

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2001

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HOUSE BILL 1157*
Committee Substitute Favorable 7/10/01

Short Title: Enforce Tax Compliance & Equality/No Fraud.

(Public)

Sponsors:

Referred to:

April 12, 2001

1 A BILL TO BE ENTITLED
2 AN ACT TO COMBAT TAX FRAUD, ENHANCE CORPORATE COMPLIANCE
3 WITH TAXES ON TRADEMARK INCOME, ASSURE THAT FRANCHISE TAX
4 APPLIES EQUALLY TO CORPORATE ASSETS, AND CONFORM
5 CORPORATE DIVIDEND TREATMENT TO THE GENERALLY ACCEPTED
6 FORMULA USED IN OTHER STATES.

7 The General Assembly of North Carolina enacts:

8

9 **ROYALTY REPORTING OPTION/FRAUD PENALTY**

10 **SECTION 1.(a)** The General Assembly finds that most corporations
11 engaged in manufacturing and retailing activities in this State comply with the State tax
12 on income generated from using trademarks in those activities. Taxpayers who do not
13 comply, however, create an unfair burden on these corporate citizens. It is the intent of
14 this section to reward taxpayers who comply, by giving them an option on how to file
15 tax returns involving royalty income. It is also the intent of this section to provide that a
16 criminal penalty applies to taxpayers who fraudulently evade the tax.

17 **SECTION 1.(b)** Part 1 of Article 4 of Chapter 105 of the General Statutes is
18 amended by adding a new section to read:

19 **"§ 105-130.7A. Royalty income reporting option; fraud penalty.**

20 (a) Purpose. – Royalty payments received for the use of trademarks in this State
21 are income derived from doing business in this State. This section provides taxpayers
22 with an option concerning the method by which these royalties can be reported for
23 taxation when the recipient and the payer are related members. As provided in this
24 section, these royalty payments can be either (i) deducted by the payer and included in
25 the income of the recipient, or (ii) added back to the income of the payer and excluded
26 from the income of the recipient. This section also sets out the criminal penalty for
27 fraudulent intent to evade the tax.

28 (b) Definitions. – The following definitions apply in this section:

29 (1) Component member. – Defined in section 1563(b) of the Code.

- 1 (2) North Carolina royalty. – An amount charged that is for, related to, or
2 in connection with the use in this State of a trademark. The term
3 includes royalty and technical fees, licensing fees, and other similar
4 charges.
- 5 (3) Own. – To own directly, indirectly, beneficially, or constructively. The
6 attribution rules of section 318 of the Code apply in determining
7 ownership under this section.
- 8 (4) Related entity. – Any of the following:
- 9 a. A stockholder who is an individual, or a member of the
10 stockholder's family enumerated in section 318 of the Code, if
11 the stockholder and the members of the stockholder's family
12 own in the aggregate at least fifty percent (50%) of the value of
13 the taxpayer's outstanding stock.
- 14 b. A stockholder, or a stockholder's partnership, limited liability
15 company, estate, trust, or corporation, if the stockholder and the
16 stockholder's partnerships, limited liability companies, estates,
17 trusts, and corporations are component members with respect to
18 the taxpayer.
- 19 c. A corporation, or a party related to the corporation in a manner
20 that would require an attribution of stock from the corporation
21 to the party or from the party to the corporation under the
22 attribution rules of section 318 of the Code, if the taxpayer
23 owns at least fifty percent (50%) of the value of the
24 corporation's outstanding stock.
- 25 (5) Related member. – A person that, with respect to the taxpayer during
26 any part of the taxable year, is one or more of the following:
- 27 a. A related entity.
- 28 b. A component member.
- 29 c. A person to or from whom there is attribution of stock
30 ownership in accordance with section 1563(e) of the Code.
- 31 (6) Royalty payment. – Either of the following:
- 32 a. Expenses, losses, and costs paid, accrued, or incurred for North
33 Carolina royalties, to the extent the amounts are allowed as
34 deductions or costs in determining taxable income before
35 operating loss deduction and special deductions for the taxable
36 year under the Code.
- 37 b. Amounts directly or indirectly allowed as deductions under
38 section 163 of the Code, to the extent the amounts are paid,
39 accrued, or incurred for a time price differential charged for the
40 late payment of any expenses, losses, or costs described in this
41 subdivision.
- 42 (7) Trademark. – A trademark, trade name, service mark, or other similar
43 type of intangible asset.

1 (8) Use. – Use of a trademark includes direct or indirect maintenance,
2 management, ownership, sale, exchange, or disposition of the
3 trademark.

4 (c) Election. – For the purpose of computing its State net income, a taxpayer
5 must add royalty payments made to, or in connection with transactions with, a related
6 member during the taxable year. This addition is not required for an amount of royalty
7 payments that meets either of the following conditions:

8 (1) The related member includes the amount as income on a return filed
9 under this Part for the same taxable year that the amount is deducted
10 by the taxpayer, and the related member does not elect to deduct the
11 amount pursuant to G.S. 105-130.5(b)(20).

12 (2) The taxpayer can establish that the related member during the same
13 taxable year directly or indirectly paid, accrued, or incurred the
14 amount to a person who is not a related member.

15 (d) Indirect Transactions. – For the purpose of this section, an indirect transaction
16 or relationship has the same effect as if it were direct.

17 (e) Fraud. – A taxpayer who receives royalty payments for the use of trademarks
18 in this State and willfully fails to report the payments as income in a return filed under
19 this Part is considered to have willfully attempted to defeat this section. A paid preparer
20 of tax returns is considered to have aided and abetted an attempt to defeat this section if
21 the preparer signs a return for a taxpayer knowing that the taxpayer received, during the
22 period covered by the return, royalty payments for the use of trademarks in this State,
23 and the return does not report the payments as income. G.S. 105-236(7) sets out the
24 penalty for these offenses."

