State of North Carolina

INDIVIDUAL INCOME TAX BULLETINS

TAXABLE YEARS 2001 AND 2002

Issued by
North Carolina Department of Revenue
P.O. Box 25000, Raleigh, North Carolina 27640-0001

TAXPAYERS' BILL OF RIGHTS

The North Carolina Taxpayers' Bill of Rights explains your rights as a taxpayer.

This **Bill of Rights** is designed to provide you with information about:

- Protection of Privacy
- Examination of Returns
- Hearing & Appeals Process
- Revenue Collection Process
- Refund of Overpaid Tax
- Penalties & Interest
- Taxpayer Assistance

As a taxpayer, you are always entitled to fair, professional, prompt and courteous service. Our goal is to apply the tax laws consistently and fairly so that your rights are protected and to see that you pay only your fair share of North Carolina tax.

Protection of Privacy — It is your right to have information about your tax history, financial situation, assessments or reviews kept in strict confidence. Any return information, correspondence, or departmental discussions concerning your tax situation will be completely confidential. Employees or former employees who violate this confidentiality are subject to criminal prosecution which may result in dismissal plus fines.

Examinations — The Department of Revenue routinely examines returns to ensure that taxpayers comply with tax statutes. If we examine your return, we may ask you to provide information to verify figures on your return.

Examinations are done by mail or through personal interviews with auditors. You have the right to ask that the examination be held at a time and place convenient for you and the auditor.

You are entitled to a fair examination and an explanation of any changes we propose to your return. Examinations do not necessarily mean additional taxes. Your case could be closed without any changes or you could receive a refund.

Representation — During any examination, review or hearing, you may have an attorney, accountant or designated agent present. You can authorize another person to represent you if you execute a written power of attorney. If you wish, the Department will suspend the proceedings at any time to permit you to consult with your authorized representative.

You may make an audio recording of the proceedings at your own expense with your own equipment. The Department may also audio record the proceedings. If we do so, you can get a copy of the transcript for a nominal charge.

Appeals — You have the right to appeal the actions of the Department of Revenue if you do not agree with a proposed assessment or reduced refund. To appeal a tax notice, you must file a written request, either for a hearing or for a written statement of the information on which the notice is based. The request must be received by the Department within 30 days from the date of the notice. If you request a written statement about your notice, you will receive it within 45 days. You then have 30 days from the date the statement was mailed to file a written request for a hearing.

Hearings — The Secretary of Revenue will notify you of the time and place of an administrative tax hearing within 60 days after you request one and at least 10 days before the date set for the hearing. The hearing will be scheduled within 90 days of your request or at a later date mutually agreed upon by you and the Department. The date set for the hearing may be postponed once at your request and once at the Secretary's request.

All parties attending a hearing may present information and ask questions. Written decisions are mailed to taxpayers following hearings.

If you disagree with the findings of your hearing, you may:

- Petition the Tax Review Board for administrative review of the decision, or
- Pay the tax and sue to recover the amount paid.

To have an administrative review, you must file a *notice of intent to petition for review* with the Tax Review Board within 30 days of the hearing decision.

After filing the "notice of intent", **you must file a written statement** or **"petition" within 90 days** of the hearing decision explaining your objections to the decision.

If the Tax Review Board upholds the decision of the Secretary of Revenue, you have the right to appeal to the Superior court. *(The appeal information is a general description of your appeals rights and does not cover all situations)*

Collections — If the proposed assessment is upheld upon the conclusion of the appeals process, the assessment become final and collectible.

You are responsible for the full amount of tax you owe, but we will not take action to collect from you until you have had an opportunity to pay voluntarily. ***It is important that you respond promptly if we contact you for payment.***

If you do not pay, the Department of Revenue may garnish your wages, bank account or other funds, issue a tax warrant to your sheriff or record a certificate of tax liability against you.

If we believe that you owe tax and collecting that tax is in jeopardy, the Department can immediately assess and collect the tax. You are entitled to an administrative tax hearing on the jeopardy assessment. If you disagree with the findings of the hearing, you have the right to bring civil action in Superior Court.

Refund of Overpaid Tax — If you believe you have overpaid your taxes, you have the right to file a claim for refund.

Generally, you can apply for a refund of tax paid at any time within three years after the due date of the return or within six months of paying the tax, whichever is later.

If we select your claim for examination, you have the same rights you would have during an examination of your return.

Penalties & Interest — By law, the Department of Revenue is required to assess penalties for the following.

- Late Filing of Returns
- Late Payment of Tax
- Negligence
- Fraud
- Bad Checks/EFT Payments
- Underpayment of Estimated Tax

You have the right to request that penalties be waived if you show reasonable cause for the error or omission resulting in the penalties.

Interest accrues on unpaid taxes from the date the tax was due until the date it is paid. The law does not permit the Department to waive interest which accrues on unpaid taxes or bad check penalties.

PREFACE

This publication was prepared for the purpose of presenting the administrative interpretation and application of North Carolina income tax laws relating to individuals, partnerships, estates, and trusts in effect at the time of publication for income years beginning on and after January 1, 2001. It does not cover all phases of the law.

Taxpayers are cautioned that this publication is intended merely as a guide and that consideration must be given to all the facts and circumstances in applying these bulletins to particular situations. Taxpayers using this publication should be aware that additional changes may result from legislative action, court decisions, and rules adopted or amended under the Administrative Procedure Act, Chapter 150B of the General Statutes. In no case should these bulletins be relied upon for years other than the taxable years 2001 and 2002.

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650 copies of this publication were printed at a cost of
$788.32 or approximately $1.21 per copy.

IMPORTANT TELEPHONE NUMBERS

FORMS	(919)715-0397 from 8:00 a.m. to 5:00 p.m., Monday through Friday, except holidays.Touch-tone callers may order forms 24 hours a day, seven days a week. Forms can also be obtained from the Department's website which is shown below.
NC TAX TALK	(919)733-4TAX, 24 hours a day, seven days a week
REFUND INQUIRIES	(919)733-4682, 24 hours a day, seven days a week
QUESTIONS	(919)733-4684 from 8:00 a.m. to 5:00 p.m., Monday through Friday, except holidays
INTERNAL REVENUE SERVICE	1-800-829-1040 (Toll-free within North Carolina)
TAX FRAUD HOTLINE	1-800-232-4939 (733-6354 in Wake County) Toll-free from 8:00 a.m. to 5:00 p.m., Monday through Friday, except holidays.

DEPARTMENT OF REVENUE WEBSITE

www.dor.state.nc.us

I. Subject: Filing Individual Income Tax Returns

1. Forms

The individual income tax return, Form D-400 or Form D-400EZ, is available from the Department of Revenue in Raleigh or from any of the branch offices located throughout the State. The returns and other related schedules are also avaliable from the Department's website at **www.dor.state.nc.us**.

2. Electronic Tax Filing

The North Carolina Department of Revenue participates in the Federal/ State Electronic Filing Program. This program allows residents, nonresidents, and part-year residents to file their federal and State individual income tax returns in a single electronic transmission. Electronic filing is the fastest, safest and most accurate way to file income tax returns. Electronic filing is offered by a rapidly growing number of tax practitioners. A list of businesses that offer electronic filing is on the Department's website, **www.dor.state.nc.us**. The State return must be transmitted with the federal return and can be a refund, zero tax due or balance due return.

To participate in the Federal/State Electronic Filing Program, a tax practitioner must file Form 8633, Application to Participate in the Electronic Filing Program, with the Internal Revenue Service. Applicants must indicate on the form that they expect to transmit returns to the Internal Revenue Service Memphis Service Center. The IRS will provide to the Department of Revenue a list of federal electronic filers that have been accepted to file returns through the Memphis Service Center. A practitioner must use computer software that has been approved for electronic filing by the IRS and the Department of Revenue. The Department of Revenue maintains a list of approved software developers on its website.

The Department of Revenue also participates in the Federal/State On-Line Filing Program. A taxpayer with a personal computer and modem can file their federal and State returns electronically. The taxpayer must use the tax preparation software or an on-line service which allows the federal and State returns to be electronically filed. A list of on-line service providers is on the Department's website.

3. Items Requiring Special Attention

The individual taxpayer or his agent should give special attention to the following items when preparing an individual income tax return:

a. The Form D-400 or Form D-400EZ for the proper year should be used. For example, a 2001 form should be used by a taxpayer whose calendar year ends December 31, 2001. A taxpayer filing on a fiscal year basis whose fiscal year begins in 2001 should also use a 2001 form. Form D-400 must be used by taxpayers filing on a fiscal year basis.

b. The first name, middle initial, last name and the current mailing address of the taxpayer (taxpayers; if joint) should be plainly printed. Do not use the preaddressed label if any of the information is incorrect. Instead, print your name and address in the applicable boxes on the tax return. Do not use the name or address shown on a wage and tax statement if incorrect. Be sure to enter your social security number(s) even if the preaddressed label is used.

c. When filing an income tax return for an unmarried individual who died during the taxable year, enter the date of death in the applicable box.

d. When filing a separate return of a decedent who was married at the time of death, enter the date of death in the applicable box and enter the address of the surviving spouse or personal representative.

e. The taxpayer is required to furnish his social security number with the return. This number is necessary to verify the identity of the taxpayer, since the Department identifies taxpayers and credits returns and payments by social security number.

   Separate returns of spouses are often interrelated whether they are living together or apart; therefore, the taxpayer is asked to furnish the name and social security number of the spouse if they file on separate forms, but not if they are divorced. This information can save time, correspondence, and difficulty for the taxpayer and the Department.

f. The same filing status claimed on the federal income tax return must also be claimed on the North Carolina income tax return. However, if either the taxpayer or the taxpayer's spouse is a nonresident and had no North Carolina taxable income for the taxable year, the filing status **Married Filing Separately** must be claimed.

g. The tax must be computed accurately and any penalty and interest prescribed by statute should be added.

h. If an individual has moved into or out of North Carolina during the tax year or is a nonresident with income from sources within North Carolina, the section on page 4 of Form D-400, "Computation of North Carolina Taxable Income for Part-Year Residents and Nonresidents" must be completed. Credit for tax paid to another state is not allowed to an individual moving into or out of this state unless he has income derived from and taxed by another state or country while he is a resident of this State. (See Credit for Tax Paid to Another State or Country on page 54.)

i. If a tax credit is claimed for tax paid to another state or country, there must be attached to the return a true copy of the return filed with the other state or country and a cancelled check, receipt, or other proof of payment of tax.

j. Every return must be signed by the taxpayer or his or her authorized agent, and joint returns should be signed by both spouses. A refund may be delayed by an unsigned return.

k. Where tax has been withheld, the original or copy of the original State wage and tax statement that was received from an employer must be attached to the return. Wage and tax statements or 1099 statements generated by tax software programs cannot be used to verify North Carolina tax withheld.

l. Any additional information that will assist in the processing and auditing of a return should be indicated on the return or a worksheet or schedule attached to the return.

m. Anyone who is paid to prepare a return must sign the return in the space provided. When more than one person prepares a return, the preparer with primary responsibility for the overall accuracy of the return must sign as the preparer. The preparer must manually sign the prepared return. Preparers may use the practitioner ID number (PTIN) in lieu the their social security number.

4. Substitute Returns

Any facsimile or substitute form must be approved by the Department of Revenue prior to its use. The guidelines for producing substitute forms are available in the publication, "Requirements for the Approval of Substitute Tax Forms." The publication is available on the Department's Website, or it can be obtained by contacting the Department's forms coordinator. If you use computer generated returns, the software company is responsible for requesting and receiving an assigned barcode. The Department publishes a list of software developers who have received approval on our website. Photocopies of the return are not acceptable. Returns that cannot be processed by our imaging and scanning equipment may be returned to the taxpayer with instructions to refile on an acceptable form.

5. Federal Forms

A taxpayer must include a copy of his federal income tax return with his North Carolina return unless his federal return reflects a North Carolina address.

6. Extensions

If an income tax return cannot be filed by the due date, an individual may apply for an automatic six-month extension of time to file the return. To receive the extension, an individual must file Form D-410, Application for Extension for Filing Individual Income Tax Return, by the original due date of the return. A copy of the individual's federal extension is not acceptable. Partnerships, estates, or trusts must file Form D-410P, Application for Extension for Filing Partnership, Estate, or Trust Tax Return, to apply for an extension of time to file a return.

Although a taxpayer is not required to send a payment of the tax estimated to be due, it will be to the taxpayer's benefit to pay as much as

he can with the extension request. An extension of time for filing the return does not extend the time for paying the tax. If the tax due is not paid by the original due date, interest will be due on the unpaid amount. The 10 percent penalty will not be due if the taxpayer pays at least 90 percent of the tax liability through withholding, estimated tax payments, or with Form D-410 by the original due date.

A late filing penalty may be assessed if the return is filed after the due date (including extensions). The penalty is 5 percent per month ($5 minimum; 25 percent maximum) on the remaining tax due.

If the application for extension is not filed by the original due date of the return, the taxpayer is subject to both a late filing penalty and a late payment penalty. The penalties will also apply if the extension is not valid.

An application for extension is considered invalid if the amount entered on the extension form as the tax expected to be due is not properly estimated. In determining whether the amount reflected as tax due on the application is properly estimated, all facts and circumstances, including the amount of tax due in prior years, whether substantial underpayments have been made in other years, and whether an individual made a bona fide and reasonable attempt to locate, gather, and consult information, must be considered.

Individuals living outside the United States or Puerto Rico (including military personnel) are granted an automatic 2-month extension for filing a North Carolina income tax return if they attach a statement to the return showing that they were living outside the United States or Puerto Rico on the date the return was due. The time for payment of the tax is also extended; however, interest is due on any unpaid tax from the original due date of the return until the tax is paid. If an individual is unable to file the return within the automatic 2-month extension period, an additional 4-month extension may be obtained by following the provisions in the first paragraph of this section; however, Form D-410 must be filed by the automatic 2-month extended date of June 15.

A return may be filed at any time within the extension period but it must be filed before the end of the extension period to avoid the late filing penalty.

If the Internal Revenue Services authorizes an extension of time for federal tax-related deadlines for persons determined to be affected by a Presidentially declared disaster, North Carolina will grant a similar extension of time to file a return or report. For North Carolina income tax purposes, the extension of time does not abate the payment of interest.

7. Amended Returns

North Carolina individual income tax returns may be amended by filing an amended tax return, Form D-400X. Instructions for filing the amended return are provided on the reverse side of the form.

8. Tax Liability

If North Carolina taxable income is less than $68,000, the tax liability must be determined by using the Tax Table in the individual income tax instructions. If taxable income is $68,000 or more, use the Tax Rate Schedule below to compute the tax.

TAX RATE SCHEDULE

If your filing status is	And your taxable income is more than	But not over	The Tax is
Single	$ 0	$ 12,750	6% of the taxable income
	$ 12,750	$ 60,000	$765 + 7% of the amount over $12,750
	$ 60,000	$ 120,000	$4,072.50 + 7.75% of the amount over $60,000
	$ 120,000	----------	$8,722.50 + 8.25% of the amount over $120,000
Head of Household	$ 0	$ 17,000	6% of the taxable income
	$ 17,000	$ 80,000	$1,020 + 7% of the amount over $17,000
	$ 80,000	$ 160,000	$5,430 + 7.75% of the amount over $80,000
	$ 160,000	$ ----------	$11,630 + 8.25% of the amount over $160,000
Married filing Jointly or Qualifying Widow(er)	$ 0	$ 21,250	6% of the taxable income
	$ 21,250	$ 100,000	$1,275 + 7% of the amount over $21,250
	$ 100,000	$ 200,000	$6,787.50 + 7.75% of the amount over $100,000
	$ 200,000	----------	$14,537.50 + 8.25% of the amount over $200,000
Married filing Separately	$ 0	$ 10,625	6% of the taxable income
	$ 10,625	$ 50,000	$637.50 + 7% of the amount over $10,625
	$ 50,000	$ 100,000	$3,393.75 + 7.75% of the amount over $50,000
	$ 100,000	----------	$7,268.75 + 8.25% of the amount over $100,000

II. Subject: Filing Requirements (G.S. 105-152)

1. General

The minimum gross income filing requirements under North Carolina law are different from the filing requirements under the Internal Revenue Code because North Carolina law does not adjust the standard deduction and personal exemption for inflation as required by the Internal Revenue Code.

2. Individuals Required to File a North Carolina Individual Income Tax Return

The following individuals are required to file a North Carolina individual income tax return:

a. Every resident of North Carolina whose income for the taxable year equals or exceeds the amount for his filing status shown in Chart A or B which follows.

b. Every part-year resident who received income while a resident of North Carolina or who received income while a nonresident attributable to the ownership of any interest in real or tangible personal property in North Carolina or derived from a business, trade, profession, or occupation carried on in North Carolina and whose total income for the taxable year equals or exceeds the amount for his filing status shown in Chart A or B which follows.

c. Every nonresident who received income for the taxable year from North Carolina sources that was attributable to the ownership of any interest in real or tangible personal property in North Carolina or derived from a business, trade, profession, or occupation carried on in North Carolina and whose total income for the taxable year equals or exceeds the amount for his filing status shown in Chart A or B which follows.

3. Minimum Gross Income Filing Requirements

The minimum gross income filing requirements for most people are shown in Chart A, on the following page:

CHART A—FOR MOST TAXPAYERS

	Filing Status	A Return is Required if Federal Gross Income Exceeds For Year 2001	For Year 2002
(1)	Single	$ 5,500	$ 5,500
	Single (age 65 or older)	$ 6,250	$ 6,250
(2)	Married—Filing Joint Return	$ 10,000	$ 10,500
	Married—Filing Joint Return, (one age 65 or older)	$ 10,600	$ 11,100
	Married—Filing Joint Return, (both age 65 or older)	$ 11,200	$ 11,700
(3)	Married—Filing Separate Return	$ 2,500	$ 2,750
(4)	Head of Household	$ 6,900	$ 6,900
	Head of Household (age 65 or older)	$ 7,650	$ 7,650
(5)	Qualifying Widow(er) with dependent child	$ 7,500	$ 8,000
	Qualifying Widow(er) (age 65 or older)	$ 8,100	$ 8,600

If an individual was not required to file a federal income tax return but had gross income inside and outside North Carolina that equals or exceeds the amount for his filing status in Chart A, a federal return must be completed and attached to the North Carolina return to show how the negative federal taxable income was determined.

The minimum gross income filing requirements for children and other dependents are shown in Chart B on the following page. The filing requirements in Chart B generally are applicable to those individuals who can be claimed as a dependent by another person (such as a parent).

Note: **Earned income** is salaries, wages, tips, professional fees, and other amounts received as pay for work actually done.

Unearned income includes taxable interest, dividends, capital gains, pensions, annuities, and social security benefits. Distributions of interest, dividends, capital gains, and other unearned income from a trust are also unearned income to a beneficiary of the trust.

Chart B—FOR CHILDREN AND OTHER DEPENDENTS

Single dependents. Were you **either** age 65 or older **or** blind?

☐ **No.** You must file a return if **any** of the following apply to you.
- Unearned income was over $500
- Earned income was over $3,000
- The total of unearned and earned income was more than the **larger** of-
  - $500, or
  - Earned income (up to $2,750) plus $250

☐ **Yes.** You must file a return if **any** of the following apply to you.
- Earned income was over $3,750 ($4,500 if 65 or older **and** blind)
- Unearned income was over $1,250 ($2,000 if 65 or older **and** blind)
- Gross income was more than-

The larger of-	Plus	This amount:
• $500, **or** • Earned income (up to $2,750) plus $250		**$750 ($1,500 if 65** or older **and** blind)

Married dependents. Were you **either** age 65 or older **or** blind?

☐ **No.** You must file a return if **any** of the following apply to you.
- Gross income was at least $10 and your spouse files a separate return and itemizes deductions.
- Unearned income was over $500
- Earned income was over $2,500
- The total of your unearned and earned income was more than the **larger** of-
  - $500, or
  - Earned income (up to $2,250) plus $250

☐ **Yes.** You must file a return if **any** of the following apply.
- Earned income was over $3,100 ($3,700 if 65 or older **and** blind)
- Unearned income was over $1,100 ($1,700 if 65 or older **and** blind)
- Gross income was at least $10 and your spouse files a separate return and itemizes deductions
- Gross income was more than-

The larger of-	Plus	This amount:
• $500, **or** • Earned income (up to $2,250) plus $250		**$600 ($1,200 if 65** or older **and** blind)

Unearned income includes taxable interest, dividends, capital gains, pensions, annuities, and social security benefits. **Earned Income** includes salaries, wages, tips, professional fees, scholarships that must be included in income, and other compensation received for personal services.

4. Joint Returns (G.S. 105-152)

G.S. 105-152 requires that a husband and wife file a joint State return if:

a. They file a joint federal income tax return and

b. Both spouses are residents of North Carolina or both spouses had North Carolina taxable income.

All other individuals must file separate returns.

On joint returns, both spouses are jointly and severally liable for the tax due. However, if a spouse has been relieved of any liability for federal income tax under Internal Revenue Code Section 6015, that spouse would not be liable for the corresponding State income tax liability.

If an individual files a joint federal return but files a separate North Carolina return, he must complete a separate federal return and attach it to his North Carolina income tax return to show how his federal taxable income would be determined on a separate federal return. In lieu of completing a separate federal return, an individual may submit a schedule showing the computation of the separate federal taxable income. In this case, an individual must attach a copy of the joint federal return unless the federal return reflects a North Carolina address.

In determining the federal taxable income on the separate federal return, deductions are allowable only to the spouse responsible for payment of the item and who actually paid the amount during the tax year. In the case of a joint obligation, nonbusiness deductions, except for medical expenses, are allowable to the spouse who actually paid the item; or if a joint obligation is paid from a joint checking account, the deductions must be allocated between the spouses according to their respective adjusted gross income. In determining the amount of medical expenses paid by each spouse from a joint checking account, each spouse is considered to have paid his or her own medical expenses.

III. Subject: Computation of Taxable Income (G.S. 105-134.2 - G.S. 105-134.5)

1. General

The starting point in determining North Carolina taxable income is taxable income for federal income tax purposes, subject to the following additions, deductions and transitional adjustments which are required because of differences in the way State and federal law treated certain tax transactions prior to January 1, 1989. These adjustments do not apply to all individuals. Each individual should determine if any of the adjustments apply to his return.

2. Additions to Federal Taxable Income (G.S. 105-134.6)

Federal taxable income must be increased by the following additions to the extent the amounts are not included in federal taxable income:

a. Interest received upon obligations of states other than North Carolina and their political subdivisions;

   This addition includes that portion of an exempt interest dividend from a regulated investment company (mutual fund) that represents interest on direct obligations of states and their political subdivisions other than North Carolina. (See page 52 for additional information on regulated investment companies.)

b. Any amount allowed as a deduction from gross income that is taxed by a separate tax under the Internal Revenue Code. This includes lump-sum distributions from certain employees' retirement plans which a taxpayer may elect to exclude from taxable income in the regular tax computation and compute the tax separately using the favorable ten-year forward averaging rules;

c. State, local, and foreign income taxes deducted on the federal return;

d. The difference in the standard deduction for federal and State income tax purposes and the difference in the personal exemption for federal and State income tax purposes. These adjustments are necessary because the federal standard deduction amounts and personal exemption amounts will be adjusted each year, if necessary, for inflation. North Carolina does not have a similar provision.

The charts that follow show the North Carolina standard deduction for individuals who are not claimed as dependents by another taxpayer. The worksheet that follows is used to calculate the North Carolina standard deduction for individuals who can be claimed as dependents by another taxpayer.

