North Carolina Department of Revenue

Beverly Eaves Perdue
Governor

Kenneth R. Lay
Secretary

Scott Peterson, Executive Director
Streamlined Sales Tax Governing Board
4205 Hillsboro Pike, Suite 305
Nashville, TN 37215

Re: North Carolina 2010 Compliance Review

Dear Mr. Peterson:

North Carolina provides the following in response to the Compliance Review and Interpretations Committee report dated August 31, 2010. You will find the applicable response after each item.

1. No 30 day rule for rate changes, but did comment that provided relief in this situation in 2009.

   Session Law 2009-575 provided that “...a retailer is not liable for an overcollection or undercollection of sales tax if the retailer has made a good faith effort to comply with the law and collect the proper amount of tax and has, due to the change under Section 27A.2 of Senate Bill 202, 2009 Regular Session, in the rate of tax imposed under G.S. 105-164.4(a), overcollected or undercollected the amount of sales tax that is due....” A 30 days savings relief was provided by the legislature for the 1% State tax increase that was enacted August 7, 2009 with an effective date of September 1, 2009.

   The additional ¼% State general sales and use tax, which was scheduled to be repealed for sales made on or after July 1, 2007, was extended for one month pending resolution of the 2007 Appropriations Act. The legislation provided that, for the month of July 2007, a retailer who made a good faith effort to comply with the law and collect the proper amount of tax would not be held liable for an over-collection or under-collection of sales tax as a result of the extension of the ¼% State tax. Additional legislation was enacted that permanently extended the ¼% tax; additional legislation also contained the “hold-harmless” provision for retailers for the month of August 2007.

2. There appear to be a number of differences in the state and local tax bases. Electricity and certain digital products are subject to state tax but not local tax. Two of the local sales taxes exempt bundled transactions which are taxed at the state level and under other local taxes.
Electricity - Subsection C. of Section 308: State and Local Tax Rates” states in part “[t]he provisions of this section do not apply to sales or use taxes levied on electricity...” As Section 308 C. affords a different rate of tax on electricity, it appears there is not a requirement to impose local tax on electricity pursuant to Section 302. There is no local tax base on electricity in any local North Carolina jurisdiction. The reduced rate of tax on electricity has been in effect for a number of years.

Digital Property - Upon review of NCGS 105-467, it does not appear that SB 202, s. 27A.3.(e), S.L. 09-451 effective January 1, 2010, which imposes the state sales tax on digital property included a corresponding addition to NCGS 105-467. A request for verification has been sent to the General Assembly staff regarding this issue. The Department issued a notice in December 2009 advising certain digital property was subject to the state and applicable local rates and the Department also included the information in the annual Form E-505, Legislative Changes mailed to all taxpayers. NCGS 105-474 states in part that “It is the intention of this Article that the provisions of this Article and the provisions of the North Carolina Sales and Use Tax Act, insofar as practicable, shall be harmonized.”

Bundled Transactions local tax base – As imposed in the NC statutes “food” that is not food sold through a vending machine, prepared food other than bakery items sold without eating utensils by an artisan bakery, soft drinks, and candy, are exempt from North Carolina state sales and use tax pursuant to NCGS 105-164.13B. and are subject to local sales and use tax at the rate of 2%. Local taxes per NCGS 105-506.2, and NCGS 105-538 are not imposed on “food” other than those items stated above. The intent of NCGS 105-506.2 and NCGS 105-538 are to clarify that if a bundled transaction contains food subject to the local rate of 2% and the “food” in the bundled transaction exceeds ten percent, the provisions of NCGS 105-164.4D bundled transactions apply.

3. The statute defines prepaid telephone calling service to include prepaid wireline calling service and prepaid wireless calling service. There is no definition for prepaid calling service (which includes both wireline and wireless service) and prepaid wireline calling service is not a defined term. This was noted in last year’s review and legislation was requested, but did not pass. There is not an effect under today’s offerings by the industry.

During the 2010 short legislative session, the Sales and Use Tax Division requested the word “wireline” be removed from NCGS 105-164.3(27) and (27b). It does not appear this request was included in any proposed legislation; therefore, a change was not made during the 2010 session. This issue has been noted for the 2011 legislative session by the Sales and Use Tax Division. As stated above, there is no effect under today’s offerings by the industry and the statutes impose tax in the same manner on all prepaid calling services as evidenced below.

