NORTH CAROLINA

STATE AND LOCAL TAXES

2006

Policy Analysis &
Statistics Division

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Policy Analysis & Statistics Division
Department of Revenue

FOREWORD

NORTH CAROLINA'S TAX SYSTEM

This booklet presents a brief sketch of all state and local taxes payable by most corporations and individuals. Although this summary was carefully compiled, it is not an official interpretation of the law. Therefore, the booklet should not be relied on as representing the position of the Secretary of Revenue.

Should further details be desired, contact the Director of the Policy Analysis and Statistics Division, North Carolina Department of Revenue, Post Office Box 871, Raleigh, North Carolina 27602-0871. Tax forms and additional information, including this booklet, are available on the Department of Revenue website at http://www.dornc.com.

This booklet is updated each year to reflect changes in the tax laws enacted by the North Carolina General Assembly. This edition includes changes enacted through the 2006 regular session. Unless otherwise noted, all changes made during 2006 were in effect at the time of publication. The next edition of *State and Local Taxes* will be available for distribution after the adjournment of the 2007 session.

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GENERAL STATE AND LOCAL TAXES

SALES AND USE TAX

Overview of Sales and Use Tax Rates

Items	State tax rate	Local tax rate
Most tangible goods Room and cottage rentals Laundry and dry cleaning services Prepaid telephone calling services Mixed beverages	4.25%	2.5%*
Food for home consumption	Exempt	2%
Motor vehicles, prescription drugs, other medical equipment, gasoline, many business purchases	Exempt	Exempt
Telecommunications services Spirituous liquor Video Programming	6.75%**	Exempt
Electricity for general use*** Sales of aircraft and boats	3%	Exempt
Manufactured/modular homes	2%/2.5%	Exempt
Certain manufacturing and farming inputs and equipment	Exempt	Exempt

* Mecklenburg County has an additional 0.5% sales tax

** The 6.75% rate represents the combined general State rate and local rate of tax that is authorized in all counties

*** Electricity sales to farmers, laundries, and dry cleaners are taxed at 2.83%. Sales to manufacturers are taxed at 2.83% until June 30, 2007 and at 2.6% thereafter.

As of December 1, 2006, the State levies a general retail sales and use tax of 4.25%, which is scheduled to decrease to 4% effective July 1, 2007. The general rate applies to purchases of tangible commodities, room and cottage rentals, and laundry and dry cleaning services. The tax does not apply to prescription drugs, insulin, false teeth, eyeglasses, gasoline, coin-operated laundries, or motor vehicles.

Counties are allowed to levy a 2.5% local sales and use tax on items taxed by the State at its general rate. As a result, the combined general State and county tax rate is 6.75% in all counties except Mecklenburg County, which has a rate of 7.25% (due to a 0.5% Public Transit Tax). The State exempts food from sales and use tax except for certain classifications, including dietary supplements, food sold from vending machines, soft drinks, candy, and prepared food. Alcoholic beverages are not food items. A local sales and use tax of 2% applies to all food that is exempt from the State sales and use tax.

Sales of electricity to manufacturers, farmers, and commercial laundries and dry cleaners for non-residential use are taxed at 2.83%. The rate for manufacturers is scheduled to decrease to 2.6% as of July 1, 2007. Electricity sold to an aluminum smelting facility for use in connection with the operation of that facility and measured by a separate meter is taxed at a rate of 0.17% until September 30, 2007, at which time it will be taxed at the same rate as sales to other manufacturers. Sales of electricity for all other purposes are taxed at a 3% state rate. Aircraft, and boats are taxed at 3% with a $1,500 maximum tax on each item. Manufactured (mobile) homes are taxed at a 2% rate; the maximum tax per section of manufactured home is $300. Modular homes are taxed at 2.5%.

Telecommunications services and cable and satellite television services are taxed at the combined general rate of 6.75%. Prepaid telephone calling arrangements and satellite radio are subject to the general state and local sales tax rates.

Purchases of the following items by manufacturers are exempt from sales tax: coal, coke, and fuel oil used in manufacturing; manufacturing machinery and equipment; and parts and accessories to manufacturing machinery. "Accessories" include most supplies used in the manufacturing process but not becoming a part of the manufactured product and also include pollution abatement equipment. Purchases of manufacturing machinery by contractors or subcontractors for use in performance of contracts to construct manufacturing facilities also are exempt. Although these items are exempt from sales tax, purchasers of these items may be subject to the privilege taxes described on page 13.

Raw materials, containers, labels, packaging and shipping materials are exempt from sales and use tax. Motor vehicle sales are exempt from the sales tax, but are taxed under the Highway Use Tax (see below).

Certain industries may receive a refund of sales taxes on purchases of building materials, fixtures and equipment if purchased for new facilities meeting specific cost thresholds. These thresholds vary by county and are either $50 million or $100 million. The qualifying industries are: 1) bioprocessing; 2) pharmaceutical and medicine manufacturing and distribution; 3) aircraft manufacturing; 4) computer manufacturing; 5) motor vehicle manufacturing; 6) semiconductor manufacturing; 7) air courier services; and 8) financial services, securities operations, and related development.