Standard Deduction Chart for Most People

Do Not use this chart if you or your spouse were 65 or older or blind,
Or if someone can claim you as a dependent.

If your filing status is:	**your standard deduction is:** tax year 2001	tax year 2002
Single	$3,000	$3,000
Married filing jointly/Qualifying widow(er)	$5,000	$5,500
Married filing separately	$2,500	$2,750
Head of household	$4,400	$4,400

Standard Deduction Chart for People Age 65 or Older or Blind

If someone can claim you as a dependent, use the worksheet for dependents instead.

Check if: You were **65** or **Older** ☐ **Blind** ☐

Your spouse was **65** or **Older** ☐ **Blind** ☐

Enter the number of boxes checked above ☐

Note: If married filing separately, include the number of boxes checked for your spouse in the total number only if your spouse had no gross income and was not claimed as a dependent by another taxpayer.

If your filing status is:	**And the total number of boxes you have checked is:**	**Your standard deduction is:** for year 2001	for year 2002
Single	1	$3,750	$3,750
	2	$4,500	$4,500
Married filing jointly/ Qualifying widow(er)	1	$5,600	$6,100
	2	$6,200	$6,700
	3	$6,800	$7,300
	4	$7,400	$7,900
Married filing separately	1	$3,100	$3,350
	2	$3,700	$3,950
	3	$4,300	$4,550
	4	$4,900	$5,150
Head of household	1	$5,150	$5,150
	2	$5,900	$5,900

Standard Deduction Worksheet for Dependents

Use this worksheet **only** if someone can claim you as a dependent

1. Enter amount of earned income ➔ ______
   (Earned income defined below) + 250 Enter total ➔ 1. ______________
2. Minimum amount. 2. $500
3. Enter the larger of line 1 or line 2. .... 3. ______________
4. Enter on line 4 the amount shown for your filing status
   - Single, enter $3,000
   - Married filing jointly/
     Qualifying widow(er), enter $5,000 ($5,500 for tax year 2002)
   - Married filing separately, enter $2,500 ($2,750 for tax year 2002)
   - Head of household, enter $4,400 .... 4. ______________
5. Enter the smaller of lines 3 or 4. **(If under 65 and not blind, Stop Here** and enter this amount on the appropriate line of Form D-400 or Form D-400EZ. .... 5. ______________
6. a. Check if: You were **65** or **Older** ☐ **Blind** ☐
   Your spouse was **65** or **Older** ☐ **Blind** ☐

   b. Enter the number of boxes you have checked ☐
   Note: If married filing separately, include the number of boxes checked for your spouse in the total number checked only if your spouse had no gross income and was not claimed as a dependent by another taxpayer.

   c. Multiply $750 ($600 if married filing jointly or separately, or qualifying widow(er)) by the number of boxes you entered on line 6b above and enter the result .... 6c. ______________
7. Add lines 5 and 6c. Enter the total here and on the appropriate line of Form D-400 or Form D-400EZ .... 7. ______________

Earned income includes salaries, wages, tips, professional fees, and other compensation received for personal services you performed. It also includes any amount received as a scholarship that you must report in income.

The standard deduction is zero for a married individual filing separately for federal income tax purposes whose spouse claims itemized deductions.

The standard deduction for nonresident aliens and individuals filing a short year return due to a change of accounting period is zero.

The personal exemption for North Carolina purposes is $2,500 for a taxpayer whose federal adjusted gross income is less than the amount shown for his filing status in the chart that follows. For a taxpayer with federal adjusted gross income equal to or more than the threshold amount, the personal exemption is $2,000.

Filing Status	Adjusted Gross Income
Married filing jointly	$100,000
Head of household	$80,000
Single	$60,000
Married filing separately	$50,000

e. The market price of donated gleaned crops for which a tax credit was claimed on the North Carolina individual income tax return.

f. The amount of federal estate tax that is attributable to income in respect of a decedent and that is deducted under Section 691 (c) of the Internal Revenue Code.

g. The amount by which the basis of property for federal purposes exceeds the basis for State purposes upon disposition of the property.

h. The amount of net operating loss carried over to a taxable year to the extent the loss is not absorbed and will be carried forward to subsequent years.

3. Deductions from Federal Taxable Income (G.S. 105-134.6)

Federal taxable income must be decreased by the following deductions to the extent the amounts are included in federal taxable income:

a. Interest upon direct obligations of the United States or its possessions;

Interest earned from obligations that are merely backed or guaranteed by the United States Government will not qualify for deduction from an individual's income. The deduction from income will not apply to distributions which represent gain from the sale or other disposition of the securities, nor to interest paid in connection with repurchase agreements issued by banks and savings and loan associations. The deduction will not apply to any portion of a distribution from an individual retirement account (IRA).

The following are examples of interest on bonds, notes, or other obligations that must be deducted from federal taxable income, if such bonds, notes, or other obligations are direct obligations of:

1) Puerto Rico, the Virgin Islands and Guam
2) A Federal Land Bank
3) A Federal Home Loan Bank
4) A Federal Intermediate Bank
(5) Farm Home Administration
(6) Export-Import Bank of the United States
(7) Tennessee Valley Authority
(8) Banks for Cooperatives
(9) U.S. Treasury bonds, notes, bills, certificates and savings bonds
(10) Production Credit Association
(11) Student Loan Marketing Association

(12) Commodity Credit Corporation
(13) Federal Deposit Insurance Corporation
(14) A Federal Farm Credit Bank
(15) Federal Financing Bank
(16) Federal Savings and Loan Insurance Corporation
(17) General Insurance Fund
(18) United States Postal Service
(19) Resolution Funding Corporation
(20) Financing Corporation (chartered by the Federal Housing Finance Board — 12 USCS 12-1441)

b. Interest on bonds, notes, and other obligations of the State of North Carolina or any of its political subdivisions;

c. Interest on obligations and gain from the sale or disposition of obligations issued before July 1, 1995 if North Carolina law under which the obligations were issued specifically exempts the interest or gain (With respect to North Carolina obligations issued after July 1, 1995, the income tax treatment of gains from the sale or disposition of such obligations is the same for federal and State purposes.);

Examples:

(1) Interest on bonds, notes, debentures, or other evidence of the indebtedness issued under G.S. 131E-28 by the North Carolina Hospital Authorities, including gain from the sale or exchange of these obligations.

(2) Interest on bonds, notes, debentures, or other evidence of indebtedness issued by the North Carolina Medical Care Commission under the Health Care Facilities Finance Act under the provisions of G.S. 131A-21. Gain from the sale or exchange of these obligations may also be deducted.

(3) Interest and gain derived from obligations issued by the North Carolina Housing Finance Agency under G.S. 122A-19.

(4) Interest and gain on bonds issued by the North Carolina State Ports Authority under G.S. 143B-456(g).

(5) Interest on bonds, notes, debentures, and any other evidence of indebtedness issued by a North Carolina Housing Authority (including any corporate agent authorized by Article 1 of Chapter 157 of the General Statutes to exercise the powers of the authority) under the provisions of G.S. 157-26. Gain from the sale or exchange of these obligations is not deductible.

(6) Interest and gain derived from bonds issued under the Joint Municipal Electric Power and Energy Act under G.S. 159B-26.

(7) Interest on bonds issued by the authorities created under the Industrial and Pollution Control Facilities Financing Act, G.S. 159C-14.

(8) Income from securities, evidence of indebtedness, and shares of capital stock issued by a corporation organized to promote, develop, and advance the prosperity and economic welfare of the State of North Carolina under the provisions of G.S. 53A-15. Gain from the sale or exchange of such obligations is deductible.

(9) Income from bonds issued by boards of trustees of State supported colleges and universities in North Carolina including any gain from the sale or exchange of them under G.S. 116-183 and 116-196.

(10) Interest and gain received from bonds and notes issued under the provision of the Higher Education Facilities Finance Act by the North Carolina Educational Facilities Finance Agency under G.S. 115E-21.

(11) Interest and gain received on obligations issued under Chapter 122D (The North Carolina Agriculture Finance Act) by the North Carolina Agriculture Finance Authority under G.S. 122D-14.

d. Taxable portion of social security benefits received under Title II of the Social Security Act and any Tier I or Tier II Railroad Retirement benefits received under the Railroad Retirement Act of 1937;

e. An amount by which any federal income tax deduction is disallowed because of the allowance of a federal income tax credit for part or all of the expense comprising the deduction to the extent that a similar State income tax credit is not allowed;

Example: If an individual itemizes his deductions and claims the mortgage interest tax credit on his federal tax return because of participating in the mortgage credit certificate program (MCC), he may reduce his North Carolina taxable income by the amount the mortgage interest deduction was reduced due to claiming the mortgage interest credit on the federal tax return.

f. Refunds of state, local, and foreign income taxes;

g. Up to $4,000 in retirement benefits from one or more federal, state, or local government retirement plans (See IV. Bailey Settlement on page 23 to determine if more than $4,000 of government retirement benefits may be deducted.)

h. Up to $2,000 in retirement benefits from one or more private retirement plans; If an individual receives federal, state, or local government retirement benefits and also receives other qualified retirement benefits, the total deduction is limited to $4,000. For married couples filing a joint return, the maximum dollar amount of retirement benefits that may be deducted from federal taxable income applies separately to the benefits received by each spouse, so that the maximum deduction on a joint return is $8,000.

The $4,000 deduction is applicable to retirement benefits received from the governments of territories and possessions of the United States.

If an individual received retirement benefits during the year from one or more private retirement plans *other than* state, local, or federal government retirement plans, he may deduct the amount received or $2,000, *whichever is less*. Married individuals filing a joint return where both received such retirement benefits may each deduct up to $2,000 for a potential total deduction of $4,000.

"Retirement benefits" are amounts paid to a former employee or to a beneficiary of a former employee under a written retirement plan established by the employer to provide payments to an employee or beneficiary after the end of the employee's employment with the employer where the right to receive the payment is based upon the employment relationship. For self-employed individuals, retirement benefits are amounts paid to an individual, or beneficiary under a written retirement plan established by the individual to provide payments after self-employment ends. Retirement benefits also include amounts received from an individual retirement account or from an individual retirement annuity (IRA).

An individual is not required to have ceased employment to qualify for the $2,000 deduction for distributions from an individual retirement account or an individual retirement annuity.

The deduction for retirement benefits is allowed only to the extent the benefits are included in federal taxable income. If an individual elects to roll-over the distribution from his employer's plan or from his individual retirement account, no deduction is allowed since the amount rolled over is not included in taxable income.

A change in the structure of a corporate employer which causes a distribution to be paid to the employee from the employer's retirement plan does not entitle the employee to claim the deduction for retirement benefits from such distribution. For example, Company A is merged with Company B. An employee of A continues to work for the merged company. During the tax year, the employee received a distribution of $5,000 representing his total credit in the non-contributory retirement plan of Company A. The employee would not be entitled to the $2,000 deduction since he had not ceased employment.

Since short-term disability benefits from the Disability Income Plan of North Carolina administered for the benefit of North Carolina teachers and state employees are not paid to a former employee under a retirement plan after the end of the employee's employment, the benefits are not subject to the $4,000 deduction from federal taxable income. Long-term disability benefits are payable after the conclusion of the short-term disability period or after salary continuation payments cease, whichever is later. Recipients of

long-term disability benefits under the Disability Income Plan of North Carolina are former employees and they are entitled to the $4,000 deduction from federal taxable income.

Benefits paid to federal civil service employees who become disabled prior to becoming age 60 upon separation from service are paid to a former employee under a retirement plan after the end of the employee's employment and are subject to the $4,000 deduction from federal taxable income.

Survivors of a member of the armed forces who receive benefits from the Retired Serviceman's Family Protection Plan or the Survivor's Benefits Plan as the result of taking a reduction in retirement pay are subject to the deduction of up to $4,000 from federal taxable income.

i. The amount of North Carolina inheritance or estate tax paid that is attributable to an item of income in respect of a decedent;

   The deduction from federal taxable income is determined by multiplying the amount of North Carolina inheritance or estate tax paid on all property transferred to the particular beneficiary, less the North Carolina inheritance or estate tax which would have been paid if the item of income in respect of a decedent had not been included, by a fraction, the numerator of which is the income in respect of a decedent the beneficiary included in federal taxable income, as adjusted, and the denominator of which is the total income in respect of a decedent transferred to the beneficiary. The deduction is allowable in the year the item of income is included in federal taxable income.

j. Income earned or received by an enrolled member of a federally recognized Indian tribe if such income is derived from activities on a federally recognized Indian reservation while the member resided on the reservation. Intangible income having a situs on the reservation and retirement income associated with activities on the reservation are considered income derived from activities on the reservation;

k. Repayments of items of income included in gross income in a prior year under the claim-of-right doctrine for which the taxpayer reduces his tax under Section 1341 of the Internal Revenue Code in the year of repayment;

   For federal income tax purposes, if the repayment claimed under a claim of right is substantial (more than $3,000) and there is insufficient income in the later year to offset the deduction, an individual may claim a credit if the benefit received by claiming the credit is greater than that received by claiming a deduction for the repayment. A taxpayer who qualifies for the credit on the federal return is still entitled to the deduction for the amount repaid on the State return. He is also considered to have made a payment of North Carolina income tax on the repayment. The payment, which is applied against the tax liability for the year in which the repayment was made, is the amount the tax

was increased in the earlier year because the income was included in gross income minus the amount the tax for the current year was decreased because the repayment was deductible. Individuals may claim the payment on the individual income tax return by including the payment on the same line as S corporation payments.

Example: In 2000, a single taxpayer reported North Carolina taxable income of $25,000 on which he paid tax of $1,624. His only income was sales commissions. In 2001, it is determined that the commissions were erroneously computed for 2000. Accordingly, the taxpayer pays back $8,000 of the commissions. His North Carolina taxable income for 2001 without regard to the $8,000 repayment is $4,000. He qualifies for a credit on the federal return for the amount repaid. The tax payment to be claimed on the 2001 North Carolina return is determined as follows:

2000			
Tax on $25,000	=	$ 1,624	
Tax on $17,000 ($25,000-$8,000)	=	1,064	
			$ 560
2001			
Tax on $4,000	=	$ 242	
Tax after deducting $8,000 payment	=	0	
			$ 242
Payment to be claimed on the 2001 North Carolina return			$ 318

l. The amount by which the basis of property for State purposes exceeds the basis for federal purposes upon disposition of the property. The deduction can be claimed only in the year in which the property is disposed.

m. Up to $35,000 of any severance wages received as a result of a taxpayer's permanent, involuntary termination from employment through no fault of the employee is deductible from federal taxable income. The severance wages deducted as a result of the same termination may not exceed $35,000 for all taxable years in which the wages were received. "Stay on pay" does not qualify for the deduction.

n. Amounts distributed to a beneficiary of the Parental Savings Trust Fund of the State Education Assistance Authority unless the distribution is a refund of earnings described in section 529 of the Internal Revenue Code.

o. See IV. Bailey Settlement.

p. Interest, investment earnings, and gains of a trust established by two or more manufacturers that signed a settlement agreement with the State to settle claims for damages attributable to a product of the manufacturers.

q. The amount paid to an individual during the taxable year from the Hurricane Floyd Reserve Fund in the Office of State Budget, Planning, and Management for hurricane relief or assistance, but not including payments for goods or services provided by the taxpayer.

4. Transitional Adjustments (G.S. 105-134.7)

The following transitional adjustments are required because of differences in the way State and federal law treated certain tax transactions prior to January 1, 1989.

a. Amounts that were included in the basis of property under federal law but not under State law prior to January 1, 1989, must be added to taxable income in the year of disposition of the property. These adjustments include the increase in basis for federal gift tax paid on property received as a gift and in certain cases where the individual was permitted under federal law to capitalize certain expenditures for interest and taxes.

b. Amounts that were included in the basis of property under State law but not under federal law prior to January 1, 1989, must be deducted from an individual's taxable income in the year of disposition of the property. Deductions of this type include the increase in basis for State gift tax paid on property received as a gift and certain business expenditures that an individual elected to expense under Section 179 of the Internal Revenue Code but which were required to be capitalized for State income tax purposes.

c. A loss or deduction that was incurred or paid and deducted in full for North Carolina income tax purposes under prior State law in a taxable year beginning before January 1, 1989, but was carried forward and deducted from federal taxable income in a taxable year beginning on or after January 1, 1989, must be added to taxable income.

   Example: The full amount of a capital loss incurred in 1988 would have been deductible on an individual's 1988 State income tax return but on his federal income tax return the amount of the deductible loss would have been limited to his capital gains plus $3,000 ($1,500 if married and filing a separate return). Any remaining loss could be carried forward to subsequent tax years and deducted on his federal income tax return in computing his federal taxable income. In this instance, the individual must add back each year that portion of the 1988 loss deducted from his federal taxable income in arriving at the amount of his North Carolina taxable income.

   In determining the amount of a capital loss to add back, short-term capital losses from taxable years beginning prior to January 1, 1989, must be applied before applying short-term capital losses incurred in taxable years beginning on or after January 1, 1989, and before applying long-term capital losses from any year. Long-term capital losses from taxable years beginning prior to January 1, 1989, must be applied before applying long-term capital losses incurred in taxable years beginning on or after January 1, 1989.

   Example: An individual carries over $6,000 of capital losses from years beginning prior to January 1, 1989, consisting of $4,000 of short-term losses and $2,000 of long-term losses. In 1989, the

individual incurs additional capital losses of $2,500, consisting of $1,500 of short-term losses and $1,000 of long-term losses. The individual claims a capital loss deduction of $3,000 on his federal income tax return. In 1990 and 1991 the individual has no additional capital gains or losses and claims a $3,000 capital loss carry-over on his 1990 federal income tax return and the balance of $2,500 capital loss carry-over on his 1991 federal income tax return. The taxpayer would be required to add back the following amounts as transitional adjustments: 1989 — $3,000 (a portion of the short-term capital loss from 1988); 1990 — $1,500 consisting of the $1,000 balance of the 1988 short-term loss and $500 of the 1988 long-term loss; 1991 — $1,500 consisting of the remaining 1988 long-term loss carry-over.

Example: Generally, for federal income tax purposes for tax years beginning on or after January 1, 1987, to the extent that the total deductions from passive activities exceed the total income from such activities for the tax year, the excess (passive activity loss) is not allowed as a deduction for that year. A disallowed passive loss is allowed to be carried forward as a deduction from passive activity income in the next succeeding tax year. Generally, losses from passive activities may not be deducted from other types of income (e.g. wages, interest, or dividends). A passive activity is one that involves the conduct of any trade or business in which the taxpayer does not materially participate. Any rental activity is a passive activity regardless of whether the taxpayer materially participates. Special rules apply to rental activities. Under State law, a passive loss carried forward from a tax year beginning prior to January 1, 1989, must be added back to federal taxable income since the entire loss was deductible on the taxpayer's return for the year the loss was incurred.

d. Amounts deducted on an individual's federal income tax return as net operating losses brought forward from tax years beginning prior to January 1, 1989, must be added to federal taxable income. For tax years prior to January 1, 1989, State law allowed a net economic loss to be carried forward to subsequent years but was computed differently from the federal net operating loss. Prior State law did not permit the loss to be carried back to prior tax years as did federal law. See V. Net Operating Losses for additional information.

   Example: An individual sustains a business loss of $100,000 in 1988, had no other business income or business expenses for that year, and received interest income of $82,000 from City of Raleigh bonds during the taxable year. For federal income tax purposes, the individual would have sustained a net operating loss of $100,000. If the individual had no income in the prior three tax years to offset the net operating loss, he could carry the $100,000 loss forward for up to 15 years and deduct it as a net operating loss on

his subsequent federal income tax returns. Under prior State law, the individual would have incurred a net economic loss of $18,000 (business loss of $100,000 less nontaxable income of $82,000) that could be carried forward to up to five years after reducing it by both taxable and nontaxable income. In this situation, the individual must add back the net operating loss deduction claimed on his federal income tax return.

e. If an individual recovered all or any portion of his contributions to an annuity for State income tax purposes for taxable years beginning prior to January 1, 1989, but such amount was not recovered for federal income tax purposes, he must include a ratable portion of the difference in the cost previously recovered for North Carolina purposes and the amount previously recovered for federal purposes on the North Carolina return for each year beginning on or after January 1, 1989.

Example: Both the employee and the employer contributed to the cost of the employee's annuity and the employee will recover his contribution within three years from the annuity starting date. For tax years beginning prior to January 1, 1989, the employee was entitled under State law to recover his contributions to the annuity in full before being taxed on the benefits. The ratable portion to be added to federal taxable income is determined as follows:

$$\frac{\text{Amount recovered on State return} - \text{Amount recovered on federal return}}{\text{Remaining Years Life Expectancy}} = \text{Addition to Taxable Income}$$

If the cost recovered for federal income tax purposes for taxable years beginning prior to January 1, 1989, is greater than the cost recovered for State income tax purposes for years prior to 1989, the ratable portion to be deducted from federal taxable income is determined as follows:

$$\frac{\text{Amount recovered on federal return} - \text{Amount recovered on State return}}{\text{Remaining Years Life Expectancy}} = \text{Deduction from Taxable Income}$$

The amount of difference in the numerator of the fractions above should reflect the cost recovered during the taxpayer's period of residence in another state. In the denominator, the remaining years life expectancy to be entered is the life expectancy determined for federal income tax purposes for the year the annuity started less the number of tax years the annuity was reportable for federal tax purposes prior to January 1, 1989. The amount of the transitional adjustment computed for the tax year 1989 will remain the same for each year of the individual's remaining life expectancy.

This transitional adjustment does not apply to retirement annuities which were exempt under prior State law, including retirement annuities from the North Carolina Teachers' and State Employees' Retirement System and the North Carolina Local Government

Employees' Retirement System. Also, this transitional adjustment will not apply to retirement annuities received by former teachers and state employees of other states which were fully exempt from North Carolina income tax prior to January 1, 1989, because the other state had no income tax law or practiced reciprocity with North Carolina with respect to taxing such benefits.

The adjustment will apply to retirement annuities received by former teachers and state employees of other states which were not fully exempt because those states practice no reciprocity or only partial reciprocity with North Carolina with respect to such benefits for taxable years beginning prior to January 1, 1989. The amount of cost recovered on the North Carolina return prior to January 1, 1989, to be used in the formula for computing the addition to federal taxable income is to be computed without considering any benefits which were excluded as the result of partial reciprocity. (This adjustment applies to a retirement annuity from any federal retirement program. The adjustment is determined as of January 1, 1989, but will apply only to tax years beginning on or after January, 1, 1992.)

f. Adjustments must also be made in the taxable income of a shareholder of an S corporation. For a discussion of the tax status of distributions from S corporations to shareholders in tax years beginning on or after January 1, 1989, see VII. S Corporations.

g. When a parent elects to report his child's unearned income, the child is treated as having no gross income for the year and is not required to file a federal income tax return. A parent electing to report a child's unearned income for federal tax purposes must add to his federal taxable income the amount of the child's unearned income in excess of $500 but not exceeding $1,500.

h. Under the "tax benefit rule," the recovery of an amount deducted or credited in an earlier year is included in federal taxable income in the current (recovery) year, except to the extent the earlier year's deduction or credit did not reduce federal income tax imposed in that year. Income attributable to such recovery items which did not provide a tax benefit for federal income tax purposes but did provide a tax benefit for State purposes for taxable years beginning prior to January 1, 1989, must be added to federal taxable income.

Other additions and deductions to federal taxable income may be required to ensure that the transition to the tax changes effective January 1, 1989, does not result in the double taxation of income, the exemption of otherwise taxable income or double allowance of deductions.

IV. Subject: Bailey Settlement

As a result of the North Carolina Supreme Court's decision in Bailey v. State of North Carolina and the settlement subsequently reached in that case, North Carolina may not tax retirement benefits received by a retiree from qualifying State, local, or federal retirement systems if the retiree was vested in the retirement system as of August 12, 1989. For most government retirement systems, a person is vested if the person had five or more years of creditable service in a qualifying State, local or federal retirement system as of August 12, 1989. For certain retirement systems, the vesting period is less.

1. Qualifying State or Local Retirement System

The following retirement systems were designated as a North Carolina state or local governmental retirement system:

System	Law Creating the System
North Carolina Teachers' and State Employees' Retirement System (TSERS)	G.S. 135, Article 1
Optional Retirement Program available to administrators and faculty of the University of North Carolina system in lieu of TSERS	G.S. 105-135-5.1
North Carolina Local Governmental Employees' Retirement System	G.S. 128, Article 3
North Carolina Consolidated Judicial Retirement System	G.S. 135, Article 4
North Carolina Legislative Retirement System	G.S. 120, Article 1A
North Carolina Disability Income Plan (both short-term and long-term disability benefits)	G.S. 135, Article 6
North Carolina Supplemental Retirement Income Plan	G.S. 135, Article 5
North Carolina Supplemental Retirement Income Plan for State Law Enforcement Officers	G.S. 143-166.30(d)
North Carolina Deferred Compensation Plan	G.S. 143B, Article 9
North Carolina National Guard Pension Fund	G.S. 127A-40
North Carolina Sheriffs' Supplemental Pension Fund	G.S. 143, Article 12H
North Carolina Registers of Deeds' Supplemental Pension Fund	G.S. 161, Article 3
North Carolina Supplemental Retirement Plan for Local Governmental Law Enforcement Officers Separate Insurance Benefits Plan for State and Local	G.S. 143-166.50(e)
Governmental Law Enforcement Officers	G.S. 143-166.60
North Carolina Firemen's and Rescue Squad Workers' Pension Fund	G.S. 58, Article 86

Charlotte Firefighters’ Retirement System	Session Laws 1947, Chapter 926, § 6(c)
Firemen’s Supplemental Fund of Hickory	Session Laws 1971, Chapter 65
Winston-Salem Police Officers’ Retirement System	Session Laws 1939, Chapter 296
Separate Insurance Benefits Plan for State and Local Government Law Enforcement Officers	G. S. 143-166.60
New Hanover County School Employees’ Retirement Plan	1979 Session Laws, Chapter 1307

No local government optional contribution plans, similar to the State’s Supplemental Retirement Income Plan and Deferred Compensation Plan, were afforded tax exemption prior to August 12, 1989. Therefore, retirement benefits from local optional contribution plans are not subject to future tax exemption.

Teachers and other employees of North Carolina’s public schools have the option of contributing to optional contribution plans established pursuant to section 403(b) of the Code. Distributions from these plans may not be excluded from taxable income under the settlement.

2. Vesting Period for Qualifying State or Local Retirement Systems

The general rule is that a participant in a qualifying State or local retirement system is vested if the participant had five or more years of creditable service as of August 12, 1989. The general rule does not apply to qualifying optional contribution plans, however, or to certain other qualifying plans.

Participants in the State’s Supplemental Retirement Income Plan (Internal Revenue Code § 401(k)) or the State’s Deferred Compensation Plan (Code § 457) are vested in the plan as of August 12, 1989, if they contributed to the plan by August 12, 1989. If the participant contributed any money to a plan before August 12, 1989, all future withdrawals from that plan are excludable from tax. Contributions to one plan prior to August 12, 1989, do not qualify contributions to the other plan as vested. If a State employee began contributing to the §401(k) plan in June 1989, and to the §457 plan in October 1989, the employee is vested only in the §401(k) plan. Participants in the State’s Supplemental Retirement Income Plan or the State’s Deferred Compensation Plan may have chosen an annuity as an investment option. In some cases, they receive the annuity payments and the subsequent tax information statement from the annuity company instead of the plan administrator. These amounts also qualify for future tax exemption if the retiree was vested.

Participants in the North Carolina Firemen’s and Rescue Workers’ Pension Plan are vested as of August 12, 1989, only if the individual had both five years of service and had paid five years of contributions to the plan by August 12, 1989. Sheriffs receiving benefits from the North Carolina Sheriffs’ Supplemental Pension Fund and Registers of Deeds receiving benefits from the North Carolina Registers of Deeds’

Supplemental Pension Fund are vested as of August 12, 1989, only if the sheriff or the register of deeds (not a deputy or assistant) had five years of service as a sheriff or a register of deeds and five years of participation in the Local Government Employees' Retirement System (or equivalent local plan) by August 12, 1989.

An employee in a qualifying State or local government retirement system who was vested prior to August 12, 1989, and who leaves employment remains vested if the employee later returns to work, provided the employee did not withdraw his or her contributions to the retirement system. If the employee withdrew his or her contributions, the employee is no longer vested in the retirement system, even if the employee subsequently buys back the service time, unless the employee returned to employment in time to become vested again before August 12, 1989.

3. Qualifying Federal Retirement Systems

The following retirement systems were designated as a federal governmental retirement system:

- Federal Civil Service Retirement System
- Federal Employees' Retirement System
- Lighthouse Retirement System
- Thrift Savings Plan
- Foreign Service Retirement and Disability System and Pension System
- Military Retirement System
- Coast Guard Retirement System
- Central Intelligence Agency Retirement System
- Commissioned Corps of the Public Health Service Retirement System
- Comptrollers' General Retirement Plan
- Judicial Plans & Pay for Federal Judges Treated as Retirement Pay by Federal Law,including:
  - Judicial Retirement System
  - Judicial Survivors' Annuities System
  - Court of Federal Claims Judges' Retirement System
  - Court of Veterans Appeals Judges' Retirement Plan
  - Judicial Officers' Retirement System (for Bankruptcy Judges and Magistrates)
  - United States Tax Court Retirement Plan
  - United States Tax Court Survivors' Annuity Plan
  - Retirement Plans for District Court Judges for the Northern Mariana Islands, the Virgin Islands, and Guam
  - Court of Appeals for the Armed Forces Judges Retirement System
- National Oceanic and Atmospheric Administration Retirement System
- Tennessee Valley Authority Retirement System and TVA Savings and Deferral Retirement Plan
- Financial Institutions Retirement Fund (Office of Thrift Supervision Employees)
- Federal Home Loan Bank Board Retirement Systems
- Federal Home Loan Mortgage Corporation Plan
- Federal Reserve Employees Retirement Plans and Thrift Plan
- Nonappropriated fund plans, including:
  - Retirement Annuity Plan for Employees of Army and Air Force Exchange Service
  - Supplemental Deferred Compensation Plan for Members of the Executive Management Program (Army and Air Force Exchange Service)
  - Nonappropriated Fund Retirement Plan for Civilian Employees
  - United States Army Nonappropriated Fund Retirement Plan
  - Retirement Plan for Civilian Employees of United States Marine Corps Morale, Welfare, and Recreation Activities and Miscellaneous Nonappropriated Fund Instrumentalities
  - Navy Exchange Service Command Retirement Plan
  - Navy Nonappropriated Fund Retirement Plan for Employees of Civilian Morale, Welfare, and Recreation Activities
  - Norfolk Naval Shipyard Pension Plan
  - Retirement Savings Plan and Trust for Employees of the Army and Air Force Exchange Service
  - Coast Guard Nonappropriated Fund Retirement Plan

- District of Columbia Police Officers and Fire Fighters' Retirement Fund and Related Funds (including payments to Secret Service and U.S. Park Police covered by the Fund)
- District of Columbia Teachers' Retirement Fund and Related Funds
- District of Columbia Judges'Retirement Fund and Related Funds
- Uniformed Services University of the Health Sciences Plan
- Smithsonian Institution Defined Contribution Retirement Plan
- USDA Graduate School Plan

4. Vesting Period for Qualifying Federal Retirement Systems

Generally, participants in the qualifying federal retirement systems listed above, including military retirees, are vested for purposes of the settlement if they had five or more years of creditable service as of August 12, 1989. The general rule, however, does not apply to the Thrift Savings Plan.

The Thrift Savings Plan has both an employee and an employer component. The employee component is similar to the State's § 401(k) and § 457 plans and allows the employee to voluntarily contribute to the Plan. The employee is vested in the employee component if the employee first made a contribution to the plan prior to August 12, 1989. The employer component includes both contributions by the employer of a fixed percentage of the employee's salary and contributions by the employer that match the employee's voluntary contributions. The employee is also vested in the employer matching contributions if the employer first made a matching contribution prior to August 12, 1989. An employee is vested in the employer fixed component only if the employee had three years of service (two years of service for certain highly ranked employees) as of August 12, 1989. One exception to the three-year rule is that an employee who died prior to completing the mandatory three years is still considered vested if the date of death was on or before August 12, 1989.

As explained above, it is possible for a participant in the Federal Thrift Savings Plan to be vested as of August 12, 1989, in some components of the plan while at the same time not being vested in other components. The annual tax information statement (Form 1099-R) does not distinguish between the various components when reporting the amount distributed during the year; therefore, the recipient cannot readily determine the amount to exclude from North Carolina income tax. When a participant in the plan ceases employment, the recipient is provided a Form TSP-8, Thrift Savings Plan Participant Statement, that identifies the cash balances in the various components. To determine the proper amount to exclude, the recipient should multiply the annual distribution by a fraction, the numerator of which is the balance of the components in which the recipient is vested as of August 12, 1989. The denominator of the fraction is the total cash balance of all components. That same fraction will be used for each year the recipient receives distributions from the plan.

5. Benefits from Other Retirement Plans

Retirees receiving benefits from government retirement plans of other states or territories were not class members in *Bailey* and are not entitled to recovery of taxes paid in earlier years or to tax exemption in future years, except for the $4,000 deduction provided by G.S. 105-134.6(b)(6). Private retirement benefits remain taxable except for the $2,000 deduction.

V. Subject: Net Operating Losses (G.S. 105-134.7)

Prior to 1989, North Carolina law provided a measure of relief to individual income taxpayers who incurred economic misfortune by allowing losses qualifying as net economic losses as defined by G.S. 105-147(9)(d)(2) to be carried forward and deducted from future gross income. With the adoption of federal taxable income as the starting point in determining North Carolina taxable income in 1989, net operating losses were recognized for State individual income tax purposes. The primary differences between net operating losses and net economic losses are (1) nontaxable income is used to reduce the amount of a net economic loss but is not used to reduce the amount of net operating loss, and (2) net economic losses can only be carried forward while net operating losses can be carried back and/or forward.

1. Determining Net Operating Losses

Since federal taxable income is the starting point for determining North Carolina taxable income, the amount of net operating loss determined for federal income tax purposes is also the net operating loss for State income tax purposes. Although adjustments to federal taxable income may be required which cause North Carolina taxable income to be different than federal taxable income in the year the loss is incurred, the law does not require or permit a separate calculation of a net operating loss for State purposes. The amount of net operating loss is the same for State and federal purposes. However, a nonresident or part-year resident must make an additional calculation to determine the portion of the total net operating loss that is from North Carolina sources.

2. Net Operating Loss Carryovers

a. Since federal taxable income is the starting point for determining North Carolina taxable income, the amount of net operating loss carried over and absorbed for federal purposes is the same amount carried over and deducted for State purposes. "Absorbed" means the amount of net operating loss carried to a year less the amount of net operating loss carried forward from that year. If, in the year to which the loss is carried, adjustments are required to the State return which result in the taxpayer not receiving full benefit of the carryover, no additional carryover of the portion of the loss not resulting in a benefit is permitted.

b. For any year in which a net operating loss is carried over but not completely absorbed for federal purposes, an addition to federal taxable income is required on the State return for the amount of net operating loss carried forward from that year.

> *Example:* A taxpayer incurs a net operating loss of $75,000 in 2001. The taxpayer amends his 1999 federal return to carry back the net operating loss and deducts the entire loss in arriving at federal taxable income. Only $50,000 of the loss is absorbed and $25,000 is carried forward to the 2000

federal return. To determine North Carolina taxable income, the taxpayer must make an addition to federal taxable income, as amended, of $25,000 on his amended 1999 State return.

c. Because North Carolina did not recognize net operating losses before 1989, a taxpayer may not carry forward a loss incurred prior to 1989. G.S. 105-134.7(a)(6) requires an addition to federal taxable income for the amount of net operating loss carried forward from a tax year prior to 1989 and deducted in arriving at federal taxable income.

3. Effect of Residency Status on Net Operating Losses

As stated earlier, the amount of net operating loss carried over and absorbed for federal tax purposes is also the amount carried over and deducted for State tax purposes. If the taxpayer is a nonresident or a part-year resident in the year the net operating loss is incurred and a resident in the year to which the loss is carried, the taxpayer receives the full benefit of the deduction, regardless of whether the net operating loss resulted from North Carolina-source activities. If the taxpayer is a resident in the year the net operating loss is incurred and a nonresident or part-year resident in the year to which the loss is carried, the taxpayer may subtract the entire portion of the net operating loss carried over and absorbed for federal purposes that year from North Carolina-source income in the numerator of the fraction used to calculate North Carolina taxable income for nonresidents and part-year residents. If the taxpayer is a nonresident or a part-year resident in both the year the net operating loss is incurred and the year to which the loss is carried, the taxpayer must determine the portion of the net operating loss that was from North Carolina sources. The North Carolina-source portion of the net operating loss is apportioned to all years to which the total net operating loss is carried. The numerator of the fraction is reduced by the attributable portion of the North Carolina-source net operating loss while the denominator is reduced by the portion of the total net operating loss carried over and absorbed in that year for federal purposes.

Example: A nonresident taxpayer incurs a net operating loss of $10,000 in 2001, $7,000 of which is from North Carolina sources. The portion of his net operating loss that is from North Carolina sources is .70 ($7,000 divided by $10,000). If the taxpayer carries the loss back to 1999 and deducts $4,000 in that year, the portion of that loss deemed to be from North Carolina sources and subtracted in determining the numerator of the fraction is $2,800 ($4,000 multiplied by .70). The denominator is reduced by the entire $4,000.

The apportionment of the North Carolina-source net operating loss to all years to which the total net operating loss is carried occurs even if the taxpayer has no other North Carolina-source income in those years to apply the net operating loss against.

4. Claiming a Net Operating Loss

a. Carrying back a net operating loss. – For federal tax purposes, a taxpayer carrying back a net operating loss may use Federal Form 1040X or, if a refund is due, Federal Form 1045. North Carolina does not have a form similar to Federal Form 1045; therefore, the taxpayer must use Form D-400X to carry back the loss. A copy of Federal Form 1045, including Schedule A, must be provided for each year to which the loss is carried back. For any year in which the loss is carried back but not completely absorbed, a copy of Schedule B of Federal Form 1045 must also be provided. In lieu of Federal Form 1045, a worksheet containing the same information as Federal Form 1045 is acceptable.

b. Carrying a net operating loss forward. – For federal tax purposes, a taxpayer carrying a net operating loss forward reports the loss as “Other Income” on the federal return. A copy of Federal Form 1045, Schedule A, or similar worksheet identifying the year in which the net operating loss was incurred and showing how the net operating loss was calculated must be attached to each State return to which the loss is carried forward. For any year in which the loss is carried forward but not completely absorbed, a copy of the Worksheet for NOL Carryover included in Federal Publication 536 or a similar worksheet must also be provided.

c. Nonresidents and part-year residents. – A taxpayer who is a nonresident or part-year resident in the year to which a net operating loss is carried over must include a schedule showing the calculation of the amount subtracted in arriving at the numerator of the fraction used to determine North Carolina taxable income.

5. Statute of Limitations

For both State and federal tax purposes, the period of time in which a taxpayer may claim a refund resulting from the carryback of a net operating loss is extended beyond the general period of limitations for claiming a refund. The period of time for claiming a refund from the carryback of a net operating loss expires three years after the date the return is due, including extensions, for the year in which the loss is incurred, not the year to which the loss is carried. For example, a calendar year taxpayer who incurs a net operating loss in tax year 2001 and files his 2001 return by April 15, 2002, has until April 15, 2005 to file a claim for refund of taxes paid for the tax year 1999 because of the carryback of the net operating loss.

6. Calculation of Interest on Overpayments

Interest accrues on an overpayment of individual income tax from a date 45 days after the latest of the following dates: (1) the date the final return is filed; (2) the date the final return is due to be filed; or (3) the date of the overpayment, until the refund is paid. An overpayment resulting from the carryback of a net operating loss is considered to have occurred

on the date the income tax return for the year in which the loss was incurred is filed or due to be filed, whichever is the later. Therefore, no interest accrues on the overpayment if refunded within 45 days of the date the tax return for the loss year is filed.

VI. Subject: Nonresidents and Part-Year Residents (G.S. 105-134.5(b)(c)(d))

1. Definition of Resident

G.S. 105-134.1(12) defines a resident as "an individual who is domiciled in this State at any time during the taxable year or who resides in this State during the taxable year for other than a temporary or transitory purpose."

Domicile is the place where an individual has a true, fixed permanent home and principal establishment, and to which place, whenever he is absent, he has the intention of returning. There are other definitions of domicile, and this definition is presented solely to be used as a guide in determining residency.

If an individual lives in North Carolina for more than 183 days of a tax year, he is presumed to be a resident for income tax purposes in the absence of factual proof to the contrary; but the absence of an individual from the State for more than 183 days raises no presumption that he is not a resident. The fact of marriage does not raise any presumption as to domicile or residence.

In many cases, a determination must be made as to when or whether a domicile has been abandoned. A long standing principle in tax administration, repeatedly upheld by the courts, is that a man can have but one domicile; and, once established, it is not legally abandoned until a new one is established. A taxpayer may have several places of abode in a year, but at no time can an individual have more than one domicile. A mere intent or desire to make a change in domicile is not enough; voluntary and positive action must be taken.

Listed below are some of the tests or factors to be considered in determining the legal residence of an individual for income tax purposes. Some factors are more important than others, and fulfilling a few does not necessarily mean a change in domicile has occurred. As implied by the list of factors below, an individual's legal state of residence is reflected more by the routine events of life than events such as voting or getting a driver's license which may occur every four or five years.

1. Ownership of home; insuring home as primary residence.
2. Place of birth of taxpayer, spouse and children; permanent residence of father.
3. Employment post of duty; business ventures, self-employment.
4. Payment of state income taxes (one of the best indicators of residency).
5. Family connections, close friends.
6. Civic ties; church, club or lodge membership.
7. Professional ties--state bar, CPA, teacher's certificate, etc.
8. Address on monthly statements for credit cards, utilities, bank accounts, loans, insurance, or anything requiring a response, such as paying bills.
9. Attendance by taxpayer, his spouse or children at State supported

colleges or universities on in-state tuition.

10. Location of healthcare providers (doctors, dentists, veterinarian, pharmacies, etc.)
11. Everyday "hometown" living, including grocery shopping, haircuts, video rentals, dry cleaning, pizza delivery, season tickets, fueling vehicles, ATM transactions, etc.
12. Subscription address for newspaper, magazines, trade publications, etc.
13. Location of pets.
14. Driver's license and automobile registrations; address on vehicle insurance policies.
15. Voter registration and ballots cast (in person or absentee).
16. Address used for federal tax returns, military purposes, passport, etc.
17. Utility usage, including electricity, gas, telephone, cable television, etc.
18. Deferring taxation on gain from sale of main home.
19. Occasional visits or spending one's leave time "at home" if a member of the armed services.

Listed below are some of the events indicating when residency changed:

1. Selling old house/buying new one.
2. Directing U.S. Postal Service to forward mail.
3. Picking up or forwarding family medical records.
4. Notifying senders of statements, bills, or subscriptions of new address.
5. Obtaining new local utilities, subscriptions, etc./discontinuing old.
6. Transferring vehicle titles.
7. Transferring memberships for church, health club, lodge, etc.
8. Applying for new state certifications, joining new bar, etc.

A legal resident of North Carolina serving in the United States Armed Forces is liable for North Carolina income tax and North Carolina income tax should be withheld from his military pay whether he is stationed in this State or in some other state or country.

An individual who enters military service while a resident of North Carolina is presumed to be a resident of this State for income tax purposes. Residency in this State is not abandoned until a definite residence is established elsewhere.

To change residency, the serviceman must not only be present in the new location with the intention of making it his domicile, but must also factually establish that he has done so.

2. Nonresidents

The term "nonresident" includes an individual:

a. Who resides in North Carolina for a temporary or transitory purpose and is, in fact, a domiciliary resident of another state or country; or

b. Who does not reside in North Carolina but has income from sources within North Carolina and is, in fact, a domiciliary resident of another state or country.

   Under the Soldiers' and Sailors' Civil Relief Act, a member of the Armed Services who is a legal resident of another state stationed in North Carolina by virtue of military orders, is not subject to North Carolina income tax on his service pay but other income from employment, a business, or tangible property in North Carolina is subject to North Carolina income tax.

   There is no presumption as to the residence of a spouse of a member of the armed forces because of marriage. Legal residence will be determined based on the facts in each case.

3. Part-Year Residents

An individual who moves his domicile (legal residence) into or out of North Carolina during the tax year, is a part-year resident.

4. Taxable Income of Nonresidents and Part-Year Residents

Nonresidents and part-year residents are required to prorate their federal taxable income to determine the portion that is subject to North Carolina tax.

The taxable income of a nonresident subject to North Carolina income tax is determined by multiplying federal taxable income, as adjusted, by the percentage obtained when dividing the portion of federal gross income, as adjusted, derived from North Carolina sources, by the total gross income from the applicable line of the federal return, as adjusted.

The taxable income of a part-year resident subject to North Carolina tax is determined by multiplying the total federal taxable income as calculated under the Internal Revenue Code, as adjusted, by the percentage obtained when dividing the portion of total federal gross income received from all sources during the period the individual was a resident of North Carolina, plus any gross income received from North Carolina sources while a nonresident, by the total federal gross income, as adjusted.

If an individual files a joint federal income tax return with his spouse but cannot qualify to file a joint North Carolina income tax return because his spouse is a nonresident and had no North Carolina taxable income, he must calculate his federal taxable income on a federal income tax form as a married person filing a separate federal income tax return and attach it to his North Carolina return to show how his separate federal taxable income was determined. The individual filing the separate federal return should report only his income, exemptions, and deductions. In lieu of making the calculation on a federal form, an individual may submit a schedule showing the computation of his separate federal taxable income. In this case, an individual must attach a copy of the joint federal return unless the federal return reflects a North Carolina address.

If an individual has income from sources within another state or country while a resident of North Carolina and the other state or country taxes

the individual on such income, he may be eligible to claim a tax credit on the North Carolina income tax return.

A nonresident is not entitled to the tax credit for tax paid another state or country.

5. Nonresident Members of Professional Athletic Teams

The North Carolina source income of a nonresident individual who is a member of a professional athletic team is determined by multiplying the individual's total compensation for services rendered as a member of a professional athletic team during the taxable year by a fraction, the numerator of which is the number of duty days spent in North Carolina rendering services for the team in any manner during the taxable year. The denominator is the total number of duty days spent both within and without North Carolina during the taxable year.

Travel days that do not involve either a game, practice, team meeting, promotional caravan or other similar team event are not considered duty days spent in North Carolina. However, such travel days are considered duty days spent within and without North Carolina.

In determining the North Carolina source income of a nonresident member of a professional athletic team, the following definitions apply:

a. The term "professional athletic team" includes, but is not limited to, any professional baseball, basketball, football, soccer or hockey team.

b. The term "member of a professional athletic team" includes those employees who are active players, players on the disabled list and any other persons required to travel and who do travel with and perform services on behalf of a professional athletic team on a regular basis. This includes, but is not limited to, coaches, managers and trainers.

c. The term "duty days" means all days during the taxable year from the beginning of the professional athletic team's official preseason training period through the last game in which the team competes or is scheduled to compete.

   Duty days also include days on which a member of a professional athletic team renders a service for a team on a date which does not fall within the aforementioned period. Such services include participation in instructional leagues, the "Pro Bowl" or promotional caravans. This includes days during the member's off-season where the member conducts training activities at the facilities of the team.

   Duty days include game days, practice days, days spent at team meetings, promotional caravans and preseason training camps, and days served with the team through all post-season games in which the team competes or is scheduled to compete.

   Duty days for any person who joins a team during the season begins on the day the person joins the team, and for any person

who leaves a team ends on the day the person leaves the team. Where a person switches teams during the taxable year, a separate duty day calculation will be made for the period the person was with each team.

Days for which a member of a professional athletic team is not compensated and is not rendering services for the team in any manner, including days when the person has been suspended without pay and prohibited from performing any services for the team, are not treated as duty days.

Days for which a player is on the disabled list are presumed not to be duty days spent in North Carolina. However, such days are considered to be included in total duty days spent within and without North Carolina.

d. The term "total compensation for services rendered as a member of a professional athletic team" means the total compensation received during the taxable year for services rendered:

(1) from the beginning of the official preseason training period through the last game in which the team competes or is scheduled to compete during that taxable year; and

(2) for an event during the taxable year which occurs on a date which does not fall within the aforementioned period such as participation in instructional leagues, the "Pro Bowl" or promotional "caravans."

Such compensation includes, but is not limited to, salaries, wages, bonuses, and any other type of compensation paid during the taxable year for services performed in that year. Such compensation does not include strike benefits, severance pay, termination pay, contract or option year buy-out payments, expansion or relocation payments, or any other payments not related to services rendered to the team.

e. "Bonuses" are included in "total compensation for services rendered as a member of a professional athletic team" and subject to allocation if they are:

(1) earned as a result of play, such as performance bonuses, during the season, including bonuses paid for championship, play-off or "bowl" games played by a team, or for selection to all-star league or other honorary positions; and

(2) paid for signing a contract, unless all of the following conditions are met:

a. the payment of the signing bonus is not conditional upon the signee playing any games for the team, or performing any subsequent services for the team, or even making the team;

b. the signing bonus is payable separately from the salary and any other compensation; and

c. the signing bonus in nonrefundable.

Where the method for determining North Carolina source income does not fairly and equitable apportion and allocate the compensation of a nonresident member of a professional athletic team for services rendered in North Carolina, the Secretary of Revenue may require the person to apportion and allocate the compensation under another method prescribed by the Secretary as long as the prescribed method results in a fair and equitable apportionment and allocation. A nonresident member of a professional athletic team may submit a proposal for an alternative method to apportion and allocate the compensation, demonstrating that the method provided under this section does not fairly and equitably apportion and allocate the compensation. If approved, the proposed method must be fully explained in the North Carolina income tax return filed by the nonresident member.

See page 90 for the withholding requirements of professional athletic teams.

VII. Subject: S Corporations (G.S. 105-131 - G.S. 105-131.8)

1. Reporting Income - In General

An individual shareholder of an S corporation is required to take into account his pro rata share of an S corporation's net income in the manner provided under Section 1366 of the Internal Revenue Code subject to certain adjustments.

2. Resident Shareholders

Since 100 percent of the S corporation's income is included in the federal taxable income starting point, no adjustment because of doing business outside of North Carolina is required by a resident.

3. Nonresident Shareholders

A nonresident shareholder of an S corporation takes into account only his share of the S corporation's income attributable to North Carolina in the numerator of the fraction in determining that portion of federal taxable income that is taxable to North Carolina. If an S corporation does business in North Carolina and one or more other states, the income attributable to North Carolina is determined by the same apportionment formula as used for other corporations.

All nonresident shareholders must include an agreement with the first S corporation return filed with North Carolina agreeing to be liable and subject to the laws of North Carolina for individual income tax purposes; otherwise, the S corporation becomes liable for the tax on the income attributable to such nonresident shareholders at the rate for single individuals.

A nonresident shareholder in an S corporation may claim the proportionate share of the tax paid on his behalf by the S corporation to North Carolina on his share of the S corporation income.

4. Tax Credits

If part of the S corporation's income is earned within and taxed by another state or country, either to the individual or to the corporation, a resident shareholder is entitled to a tax credit on his individual income tax return for his share of the tax paid to the other state or country. A shareholder claiming the tax credit must attach a schedule to his income tax return reflecting the total amount of tax paid to the other state or country by the S corporation, and explaining how his pro rata share of the tax was determined. A separate tax credit must be calculated for each state or country to which the S corporation paid tax. Nonresident shareholders are not allowed credit for tax paid to another state or country.

5. Basis in Stock

Due to different tax treatment of an S corporation's income for State and federal purposes for taxable years beginning before January 1, 1989, a shareholder's basis in the stock of an S corporation for State tax purposes may be different than for federal tax purposes; thereby causing transitional adjustments in determining North Carolina taxable income

upon receipt by the shareholder of distributions from the S corporation and upon disposition of the S corporation stock.

The initial basis of the stock in an S corporation to a nonresident of North Carolina is zero, and the nonresident shareholder is not taxed on distributions from the corporation and recognizes no income or loss upon disposition of the stock. A nonresident shareholder's basis in the S corporation stock is adjusted for his pro rata share of the income or loss of the corporation.

A resident shareholder's initial basis in the stock of an S corporation is determined as of the later of the date the stock is acquired, the effective date of the S corporation election, or the date the shareholder became a resident of North Carolina. A resident shareholder's basis in the stock is increased by his pro rata share of the corporation's income adjusted pursuant to G.S. 105-131.2 except for income exempt from federal or State income taxes and deductions for depletion in excess of the basis of the property being depleted. The basis is decreased by distributions to the extent deemed a return of basis; a pro rata share of the losses of the corporation as adjusted; nondeductible expenses of the corporation; and the amount of the shareholder's deduction for depletion of oil and gas wells to the extent the deduction does not exceed the proportionate share of the adjusted basis of that property allocated to the shareholder. The adjustments to the basis do not apply to tax periods beginning prior to January 1, 1989.

The aggregate amount of losses taken into account by the shareholder of an S corporation may not exceed the combined adjusted basis of the shareholder's stock and indebtedness of the corporation to the shareholder.

Example:

> A is a resident of North Carolina and his share of the loss of an S corporation for the tax year 1989 is $50,000. On January 1, 1989, A's basis in the S corporation stock for federal income tax purposes was $110,000, comprised of $40,000 initial cost plus his share of the undistributed income of the S corporation of $70,000. Since for federal tax purposes the loss does not exceed his basis, the $50,000 is allowed as a deduction in computing federal taxable income. For State tax purposes, his basis is the $40,000 initial cost since the prior year undistributed income is not included in his basis due to being for tax years prior to January 1, 1989. Therefore, the loss that A may take into account in determining his North Carolina taxable income is $40,000 and he is required to adjust federal taxable income by $10,000 ($50,000 total loss less $40,000 basis).

6. Distributions

A resident shareholder must take into account distributions from an S corporation in computing North Carolina taxable income to the extent the distributions are characterized as dividends or as gains pursuant to Section 1368 of the Internal Revenue Code. Section 1368 of the Code provides that if the S corporation has no accumulated earnings and profits, the amount distributed to a shareholder reduces the adjusted basis in his stock. If the distribution exceeds his basis, the excess is treated as a capital gain. If the S corporation has earnings and profits, the distribution is applied in the following order:

(1) To the Accumulated Adjustments Account (AAA) which basically includes the income during the period the corporation has been an S corporation reduced by its losses and distributions during that period. The AAA for State income tax purposes *does not* include the federal AAA for tax years beginning prior to January 1, 1989. The shareholder does not take into account distributions from the AAA in determining taxable income but such distributions reduce the adjusted basis of his stock.

(2) To Earnings and Profits (E and P): An S corporation is not considered to have earnings and profits for State tax purposes for years in which it operates as an S corporation after January 1, 1989. The E and P account basically includes the earnings and profits on hand from the period the corporation was a C corporation; and for State tax purposes, the E and P account also includes the undistributed earnings and profits of the S corporation from tax years beginning before January 1, 1989, (the federal AAA that existed on the day North Carolina began to measure the S corporation shareholder's income by reference to the income of the S corporation). The amount distributed to the shareholder from the E and P account is taxed to the shareholder as a dividend. Since the State E and P account includes the federal AAA that existed prior to the change in State law taxing the S corporation income to the shareholders, federal taxable income must be increased for any distributions from the federal AAA that existed prior to the law change.

(3) To the basis of the shareholder's stock. Any excess over the shareholder's basis is taxed as a capital gain.

A shareholder who makes an election for federal tax purposes to treat distributions from the S corporation as being paid first from earnings and profits may not make a different election for State purposes.

The following examples illustrate transitional adjustments required in determining North Carolina taxable income of a shareholder from distributions of S corporations:

(1) A North Carolina corporation chartered on January 1, 1986, elected to be taxed as an S corporation for federal income tax purposes. Taxpayer A invested $100,000 in the corporation; and at the end

of the tax year 1988, A's pro rata share of the S corporation's accumulated adjustments account for federal income tax purposes was $50,000. A's pro rata share of the S corporation's net income for the tax year 1989 was $20,000. The S corporation distributed $100,000 to A during the tax year 1989. In this case, A would include his $20,000 share of the S corporation's net income in his federal taxable income. For federal income tax purposes, A would not be taxed on any part of the $100,000 distribution since it is considered to have been paid from his accumulated adjustments account and reduces the basis of his stock.

Original investment	$ 100,000
Accumulated adjustments account at the end of 1989 ($50,000 plus $20,000)	70,000
Adjusted basis of stock at end of year	$ 170,000
Less: Distribution	100,000
Adjusted basis of stock as of January 1, 1990	$ 70,000

For State income tax purposes, the $50,000 accumulated adjustments account balance on December 31, 1988, is treated as additional earnings and profits and A's federal taxable income must be increased for any part of the distribution attributable to earnings and profits in determining North Carolina taxable income. The amount is determined as follows:

Investment in the corporation		$ 100,000
Pro rata share of 1989 earnings — accumulated adjustments account		20,000
Adjusted basis in stock at end of tax year		$ 120,000
Distributions	$100,000	
Applied to accumulated adjustments account	(20,000)	(20,000)
Balance of distribution	$ 80,000	
Earnings and profits	(50,000)	
Balance of distribution	$ 30,000	(30,000)
Basis in stock as of January 1, 1990		$ 70,000

The $50,000 from earnings and profits is a transitional adjustment and represents a dividend to the shareholder.

(2) Shareholders of a North Carolina C corporation elect to be taxed as an S corporation effective for the tax year beginning January 1, 1989. Taxpayer B, a resident of North Carolina, owned 4,000 shares of the corporate stock with a basis of $500,000 at the time of the election. At that time, B's pro rata share of the C corporation's

undistributed earnings and profits was $800,000. During the tax year 1989, his pro rata share of the S corporation's earnings was $50,000 and the corporation distributed $1,000,000 to B in 1989. In this case, B would include in federal taxable income his $50,000 pro rata share of the S corporation's net income and dividends of $800,000 representing his share of the undistributed earnings and profits accumulated during the period the corporation operated as a C corporation. His basis in the corporate stock for federal tax purposes would be reduced to $350,000 determined as follows:

Cost of stock		$500,000
1989 earnings — added to accumulated adjustments account		50,000
Basis before deductions		$ 550,000
Distributions	$ 1,000,000	
Applied to accumulated adjustments account	(50,000)	(50,000)
Balance	$ 950,000	
Applied to earnings and profits	(800,000)	
Balance of distribution	$ 150,000	(150,000)
Basis in stock as adjusted as of January 1, 1990		$350,000

No adjustment would be necessary in determining North Carolina taxable income since the State and federal accumulated adjustment account and the accumulated earnings and profit account are the same.

(3) Shareholders of a North Carolina C corporation elected to be taxed as an S corporation for federal income tax purposes effective January 1, 1986. At that time, taxpayer X owned 200 shares of the stock with a cost basis of $50,000. X's pro rata share of the C corporation's undistributed earnings and profits on January 1, 1986, was $20,000. His pro rata share of the earnings of the S corporation was $10,000; $5,000; ($10,000); and $15,000, respectively, for the tax years 1986, 1987, 1988 and 1989. No distributions were made to X in the tax years 1986 and 1988. Distributions were made to X of $10,000 in 1987 and $35,000 in 1989. In this case, X must include his pro rata share of the 1989 earnings of $15,000 in his 1989 federal taxable income. The part of the $35,000 distribution that is included in federal taxable income as a dividend is determined as follows:

Distributions in 1989		$ 35,000
Accumulated adjustments account —		
1986 share of income	$ 10,000	
1987 share of income	5,000	
1987 distribution	(10,000)	
1988 share of income (loss)	(10,000)	
Balance as of 12/31/88	(5,000)	
1989 share of income	15,000	
Total		10,000
Balance of distribution		$ 25,000
Applied to undistributed earnings while a C corporation (dividend)		20,000
Excess distribution applied to reduce basis		$ 5,000

For federal tax purposes, X must include the $20,000 distribution of earnings and profits in his federal taxable income as dividends. The adjustment required in computing his North Carolina taxable income is determined as follows:

Distributions in 1989		$ 35,000
Applied to accumulated adjustments account — (1989 share of income)		15,000
Balance of distribution		$ 20,000
Undistributed earnings and profits:		
Balance January 1, 1986	$ 20,000	
Federal accumulated adjustments account as of December 31, 1988	(5,000)	
Earnings and profits as adjusted for State tax purposes (treated as dividend)	15,000	(15,000)
Excess distribution applied to reduce basis		$ 5,000

X would be entitled to deduct $5,000 ($20,000 less $15,000) from his federal taxable income as a transitional adjustment in computing his North Carolina taxable income.

7. Losses

The amount of loss a shareholder may deduct is limited to the adjusted basis of the shareholder's stock, plus the adjusted basis of any loans owed to the shareholder by the corporation. The amount of the loss for the taxable period is figured before the shareholder's basis in the stock is adjusted for any distributions during the tax year. If the amount of the loss of a shareholder is limited because it exceeds the adjusted basis, the excess is treated as incurred by the corporation in the next tax year.

8. Foreign S Corporations

North Carolina income tax is required to be withheld from compensation paid to foreign S corporations for certain personal services performed in North Carolina. (See the section on withholding from nonresidents for personal services performed in North Carolina on page 81.) If the S corporation has obtained a certificate of authority from the Secretary of State, no tax is required to be withheld if the S corporation provides to the payer the S corporation's corporate identification number issued by the Secretary of State.

S Corporations may claim credit on the S corporation franchise and income tax return, Form CD-401S, for the portion of the tax withheld attributable to shareholders on whose behalf the corporation files a composite return. The portion of the tax withheld attributable to shareholders who are not part of a composite return must be allocated to those shareholders on Schedule K of the S corporation return.

VIII. Subject: Estates and Trusts (G.S. 105-160 - G.S. 105-160.8)

1. General

All income of an estate or trust is taxed to the fiduciary or the beneficiary. The conduit rules for taxing estates and trusts are applicable for North Carolina income tax purposes. Under the conduit rules, regardless of who is taxed, the income retains its same character as when received by the estate or trust.

North Carolina's trust and estate tax is based on the state of residence of the trust's income beneficiaries and not on the situs of the trust's trustees or where the trust is created. North Carolina law requires the tax to be computed on the taxable income of the trust that is for the benefit of a resident of this State, or for the benefit of a nonresident to the extent that the income (1) is derived from North Carolina sources and is attributable to the ownership of any interest in real or tangible personal property in this State or (2) is derived from a business, trade, profession, or occupation carried on in this State.

2. Estates and Trusts Returns

The federal taxable income of the fiduciary is the starting point for preparing a North Carolina Income Tax Return for Estates and Trusts, Form D-407 and requires the same additions, deductions, and transitional adjustments to federal taxable income as required for individuals.

The fiduciary responsible for administering the estate or trust is responsible for filing the return and paying the tax. The fiduciary must file an income tax return for the estate or trust for which he acts if he is required to file a federal return for estates and trusts and (1) the estate or trust derives income from North Carolina sources or (2) the estate or trust derives any income which is for the benefit of a resident of North Carolina.

The return is required to be filed on or before April 15 if on a calendar year basis and on or before the 15th day of the fourth month following the end of the fiscal year if on a fiscal year basis.

Fiduciaries should be consistent in the use of the name and address of an estate or trust on a return. If a different name for an estate or trust is used in any year from that used in a prior year, that fact should be noted on the first page of the return and the name used in the prior year indicated. The use of numbers assigned by banks to trusts are also helpful in the processing of trust returns after they are filed.

3. Payment of Tax

The tax rate for estates and trusts is the same as the tax rates for single individuals. (See the Tax Rate Schedule on page 5.)

The tax due on an estates and trusts return is payable in full by the due date of the return.

4. Penalties

The penalty for failure to file an estate or trust return by the due date is 5 percent of the tax per month with a minimum of $5.00 and a maximum of 25 percent of the tax.

The penalty for failure to pay the tax by the due date is 10 percent of the tax with a minimum penalty of $5.00.

Other penalties for fraud, negligence, and criminal penalties for willful failure to comply with the income tax laws are similar to those applicable to individuals.

5. Allocation of Adjustments

The additions and deductions to federal taxable income of an estate or trust must be apportioned between the estate or trust and the beneficiaries based on the distributions of income made during the taxable year. Unless the trust instrument or will that created the estate or trust specifically provides for the distribution of certain classes of income to different beneficiaries, the apportionment of additions and deductions to the beneficiaries is determined on the basis that each beneficiary's share of the income for regular tax purposes from Schedule K-1, Federal Form 1041 relates to adjusted total income from Federal Form 1041. If the trust instrument or will specifically provides for the distribution of certain classes of income to different beneficiaries, any addition or deduction directly attributable to a particular class of income must be apportioned to the beneficiary to which that class of income is distributed. In allocating the adjustments, for State purposes the amount of income for regular tax purposes on Federal Schedule K-1 must be adjusted for distributions to the beneficiary which are not reflected in income for regular tax purposes. The adjusted total income on Federal Form 1041 must be adjusted (1) to exclude classes of income that are not part of the distribution to the beneficiary; (2) to include classes of income that are a part of the distribution to the beneficiary which are not included in adjusted total income; and (3) by any deduction treated differently for State and federal tax purposes that adjust federal taxable income pursuant to G.S. 105-134.6 and G.S. 105-134.7. After apportioning the additions and deductions to the beneficiaries, the balance is apportioned to the fiduciary.

6. Allocation of Income Attributable to Nonresidents

If the estate or trust has income from sources outside of North Carolina and if any of the beneficiaries are nonresidents of North Carolina, the portion of federal taxable income of the fiduciary that is subject to North Carolina tax must be determined. If there is no gross income from dividends, interest, other intangibles or from sources outside North Carolina for the benefit of a nonresident beneficiary, the total income of the estate or trust is taxable to the fiduciary.

The determination of the amount of undistributed income from intangible property which is for the benefit of a resident is based on the beneficiary's state of residence on the last day of the taxable year of the trust. In the

case of both resident and nonresident beneficiaries, the determination of the amount of undistributed income from intangible property which is for the benefit of a resident is made on the basis that the resident beneficiary's interest for the taxable year relates to the interest of both resident and nonresident income beneficiaries for the taxable year.

7. Tax Credits

Estates and trusts are allowed all tax credits allowed to individuals except for:

a. Tax credit for income taxes paid by individuals to other states or countries,
b. Tax credit for child and dependent care,
c. Tax credit for the disabled,
d. Tax credit for children,
e. Tax credit for charitable contributions, and
f. Tax credit for long-term care insurance.

Form D-407TC is used to report any tax credits claimed on an estate or trust return. The amounts reflected on Form D-407TC are the portions of the tax crdits allocated to the trust or estate. A fiduciary required to pay an income tax to North Carolina for a trust for which he acts may claim a credit for tax imposed and paid to another state or country on income form sources within that state or country under the provisions of G.S. 105-160.4(a).

A resident beneficiary of an estate or trust, the fiduciary of which pays an income tax to another state or country on distributable income reportable to North Carolina which is derived from sources in the other state or country may claim a credit against his North Carolina tax for his share of tax paid the other state or country under the provisions of G.S. 105-160.4(e).

Part 4 of Form D-407TC is to be used in computing the tax credit allowable to the estate or trust. Before this schedule may be completed, however, there must be an allocation between the estate or trust and its beneficiaries of the tax paid and the gross income on which such tax was paid to the other state or country.

The fiduciary's share and each beneficiary's share of the gross income on which tax has been paid to another state or country is determined by the governing instrument and should be entered in the appropriate schedule on the return. The fiduciary's share of total gross income to be used in the tax credit computation schedule is the total gross income from Federal Form 1041.

IX. Subject: Partnerships (G.S. 105-154)

1. General

The partnership's taxable income determined under the Internal Revenue Code is the starting point for preparing the North Carolina partnership income tax returns. The same additions, deductions, and transitional adjustments to federal taxable income required for individuals apply to partnerships.

2. Partnership Returns

A North Carolina partnership return (Form D-403), must be filed by every partnership doing business in North Carolina if a federal partnership return was required to be filed. The return should include the names and addresses of the individuals entitled to share in the net income of the partnership and should be signed by the managing partner and the individual preparing the return. For individual income tax purposes, the term "business carried on in this State" means the operation of any activity within North Carolina regularly, continuously, and systematically for the purpose of income or profit. A sporadic activity, a hobby, or an amusement diversion does not come within the definition of a business operation in this State. Income from an intangible source which is received in the course of a business operation in this State so as to have a taxable situs here (including such income which is included in the distributive share of partnership income, whether distributed or not) is included in the numerator of the fraction used in determining the portion of federal taxable income that is taxable to North Carolina by a nonresident.

A partnership whose only activity is as an investment partnership is not considered to be doing business North Carolina. An investment partnership is a partnership that is not a dealer in securities, as defined in section 475(c)(1) of the Internal Revenue Code, and that derives income exclusively from buying, holding, and selling securities for its own account. An investment partnership is not required to file an income tax return in North Carolina or pay income tax to North Carolina on behalf of its nonresident partners.

3. Schedule NC K-1

Schedule NC K-1 is used by the partnership to report each partner's share of the partnership's income, adjustments, tax credits, tax paid, etc. The NC K-1 must reflect the net tax paid by the partnership. The partnership must provide a completed Schedule NC K-1, or other schedule containing the same information, to each person who was a partner in the partnership at any time during the year. This schedule must be provided to each partner on or before the day on which the partnership return is required to be filed. When reporting the distributive share of tax credits, a list of the amount and type of tax credits should be provided each partner.

4. Penalties

The penalty for failure to file a partnership return on which tax is due on or before the due date is 5 percent of the tax for each month, or part of a month, the return is late. The minimum penalty is $5.00; the maximum penalty is 25 percent of the unpaid tax. If a partnership does not pay the tax due on or before the original due date of the return, a late payment penalty of 10 percent of the unpaid tax (minimum $5.00) is due. If the partnership has a valid extension of time for filing the return, a 10 percent late payment penalty will apply on the remaining balance due if the tax paid by the due date is less than 90 percent of the total tax due. In addition, penalties are provided by law for willful failure to file a return on time and for willful attempt to evade or defeat the tax.

5. Nonresident Partners

When an established business in North Carolina is owned by a partnership having one or more nonresident members, the managing partner is responsible for reporting the share of the income of each nonresident partner and is required to compute and pay the tax due for each nonresident partner. If the nonresident partner is a corporation, partnership, trust or estate, the managing partner is not required to pay the tax on that partner's share of the partnership income provided the partner signs an affirmation that the partner will pay the tax with its corporation, partnership, trust or estate income tax return. In such cases, a copy of the affirmation must be attached to the partnership return when it is filed. The tax rate is the same as the tax rate for single individuals. (See the Tax Rate Schedule on page 5.) The manager is authorized by statute to withhold the tax due from each nonresident partner's share of the partnership net income. Payment of the tax due by the managing partner on behalf of corporations, partnerships, trusts and estates that are partners does not relieve the partner from filing a North Carolina income tax return; however, credit for the tax paid by the managing partner may be claimed on the income tax return. Although a partnership may treat guaranteed payments to a partner for services or for use of capital as if they were paid to a person who is not a partner, such treatment is only for purposes of determining its gross income and deductible business expenses. For other tax purposes, such guaranteed payments are treated as a partner's distributive share of ordinary income. In determining the allowable North Carolina deductions from federal taxable income, do not include a partner's salary, interest on a partner's capital account, partner relocation and mortgage interest differential payments, or payments to a retired partner regardless of whether they were determined without regard to current profits. These types of payments are treated as part of the partner's share of the partnership income.

A nonresident individual partner is not required to file a North Carolina individual income tax return when the only income from North Carolina sources is the nonresident's share of income from a partnership doing business in North Carolina and the manager of the partnership has paid

the tax due for the nonresident individual partner. A nonresident individual partner may file an individual income tax return and claim credit for the tax paid by the manager of the partnership if the payment is properly identified on the individual income tax return.

In determining the tax due for nonresident partners, a partnership must apportion to North Carolina the income derived from its activities carried on within and outside North Carolina that are not segregated from its other business activities. A partnership's business activities are not segregated if it does not employ a method of accounting that clearly reflects the income or loss of its separate activities. A partnership must allocate to North Carolina the income derived from business activities in North Carolina that are segregated from its other business activities. Income derived from a partnership's business activities outside of North Carolina that are segregated from its other business activities are not includable in determining the tax due for nonresident partners. This allocation of income does not affect the partnership income of a resident partner because he is taxed on his share of the net income of the partnership whether or not any portion of it is attributable to another state or country.

6. Disposition of Partner's Interest

An interest in a partnership is intangible personal property. A nonresident does not include the gain from the sale of his interest in a partnership in the numerator of the fraction unless the sale of the partnership interest conveys title to specific partnership property. If a partnership owning an interest in another partnership sells its interest in that partnership, a nonresident partner does not include his distributive share of the gain realized by the partnership from the sale of its partnership interest in the numerator unless the partnership selling its interest is carrying on a trade or business in this State.

A nonresident must include his distributive share of the gains or losses from the sale or other disposition of the partnership's assets in the numerator of the fraction in determining North Carolina taxable income. If the sale of partnership interests conveys title to specific partnership property instead of to limited interests in the partnership, the transaction will be considered as a sale of partnership assets for purposes of determining North Carolina taxable income. In determining whether a sale or other disposition of partnership assets or of partnership interests has occurred, the substance of the transaction, rather than the form, controls the taxable consequences of the sale or other disposition.

7. Part-Year Residents

A part-year resident with distributive income from a partnership doing business in North Carolina and in one or more other states must prorate his share of the partnership's income attributable and not attributable to North Carolina between his periods of residence and nonresidence in accordance with the number of days in each period. The amount required to be included in the numerator of the fraction for determining taxable

income is the taxpayer's share of partnership income determined for the period of residence plus the taxpayer's share of the partnership income attributable to North Carolina during the period of nonresidence.

8. Estimated Income Tax

No estimated income tax is required of a partnership. Resident individual partners who meet statutory requirements must pay estimated income tax on Form NC-40. Nonresident individual partners are not required to pay estimated tax on their distributive share of partnership income.

9. Interest Income Passed Through to Partners

Although the interest income passed through to a partner in a partnership retains its same character as when received by the partnership, the expenses incurred in earning such income are deductible by the partnership and net interest income after expenses is reflected in the partners's pro rata share of the income of the partnership. For interest income subject to federal income tax, the partner's federal gross income reflects the net interest income after expenses incurred in earning the income. Interest income not subject to federal income tax is not reflected in the partner's federal taxable income. In these cases, a partner must adjust federal taxable income as required by G.S. 105-134.6(b) or G.S. 105-134.6(c), for the amount of interest attributable to the partnership.

10. Income Tax Credits of Partnerships

A partnership may pass through to each of its partners the partner's distributive share of an income tax credit for which the partnership qualifies. Effective for taxable years beginning on or after January 1, 2002, any dollar limit on the amount of a tax credit applies to the partnership as a whole instead of to the individual partners. The maximum dollar limits and other limitations that apply in determining the amount of tax credit available to a taxpayer apply to the same extent in determining the amount of tax credit for which the partnership qualifies, except the limitation that the tax credit cannot exceed the tax liability of the taxpayer.

Notwithstanding the above provisions, with respect to the allocation by the partnership of the tax credit for certain real property donations, the specific dollar limitations apply separately to each partner instead of to the partnership as a whole. This provision is effective for taxable years beginning on or after January 1, 2002 and expires for taxable years beginning on or after January 1, 2005.

11. Limited Liability Companies

The "North Carolina Limited Liability Company Act" (Chapter 57C of the North Carolina General Statutes) permits the organization and operation of limited liability companies. A limited liability company is a business entity that combines the S corporation characteristic of limited liability with the flow-through features of a partnership. Limited liability

companies are subject to State taxation according to their classification for federal income tax purposes; therefore, if a limited liability company is classified as a partnership for federal income tax purposes, the company and its members are subject to tax to the same extent as a partnership and its partners and is required to file a North Carolina partnership return.

A limited liability company may be organized by a single member by delivering executed articles of organization to the Secretary of State.

12. Foreign Partnerships

North Carolina income tax is required to be withheld from compensation paid to foreign partnerships for certain personal services performed in North Carolina. (See the section on withholding from nonresidents for personal services performed in North Carolina on page 81.) If the partnership has a permanent place of business in North Carolina, no tax is required to be withheld if the partnership provides to the payer the partnership's address and taxpayer identification number.

Partnerships may claim credit on the partnership income tax return, Form D-403, for the portion of the tax withheld attributable to nonresident partners on whose behalf the managing partner pays tax. The portion of the tax withheld attributable to resident partners or nonresident partners that have provided an affirmation to the managing partner (see Nonresident Partners on page 48) must be allocated to those partners on Schedule NC K-1.

X. Subject: Taxable Status of Distributions from Regulated Investment Companies

1. General

Distributions received from regulated investment companies (mutual funds) by a shareholder who was a North Carolina resident must be included in his North Carolina taxable income to the same extent included in his federal taxable income; except that (1) an amount not included in his federal gross income which was determined to be an "exempt interest dividend" for federal income tax purposes, must be added to federal taxable income to the extent it represents interest on obligations of states other than North Carolina and their political subdivisions, and (2) an amount included in his federal gross income which represents interest received from direct obligations of the United States or its possessions must be deducted from federal taxable income.

Distributions from a regulated investment company other than "capital gain distributions" and "exempt interest dividends" are included in federal taxable income in the same manner as distributions of other corporations. Distributions from earnings and profits are ordinary dividends (taxable dividends) unless the mutual fund notifies the taxpayer to the contrary.

Capital gain distributions are paid by mutual funds from their net realized long-term capital gains. The individual receiving a capital gain distribution must report the distribution as a long-term capital gain on his federal income tax return.

2. Exempt Interest Dividends

A mutual fund is qualified to pay exempt interest dividends only if at the close of each quarter of its taxable year at least 50 percent of the value of the total assets of the company consist of state and local bonds, the interest from which is exempt from federal income tax and certain other obligations on which the interest is exempt from federal income tax under provisions of federal law other than the Internal Revenue Code, as those provisions of the law were in effect on January 6, 1983. A mutual fund paying exempt interest dividends to its shareholders must send its shareholders a statement within 60 days after the close of the taxable year showing the amount of exempt interest dividends. The exempt interest dividends are not required to be included in federal taxable income.

Since interest from states other than North Carolina and their political subdivisions is required to be added to federal taxable income in calculating North Carolina taxable income, the exempt interest dividends received from mutual funds must be added to federal taxable income to the extent such dividends *do not* represent interest from bonds issued by North Carolina and political subdivisions of North Carolina, Guam, Puerto Rico, and the United States Virgin Islands, including the governments thereof and their agencies, instrumentalities and authorities, provided the mutual fund furnishes a supporting statement to the taxpayer. In the absence of such statement, the total amount designated as exempt interest

must be added to federal taxable income in computing the taxpayer's North Carolina taxable income.

3. Ordinary Dividends

Interest in the form of dividends from regulated investment companies (mutual funds, investments, etc.) is deductible from an individual's federal taxable income to the extent the distributions represent interest on direct obligations of the United States Government. The fund must furnish the taxpayer a statement verifying the amount of interest paid to him which accrued from direct obligations of the United States Government. Interest earned on obligations that are merely backed or guaranteed by the United States Government will not qualify for the deduction. Further, this deduction does not apply to distributions which represent gain from the sale or other disposition of the securities nor to interest paid in connection with repurchase agreements issued by banks and savings and loan associations.

The taxpayer may not deduct mutual fund dividends on the basis of a percentage of investments held by the fund (i.e., a fund has 75 percent of its investments in United States Treasury Notes). The statement to support the deduction must specify the amount received by the taxpayer which represents interest on direct obligations of the United States Government.

This procedure will also apply with respect to interest on obligations of the State of North Carolina and any of its political subdivisions to the extent included in federal taxable income.

4. Capital Gain Distributions

The portion of distributions from a regulated investment company that represents capital gain is reportable on the federal income tax return as capital gain income and not dividend income. Therefore, under G.S. 105-134.6(b)(2) capital gain distributable to a shareholder who is a resident of North Carolina and attributable to the sale of an obligation issued before July 1, 1995, the profit from which is exempt by North Carolina statute is deductible from federal taxable income in determining the North Carolina taxable income of an individual, trust or estate.

XI. Subject: Tax Credits

1. Credit for Corporate Tax Paid by S Corporation to Another State or Country (G.S. 105-131.8)

Credit is allowed to a resident shareholder for his share of the corporate tax paid by an S corporation to another state or country that taxes the corporation rather than the shareholder on the S corporation's income, or the computed credit, whichever is less.

If credit is claimed for the shareholder's part of the corporate tax paid, a schedule must be attached to the North Carolina return showing the total tax paid by the S corporation and how the pro rata share of the tax was determined. A separate tax credit must be calculated for each state or country to which the S corporation paid tax.

2. Credit for Income Tax Paid to Another State or Country (G.S. 105-151)

A tax credit is allowed to an individual who is a resident of North Carolina for tax imposed by and paid to another state or country on income that is also taxed by North Carolina, subject to the following conditions:

a. The income must have been derived from sources in the other state or country and must have been taxed under the laws of that state or country, regardless of the legal residence of the taxpayer.

b. The credit allowable is the smaller of either the tax paid the other state or country on income also taxed by North Carolina or the product obtained by multiplying the North Carolina tax computed before credit by a fraction in which the numerator is the part of the North Carolina income, as adjusted, which is taxed in the other state or country and the denominator is the total income as adjusted, received while a resident of North Carolina. If credits are claimed for taxes paid to more than one state or country, a separate computation must be made for each state or country and the separate credits combined to determine the total credit.

c. Receipt or other proof showing payment of income tax to the other state or country and a true copy of the return filed with the other state or country must be submitted with the North Carolina return. No credit is allowed for income taxes paid to a city, county, or other political subdivision of a state or to the federal government.

   If any tax for which a resident has claimed a tax credit on his North Carolina income tax return is refunded at any time by the other state or country, a tax equal to that portion of the credit allowed for the taxes credited or refunded must be paid to North Carolina within thirty days of the date of receipt of this refund or notice of the credit.

The tax credit allowed to a North Carolina resident is determined as follows:

Portion of total federal income while a resident of N.C., as adjusted, taxed in another state or country
Total federal income while a resident of N.C., as adjusted   x   Tax due N.C. = Tax credit

After making the computation by use of this formula, the tax credit allowed as a deduction for the North Carolina tax is either the credit obtained by use of the formula or the actual amount of income tax paid to the other state or country, whichever is the smaller.

Example 1: A full-year resident of North Carolina files a 2001 North Carolina return as a single individual. His total income is $37,000. He worked temporarily in South Carolina, earning $5,000 on which he paid tax of $131 to South Carolina. The taxpayer claimed the standard deduction in computing his federal taxable income which was $29,550. The credit against his North Carolina income tax is determined as follows:

Federal taxable income	$	29,550.00
State standard deduction and personal exemption adjustment		1,950.00
North Carolina taxable income	$	31,500.00
North Carolina tax due	$	2,079.00

Less tax credit:

Portion of total federal income, while a resident of N.C., as adjusted, taxed in another state $ 5,000   x   2,079.00 = 291.00
Total federal income, as adjusted, while a resident of N.C. $37,000

Since the $131 tax paid to South Carolina is less than the computed tax credit of $291.00, the allowable tax credit is the actual tax paid to South Carolina	$	131.00
N.C. tax due	$	1,948.00

Example 2: A husband and wife are both residents of North Carolina and file a joint 2001 North Carolina income tax return. Their total income is $40,000, $5,500 of which was received from rental property, owned jointly, in Virginia. A total of $2,000 income was received by the husband for temporary

employment in South Carolina. The taxpayers claimed the standard deduction in computing their federal taxable income which was $26,600. They paid tax of $290 on the income earned in Virginia and the husband paid tax of $102 on the income reported to South Carolina. The credit against their North Carolina income tax is determined as follows:

Federal taxable income	$ 26,600.00
State standard deduction and personal exemption adjustment	3,400.00
North Carolina taxable income	$ 30,000.00
North Carolina tax due	$ 1,889.00

Less tax credit:

Portion of total federal income while a resident of N.C., as adjusted, taxed by Virginia $5,500 x 1,889.00 = 264.00
Total federal income, $40,000 as adjusted, while a resident of N.C.

Portion of total federal income while a resident of N.C., as adjusted, taxed by South Carolina $2,000 x 1,889.00 = 94.00
Total federal income, $40,000 while a resident of N.C., as adjusted

Total credit	$ 358.00
Net North Carolina tax due	$ 1,531.00

The computed credits are allowed since each is less than the amount paid to the other state.

Example 3: Taxpayer, a single man, became a North Carolina resident on June 1. Prior to moving to North Carolina he had income in South Carolina of $4,000. From June 1 through December 31, he had $6,000 income in South Carolina and $10,000 in North Carolina. He paid income tax to South Carolina of $400 on the $10,000 South Carolina income. The taxpayer claimed the standard deduction in computing his 2001 federal taxable income which was $12,550. His tax credit is determined as follows:

Federal taxable income .... $ 12,550.00

State standard deduction and
personal exemption adjustment 1,950.00

North Carolina taxable income before part-year
resident adjustment .... $ 14,500.00

Total federal income, as adjusted, a while a
N.C. resident plus total income from N.C.
sources while a nonresident
as adjusted $16,000 x $14,500.00 = $11,600
Total federal income $20,000 N.C. taxable
from all sources, income
as adjusted

North Carolina taxable income $11,600.00

North Carolina tax on $11,600 taxable
income .... $ 698.00

Less tax credit:

Portion of total federal
income, while a N.C.
resident, as adjusted,
taxed by S.C. $ 6,000 x $698 = $265.00*
Total federal income $16,000 N.C. tax
while a N.C.
resident, as adjusted

(*The computed credit is determined only with
respect to income while taxpayer is a resident
of North Carolina.)

S.C. income
taxed by N.C. $ 6,000 x $400 = $240**
Total S.C. income $10,000 S.C. tax

Since the $240 tax paid to South Carolina on
income also taxed by North Carolina is less
than the $265.00 computed credit, the allowable
credit is .... $ 240.00

Net tax due North Carolina .... $ 458.00

(**Since a part of the tax paid South Carolina was on income not taxed by North Carolina, this computation is necessary to determine that portion of the South Carolina tax that was paid on income also taxed by North Carolina.)

3. Handicapped Dwelling Units (G.S. 105-151.1)

A tax credit of $550.00 for each dwelling unit completed during the taxable year is allowable to an owner who constructs multi-family rental units located in North Carolina which conform to Volume I-C of the North Carolina Building Code. To receive the credit the taxpayer must attach a copy of the occupancy permit on which the building inspector

has recorded the number of units completed during the year. If the credit exceeds the tax liability for the year reduced by all other credits, the excess may be carried over only to the succeeding tax year. A taxpayer who is entitled to a carry-over must attach a schedule showing how the amount of the carry-over was determined.

4. Child and Dependent Care Expenses (G.S. 105-151.11)

A tax credit is allowable for the employment-related expenses for child and dependent care. The credit is calculated on the net qualified federal employment-related expenses after reduction for any employer-paid dependent care assistance that is excluded from federal gross income.

In calculating the credit, include qualified child care expenses incurred in the previous tax year but not paid until the current tax year. In the case of a married couple that file a joint federal return when only one spouse files a North Carolina return, that spouse calculates the amount of expenses used to determine the credit by multiplying total qualified expenses by the ratio of that spouse's total income to the total income of both spouses. For dependents who were seven years old or older and not physically or mentally incapable of caring for themselves, the credit is from 7 percent to 9 percent of the net qualified federal employment-related expenses depending on filing status and federal adjusted gross income as shown in the following table.

For dependents who were under the age of seven and dependents who were physically or mentally incapable of caring for themselves, the credit is from 10 percent to 13 percent of the net qualified federal employment-related expenses depending on filing status and federal adjusted gross income as shown in the following table. An individual who is not able to dress, clean, or feed himself because of a physical or mental condition is not able to care for himself. Individuals with mental conditions who require constant attention to prevent them from injuring themselves or others are considered to be unable to care for themselves.

For a dependent who reaches age 7 during the taxable year and who is *not* physically or mentally incapable of caring for himself, the tax credit for employment-related expenses incurred prior to the dependent's 7th birthday will be calculated by using the applicable percentage in column A, and the tax credit for employment-related expenses incurred after the dependent becomes age 7 will be calculated by using the applicable percentage in column B.

A nonresident or part-year resident is allowed a prorated credit based on the percentage of the taxpayer's total income that is taxable for North Carolina income tax purposes.

Filing Status	Federal AGI	Column A	Column B
Head of Household	Up to $20,000	13%	9%
	Over $20,000 up to $32,000	11.5%	8%
	Over $32,000	10%	7%
Surviving Spouse or Joint Return	Up to $25,000	13%	9%
	Over $25,000 up to $40,000	11.5%	8%
	Over $40,000	10%	7%
Single	Up to $15,000	13%	9%
	Over $15,000 up to $24,000	11.5%	8%
	Over $24,000	10%	7%
Married Filing Separately	Up to $12,500	13%	9%
	Over $12,500 up to $20,000	11.5%	8%
	Over $20,000	10%	7%

5. Real Property Donated for Public Purposes (G.S. 105-151.12)

A credit is allowed for donating interests in real property located in North Carolina to the State, local government, or other qualified organization. To qualify for the credit the property must be certified by the Department of Environment and Natural Resources as suitable for use as public beach access, public access to public waters or trails, fish and wildlife conservation or other similar land conservation purposes. The credit is allowed for 25 percent of the fair market value of the interest donated but may not exceed $250,000. Any unused credit may be carried forward for the next succeeding five years. Marshland for which a claim has been filed pursuant to G.S. 113-205 pertaining to grants in navigable waters of coastal counties of North Carolina, will not qualify for this credit unless the offer of donation is made before December 31, 2003.

In the case of property owned by a married couple where both spouses are required to file North Carolina income tax returns, the credit is allowed only if the couple files a joint return.

6. Conservation Tillage Equipment (G.S. 105-151.13)

A credit is allowable for the purchase of certain conservation tillage equipment for use in a farming business, including tree farming, for 25 percent of the cost of the equipment up to a maximum credit of $2,500 for any income year. Qualifying conservation tillage equipment is (1) a planter designed to minimize disturbance of the soil in planting crops or trees, including equipment that may be attached to equipment already owned by the taxpayer, or (2) equipment designed to minimize disturbance of the soil in reforestation site preparation, including equipment that may be attached to equipment already owned by the taxpayer; provided, however, this shall include only those items of equipment generally known as a ‘KG-Blade’, and ‘drumchopper’, or a ‘V-Blade’.

The credit may be claimed only by the first purchaser of the equipment and may not be claimed by a person who purchases the equipment for

use outside of North Carolina. Any excess credit may be carried forward for the next succeeding five years. The basis in any equipment for which a credit is allowed must be reduced by the amount of credit.

7. Gleaned Crops (G.S. 105-151.14)

A credit is allowable for unharvested crops which are donated by a grower to a qualified charitable organization. The credit is 10 percent of the season average price of the crop as determined by the North Carolina Crop and Livestock Reporting Service in the North Carolina Department of Agriculture and Consumer Services or the average price of the crop in the nearest local market for the month in which the crop is gleaned if the Crop and Livestock Reporting Service does not determine the season average price.

If the tax credit is claimed, the amount of the market price of the donated crops must be added to federal taxable income in determining North Carolina taxable income.

8. Credit for Disabled Taxpayer, Dependent and/or Spouse (G.S. 105-151.18)

A tax credit equal to one-third of the amount of the federal tax credit allowed under the Internal Revenue Code is allowed to an individual who is permanently and totally disabled. Although the federal tax credit is allowed for being 65 or older, no portion of the tax credit is allowed on the North Carolina return for being 65 or older.

A tax credit is also allowed to a taxpayer who is allowed an exemption under the Internal Revenue Code for a totally and permanently disabled dependent or spouse. To claim the credit, a statement from a physician or local health department must be attached to the return certifying that the dependent was unable to engage in any substantial gainful activity by reason of a physical or mental impairment that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not less than 12 months. The allowable credit is determined by completing Form D-429, "Worksheet for Determining Tax Credit for Disabled Taxpayer, Dependent, and/or Spouse."

A taxpayer who claims the tax credit for being permanently and totally disabled may also be eligible to claim the tax credit for a permanently and totally disabled dependent or spouse for whom the taxpayer claimed an exemption under the Internal Revenue Code.

A nonresident or part-year resident is allowed the tax credit for a disabled taxpayer and the tax credit for a disabled dependent or spouse in the proportion that federal taxable income (as adjusted) is taxable to North Carolina.

9. Farm Machinery (G.S. 105-151.21)

A credit of up to $1,000 is allowable to an individual farmer for the amount of property tax paid during the taxable year on farm machinery or attachments and repair parts for farm machinery. Farm machinery is

defined as machinery that is subject to State sales tax at the rate of one percent under G.S. 105-164.4A.

10. Credit for the Use of North Carolina Ports (G.S. 105-151.22)

A tax credit is allowed for a portion of the wharfage, handling, and throughput charges for importing goods to and exporting goods from the North Carolina ports of Morehead City and/or Wilmington. The credit is equal to the amount of increase in charges in the current year over the average of charges paid in the current and previous two years without consideration of the free-on-board cargo terms under which the cargo is moved. The credit is limited to 50 percent of the current year's tax and any unused credit can be carried over for the next five years. A taxpayer's maximum accumulated credit is $1,000,000 ($2,000,000 effective for taxable years beginning on or after January 1, 1998). To obtain the credit, the taxpayer must include with the return a statement from the State Ports Authority certifying the amount of charges paid by the taxpayer for which the credit is claimed. The credit expires for taxable years beginning on or after January 1, 2003.

