

STATE OF NORTH CAROLINA

BEFORE THE
SECRETARY OF REVENUE

COUNTY OF WAKE

IN THE MATTER OF:

The Proposed Assessment of additional Franchise)
Tax for the tax years 2000 through 2002 by the)
Secretary of Revenue of North Carolina)

vs.)

(Taxpayer))

FINAL DECISION

Docket # 2007-28

This matter was heard before Eugene J. Cella, Assistant Secretary for Administrative Tax Hearings, at the North Carolina Department of Revenue in the City of Raleigh on May 18, 2007 regarding assessments of additional franchise tax, penalty, and interest proposed against (Taxpayer), hereinafter referred to as "Taxpayer," for the tax years 2000 through 2002. (Taxpayer's Vice President and Tax Counsel) and (another employee) represented Taxpayer via telephone. The Corporate, Excise and Insurance Tax Division was represented by Gregory B. Radford, Director, Lennie Collins, Assistant Director, and Bobby L. Weaver, Jr., Administration Officer.

ISSUES

- I. Whether Taxpayer's investment in (a limited liability company) ("LLC"), which is taxed as a partnership for federal income tax purposes, produces apportionable business income under the North Carolina General Statutes.
- II. Whether Taxpayer's capital, its affiliated indebtedness and its accumulated retained earnings should be subject to North Carolina Franchise Tax.

EVIDENCE

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

Submitted by the Division:

- D-1 Taxpayer's North Carolina Franchise And Income Tax Return For The Tax Year Ending December 31, 2000.

- D-2 Taxpayer's North Carolina Franchise And Income Tax Return For The Tax Year Ending December 31, 2001.
- D-3 Taxpayer's North Carolina Franchise And Income Tax Return for the Tax Year Ending December 31, 2002.
- D-4 Auditor's Report for the Audit Period 2000 through 2002 dated May 15, 2006.
- D-5 Notice of Corporate Franchise Tax Assessment for Tax Year 2000 dated July 11, 2006.
- D-6 Notice of Corporate Franchise Tax Assessment for Tax Year 2001 dated July 11, 2006.
- D-7 Notice of Corporate Franchise Tax Assessment for Tax Year 2002 dated July 11, 2006.
- D-8 Hearing request letter dated August 9, 2006 from (an employee) with Taxpayer to the Department.
- D-9 Letter dated December 18, 2006 from Bobby L. Weaver, Jr., Administrative Officer in the Corporate, Excise and Insurance Tax Division, to (an employee of Taxpayer).
- D-10 Letter dated February 9, 2007 from Eugene J. Cella, Assistant Secretary of Revenue, to (Vice President of Taxpayer).
- D-11 Attorney General's Opinion dated January 7, 1947.
- D-12 Excerpt from 2006 Multistate Corporate Tax Guide published by CCH Incorporated.
- D-13 Final Decision of Michael A. Hannah, Assistant Secretary of North Carolina Department of Revenue, for Docket # 97-548.
- D-14 Administrative Decision No. 351 entered by the Tax Review Board on January 28, 1999 upon appeal of the taxpayer in the Hearings Officer's Final Decision for Docket #97-548
- D-15 North Carolina Administrative Rule NCAC T17.05C.1702.
- D-16 Letter dated April 17, 2007 from (Vice President of Taxpayer) to Eugene J. Cella, Assistant Secretary of Revenue.
- D-17 Letter dated April 18, 2007 from Eugene J. Cella, Assistant Secretary of Revenue, to (Vice President of Taxpayer).
- D-18 North Carolina Administrative Rule NCAC T17.05C.1701.
- D-19 North Carolina Administrative Rule NCAC T17.05B.1110.

FINDINGS OF FACT

Based on the foregoing evidence of record, the Assistant Secretary for Administrative Tax Hearings makes the following findings of fact:

1. Taxpayer was incorporated on (Date), 1976 in the State of Delaware.
2. Taxpayer is a holding company that is invested in various partnerships that lease automobiles and other equipment.
3. Taxpayer engaged in no other business activities aside from managing its investments as a holding company.
4. During the audit period, January 1, 2000 through December 31, 2002, Taxpayer's largest investment was a 33.33% interest in LLC.
5. Taxpayer invested in LLC with two other unrelated entities that lease automobiles and other equipment.
6. LLC elected to be treated as a partnership for federal income tax purposes.
7. Taxpayer filed North Carolina Corporate Income and Franchise Tax returns for the tax years 2000 through 2002.
8. Taxpayer reported an apportionment factor of 0.00% for each year.
9. During an examination of Taxpayer's corporate tax returns for the tax years 2000 through 2002, the auditor discovered that Taxpayer failed to include its pro rata share of the LLC's apportionment data in its apportionment calculation.
10. Taxpayer also failed to report affiliated indebtedness as reflected on its books and records in its capital stock, surplus, and undivided profits franchise tax base.
11. The auditor adjusted the apportionment factor by including Taxpayer's proportionate share of LLC's attributes in Taxpayer's apportionment factor pursuant to G.S. 105-130.4 and NCAC T17:05C.1702.
12. The auditor also adjusted Taxpayer's capital stock base to include its affiliated indebtedness as required under G.S. 105-122(b).
13. Taxpayer understated its franchise tax liability for each tax period by 25% or more.
14. The Department issued proposed franchise tax assessments dated July 11, 2006 for the additional franchise tax due, a 25% penalty for a large tax deficiency, and additional interest.

