



# State of North Carolina Office of the State Controller

Michael F. Easley, Governor

Robert L. Powell, State Controller

November 15, 2001

## MEMORANDUM No. 02-34

**TO:** Chief Fiscal Officers/Vice Chancellors

**FROM:** Robert Powell  
State Controller

**SUBJECTS:** **Year End Tax Update**

- I. IRS Modernization Plan**
- II. Streamline Sales and Use Tax Agreement**
- III. Tax Rate Changes**
- IV. CP 2100 Notices and Backup Withholding of Federal Income Tax**
- V. Year End Payroll Issues**
- VI. Ordering Tax Forms for 2001 Year End Processing**
- VII. NCAS 1099 Processing Schedule for 2001 Reporting Year**

The following is a year end update of changes in state and federal taxes that may affect your agency. Also there is a discussion of year end payroll issues that must be addressed before W-2 forms can be generated. As a result of the Internal Revenue Service Modernization Plan, the Office of the State Controller (OSC) requests that all agencies and universities contact us should your agency have tax questions or problems. The IRS has advised the OSC that it will do everything possible to assist State agencies in resolving problems without assessing penalties and an IRS special agent has been assigned to assist us in that purpose.

### **I. IRS Modernization Plan**

The Internal Revenue Service Modernization Plan created the Tax Exempt and Governmental Entities Division. This Division is composed of four segments: Exempt Groups, Employee Plans, Customer Account Services, and Governmental Entities. Governmental Entities is composed of three offices, Indian Tribal Governments, Tax Exempt Bonds, and Federal, State, & Local Governments. The stated mission of the Federal, State, and Local Government office is to provide direct, quality service to governments by helping them understand and comply with applicable tax laws.

The emphasis of this program is on Federal employment taxes. This includes (but is not limited to) taxability and reporting of employee benefits and compensation, non-employee compensation, and correct determination of Section 218 coverage. Section 218 refers to the coverage of state and local government employees for social security and Medicare taxes (who is covered and who is not). In North Carolina the custodian of our Section 218 Agreement is the Director of the Retirement System.

The Greensboro office of the IRS is home to a regional Federal, State and Local Governments group. This is the office we will be working with in the future to resolve problems and disputes.

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## II. Streamline Sales and Use Tax Agreement

Senate Bill 144 which was ratified by the General Assembly this session made a significant change in the sourcing of sales for purposes of the sales and use tax. G.S. 105-164.4B now uses the following principles to source the sale of a product.

1. *Over the counter sales.* When the purchaser receives a product at a business location of the seller, the sale is sourced to that business location.
2. *Delivery to a specified address.* When a purchaser receives a product at a location specified by the purchaser and the location is not a business location of the seller, the sale is sourced to the location where the purchaser receives the product.
3. *Delivery address unknown.* When a seller of a product does not know the address where a product is received, the sale is sourced to the first address listed in this subsection that is known to the seller: (a) the business or home address of the purchaser; (b) the billing address of the purchaser; or (c) the address of the seller.

Senate Bill 144 also changed the definition of *sales price*. Previously, early payment and other cash discounts were considered part of the sales and use tax base for purposes of applying the tax. Under the new definition, sales price does not include discounts, including cash, term, or coupons, that are not reimbursed by a third party, are allowed by the retailer, and are taken by a consumer on a sale. In other words, *cash discounts are now excluded from sales price*.

Please note, for agencies on the North Carolina Accounting System (NCAS), the system will be set to compute the amount of sales and use tax to remit with the invoices taking into account any applicable cash discount on January 1, 2002. The effective date of the above changes is January 1, 2002.

## III. Tax Rate Changes

**Backup Withholding Tax Rate Changes.** Effective for payments made after August 6, 2001, the backup withholding tax rate on payments to independent contractors who have not provided a taxpayer identification number (IRC 3406(a)(1)) has been reduced from 31% to 30.5%. On January 1, 2002 the backup withholding rate goes to 30%.