NCGS 105-164.3(27) as currently written states the following:
Prepaid telephone calling service. – Prepaid wireline calling service or prepaid wireless calling service.
NCGS 105-164.3(27b) as currently written states the following:

Prepaid wireline calling service. – A right that meets all of the following requirements:

a. Authorizes the exclusive purchase of wireline telecommunications service.

b. Must be paid for in advance.

c. Enables the origination of calls by means of an access number, authorization code, or another similar means, regardless of whether the access number or authorization code is manually or electronically dialed.

d. Is sold in units or dollars whose number or dollar value declines with use and is known on a continuous basis.

The imposition of tax on prepaid telephone calling service is noted in the following statute:

NCGS 105-164.4 (4d). The sale or recharge of prepaid telephone calling service is taxable at the general rate of tax. The tax applies regardless of whether tangible personal property, such as a card or a telephone, is transferred. The tax applies to a service that is sold in conjunction with prepaid wireless calling service. Prepaid telephone calling service is taxable at the point of sale instead of at the point of use and is sourced in accordance with G.S. 105-164.4B. Prepaid telephone calling service taxed under this subdivision is not subject to tax as a telecommunications service.

4. The definition of “postpaid calling service” does not exclude prepaid wireless calling service.

The definition of “postpaid calling service” as defined per NCGS 105-164.4C(h)(5) does not contain the specific language “[a] post-paid calling service includes a telecommunication service, except a prepaid wireless calling service, that would be a prepaid calling service except it is not exclusively a telecommunication service.” The definition of “postpaid calling service” as defined per statute does state that “[a] postpaid calling service includes a service that meets all the requirement of a prepaid wireline telephone calling service, except the exclusive use requirement.” The definition of postpaid calling service is defined within NCGS 105-164.4C that is specific to telecommunications service and ancillary service.

5. The sourcing statute puts the option of using the mobile phone number with the fourth step (address of the payment instrument) instead of the fifth (ship from, service performed).

NCGS 105-164.4B provides for the sourcing provisions. The general sourcing provisions provide that a sales is sourced based on the business location of the seller, at the location where the purchaser receives the product if other than the business location of the seller, or based on the following where the delivery address is unknown.

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 or location listed in this subdivision that is known to the seller:

a. The business or home address of the purchaser.

b. The billing address of the purchaser or, if the product is prepaid wireless calling service, the location associated with the mobile telephone number.
c. *The address from which tangible personal property was shipped or from which a service was provided.*

The statute as constructed clearly states that prepaid wireless calling services are sourced based on the location associated with the mobile telephone number for transactions when the sale is not sourced to the business location of the seller or the location specified by the purchaser and the location is not the business location of the seller. Inclusion of the option for using the mobile phone number with the fourth step (address of the payment instrument) under Section 314 instead of the fifth (ship from, service performed) in the statute does not result in a sourcing conflict. It is clear where the delivery address is unknown relative to prepaid wireless calling services, the location associated with the mobile telephone number is allowable.

6. The definition of “receive” and “receipt” does not have the words “or taking possession or making first use of digital goods”. Several types of digital goods are taxed in the state.

NCGS 105-164.3(36) defines “sale or selling” to include “[t]he transfer for consideration of title or possession of tangible personal property or digital property...” Additionally, NCGS 105-164.26 states “[t]hat digital property sold for delivery or access in this State is sold for storage, use, or consumption in this State.” During the 2011 legislative session, the Department will request an adjustment to the statute to incorporate the “making first use of digital goods” to clarify and to ensure compliance with Section 311.

7. The sourcing for mobile telecommunications service excludes prepaid wireless calling service. The SSUTA excludes prepaid calling service (which is mainly wireline) and not prepaid wireless calling service.

As indicated in response to number 3 above, “wireline” is included in the statutes with no effect. “Mobile telecommunications service is sourced to the place of primary use” pursuant to NCGS 105-164.4C(a2)(1). Prepaid telephone calling services are sourced in accordance with the general sourcing provisions pursuant to NCGS 105-164.4B and Section 310. The request to remove “wireline” will be made for the 2011 legislative session.

8. The sourcing for private communications does not follow the SSUTA with respect to segments that are not billed separately.

NCGS 105-164.4C(e)(4) states “[i]f all the customer’s channel termination points are not located in this State and the service is not billed on the basis of channel termination points or channel mileage, a percentage of the charge for the service is sourced to this State. The percentage is determined by dividing the number of channel termination points in this State by the total number of channel termination points.” The calculation of the percentage is consistent with Section 314C.d. The statute does not clarify that the calculation is for use for “service for segments of a channel located in more than one jurisdiction or levels of jurisdiction and which segments.” However, reading NCGS 105-164.4C(e) in its entirety, indicates gross receipts from private telecommunications service are sourced consistent with Section 314 requirements.
9. The definition of “service address” is not complete. It includes the first step but not the second (origination of the signal) or third (place of primary use).