15. Taxpayer timely protested the proposed franchise tax assessments and requested an administrative tax hearing. Taxpayer also requested a waiver of the penalties.
16. Taxpayer contended that its pro-rata share of LLC's net income should be classified as allocable nonbusiness income because Taxpayer limits its connection to LLC to the mere investment of funds and does not materially participate in the day-to-day operations of LLC.
17. Taxpayer argued that the apportionment method employed by the auditor results in an unfair and inequitable result because its investment in LLC was minimal in comparison to its total capital.
18. Taxpayer further argued that the auditor's approach to computing its franchise tax liability by subjecting all of its capital (based on its investments in consolidated affiliates) to apportionment simply by virtue of its minority investment in an LLC did not accurately reflect the extent of its business activity in North Carolina.
19. Taxpayer has not had a penalty waiver under the good compliance provision of the penalty waiver policy.
20. The Department's penalty waiver policy outlines two categories of criteria used by the Department when determining whether or not to waive a civil penalty. These criteria are: (1) general waiver criteria, and (2) special circumstances. The category of general waiver criteria consists of three automatic reasons to waive or reduce a penalty and one conditional reason of good compliance record. The three automatic reasons for penalty waiver include: (1) the death of the taxpayer, the taxpayer's immediate family member, or the taxpayer's tax preparer; (2) serious, sudden illness of the taxpayer, the taxpayer's immediate family member, or the taxpayer's tax preparer that prevented compliance; and (3) a natural disaster that destroyed property that prevented compliance. The good compliance provision provides that a taxpayer may be granted one "free penalty pass" every three years by the Department if the taxpayer has filed all tax returns due, has paid all tax and interest due on the returns filed, and the penalty imposed was not the result of a repeated mistake made by the taxpayer. The category of special circumstances consists of all other reasons to waive or reduce a penalty. The waiver or reduction of a penalty based on the category of special circumstances is the exception rather than the rule.
21. The Secretary has previously ruled on the issue of whether partnership income received by a corporation is business income. In Final Decision Docket No. 97-548, a holding company argued that an income distribution from a tiered partnership was nonbusiness income because it was received from a limited partnership interest in a partnership that held a limited partnership interest in an operating partnership that was doing business in North Carolina. Similar to Taxpayer, the holding company in that case also argued that it did not participate in the day-to-day operations of the partnership. However, the Secretary held that the holding company was doing business in this State and ruled that the income received from the partnership was business income to the holding company. The Final Decision was later upheld by the Tax Review Board in Administrative Decision No. 351.

CONCLUSIONS OF LAW

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

1. A corporation is subject to the corporate income tax if it is doing business in this State. G.S. 105-130.1.
2. For income tax purposes, the term "doing business" means the operation of any business enterprise or activity in North Carolina for economic gain. NCAC T17: 5C .0102(a). Corporations who are partners in a partnership or joint venture operating in North Carolina are considered to be 'doing business.' NCAC T17: 5C .0102(b).
3. The "doing business" rule does not distinguish between general and limited partners of a partnership. Therefore, a limited or general partner in a partnership that is "doing business" in North Carolina is likewise "doing business" in North Carolina.
4. Taxpayer is "doing business" in North Carolina by virtue of its ownership interest in LLC because LLC is doing business in North Carolina and has elected to be treated as a partnership for federal tax purposes.
5. During the years 2000 and 2001, G.S. 105-130.4(a)(1) defined "business income" as: "[i]ncome arising from transactions and activity in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation's regular trade or business operations." "Nonbusiness income" was defined as all income other than business income. G.S. 105-130.4(a)(5).
6. "State net income" means the taxpayer's federal taxable income as determined under the Code, adjusted as provided in G.S. 105-130.5.
7. Internal Revenue Code Section 706(a) provides that a partner must take into account separately its distributive share of certain items of partnership income, gain, loss, deduction or credit in determining its federal taxable income. The partner's distributive share of partnership items is includible on its corporate income tax return for the tax year in which the partnership tax year ends.
8. A corporation which is a member of a partnership or joint venture doing business in North Carolina is subject to North Carolina income tax and is required to include in the total net income subject to apportionment and allocation its share of the partnership's net income or net loss to the same extent required for federal income tax purposes. NCAC T17: 5C .1701.

