

# PROPERTY TAX IN NORTH CAROLINA

## The Discovery of Unlisted and Underlisted Property

### Introduction

Almost nothing causes more consternation in the property tax process than the receipt by a taxpayer of a “notice of discovery” issued by a county assessor. The increasing use by counties of contract auditors – some of whom work on a contingency fee driven by the size of the discovery – has not lessened taxpayer anxiety over the receipt of a notice asserting that it has failed to list, or that it underlisted, its assets for property tax assessment.

Although the author’s perspective is that of counsel for taxpayers, presumably the discovery by an assessor that a taxpayer has apparently failed to adequately list its assets does not do much to engender trust or goodwill on his part.

Not infrequently, word of the discovery finds its way into the press, the local elected officials scent a new source of revenue, and the process goes downhill from there.

#### **A. What is a “Discovery Assessment”?**

The phrase “discovered property” includes all of the following:

- a. Property that was not listed during a listing period.
- b. Property that was listed but the listing included a substantial understatement.
- c. Property that has been granted an exemption or exclusion and does not qualify for the exemption or exclusion.<sup>1</sup>

The phrase “to discover property” means to determine any of the following:

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<sup>1</sup> N.C. Gen. Stat. § 105-273(6a).

- a. Property has not been listed during a listing period.
- b. A taxpayer made a substantial understatement of listed property.
- c. Property was granted an exemption or exclusion and the property does not qualify for an exemption or exclusion.<sup>2</sup>

There is no North Carolina case law quantifying the term “substantial understatement”. The term is defined in N.C. Gen. Stat. §105-273(13b) as the “omission of a material portion of the value, quantity or other measurement of taxable property.” The determination of materiality is left to the assessor, subject to review by the local board and thereafter by the Property Tax Commission.

**B. “Discovery” Assessments and Appeal Procedure**

If the county tax assessor determines that a taxpayer has not properly listed all real or personal property required to be listed, the assessor may make a discovery assessment of the unreported or underreported property and charge penalties at the rate of 10% per year for the failure to report the property.<sup>3</sup> The assessor may make a discovery for the current year and the prior five (5) years.<sup>4</sup> Thus, the penalty for the earliest year of the discovery may be as much as 60% of the tax for the year. Interest begins to run from January 6 of the year after the year the discovery is made.<sup>5</sup>

Once the county tax assessor makes a discovery assessment, the assessor’s listing and appraisal of the discovered property will become final unless the taxpayer files with

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<sup>2</sup> N.C. Gen. Stat. § 105-273(6b).

<sup>3</sup> N.C. Gen. Stat. § 105-312. A copy of the statute which governs discovery procedures is attached as Attachment A.

<sup>4</sup> N.C. Gen. Stat. § 105-312(f) and (g).

<sup>5</sup> N.C. Gen. Stat. § 105-312(j).

the assessor a written exception to the discovery within thirty (30) days from date of the notice of discovery.<sup>6</sup> Upon receipt of a timely written exception, the assessor will arrange a conference with the taxpayer to allow the taxpayer an opportunity to present evidence and argument regarding the discovery.<sup>7</sup> The conference, by agreement, may take place over a period of time. Within fifteen (15) days of the conclusion of the conference, the assessor must give written notice of his final decision to the taxpayer.<sup>8</sup> The taxpayer then has fifteen (15) days from the date of the notice to appeal to the county board of equalization and review.<sup>9</sup> The request for review may be made at the conference with the assessor or in writing to the assessor.<sup>10</sup> Good practice dictates that the request for review be made in writing. Appeal of a decision by the board of equalization and review may be made to the North Carolina Property Tax Commission within thirty (30) days from the date the board mails notice of its decision to the taxpayer.<sup>11</sup>

In making his discovery, the assessor is charged by the statute with making “a tentative appraisal of the discovered property in accordance with the best information available to him.”<sup>12</sup> The assessor making the discovery assessment has the benefit of two presumptions:

- a) that the discovered property should have been listed by the same taxpayer for the preceding five (5) years with the burden of proof on the taxpayer to

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<sup>6</sup> N.C. Gen. Stat. § 105-312(d).

<sup>7</sup> Id.

<sup>8</sup> Id.

<sup>9</sup> Id; N.C. Gen. Stat. § 105-322(g)(5)a.

<sup>10</sup> N.C. Gen. Stat. § 105-312(d).

<sup>11</sup> N.C. Gen. Stat. § 105-290(b) and (e).

<sup>12</sup> N.C. Gen. Stat. § 105-312(c).

prove to the contrary by showing it was not in existence, was actually listed or that it was not his duty to list it;<sup>13</sup> and

- b) that the assessment is correct.<sup>14</sup>

These presumptions give the assessor substantial leverage.

