

STATE OF NORTH CAROLINA

BEFORE THE
SECRETARY OF REVENUE

COUNTY OF WAKE

IN THE MATTER OF:)
)
 The Proposed Reduction in Corporate)
 Income Tax Refund for Fiscal Year)
 Ending August 31, 1999 and Proposed)
 Corporate Income Tax Assessment for)
 Fiscal Year ending August 31, 2001)
 by the Secretary of Revenue)
 of North Carolina)
)
 vs.)
)
 (Taxpayer))

FINAL DECISION
DOCKET NO. 2004-108

An Administrative Hearing was conducted before Eugene J. Cella, Assistant Secretary of the North Carolina Department of Revenue, in the city of Raleigh on May 12, 2004, regarding a proposed reduction in a corporate income tax refund requested by (Taxpayer) for the tax year ending August 31, 1999 and a proposed assessment of additional corporate income tax against Taxpayer for the tax year ending August 31, 2001. Taxpayer was represented by (an employee of Taxpayer) and (two accountants from an in-state accounting firm). The Corporate, Excise, and Insurance Tax Division of the Department of Revenue was represented by Gregory B. Radford, Director, and Perry Draper, Administrative Officer. Taxpayer's parent is hereinafter referred to as "Parent."

ISSUES

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

- I. Whether certain furniture and fixtures used in Taxpayer's business qualify as machinery and equipment for

purposes of the tax credit for investing in machinery and equipment in G.S. 105-129.9?

- II. Whether the proposed reduction in corporate income tax refund and proposed assessment of additional corporate income tax are lawful and proper?

EVIDENCE

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

Submitted by the Department:

- D-1 Taxpayer's original and amended Corporate Franchise and Income Tax return for FYE August 31, 1998.
- D-2 Taxpayer's original and amended Corporate Franchise and Income Tax return for FYE August 31, 1999.
- D-3 Taxpayer's Corporate Franchise and Income Tax return for FYE August 31, 2000.
- D-4 Taxpayer's Corporate Franchise and Income Tax return for FYE August 31, 2001.
- D-5 Auditor's Reports dated July 17, 2003 for the fiscal years ending August 31, 1999 through August 31, 2001, including Audit Remarks and Credit Schedules.

- D-6 Notice of Corporate Income Tax Assessment dated July 29, 2003 for the fiscal year ending August 31, 2001.
- D-7 Letter from Taxpayer to the Department of Revenue dated August 27, 2003, protesting the proposed adjustments to the fiscal years ending August 31, 1999 through August 31, 2001 and requesting an administrative tax hearing.
- D-8 Letter from Perry L. Draper, Administrative Officer in the Corporate, Excise and Insurance Tax Division, to Taxpayer dated October 9, 2003.
- D-9 Letter from Taxpayer to Gregory B. Radford, Director of the Corporate, Excise and Insurance Tax Division, dated October 31, 2003.
- D-10 Letter from Mr. Draper to Taxpayer dated February 4, 2004.
- D-11 Letter from Taxpayer to Mr. Draper dated February 18, 2004.
- D-12 Letter from Mr. Eugene J. Cella, Assistant Secretary of Revenue, to Taxpayer dated March 11, 2004, scheduling a hearing for May 12, 2004 at 3:00 p.m.
- D-13 Definitions of “tool” and “implement” from *The American Heritage® Dictionary of the English Language, Fourth Edition*.
- D-14 Definitions of “machinery” and “equipment” from *Bartleby.com* and *Merriam-Webster Online Dictionary*.
- D-15 N.C. Administrative Code T17, 7B .0202, entitled Classification of Manufacturing Activities.

D-16 IRS Publication No. 587, Depreciation.

D-17 IRS Website Information - Figuring Depreciation under MACRS.

Submitted by Taxpayer:

T-1 Power of Attorney from Taxpayer authorizing (two accountants from an in-state accounting firm) to represent Taxpayer in this matter.

T-5 Certificate of Eligibility issued by the North Carolina Department of Commerce to Taxpayer for the tax year 2000.

T-6 Certificate of Eligibility issued by the North Carolina Department of Commerce to Taxpayer for the tax year 2001.

T-7 Invoices dated May 7 and June 7, 2001.

Exhibits T-2, T-3, and T-4 were duplicates of exhibits introduced by the Department and thus were not included in the record.

At the hearing, the Assistant Secretary asked the Department to provide a history of the enactment of Session Law 1997-277. The Assistant Secretary also ordered the record held open until June 24, 2004 to allow Taxpayer time to submit additional information and for the Department to respond. The Assistant Secretary places the following into the record:

D-18 Memo dated May 19, 2004 to Eugene J. Cella, Assistant Secretary for Administrative Hearings from Gregory B. Radford, Director, Corporate, Excise and Insurance Tax Division, Subject: Hearing Follow-up.

D-19 Letter from Taxpayer to Mr. Eugene J. Cella, Assistant Secretary Administrative Tax Hearings, dated June 7, 2004 with related attachments.

D-20 Letter from Mr. Eugene J. Cella, Assistant Secretary of Revenue, to (an accountant in an in-state accounting firm) dated September 24, 2004.

- D-21 Letter from Perry L. Draper, Administrative Officer, to (an accountant in an in-state accounting firm) dated September 29, 2004 with related attachments.
- D-22 Letter from Taxpayer to Mr. Perry L. Draper, Administrative Officer, dated October 8, 2004, with related attachments.
- D-23 Letter from Mr. Eugene J. Cella, Assistant Secretary of Revenue, to (an accountant in an in-state accounting firm) and Mr. Gregory B. Radford, Director, Corporate, Excise & Insurance Tax Division dated October 25, 2004.

FINDINGS OF FACT

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

1. Taxpayer was incorporated in North Carolina on November 17, 1997 and is principally engaged in business in this State as a “management company.”
2. Taxpayer is wholly owned by Parent company and is located in (City), North Carolina.
3. Taxpayer began operating as a central office on January 1, 1998.
4. Between January 1, 1998 and August 31, 1998, Taxpayer converted warehouse space to office space and hired over 40 new employees to perform central office functions.

5. Taxpayer performs all of the administrative functions for the affiliated group's retail stores throughout the United States.
6. Taxpayer has no business activities or operations in North Carolina other than the administrative functions it performs for the affiliated group's retail stores.
7. Taxpayer timely filed its Corporate Income and Franchise Tax Returns for the initial filing year of November 17, 1997 through August 31, 1998 and the fiscal years ending August 31, 1999, August 31, 2000, and August 31, 2001 under extensions.
8. An amended Corporate Income and Franchise Tax Return filed for the Initial filing year was received by the Department on July 9, 2001. The amended return provided an approved copy of the Certificate of Eligibility by the Secretary North Carolina Department of Commerce for William S Lee Tax Credits. Taxpayer also included in the amended return a computation of the Credit for Investing in Machinery and Equipment.
9. Taxpayer received the certificate of eligibility for William S. Lee credits as a central office.
10. An amended Corporate Income and Franchise Tax Return was filed for fiscal year ended August 31, 1999 claiming a refund based on the first installment of the Machinery and Equipment Credit for machinery and equipment placed in service in the initial filing year and certain other credits provided for under Article 3A of the William S. Lee Act. The amended return also established eligibility for additional machinery and equipment purchased during the year. The Department disallowed a portion of the M&E credit installment and reduced the refund requested by \$24,778.00. The portion of the credit disallowed by the Department was

- for office furniture and fixtures, such as work stations, file cabinets, desks, and chairs based on the Department's position that furniture and fixtures were not "machinery and equipment" under Article 3A of Chapter 105.
11. The Corporate Income and Franchise Tax Return filed for fiscal year ended August 31, 2000 claimed installments of the Credit for Machinery and Equipment that were partially disallowed under audit by the Department. The portion of the credit disallowed by the Department was for office furniture and fixtures, such as work stations, file cabinets, desks, and chairs based on the Department's position that furniture and fixtures were not "machinery and equipment" under Article 3A of Chapter 105. The adjustment resulted in no tax effect for the year because the allowable credits exceeded 50% of the total corporate income tax.
 12. The Corporate Income and Franchise Tax Return filed for Fiscal year ended August 31, 2001 claimed installments of the Credit for Machinery and Equipment that were partially disallowed under audit by the Department. The portion of the credit disallowed by the Department was for office furniture and fixtures, such as work stations, file cabinets, desks, and chairs based on the Department's position that furniture and fixtures were not "machinery and equipment" under Article 3A of Chapter 105. The adjustment resulted in additional tax due of \$84,162.00 and interest of \$9,064.84. The taxpayer timely paid the amount assessed and requested a refund of the \$93,226.84 paid.
 13. Taxpayer filed a letter of protest dated August 27, 2003 providing additional information and requested an administrative hearing.
 14. Taxpayer protested the portion of the Department's audit adjustments related to the Machinery and Equipment Tax Credit. Specifically, Taxpayer protests the denial of credits claimed for office furniture and

fixtures, such as work stations, file cabinets, desks, and chairs, used by the central office of Taxpayer.

15. The items of office furniture and fixtures were used by Taxpayer in its central office functions.
16. The items of office furniture and fixtures were essential to the functioning of that business.
17. The office furniture and fixtures were capitalized for income tax purposes and were not leased to others.

CONCLUSIONS OF LAW

Based on the foregoing findings of fact, the Assistant Secretary makes the following conclusions of law:

1. Article 3A of Chapter 105 of the General Statutes provides tax credits to certain businesses. The tax credits include a credit for new jobs, a credit for investing in machinery and equipment, a credit for research and development, a credit for worker training, and a credit for investing in central office property.
2. One of the businesses eligible for the Article 3A credits is a central office that hires at least 40 new employees.
3. Taxpayer is an eligible business because it is a central office that hired at least 40 new employees.
4. A taxpayer that is an eligible business and that meets all general eligibility requirements in Article 3A is entitled to the credit for investing in

machinery and equipment if the taxpayer purchases or leases eligible machinery and equipment and places them in service in this State during the taxable year. The credit is equal to the applicable percentage of the excess of the eligible investment amount over the applicable threshold. Machinery and equipment are eligible if they are capitalized by the taxpayer for tax purposes under the Code and not leased to another party.