**Sales and Use Tax Rate Changes.** Effective October 16, 2001 the State sales and use tax rate will increase by  $\frac{1}{2}\%$  to  $4\frac{1}{2}\%$ . The county portion will remain at 2% ( $2\frac{1}{2}\%$  for Mecklenburg) for a combined rate of  $6\frac{1}{2}\%$ . These rates will remain in effect until June 30, 2003. At that time the State rate will revert to 4% and the counties will have the option of raising their rates an additional  $\frac{1}{2}\%$ . Information on this increase from the Department of Revenue is attached for your review.

**Tax Rate Reduction for Supplemental Pay.** Effective for payments made after August 6, 2001, the supplemental tax rate on bonuses, nonqualified moving expenses, miscellaneous pay, etc. has been reduced from 28% to 27.5%, effective August 7, 2001. This rate is further reduced to 27% effective January 1, 2002 and will drop to 26% on January 1, 2004.

**Social Security Wage Base for 2002.** For 2002 the social security wage base is increased to \$84,900. This increase was larger than expected. The maximum amount of social security tax will be \$5,263.80.

## IV. CP 2100 Notices and Backup Withholding of Federal Income Tax

In October, the IRS will issue CP2100 notices for 1099 information returns filed for tax year 2000. These CP2100 notices will detail vendors and TINs that are not in agreement with the information that is on file with either the IRS or the Social Security Administration. IRS procedure requires each agency to compare its records with the information furnished by the IRS. **This comparison is a legal requirement; it is not subject to management discretion.** The agency must obtain a certified TIN within 30 days of receipt of this notice. The certified TIN is obtained on a Form W-9. Vendors that appear on the CP2100 list for two out of three years must be subject to immediate backup withholding. Backup withholding must continue until the IRS notifies the agency to stop withholding. This notification is made on an IRS Letter 147C or SSA Form 7028.

Agencies that receive CP2100s will eventually receive IRS 972CG notices, usually in August of the following year. 972CG Notices are notices of proposed assessment. The IRS uses these notices to propose an assessment based on the number of mismatches that were reported on the magnetic tapes or paper 1099 forms. To avoid

paying a penalty, the agency is required to show that due diligence was followed. The due diligence requirements along with a detailed discussion of backup withholding is found on the SIG at [http://www.osc.state.nc.us/OSC/sigdocs/sig\\_docs/1099\\_withholding.html](http://www.osc.state.nc.us/OSC/sigdocs/sig_docs/1099_withholding.html).

Please have your staff review any IRS CP2100 notice that you receive in October and follow the procedures set forth at the above web site. Set to inactive or delete any vendor not corrected during your review or make that vendor subject to federal backup withholding if a certified W-9 is not received within the prescribed time period.

## V. Year End Payroll Issues

**Educational Expenses.** Code Section 127 excludes up to \$5,250 per year for employer-provided non-job related undergraduate educational assistance. This exclusion is available for expenses paid in relation to courses beginning before January 1, 2002. For Year 2001, reimbursement of non-job related graduate level education is generally taxable income and must be run through the payroll system. Job-related graduate level assistance must maintain or improve skills required for the employee's current job or satisfies certain express employer-imposed conditions for continuing employment to meet Code Section 132(d) requirement as a non-taxable working condition fringe. Graduate courses beginning after January 1, 2002 will be exempt from taxation just as undergraduate courses are. The Economic Growth and Tax Relief Reconciliation Act of 2001 made the exclusion for Code Section 127, Educational Assistance permanent.

Year 2001 taxable educational assistance (graduate level) should be entered into Central Payroll no later than November 30, 2001. FICA and income taxes must be withheld from taxable educational assistance. These payments are exempt from State retirement.