11. Credit for Children (G.S. 105-151.24)

A tax credit of $60 ($75 effective for taxable years beginning on or after January 1, 2002) is allowable for each dependent child for whom an individual was allowed to deduct a personal exemption on his federal return if his federal adjusted gross income is less than the amount shown for his filing status in the chart below.

Filing Status	Adjusted Gross Income
Married filing jointly	$ 100,000
Head of household	$ 80,000
Single	$ 60,000
Married filing separately	$ 50,000

The credit for children can be claimed only for a child who was under 19 years of age on the last day of the year or for a student under the age of 24 on the last day of the year for whom an individual furnished more than 50 percent of the support. A child is a son, stepson, daughter, stepdaughter, or legally adopted child for whom an individual provided more than half of the support for the taxable year. The credit is also allowed for a foster child if the child lived in the taxpayer's home for the entire year and the taxpayer provided care for the child as his own child.

A nonresident or part-year resident is allowed the tax credit for children in the proportion that federal taxable income (as adjusted) is taxable to North Carolina.

12. Credit for Construction of a Poultry Composting Facility (G.S. 105-151.25)

A tax credit is allowed to a taxpayer for constructing a poultry composting facility in North Carolina for the composting of poultry

carcasses from commercial poultry operations. The credit is equal to 25 percent of the installation, materials, and equipment costs of construction paid during the taxable year, not to exceed $1,000 for any single installation. That portion of construction costs represented by State or federal agency provided funds cannot be used in determining the credit.

The credit may not exceed the tax liability for the year, reduced by other credits and any unused credit may not be carried over to another tax year.

13. Credit for Charitable Contributions (G.S. 105-151.26)

A tax credit for charitable contributions is allowed to an individual who elects the standard deduction on the federal income tax return. The credit is not allowed to an individual who claims itemized deductions on the federal return. The credit equals 7 percent of the contributions for the taxable year which exceed 2 percent of the individual's federal adjusted gross income. The credit may not be claimed for contributions for which the credit for certain real property donations or the credit for gleaned crops is claimed. Nonresidents and part-year residents may claim a prorated credit equal to the percentage of income that is subject to North Carolina tax.

The credit may not exceed the tax liability for the year, reduced by other credits. Any unused credit may not be carried over to another tax year.

14. Credit for Long-Term Care Insurance (G.S. 105-151.28)

A tax credit is allowed for the qualifying premiums paid during the taxable year on a qualified long-term care insurance contract(s) that provides insurance coverage for an individual, the individual's spouse, or a dependent for whom the individual was allowed to claim a personal exemption on the federal return. The credit is 15 percent of the premium costs but may not exceed $350 for each qualified long-term care insurance contract for which a credit is claimed. Qualified long-term care insurance contracts are defined in section 7702B of the Internal Revenue Code.

No credit is allowed for payments that are deducted from, or not included in, federal gross income for the taxable year. The credit is not allowable if medical expenses are claimed as an itemized deduction on the federal return. Self-employed individuals who claim a deduction for health insurance premiums on the federal return must reduce any allowable credit by the applicable percentage of health insurance premiums deducted from gross income for federal income tax purposes. For tax year 2001, the applicable percentage is 60 percent (70 percent for tax year 2002). An example of payments that are not included in federal gross income are premiums paid through an employer-sponsored plan in which the payments are excluded from taxable wages (pre-taxed dollars).

A nonresident or part-year resident is allowed the tax credit in the proportion that federal taxable income (as adjusted) is taxable to North Carolina.

15. Qualified Business Investments (G.S. 105-163.010 through G.S. 105-163.014)

A tax credit is allowed to individuals, estates, and trusts that make qualified investments directly in equity securities or subordinated debt of a qualified business venture or a qualified grantee business. These organizations are defined in G.S. 105-163.010 and are required to register with the Secretary of State. The credit is also allowable to partnerships, S corporations, limited liability companies, and other pass-through entities that make qualifying investments. However, the credit is not allowed to a pass-through entity that has committed capital under management in excess of $5,000,000. Nor is the credit allowed if a broker's fee or commission or other similar remuneration is paid or given directly or indirectly for soliciting the investment in a qualified business. A pass-through entity that is itself a qualified business is not entitled to the credit for an investment in another qualified business.

The credit allowed a taxpayer for one or more investments in a single tax year is 25 percent of the amount invested or $50,000, whichever is less, regardless of whether the investments were made directly by the taxpayer or indirectly though a pass-through entity. The credit allowed a pass-through entity is 25 percent or $750,000, whichever is less. The $50,000 limitation for individuals does not apply to unused amounts carried forward from previous years. If the owner's share of the pass-through entity's credit is limited due to the maximum allowable credit, the pass-through entity and its owners may not reallocate the unused credit among the other owners.

A taxpayer's basis in the equity securities or subordinated debt acquired as a result of an investment in a qualified business venture or a qualified grantee business must be reduced by the amount of allowable credit. To be eligible for the credit a taxpayer must file an application (Form D-499) for the credit with the Secretary of Revenue on or before April 15 of the year following the calendar year in which the investment was made and must include (1) copies of canceled check(s) or other documents which verify the investment, (2) copies of stock certificates or subordinated debt instrument(s) issued by the qualified business, and (3) the Certificate of Qualified Status for each organization for which credit is claimed. If an investment shown on an application was paid for other than in money (real estate, personal property, etc.), a taxpayer must include with the application a certified appraisal of the value of the property used to pay for the investment. The application for a credit for an investment made by a pass-through entity must be filed by the pass-through entity.

Pursuant to rule .0612, subchapter 6B, Title 17 of the North Carolina Administrative Code, the date set for filing the application may be extended provided a written statement is furnished by April 15 requesting

additional time to file the application; however, the application must be filed by September 15. An extension of time to file the individual income tax return, Form D-400, does not extend the time for filing Form D-499. The credit is allowable for the taxable year beginning during the calendar year following the calendar year in which the investment was made and any unused credit can be carried forward for the next succeeding five years.

The total amount of the credits allowable to all taxpayers for each calendar year may not exceed $6,000,000. If the total credits for which applications are received exceed $6,000,000, the credits claimed will be allocated in proportion to the size of the credit claimed by each taxpayer.

If the credit is reduced, the taxpayer will be notified by the Department of Revenue of the amount of reduction of the credit on or before December 31 of the year following the calendar year in which the investment was made.

A taxpayer will forfeit the credit if:

(1) Within three years after the investment was made, the taxpayer participates in the operation of the qualified business. A taxpayer participates in the operation of the qualified business if the taxpayer, the taxpayer's spouse, parent, brother or sister, child, or an employee of any of these individuals or of a business controlled by any of these individuals provides services of any nature to the qualified business for compensation, whether as an employee, a contractor, or otherwise.

(2) The registration of the qualified business is revoked because the qualified business provided false information to the Secretary of State on its registration application.

(3) The taxpayer transfers the securities received in the investment to another person or entity within one year except in the case of (a) the death of the taxpayer, (b) a final distribution in liquidation, or (c) a merger, conversion, consolidation, or other similar transaction in which no cash or tangible property is received.

(4) The organization in which the investment was made makes a redemption of the securities within five years. Forfeiture does not occur if a redemption is made by a qualified business that engages primarily in motion picture film production if (1) the redemption occurred because the qualified business completed production of a film, sold the film, and was liquidated and (2) neither the qualified business nor a related person as described in Code section 267(b) or 707(b), continues to engage in business with respect to that film.

A taxpayer who forfeits any credit must repay the credit plus interest 30 days after the date the credit is forfeited. The credit is repealed effective for investments made on or after January 1, 2004.

16. Credit for Investing in Renewable Energy Property (G.S. 105-129.15 through G.S. 105-129.18)

A tax credit is allowed for 35% of the cost of renewable energy property constructed, purchased, or leased and placed into service in the State during the taxable year. Renewable energy property includes biomass equipment, hydroelectric generators, solar energy equipment, and wind equipment. The credit is not allowable for renewable energy property leased from another person unless the taxpayer has written certification from the lessor that he will not claim a credit with respect to the leased property.

If the renewable energy property serves a single-family dwelling, the credit is taken in the taxable year in which the property is placed in service. For all other property, the credit is taken in five equal installments beginning with the year the property is placed in service. The credit may not exceed 50% of the tax for the year, reduced by the sum of all other tax credits. This limitation applies to the cumulative amount of credit, including carryforwards. Any unused portion of the credit may be carried forward for the succeeding five years. If the property is disposed of, taken out of service, or moved out of the State during the five-year installment period, the credit expires and any remaining installments of the credit may not be taken.

The credit is subject to various ceilings. For nonresidential property, the credit may not exceed $250,000 per installation. For renewable energy property placed in service for residential purposes, the following ceilings apply:

- $1,400 per dwelling unit for solar energy equipment for domestic water heating;
- $3,500 per dwelling unit for solar energy equipment for active space heating, combined active space and domestic hot water systems, and passive space heating; and
- $10,500 per installation for any other renewable energy property.

The credit is repealed effective for taxable years beginning on or after January 1, 2006.

17. Business Targeted Tax Credits

Individuals, partnerships, trusts, and estates may be eligible to claim business targeted tax credits for:

- Creating Jobs
- Investing in Machinery and Equipment
- Research and Development
- Worker Training
- Investing in Central Administrative Office Property
- Contributions to Development Zone Projects (beginning with tax year 2001)

- Investing in Business Property (Repealed effective for property placed in service on or after January 1, 2002.)
- Low Income Housing (beginning with tax year 2000)
- Rehabilitating Income-Producing Historic Structure
- Rehabilitating Nonincome-Producing Historic Structure
- Nonhazardous dry-cleaning equipment

For information about these credits, see Business Targeted Tax Incentives and Credits in the Corporate Income Tax Bulletins.

XII. Subject: Statute of Limitations and Federal Changes

1. General

The law contains certain time limitations, generally referred to as the "statute of limitations."

There are also specific requirements for the reporting of federal income tax changes.

2. Limitations for Assessments

(a) An assessment for tax or additional tax due may be made within three years after the date a return is actually filed or within three years from the date required by law for filing the return, whichever is later. If a taxpayer has forfeited a tax credit, an assessment may be proposed within three years of the date of forfeiture.

An income tax return from which information required to calculate the taxpayer's income tax liability has been omitted is not a return for the purpose of determining the applicable statute of limitations. The date the return is filed which contains sufficient information upon which to determine the tax liability is the determining date.

There is no statutory provision prohibiting an assessment for a given year after an assessment has already been proposed for that year.

(b) If a return for any income year beginning on or after January 1, 1969, has not been filed by a taxpayer, any tax or additional tax due from the taxpayer for such year may be assessed at any time.

(c) When fraud is involved, there is no statute of limitations for an assessment for tax or additional tax. This is the case regardless of whether or not a return has been filed by the individual.

3. Federal Changes

(a) If the amount of net income reported or reportable by any taxpayer for any year is changed, corrected, or otherwise determined by the U.S. Government, the taxpayer must file a North Carolina return or amended return reporting that change or determination of net income within two years after receipt of the Internal Revenue Agent's Report.

(b) If an individual files a return or amended return reflecting the corrected or determined net income, an assessment of additional tax or a refund may be made within one year from the date this return is actually filed. If the individual does not file a return reflecting the federal changes or determination of net income within two years after receipt of the Internal Revenue Agent's Report, and a report is received from the U.S. Government reflecting the corrected net income, an assessment may be made within three years from the date of receipt by the Department of Revenue or the report from the U.S. Government. The individual forfeits his

right to any refund which might be due by reason of the changes, provided the statute of limitations has otherwise expired.

Even though an individual has two years following receipt of the Internal Revenue Agent's Report to report the federal changes, an assessment can be proposed by the Department immediately following the receipt from any source of information concerning the correction, change in, or determination of the net income of the taxpayer by the U.S. Government.

If no return reflecting the changes made is received from the individual and no report is received from the U.S. Government, no statute of limitations applies, and an assessment for income tax may be made at any time based on the information acquired.

(c) When an Internal Revenue Agent's Report is received reflecting changes made in the net taxable income of an individual, the Department may assess tax or additional tax or refund an overpayment of tax based on applicable federal changes and may also make any other changes based on any facts or evidence discovered from any other source. This is the case regardless of whether or not a previous assessment or refund has been made for the same taxable year.

4. Federal Changes and Fraud

When there is a federal change and a fraud penalty is assessed by the federal government, the State may open the year on the basis of either fraud or the federal assessment; and if a State return has not been filed, the 50 percent fraud penalty and the 5 percent per month ($5.00 minimum; 25 percent maximum) delinquency penalty may be assessed.

5. Collection of Tax

If an income tax liability has been established within the proper time, there is no statute of limitations for the collection of tax due unless a certificate of tax liability is docketed. The tax represented by a certificate of tax liability abates 10 years from the date it was recorded unless the time is extended by the specific provisions of G.S. 105-242(c).

6. Refunds

G.S. 105-266 authorizes refunds to taxpayers for overpayment of taxes of $1.00 or more. A refund of less than $1.00 will not be made unless a written request is received from the taxpayer. The section also provides a time limit for refunds by specifying that "no overpayment shall be refunded irrespective of whether upon discovery or receipt of written demand if such discovery is not made or such demand is not received within three (3) years from the date set by the statute for the filing of the return or within six (6) months of the payment of the tax alleged to be an overpayment whichever date is the later."

The time limit for claiming refunds is three years from the due date or six months after payment whichever is later, except in the case of federal

changes as explained in 3. However, special rules extending the time for filing refund claims beyond the normal three-year statute of limitations apply to overpayments attributable to (1) worthless debts or securities, (2) capital loss carrybacks, or (3) net operating loss carrybacks. For overpayments resulting from worthless debts or securities, the period of time for demanding an overpayment is seven years; for overpayments resulting from capital loss or net operating loss carrybacks, the period of time is three years from the due date of the tax return for the year in which the loss was incurred instead of three years from the due date of the tax return for the year to which the loss is carried back.

Under G.S. 105-266.1, a taxpayer may apply for a refund of tax or additional tax paid at any time within three years after the due date of the return or within six months from the date of payment of the tax, whichever is later. The Secretary of Revenue may grant an administrative tax hearing to determine if the tax paid was excessive or incorrect. If the taxpayer has been granted an extension of time for filing the return, the three year period referred to in G.S. 105-266 is three years from the extended date.

A refund barred by the statute of limitations may not be applied to a tax liability for another year.

The Secretary of Revenue may not refund taxes levied under an unconstitutional statute or taxes imposed illegally unless the taxpayer makes demand for refund of such taxes within three years of payment as provided under G.S. 105-267.

7. Soldiers' and Sailors' Civil Relief Act

Certain sections of the Soldiers' and Sailors' Civil Relief Act of 1940, as amended, are pertinent to the question of deferring collection of taxes due from persons serving in the Armed Forces.

Section 513 of the Soldiers' and Sailors' Civil Relief Act provides for deferment of payment of income taxes by military personnel for the period of military service plus six months thereafter. This applies to income taxes accrued prior to and during the period of military service; however, payment of income taxes is deferred only if the individual's ability to pay the tax is materially impaired by reason of military service.

8. Combat Zone

An individual serving in the Armed Forces, or serving in support of the Armed Forces, in an area designated by the President as a combat zone who receives an extension of time to file his or her federal income tax return and receives relief from the accrual of penalty and interest as a result of serving in a combat zone or for being hospitalized as a result of wounds, disease, or injury sustained while serving in a combat zone, will receive the same extension of time for filing and the same relief from the accrual of penalty and interest for State income tax purposes.

The compensation of a military or civilian employee of the United States who dies as a result of terroristic or military action is exempt from State

income tax for the same periods for which his income is exempt for federal income tax purposes.

9. Waiver of Time Limitation

A taxpayer may make a written waiver of the limitations of time specified by law for assessing any tax or additional tax, for either a definite or indefinite period of time, and if such waiver is accepted, the Secretary of Revenue may propose an assessment at any time within the extended period. An agreement by a taxpayer to extend the time in which the Secretary of Revenue can assess the taxpayer automatically extends the period of time for refunds of overpayments by the taxpayer.

XIII. Subject: Penalties, Interest, and Required Filing of Information Returns

1. General

The North Carolina Statutes provide both civil and criminal penalties for failure to comply with the income tax laws.

In addition to any applicable penalty, all assessments of taxes or additional taxes bear interest at the applicable rate from the due date until date of payment.

2. Failure To File and Failure To Pay Penalties

Under the provisions of G.S. 105-236, both the late filing and late payment penalties can be applied for the same month. If the return is filed late without payment of the tax shown due, both the late filing and late payment penalties will be assessed at the same time.

If the return is filed under an extension, the late filing penalty will be assessed from the extended filing date rather than from the original due date. The late payment penalty is 10 percent of the tax not paid by the original due date of the return and will apply on any remaining balance due if the tax paid by the original due date of the return is less than 90 percent of the total amount of tax due. If the 90 percent rule is met, any remaining balance due, including interest, must be paid with the income tax return on or before the expiration of the extension period to avoid the late payment penalty. Interest is due from the original due date to the date paid.

The late-payment penalty will not be assessed if the amount shown due on an amended return is paid with the return. Proposed assessments of additional tax due are subject to the 10 percent late-payment penalty if payment of the tax is not received within 30 days of the assessment.

3. Negligence Penalties

When there is an understatement of taxable income equal to 25 percent or more of gross income, the 25 percent negligence penalty will be assessed. When the percentage of understatement of taxable income is less than 25 percent, the 10 percent negligence penalty may be applied. The application of the 10 percent negligence penalty will be made on the basis of the facts in each case. When the accuracy penalty has been assessed for federal income tax purposes, the 10 percent negligence penalty will be assessed for State income tax purposes, unless the 25 percent negligence penalty applies.

A negligence penalty cannot be assessed when the fraud penalty has been assessed with respect to the same deficiency. There is no minimum dollar amount of negligence penalty.

4. Failure To Report Federal Changes

When a taxpayer fails to report federal changes within two years from the date he receives the federal revenue agent's report or other

final determination of corrected net income, he is subject to the failure to file penalty and forfeits his right to any refund as the result of the federal changes. The failure to file penalty begins at the expiration of the two-year period.

5. Fraud

When an examination of an income tax return is based on a federal audit report and the fraud penalty has been assessed for federal purposes, the 50 percent fraud penalty will be assessed for State purposes. When the fraud penalty is assessed, no penalty for negligence shall be assessed with respect to the same deficiency; however, other penalties for failure to file and underpayment of estimated income tax will be assessed if applicable with respect to the same deficiency.

6. Collection Assistance Fee

Any tax, penalty, and interest not paid within 90 days after a final notice of assessment has been mailed is subject to a 20 percent collection assistance fee. The fee will not apply if payments are being made pursuant to an installment agreement that became effective within 90 days after the final notice was mailed.

7. Interest

Interest accrues on tax not paid by the original due date even though a taxpayer may have an extension of time for filing the return. Interest on overpayments accrues beginning 45 days after the latest of (1) the date the final return was filed, (2) the date the final return was due to be filed, or (3) the date of the overpayment. The law requires the interest rate to be determined on or before June 1, for the following six-month period beginning on July 1 and on or before December 1 for the following six-month period beginning on January 1. The current rate of interest may be obtained by contacting the Department of Revenue.

8. Underpayment of Estimated Income Tax

The computation of penalty for underpayment of estimated income tax should be made on Form D-422 and submitted with the individual's income tax return. (See XX. Penalty for Underpayment for explanation.)

9. Waiver of Penalty

Any penalty may be waived by the Secretary of Revenue pursuant to the Department of Revenue penalty policy. A request for waiver or reduction of penalty must be in writing and must include an explanation for the request. Interest on the tax due cannot be waived or reduced.

XIV. Subject: Miscellaneous Rules

1. When a payment is received by the Department of Revenue for less than the correct tax, penalty, and interest due under the law and the facts and the payment includes the statement, "paid in full" or other similar statements, the payment will be deposited as required by G.S. 147-77. The endorsement and deposit of the payment with such statement will not make the statement binding on the Department of Revenue and will not prevent the collection of the correct balance due.
2. The Department of Revenue is authorized by law to photograph, photocopy, or microphotocopy all records of the Department, including tax returns, and such copies, when certified by the Department as true and correct copies, shall be admissible in evidence in all actions, proceedings, and matters as the original would have been. (G.S. 8-45.3)
3. In some cases debts owed to certain State and county agencies will be collected from an individual's income tax refund. If the agency files a claim with the Department for a debt of at least $50.00 and the refund is at least $50.00, the debt will be set off and paid from the refund. The Department will notify the debtor of the set-off and will refund any balance which may be due. The agency receiving the amount set-off will also notify the debtor and give the debtor an opportunity to contest the debt. If an individual has an outstanding federal income tax liability of at least $50.00, the Internal Revenue Service may claim the individual's North Carolina income tax refund.
4. An individual may elect to contribute all or any portion of his income tax refund (at least $1.00 or more) to the North Carolina Nongame and Endangered Wildlife Fund. Once the election is made to contribute, the election cannot be revoked after the return has been filed.

   The contribution will be used to assist in the management and protection of North Carolina's many nongame species, including endangered wildlife. The Nongame and Endangered Wildlife Fund will be the primary source of money to support much needed research, public education, and management programs designated specifically to benefit nongame wildlife.
5. A taxpayer may designate $1.00 of the tax that he pays for use by the Democratic or Republican Parties. If the taxpayer does not wish to specify a party, the amount designated will be distributed to political parties in North Carolina on a pro rata basis according to voter registrations. No political party with less than one percent of the total number of registered voters in the State will receive any of the designated funds. Married couples filing a joint return may make a designation only if their income tax liability is $2.00 or more. The designation will neither increase the tax nor reduce the refund.

6. Tenancy by the Entirety: When filing separate returns, a determination must be made as to that portion of the income or loss from real property that must be reported by each spouse. Under G.S. 39-13.6, a husband and wife have equal right to the control, use, possession, rents, income, and profit from real property held as tenants by the entirety and each spouse is taxed on one-half of the income or loss from such property located in North Carolina.

   When real property conveyed jointly in the name of husband and wife is located in another state and the share of ownership of each is not fixed in the deed or other instrument creating the co-tenancy, each spouse is considered as having received one-half of the income or loss from the real property unless they can demonstrate that the laws of that particular state with respect to the right to the income from the property allocate the income or losses in a different manner.

7. An individual may elect to have his income tax refund applied to estimated income tax for the following year. For example, an individual due a refund on his 2001 income tax return may have all or any portion of the refund applied to his estimated tax for 2002. The individual may not, however, file a 2001 tax return in 2003 and request the refund be applied to his 2003 estimated tax since the refund can only be applied to the tax year which follows the year for which the request for refund is made. The last allowable date for making a 2002 estimated tax payment is January 15, 2003; therefore, you must file your 2001 income tax return by January 15, 2003, to elect to apply a portion of your refund to 2002 estimated tax.

   If an individual makes a valid election, that individual may not revoke the election in order to have the amount refunded or applied in any other manner, such as an offset against any subsequently determined tax liability.

8. Cancelled checks, receipts, or other evidence to substantiate deductions on the tax return should be kept for a period of at least three years from the due date of the return or three years from the date the return is filed, whichever is later. Lack of adequate records could result in the disallowance of all or part of the deductions claimed.

   A cancelled check, money order stub, or Departmental receipt showing payment of tax should be kept for at least five years from the due date of the tax return.