The general State and local sales tax rate applies to the sales price of mixed beverages. The rate is 6.75% on spirituous liquor other than mixed beverages.

There is an annual sales tax holiday the first Friday, Saturday, and Sunday in August. During this time, State and local sales and use taxes do not apply to certain articles of clothing, school supplies, computers, computer supplies, and sport or recreational equipment.

PERSONAL INCOME TAX

North Carolina taxable income is taxable income as calculated for federal income tax purposes, with certain adjustments.

ADJUSTMENTS TO TAXABLE INCOME

Deductions. An amount is deducted from taxable income to the extent each item listed below was included in gross income or was not deducted from gross income.

Interest upon obligations of the United States; its possessions; the state of North Carolina; political subdivisions of the state of North Carolina; or nonprofit educational institutions organized or chartered under the laws of the State.

Interest upon obligations which are exempt from tax under North Carolina law. For example, interest on obligations of the North Carolina Housing Finance Agency and the North Carolina Educational Facilities Finance Act are exempt from the personal income tax.

Social Security benefits and Railroad Retirement Act benefits.

Refunds of state, local, and foreign income taxes.

20% of amounts added to North Carolina taxable income in taxable years 2002 through 2004 as accelerated depreciation.

Generally retirement benefits received by retirees of the state of North Carolina and its local governments or by retirees of the United States government (including military) are exempt if the retiree had five or more years of creditable service as of August 12, 1989. The exclusion also applies to retirement benefits received from the State's §401(k) and §457 (deferred compensation) plans if the retiree contributed to the plan prior to August 12, 1989.

Up to $4,000 in state, local, or federal government retirement benefits if the retiree did not have five years of creditable service as of August 12, 1989, or if the benefits are received from another state and its local governments, and up to $2,000 in private retirement benefits received by an individual taxpayer. (**Note**: No more than $4,000 in total retirement benefits can be deducted for each taxpayer in this group.)

The amount by which a taxpayer's federal tax deductions were reduced because of a federal tax credit, when a similar state tax credit does not exist.

Severance wages received by a taxpayer from an employer as the result of the taxpayer's permanent, involuntary termination from employment through no fault of the employee. The amount of severance wages deducted as the result of the same termination may not exceed $35,000 for all taxable years in which the wages are received.

Inheritance tax and estate tax paid to North Carolina on an item of income in respect of a decedent.

For taxpayers below certain income thresholds, up to $750 per taxpayer ($1,500 per married couple) of amounts contributed to the Parental Savings Trust Fund, effective for tax years beginning on or after January 1, 2006.

Additions. An amount is added to taxable income to the extent each item listed below was not included in gross income or was deducted from gross income.

Interest upon obligations of other states and their political subdivisions.

Lump-sum distributions from a pension or profit-sharing plan.

Any state, local, or foreign income tax or general sales tax deducted on the federal return.

Any amounts deducted from gross income and taxed under the Internal Revenue Code by a tax other than the tax imposed in Section 1.

Income from domestic production activities

PERSONAL EXEMPTION AMOUNTS

North Carolina allows a personal exemption of $2,500 for the taxpayer (unless he is claimed as a dependent on someone else's return) and $2,500 for each dependent provided that the taxpayer's federal adjusted gross income is less than the threshold amount for his filing status, as shown below.

Filing Status	Federal AGI
Married, filing jointly	$100,000
Head of household	80,000
Single	60,000
Married, filing separately	50,000

A taxpayer whose federal adjusted gross income is equal to or greater than the threshold amount for his filing status is allowed a personal exemption of $2,000 (unless he is claimed as a dependent on someone else's return) and $2,000 for each dependent. Unlike the federal system, North Carolina does not index personal exemptions for inflation. An addition to federal taxable income must be made for the difference between the federal and State personal exemption amounts.

STANDARD DEDUCTION AMOUNTS

North Carolina allows a basic standard deduction that does not include the cost-of-living adjustment permitted under federal law. This adjustment amount must be added back to taxable income. The standard deduction amounts are:

Filing Status	Amount
Married, filing jointly	$6,000
Qualifying widow(er)	6,000
Head of household	4,400
Single	3,000
Married, filing separately	3,000

If a taxpayer chooses to itemize deductions, the amount of state and local income taxes or general sales taxes deducted on his federal return must be added back to taxable income. A higher income taxpayer who was required to reduce itemized deductions claimed on his federal return must add back only the pro rata portion of these taxes deducted for federal tax purposes.

AGED OR BLIND ADDITIONAL DEDUCTIONS

An amount in addition to the basic standard deduction is allowed for a taxpayer who is 65 years old or older or blind (and/or whose spouse is 65 years old or older or blind, and a joint return is filed). The table below shows the dollar value of one additional deduction for each filing status.

