

FINAL AGENCY DECISION

THESE CONSOLIDATED CASES came before the North Carolina Department of Revenue (“Department”) from the Decision of the Honorable Beecher R. Gray, Administrative Law Judge (ALJ), filed in the Office of Administrative Hearings (“OAH) on August 5, 2010 in which the ALJ ruled both on (i) Respondent’s Motion for Summary Judgment and (ii) the case on the merits based on the record. The parties filed stipulated facts in these contested cases and further stipulated on the record that the stipulated facts would constitute the factual record in these cases without the production of further evidence. The official administrative record was received by the Department from OAH on September 17, 2010. By letter dated September 21, 2010, each party was notified of the opportunity to file exceptions to the Administrative Law Judge’s Decision as well as file a supporting brief and proposed final order. Upon request of Respondent, the time for each party to submit exceptions, briefs, and proposed final decisions was extended to October 25, 2010. The undersigned filed an Order Extending Time to Make Final Agency Decision which extended said time to and including December 16, 2010. After 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 briefs, exceptions, proposed orders, and other documents filed or submitted by the parties, the Department makes the following Final Agency Decision:

APPEARANCES

Petitioners:	[Attorneys for Petitioners] [Address and phone number of Attorneys]
Respondent:	Tenisha S. Jacobs Assistant Attorney General N.C. Department of Justice P. O. Box 629 Raleigh, NC 27602-0629 (919) 716-6550

Deletions from the Issues, Applicable Statutes and Rules, Findings of Fact, and Conclusions of Law of the ALJ are marked with ~~strike throughs~~ and additions/modifications are in **bold**.

ISSUES

(1) Whether the North Carolina Revenue Laws authorize **individual** shareholders of an S Corporation to claim deductions under N.C. Gen. Stat. § 105-134.6(b)(17) on their North Carolina individual tax returns ~~for tax years~~ for additional first year depreciation previously added back **by a C corporation** on its C corporation income tax returns under N.C. Gen. Stat. § 105-130.5(a)(15) ~~by the S corporation while such S corporation was taxed as a C corporation.~~

(2) Whether the Notices of Final Determination issued to Petitioners on October 12, 2009 were issued in error.

APPLICABLE STATUTES, AND RULES, AND BULLETINS

N.C. Gen. Stat. § 105-130.3

N.C. Gen. Stat. § 105-130.5(a)(15)

N.C. Gen. Stat. § 105-130.5(b)(21)

N.C. Gen. Stat. § 105-131(a)

N.C. Gen. Stat. § 105-131(b)(7)

N.C. Gen. Stat. § 105-131(b)(8)

N.C. Gen. Stat. § 105-131.1(a)

N.C. Gen. Stat. § 105-131.1(b)

N.C. Gen. Stat. § 105-134.6(b)(17)

N.C. Gen. Stat. § 105-134.6(a)

N.C. Gen. Stat. § 105-134.6(c)(8)

The Department's 2005-2006 Individual Income Tax Bulletin

The Department's 2007-2008 Individual Income Tax Bulletin

STIPULATED FINDINGS OF FACT

The Department hereby adopts all Findings of Fact stipulated by the parties as set forth in the Decision of the Administrative Law Judge, as follows:

The collective Petitioners, [Taxpayers 1 and 2, Taxpayer 3, Taxpayers 3 and 4, and Taxpayers 5 and 6], and Respondent North Carolina Department of Revenue, filed the following Stipulations, with corresponding Exhibits as found in the official record, in these consolidated cases:

DEFINITIONS

In addition to the terms defined elsewhere, the following terms shall have the following meanings:

1. "Additional first year depreciation" shall mean the special accelerated depreciation allowed under Section 168(k) or Section 1400L of the Internal Revenue Code.
2. "C corporation" shall mean a corporation that is not an S corporation.
3. "[Corporation 1]" shall mean [Corporation 1] and includes its wholly owned subsidiaries [Subsidiary 1; Subsidiary 2; Subsidiary 3; Subsidiary 4; and Subsidiary 5].
4. "Federal taxable income" shall have the same meaning as the term "taxable Income" defined in N.C. Gen. Stat. § 105-134.1(16).
5. "Form CD-405" shall refer to Form CD-405: Corporation Tax Return published by the North Carolina Department of Revenue. The term also includes all schedules and forms (*e.g.*

CD-425, CD-429, CD-478, CD-478F) referenced in or attached to a Form CD-405.

6. "Form D-400" shall refer to Form D-400: Individual Income Tax Return published by the North Carolina Department of Revenue. The term also includes all schedules referenced in or attached to a Form D-400.

7. "Form D-400X" shall refer to Form D-400X: Amended North Carolina Individual Income Tax Return published by the North Carolina Department of Revenue.

8. "S corporation" shall mean a corporation for which a valid election under Section 1362(a) of the Internal Revenue Code is in effect.

A. [Taxpayers 1 and 2]. For purposes of this Paragraph A, [Taxpayers 1 and 2] shall be referred to as the "Petitioners."

1. The document referenced herein as Exhibit A-1 is a true and accurate copy of Petitioners' Form D-400 for tax year 2002.

2. Petitioners made no additions to federal taxable income for additional first year depreciation on Line 36, "Adjustment for 30% additional first year depreciation," of Petitioners' Form D-400 for tax year 2002.

