipulations of Fact).

The Department adopts Finding of Fact # 3 of the ALJ's Decision on Interest Reduction which is denoted here as Finding of Fact number 14(a) and deletes Findings of Fact numbers 15, 16, 17, and 18 of the original Final Agency Decision from this Amended Final Agency Decision. Finding of Fact number 14(a) adopts Finding of Fact # 3 in the ALJ's Decision on Interest Reduction as follows:

14(a) Respondent cannot explain the inactivity by the agency during the four (4) year gap.

~~The Department determines that portions of Finding of Fact # 3 in the ALJ's Decision on Interest Reduction are contrary to the evidence in the record and shall be modified. Therefore, the Department modifies said Finding of Fact which is denoted as Finding of Fact #15 in this consolidated final agency decision as follows:~~

- ~~15. Respondent cannot **could not locate any records to** explain the inactivity by the agency during the four (4) year gap **between September 2002 and May 2006.** (Respondent's Brief on Petitioner's Request for Abatement of Interest, p 2).~~

~~The Department determines that Petitioner's statements concerning the inactivity from 2002 until May 16, 2006 as supported by a preponderance of the evidence in the record shall be included in the Findings of Fact. Therefore, the Department includes the following evidence from the record which is denoted as Finding of Fact #16 in this consolidated final agency decision as follows:~~

- ~~16. **Petitioner presents two possibly conflicting versions of its actions and responses for the inactivity between September 2002 and May 2006:**~~
- ~~• **that it "tried unsuccessfully for the next two (2) years to obtain written resolution from Respondent regarding this issue" (Petitioner's Attachment to Petition, pp 2 and 4; Petitioner's Prehearing Statement, p 3) and**~~
 - ~~• **that "Petitioner had believed Respondent had accepted its protest and all proposed assessments were resolved." (Petitioner's Attachment to Petition, p 4; see also Aff. of Mary Willis, ¶ 13).**~~

~~The Department determines that conflicting testimony offered by Petitioner and Respondent concerning the activity/inactivity in 2002 as supported by a preponderance of the evidence in the record shall be included in the Findings of Fact. Therefore, the Department includes the following evidence from the record which is denoted as Findings of Fact #'s 17 and 18 in this consolidated final agency decision as follows:~~

~~17. The testimony of Petitioner is that it received a notice of tax due in late 2002 which it was told was a mistake and which led to Petitioner's assumption that the matter had been resolved in Petitioner's favor. (Aff. Of Mary Willis, ¶¶ 11-13).~~

~~18. The testimony of Respondent is that "no notices for corporate income tax were sent to Petitioner in November or December 2002." (Aff. Of Donna P. Powell, ¶¶ 2-4).~~

The Department adopts Findings of Fact #'s 14-42 of the ALJ's Decision on Market Discount which are denoted as Findings of Fact #'s 19-47 of this consolidated final agency decision as follows:

19. On May 30, 2006, representatives for each of Petitioner and Respondent discussed the disputed income tax assessment by telephone. (Stip. Fact 14).
20. By letter dated May 31, 2006, Respondent provided to Petitioner a Conference Request Form for execution. (Stip. Fact 15; Exhibit F of the Stipulations of Fact).
21. 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; Exhibit G of the Stipulations of Fact).
22. On July 31, 2006, Petitioner submitted its protest letter to Respondent. (Stip. Fact 17; Exhibit H of the Stipulations of Fact).
23. On August 14, 2006, representatives for each of Petitioner and Respondent discussed the disputed income tax assessment by telephone. (Stip. Fact 18).
24. By letter dated August 16, 2006, Respondent provided to Petitioner a Conference Request Form for execution. (Stip. Fact 19; Exhibit I of the Stipulations of Fact).
25. On August 17, 2006, Petitioner completed and submitted to Respondent the Conference Request Form for an informal conference with Respondent. (Stip. Fact 20; Exhibit J of the Stipulations of Fact).
26. On August 24, 2006, Respondent responded to Petitioner by letter confirming the date and time for the informal conference. (Stip. Fact 21; Exhibit K of the Stipulations of Fact).
27. On October 24, 2006, representatives for each of Petitioner and Respondent participated in an informal conference to address the disputed income tax assessment. (Stip. Fact 22).
28. On November 15, 2006, a representative for Petitioner provided supplemental information to Respondent by letter. (Stip. Fact 23; Exhibit L of the Stipulations of Fact).
29. On February 8, 2007, Respondent responded by letter to Petitioner's supplemental information. (Stip. Fact 24; Exhibit M of the Stipulations of Fact).