Filing Status	Dollar Value of One Additional Deduction
Single	$750
Married, filing jointly	600
Married, filing separately	600
Head of household	750
Qualifying widow(er)	600

TAX CREDITS

There is a tax credit of $100 for each dependent child for which the taxpayer was allowed to claim a personal exemption, provided that the taxpayer's federal adjusted gross income is less than the threshold amount for his filing status, as follows:

Filing Status	Federal AGI
Married, filing jointly	$100,000
Head of household	80,000
Single	60,000
Married, filing separately	50,000

A nonresident or part-year resident may claim the credit, but must reduce it by multiplying the credit by the same fraction used to determine the portion of total taxable income subject to North Carolina tax. The credit may not exceed the amount of tax for the taxable year reduced by the sum of all tax credits.

A person who is allowed a credit against federal income tax is also allowed a credit against North Carolina income tax for expenses incurred for child or dependent care. This credit is based on the taxpayer's filing status and adjusted gross income. The credit ranges from 7% to 9% of employment-related expenses for a dependent who is seven years old or older. The credit ranges from 10% to 13% of employment-related expenses for a dependent, of any age, who is not physically or mentally capable of caring for himself or for a dependent who is less than seven years old. The maximum amount of expenses for which a credit may be claimed for one dependent is $3,000; the maximum for more than one dependent is $6,000.

Other income tax credits are available. There is a tax credit for income taxes paid to other states on income taxable in North Carolina. There are tax credits for the disabled, for property taxes paid on farm machinery, and a limited tax credit for charitable contributions made by taxpayers who claim the standard deduction. Tax credits are allowed for construction of handicapped dwelling units, real property donations for public access and conservation, certain energy-saving equipment, conservation tillage equipment, permitting the gleaning of crops, constructing poultry composting facilities, and recycling oyster shells. There are also credits for individuals who purchase the equity securities of a qualified business directly from the business, and a credit for a portion of the increase in wharfage, handling, and throughput charges paid by a cargo owner on exported or imported processed cargo, including forest products, loaded onto or unloaded from an ocean carrier calling at North Carolina ports at Wilmington or Morehead City. This ports credit ends for taxable years beginning on or after January 1, 2009.

North Carolina law also allows several income tax credits intended to promote economic development, which may be available to owners of businesses. Please see the sections "TAX CREDITS FOR GROWING BUSINESSES (ARTICLE 3J)" and "OTHER INCOME TAX CREDITS" beginning on page 12 of this booklet for additional information about these credits.

TAX RATES

If you are:	and taxable income is:	the tax rate is:
Married, filing jointly	$ 0 - $ 21,250	6% of taxable income
	21,251 - 100,000	$1,275 + 7% of taxable income > $21,250
	100,001 - 200,000	$6,787.50 + 7.75% of taxable income > $100,000
	200,001 or more	$14,537.50 +8% of taxable income > $200,000
Qualifying widow(er)	$ 0 - $ 21,250	6% of taxable income
	21,251 - 100,000	$1,275 + 7% of taxable income > $21,250
	100,001 - 200,000	$6,787.50 + 7.75% of taxable income > $100,000
	200,001 or more	$14,537.50 +8% of taxable income > $200,000
Head of household	$ 0 - $ 17,000	6% of taxable income
	17,001 - 80,000	$1,020 + 7% of taxable income > $17,000
	80,001 - 160,000	$5,430 + 7.75% of taxable income > $80,000
	160,001 or more	$11,630 + 8% of taxable income > $160,000
Single	$ 0 - $ 12,750	6% of taxable income
	12,751 - 60,000	$765 + 7% of taxable income > $12,750
	60,001 - 120,000	$4,072.50 + 7.75% of taxable income > $60,000
	120,001 or more	$8,722.50 + 8% of taxable income > $120,000
Married, filing separately	$ 0 - $ 10,625	6% of taxable income
	10,626 - 50,000	$637.50 + 7% of taxable income > $10,625
	50,001 - 100,000	$3,393.75 + 7.75% of taxable income > $50,000
	100,001 or more	$7,268.75 + 8% of taxable income > $100,000

Note: The 8% tax rate is effective for taxable years beginning on or after January 1, 2007 and expires for taxable years beginning on or after January 1, 2008. For tax year 2006, the maximum rate was 8.25%

PROPERTY TAXES

The principal source of local revenue is a property tax on real estate and tangible personal property, including all machinery and equipment. The State does not levy a tax on such property.

PROPERTY TAX ASSESSMENT

There is only one assessment in each county. The value as determined by the county assessor constitutes the base for all levies, including those of cities and towns on property located within the municipality. Property is to be assessed at 100% of appraised value. Although appraised value is to be "full value," this standard is not always achieved for real property. This is largely because real property is required to be revalued every eight years, although counties may revalue earlier. Property appraised at full value at the time of appraisal may appreciate until appraised value is only 50-60 % of true value by the end of the eight-year period. Actual ratios vary from county to county.

Real property owned by businesses and individuals consists of land and buildings and is permanently listed for property tax. The owner is only required to list the construction or acquisition of improvements on and separate rights in real property.