9. An individual may elect to contribute all or any portion of his income tax refund (at least $1.00 or more) to the North Carolina Candidates Financing Fund. Once the election is made to contribute, the election cannot be revoked after the return has been filed.

The Candidates Financing Fund was created to encourage candidates for governor to limit their campaign spending, and contributions made from refunds will be placed in the Fund.

10. In determining North Carolina taxable income, G.S. 105-134.6(b) allows an individual to deduct from his federal taxable income interest received from obligations of the United States or its possessions, the State of North Carolina or its political subdivisions, and nonprofit educational institutions located in North Carolina, to the extent the interest is included in his federal gross income. Under this statute, an individual is allowed to deduct the total of such interest included in his federal gross income even though certain expenses incurred in earning the interest are allowed as deductions on his federal income tax return.

    G.S. 105-134.6(c) requires an individual to add interest income received from obligations of states other than North Carolina and their political subdivisions to federal taxable income in calculating his North Carolina taxable income, to the extent the interest is not included in his federal gross income. Under this statute, an individual is required to add the total of such interest to federal taxable income even though he may have incurred expenses in earning the interest.

    Similar adjustments may be required by a partner or beneficiary. Although the interest income passed through to a partner in a partnership or to a beneficiary of an estate or trust retains its same character as when received by the partnership or the estate or trust, the expenses incurred in earning such income are deductible by the partnership or the estate or trust, and the net interest income after expenses is reflected in the partner's or beneficiary's pro rata share of the net income of the partnership or fiduciary. For interest income subject to federal income tax the partner's or beneficiary's federal gross income reflects the net interest income after expenses incurred in earning the income. Interest income not subject to federal income tax is not reflected in the partner's or beneficiary's federal taxable income. In these cases, a partner or beneficiary must adjust his federal taxable income as required by G.S. 105-134.6(b) and G.S. 105-134.6(c), for the net amount of interest attributable to the partnership or the estate or trust.

11. Every individual, fiduciary, partnership, corporation, or unit of government buying real property located in North Carolina from a nonresident individual, partnership, estate or trust is required to complete Form NC-1099NRS, Sale of Real Property by Nonresidents, reporting the seller's name, address, and social security number, or federal employer identification number; the location of the property; the date of closing; and the gross sales price of the real property and its associated tangible personal property. Within fifteen days of the closing date of the sale, the buyer must file the report with the Department of Revenue and furnish a copy of the report to the seller.

12. Like all states that have a sales tax, North Carolina has a use tax on out-of-state purchases. The use tax applies to purchases made outside the State for use inside the State. North Carolina residents are responsible for paying use tax on their out-of-state purchases. Effective for tax years beginning on or after January 1, 1999, the use tax is reported on the income tax return.

A North Carolina resident owes use tax on an out-of-state purchase when the item purchased is subject to the North Carolina sales tax and the retailer making the sale does not collect sales tax on the sale or the state and local sales tax imposed by the other state is less than the state and local sales tax imposed by North Carolina. Items that are subject to sales tax include computers and other electronic equipment, software, books, audio and video tapes, compact discs, records, clothing, appliances, furniture and other home furnishings, sporting goods, and jewelry. Out-of-state retailers include mail-order companies, television shopping networks, firms selling over the internet, and retailers located outside North Carolina. When an out-of-state retailer does not collect sales tax, or the tax collected is less than the state and local sales tax imposed by North Carolina, the responsibility of paying the tax falls on the purchaser. North Carolina residents are responsible for paying use tax on the following purchases when the applicable sales tax is not collected and the purchases are for use in this State:

- Catalog, internet, or mail-order purchases from out-of-state vendors.
- Purchases from other states or countries.
- Purchases from television shopping networks or clubs.
- Vacation or other travel purchases, whether delivered to you in another state or shipped to you in North Carolina.
- Any other purchases subject to tax on which the applicable tax was not paid.

The use tax is calculated at the same rate as the sales tax, which is 6½% (6% prior to October 16, 2001) in all counties except Mecklenburg. In Mecklenburg County, the rate is 6½% for purchases made prior to October 16, 2001 and 7% for purchases made on or after October 16, 2001. Taxpayers who paid another state’s sales or use tax on out-of-state purchases may credit that amount against the North Carolina use tax due. Taxpayers may not claim a credit for sales tax or value-added tax paid to another country.

Worksheets for determining the North Carolina use tax are available in the individual income tax instructions.

XV. Subject: Withholding from Pensions, Annuities, and Deferred Compensation (G.S. 105-163.2A)

1. General

A pension payer required to withhold federal tax under section 3405 of the Code on a pension payment to a North Carolina resident must also withhold State income tax from the pension payment. If a payee has provided a North Carolina address to a pension payer, the payee is presumed to be a North Carolina resident and the payer is required to withhold State tax unless the payee elects no withholding. A pension payer that either fails to withhold or to remit tax that is withheld is liable for the tax.

A pension payer must treat a pension payment paid to an individual as if it were an employer's payment of wages to an employee. If the pension payer has more than one arrangement under which distributions may be made to an individual, each arrangement must be treated separately.

2. Definitions.

Unless otherwise specified below, the definitions, provisions, and requirements of section 3405 of the Internal Revenue Code with respect to federal withholding on pensions are applicable to State withholding on pensions.

a. Pension payer – A payer or a plan administrator with respect to a pension payment under section 3405 of the Code.

b. Pension payment – A periodic payment or a nonperiodic distribution, as those terms are defined in section 3405 of the Code.

3. Amount to Withhold

In the case of a **periodic payment,** as defined in Code section 3405(e)(2), the payer must withhold as if the recipient were a married person with three allowances unless the recipient provides an exemption certificate (Form NC-4P) reflecting a different filing status or number of allowances. Form NC-4P, Withholding Certificate for Pension or Annuity Payments, is used by a recipient of pension payments who is a North Carolina resident to report the correct filing status, number of allowances, and any additional amount the recipient wants withheld from the pension payment. It may also be used to elect not to have State income tax withheld. In lieu of Form NC-4P, payers may use a substitute form if it contains all the provisions included on Form NC-4P.

For a **nonperiodic distribution**, as defined in Code section 3405(e)(3), four percent (4%) of the distribution must be withheld. A nonperiodic distribution includes an eligible rollover distribution as defined in Code section 3405(c)(3). State law differs from federal law with respect to eligible rollover distributions. Federal law imposes a higher rate of withholding on eligible rollover distributions than on other nonperiodic distributions. State law imposes the same rate of withholding on all nonperiodic distributions.

4. Election Not to Have Income Tax Withheld

A recipient may elect not to have income tax withheld from a pension payment unless the pension payment is an eligible rollover distribution. A recipient of a pension payment that is an eligible rollover distribution does not have the option of electing not to have State tax withheld from the distribution.

Except for eligible rollovers, a recipient of a pension payment who has federal income tax withheld can elect not to have State income tax withheld. Conversely, a recipient who has State income tax withheld can elect not to have federal income tax withheld.

An election not to have tax withheld from a pension payment remains in effect until revoked by the recipient. An election not to have tax withheld is void if the recipient does not furnish the recipient's tax identification number to the payer or furnishes an incorrect identification number. In such cases, the payer will withhold on periodic payments as if the recipient is married claiming three allowances and on nonperiodic distributions at the rate of 4 percent.

A nonresident with a North Carolina address should also use Form NC-4P to elect not to have State income tax withheld. Completing Form NC-4P and electing not to have State tax withheld does not infer that the recipient is a resident of North Carolina.

5. Exceptions to Withholding

Tax is not required to be withheld from the following pension payments:

a. A pension payment that is wages.

b. Any portion of a pension payment that meets both of the following conditions:

   (1) It is not a distribution or payment from an individual retirement plan as defined in section 7701 of the Code.
   (2) The pension payer reasonably believes it is not taxable to the recipient.

c. A distribution described in section 404(k)(2) of the Code, relating to dividends on corporate securities.

d. A pension payment that consists only of securities of the recipient's employer corporation plus cash not in excess of $200 in lieu of securities of the employer corporation.

e. Distributions of retirement benefits received from North Carolina State and local government retirement systems and federal retirement systems identified as qualifying retirement systems under the terms of the *Bailey/Emory/Patton* settlement that are paid to retirees who were vested in the retirement systems as of August 12, 1989.

6. Notification Procedures for Pension Payers

A pension payer is required to provide each recipient with notice of the right not to have State withholding apply and of the right to revoke the

election. The notice requirements for North Carolina purposes are the same as the federal notice requirements, which are provided in section 3405(e)(10) of the Code. Section D of Federal Regulation 35.3405-1 contains sample notices that may be modified for State purposes to satisfy the notice and election requirements for periodic payments and nonperiodic distributions.

Under federal law, instead of notification that tax will be withheld unless the recipient chooses not to have tax withheld, pension payers may notify recipients whose annual payments are less than $5,400 that no federal tax will be withheld unless the recipient chooses to have federal withholding apply. Such notice may be provided when making the first payment. The same provision will be followed for North Carolina purposes with respect to State withholding from recipients whose annual payments are less than $5,400.

7. Reporting and Paying the Withheld Tax

A pension payer required to withhold State tax from a pension payment but is not already registered with the Department of Revenue for wage withholding must register by completing Form AS/RP1, Registration Application for Sales and Use Tax or Income Tax Withholding. The completed form should be mailed to the N.C. Department of Revenue, Business Registration Unit, P.O. Box 25000, Raleigh, North Carolina 27640-0100. The payer will be assigned an account identification number and will receive forms for paying the State tax withheld. The payer will initially be classified as a quarterly filer. The filing frequency may change after the first year depending on the amount of tax withheld during the first year.

A payer that withholds tax from pensions and also withholds tax from wages must report the withholding from pensions with the wage withholding unless the payer chooses to report the withholding from pensions separately. For those payers that do not choose to report the two types of withholding separately, the payment of tax withheld from pensions is due at the time the withholding from wages is due and the payer will be subject to penalties and interest on both types of withholding based on that due date. Payers that also withhold from wages but choose to report the withholding from pensions separately must file Form AS/RP1 to receive a separate account identification number. They will receive separate forms for paying the tax withheld from pensions.

A payer that initially chooses to report withholding from pensions separately may, at any time, begin reporting the two types of withholding together. If combined reporting is preferred, a payer should report the combined withholding under the account number for reporting wages. The payer should complete the Out of Business Notification for the separate pension withholding account and file it with the Department. The separate withholding account will be closed. A payer that initially reports the two types of withholding at the same time may choose to begin reporting the withholding on pensions separately by notifying the Business Registration Unit. The payer must continue to report the two

types of withholding together until the payer receives the separate account identification number and remittance forms from the Department. In either case, the payer must file separate annual reconciliations for the year in which the choice is changed.

8. Annual Statements

Payers must report pension income and State tax withheld on Federal Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-sharing Plans, IRAs, Insurance Contracts, etc. Form 1099-R must be given to the recipient on or before January 31 following the calendar year in which the pension payments were made. The payer must file an annual reconciliation with the Department of Revenue that reconciles the amounts withheld from each recipient. Payers choosing to report pension withholding with wage withholding must file one annual reconciliation report that includes the two types of withholding. Payers subject to both wage withholding and pension withholding that report the two types of withholding separately must file separate annual reconciliations for each type of withholding. The annual reconciliation for withholding from pensions is due on or before February 28.

XVI. Subject: Withholding From Nonresidents for Certain Personal Services (G.S. 105-163.1 through G.S. 105-163.24)

1. General

North Carolina income tax is required to be withheld from non-wage compensation paid to nonresidents for certain personal services rendered in this State. The requirement to withhold applies to payers who, in the course of a trade or business, pay more than $1,500 of non-wage compensation to a nonresident individual or to a nonresident entity for services performed in this State in connection with a performance, an entertainment or athletic event, a speech, or the creation of a film, radio, or television program. These payers must withhold North Carolina income tax at the rate of four percent (4%) from the compensation.

2. Definitions

a. Compensation - Consideration a payer pays a nonresident individual or nonresident entity for personal services performed in this State.

b. Contractor - Either of the following:

   (1) A nonresident individual who performs in this State for compensation other than wages any personal services in connection with a performance, an entertainment or athletic event, a speech, or the creation of a film, radio, or television program.

   (2) A nonresident entity that provides for the performance in this State for compensation of any personal services in connection with a performance, an entertainment or athletic event, a speech, or the creation of a film, radio, or television program.

c. Nonresident entity - Any of the following:

   (1) A foreign limited liability company that has not obtained a certificate of authority from the Secretary of State pursuant to Article 7 of Chapter 57C of the General Statutes.

   (2) A foreign limited partnership or a general partnership formed under the laws of any jurisdiction other than this State, unless the partnership maintains a permanent place of business in this State.

   (3) A foreign corporation that has not obtained a certificate of authority from the Secretary of State pursuant to Article 15 of Chapter 55 of the General Statutes.

d. Payer - A person who, in the course of a trade or business, pays a nonresident individual or a nonresident entity compensation for personal services performed in this State.

3. Exceptions to Withholding

Tax is not required to be withheld from compensation paid to a nonresident entity if the entity meets certain requirements. No tax is required to be withheld if the entity is a corporation or a limited liability

company that has obtained a certificate of authority from the Secretary of State. The payer must obtain from the entity and retain in its records the entity's identification number issued by the Secretary of State.

If the entity is a partnership, no tax is required to be withheld if the partnership has a permanent place of business in this State. The payer must obtain from the partnership and retain in its records the partnership's address and taxpayer identification number.

No tax is required to be withheld from an entity that is exempt from North Carolina corporate income tax under G.S. 105-130.11. This includes any organization that is exempt from federal income tax under the Internal Revenue Code. The entity must provide documentation of its tax exemption to the payer, such as a copy of the organization's federal determination letter of tax exemption or a copy of a letter of tax exemption from the Department of Revenue.

Tax is not required to be withheld from personal services income paid to an individual who is an ordained or licensed member of the clergy or who is a resident of North Carolina. The payer must obtain from any individual from whom the payer does not withhold because the individual is a resident of this State the individual's address and social security number and retain this information in its records.

4. Threshold

Withholding is required only if the contractor is paid or is expected to be paid more than $1,500 during the calendar year. Tax is not required to be withheld from a payment of compensation to a contractor if the payment is $1,500 or less and, at the time the payment is made, the payer does not believe that the total compensation to be paid to the contractor during the year will exceed $1,500. If additional compensation paid to the contractor later in the year causes total compensation for the year to exceed $1,500, the payer is not required to withhold tax from the additional compensation to make up for the compensation from which no tax was withheld. ***For example***, the payer pays a nonresident $900 in January, 2002. Since the compensation is $1,500 or less, no tax is withheld. Later in 2002, the same nonresident is paid an additional $800. The payer must withhold $32 from the $800 compensation ($800 x 4%) because the total compensation paid to the contractor for the year now exceeds $1,500. If the payer makes regular payments to the contractor during the year, the total of which is expected to exceed $1,500, tax must be withheld from each payment.

5. When Services Are Performed in North Carolina

Withholding is required only if the compensation is paid for services performed in this State. In most cases, the nonresident contractor will provide the service entirely in North Carolina; in those instances, tax must be withheld from the total amount of compensation.

If the nonresident contractor performs the contracted services in more than one state, the payer must withhold North Carolina tax only from the

portion of the compensation that is attributable to this State. In determining the portion of the compensation subject to withholding of North Carolina income tax, a nonresident contractor performing contracted services in North Carolina and in one or more other states must use a method of determining North Carolina source income that fairly and equitably apportions and allocates the compensation for services rendered in North Carolina.

Generally, contractors should use the "duty day" method to allocate the compensation to North Carolina. A duty day is any day or part of a day in which an activity connected with the service is performed. This includes, but is not limited to, meetings, delivery of products, and promotional activities. The contractor's North Carolina source income is determined by multiplying the total compensation for the contracted service by a fraction, the numerator of which is the number of duty days spent in North Carolina rendering services under the contract and the denominator of which is the total number of duty days spent both within and outside of North Carolina during the taxable year in rendering services under the contract. ***For example***, a foreign corporation enters into a contract for $100,000 to provide a performance in North Carolina. The corporation's representative spends one day in North Carolina reviewing the location of the performance and discussing other contractual matters. The corporation spends thirty-nine days outside North Carolina preparing for the performance and another ten days in North Carolina performing. The North Carolina payer must withhold $880 from the compensation paid to the contractor [($100,000 x 11/50) x 4%].

In some instances, the duty day method of determining North Carolina source income will not equitably apportion and allocate the compensation for services rendered in North Carolina. In those cases, the Secretary may require a different method or the contractor may deviate from the general method by submitting a proposed alternative method for the Secretary's approval.

6. Reporting and Paying the Withheld Tax

A payer who withholds tax from personal services income but who is not already registered with the Department of Revenue for wage withholding must register by completing Form AS/RP1, Registration Application for Sales and Use Tax and/or Income Tax Withholding, and returning the form to the North Carolina Department of Revenue at Post Office Box 25000, Raleigh, North Carolina 27640. The payer will be assigned an account identification number, will receive forms for paying the tax withheld from personal services income, and will pay the tax on a quarterly basis.

A payer who withholds tax from personal services income and who also withholds tax from wages must report the withholding from personal services income with the wage withholding unless the payer elects to report the withholding from personal services income separately from the wage withholding. For those payers who do not elect to report the two types of withholding separately, the payment of tax withheld from

personal services income is due at the time the withholding from wages is due and the payer will be subject to penalties and interest on both types of withholding based on that due date. A payer electing to report the withholding from personal services income separately will be assigned a separate account identification number for the withholding from personal services income, will receive special forms for paying the tax withheld, and will pay the tax on a quarterly basis.

A payer who initially elects to report the withholding from personal services income separately may, at any time, begin reporting the two types of withholding together. A payer who initially reports the two types of withholding at the same time may elect to begin reporting the withholding from personal services income separately by notifying the Business Registration Unit. The payer must continue to report the two types of withholding together until the payer receives the separate account identification number and remittance forms from the Department. In either case, the payer must file separate annual reconciliations for the year in which the election is changed (See Annual Statements below).

7. Annual Statements

A payer must give each contractor from whom tax was withheld duplicate copies of a written statement containing the following information:

- the names, addresses, and taxpayer identification numbers of the payer and the contractor;
- the total amount of compensation paid to the contractor during the calendar year;
- the total amount withheld from the amount paid to that contractor during the year.

Payers must report personal services income and the tax withheld on Form NC-1099PS. For compensation paid to individuals, the payer may complete federal Form 1099-MISC in lieu of Form NC-1099PS. The statement must be given to the contractor on or before January 31 following the calendar year in which the compensation is paid. If the personal services are completed before the end of the year, the statement must be given within 45 days of the last payment of compensation only if the contractor requests the statement at that time. The payer must file an annual report with the Department of Revenue reconciling the amounts withheld from each contractor. Taxpayers choosing to treat withholding from personal services income as wage withholding must report the two types of withholding on one annual reconciliation report. Taxpayers subject to both wage withholding and withholding from personal services income who report the two types of withholding separately must file separate annual reconciliations for each type of withholding. The annual reconciliation for withholding from personal services income is due on or before February 28.

8. Claiming Credit for Tax Withheld

Individuals having tax withheld from personal services income should claim credit for the tax withheld on the same line on the individual income tax return, Form D-400, as credit is claimed for wage withholding. Partnerships (including limited liability companies filing as partnerships) may claim credit on the partnership income tax return, Form D-403, for the portion of the tax withheld that is attributable to nonresident partners on whose behalf the managing partner is required to pay tax. The portion of the tax withheld that is attributable to resident partners must be allocated to those partners on Schedule NC K-1. S corporations may claim credit on the S corporation franchise and income tax return, Form CD-401S, for the portion of the tax withheld that is attributable to shareholders on whose behalf the corporation files a composite income tax return. The portion of the tax withheld that is attributable to shareholders who are not part of a composite return must be allocated to those shareholders on Schedule K of the S corporation return.

9. Refund of Tax Withheld in Error

A payer who improperly withholds tax from personal services income may refund the contractor the amount withheld in error if the refund is made before the end of the calendar year and before the payer furnishes the person the annual statement of tax withheld. A payer who makes a refund should not report the amount refunded on the annual statement nor remit the amount refunded to the Department. If the amount refunded has already been remitted, the payer must reduce the next payment of tax withheld from compensation paid to that person by the amount refunded. If no additional compensation is due to be paid to that person, and the amount withheld in error has already been remitted, the payer may not refund the tax withheld in error. The contractor must file an income tax return and claim credit for the tax withheld.

XVII. Subject: Withholding of Income Tax (G.S. 105-163.1 - 105-163.24)

1. General

G.S. 105-163.1 through G.S. 105-163.10 and G.S. 105-163.22 through G.S. 105-163.24 require employers to withhold income tax from compensation paid to their employees.

2. Withholding From Wages

Income tax must be withheld according to tables prepared by the North Carolina Department of Revenue or by using an acceptable alternate method and employers must pay over the amount withheld to the Department. These requirements are explained in the booklet, "Income Tax Withholding Tables and Instructions for Employers," Form NC-30, which is available on the Department of Revenue website **www.dor.state.nc.us.**

3. Withholding from Pensions, Annuities, and Deferred Compensation (See page 77.)

4. Withholding from Nonresidents for Personal Services Performed in North Carolina (See page 81.)

5. Wages

For North Carolina income tax purposes, the term wages has the same meaning as in Section 3401 of the Internal Revenue Code, except that it does not include the amount an employer pays an employee for reimbursement of ordinary and necessary business expenses of the employee.

If an employer enters into a voluntary agreement to withhold North Carolina tax on income not requiring withholding, the amount withheld will be accepted and the employee will receive credit on his annual income tax return provided the rules which apply to withholding are followed. Since the agreement to withhold is voluntary between the employer and the employee and is not required by law, the employee should understand that he cannot receive credit for any amount withheld that is not properly paid to the Department of Revenue.

6. Employee's Withholding Allowance Certificate

Each new employee, before beginning employment, must furnish his employer with a signed North Carolina Employee's Withholding Allowance Certificate, Form NC-4. A certificate filed by a new employee is effective upon the first payment of wages thereafter and remains in effect until a new one is furnished. State and federal definitions of dependent, single person, married, head of household, and qualifying widow(er) are the same; however, the number of allowances an individual is entitled to will differ. **Federal Exemption Certificates Are Not Acceptable**. If an employee fails to furnish an exemption certificate, Form NC-4, the

employer must withhold tax as if the employee is single with zero allowances.

The employer is not required to ascertain whether or not the total amount of allowances claimed is greater than the total number to which the employee is entitled. If, however, the employer has reason to believe that the number of allowances claimed by an employee is greater than the number to which such employee is entitled, the employer is requested to notify the Department of Revenue immediately.

If an employee's allowances should decrease, requiring more tax to be withheld, the employee is required to furnish his employer with an amended certificate within 10 days after the change. Should the allowances increase, requiring less tax to be withheld, the employee may furnish his employer with an amended certificate at any time after the change occurs.

7. Additional Withholding Allowances

Additional withholding allowances may be claimed by taxpayers expecting to have allowable itemized deductions exceeding the standard deduction or allowable adjustments to income. One additional allowance may be claimed for each $2,500 that the itemized deductions are expected to exceed the standard deduction and for each $2,500 of adjustments reducing income ($2,000 if the annual income equals or exceeds the following amounts for the employee's filing status: single — $60,000; head of household — $80,000; or married — $50,000). If an employee will be entitled to a tax credit, he may claim one additional allowance for each $175 of tax credit ($140 if the annual income equals or exceeds the following amounts for the employee's filing status: single — $60,000; head of household — $80,000; or married or qualifying widow(er) — $50,000).