30. On February 26, 2007, a representative for Petitioner provided a response to Respondent by letter. (Stip. Fact 25; Exhibit N of the Stipulations of Fact).
31. On March 16, 2007, Respondent responded by letter to Petitioner. (Stip. Fact 26; Exhibit O of the Stipulations of Fact).
32. On April 13, 2007, counsel for Petitioner requested by letter to Respondent a hearing on the disputed income tax assessment. (Stip. Fact 27; Exhibit P of the Stipulations of Fact).
33. A hearing on the disputed income tax assessment was scheduled for August 8, 2007, at 1:00 P.M. (Stip. Fact 28).
34. On August 3, 2007, counsel for Petitioner and representatives for Respondent discussed the pending hearing on the disputed income tax assessment by telephone. (Stip. Fact 29).
35. On August 7, 2007, Respondent confirmed cancellation of the scheduled hearing by letter to counsel for Petitioner. (Stip. Fact 30; Exhibit Q of the Stipulations of Fact).
36. On 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; Exhibit R of the Stipulations of Fact).
37. On September 20, 2007, Petitioner completed and submitted to Respondent its response requesting application of the new procedures on the form provided by Respondent. (Stip. Fact 32; Exhibit S of the Stipulations of Fact).
38. On June 23, 2008, counsel for Petitioner and a representative of Respondent discussed by telephone scheduling an informal conference. (Stip. Fact 33).
39. On June 26, 2008, Respondent confirmed with Petitioner by letter that the June 23, 2008, telephone conference qualified as an informal conference. (Stip. Fact 34; Exhibit T of the Stipulations of Fact).
40. On September 12, 2008, Respondent issued its Notice of Final Determination on the disputed income tax assessment. (Stip. Fact 35; Exhibit U of the Stipulations of Fact).
41. On November 11, 2008, Petitioner filed its Petition for contested case hearing. (Stip. Fact 36).
42. On December 17, 2008, Petitioner and Respondent filed their respective Prehearing Statements.
43. On February 13, 2009, Petitioner and Respondent filed Stipulations of Fact.

44. On February 17, 2009, Respondent filed its Motion for Summary Judgment and submitted a supporting Brief on February 23, 2009.
45. On February 18, 2009, Petitioner filed its Motion for Summary Judgment and submitted a supporting Memorandum of Law on February 25, 2009.
46. 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.
47. 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 re-characterized 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 hearing.

The Department determines that additional Findings of Fact shall be added to the ALJ's Findings of Fact to properly reflect the briefs and written documentation added to the record from the time the ALJ's Decision on Market Discount was filed on June 30, 2009 until the ALJ's Decision on Interest Reduction was filed on November 16, 2009. Therefore, the Department supplements the ALJ's Findings of Fact by including Findings of Fact #'s 48-50 in this consolidated final agency decision as follows:

- 48. Respondent's Brief on Petitioner's Request for Abatement of Interest was filed on July 20, 2009.**
- 49. Petitioner's Reply to Brief of Respondent North Carolina Department of Revenue on the issue of accrued interest was filed on August 3, 2009.**
- 50. By letter dated July 10, 2009, Petitioner transmitted to Respondent a check in the amount of \$49,963.00 in payment of the tax amount of the corporate income tax assessment. No accrued interest on this assessment for any period was paid by Petitioner. (Petitioner's Reply to Brief of Respondent, p 4 and Petitioner's Exhibit 1 attached thereto).**

CONCLUSIONS OF LAW

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

The Department adopts Conclusions of Law #'s 1-6 of the ALJ's Decision on Market Discount which are denoted as Conclusions of Law #'s 1-6 in this consolidated final agency decision 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 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).

The Department rejects Conclusions of Law #'s 1-4 of the ALJ's Decision on Interest Reduction as the Findings of Fact show genuine issues of material fact on the issue of accrued interest and the Department determines said Conclusions of Law to be erroneous as a matter of law. ~~1. 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 earned on the disposition of the Bonds. 2. The imposition of interest on Petitioner's Corporate income tax constitutes an economic penalty against Petitioner. 3. It would be inequitable for Petitioner to pay the interest that accrued during the period beginning July 2002 and ending in May 16, 2006, on Petitioner's corporate income tax assessed. 4. Petitioner is entitled to judgment as a matter of law that the interest assessed on the corporate income tax due on Petitioner's market discount income should be abated for the period beginning July 2002 and ending in May 16, 2006.~~ The Department adopts the following Conclusions of Law on the issue of whether the assessment of accrued interest was proper and whether accrued interest for the period beginning July 2002 and ending on May 16, 2006 should be reduced:

- 7. 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."**
- 8. Interest was properly assessed pursuant to N.C. Gen. Stat. § 105-241.21(b).**

9. **Accrued interest is not a penalty.**
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. Ala. 1932), affirmed, 287 U.S. 32, 53 S. Ct. 69 (1932).
11. **Accrued interest was properly assessed and cannot be abated as there has been no error or mistake in the assessment.**
12. **Respondent “may compromise a taxpayer’s tax liability for a tax that is collectible under G.S. 105-241.22” when such compromise is determined to be “in the best interest of the State” and when one of several findings, which include preventing an “unjust result under the circumstances,” is made. N.C. Gen. Stat. 105-237.1 (entitled “Compromise of liability”).**
13. **The use of the term “may compromise” makes Respondent’s decision to compromise a taxpayer’s tax liability discretionary, not mandatory.**
14. **Respondent may collect a tax at various points, including when the parties “agree on a settlement concerning the amount of tax due” and when “a final decision is issued on a proposed assessment of tax after a contested case hearing.” N.C. Gen. Stat. 105-241.22 (entitled “Collection of tax”).**
15. **Summary judgment is not appropriate where there is a need to find material facts.** *Robertson v. Hartman*, 90 N.C. App. 250, 368 S.E.2d 199 (1988).
16. **There are genuine issues of material fact concerning whether a recommendation should be made that Respondent, in its discretion, consider reducing or waiving the accrued 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.**

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’s Decision Granting Partial Summary Judgment for Respondent on the issue of the deductibility of Market Discount income for purposes of North Carolina corporate income tax (“Decision on Market Discount”) 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; accrued interest in the amount of \$1,132.63 as shown due on the Notice of Assessment issued to Petitioner by Respondent on July 8, 2002 is sustained; and accrued interest which accrued from May 16, 2006 until the tax was paid in full is sustained.

The Department hereby decides that Petitioner was not entitled to summary judgment as a matter of law with regard to the second issue concerning a reduction of the accrued interest for the period July 2002 through May 16, 2006 as ~~there are~~ genuine issues of material fact *exist with regard to whether the accrued interest for the period beginning in July 2002 and ending on May 16, 2006 should be reduced or waived pursuant to the standard set forth in N.C. Gen. Stat. § 105-237.1*. The ALJ's Decision Granting Partial Summary Judgment for Petitioner on Petitioner's request for the reduction of accrued interest on the corporate income tax assessment ("Decision on Interest Reduction") which was filed on November 16, 2009 is rejected and this issue is remanded to the ALJ for hearing.

The issue concerning accrued interest is remanded to the ALJ for hearing and decision, as required by N.C. Gen. Stat. § 150B-36(d), on the question of whether or not the accrued interest for the period beginning in July 2002 and ending on May 16, 2006 should be reduced or waived pursuant to the standard set forth in N.C. Gen. Stat. § 105-237.1.

This Amended Final Agency Decision, In Part, and Remanded, In Part is made this 10th day of December, 2013.

NORTH CAROLINA DEPARTMENT OF REVENUE

Janice W. Davidson
Agency Legal Specialist II
North Carolina Department of Revenue

CERTIFICATE OF SERVICE

I certify that a copy of the Department's **Amended Final Agency Decision, In Part, and Remanded, In Part**, has been served upon each party personally or by certified mail addressed to the party at the latest address given by the party to the agency pursuant to N.C. Gen. Stat. § 150B-36(b3) and a copy has been served upon each party's attorney of record, the Administrative Law Judge (ALJ), and the Office of Administrative Hearings as follows:

By Certified Mail:

The Fidelity Bank
100 South Main Street
Fuquay-Varina, NC 27526

By First Class Mail:

A. Rexford Willis, III
Amy P. Wang
Donalt J. Eglinton
Ward and Smith, P.A.
P O Box 867
New Bern, NC 28563-0867

Robin Adams Anderson, ALJ
Office of Administrative Hearings
6714 Mail Service Center
Raleigh NC 27699-6714

Kim Hausen, Chief Hearings Clerk
Office of Administrative Hearings
6714 Mail Service Center
Raleigh NC 27699-6714

By Personally Delivering:

North Carolina Department of Revenue
Attn: Jeff Epstein
Chief Operating Officer
501 N Wilmington St., P O Box 871
Raleigh NC 27602-0871

Kay Miller Hobart
Perry J. Pelaez
Attorney General's Office - Revenue
501 N Wilmington St., P O Box 629
Raleigh NC 27602-0629

This the 10th day of December, 2013.

/s/ Janice W. Davidson

Janice W. Davidson
Agency Legal Specialist II
North Carolina Department of Revenue
P O Box 871
Raleigh, North Carolina 27602-0871