25 **SECTION 1.(c)** G.S. 105-130.4(a)(4) reads as rewritten:

26 "(4) 'Excluded corporation' means any corporation engaged in business as a
27 building or construction contractor, a securities dealer, or a loan
28 company or a corporation ~~which~~that receives more than fifty percent
29 (50%) of its ordinary gross income from ~~investments in and/or dealing~~
30 in intangible property."

31 **SECTION 1.(d)** G.S. 105-130.5(a) is amended by adding a new subdivision
32 to read:

33 "(a) The following additions to federal taxable income shall be made in
34 determining State net income:

35 ...

36 (14) Royalty payments required to be added by G.S. 105-130.7A, to the
37 extent deducted in calculating federal taxable income."

38 **SECTION 1.(e)** G.S. 105-130.5(b) is amended by adding a new subdivision
39 to read:

40 "(b) The following deductions from federal taxable income shall be made in
41 determining State net income:

42 ...

1 (20) Royalty payments received from a related member who added the
2 payments to income under G.S. 105-130.7A for the same taxable
3 year."

4 **SECTION 1.(f)** G.S. 105-130.7A(e), as enacted by this section, becomes
5 effective December 1, 2001, and applies to offenses committed on or after that date. The
6 remainder of this section is effective for taxable years beginning on or after January 1,
7 2001. Notwithstanding G.S. 105-163.41, no addition to tax may be made under that
8 statute for a taxable year beginning on or after January 1, 2001, and before January 1,
9 2002, with respect to an underpayment of corporation income tax by a payer of royalties
10 who adds the payments to State net income pursuant to G.S. 105-130.7A(c), to the
11 extent the underpayment was created or increased by this section.

12 **EQUALIZE FRANCHISE TAX ON CORPORATE-AFFILIATED LLCs**

13 **SECTION 2.(a)** The General Assembly finds that most corporations
14 engaged in business in this State comply with the State franchise tax on corporate
15 assets. Some taxpayers, however, take advantage of an unintended loophole in the law
16 and avoid franchise tax by transferring their assets to a controlled limited liability
17 company. This tax avoidance creates an unfair burden on corporate citizens that pay the
18 franchise tax on their assets. It is the intent of this section to apply the franchise tax
19 equally to assets held by corporations and assets held by corporate-affiliated limited
20 liability companies. It is also the intent of this section to provide that a criminal penalty
21 applies to taxpayers who fraudulently evade the tax.

22 **SECTION 2.(b)** G.S. 105-114 is amended by adding a new subsection to
23 read:

24 "(c) Limited Liability Companies. – If a corporation is a member of a limited
25 liability company and the limited liability company's governing law provides that
26 seventy percent (70%) or more of its assets, after payments to creditors, must be
27 distributed upon dissolution to the member corporation or to includible corporations of
28 an affiliated group in which the member corporation is includible, then (i) a percentage
29 of the limited liability company's income, assets, liabilities, and equity is attributed to
30 that member corporation and must be included in the member corporation's computation
31 of tax under this Article, and (ii) the member corporation's investment in the limited
32 liability company is not included in the member corporation's computation of tax under
33 this Article. The attributable percentage is equal to the percentage of the limited liability
34 company's assets, after payments to creditors, that would be distributable to the member
35 corporation under the limited liability company's governing law if the limited liability
36 company dissolved as of the last day of the member corporation's taxable year. In all
37 other cases, none of the limited liability company's income, assets, liabilities, or equity
38 is attributed to a member corporation under this Article. A limited liability company's
39 governing law is determined under G.S. 57C-6-05 or G.S. 57C-7-01, as applicable. The
40 definitions in section 1504 of the Code apply in this subsection.

41 A taxpayer who, because of fraud with intent to evade tax, underpays the tax under
42 this Article on assets attributable to it under this subsection is guilty of a Class H felony
43 in accordance with G.S. 105-236(7)."
44

1 **SECTION 2.(c)** This section becomes effective January 1, 2002, and applies
2 to taxes due on or after that date.

3
4 **CONFORM NORTH CAROLINA'S SUBSIDIARY DIVIDEND DEDUCTION**
5 **TO THE GENERALLY ACCEPTED TREATMENT USED IN OTHER STATES**

6 **SECTION 3.(a)** G.S. 105-130.5(a)(7) and G.S. 105-130.7(b) are repealed.

7 **SECTION 3.(b)** G.S. 105-130.5(b) is amended by adding two new
8 subdivisions to read:

9 "(b) The following deductions from federal taxable income shall be made in
10 determining State net income:

11 ...

12 (3a) Dividends treated as received from sources outside the United States
13 as determined under section 862 of the Code, to the extent included in
14 federal taxable income.

15 (3b) Any amount included in federal taxable income under section 78 or
16 section 951 of the Code."

17 **SECTION 3.(c)** This section is effective for taxable years beginning on or
18 after January 1, 2001. Notwithstanding G.S. 105-163.41, no addition to tax may be
19 made under that statute for a taxable year beginning on or after January 1, 2001, and
20 before January 1, 2002, with respect to an underpayment of corporation income tax to
21 the extent the underpayment was created or increased by this section.

22
23 **MONITORING**

24 **SECTION 4.(a)** The Department of Revenue must report to the Revenue
25 Laws Study Committee by December 1, 2001, on its plans and actions to implement the
26 provisions of this act. In addition, the Department of Revenue must report to the
27 Revenue Laws Study Committee by May 1, 2002, and December 1, 2002, on the effects
28 of this act. These reports must include any recommendations the Department has for
29 changes to this act or to other similar provisions in the Revenue Act.

30 **SECTION 4.(b)** This section is effective when it becomes law.