3. Petitioners made no additions to federal taxable income for additional first year depreciation on Line 37, "Other federal taxable income additions," of Petitioners' Form D-400 for tax year 2002.

4. The document referenced herein as Exhibit A-2 is a true and accurate copy of Form CD-405 of [Corporation 1] for tax year 2002.

5. [Corporation 1] made an addition to federal taxable income for additional first year depreciation on Line 1(f), "30% additional first-year depreciation," of Schedule H of [Corporation 1]'s Form CD-405 for tax year 2002.

6. The document referenced herein as Exhibit A-3 is a true and accurate copy of Form CD-405 of [Corporation 2] for tax year 2002.

7. [Corporation 2] made an addition to federal taxable income for additional first year depreciation on Line 1(f), "30% additional first-year depreciation," of Schedule H of [Corporation 2]'s Form CD-405 for tax year 2002.

8. The document referenced herein as Exhibit A-4 is a true and accurate copy of Petitioners' Form D-400 for tax year 2003.

9. Petitioners made no additions to federal taxable income for additional first year depreciation on Line 36, "Adjustment for additional first-year depreciation," of Petitioners' Form D-400 for tax year 2003.

10. The amount reflected on Line 37 of Petitioners' Form D-400 for tax year 2003 represents Petitioners' share of additional first year depreciation attributable to [Corporation 2] for the period August 1, 2003 through December 31, 2003.

11. The "\$251" amount reflected on the line entitled "From K-1 [Corporation 2]" on Statement 1 to Petitioners' Form D-400 for tax year 2003 represents Petitioners' share of additional first year depreciation attributable to an S corporation.

12. [Corporation 2] was an S corporation during the period August 1, 2003 and December 31, 2003.

13. [Corporation 2] was a C corporation during the period January 1, through July 31, 2003.

14. [Corporation 2] was a C corporation during 2002.

15. Petitioners made no additions to federal taxable income for additional first year depreciation attributable to a C corporation(s) on Line 37 of Petitioners' Form D-400 for tax year 2003.

16. The document referenced herein as Exhibit A-5 is a true and accurate copy of Petitioners' Form D-400X for tax year 2003.

17. Petitioners made no additions to federal taxable income for additional first year depreciation on Line 36, "Adjustment for additional first year depreciation," of Petitioners' Form D-400X for tax year 2003.

18. The amount reflected on Line 37 of Petitioners' Form D-400X for tax year 2003 represents Petitioners' share of additional first year depreciation attributable to [Corporation 2] for the period August 1, 2003 through December 31, 2003.

19. The "\$251" amount reflected on the line entitled "From K-1 - [Corporation 2]" on Statement 1 to Petitioners' Form D-400X for tax year 2003 represents Petitioners' share of additional first year depreciation attributable to an S corporation.

20. Petitioners made no additions to federal taxable income for additional first year depreciation attributable to a C corporation(s) on Line 37 of Petitioners' Form D-400X for tax year 2003.

21. The document referenced herein as Exhibit A-6 is a true and accurate copy of Form CD-405 of [Corporation 1] for tax year 2003.

22. [Corporation 1] made an addition to federal taxable income for additional first year depreciation on Line 1(f), "30% additional first-year depreciation," of Schedule H of [Corporation 1]'s Form CD-405 for tax year 2003.

23. The document referenced herein as Exhibit A-7 is a true and accurate copy of Form CD-405 of [Corporation 2] for tax year 2003.

24. [Corporation 2] made an addition to federal taxable income for additional first year depreciation on Line 1(f), “30% additional first-year depreciation,” of Schedule H of [Corporation 2]’s Form CD-405 for tax year 2003.

25. The document referenced herein as Exhibit A-8 is a true and accurate copy of Petitioner’s Form D-400 for tax year 2004.

26. The document referenced herein as Exhibit A-9 is a true and accurate copy of Petitioner’s Form D-400X for tax year 2004.

27. The “\$1,970” amount reflected on the line entitled “Form K-1 – [Corporation 2]” on Statement 1 to both Forms D-400 and D-400X for tax year 2004 represents Petitioners’ share of additional first year depreciation attributable to an S corporation.

28. The “\$249” amount reflected on the line entitled “From K-1 – [Limited Liability Company]” on Statement 1 to both Forms D-400 and D-400X for tax year 2004 represents Petitioners’ share of additional first year depreciation attributable to a limited liability company taxed as a partnership.

29. [Limited Liability Company] was a limited liability company taxed as a partnership during tax year 2004.

30. The “\$320” amount reflected on the line entitled “From K-1 – [Charitable Remainder Trust]” on Statement 1 to both Form D-400 and D-400X for tax year 2004 is not for additional first year depreciation.

31. Petitioners made no additions to federal taxable income for additional first year depreciation attributable to a C corporation(s) on Line 36, entitled “Adjustment for additional first year depreciation,” of both Forms D-400 and D-400X for tax year 2004.

32. Petitioners made no additions to federal taxable income for additional first year depreciation attributable to a C corporation(s) on Line 37, entitled “Other federal taxable income additions,” of both Petitioners’ Forms D-400 and D-400X for tax year 2004.

33. The document referenced herein as Exhibit A-10 is a true and accurate copy of Form CD-405 of [Corporation 2] for tax year 2004.

34. [Corporation 1] made an addition to federal taxable income for additional first year depreciation on Line 1(f), “30% additional first-year depreciation,” of Schedule H of [Corporation 1]’s Form CD-405 for tax year 2004.