### C. The Use of Contract Auditors

In recent years, many counties have used the services of contract auditors, some of whom work on a contingent fee basis. This procedure, while objectionable to taxpayers confronted by an auditor who will be paid based upon his success in defending his discovery assessment recommendations to the assessor, has been approved by the North Carolina Supreme Court.<sup>15</sup>

Contract auditors are generally former assessors who have entered private practice and who market their expertise to counties. Since the auditing of personal property can be complex, and since counties are frequently shorthanded or do not have the resources to devote to this effort, it has been perfectly natural for counties to resort to outside help, just as they frequently do during the revaluation process.<sup>16</sup>

Taxpayer concerns over the use of contractors are largely driven by the nature of the compensation arrangements. They fear that the auditor will be aggressive in his discovery techniques, will resolve every doubt or judgment call against the taxpayer, and

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<sup>13</sup> N.C. Gen. Stat. § 105-312(f).

<sup>14</sup> There is no separate statutory presumption of correctness afforded to discovery assessments, but the general presumption of correctness given to assessments is also given to discovery assessments. See In Re Appeal of AMP, Inc., 287 N.C. 547, 215 S.E. 2d 542 (1975)

<sup>15</sup> In Re Appeal of Philip Morris U.S.A., 335 N.C. 227, 436 S.E.2d 828 (1993), reh'g denied, 335 N.C. 566, 441 S.E.2d 118, cert. denied, 512 U.S. 1228, 114 S.Ct. 2726 (1994).

will resist attempts to negotiate a resolution of the discovery which will reduce the fee paid to them.

Assessors take the position that the auditors are merely gathering data and making recommendations but that the assessors make the final judgment as to the assessment to be made. No doubt this is largely true, but based on the author's experience, taxpayer fears are sometimes justified.

**D. Compromise/Settlement of Discovery Assessments**

While the assessor has authority to determine the value of discovered property, he does not have authority to waive the assessment of penalties.

The county board of commissioners is authorized to compromise, settle, or adjust the county's claim for taxes arising from a discovery assessment, including the penalties associated therewith.<sup>17</sup> This power may be delegated by the board of commissioners to the board of equalization and review or to any special board established by local act.

This power to compromise discovery assessments constitutes an exception to the general rule that tax assessments may not be compromised without significant peril in the way of personal liability to the county commissioners.<sup>18</sup> However, to qualify for the compromise provisions, the taxpayer will generally have to forego its appeal remedies to the Property Tax Commission, allow the assessment to become final and hope that it will be able to negotiate a compromise of the penalties and/or tax with the county commission.

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<sup>16</sup> N.C. Gen. Stat. § 105-299 authorizes counties to retain "persons or firms having expertise in one or more of the duties of the assessor to assist him. . ."

<sup>17</sup> N.C. Gen. Stat. § 105-312(k).

(Theoretically, this relief might also be available after trial before the Property Tax Commission, but experience indicates that county commissioners will be loath to compromise after incurring the expense of a trial to vindicate the county's assessment.)

**E. The Source of Discovery Assessments**

*1) Discovery Techniques*

The assessor will probably begin his internal audit or desk review by comparing the current business personal property listing with the prior year's listing. Unexplained changes from year to year may determine whether a more in-depth audit is called for and are frequently the beginning point for a discovery assessment.

Reconciliation of the business personal property listing form to the fixed asset report for the location under audit is generally the next step. The auditor will generally also attempt to tie the fixed asset report to the company's general ledger to ensure there are no discrepancies there. The auditor will therefore usually ask for the fixed asset report as of January 1 of each year under audit, the general ledger and the corporate policy on expensing of acquisitions.

*2) Personalty Subject to Discovery Dispute*

When the taxpayer books do not match the business personal property listing form, the following are often some of the reasons for the mismatch and the source of discovery.

- Ghost assets – Assets retired and removed from the premises but not removed from the books

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<sup>18</sup> N.C. Gen. Stat. § 105-380.

- Idle assets – Assets not in use but still on site and still on the books
- Fully depreciated assets – Assets depreciated to \$0 on the books but still on the premises
- Transferred assets – Into or from the reporting location
- Situs
- Expensed assets – Assets purchased but expensed and not on the books
- Leased assets – Assets technically owned by a third party but leased for financing purposes to the taxpayer
- Construction in process (CIP) – Assets under construction/installation, not yet placed in service and therefore not separately capitalized and listed on the fixed asset report
- Capitalized interest – Interest capitalized under accounting standards which may – or may not – reflect financing costs on self-constructed assets
- Supplies/Spare Parts/Samples Inventories
- Leasehold Improvements – To whom do they belong? Who should list them? Are they even “leasehold” improvements? Are they real or personal?
- Classification disputes – Is it a computer or is it machinery and equipment?
- Real/personal issues – Is it real or is it personalty?
- Capitalized computer software purchased from third parties
- Leasehold interests in exempt property
- Assets entitled to exemption for which the exemption has not yet been obtained
- Inclusion of personal property in real estate assessed under the income approach

**F. Immaterial Irregularities**

The discovery statutes are clear that only unlisted property, property which has been substantially understated during the listing process, or property inadvertently granted an exemption or exclusion from assessment is properly discoverable. Thus, it would appear on the face of the statutes, that property that has been properly listed by the taxpayer “may not thereafter be discovered” for the year of listing by the assessor if the assessor failed to assign it a value during the assessment process or assigned it a value which he thereafter concluded was inadequate.

