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HOUSE BILL 1157\*  
Committee Substitute Favorable 7/10/01  
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Short Title: Enforce Tax Compliance & Equality/No Fraud.

(Public)

Sponsors:

Referred to:

April 12, 2001

A BILL TO BE ENTITLED

AN ACT TO COMBAT TAX FRAUD, ENHANCE CORPORATE COMPLIANCE WITH TAXES ON TRADEMARK INCOME, ASSURE THAT FRANCHISE TAX APPLIES EQUALLY TO CORPORATE ASSETS, AND CONFORM CORPORATE DIVIDEND TREATMENT TO THE GENERALLY ACCEPTED FORMULA USED IN OTHER STATES.

The General Assembly of North Carolina enacts:

**ROYALTY REPORTING OPTION**

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

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

**"§ 105-130.7A. Royalty income reporting option.**

(a) Purpose. – Royalty payments received for the use of trademarks in this State are income derived from doing business in this State. This section provides taxpayers with an option concerning the method by which these royalties can be reported for taxation when the recipient and the payer are related members. As provided in this section, these royalty payments can be either (i) deducted by the payer and included in the income of the recipient, or (ii) added back to the income of the payer and excluded from the income of the recipient.

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

(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 eighty percent (80%) of the value  
13 of 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 eighty percent (80%) 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 would be attribution of stock  
30 ownership in accordance with section 1563(e) of the Code if the  
31 phrase '5 percent or more' were replaced by 'twenty percent  
32 (20%) or more' each place it appears in that section.
- 33           (6) Royalty payment. – Either of the following:
- 34           a. Expenses, losses, and costs paid, accrued, or incurred for North  
35 Carolina royalties, to the extent the amounts are allowed as  
36 deductions or costs in determining taxable income before  
37 operating loss deduction and special deductions for the taxable  
38 year under the Code.
- 39           b. Amounts directly or indirectly allowed as deductions under  
40 section 163 of the Code, to the extent the amounts are paid,  
41 accrued, or incurred for a time price differential charged for the  
42 late payment of any expenses, losses, or costs described in this  
43 subdivision.

1           (7) Trademark. – A trademark, trade name, service mark, or other similar  
2           type of intangible asset.

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

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

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

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

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

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

20           "(4) 'Excluded corporation' means any corporation engaged in business as a  
21           building or construction contractor, a securities dealer, or a loan  
22           company or a corporation ~~which~~that receives more than fifty percent  
23           (50%) of its ordinary gross income from ~~investments in and/or dealing~~  
24           in intangible property."

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

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

29           ...

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

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

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

36           ...

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

40           **SECTION 1.(f)** This section is effective for taxable years beginning on or  
41           after January 1, 2001. Notwithstanding G.S. 105-163.41, no addition to tax may be  
42           made under that statute for a taxable year beginning on or after January 1, 2001, and  
43           before January 1, 2002, with respect to an underpayment of corporation income tax by a

1 payer of royalties who adds the payments to State net income pursuant to G.S.  
2 105-130.7A(c), to the extent the underpayment was created or increased by this section.

#### 4 **EQUALIZE FRANCHISE TAX ON CORPORATE-AFFILIATED LLCs**

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

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

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

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

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

#### 39 **CONFORM NORTH CAROLINA'S SUBSIDIARY DIVIDEND DEDUCTION** 40 **TO THE GENERALLY ACCEPTED TREATMENT USED IN OTHER STATES**

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

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

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

3       ...

4       (3a) Dividends treated as received from sources outside the United States  
5           as determined under section 862 of the Code, to the extent included in  
6           federal taxable income.

7       (3b) Any amount included in federal taxable income under section 78 or  
8           section 951 of the Code."

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

#### 14 15 **MONITORING**

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

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