Service address is not a defined term in the North Carolina General Statutes but was partially defined in Sales and Use Tax Technical Bulletin 21. Section 21-1J.2.s. has been adjusted to add the missing component to the definition of service address (copy included). The updated version will be posted to the Department’s website.

10. The bad debt technical bulletin allocates amounts collected that were previously reported as bad debt proportionately first to sales price and secondly to interest and other charges. It should be proportionately to sales price “and sales tax thereon.”

Section 45-4 D. of the Sales and Use Tax Technical Bulletin has been updated to incorporate “and sales tax thereon.” The updated version will be posted to the Department’s website (copy included). Additionally, we have revised SD-03-2 originally issued October 15, 2003 in include “and sales tax thereon.”

11. The effective date language in the statute for services covering periods before and after the statutory effective date contains the sentence: “For a service billed before it is provided, the first billing period starts on the first day of the month after the effective date.” The Agreement provides that the change is effective on the first billing period on or after the statutory effective date. The first billing period could be any day of the month.

NCGS 105-164.15A(a) as enacted states the following:

(a) Services. – The effective date of a tax change for a service taxable under this Article is administered as follows:
(1) For a service that is provided and billed on a monthly or other periodic basis:
   a. A new tax or a tax rate increase applies to the first billing period that starts on or after the effective date. For a service billed after it is provided, the first billing period starts on the effective date. For a service billed before it is provided, the first billing period starts on the first day of the month after the effective date.

For the September 1, 2010 rate increase, the notice issued by the Department stated the following: “[f]or a service billed before it is provided, the first billing period starting on or after October 1, 2009 is subject to the rate increase.


The Department administers the rate increase to apply to any billing period that starts on or after the first day of the month following the rate increase for those services billed before they are provided by the service provider. The Department will request that the statute be amended during the 2011 legislative session to clarify that the rate increase applies on or after the effective date of the increase to any service billed in advance on or after the effective date of the increase.

12. The technical bulletin on bundled transactions provides that transactions with “10% or more” taxable property are taxable. This should be “more than 10%.”
The Department is in agreement that the technical bulletin was incorrect. Sales and Use Tax Technical Bulletin 34-25D.2. has been updated and will be posted to the website (copy included).

13. The statute cited for providing relief from liability from errors in the taxability matrix for sellers and certified service providers (Section 328) and purchasers (Section 331) only relates to errors in information on rates, boundaries and taxing jurisdiction assignments. There is no provision for errors in the taxability matrix.

This issue was noted during last year’s compliance review. As indicated last year, NCGS 105-264 provide that a taxpayer is not liable for any penalty or additional assessment attributable to erroneous advice, either in writing or verbal, furnished by the Department when all of the following conditions are satisfied: (1) The advice was reasonably relied upon by the taxpayer, (2) The penalty or additional assessment did not result from the taxpayer’s failure to provide adequate or accurate information, and (3) The Department provided the advice in writing or the Department’s records establish that it provided erroneous verbal advice. Effective July 16, 2008; HB 2436, s. 28.16(e), S.L. 08-107.)

Thank you for an opportunity to comment regarding these issues. Please advise if there are additional items that require comments or clarifications.

Sincerely,


Eric K. Wayne, Director
Sales and Use Tax Division
m. **Place of Primary Use** – The street address representative of where the use of a customer’s telecommunications service primarily occurs. The street address must be the customer’s residential street address or primary business street address. For mobile telecommunications service, the street address must be within the licensed service area of the service provider. If the customer who contracted with the telecommunications provider for the telecommunications service is not the end user of the service, the end user is considered the customer for the purpose of determining the place of primary use. [G.S. 105-164.3(26a)]

n. **Postpaid Calling Service** – A telecommunications service that is charged on a call-by-call basis and is obtained by making payment at the time of the call either through use of a credit card or payment mechanism, such as a bank card, travel card, credit card, or debit card, or by charging the call to a telephone number that is not associated with the origination or termination of the telecommunications service. A postpaid calling service includes a service that meets all the requirements of a prepaid calling service, except the exclusive use requirement. [G.S. 105-164.4C(h)(5)]

o. **Prepaid Telephone Calling Service** – Prepaid wireline calling service or prepaid wireless calling service. [G.S. 105-164.3(27)]

p. **Prepaid Wireline Calling Service** – A right that meets all of the following requirements:

1. Authorizes the exclusive purchase of wireline telecommunications service.
2. Must be paid for in advance.
3. Enables the origination of calls by means of an access number, authorization code, or another similar means, regardless of whether the access number or authorization code is manually or electronically dialed.
4. Is sold in units or dollars whose number or dollar value declines with use and is known on a continuous basis. [G.S. 105-164.3(27a)]

q. **Prepaid Wireless Calling Service** – A right that meets all of the following requirements:

1. Authorizes the purchase of mobile telecommunications service, either exclusively or in conjunction with other services.
2. Must be paid for in advance.
3. Is sold in units or dollars whose number or dollar value declines with use and is known on a continuous basis. [G.S. 105-164.3(27b)]

r. **Private Telecommunications Service** – Telecommunications service that entitles a subscriber of the service to exclusive or priority use of a communications channel or group of channels. [G.S. 105-164.4C(h)(7)]

s. **Service Address** – The location of the telecommunications equipment to which a customer’s call is charged and from which the call originates or terminates, regardless of where the call is billed or paid. If this location is not known, service address means the origination point of the signal of the telecommunications services first identified by either the seller’s telecommunications system or in information received by the seller from its service provider, where the system used to transport such signals is not that of the seller. If this location is not known, service address means the location of the customer’s place of primary use.
applied first proportionally to the taxable price of the property or service and sales tax thereon, and secondly to interest, service charges, and any other charges.

E. Effective with the entry of North Carolina as a member state to the Streamlined Sales and Use Tax Agreement (Agreement), a Certified Service Provider (CSP) who enters into a contract with the Governing Board of the Agreement to offer services to collect and remit sales and use taxes on behalf of a seller/taxpayer may claim any bad debt deduction that would ordinarily be claimed by the seller/taxpayer. The terms of the contract between the Governing Board and a CSP will establish the procedures for credits by the CSP to a seller/taxpayer for allowable bad debt taken by the CSP.

History Note: Authority G.S. 105-164.3; 105-164.13; 105-164.22; 105-164.42C; 105-164.42I; 105-264; Issued: October 11, 2010; July 1, 2005.
DIRECTIVE

Subject:   Worthless Accounts/Bad Debts
Tax:      Sales and Use Tax
Law:      G.S. 105-164.13(15)
Issued By:  Sales and Use Tax Division
Issued Date:   October 15, 2003
Revised Date: October 11, 2010
Number:   SD-03-2

This Directive explains the deduction from gross retail sales allowable for worthless accounts upon which the sales and use tax has been previously paid that are charged off for income tax purposes. The Directive sets out the current treatment of such worthless accounts and clarifies the timing of when bad debts may be deducted from gross receipts.

Section I. The Law
G.S. 105-164.13(15) provides that:
Accounts of purchasers, representing taxable sales, on which the tax imposed by this Article has been paid, that are found to be worthless and actually charged off for income tax purposes may, at corresponding periods, be deducted from gross sales. In the case of a municipality that sells electricity, the account may be deducted if it meets all the conditions for charge-off that would apply if the municipality were subject to income tax. Any accounts deducted pursuant to this subdivision must be added to gross sales if afterwards collected.

Section II. Worthless Accounts (Bad Debts)
In reporting sales and use taxes on an accrual basis, accounts of purchasers representing taxable sales on which the tax has been paid may be determined to be worthless and will actually be charged off for income tax purposes as “bad debts.” The term “bad debts” will bear the same meaning as defined by 26 U.S.C. Sec.166, but shall exclude finance charges or interest, sales and use taxes charged on the sales or purchase price, amounts that cannot be collected on property that remains in the possession of the seller until the purchase price is paid, expenses incurred in attempting to collect a debt, and repossessed property. The amount charged off representing taxable retail sales may, during corresponding periods, be deducted from gross taxable sales provided the vendor maintains records disclosing separately the portion of bad debts representing taxable sales and the portion representing nontaxable sales. The amount of any deduction taken that is attributable to bad debts shall not include accrued interest. If a deduction is taken for a bad debt and the debt is subsequently collected in
whole or in part, the tax on the amount collected must be paid and reported on the sales and use tax return filed for the period in which the collection occurs. For purposes of reporting collection of the bad debt subsequent to having charged off and deducted such bad debt, any payments on the debt shall be applied first proportionally to the taxable price of the property or service, and secondly to interest, service charges, and any other charges. **As revised, October 11, 2010**, for purposes of reporting collection of the bad debt subsequent to having charged off and deducted such bad debt, any payments on the debt shall be applied first proportionally to the taxable price of the property or service and sales tax thereon, and secondly to interest, service charges, and any other charges.