However, N.C. Gen. Stat. §105-394 (see Attachment B) allows the assessor to correct “immaterial irregularities.” Two cases illustrate the possible scope of N.C. Gen. Stat. §105-394.

The Court of Appeals in In re Nuzum-Cross Chevrolet, 59 N.C. App 332, 296 S.E. 2nd 499 (1982), disc. rev. denied, 307 N.C. 576, 299 S.E. 2nd 645 (1983) ruled that a clerical error was an immaterial irregularity and as such the assessor could correct a tax bill and bill a taxpayer for a higher value than it had originally been assessed. In that case, the taxpayer timely listed its business personal property, attaching to the abstract a typewritten sheet of paper with the required figures. Due to an error by the assessor’s office in transposing figures from the attached sheet to a summary sheet, the taxpayer was taxed on a lower value than it should have been. When the tax supervisor discovered the error, he sent the taxpayer a bill for the unpaid taxes and thereafter issued a notice of attachment and

garnishment. After a hearing challenging the garnishment, the trial judge issued an order directing the garnishee to remit the total due minus any penalty and interest. In affirming the decision of the trial judge, the Court of Appeals held that “a clerical error by a tax supervisor’s office is an immaterial irregularity” under N.C. Gen. Stat. §105-394(11) which would not invalidate the tax levied on the property.

In Nuzum-Cross, the assessor could not have made a discovery assessment since the property had been properly listed. However, he was able to increase the assessment two years after the clerical error due to the provisions of N.C. Gen. Stat. §105-394.

In In re Appeal of Dickey, 110 N.C. App. 823, 431 S.E. 2nd 203 (1993), the taxpayers properly listed a newly constructed house, but the tax office apparently lost the section of the listing form that listed the new construction and while assessing the lot, failed to assess the house. The next year the assessor notified the taxpayers that their property had been “taxed improperly” for the prior year and pursuant to N.C. Gen. Stat. §105-312 increased the assessment for the prior year. On appeal to the Property Tax Commission, the Commission found that the taxpayer had properly listed the house and that the house could not be considered discovered property. On appeal the Court of Appeals agreed that the house could not be discovered because the evidence in the record supported the Commission’s finding that the taxpayers had listed their property and that N.C. Gen. Stat. §105-312 would therefore not apply.

However, on appeal the County also argued that the assessor’s failure to levy any tax on the house in 1989 was an “immaterial irregularity” which did not invalidate the tax

owed on the house in 1989 and imposed by the assessor in 1990. Noting the language of N.C. Gen. Stat. §105-394(3) that the “failure to list, appraise, or assess any property for taxation . . .” was an immaterial irregularity, the Court held that the failure by the assessor, due to an administrative error to include on the taxpayer’s 1989 tax bill an assessment for the improvements to the lot, was an immaterial irregularity and did not invalidate the tax owed on the house.

The Court also noted that N.C. Gen. Stat. § 105-394 imposes no time limit within which the assessor may correct an immaterial irregularity, stating that the imposition of a time limit was a question for the legislature. (However, see the 10 year statute of limitations in N.C. Gen. Stat. § 105-378.) The above two cases make it clear that for both personal property (Nuzum-Cross) and real property (Dickey) if the assessor makes a clerical error or completely fails to assess property, he may invoke N.C. Gen. Stat. §105-394 and correct his assessment without using the discovery process.

However, what if the property is listed but the assessor makes a mistake in his valuation? The two provisions which might be pertinent appear to be N.C. Gen. Stat. §105-394(3) “the failure to list, appraise, or assess any property for taxation . . .” and N.C. Gen. Stat. §105-394(11) “any other immaterial informality, omission, or defect on the part of any person in any proceeding or requirement of this Subchapter.”

The Department of Revenue takes the position that N.C. Gen. Stat. §105-394 acts as a “backstop” to N.C. Gen. Stat. §105-287 and N.C. Gen. Stat. §105-312 and that an assessor can broadly invoke the provisions of N.C. Gen. Stat. §105-394 to correct errors

made by the assessor, including appraisal errors. It appears to this writer that the statutes have to be read together, that N.C. Gen. Stat. §105-312 is the remedy for discoveries, N.C. Gen. Stat. §105-287 is the post revaluation year remedy for some errors, but only appraisal errors resulting from “a misapplication of the schedules, standards and rules,” that N.C. Gen. Stat. §105-394(3) applies only when the assessor has not made any appraisal of the property and that N.C. Gen. Stat. §105-394(11) applies to assessors’ omissions and not appraisal errors.