Household tangible personal property in the personal residence of the owner is exempt from property taxation. A homestead exemption is allowed if the property owner is age 65 or over, or is totally and permanently disabled, <u>and</u> the combined income of owner and spouse does not exceed a maximum amount that is adjusted each year for inflation. For 2006, this income maximum is $19,700. The exclusion is equal to the greater of $20,000 or 50% of the appraised value of the residence. The homestead exemption is applicable only to the owner's permanent residence. A separate exclusion of $38,000 applies to the assessed value of housing and land owned and used as a residence by a disabled veteran who receives benefits under U.S.C. 2101, but this exclusion must be the total exclusion applicable to the property.

Every business is required to list their tangible personal property during January with the county assessor of the county in which the property is located. In order to receive the standard forms and other listing information, businesses should contact the county assessor to make sure they are on the roster of taxpayers or "tax roll".

Non-business owners and individuals are also required to annually list, during January, certain tangible personal property including unregistered motor vehicles, multi-year or permanently registered trailers, watercraft, and engines for watercraft, aircraft. A mobile home (single or double-wide) also must be listed if it meets any one or more of the following conditions: 1) is not placed on a permanent foundation; 2) is on land owned by someone other than the owner of the mobile home; or 3) still retains the moving hitch, wheels, and axles.

New manufacturing machinery is generally appraised at cost and is depreciated annually until it reaches a minimum value, frequently 25% of cost. The annual depreciation varies but a common figure is 10% per year. Most counties have adopted the "trending" procedure to value machinery and equipment. Under this procedure the machinery is valued at replacement cost each year and then depreciated according to its age and expected life.

Property taxes are based on assessments as of January 1, are due September 1, but may be paid at par as late as January 5 of the following year.

TAX RATES

The tax rates vary from county to county and from town to town. The weighted average county-wide tax rate for all 100 counties for 2005-06 was 65¢ per $100 of appraised valuation. County-wide rates ranged from 25¢ to $1.10 per $100 of appraised valuation. Cities and towns levy taxes above the county tax. Municipal tax rates ranged from 2¢ to 82¢ per $100 in 2005-06, and the average rate was 43.5¢ per $100 of value. There are few special district taxes apart from school levies and rural fire district levies. Sixteen school districts have tax levies separate from the county rate. These rates range from 2¢ to 21¢ per $100. Fire district rates usually are very low, 20¢ or less per $100. In much of the State, only county-wide rates apply outside of cities and towns.

PROPERTY TAX EXEMPTIONS AND EXCLUSIONS

There are only a few exemptions and exclusions of interest to manufacturers and retail/wholesale establishments. They are described in the following paragraphs.

Excluded from property taxation are manufacturers' inventories (raw materials, goods in process, finished goods, materials or supplies consumed in processing, crops, and other agricultural or horticultural products held for sale), contractors' inventories (goods held by contractors to be furnished in the course of building, installing, repairing, or improving real property), livestock, poultry, and feed used in production of livestock and poultry, and inventories of retail and wholesale merchants (tangible personal property held for sale and not manufactured, processed, or produced by the merchant).

Computer software is exempt from taxation. This exemption does not apply to embedded software and capitalized software purchased or licensed from an unrelated entity.

Property which has been imported from a foreign country and is stored at the seaport terminal while awaiting further shipment is exempt for the first year of storage.

"Bill and hold" goods manufactured in North Carolina and held by the manufacturer for shipment to a nonresident customer are exempt.

Motor vehicle chassis belonging to nonresidents which enter the State temporarily for the purpose of having a body mounted thereon are exempt from taxation.

Nuclear materials held for the purpose of, or in the process of, manufacture or processing, or held by the manufacturer for delivery are exempt from taxation.

Improvements on brownfields properties are partially excluded from property taxation. The exclusion is for a five-year period beginning when the improvements are made and declines during the period from 90% of the appraised value for the first year to 10% for the fifth year. The improvements are fully taxable in the sixth and subsequent years after the improvements are made. The property must be subject to a brownfields agreement entered into by the owner with the Department of Environment and Natural Resources pursuant to G.S. 130A-310.32.

Property used to reduce air or water pollution receives special treatment under the tax laws of North Carolina if the Board of Environmental Management or local air pollution control program certifies that the property complies with the requirements of the Board.

Such real and tangible personal property is exempt from taxation under the property tax laws and is subject to the preferential 1% state sales tax rate as "accessory" to manufacturing machinery.

Further, the cost may be excluded from the three alternate bases in computing the franchise tax and may be amortized over 60 months for corporation income tax purposes.

Personal property used exclusively for the prevention or reduction of dust in textile plants is also exempt from local property taxes.

Equipment or facilities installed for the purpose of recycling solid waste or resource recovery from solid waste receives the same treatment under the tax laws as that given to pollution abatement equipment described above.

REAL ESTATE TRANSFER TAX

An excise tax is levied on transfers of real estate at the rate of $1 of each $500, or fraction thereof, of the consideration or value of the property conveyed.

In addition, seven counties - Dare, Camden, Chowan, Currituck, Pasquotank, Perquimans, and Washington - are authorized to levy a local real estate transfer tax of $1 per $100 of the full consideration including the value of any lien on the property at the time of sale.

HIGHWAY USE TAX

North Carolina levies a tax on the privilege of using the highways at the rate of 3% of the retail value of a motor vehicle. The tax cannot exceed $1,000 for Class A and Class B commercial motor vehicles (as defined by law). Tax is paid when a vehicle is purchased or titled in North Carolina. If the motor vehicle is purchased from an automobile dealer, "retail value" is sales price less any trade-in allowance. For casual sales, "retail value" is the value set in a schedule of values adopted by the Commissioner of Motor Vehicles, less any trade allowance. The tax cannot exceed $150 if the vehicle, at the time of applying for a certificate of title, is and has been titled in another state for at least 90 days. A credit may apply if an equivalent tax has been paid in another state or if the vehicle was at one time titled in North Carolina.

A retailer who is engaged in the business of leasing or renting motor vehicles, and who purchases a motor vehicle for his business, can elect either to pay the use tax whenever he purchases the vehicle or collect a tax on the gross receipts from the lease or rental of the vehicle. The rate to be applied on the gross receipts from long-term lease or rental of the vehicle (at least 365 continuous days to the same person) is 3%. Gross receipts from short-term leases or rentals are taxed at 8%. Taxable gross receipts do not include the allowance for a motor vehicle taken in trade on the transaction. The tax cannot exceed $1,000 if the vehicle is a Class A or Class B commercial vehicle leased continuously to the same person.

MOTOR FUEL TAX

The State gasoline tax is 29.9¢ per gallon during the period July 1 through December 31, 2006. The rate consists of a motor fuels tax of 17.5¢ per gallon plus a rate equal to the greater of 3.5¢ per gallon or 7% of the average wholesale price per gallon, now 12.4¢. The wholesale price component of the rate is set semi-annually by the Secretary of Revenue. There are no local gasoline taxes.

TOBACCO PRODUCTS TAX

An excise tax of 35¢ per package of 20 is levied on cigarettes. Tobacco products other than cigarettes are subject to a tax of 3% of the wholesale price.

ALCOHOLIC BEVERAGE TAXES

Alcoholic beverages are sold only where authorized by local election.

Beer, wine and liquor are subject to the following excise taxes, in addition to the general State and local sales and use taxes:

Beer is taxed at rates equivalent to 5¢ per can or bottle of 12 ounces.

Unfortified wine is taxed at 21¢ per liter while fortified wine is taxed at 24¢ per liter. Unfortified wine may contain added brandy as long as the total alcoholic content does not exceed 16%.

Liquor is sold through government operated stores and, although a tax is levied on sales, retail prices including the tax are competitive with or lower than prices in most other states. The excise tax on liquor from ABC stores is 25%.

The law authorizes local elections to permit sales of liquor "by the drink" by qualified restaurants and clubs. An additional tax of $20 on each four liters is levied on liquor purchased by restaurants or clubs for sale by the drink.

OCCUPANCY TAX

A local occupancy tax on the rental of rooms and lodging is levied in certain counties and municipalities primarily for the purpose of generating revenue to promote travel and tourism. The North Carolina General Assembly authorizes the transient occupancy tax for a specific county or municipality, prescribing the administration, rate limitation, and disposition of taxes, with the local government having the option of imposing the levy. Tax rates vary, but the most common rate is 3%.

WHITE GOODS DISPOSAL TAX

The State levies a flat rate tax of $3 on the purchase of each new white good, which includes such large appliances as refrigerators, freezers, washing machines, dishwashers, clothes dryers, ranges, and unit air conditioners. Persons who buy at least 50 new white goods in the same sale for use in dwellings that do not already contain such white goods can receive a refund of 60% of this tax.

SCRAP TIRE DISPOSAL TAX

The State levies a scrap tire disposal tax on each new tire sold. Exemptions include: recapped tires, bicycle tires, and other tires for vehicles propelled by human power. The tax is 1% of the sales price on tires with a bead diameter of at least 20 inches, and 2% on tires with a bead diameter of less than 20 inches.

PIPED NATURAL GAS TAX

The piped natural gas tax rate is a declining block rate based on the number of therms of gas consumed in a month. The rate starts at 4.7¢ for the first 200 therms received and declines to 0.3¢ per therm received in excess of 500,000.

SPECIFIC STATE AND LOCAL TAXES FOR BUSINESSES

CORPORATE INCOME TAX

An income tax is levied at the rate of 6.9% on the portion of net income allocable to the State. Corporations with taxable nexus in North Carolina and at least one additional state calculate their North Carolina apportionable income through use of the apportionment formula as described in the franchise tax section on the next page. Non-apportionable income is directly allocated in accordance with applicable revenue statutes. Corporations without taxable nexus in at least one state other than North Carolina are not permitted to apportion income.

If a corporation believes that the statutory apportionment formula results in the allocation to this State of a greater portion of its net income than is reasonably attributable to business or earnings within the State, it may petition the Tax Review Board for authorization to use a method of allocation which will more accurately reflect the income attributable to this State. Petition may be made prior to commencement of operations in the State based on contemplated business, but in any event must be made not later than 90 days after the regular or extended due date of the tax return. Since decisions of the Board are under authority of specific statutory power, they have the weight of law. In addition to permanent orders, this body also issues limited orders to deal with formula difficulties arising during the start-up period of new plants and businesses.

The board consists of the State Treasurer, Chairman; the Chairman of the Utilities Commission; a public member appointed by the Governor; and the Secretary of Revenue. Petitions and other correspondence may be addressed to Ms. Janet L. Shires, Executive Secretary, Tax Review Board, Post Office Box 871, Raleigh, North Carolina 27602-0871. Ms. Shires' telephone number is (919) 733-7711.

In determining net income, North Carolina allows – in addition to operating expenses, depreciation, etc. – a deduction for all taxes paid or accrued in the year, except taxes on income; contributions not to exceed five percent of net income; income from tax exempt securities; payments to employee pension or profit-sharing trusts; current year losses; and net economic losses (as defined in the law) of any or all of the 15 preceding years. Domestic production income excluded under section 199 of the Internal Revenue Code (IRC) and income from international shipping activities excluded under subchapter R of chapter 1 of the IRC must be added to income.

Taxpayer were required to add to federal taxable income, a percentage of the 30% additional first-year depreciation deduction allowed for federal income tax purposes in section 168(k) of the Internal Revenue Code under the Job Creation and Worker Assistance Act of 2002. The applicable percentages of the bonus depreciation to be added were: 100% for tax year 2002, 70% for 2003, 70% for 2004, and 0% for subsequent years. A taxpayer may deduct 20% of the total amount of bonus depreciation added to federal taxable income in tax years 2002 through 2004 in each of the first five taxable years beginning on or after January 1, 2005.

North Carolina's treatment of the taxability of subsidiary dividends received conforms to the federal determination. Taxable income is reduced by the amount of special deductions on the federal form. Because this income is nontaxable, corporations are required to attribute expenses to non-taxed dividends in arriving at State taxable income. North Carolina provides limits on the potential tax liability of certain taxpayers as a result of the attribution of expenses to dividends. For most corporations, the amount of expenses attributed to dividends is limited to 15% of the dividends. For bank holding companies or electric power holding companies, which are required by federal law to maintain a holding company structure, special limits apply and tax credits are available to recoup part of the additional tax paid due to attribution of expenses to dividends.

Quarterly estimated income tax payments are required if a corporation expects to have an income tax liability of $500 or more.

FRANCHISE TAX

A franchise tax is levied on business corporations (including those electing federal S Corporation status) at the rate of $1.50 per $1,000 of the largest of three alternate bases. These bases are (a) the amount of the capital stock, surplus, and undivided profits apportionable to the State; or (b) 55 % of appraised value of property in the State subject to local taxation; or (c) the book value of real and tangible personal property in the State less any debt outstanding which was created to acquire or improve real property in the State. Book value may be computed by use of the same depreciation methods as are permitted for federal income tax purposes.

Only corporations with taxable nexus in one or more other states are permitted to apportion "capital" as described in (a) above. The formula used by corporations to determine the amount of "capital" apportionable to North Carolina is the total of the following ratios divided by 4: the ratio of payrolls in the State to total payrolls; the ratio of the value of tangible property used in the State to the value of all tangible property used, wherever located; and two times the ratio of sales of merchandise shipped to North Carolina customers to total sales. In computing the property ratio, owned property is valued at original cost and leased property is valued at eight times the annual rental rate.

For several other types of industries (construction contractor, securities dealer, a loan company or a corporation that receives more than 50% of its ordinary gross income from intangible property), apportionment is based only on the sales factor.

The franchise taxes on utilities vary. Electric power companies are taxed at 3.22% of their taxable gross receipts. Water companies pay 4% of their taxable gross receipts, while public sewerage companies pay 6% of taxable gross receipts. Telephone companies are subject to the general business franchise tax.

Holding companies (80% of gross income is from subsidiaries) are separately taxed and the tax may not exceed $75,000 when it is computed on the capital stock, surplus, and undivided profits base.

The minimum franchise tax is $35.

INCORPORATION FEES

A fee of $125 is payable to the Office of the Secretary of State upon filing articles of incorporation; this fee is $60 for non-profit corporations. There is a fee of $250 for application for certificate of authority on foreign companies only. In addition, an annual report with a $20 filing fee may be paid with the corporation's income and franchise tax return or may be filed and paid electronically with the North Carolina Secretary of State. The franchise tax and corporate income tax are reported on the same return.

For corporations set up as LLCs, a fee of $125 is due when filing articles of organization; a fee of $250 for application for certificate of authority. An annual report with a $200 filing fee is also required, but LLCs subject to the franchise tax may receive a franchise tax credit equal to the difference between this fee and the standard $20 annual report fee.

Various fees other than those mentioned above are imposed when documents are delivered to the Office of the Secretary of State for filing. Additional information can be obtained from the Corporations Division, Office of the Secretary of State, Post Office Box 29622, Raleigh, North Carolina 27626-0622, and from the Secretary of State's website at http://www.secstate.state.nc.us.

TAX CREDITS FOR GROWING BUSINESSES (ARTICLE 3J)

Effective for taxable years beginning on or after January 1, 2007, Article 3J provides tax credits to growing businesses. These credits replace the Article 3A credits, also known as the William Lee Act, which expired for taxable years beginning on or after January 1, 2007, with some exceptions. A taxpayer cannot take Article 3J credits and Article 3A credits with respect to the same establishment. The Article 3A credits are not discussed here, but information on those credits is available at http://www.dornc.com/taxes/corporate/Article3A_Guidelines06.pdf.

Credits are available for 1) creating jobs; 2) investing in business property; and 3) investing in real property (limited geographic availability). The Article 3J tax credits are based on a system that divides the State into three development tiers, with tier one being the most economically distressed and tier three being the least economically distressed. Each county is assigned an annual tier designation by the Secretary of Commerce. The Department of Commerce publishes a list county tier designations at http://www.nccommerce.com/finance/tiers/. Within each tier, there may be urban progress zones or agrarian growth zones, a list of which also will be published by the Department of Commerce.

The amount of the creating jobs credit and the number of jobs that must be created to qualify varies by tier and whether the job is created in an urban progress or agrarian growth zone. The business property credit is calculated as a percentage of the amount of investment over a threshold. The threshold and percentage vary by the tier of the location where the property is located, with urban progress and agrarian growth zones treated as being in tier 1. The real property credit is available only for property in service in a tier 1 county.

To qualify for the Article 3J credits, job creation or investment must occur at an establishment whose primary activity is one of the following: 1) aircraft maintenance and repair; 2) an air courier services hub; 3) a company headquarters (creation of at least 75 jobs within 24 months); 4) a customer service call center; 5) an electronic shopping and mail order house; 6) information technology and services; 7) manufacturing; 8) a motorsports facility; 9) a motorsports racing team; 10) research and development; 11) warehousing; or 12) wholesale trade.

In addition, a taxpayer must satisfy general eligibility requirements by: 1) meeting wage standards published by the Department of Commerce; 2) providing health insurance for all full-time employees at the credit-qualifying establishment and cover at least 50% of health care premiums; 3) having a good environmental record; 4) having a good OSHA record; and 5) having no overdue tax debts with the State.

The creating jobs and business property credits are taken in four equal installments and the real property credit in seven installments, beginning with the taxable year following the year in which the qualifying activity took place. The credits are allowed against the franchise tax, the income tax, and the gross premiums tax. The taxpayer may divide a credit between the taxes against which it is allowed. The total of all credits may not exceed 50% of the cumulative amount of taxes against which they are allowed for the taxable year, reduced by the sum of all other credits against those taxes. Unused credits may be carried forward for the succeeding five years (15 years for the credit for investment in real property and 20 years for investments of $150,000,000 over two years).

Additional information on the Article 3J credits is available on the Department of Revenue website at http://www.dornc.com/taxes/corporate/article3j.pdf.

OTHER INCOME TAX CREDITS

Income tax credits also are available for the following: 1) investing in renewable energy property; 2) construction of low-income housing; 3) construction of renewable fuel facilities; 4) North Carolina State Ports Authority wharfage, handling and throughput charges; 5) contributions of cash or property to improvement projects undertaken by development zone agencies; 6) rehabilitating historic structures and historic mills; 7) donations of real property used for public access or conservation, conservation tillage equipment, gleaned crops; 8) S&L supervisory fees; 9) construction of cogenerating power plants; 10) recycling of oyster shells; 11) certain telephone subscriber line charges; 12) investing in large or major recycling facilities; 13) construction of dwelling units for handicapped persons; 14) construction of poultry composting facilities; 15) certain holding company expenses related to dividends; 16) qualified film or television production expenses; 17) small business health insurance costs; and 18) expenses of research performed in the state or payments for research to universities in the state.

INCOME TAXES FOR S CORPORATIONS

S Corporations are not subject to the corporate income tax. Each shareholder's pro rata share of S Corporation income attributable to North Carolina is taxed under the individual income tax. A shareholder who is a resident of the State also takes into account his share of S Corporation income not attributable to North Carolina when computing his individual income tax.

An S Corporation incorporated or doing business in this State is required to file an information return with the Department of Revenue. The return should show the name, address, social security or federal identification number of each shareholder, and for each shareholder, income attributable and the amount of income not attributable to the State.

An S Corporation is required to file an agreement with the Department of Revenue for each nonresident shareholder whereby each nonresident shareholder agrees to file an income tax return, pay tax imposed by the State, and be subject to personal jurisdiction in the State for purposes of collecting unpaid taxes, penalties, interest, etc. However, an S Corporation may file a composite return and make composite payment of tax to the Department of Revenue on behalf of some or all of its nonresident individual shareholders.

SPECIAL TAX PROVISIONS FOR LIMITED LIABILITY COMPANIES

An LLC is subject to income taxation as a partnership if it is classified as a partnership for federal income tax purposes or as a corporation if it is classified as a corporation for federal income tax purposes. An LLC classified as a c-corporation for federal income tax purposes is subject to the franchise tax, but all other LLCs are exempt.. However, it is the intent of the law that the franchise tax applies equally to assets held by corporations and assets held by corporate-affiliated LLCs. A non-corporate LLC's assets are attributed to a controlling corporation if the corporation or affiliated group of corporations owned 50% or more of the LLC's assets. This is to avoid the possibility of corporations reducing their franchise tax by transferring assets to their LLC.

WITHHOLDING INCOME TAX

Employers are required to withhold individual income tax from wages and salaries of their employees. A pension payer that must withhold federal income tax from a pension payment to a North Carolina resident is required to withhold State income tax. A pension recipient may elect not to have taxes withheld and certain pension payments are exempt.

EMPLOYMENT SECURITY TAX

Business entities are subject to a payroll tax under the North Carolina Employment Security Law if they have one or more employees for 20 different weeks during a calendar year or pay $1,500 in wages in any calendar quarter during a calendar year in this State. The tax is payable quarterly and applies to wage payments up to $16,700 per employee per year in 2005. Entities commencing business in North Carolina are subject to a tax rate of 1.20% during the first two years. The rate may be changed after the entity comes under experience rating. The minimum tax rate allowed in 2006 under the experience rating tables is 0% of taxable payrolls; the maximum tax rate, 6.84%.

The tax is administered by the Employment Security Commission of North Carolina. Information regarding the tax is available at www.ncesc.com/business/ui/uitax.asp.

OCCUPATIONAL LICENSE TAXES

Occupational license taxes are levied by the county and municipal governments on a variety of occupations and businesses. State law limits the tax which may be levied on certain occupations and businesses by local governments, and prohibits the taxation of others by these units. Municipalities have general licensing authority, but are specifically limited in regard to certain businesses.

INSURANCE TAX

In lieu of paying the corporate income and franchise tax, insurance companies are subject to this tax. Most insurance companies must pay a tax rate of 1.9% of their gross premiums. The tax rate on gross receipts for contracts applicable to liabilities under the Workers' Compensation Act is 2.5%. The tax rate on HMOs is 1%, but it will increase to 1.9% as of January 1, 2007. Insurance companies also are subject to a regulatory charge equal to a percentage of their gross premiums tax. For 2006, the rate is 5.5%.

DRY-CLEANING SOLVENT TAX

Dry-cleaning solvent retailers and dry-cleaning facilities must pay $10 for each gallon of dry-cleaning solvent that is chlorine-based and $1.35 for each gallon of dry-cleaning solvent that is hydrocarbon-based.

PRIVILEGE TAXES ON MANUFACTURING FUEL AND CERTAIN MACHINERY AND EQUIPMENT

A privilege tax of 1% of sales price is imposed on purchasers of fuel, other than electricity or natural gas, used to operate a manufacturing plant. A privilege tax of 1% of sales price, with a maximum of $80 per article, is imposed on purchasers of manufacturing machinery, parts, and accessories stored, used, or consumed in the state. A privilege tax of 1% of sales price, with a maximum of $80 per article, also is imposed on purchasers of crane systems, port or dock facilities, rail equipment, and material handling equipment if they are used in connection with a major recycling facility in the state, and on research and development companies in the physical, engineering, and life sciences that purchase certain capitalized equipment.

SPECIFIC STATE TAXES FOR INDIVIDUALS

ESTATE TAX

North Carolina has no inheritance tax, but it does impose an estate tax based on the federal estate tax calculation. For decedents dying on or after January 1, 2005, North Carolina estate tax is imposed on the estate when a federal estate tax would be payable if the federal estate tax was determined without regard to the deduction for state death taxes. The North Carolina estate tax is equal to the state death tax credit that was allowable under section 2011 of the Internal Revenue Code as it existed prior to 2002. The amount of the North Carolina estate tax is limited to the federal estate tax that would be payable if the federal estate tax was computed without regard to the deduction for state death taxes.

GIFT TAX

A gift tax is imposed on a donor and the rate varies based upon the class of donee. Donees are divided into three classes: Class A includes any lineal ancestor or descendant, or adopted child or stepchild; Class B includes brother, sister, descendant of a brother or sister, and aunt or uncle by blood of the donor; Class C includes all others. Gifts of $11,000 or less per year to any individual are not taxable. (Exclusion does not apply to gifts of future interest.) Gifts to spouses are exempt, including property given to a spouse as a qualified terminable interest property under federal law.

In addition, a lifetime exemption of $100,000 is allowed each donor for gifts made to Class A donees. When this exemption or any part thereof is applied against gifts to more than one donee, it is apportioned among the donees in the same ratio as the gross gift after exclusion to each donee is to the total gifts to Class A donees in the calendar year in which the gifts are made.

RATES OF TAX

	Taxable Portion of Share	Rate for Class A Donees	Rate for Class B Donees	Rate for Class C Donees
First	$ 5,000	1%	4%	8%
Next	5,000	1	5	8
Next	15,000	2	6	9
Next	25,000	3	7	10
Next	50,000	4	8	11
Next	100,000	5	10	12
Next	50,000	6	10	12
Next	250,000	6	11	13
Next	500,000	7	12	14
Next	500,000	8	13	15
Next	500,000	9	14	16
Next	500,000	10	15	16
Next	500,000	11	15	17
All over	3,000,000	12	16	17

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