**Section III. When Bad Debts are Deductible**
In order for a worthless account to be "charged off for income tax purposes," the account must be written off as uncollectible on the claimant's books and records. If the charge-off is not made until the income tax return is filed, the bad debt should generally be deducted within one month of the date the income tax return reflecting the bad debt is filed. If the charge-off is made during the income tax year, the deduction of the bad debt should be taken for the period in which the charge-off occurs. A taxpayer is required to make the deduction for sales and use tax purposes within three (3) years of charging off an account for income tax purposes. If a taxpayer fails to deduct a bad debt for sales and use tax purposes within three years of the date the bad debt is deducted for income tax purposes, the deduction from taxable gross receipts is not allowable.

A taxpayer who is not required to file income tax returns may deduct a bad debt on a return filed for the period in which the bad debt is charged off in its books and records as uncollectible and would otherwise be eligible for a bad debt deduction for income tax purposes if the taxpayer were required to file income tax returns. In this instance, the taxpayer is required to make the deduction for sales and use tax purposes within three (3) years of the date the account is recognized and finally expensed as a bad debt in its books and records.

**Section IV. Refund Provisions**
When the amount of the bad debt deduction exceeds the amount of taxable sales and the tax due is a credit (negative) balance on the sales and use tax return, a refund claim may be filed within the statute of limitations for filing refund claims. The claim must be filed within three years of the date the bad debt becomes eligible for deduction from gross retail sales on the sales and use tax return.

**Section V. Certified Service Providers**
If filing responsibilities are assumed by a Certified Service Provider (CSP) who files returns and remits sales and use tax on behalf of a seller/taxpayer, the CSP may claim any bad debts that would ordinarily be claimed by the seller/taxpayer in accordance with the above procedures. The CSP must issue a credit or refund for the tax paid on the bad debt to the seller/taxpayer before deducting the bad debt from gross retail sales or filing a refund claim based on a return bearing a credit (negative) balance of tax due.

Questions about this Directive may be directed to the Taxpayer Assistance Division of the North Carolina Department of Revenue, P. O. Box 1168, Raleigh, N. C. 27602 or by telephone toll free to (877) 252-3052.
b. The "retail sale" of services where one service is provided that is essential to the use or receipt of a second service and the first service is provided exclusively in connection with the second service and the true object of the transaction is the second service.

An example of this exclusion would be the preparation of a will by an attorney. The true object of the transaction is the providing of the attorney's services and the tangible personal property is essential to the use of the service. The attorney is selling nontaxable services and is not making a sale of a bundled transaction. Sales or use tax is not due on the attorney's charges for services; sales or use tax is due on the attorney's purchases of tangible personal property used to fulfill the services.

Transactions that qualify under the "true object exclusion" in D. 1. of this Bulletin are not affected by special "bundled transaction" taxability rules.

2. Ten Percent (10%) Exclusion
For a bundled transaction that consists of tangible personal property other than food and exempt medical products, a bundle that contains more than ten percent (10%) of taxable items is subject to sales and use tax on the total amount charged for the bundled products. If a bundle consists of ten percent (10%) or less of taxable items, the charge for the bundle is not subject to sale or use tax and sales or use tax is not due on the purchase price of the taxable items included in the bundle.

3. Fifty Percent (50%) Exclusion
a. **Food** – For a bundled transaction that only includes tangible personal property and consists of more than fifty percent (50%) of food items that are exempt from State sales and use tax, the total charge for the bundle is subject to the 2% local tax on food.

b. **Medical products** – For a bundled transaction that only includes tangible personal property and consists of prescription drugs, prosthetic devices, mobility enhancing equipment sold on prescription, durable medical equipment sold on prescription, or durable medical supplies sold on prescription, the total charge for the bundle is exempt if the portion of the bundle attributable to exempt medical products exceeds fifty percent (50%).

Sales or use tax is not due on the purchase price of items included in the bundle that would otherwise be taxable when sold at retail.

4. **Determination of Threshold**
In determining the percentages of products included in a bundle, a retailer may use either the cost price of products included in the bundle or the sales price of the products when sold separately. A retailer cannot use a combination of the cost price and sales price of products to make this determination.

E. **Specific Transactions and Examples**

For a bundled transaction that includes services, a retailer is authorized to allocate a price to each product included in a bundle and collect tax on the price allocated to the taxable products. A retailer's business records kept in the ordinary course of business must be maintained to support the allocation made.

An example is a firm that provides taxable telecommunications services, taxable video programming services, and exempt Internet access services and offers all the services in a