35. The document referenced herein as Exhibit A-11 is a true and accurate copy of

Petitioner's Form D-400 for tax year 2005.

36. The document referenced herein as Exhibit A-12 is a true and accurate copy of Petitioner's Form D-400X for tax year 2005.

37. Petitioners claimed an individual income tax deduction for additional first year depreciation on Line 45, "Adjustments for additional first year depreciation added back in 2002, 2003 and 2004" of both Petitioners' Form D-400 and Form D-400X for tax year 2005.

38. For tax year 2005, the amount reflected on Line 45 of both Petitioners' Form D-400 and Form D-400X represents a deduction for a portion of the additional first year depreciation previously added back on Petitioners' individual income tax returns for tax years 2002, 2003 and 2004.

39. Petitioners claimed an individual income tax deduction for additional first year depreciation on Line 46, "Other federal taxable income deductions," of both Petitioners' Form D-400 and D-400X for tax year 2005.

40. The amount claimed as an individual income tax deduction on Line 46 of both Petitioners' Form D-400 and Form D-400X for tax year 2005 is for additional first year depreciation previously added back to federal taxable income by a C corporation(s).

41. For tax year 2005, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 2 to Forms D-400 and D-400X represents additional first year depreciation previously added back to federal taxable income by a C corporation(s).

42. For tax year 2005, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 2 to both Petitioners' Form D-400 and D-400X represents, in part, additional first year depreciation attributable to [Corporation 1] for 2002, 2003 and 2004 that was previously added back on [Corporation 1]'s C corporate income tax returns for tax years 2002, 2003 and 2004.

43. For tax year 2005, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 2 to both Petitioners' Form D-400 and Form D-400X represents, in part, additional first year depreciation attributable to [Corporation 2] for 2002 through July 31, 2003 that was previously added back on [Corporation 2]'s C corporate income tax returns for tax years 2002 and 2003.

44. [Corporation 1] was a C corporation during 2002, 2003 and 2004.

45. Petitioners made no additions on their 2002, 2003 and 2004 individual income tax returns for the additional first year depreciation deducted on Line 46 of both Petitioners' Form D-400 and D-400X for tax year 2005.

46. The document referenced herein as Exhibit A-13 is a true and accurate copy of Petitioners' Form D-400 for tax year 2006.

47. Petitioners claimed an individual income tax deduction for additional first year depreciation on Line 45, "Adjustments for additional first year depreciation added back in 2002, 2003 and 2004," of Petitioners' Form D-400 for tax year 2006.

48. For tax year 2006, the amount reflected on Line 45 of Petitioners' Form D-400 represents a deduction for a portion of the additional first year depreciation previously added back on Petitioners' individual income tax returns for tax years 2002, 2003 and 2004.

49. Petitioners claimed an individual income tax deduction for additional first year depreciation on Line 46, "Other federal taxable income deductions," of Petitioners' Form D-400 for tax year 2006.

50. The amount Petitioners claimed as an individual income tax deduction on Line 46 of Form D-400 for tax year 2006 is for additional first year depreciation previously added back to federal taxable income by a C corporation.

51. For tax year 2006, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 2 to Form D-400 represents additional first year depreciation previously added back to federal taxable income by a C corporation(s).

52. For tax year 2006, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 2 to Form D-400 represents, in part, additional first year depreciation attributable to [Corporation 1] for 2002, 2003 and 2004 that was previously added back on [Corporation 1]'s C corporate income tax returns for tax years 2002, 2003 and 2004.

53. For tax year 2006, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 2 to Form D-400 represents, in part, additional first year depreciation attributable to [Corporation 2] for 2002 through July 31, 2003 that was previously added back on [Corporation 2]'s C corporate income tax returns for tax years 2002 and 2003.

54. Petitioners made no additions to their 2002, 2003 and 2004 individual income tax returns for the additional first year depreciation deducted on Line 46 of Petitioners' Form D-400 for tax year 2006.

55. The document referenced herein as Exhibit A-14 is a true and accurate copy of Petitioners' Form D-400 for tax year 2007.

56. Petitioners claimed an individual income tax deduction for additional first year depreciation on Line 45, "Adjustments for additional first year depreciation added back in 2002, 2003 and 2004," of Petitioners' Form D-400 for tax year 2007.

57. For tax year 2007, the amount reflected on Line 45 of Petitioners' Form D-400 represents a deduction for a portion of the additional first year depreciation previously added back on Petitioners' individual income tax returns for tax years 2002, 2003 and 2004.

58. Petitioners claimed an individual income tax deduction for additional first year depreciation on Line 47, entitled "Other federal taxable income deductions," of Petitioners' Form D-400 for tax year 2007.

59. The amount Petitioners claimed as an individual income tax deduction on Line 47 of Petitioners' Form D-400 for tax year 2007 is for additional first year depreciation previously added back to federal taxable income by a C corporation(s).

60. Petitioners made no additions on their 2002, 2003 and 2004 individual income tax returns for the additional first year depreciation deducted on Line 47 of Petitioners' Form D-400 for tax year 2007.

B. Petitioner 3. For purposes of this Paragraph B, [Petitioner 3] shall be referred to as the "Petitioner."

1. The document referenced herein as Exhibit B-1 is a true and accurate copy of Petitioner's Form D-400 for tax year 2002.

2. Petitioner made no additions to federal taxable income for additional first year depreciation on Line 36, "Adjustments for 30% additional first year depreciation," of Petitioner's Form D-400 for tax year 2002.

3. Petitioner made no additions to federal taxable income for additional first year depreciation on Line 37, "Other federal taxable income additions," of Petitioner's Form D-400 for tax year 2002.

4. The "\$623" amount reflected on the line entitled "From K-1 – [Irrevocable Trust]" on Statement 1 to Petitioner's Form D-400 for tax year 2002 is not for additional first year depreciation.

5. The document referenced herein as Exhibit B-2 is a true and accurate copy of Petitioner's Form D-400 for tax year 2003.

6. Petitioner made no additions to federal taxable income for additional first year depreciation on Line 36, "Adjustment for additional first year depreciation," of Petitioner's Form D-400 for tax year 2003.

7. A portion of the amount reflected on Line 37 of Petitioner's Form D-400 for tax year 2003 represents Petitioner's share of additional first year depreciation attributable to an S corporation for the period August 1, 2003 through December 31, 2003.

8. Of the "\$3,159" amount reflected on Line 37, "Other federal taxable income additions," of Petitioner's Form D-400 for tax year 2003, \$2,258 represents Petitioner's share of additional first year depreciation attributable to [Corporation 2] for the period August 1, 2003 through December 31, 2003.

9. The "\$2,258" amount reflected on the line entitled "From K-1 – [Corporation 2]" on Statement 1 to Petitioner's Form D-400 for tax year 2003 represents Petitioner's share of additional first year depreciation attributable to an S corporation.

10. The "\$901" amount reflected on the line entitled "From K-1 – [Irrevocable Trust]" on Statement 1 to Petitioner's Form D-400 for tax year 2003 is not for additional first year depreciation.

11. Petitioner made no additions to federal taxable income for additional first year depreciation attributable to a C corporation(s) on Line 37 of Petitioner's Form D-400 for tax year 2003.

12. The document referenced herein as Exhibit B-3 is a true and correct copy of Petitioner's Form D-400 for tax year 2004.

13. The document referenced herein as Exhibit B-4 is a true and accurate copy of Petitioner's Form D-400X for tax year 2004.

14. Petitioner made no additions to federal taxable income for additional first year depreciation attributable to a C corporation(s) on Line 36, entitled "Adjustment for additional first year depreciation," of Petitioner's Form D-400 and Form D-400X for tax year 2004.

15. Petitioner made no additions to federal taxable income for additional first year depreciation on Line 37, entitled "Other federal taxable income additions," of Petitioner's Form D-400 and D-400X for tax year 2004.

16. The document referenced herein as Exhibit B-5 is a true and correct copy of Petitioner's Form D-400 for tax year 2005.

17. Petitioner claimed an individual income tax deduction for additional first year depreciation on Line 45, "Adjustments for additional first year depreciation added back in 2002, 2003 and 2004," of Petitioner's Form D-400 for tax year 2005.

18. For tax year 2005, the amount reflected on Line 45 of Petitioner's Form D-400 represents a deduction for a portion of the additional first year depreciation Petitioner previously added back on his individual income tax returns for tax years 2002, 2003 and 2004.

19. Petitioner claimed an individual income tax deduction for additional first year depreciation on Line 46, "Other federal taxable income deductions," of Petitioner's Form D-400 for tax year 2005.

20. The amount Petitioner claimed as an individual income tax deduction on Line 46 of his Form D-400 for tax year 2005 is for additional first year depreciation previously added back by a C corporation(s).

21. For tax year 2005, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 3 to Petitioner's Form D-400 represents additional first year depreciation previously added back by a C corporation(s).

22. For tax year 2005, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 3 to Form D-400 represents, in part, additional first year depreciation attributable to [Corporation 1] for 2002, 2003 and 2004 that was previously added back on [Corporation 1]'s C corporate income tax returns for tax years 2002, 2003 and 2004.

23. For tax year 2005, the amount reflected on the line entitled "Total to Form D-400," on Statement 3 to Form D-400 represents, in part, additional first year depreciation attributable to [Corporation 2] for 2002 through July 31, 2003 that was previously added back on [Corporation 2]'s C corporate income tax returns for tax years 2002 and 2003.

24. Petitioner made no additions on his 2002, 2003 and 2004 individual income tax returns for the additional first year depreciation he deducted on Line 46 of his Form D-400 for tax year 2005.

25. The document referenced herein as Exhibit B-6 is a true and accurate copy of Petitioner's Form D-400 for tax year 2006.

26. Petitioner claimed an individual income tax deduction for additional first year depreciation on Line 45, "Adjustments for additional first year depreciation added back in 2002, 2003 and 2004," of Petitioner's Form D-400 for tax year 2006.

27. For tax year 2006, the amount reflected on Line 45 of Petitioner's Form D-400 represents a deduction for a portion of the additional first year depreciation Petitioner previously added back on his individual income tax returns for tax years 2002, 2003 and 2004.

28. Petitioner claimed an individual income tax deduction for additional first year depreciation on Line 46, entitled "Other federal taxable income deductions," of Petitioner's Form D-400 for tax year 2006.