8. Penalty

G.S. 105-163.5 provides a civil penalty against an employee who furnished his employer with an allowance certificate that contains information which has no reasonable basis and results in a lesser amount of tax being withheld than would have been withheld had the employee furnished reasonable information. The penalty is 50 percent of the amount not properly withheld.

9. Submission of Certain Withholding Allowance Certificates

An employer is required to submit copies of any withholding allowance certificates on which the employee claims more than 10 withholding allowances or claims exemption from withholding and the employee's wages would normally exceed $200 per week.

An employer filing quarterly withholding reports is required to submit copies of the certificates received during the quarter at the time for filing his quarterly report. An employer filing monthly withholding reports is required to submit copies of the certificates received during the quarter at the time for filing his monthly report for the third month of the calendar quarter. Copies may be submitted earlier and for shorter reporting periods.

Copies of the certificates, along with a letter showing the employer's name, address, withholding identification number, and the number of certificates submitted, are to be mailed to: North Carolina Department of Revenue, Withholding Section, P.O. Box 25000, Raleigh, North Carolina 27640-0001.

The employer shall withhold on the basis of the certificate until written notice is received from the Department that the certificate is defective. As part of that written notice, the Department will advise the employer to ignore the allowance certificate filed and to withhold on a number specified.

The employer shall promptly furnish the employee a copy of the written notice.

If the employee files a new certificate, the employer shall honor that certificate only if the employee does not claim exempt and claims a number smaller than the number allowed in the Department's written notice. If the new certificate claims a number larger than the employee has been allowed and the employee specifies, in writing, any circumstances as justification to support the claims, the employer must forward a copy of the certificate and the employee's written statement to the Department for review. The employer shall continue to withhold as specified in the Department's written notice until written notice is received from the Department advising the employer to withhold on the basis of the new certificate.

To increase withholding an employee may claim less than his allowable allowances or may enter into an agreement with his employer and request that an additional amount be withheld by entering the desired amount on Form NC-4.

An employee working for two or more employers should claim his allowable allowance with only one employer and claim zero allowances with the other employers.

If an employee claims total exemption from withholding, his wages will be exempt from withholding of North Carolina income tax for the remainder of the calendar year unless the employee withdraws the statement during the year. An employee claiming exemption from withholding must complete a new certificate by February 15. If the employee does not complete a new certificate, the employer must withhold on the basis of a single individual with zero withholding allowances.

10. Employers

An employer is any person or organization for whom an individual performs any service as an employee. The term includes federal, state, and local governmental agencies as well as religious, charitable, educational, and other nonprofit organizations even though they may be exempt for other tax purposes. **Note:** Compliance with any of the provisions of North Carolina withholding by a nonresident employer will not be deemed to be evidence that the nonresident is doing business in this state. (G.S. 105-163.4).

11. Employees

For North Carolina income tax withholding purposes, an employee is either a resident individual legally domiciled in this State who performs services within or outside North Carolina for wages, or a nonresident of this State who performs services within the State for wages. To prevent double withholding and to anticipate any tax credits allowable to a North Carolina resident, withholding of North Carolina tax is not required from wages paid to a resident for services performed in another state if that state requires withholding. This relief from double withholding does not relieve the resident of his obligation to file a North Carolina individual income tax return and pay any balance due after tax credit.

All wages received by a nonresident for services performed in this State are subject to withholding of North Carolina income tax. Any relief from double withholding must be granted by his state of residence.

12. Employer-Employee Relationship

Everyone who performs services subject to the will and control of an employer, both as to what shall be done and how it shall be done, is an employee. An employer-employee relationship exists when the person for whom the services are performed has the right to control and direct the individual performing the services. Managers and other supervisory personnel, officers of corporations, and elected public officials are employees. Whether the employer actually controls and directs the manner in which the services are performed does not matter if he has the right to do so, and it does not matter that the employee is called by some other name such as partner, agent, or independent contractor; nor whether the individual works full or part time; nor how the payments are measured, paid, or what they are called.

Lawyers, physicians, contractors, and others who follow an independent trade, business, or profession in which they offer their services to the public, generally are not employees. If an individual is subject to the control and direction of another only as to the results of his work and not as to the methods of accomplishing the results, he is generally an independent contractor and not an employee.

13. Ministers

An ordained or licensed clergyman who performs services for a church of any religious denomination may file an election with the Secretary of Revenue and the church he serves to be considered an employee of the church instead of self-employed. Until a clergyman files the election, amounts paid by a church to a clergyman are not subject to withholding.

14. Common Carriers

The Amtrak Reauthorization and Improvement Act of 1990 provides that no part of the compensation paid to an employee of an interstate railroad subject to the jurisdiction of the Surface Transportation Board (STB) may be subject to income tax, or income tax withholding, in any state except the state of the employee's residence when such employee performs regular assigned duties in more than one state. The Act also

precludes the taxation of compensation paid by an interstate motor carrier subject to the jurisdiction of the STB or to an employee of a private motor carrier performing services in two or more states except by the state of the employee's residence. Therefore, the compensation received by such nonresident employees for services performed in this State will not be subject to North Carolina income tax or income tax withholding.

Under the Federal Aviation Act (49 USCS-40116), a nonresident airline employee rendering service on an aircraft would not be liable for North Carolina income tax unless his scheduled flight time in North Carolina is more than 50 percent of his total scheduled flight time during the calendar year. If the employee's flight logs show that more than 50 percent of the scheduled flight time is in North Carolina, the amount of income reportable to this state would be based on the percentage that his North Carolina flight time is to his total flight time for the year.

15. Federal Employees

Under an agreement with this State, federal agencies withhold North Carolina income tax from the military pay of members of the Armed Forces designated as legal residents of North Carolina, and from the pay of civilian federal employees whose regular place of employment is in North Carolina.

16. Seamen

The Vessel Worker Tax Fairness Act, 46 U.S.C. § 11108, prohibits withholding of state income tax from the wages of a seaman on a vessel engaged in foreign, coastwise, intercoastal, interstate, or noncontiguous trade or an individual employed on a fishing vessel or any fish processing vessel. Vessels engaged in other activity do not come under the restriction; however, any seaman who is employed in coastwide trade between ports in this State may have tax withheld if such withholding is pursuant to a voluntary agreement between such seaman and his employer.

With respect to income obtained while: (1) engaged as a pilot (licensed under section 7101 of Title 46 of the Code or under the laws of a state) on a vessel performing duties in more than one state; or (2) performing regularly assigned duties as a master, officer or crewman on a vessel operating on the navigable waters of more than one state, an individual is subject to income tax only in the state and political subdivision in which the individual resides.

Seamen who are exempt from withholding as specified above, should determine whether they meet the requirements for making payments of estimated income tax.

17. Professional Athletes

Professional athletic teams must withhold income tax from the North Carolina source income of a nonresident member of the team at the highest rate for individuals with no allowance for any withholding exemption. (The

highest rate in effect for 2001 and 2002 is 8.25 percent.) Taxes shall be withheld from the income of a resident member of the team in the same manner as taxes are withheld from other residents.

Professional athletic teams not domiciled in this State are classified as quarterly employers and must file returns reporting the amount of taxes withheld and pay the amounts withheld on a quarterly basis.

Professional athletic teams that are domiciled in this State shall determine their filing and paying requirements in the same manner as all employers domiciled in this State.

A professional athletic team must include with its annual reconciliation a list of all employees who received North Carolina source income during the year. The list must include the following information:

a. The name, social security number, and mailing address of each employee;
b. Whether the employee is a resident of this State;
c. The total amount of income;
d. The amount of North Carolina source income;
e. The total amount deducted and withheld.

A nonresident member of a professional athletic team is not required to file a North Carolina individual income tax return when the only income from North Carolina sources is the compensation received for services rendered as a member of the team and the team has met the withholding requirements above. The individual may file an individual income tax return and claim credit for the tax withheld.

An individual is liable for any additional tax, penalty, or interest due if his team does not properly determine his North Carolina source income or properly withhold tax from that income.

18. Domestic Employees

Employers are not required to withhold State income tax from the wages of domestic employees; however, the employer and employee may enter into a voluntary agreement to withhold from the employee's wages. The amount to withhold is based on the employee information shown on Form NC-4. Employers may wish to contact the Employment Security Commission regarding any employment insurance liability.

19. Farm Labor

Compensation paid by a farmer for services performed on the farmer's farm in producing or harvesting agricultural products or in transporting the agricultural products to market is subject to North Carolina withholding if the compensation is subject to withholding of federal income taxes. Generally, wages paid to agricultural workers are subject to federal income tax withholding if the worker is paid $150 or more during the year or the employer pays $2,500 or more to all agricultural workers during the year.

20. Severance Wages

The first $35,000 of severance wages paid to an employee (whether paid in one year or over several years) as a result of the employee's permanent, involuntary termination from employment through no fault of the employee is exempt from withholding.

21. Supplemental Wage Payments

If an employer pays supplemental wages separately (or combines them in a single payment and specifies the amount of each), the income tax withholding method depends partly on whether the employer withholds income tax from the employee's regular wages.

If tax has been withheld on the regular wages and the supplemental amount is not paid in a single payment together with regular wages, the employer may treat the supplemental wages as wholly separate from the regular wages and apply a flat rate of 6 percent to the supplemental wage payment without making any allowance for exemptions. Otherwise, the supplemental wages are added to the regular wages for the most recent payroll period. The income tax is figured as if the regular wages and supplemental wages constitute a single payment. The tax already withheld from the regular wages is subtracted from this amount. The remaining tax is then withheld from the supplemental wages. If the employer did not withhold income tax from the employee's regular wages, the employer must add the supplemental wages to the employee's regular wages paid for the current or last preceding payroll period and withhold tax as though the supplemental wages and regular wages were one payment.

Tips treated as supplemental wages. The employer withholds the income tax on tips from wages or from funds the employee makes available. If an employee receives regular wages and reports tips, the employer figures income tax as if the tips were supplemental wages. If the employer has not withheld income tax from the regular wages, the employer adds the tips to the regular wages and withholds income tax on the total. If the employer withheld income tax from the regular wages, the employer can withhold on the tips as explained above.

22. Wage and Tax Statements

An employer should use the six-part Federal Form W-2 or any other alternate forms which have been designed for his payroll equipment if they provide the same information and the same number of copies as the official form. When completed, the state copies must show the employer's North Carolina withholding identification number and must clearly designate the state tax as North Carolina tax. Statements which do not meet the above requirements will not be accepted and employees cannot be given credit for the tax withheld.

23. Reciprocity Of Tax Credits

North Carolina does not allow income tax credit to nonresidents; therefore, any relief from double taxation must be granted by the state of residence. North Carolina provides such relief to its residents as explained in 11.

24. Credit For Income Tax Withheld

G.S. 105-163.10 provides that the amount deducted and withheld during any calendar year from the compensation of any individual shall be allowed as a credit to that individual against the tax imposed under G.S. 105-134.2 for taxable years beginning in such calendar year. For example, a taxpayer filing his return for a fiscal year ending September 30, 2001, will be allowed credit for tax withheld from his wages for the calendar year ending December 31, 2000. This is the case even though the taxpayer must report the income on his return for the fiscal year ending September 30, 2001.

XVIII. Subject: Reporting and Paying Tax Withheld

1. New Employers

Each new employer who is required to withhold North Carolina income tax must complete and file with the Department an application for a withholding identification number which can be obtained from any office of the Department. A withholding identification number will be assigned which should be recorded in a permanent place and used on all reports and correspondence concerning withholding.

2. Reports and Payments

North Carolina does not use a deposit system for income tax withheld similar to the federal system. Withheld taxes are paid quarterly, monthly, or semiweekly. Employers who withhold an average of less than $250 from wages each month must file a quarterly return and pay the withheld taxes on a quarterly basis. The quarterly return and payment are due by the last day of the month following the end of the calendar quarter.

Employers who withhold an average of at least $250 but less than $2,000 from wages each month must file a monthly return and pay the withheld taxes on a monthly basis. All monthly returns and payments are due by the fifteenth day of the month following the month in which the tax was withheld; except the return and payment for the month of December are due by the thirty-first day of January.

Employers who withhold an average of at least $2,000 from wages each month must file a report and pay the withheld taxes at the same times they are required to file reports and pay the tax withheld on the same wages for federal income tax purposes. The due dates for reporting and paying North Carolina income tax withheld is determined by the due dates for depositing federal employment taxes (income tax withheld and FICA). Each time an employer is required to deposit federal employment taxes, he must remit the North Carolina income tax withheld on those same wages, regardless of the amount of State tax withheld.

Exception: For federal tax purposes, if an employer withholds $100,000 or more, the deposit is required on the next banking day. North Carolina law does not adopt this provision of federal law, and the State income tax withholding on the same wages is due on or before the normal federal semi-weekly due date for those wages. The employer must mail or deliver payment of the North Carolina income tax withheld by the due date.

The North Carolina Quarterly Income Tax Withholding Return, Form NC-5Q, reconciles the tax paid for the quarter with the tax withheld for the quarter. The due dates for Form NC-5Q are the same as for the federal quarterly return (Federal Form 941); on or before the last day of the month following the close of the quarter. An employer has 10 additional days to file the return if all required payments were made during the quarter and no additional tax is due.

3. Reporting and Paying Tax Withheld from Pensions, Annuities, and Deferred Compensation (See page 77.)

4. Reporting and Paying Tax Withheld from Nonresidents for Personal Services Performed in North Carolina (See page 81.)

5. Electronic Funds Transfer

The Department of Revenue requires certain employers remitting an average of $20,000 per month per tax type to pay taxes by electronic funds transfer (EFT). Employers required to remit payments by this method will be notified in writing at least 60 days prior to the first month that an EFT payment is due. Voluntary participation is offered for all filing frequencies for nonmandated employers who are interested in paying electronically. For questions concerning electronic funds transfer, contact the EFT Section at (919)733-7307.

6. Amounts Withheld Are Held In Trust For The Secretary Of Revenue.

Any amount withheld by an employer is deemed to be held in trust for the Secretary of Revenue.

A penalty of 10 percent of the amount due is imposed for failure to withhold or to pay the tax when due. The penalty for failure to timely file a withholding return is 5 percent of the tax due per month (maximum 25 percent).

An employer who fails to withhold or pay the amount required to be withheld is personally and individually liable for the tax. If an employer has failed to withhold or to pay over income tax withheld or required to have been withheld, the tax not deducted or paid may be assessed against the responsible officers. The liability includes the tax not deducted or paid and any penalties and interest previously assessed against the employer. More than one person may be liable as an officer responsible for the payment of withholding taxes; however, the amount of the income tax withheld or required to have been withheld will be collected only once, whether from the employer or one or more responsible officers. The term “responsible officer” means the president and the treasurer of a corporation, the manager of a limited liability company, and any officer of a corporation or member of a limited liability company who has a duty to deduct, account for, or pay over income tax withheld. It is not necessary that the failure to collect and pay the withholding amounts was willful; it is only necessary that the responsible officer failed to pay the tax withheld or required to have been withheld to the Secretary of Revenue.

When the Department of Revenue determines that collection of the tax is in jeopardy, an employer may be required to report and pay the tax at any time after payment of the wages.

7. Annual Reports

At the end of each calendar year employers are required to furnish wage and tax statements to employees. Two copies must be furnished to the employee and one copy must be furnished to the Department. The Internal Revenue Service supplies a six-part Form W-2 which will produce the required federal and North Carolina statements in one packet.

The copies of the wage and tax statements for the Department of Revenue must be filed with the Annual Reconciliation of North Carolina Income Tax Withheld.

A payer who withholds from compensation paid to a nonresident contractor must provide the nonresident contractor a statement showing the total compensation paid and the amount withheld during the calendar year. The payer must give **Form NC-1099PS, Personal Services Income Paid To A Nonresident**, to the contractor on or before January 31 following the calendar year, or if the contractor requests the statement before then, within 45 days after the last payment of compensation to the contractor. Federal Form 1099-MISC may be filed in lieu of Form NC-1099PS.

Form NC-1099NRS, **Report of Sale of Real Property by Nonresidents**, is required to be filed by any person buying real property located in North Carolina from a nonresident. The form must be filed within 15 days of the closing date of the sale.

A payer who withholds from pension income must give the recipient Federal Form 1099-R, showing the pension amount paid and the North Carolina tax withheld on or before January 31 following the year in which the pension payments were made.

Forms NC-1099PS, NC-1099NRS, and Federal Form 1099-R must be filed with North Carolina; however, other reports of 1099 information (interest, rents, premium, dividends, etc.) are not required to be reported to North Carolina unless the payments have not been reported to the Internal Revenue Service.

XIX. Subject: Estimated Income Tax (G.S. 105-163.15)

1. Forms

The form for payment of estimated individual income tax, Form NC-40, is available from the Department of Revenue in the form of personalized payment vouchers or a four-part nonpersonalized payment form. Both types of forms include the necessary vouchers and instructions for making payments.

2. Requirements for Filing

An individual is required to pay estimated income tax if the tax shown due on the income tax return for the taxable year, reduced by the North Carolina tax withheld and allowable tax credits, is $1,000 or more regardless of the amount of income the individual has that is not subject to withholding. Married individuals can make joint payments of estimated income tax even if they are not living together; however, they are not entitled to make joint estimated tax payments if they are separated under a decree of divorce or of separate maintenance. Also, they may not make joint estimated tax payments if either of them is a nonresident alien or if either of them have different tax years.

Whether a husband and wife make joint estimated tax payments or separate payments will not affect their choice of filing a joint income tax return or separate return. If they make joint payments and then file separate returns, they may divide the estimated tax payments between them.

A taxpayer filing a short period return because of changing his income year is required to make estimated income tax payments on the installment dates which fall within the short period and 15 days after the close of the short period which would have been due had he not changed his income year. The penalty for underpayment of estimated income tax for a short period will be computed for the period of underpayment based on the tax shown due on the short period return and computed in the same manner as it would have been computed had the taxpayer not changed his income year.

3. Applying Prior Year's Income Tax Refund to Current Year's Estimated Income Tax

An individual may elect to have his income tax refund applied to estimated income tax for the following year. For example, an individual due a refund on his 2001 income tax return may have all or any portion of the refund applied to his estimated tax for 2002. The individual may not however, file a 2001 tax return in 2003 and request the refund be applied to his 2003 estimated tax since the refund can only be applied to the tax year which follows the year for which the request for refund is made. The last allowable date for making a 2002 estimated tax payment is January 15, 2003; therefore, you must file your 2001 income tax return by January 15, 2003, to elect to apply a portion of your refund to 2002

estimated tax. If an individual makes a valid election, that individual may not revoke the election after the return has been filed in order to have the amount refunded or applied in any other manner, such as an offset against any subsequent determined tax liability.

XX. Subject: Penalty for Underpayment of Estimated Income Tax (G.S. 105-163.15)

1. General

A civil penalty may be due for underpayment of estimated income tax. The penalty is computed separately for each payment period, therefore an individual may owe the penalty for an early period even if that individual later paid enough to make up the underpayment. If an individual did not pay enough tax by the due date of each of the payment periods, he may owe a penalty even if he is due a refund when he files his return.

2. Avoiding Penalty

The penalty for underpayment of estimated income tax will not apply if the individual makes payments of estimated income tax on each installment date for 25 percent of the lesser of (1) 90 percent (66.67 percent for farmers and fishermen) of the tax (after tax credits) on the current year's return, (2) 100 percent of the tax on the preceding year's return (provided it was a taxable year of 12 months and the individual filed a return for that year), or (3) 90 percent (66.67 percent for farmers and fishermen) of the tax determined by annualizing the income received during the year up to the month in which the installment is due. Also, no penalty for underpayment will be due if an individual had no tax liability for the preceding year or if the total tax shown on the current year return minus the amount paid through withholding is less than $1,000.

3. Underpayments

An underpayment is the excess of the required installment (or, if lower, the annualized income installment) for a payment period over the portion of the amount paid by the due date that is not applied to an underpayment for an earlier payment period.

Payments include income tax withheld and are considered payments of estimated tax in equal installments on the required installment dates (usually four), unless the individual can prove otherwise. A payment of estimated tax is credited against unpaid installments in the order in which the installments are required to be paid.

4. Overpayments

An overpayment for any period occurs when the withholding and estimated tax payments are more than the total of any underpayments for an earlier period plus the lesser of the required installment or the annualized income installment for the period. If there is an overpayment for a period, it should be carried to the next period and added to the withholding and estimated tax paid for that later period to determine any underpayment or overpayment for that later period.

5. Determining An Underpayment

No penalty will be due if the estimated tax payments were made on time and the payment for each period was at least as much as either the required installment or the annualized income installment for the period.

Use Form D-422, Penalty for Underpayment of Estimated Income Tax, to determine any underpayment.

The required installment for any payment period is the lesser of 22.5 percent of the tax shown on the current year return or 25 percent of the tax shown on the prior-year return (if the prior-year return covered all 12 months of the year). However, if the annualized income installment for any period is less than the required installment for the same period and the annualized income installment is used in determining the underpayment, add the difference between the annualized income installment and the required installment to the required installment for the next period. If the annualized income installment for the next payment period is used, add the difference between the annualized income installment for that period and the required installment (as increased) for that period to the required installment for the following payment period.

There will be no underpayment for any payment period in which the estimated tax payments, reduced by any amounts applied to underpayments in earlier periods, were paid by the due date for the period and were at least as much as the annualized income installment for the period.

6. Period of Underpayment

The penalty is applied to the number of days that the installment was not paid. For tax year 2001, for example, determine the period of the underpayment by counting the number of days after the due date of the installment to and including the date of payment, or April 15, 2002, whichever is earlier. Fiscal year taxpayers use the 15th day of the 4th month following the close of the fiscal year instead of April 15, 2002.

Calendar year taxpayers' payments were due on April 15, June 15, and September 15, and January 15 of the following year. If the 15th of the month is on a weekend, the payment is due on the next business day.

Payments for fiscal year taxpayers were due on the 15th day of the 4th month, the 15th day of the 6th month, and the 15th day of the 9th month of the fiscal year, and the 15th day of the 1st month after the end of the fiscal year.

Periods and amounts of underpayment are determined by applying estimated tax payments to any underpayments of earlier installments in the order in which such installments were required to be paid.

If a payment of estimated tax is applied to an underpayment for an earlier period, but the payment is less than the underpayment, there will be more than one period of underpayment for the earlier period.

The first period of underpayment for any payment period will be from the day after the due date for the payment period to the date of the first applied payment. Later periods of underpayment for that payment period will be from the day after the due date for the payment period to the date of the next applied payment or April 15 of the following year, whichever is earlier.

To determine the penalty for a payment period with more than one period of underpayment, compute a penalty amount separately for each of the periods of underpayment using the number of days in each period of underpayment, the correct underpayment balance, and the appropriate penalty rates.

7. Farmers and Fishermen

The following special rules for underpayment of estimated tax apply to farmers and fishermen:

a. The penalty for underpaying 2001 estimated tax will not apply if the return was filed and all tax was paid by March 1, 2002. For fiscal year taxpayers the penalty will not apply if the return is filed and tax due is paid by the first day of the third month after the end of the tax year.

b. Any penalty owed for underpaying 2001 estimated tax will be determined from one payment due date, January 15, 2002.

c. The underpayment penalty for 2001 is computed on the difference between the amount of estimated tax paid by the due date and the lesser of 100 percent of the tax shown on the 2000 return or 66 $^2/_3$ percent of the 2001 tax.

Even if these special rules apply to a farmer or fisherman, he will not have to pay a penalty if the tax due (less withholding) is less than $1,000 or if he had no tax liability for the prior year.

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