



State of North Carolina Office of the State Controller

Michael F. Easley, Governor

Robert L. Powell, State Controller

November 24, 2003

MEMORANDUM NO. 04-10

TO: Chief Fiscal Officers/Vice Chancellors

FROM: Robert L. Powell
State Controller

SUBJECTS: Year End Tax Update

- I. State Agency Exemption from Sales and Use Tax
- II. Other Sales and Use Tax Changes
- III. Worker Classification (Independent Contractor vs Employee)
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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 who may find this information useful.

I. State Agency Exemption from Sales and Use Tax.

The General Assembly has amended G.S. 105-164.13 to allow for an exemption for State agencies from the sales and use tax on items purchased by the State agency for its own use. The law further requires the purchase to be made pursuant to a valid purchase order issued by the agency and bearing the exemption number and a description of the property, or be paid for with a State-issued check, electronic deposit, credit card, procurement card, or credit account of the state-agency. For purchases other than by purchase order, the agency must provide to or have on file with the retailer the agency's exemption number. For indirect purchases of building material, etc. the state agency will continue to request a quarterly refund of the local sales and use taxes paid.

This exemption is effective for purchases made on or after July 1, 2004. State agencies, universities, licensing boards and the Departments of Public Instruction and Community Colleges are included in the exemption. The individual community colleges and local education units remain subject to the sales and use tax as in the past.

Agencies should request an exemption number from the Department of Revenue after January 1, 2004. The Department of Revenue will soon be issuing instructions on requesting exemption numbers. The Office of State Budget and Management will be addressing issues related to this legislation.

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II. Other Sales and Use Tax Changes

Prior to July 15, 2003, sales of candy, soft drinks, and prepared food were exempt from the general State rate of tax when they were sold for home consumption and eligible for purchase under the Federal Food Stamp Program; however, these items were subject to the 2% local sales and use tax. Sales of soft drinks and prepared food made on or after July 15, 2003 are subject to the combined general rate of State tax and the applicable local rate of tax.

Effective October 1, 2003, the 2% local sales and use taxes imposed on food will be administered as if the taxes were imposed as a State sales and use tax. Effective with the October 2003 sales and use tax return, the 2% local tax on food will be reported as a separate line item and taxpayers with locations in multiple counties will not be required to report the amount of local sales and use tax on food by county. The 2½% local tax on all items subject to the general State rate of tax must continue to be reported by county.

Effective January 1, 2004, 50% of all receipts from sales of closed container soft drinks sold through vending machines are exempt from State and local sales or use tax. Prior to this date, all receipts from these sales are taxable. Also, on this date, candy will be treated like any other food item and will be exempt from the State sales and use tax and subject to the 2% local tax.

Effective July 15, 2003, only the charge for custom computer software and the portion of prewritten computer software that is modified or enhanced, if the modification or enhancement is designed and developed to the specifications of a specific purchaser and the charges for the modification or enhancement are separately stated, is exempt from the sales and use tax. Prior to this change, prewritten software that was modified or enhanced based on the specifications of a specific customer was considered custom computer software and was exempt from the tax. Under the new law, canned or prewritten software will not be exempt as a result of customized modification or enhancement.

III. Worker Classification (Independent Contractor vs Employee)

State Accounting Division (SAD) Memorandum No 02-71 dated May 1, 2002, discussed the rules pertaining to the determination of employment status (independent contractor vs employee). The Office of the State Controller continues to receive complaints from the Social Security Administration about retired state employees being hired back on personal service contracts without social security or income tax being withheld and Form W-2 being issued. The hiring of former and retired employees is one of the most common problems for failure to properly withhold FICA that the state agencies have. Please refer to the above memo for the rules that pertain to making a determination of worker status if you are working a retired State employee on a personal services agreement.

IV. Various Tax Rate Changes

Backup Withholding Tax Rate Changes. Effective for payments made after January 1, 2003, 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 28%.

Tax Rate Reduction for Supplemental Pay. Effective for payments made after May 28, 2003, the supplemental tax rate on bonuses, nonqualified moving expenses, miscellaneous pay, etc. has been reduced to 25%.

Social Security Wage Base for 2004. For 2004 the social security wage base is increased to \$87,900. The maximum amount of social security tax will be \$5,449.80.

Standard Business Mileage Rate Goes to 37.5 cents for 2004. The standard business mileage rate for transportation expenses paid or incurred beginning January 1, 2004 will be 37.5 cents per mile. Employees may be reimbursed this amount or less and not have to include any portion of the reimbursement in income. Since many agencies are reimbursing at a rate less than the federal standard mileage rate, the employees may be able to deduct the difference on their personal income tax return.

V. 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 2002. These CP2100 notices will detail vendors and Taxpayer Identification Numbers (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/OSC/sigdocs/sig_docs/documentation/policies_procedures/step_by_steps/1099_Withholding.html.

Please have your staff review any IRS CP2100 notice that you receive and follow the procedures set forth at the above web site. Inactivate 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.

VI. New SSA/INS Procedures

The IRS imposes 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 that Central Payroll is now verifying SSN's for new hires on a quarterly basis.

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 2003, 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.*

2003 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. The excess of mileage reimbursements over the 12 cents per mile allowed by the IRS is a nonqualified moving expense and is subject to reporting in boxes 1,3, and 5.

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, 2003, 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 of service would be entitled to 1 month's wage as a severance salary continuation payment. Excluding 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. However, some RIF payments may be exempt from FICA. Please contact the OSC if you are making RIF payments to an individual and you need to determine the status of the payment for FICA.

VIII. Ordering Tax Forms for 2003 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 2003. 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 and 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 2003 Reporting Year

OSC-Financial Systems Division will issue detailed instructions on the schedule for 2003 calendar year Form 1099 processing. However, there are some 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.