29. The amount Petitioner claimed as an individual income tax deduction on Line 46 of Petitioner's Form D-400 for tax year 2006 is for additional first year depreciation previously added back to federal taxable income by a C corporation(s).

30. Petitioner made no additions to his 2002, 2003 and 2004 individual income tax Returns for the additional first year depreciation he deducted on Line 46 of his Form D-400 for tax year 2006.

C. Petitioners 3 and 4. For purposed of this Paragraph C, Petitioners 3 and 4 shall be referred to as the "Petitioners."

1. The document referenced herein as Exhibit C-1 is a true and accurate copy of Petitioners' Form D-400 for tax year 2007.

2. Petitioners claimed an individual income tax deduction for additional first year depreciation on Line 45, "Adjustments for additional first year depreciation added back in 2002, 2003 and 2004," of Petitioners' Form D-400 for tax year 2007.

3. For tax year 2007, the amount reflected on Line 45 of Petitioners' Form D-400 represents a deduction for a portion of the additional first year depreciation previously added back on individual income tax returns for tax years 2002, 2003 and 2004.

4. Petitioners claimed an individual income tax deduction for additional first year depreciation on Line 47, "Other federal taxable income deductions," of Petitioners' Form D-400 for tax year 2007.

5. The amount Petitioners claimed as an individual income tax deduction on Line 47 of Petitioners' Form D-400 is for additional first year depreciation previously added back to federal taxable income by a C corporation(s).

6. Petitioners made no additions on their 2002, 2003 and 2004 individual income tax returns for the additional first year depreciation Petitioners deducted on Line 47 of their Form D-400 for tax year 2007.

D. Petitioners 5 and 6. For purposes of this Paragraph D, Petitioners 5 and 6 shall be referred to as the "Petitioners."

1. The document referenced herein as Exhibit D-1 is a true and accurate copy of Petitioners' Form D-400 for tax year 2002.

2. Petitioners made no additions to federal taxable income for additional first year depreciation on Line 36, "Adjustment for 30% additional first year depreciation," of Petitioners' Form D-400 for tax year 2002.

3. Petitioners made no additions to federal taxable income for additional first year depreciation on Line 37, "Other federal taxable income additions," of Petitioners Form D-400 for tax year 2002.

4. The "\$623" amount reflected on the line entitled "From K-1 – [Irrevocable Trust]" on Statement 1 of Petitioners' Form D-400 for tax year 2002 is not for additional first year depreciation.

5. The document referenced herein as Exhibit D-2 is a true and accurate copy of Petitioners' Form D-400 for tax year 2003.

6. Petitioners made no additions to federal taxable income for additional first year depreciation on Line 36, "Adjustment for additional first year depreciation," of Petitioners' Form D-400 for tax year 2003.

7. Petitioners made no additions to federal taxable income for additional first year depreciation on Line 37, "Other federal taxable income additions," of Petitioners Form D-400 for tax year 2003.

8. The "\$901" amount reflected on the line entitled "From K-1 – [Irrevocable Trust]" on Statement 1 of Petitioners' Form D-400 for tax year 2003 is not for additional first year depreciation.

9. Petitioners made no additions to federal taxable income for additional first year depreciation attributable to a C corporation(s) on Line 37 of Petitioners Form D-400 for tax year 2003.

10. The document referenced herein as Exhibit D-3 is a true and accurate copy of Petitioners' Form D-400 for tax year 2004.

11. Petitioners made no additions to federal taxable income for additional first year depreciation on Line 36, "Adjustment for additional first year depreciation," of Petitioners' Form D-400 for tax year 2004.

12. Petitioners' made no additions to federal taxable income for additional first year depreciation on Line 37, "Other federal taxable income additions," of Petitioners' Form D-400 for tax year 2004.

13. The "\$113" amount reflected on the line entitled "From K-1 – [Irrevocable Trust]" on Statement 1 to Petitioners' Form D-400 for tax year 2004 is not for additional first year depreciation.

14. Petitioners made no additions to federal taxable income for additional first year depreciation attributable to a C corporation(s) on Line 37 of Petitioners' Form D-400 for tax year 2004.

15. The document referenced herein as Exhibit D-4 is a true and accurate copy of Petitioners' Form D-400 for tax year 2005.

16. Petitioners did not claim an individual income tax deduction for additional first year depreciation on Line 45, "Adjustments for additional first year depreciation added back in 2002, 2003 and 2004," of Petitioners' Form D-400 for tax year 2005.

17. Petitioners claimed an individual income tax deduction for additional first year depreciation on Line 46, "Other federal taxable income deductions," of Petitioners' Form D-400 for tax year 2005.

18. The amount Petitioners claimed as an individual income tax deduction on Line 46 of Petitioners' Form D-400 for tax year 2005 is for additional first year depreciation previously added back to federal taxable income by a C corporation(s).

19. For tax year 2005, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 2 to Form D-400 represents additional first year depreciation previously added back to federal taxable income by a C corporation(s).

20. For tax year 2005, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 2 to Petitioners' Form D-400 represents additional first year depreciation attributable to [Corporation 1] for 2002, 2003 and 2004 that was previously added back on [Corporation 1]'s C corporate income tax returns for tax years 2002, 2003 and 2004.

21. For tax year 2005, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 2 to Petitioners' Form D-400 represents additional first year depreciation attributable to [Corporation 1] for 2002, 2003 and 2004 that was previously added back on [Corporation 2]'s C corporate income tax returns for tax years 2002 and 2003.