5. Machinery and equipment is defined under the Act as “[e]ngines, machinery, equipment, tools, and implements used or designed to be used in the business for which the credit is claimed. The term does not include real property as defined in G.S. 105-273 or rolling stock as defined in G.S. 105-333.”
6. A tax credit is similar to a deduction or exemption; all three are methods that, when approved by the legislature, result in a reduced tax liability.
7. The allowance of a credit is a matter of legislative grace and a taxpayer claiming a credit must bring itself within the statutory provisions allowing it.
8. Because a credit provides an exemption from the tax otherwise due, all doubts are resolved against the credit and in favor of taxation. The taxpayer bears the burden to prove it is entitled to the credit.
9. Workstations, file cabinets, desks, and chairs are essential to the day-to-day business functions of a central office.
10. Without these items, the central office could not perform the functions for which it is designed.
11. Furniture and fixtures essential to the day-to-day functions of the central office constitute equipment within the meaning of the statute.

12. Engines, machinery, equipment, tools, and implements essential to the function of a central office qualify as machinery and equipment for purposes of the machinery and equipment credit.
13. Machinery and equipment essential to the function of a central office may not be essential to the function of another eligible business and vice versa. What constitutes machinery and equipment essential to the function of an eligible business depends on the facts and circumstances. The taxpayer bears the burden to prove that the items claimed as machinery and equipment are essential to the day-to-day functions of the business.
14. The proposed reduction to the refund for the fiscal year ending August 31, 1999 and the proposed assessment for the fiscal year ending August 31, 2001, to the extent herein modified, are lawful and proper.

DECISION

Based on the foregoing evidence of record, findings of fact, and conclusions of law, the Assistant Secretary of Revenue finds the proposed reduction in refund for the fiscal year ending August 31, 1999 and the proposed assessment for the fiscal year ending August 31, 2001, as herein modified, to be lawful and proper and are hereby affirmed.

Taxpayer was incorporated in the State of North Carolina on November 17, 1997 and is principally engaged in business in the state as a management company. Taxpayer is wholly owned by Parent and is located in (City), North Carolina. Since January 1, 1998 the taxpayer has performed all the administrative functions for the group's retail stores throughout the United States, hired forty

additional employees in the required time period, and is a central administrative office (now called central office) as defined in G.S. 105-129.2(2)a.

Taxpayer timely filed an amended Corporate Income and Franchise Tax return for its initial year ended August 31, 1998 to claim eligibility for certain Bill Lee credits, including the credit for machinery and equipment. Taxpayer claimed the first installment of the machinery and equipment credit for machinery and equipment placed in service during its initial year on its amended corporate tax return for the year ending August 31, 1999 and also reported new investments in machinery and equipment during that fiscal year. Taxpayer continued to claim installments of the machinery and equipment credit on the original returns for years ending August 31, 2000; and, August 31, 2001.

Taxpayer's returns were audited by the Department and several adjustments were proposed to the returns, including an adjustment to the calculation of the credit for machinery and equipment to disallow the inclusion of furniture and fixtures, such as work stations, file cabinets, desks, and chairs, as eligible for the credit under the premise that furniture and fixtures do not meet the definition of "machinery and equipment."

G.S. 105-129.2(15) (formerly G.S. 105-129.2(10)) defines "machinery and equipment" as "[e]ngines, machinery, equipment, tools, and implements used or designed to be used in the business for which the credit is claimed..." There are two parts to this definition that a taxpayer must meet for the investment to qualify for the M&E credit. First, the assets must be "engines, machinery, equipment, tools, and implements." Those terms are not further defined in the Article. Second, the machinery and equipment must be "used or designed to be used in the business for which the credit is claimed." The phrase "used or designed to be used" is also not further defined. It is my determination, after reviewing all the facts presented, that furniture and fixtures constitute equipment as that term is commonly understood. In addition, the furniture and fixtures at issue here, such

as work stations, file cabinets, desks, and chairs, are essential to the day to day business functions of a central office and, therefore, are "used or designed to be used" in a central office. Therefore, work stations, file cabinets, desks, and chairs qualify as "machinery and equipment" for purposes of the M&E credit. Other furniture and fixtures, such as, but not limited to, art work, potted plants, cooking equipment, cafeteria tables and chairs, tropical fish tanks, rugs, fountains, while potentially beneficial to the overall environment of a central office, are not essential to its operation and would not qualify as "used or designed to be used" in a central office.

The proposed reduction in refund for the fiscal year ending August 31, 1999 and the proposed assessment of additional corporate income tax for the fiscal year ending August 31, 2001, are hereby modified to allow the previously disallowed work stations, file cabinets, desks, and chairs as eligible machinery and equipment. The additional refund of tax for the fiscal year ending August 31, 1999 is \$7,032.00 and the tax to be refunded for the fiscal year ending August 31, 2001 is \$38,982.00. The overpayments of tax resulting from this adjustment shall be refunded, along with applicable interest.

This the 19th day of November, 2004.

Signature _____

Eugene J. Cella
Assistant Secretary of Revenue