9. Under G.S. 105-130.4(i), all business income of corporations other than public utilities and excluded corporations shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four.
10. For tax years beginning on or after January 1, 2002, G.S. 105-130.4(a)(1) defines “apportionable income” as “all income that is apportionable under the United States Constitution.” “Nonapportionable income means all income other than apportionable income.” G.S. 105-130.4(a)(5).
11. Under G.S. 105-130.3, the income tax is imposed on the State net income of every C corporation doing business in this State at sixth and ninety one-hundredths percent (6.9%) of the corporation’s State net income.
12. Where the business of the partnership is directly or integrally related to the business of the corporate partner, the corporate partner's share of the partnership net income is classified as business or apportionable income. NCAC T17: 5C .1702.
13. When classified as business or apportionable income, the corporate partner's apportionment factors shall include its proportionate share of the partnership's property, payroll and sales. NCAC T17: 5C .1702.
14. As a holding company with no other business activities apart from its ownership interest in its investments, the businesses of Taxpayer and LLC are directly or integrally related; the income from LLC is apportionable business income under G.S. 105-130.4; and the proportionate share of the partnership’s property, payroll and sales are includible in Taxpayer’s apportionment factors.
15. This decision regarding the taxation of a corporate partner of a partnership is supported by an opinion of the Attorney General dated January 7, 1947.
16. A corporation not organized under the laws of this State is subject to the franchise tax for doing business in this State and for the benefit and protection the corporation receives from the from the government and laws of this State in doing business in this State. G.S. 105-114(a1)(2).
17. For franchise tax purposes, the term “doing business” means each and every act, power, or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State. G.S. 105-114(b)(3).
18. The provisions of G.S. 105-122 relating to indebtedness of a corporation for franchise tax purposes are mandatory. A debtor corporation, such as Taxpayer, is required to add to its capital stock, surplus and undivided profits all indebtedness owed to a parent, subsidiary or affiliated corporation as a part of its capital used in its business and as a part of the base for franchise tax.

19. A corporation reporting under G.S. 105-122 includes all capital employed in its tax base.
20. Taxpayer is required to include affiliated indebtedness as a part of its capital used in its business and as a part of the base for franchise tax.
21. A taxpayer's franchise tax Capital Stock, Surplus and Undivided Profits base is apportioned through use of the fraction computed for apportionment of its income under Article 4. G.S. 105-122(c)(1).
22. A multistate corporate taxpayer must use the applicable allocation and apportionment formula prescribed by G.S. 105-130.4 unless the Tax Review Board grants it permission to use an alternative formula.
23. Under G.S. 105-130.4(t), a taxpayer may file a petition with the Tax Review Board for permission to use an allocation and apportionment formula other than the statutory formula in G.S. 105-130.4 in calculating its income tax.
24. G.S. 105-122(c)(2) also authorizes a taxpayer who believes the statutory method of apportionment operates to subject it to tax on a greater portion of its capital stock, surplus and undivided profits than is reasonably attributable to its business within the State to file a petition with the Tax Review Board for permission to use an allocation and apportionment formula other than the statutory formula in G.S. 105-130.4 in calculating its capital stock base.
25. The petition must be filed with the Tax Review Board no later than 90 days after the original or extended due date of the tax return. NCAC T20: 4 .1702.
26. Taxpayer did not petition the Tax Review Board for relief from the statutorily required apportionment formula.
27. Pursuant to G.S. 105-236(5), if a taxpayer understates its tax liability by 25% or more, the Secretary shall assess a penalty equal to 25% of the deficiency. Application of the 25% penalty for a large tax deficiency is determined by a simple mathematical calculation; no finding of negligence is required.
28. The law grants the Secretary of Revenue the authority to waive or reduce all civil penalties imposed on a taxpayer by the Department of Revenue, including the 25% penalty for a large tax deficiency. The Secretary exercises his authority through the established policies and procedures of the Department, including the Department's penalty waiver policy.
29. Taxpayer is eligible for waiver of the assessed negligence penalties upon payment of the additional tax and interest due under the good compliance provision of the Department's penalty policy.

DECISION

The proposed assessment of additional franchise tax, interest and penalty for tax years 2000, 2001, and 2002 are hereby sustained based on the aforementioned findings of fact and conclusions of law. Upon payment in full of the tax and interest, the penalties will be waived if Taxpayer meets the terms of the good compliance provisions of the Department's Penalty Waiver Policy.

This the _____ day of _____, 2007.

Signature

Eugene J. Cella, Assistant Secretary of Revenue