22. Petitioners made no additions on their 2002, 2003 and 2004 individual income tax returns for the additional first year depreciation deducted on Line 46 of Petitioners' Form D-400 for tax year 2005.

23. The document referenced herein as Exhibit D-5 is a true and accurate copy of Petitioners' Form D-400 for tax year 2006.

24. Petitioners did not claim an individual income tax deduction for additional first year depreciation on Line 45, "Adjustments for additional first year depreciation added back in 2002, 2003 and 2004," of Petitioners' Form D-400 for tax year 2006.

25. Petitioners claimed an individual income tax deduction for additional first year depreciation on Line 46, "Other federal taxable income deductions," of Petitioners' Form D-400 for tax year 2006.

26. The amount claimed as an individual income tax deduction on Line 46 of Petitioners' Form D-400 for tax year 2006 is for additional first year depreciation previously added back to federal taxable income by a C corporation(s).

27. For tax year 2006, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 2 to Form D-400 represents additional first year depreciation previously added back to federal taxable income by a C corporation(s).

28. For tax year 2006, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 2 to Form D-400 represents additional first year depreciation attributable to [Corporation 1] for 2002, 2003 and 2004 that was previously added back on [Corporation 1]'s C corporate income tax returns for tax years 2002, 2003 and 2004.

29. For tax year 2006, the amount reflected on the line entitled "Total to Form D-400, Line 46" on Statement 2 to Petitioners' Form D-400 represents additional first year depreciation attributable to [Corporation 1] for 2002, 2003 and 2004 that was previously added back on [Corporation 2]'s C corporate income tax returns for tax years 2002 and 2003.

30. Petitioners made no additions on their 2002, 2003 and 2004 individual income tax returns for the additional first year depreciation deducted on Line 46 of Petitioners' Form D-400 for tax year 2006.

31. The document referenced herein as Exhibit D-6 is a true and accurate copy of Petitioners' Form D-400 for tax year 2007.

32. Petitioners did not claim an individual income tax deduction for additional first year depreciation of Line 45, "Adjustments for additional first year depreciation added back in 2002, 2003 and 2004," of Petitioners' Form D-400 for tax year 2007.

33. Petitioners claimed an individual income tax deduction for additional first year depreciation on Line 47, "Other federal taxable income deductions," of Petitioners' Form D-400 for tax year 2007.

34. The amount claimed as an individual income tax deduction on Line 47 of Petitioners' Form D-400 for tax year 2007 is for additional first year depreciation previously added back to federal taxable income by a C corporation(s).

35. Petitioners made no additions on their 2002, 2003 and 2004 individual income tax returns for the additional first year depreciation deducted on Line 47 of Petitioners' Form D-400 for tax year 2007.

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 Conclusion of Law Number 1 of the ALJ's Decision.

1. The parties properly are before the Office of Administrative Hearings.

The Department rejects Conclusions of Law Numbers 2, 3, and 4 of the ALJ's Decision as the Department determines said Conclusions of Law to be erroneous as a matter of law. N.C. Gen. Stat. § 105-130.3 provides that C corporations are separately taxable entities on which income tax is imposed on the net income of the C corporation. N.C. Gen. Stat. § 105-130.5(a)(15) concerning additions to federal taxable income and N.C. Gen. Stat. § 105-130.5(b)(21) concerning deductions from federal taxable income apply only to C corporations.

N.C. Gen. Stat. § 105-131(a) provides that N.C. Gen. Stat. § 105-131 through N.C. Gen. Stat. § 105-131.8 may be cited as the S Corporation Income Tax Act. N.C. Gen. Stat. § 105-131(b)(7) defines "pro rata share" as "the share determined with respect to an S Corporation shareholder for a taxable period in the manner provided in section 1377(b)(1) of the Code." N.C. Gen. Stat. § 105-131(b)(8) provides that an "S Corporation" is a "corporation for which a valid election under section 1362(a) of the Code is in effect." N.C. Gen. Stat. § 105-131.1(a) provides

that unlike C corporations, an S corporation is not taxed as a separate tax entity at the corporate level. Rather, N.C. Gen. Stat. § 105-131.1(b) provides that an S corporation is a pass-through vehicle through which the income is passed through the business and reported at the individual income tax level by the shareholders. N.C. Gen. Stat. § 105-134.6(a) and N.C. Gen. Stat. § 105-134.6(b)(17) concerning adjustments to taxable income apply to the pro rata share of each individual shareholder of an S corporation.

Petitioners in the consolidated cases have stipulated that they made no additions on their 2002, 2003, or 2004 individual income tax returns under N.C. Gen. Stat. § 105-134.6(c)(8) for the additional first year depreciation for which they seek deductions under N.C. Gen. Stat. § 105-134.6(b)(17). See Stipulated Findings of Fact, §§ A.42-43, 45, 53-54 and 58-60; B.22-24 and 28-30; C.4-6; D.20-22, 28-30 and 33-35. N.C. Gen. Stat. § 105-134.6(b)(17) specifically provides that an individual taxpayer is only allowed to deduct “an amount equal to twenty percent (20%) of the amount *previously added to taxable income in a previous year*” as *bonus depreciation under N.C. Gen. Stat. § 105-134.6(c)(8)*. (Emphasis added). Thus, in order for an individual taxpayer to deduct additional first year depreciation, he must have *first* added it back to his federal taxable income. See N.C. Gen. Stat. § 105-134.6(b)(17).

That an individual taxpayer must have added the additional depreciation to his income before later being able to deduct the depreciation from his income is confirmed in various documents published by the Department. For example, the Department’s 2005-2006 Individual Income Tax Bulletin states that under N.C. Gen. Stat. § 105-134.6, federal taxable income must be decreased by an “amount equal to 20 percent of the total additional first-year depreciation *an individual added back* on the 2002, 2003, and 2004 State returns.” See Affidavit of Gail Beamon (“Beamon Aff.”) at Exhibit 8, p.19 (emphasis added); see also *id.* at Exhibit 9, 2007-2008 Individual Income Tax Bulletin, p. 19. As “in all tax cases, the construction placed upon the statute by the Secretary” in such documents is entitled to “due consideration by a reviewing court.” *Aronov v. Secretary of Revenue*, 323 N.C. 132, 140, 371 S.E.2d 468, 473 (1988); see also *Polaroid Corporation v. Offerman*, 349 N.C. 290, 303, 507 S.E.2d 284, 292 (1998) (recognizing that an interpretation of a statute by the Secretary of Revenue is “prima facie correct” and the failure of the General Assembly to amend a statute in light of such interpretation “demonstrates its implied acquiescence in the Secretary of Revenue’s interpretation.”)

Here, the deductions at issue were claimed by the Petitioners on their individual income tax returns and represent additional first year depreciation previously added back to federal taxable income by C corporations on their corporate income tax returns filed during tax years 2002, 2003, or 2004. Under the statutory scheme enacted by the General Assembly, the corporate taxpayers are the proper taxpayers entitled to the deductions under N.C. Gen. Stat. § 105-130.5(b)(21). See *Holly Farms Poultry Industries, Inc. v. Clayton*, 9 N.C. App. 345, 349, 176 S.E.2d 367, 370 (1970) (a “deduction may be taken only by the taxpayer to whom it accrues.”) Petitioners attempt to circumvent the requirements of N.C. Gen. Stat. § 105-134.6(b)(17) by relying on their status as shareholders in pass-through entities as a basis for claiming deductions belonging to corporate taxpayers. However, even as shareholders in pass-through entities, Petitioners must still bring themselves within the scope of N.C. Gen. Stat. § 105-134.6(b)(17) and (c)(8).

Deductions such as N.C. Gen. Stat. § 105-134.6(b)(17) are “privileges, not rights, and are allowed as a matter of legislative grace.” *Aronov*, 323 N.C. at 140, 371 S.E.2d at 472. Petitioners, as the parties “claiming the deduction must bring [themselves] within the statutory provisions authorizing it.” *Holly Farms*, 9 N.C. App. At 349, 176 S.E.2d at 370. Because Petitioners made no additions to their federal taxable income on their 2002 through 2004 individual income tax returns for the additional depreciation previously added back to federal taxable income by C corporations on their corporate income tax returns filed during the same period, Petitioners do not satisfy their burden. In order for individuals to properly claim a deduction for additional first year depreciation, the additional first year depreciation *must first be added back to the federal taxable income by the individual* under N.C. Gen. Stat. § 105-134.6(c)(8).

For the reasons set forth above, N.C. Gen. Stat. § 105-134.6(b)(17) does not authorize Petitioners to deduct additional first year depreciation previously added back to income by a C corporation under N.C. Gen. Stat. § 105-130.5(a)(15). I find that Conclusion of Law Number 2 as written in the Decision of the ALJ is erroneous as a matter of law. I have therefore rewritten Conclusion of Law Number 2 to read as follows:

2. N. C. Gen. Stat. § 105-134.6(b)(17) **does not authorizes individual** ~~the~~ shareholders of an S corporation to deduct ~~their pro-rata share of any~~ first year depreciation previously added back by **a C corporation** ~~the S corporation~~ under N.C. Gen. Stat. § 105-130.5(a)(15) ~~while such S corporation was taxed as a C corporation.~~

For the reasons set forth above, N.C. Gen. Stat. § 105-134.6(b)(17) does not authorize Petitioners to deduct additional first year depreciation previously added back to income by a C corporation under N.C. Gen. Stat. § 105-130.5(a)(15). I find that Conclusion of Law Number 3 as written in the Decision of the ALJ is erroneous as a matter of law. I have therefore rewritten Conclusion of Law Number 3 to read as follows:

3. Petitioners **improperly** claimed deductions under N.C. Gen. Stat. § 105-134.6(b)(17) on their respective North Carolina individual income tax returns for tax years 2005-2007 for additional first year depreciation previously added back on certain C corporation income tax returns under N.C. Gen. Stat. § 105-130.5(a)(15) for tax years 2002-2004 by C corporations ~~of which Petitioners were shareholders.~~

In Conclusion of Law No. 4, the ALJ concludes, in part, that Respondent’s interpretation does not “comport with the legislative intent to decouple from the federal bonus depreciation provisions by merely delaying the timing of the add-back deductions otherwise allowable.” Neither the ALJ’s Decision nor the record contain any facts to support this conclusion. Although both parties discussed at the July 8, 2010 hearing in this matter the backdrop against which many states enacted statutes similar to those at issue, this is not indicative of the legislative intent of the North Carolina General Assembly. (*See* Transcript of Hearing). Instead, the plain language of N.C. Gen. Stat. § 105-134.6(b)(17) reflects the intent of the legislature to allow an individual a deduction for only that additional first year depreciation previously added back to taxable income under N.C. Gen. Stat. § 105-134.6(c)(8).

In interpreting statutes, one must “first determine whether the statute is clear and unambiguous.” *Parkdale America, LLC v. Hinton*, _ N.C. App. _, 684 S.E.2d 458, 461 (2009). “When the meaning of the statute is clear, there is *no need for construction* and the clear intent of the Legislature must be given effect.” *In re Clayton Marcus*, 286 N.C. 215, 219, 210 S.E.2d 199, 202 (1974) (emphasis added). To do so, the “court applies the words [of the statute] in their plain and definite meaning.” *Parkdale*, _ N.C. App. At _, 684 S.E.2d at 461.

Here, the language of N.C. Gen. Stat. § 105-134.6(b)(17) is clear, unambiguous and plain on its face: for each of the first five taxable years beginning on or after 2005, an individual is allowed a deduction for an amount equal to “twenty percent (20%) of the amount *added to taxable income in a previous year*” as additional first year depreciation under N.C. Gen. Stat. § 105-134.6(c)(8). (Emphasis added). Thus, in determining legislative intent, this language must be given “primary consideration.” *Parkdale*, _ N.C. App. At _, 684 S.E.2d at 461. (“[t]he primary consideration in determining legislative intent is the words chosen by the legislature”).

As previously noted, Petitioners have stipulated that they made no additions to income on their 2002, 2003, or 2004 individual income tax returns under N.C. Gen. Stat. § 105-134.6(c)(8) for the additional first year depreciation for which they seek deductions under N.C. Gen. Stat. § 105-134.6(b)(17). Because Petitioners made no additions to their federal taxable income on their 2002 through 2004 individual income tax returns attributable to the additional first year depreciation at issue, they are not entitled to claim the deductions under the plain language of N.C. Gen. Stat. § 105-134.6(b)(17).

Pursuant to the reasons set forth above, I find that Conclusion of Law Number 4 as written in the Decision of the ALJ is not supported by either the stipulated findings of fact or the evidence contained in the record and is erroneous as a matter of law. I have therefore rewritten Conclusion of Law Number 4 to read as follows:

4. ~~Respondents’ literal interpretation of the word “taxpayer” in G.S. 105-134.6(b)(17) effectively denies the add-back deductions to an individual shareholder if the relevant depreciation previously was added back on a corporate return. The plain language of N.C. Gen. Stat. § 134.6(b)(17) reflects the intent of the legislature to allow an individual a deduction for only that additional first year depreciation previously added back to taxable income under N.C. Gen. Stat. § 134.6(c)(8). Respondent’s Such literal interpretation of this statute, as reflected in its Individual Income Tax Bulletins does not comport with the legislative intent to decouple from the federal bonus depreciation provisions by merely delaying the timing of add-back deductions otherwise allowable comports with the clear and unambiguous language of N.C. Gen. Stat. § 134.6(b)(17). Because Petitioners made no additions on their 2002 through 2004 individual income tax returns for the additional first year depreciation previously added back to federal taxable income by C corporations on their corporate tax returns, they are not entitled to deductions under N.C. Gen. Stat. § 105-134.6(b)(17) attributable to such additions. Construction of the relevant Chapter 105 revenue statutes shows the intent of the General Assembly to allow the pro-rata add-back deductions to both corporate taxpayers and individual taxpayers, including pass-through shareholders of S corporations. The Notices of Final Determination issued to Petitioners on October 12, 2009 were therefore proper in their entirety issued in error.~~

DECISION

For the reasons set forth herein, the Department hereby REVERSES the Decision of the ALJ in the above captioned consolidated cases and UPHOLDS the Notices of Final Determination (“Notices”) issued by the Respondent to the Petitioners on October 12, 2009 in their entirety. Accordingly, the Notices are sustained as to the tax, penalties, and interest shown due on the Notices, plus accrued interest until the tax is paid in full.

Tax, penalties, interest, and the rates interest accrues are as follows for the designated tax years:

[Amounts due are listed for Petitioner 1 and 2, Petitioner 3, and Petitioners 5 and 6.]

[Claim for refund of Petitioners 3 and 4 is denied.]

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. § 105-241.15 may commence such an appeal by filing a Petition for Judicial Review in the Superior Court of Wake County 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 Final Agency Decision. Before filing a petition for judicial review, a taxpayer must pay the amount of tax, penalties, and interest that this Final Agency Decision states is due. N.C. Gen. Stat. § 105-241.16.

Under N.C. Gen. Stat. § 150B-47, the Department is required to file the official record in the contested case under review, any exceptions, proposed findings of fact, or written arguments submitted to the Department, as well as the Department’s Final Agency Decision, with the reviewing court within 30 days of receipt of the Petition for Judicial Review. Consequently, a copy of the petition must be sent to the following address: North Carolina Department of Revenue, ATTN: Janice W. Davidson, 1429 Rock Quarry Road, Suite 105, Raleigh, North Carolina 27610, at the time the appeal is initiated to insure timely filing of the record.

This the 15th day of December, 2010.

NORTH CAROLINA DEPARTMENT OF REVENUE

/s/ Janice W. Davidson

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