



# State of North Carolina Office of the State Controller

Michael F. Easley, Governor

Robert L. Powell, State Controller

November 22, 2004

## MEMORANDUM NO. 05-15

**TO:** Chief Fiscal Officers  
Vice Chancellors for Finance

**FROM:** Robert L. Powell  
State Controller

**SUBJECT:** Year End Tax Update

As part of the State Controller's responsibility for statewide tax compliance, this document contains payroll and tax information that your agency or institution will need as you close out the 2004 tax year and begin the 2005 tax year. Please forward this important memorandum to members of your staff that may be impacted by the following changes.

### I. STATE AGENCY EXEMPTION FROM SALES AND USE TAX

The General Assembly 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, effective July 1, 2004. 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.

We are still reviewing unusual circumstances related to this new exemption. The law change did not address all situations and, because of the timing of a particular transaction, it may sometimes be difficult to determine which law to apply to a purchase. Leases and maintenance agreements in particular have been difficult. Please call the Office of the State Controller or Department of Revenue if you need assistance.

### II. SOCIAL SECURITY ADMINISTRATION CHANGES TO SOCIAL SECURITY CARDS

Newly issued Social Security Card wording that indicate a card is valid for employment purposes now reads "Valid for work only with DHS authorization" (DHS – Department of Homeland Security). Also, the "Void" shadow that appeared when a card was photocopied has been replaced with the line, "Do not carry your card with you". These changes are to help prevent identity theft.

### III. SUPPLEMENTAL MILITARY PAY (DIFFERENTIAL PAY)

Supplemental pay (differential pay) from an employer to an employee in active service with the US Armed Forces or on indefinite assignment (more than 30 days) with the state National Guard is not a wage.

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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/](http://www.osc.state.nc.us/OSC/)

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Therefore, it is not subject to federal income tax withholding, social security, Medicare or unemployment taxes. According to the IRS, even though the employment relationship still exists, "the employment tax relationship is broken".

However, if the supplemental pay is provided while the employee is on temporary assignment (up to 30 days) with the state National Guard or Armed Forces Reserve, the pay is considered a wage subject to normal taxation and W-2 reporting.

Supplemental military pay (differential pay) is compensation paid to employees to make up the difference between what the employee is receiving from the military and what the employee would be receiving on his/her regular job with the State.

(Central Payroll will continue to process differential pay through the payroll system; however, it should be exempted from FICA. Please contact Central Payroll if you are making payments under the State's Differential Pay Plan.)

#### **IV. EXCLUDING EMPLOYMENT RELATED TERMINATION PAYMENTS FROM INCOME**

The State continues to have problems taxing employment related termination payments. These payments are made in settlement of potential tort claims arising from an employment type relationship between the employee, or potential employee, and the State.

The issue in making employment settlement payments is whether the amounts are for personal physical injuries, and thus non-taxable compensation, or damages for non-physical injuries that are not excludible from gross income.

IRC 104(a)(2) provides income exclusion for damages an individual receives on account of personal injuries and sickness. Since August 20, 1996, this income exclusion applies only to personal physical injuries and sickness. Damages for nonphysical injury or sickness (such as age discrimination, disability discrimination, injury to reputation) are no longer excludible from gross income. Further, damages for emotional distress (including the physical symptoms of emotional distress) cannot be excluded from income under IRC 104(a)(2), except to the extent of payments for medical care attributable to emotional distress.

The courts have set forth four discrete elements that a taxpayer needs to show in order to exclude a settlement or portion of a settlement from income: (1) there was an underlying claim in tort; (2) the claim existed at the time of the settlement; (3) the claim encompassed personal injuries; and (4) the agreement was executed "in lieu" of the prosecution of the tort claim and "on account of" the personal injury rendering it a settlement rather than a severance agreement.

Attorney fees can be excluded from wages providing they are separately provided for in the agreement and paid directly to the attorney. Otherwise, attorney fees included in a back pay settlement are treated as part of the back pay amount.

Payments for employment related termination should not be made without careful consideration of the tax implications. We have repeatedly found instances where employment settlements stated that taxes would not be withheld and 1099 forms would be sent. Regardless of how the settlement agreement is worded, the Internal Revenue Code will be the controlling authority in this matter. In most instances, the payments must be made through the payroll system with employment taxes withheld. Punitive damages are generally reported on Form 1099 MISC, block 3.

Please make your legal staff aware of the tax implications any time employment termination payments are made.

#### **V. VARIOUS TAX RATE CHANGES**

**Backup Withholding Tax Rate Changes.** The backup withholding tax rate on payments to independent contractors who have not provided a taxpayer identification number (IRC 3406(a)(1)) is 28%. This rate remains unchanged in 2005.

**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%. For supplemental wage payments over \$1,000,000 the rate goes to 35%, effective for payments made after December 31, 2004.

**Social Security Wage Base for 2005.** For 2005 the social security wage base is increased to \$90,000. The maximum amount of social security tax will be \$5,580.00. The 6.2% social security and 1.45% Medicare rates remain the same.

**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. The standard business mileage rate for 2005 has not been set by the IRS as of this date.

## VI. 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 2003. 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/sigdocs/sig\\_docs/1099\\_withholding.html](http://www.osc.state.nc.us/sigdocs/sig_docs/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.

## 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 2004, undergraduate and graduate expenses for education continue to 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. *Refer to Moving Expense topic on OSC web site for discussion of qualified v. non-qualified moving expenses.*

2004 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 14 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, 2004, 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 be done at the time payment is 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 2004 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 2004. 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 2004 REPORTING YEAR**

OSC-Financial Systems Division will issue detailed instructions on the schedule for 2004 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 allows mismatched records to 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.

In conclusion, I appreciate your attention to these important tax and payroll matters. Please make certain that the appropriate parties within your agency/institution are made aware of the importance of this memorandum. All questions regarding these payroll and tax changes can be directed to Randy Thomas at (919) 981-5488.