



State of North Carolina Office of the State Controller

Michael F. Easley, Governor

Robert L. Powell, State Controller

November 19, 2002

MEMORANDUM NO. 03-24

TO: Chief Fiscal Officers/Vice Chancellors

FROM: Robert L. Powell
State Controller

SUBJECTS: Year End Tax Update

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The following is an update of tax and payroll related issues for your agency/university. Please forward this memo to staff members that may find this information useful.

I. Increase in County Sales and Use Tax Rate

Due to legislation enacted by the 2002 session of the General Assembly, all counties have been authorized to levy an additional ½% local sales and use tax. Thus far 78 counties have adopted resolutions to levy the additional ½% local sales and use tax, effective December 1, 2002. In addition, 3 other counties will begin to levy the additional ½%, effective January 1, 2003. A list of those counties should have been provided to each agency filing sales and use tax reports. Also, the Department of Revenue has a list of those counties on its web site. <http://www.dor.state.nc.us/>

The variable tax rates that agencies/universities must deal with this coming year make the Department of Revenue's new sourcing rules even more important. 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

MAILING ADDRESS
1410 Mail Service Center
Raleigh, NC 27699-1410

Telephone: (919) 981-5454
Fax Number: (919) 981-5567
State Courier: 56-50-10

LOCATION
3512 Bush Street
Raleigh, NC

Website: www.osc.state.nc.us/OSC/

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seller: (a) the business or home address of the purchaser; (b) the billing address of the purchaser; or (c) the address of the seller.

As previously reported, the definition of *sales price* was also changed. Under the old law, 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*.

II. Tax Rate Changes

Backup Withholding Tax Rate Changes. Effective for payments made after January 1, 2002, the backup withholding tax rate on payments to independent contractors who have not provided a taxpayer identification number (IRC 3406(a)(1)) was reduced to 30%.

Tax Rate Reduction for Supplemental Pay. Effective for payments made after January 1, 2002, the supplemental tax rate on bonuses, nonqualified moving expenses, miscellaneous pay, etc. has been reduced to 27%. This rate will be further reduced to 26% effective January 1, 2004.

Social Security Wage Base for 2003. For 2003 the social security wage base is increased to \$87,000. This increase was larger than expected. The maximum amount of social security tax will be \$5,394.00.

Standard Business Mileage Rate Goes to 36 cents for 2003. The standard business mileage rate for transportation expenses paid or incurred beginning January 1, 2003 will be 36 cents per mile. Employees may be reimbursed this amount or less and not have to include any portion of the reimbursement in income.

III. CP 2100 Notices and Backup Withholding of Federal Income Tax

The IRS is in the process of issuing CP2100 notices for 1099 information returns filed for tax year 2001. 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 OSC Systems Information Guide (SIG) at

http://www.osc.state.nc.us/sigdocs/sig_docs/documentation/policies_procedures/1099_Complete.pdf.

Please have your staff review any IRS CP2100 notice that you receive 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.

IV. New SSA/INS Procedures

The IRS has announced that it will impose upon employers a \$50 penalty for each Form W-2 where the employee's name and social security number do not match the SSA's database. Penalties are to begin with tax year 2002 W-2 forms and the first penalty notices will be sent in June 2004. Please note, Central Payroll is now verifying SSNs for new hires on a quarterly basis.

Most name/SSA mismatches are caused by newly married females not providing the employer with their new name/SSA combination. There is also a problem with some illegal aliens providing fictitious names and SSN's. The SSA will now begin verifying the immigration documents against an INS database before

assigning an SSN. The SSA had previously checked the INS database, but because of an up-to-30-day delay in updating the database, if a person could not be found, but the presented documents looked valid, an SSN was issued. The INS is now shorting the waiting period from 30 to 7 days so hopefully these numbers can be verified on a more timely basis in the future.

V. Federal Court of Claims Finds Reduction in Force Payments May Not be FICA Wages

In the case of *CSX Corp., Inc. v. U.S. No.95-858T, 2002 U.S. Claims*, the Federal Court of Claims found that payments to permanently laid-off employees under a reduction in force program (RIF) qualified as supplemental unemployment compensation benefits under IRC 3402(o)(2); and therefore, were not wages for FICA-tax purposes. In the same case, payments to employees whose hours or rates of pay were cut or who left work voluntarily in return for the payments did not qualify and were FICA wages.

The OSC has contacted the IRS concerning the findings in this case. It would appear that payments to employees involuntarily terminated from State employment as a result of a reduction in force would qualify as supplemental unemployment compensation and not be FICA wages. However, at this time we have not received a response from the IRS concerning this matter.

Due to the difficulty involved in correcting employee W-2 records, the OSC **will not exempt** any RIF payments from FICA at this time. When it can be determined positively that the IRS will follow the decision in *CSX*, Central Payroll will notify agencies and correct W-2 forms by exempting the RIF payments from FICA.

VI. Reporting Compensation Paid to Jurors

The IRS has issued a ruling stating that juror's compensation of \$600 or more must be reported on Form 1099-MISC in box 3 as "other income," under Internal Revenue Code Sec. 6041, and that the compensation is not subject to federal income or social security and Medicare tax withholding.

VII. Year End Payroll Issues

Educational Expenses. Code Section 127 excludes up to \$5,250 per year for employer-provided non-job related educational assistance. For tax year 2002, undergraduate and graduate expenses for education qualify for this exemption.

Unless your agency/university provided more than \$5,250 in educational expenses to or on behalf of employees that were not job related, you should not report or withhold tax on any educational payment made to or on behalf of any employee.

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.*

2002 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 12, 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.

Taxable moving expense is entered into the payroll system by your payroll officer. Non-taxable but reportable, moving expenses should be forwarded to Central Payroll no later than November 30, 2002, 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 16.

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 should have been done at the time payment was made to the employee.

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

VIII. Ordering Tax Forms for 2002 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 2002. This is the same as last year. These forms will require "stuffing" of the envelopes by your agency's staff. This is identical to last year's procedures. 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 an electronic transmission will be made 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.

IX. NCAS 1099 Processing Schedule for 2002 Reporting Year

OSC-Financial Systems Division will issue detailed instructions on the schedule for 2002 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 electronically to the IRS. The transmission 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.

Should you have questions concerning the above, please call Randy Thomas at (919) 981-5488.