

**GENERAL ASSEMBLY OF NORTH CAROLINA  
SESSION 2001**

**HOUSE BILL 1157  
RATIFIED BILL**

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.
- (2) North Carolina royalty. – An amount charged that is for, related to, or in connection with the use in this State of a trademark. The term includes royalty and technical fees, licensing fees, and other similar charges.
- (3) Own. – To own directly, indirectly, beneficially, or constructively. The attribution rules of section 318 of the Code apply in determining ownership under this section.
- (4) Related entity. – Any of the following:
  - a. A stockholder who is an individual, or a member of the stockholder's family enumerated in section 318 of the Code, if the stockholder and the members of the stockholder's family own in the aggregate at least eighty percent (80%) of the value of the taxpayer's outstanding stock.
  - b. A stockholder, or a stockholder's partnership, limited liability company, estate, trust, or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts, and corporations are component members with respect to the taxpayer.

- c. A corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of section 318 of the Code, if the taxpayer owns at least eighty percent (80%) of the value of the corporation's outstanding stock.
- (5) Related member. – A person that, with respect to the taxpayer during any part of the taxable year, is one or more of the following:
  - a. A related entity.
  - b. A component member.
  - c. A person to or from whom there would be attribution of stock ownership in accordance with section 1563(e) of the Code if the phrase '5 percent or more' were replaced by 'twenty percent (20%) or more' each place it appears in that section.
- (6) Royalty payment. – Either of the following:
  - a. Expenses, losses, and costs paid, accrued, or incurred for North Carolina royalties, to the extent the amounts are allowed as deductions or costs in determining taxable income before operating loss deduction and special deductions for the taxable year under the Code.
  - b. Amounts directly or indirectly allowed as deductions under section 163 of the Code, to the extent the amounts are paid, accrued, or incurred for a time price differential charged for the late payment of any expenses, losses, or costs described in this subdivision.
- (7) Trademark. – A trademark, trade name, service mark, or other similar type of intangible asset.
- (8) Use. – Use of a trademark includes direct or indirect maintenance, management, ownership, sale, exchange, or disposition of the trademark.
- (c) Election. – For the purpose of computing its State net income, a taxpayer must add royalty payments made to, or in connection with transactions with, a related member during the taxable year. This addition is not required for an amount of royalty payments that meets either of the following conditions:
  - (1) The related member includes the amount as income on a return filed under this Part for the same taxable year that the amount is deducted by the taxpayer, and the related member does not elect to deduct the amount pursuant to G.S. 105-130.5(b)(20).
  - (2) The taxpayer can establish that the related member during the same taxable year directly or indirectly paid, accrued, or incurred the amount to a person who is not a related member.
- (d) Indirect Transactions. – For the purpose of this section, an indirect transaction or relationship has the same effect as if it were direct."

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

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

**SECTION 1.(d)** G.S. 105-130.5(a) is amended by adding a new subdivision

to read:

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

...

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

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

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

...

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

**SECTION 1.(f)** This section is effective for taxable years beginning on or after January 1, 2001. Notwithstanding G.S. 105-163.41, no addition to tax may be made under that statute for a taxable year beginning on or after January 1, 2001, and before January 1, 2002, with respect to an underpayment of corporation income tax by a payer of royalties who adds the payments to State net income pursuant to G.S. 105-130.7A(c), to the extent the underpayment was created or increased by this section.

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

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

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

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

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

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

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

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

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

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

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

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

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

### **MONITORING**

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

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

In the General Assembly read three times and ratified this the 25<sup>th</sup> day of July, 2001.

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Beverly E. Perdue  
President of the Senate

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James B. Black  
Speaker of the House of Representatives

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Michael F. Easley  
Governor

Approved \_\_\_\_\_ .m. this \_\_\_\_\_ day of \_\_\_\_\_, 2001