**Moving Expenses.** Employees will report on Form 3903, Moving Expenses (1040 Personal Tax Return) only the qualified moving expenses paid directly by them, and they will reduce these expenses by the amounts reimbursed by their employers and reported on Form W-2, in Box 13. See *OSC Memo 98-40, dated March 9, 1998, for discussion of qualified v. non-qualified moving expenses.*

2001 Form W-2 reporting requirements are as follows:

- do not report qualified moving expenses you pay directly to a third party on behalf of an employee;
- report in box 13, code P, qualified moving expenses you have directly reimbursed to the employee;
- report nonqualified moving expenses, whether paid to a third party or directly to the employee, as wages in boxes 1, 3, and 5. These amounts are subject to federal income tax withholding and social security and Medicare taxes.

Central Payroll uses OSC Form 325 to accumulate the non-taxable moving expenses you have directly reimbursed to the employee. Taxable moving expenses are entered directly into Central Payroll with FICA and income taxes withheld. There is no withholding of State retirement on moving expense reimbursements.

Both taxable, and non-taxable but reportable, moving expenses should be entered or forwarded to Central Payroll no later than November 30, 2001, for processing on this year's Form W-2.

**North Carolina Severance Wage Exemption.** N.C. income tax should not be withheld from the first \$35,000 in severance wages, including severance salary wage continuation payments made during a reduction in force. In addition to not withholding N.C. income tax from these payments, the employees Form W-2, N.C. Wage Block should be net of the qualified severance wage. For example:

*An employee with 3 years service would be entitled to 1 month's wage as a severance salary continuation payment. Ignoring the reduction for State retirement, deferred compensation, and cafeteria plans, an employee making \$2,000 per month who is terminated at the end of August would have reported \$18,000 (8 mos. salary, 1 mos. severance) in Federal wages in Block 1 of the W-2 form, and \$16,000 in State wages in Block 17.*

Each agency or university on Central Payroll should identify reduction in force "RIF" employees and amounts paid that are to be considered severance wages. This identification should be made on or before November 30, 2001.

The Internal Revenue Code does not exclude severance wages from federal taxable income.

## VI. Ordering Tax Forms for 2001 Year End Processing

IRS forms 1099-MISC, 1099-G, and 1099-INT will be generated by the NCAS system as laser returns for year-end 2001. These forms will require "stuffing" of the envelopes by your agency's staff. Prior year 1099 forms were self

mailers but due to complaints about print quality, the OSC decided to make the change to self generated forms using IRS specifications. The OSC will provide envelopes with returns that include the required IRS statement, "Important Tax Information" on the front. The system generated laser forms are for providing the recipient's copy; they are not suitable for submission to the IRS. The NCAS generated laser forms are designed to provide the recipient with a copy and a magnetic tape will be provided to the IRS.

The OSC will also order a supply of 1099 forms for use in making reissues and corrections. These forms will include copy A which is suitable for paper submissions to the IRS. We will also have a supply of 1096 forms for use as transmittals with the paper 1099s that are submitted to the IRS.

**VII. NCAS 1099 Processing Schedule for 2001 Reporting Year**

OSC-Financial Systems Division will issue detailed instructions on the schedule for 2001 calendar year Form 1099 processing. However, the following are some of the general procedures that will be observed by NCAS agencies.

For all NCAS agencies, amounts paid through the AP System will be reported magnetically to the IRS. The tape generated will list the agencies name and EIN. The address will show a return address for the Office of the State Controller. This is so mismatched records can be corrected in a more thorough and efficient manner.

Some agencies will need to prepare NC1099PS forms for withheld NC income tax. These forms will not be system generated, which means they will need to be hand-typed. Forms may be obtained from the N.C. Department of Revenue or you may call (919)981-5488 and have forms sent inter-office to you. In addition to the preparation of the NC1099PS's, you will also need to prepare the NC-3, Annual Reconciliation which requires copies of the NC1099PS be attached to the NC-3 for submission to the Department of Revenue.

We have attached a discussion of the new sales and use tax rates from the Department of Revenue. Also included are questions and answers concerning the imposition of the N.C. withholding tax on non-residents. Should you have questions concerning the above, please call Randy Thomas at (919)981-5488.

Attachments: