

North Carolina Income / Franchise Tax 101



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North Carolina Overview

- Net Income Tax
- Franchise Tax
- Apportionment
- Penalty Provisions
- Good compliance waiver
- Contingent Event

North Carolina

Net Income Tax (Article 4)

- Federal Taxable Income starting point (§105-130.5)
- Addbacks (a)
 - (1) State Income Tax**
 - (2) Interest expense incurred related to tax-exempt interest income
 - (3) Contributions (pursuant to federal limitations)**
 - (4) Municipal Bond Interest of other states**
 - (5) Capital Loss Carryover**
 - (6) Net Operating Loss Carryforward**
 - (9) Intercompany Payments in Excess of Fair Compensation**
 - (10) Income tax credits – after apportionment or reduce credit**
 - (11) Depletion allowance to the extent it exceeds cost depletion
 - (12) Depreciation of certain utilities

North Carolina

Net Income Tax (Article 4)

- Addbacks (a) (cont'd)

(14) Royalty Payments (§105-130.7A)

(16) Subchapter R exclusion related to International Shipping

(19) Captive REIT Dividends Paid Deduction

(22) IRC §163(e)(5)(F) Original issue discount

(24) Bonus Depreciation (§105-130.5B)

(25) Net Interest Expense to a Related member (§105-130.7B)

(26) IRC §1400Z-2(a) Gain Deferral

(27) IRC §1400Z-2(c) Gain Exclusion

(28) IRC §250 Deduction (FDII)

(29) IRC §965(c) Deduction

(30) Infrastructure payments made to affiliate

(31) IRC 163(j) adjustment to decouple from section 2306 of the CARES Act (2019 and 2020 only)

(32) Expenses related to forgiveness of covered loan under the CARES Act

North Carolina

Net Income Tax (Article 4) (§105-130.5)

- Major Deductions (b)
 - (1) **U.S. Government Interest**
 - (1a) **North Carolina municipal bond interest**
 - (2) **Intercompany Payments subject to addback by payor**
 - (3a) **Foreign Dividends, net of related expenses**
 - (3b) **§78 Dividends (gross-up), §§ 951, 951A and 965, net of related expenses**
 - (4) **State Net Economic Loss (§105-130.8A(e))**
 - (4a) **State Net Operating Loss (§105-130.8A)**
 - (5) **Contributions under N.C. Limitations (§105-130.9)**

North Carolina

Net Income Tax (Article 4) (§105-130.5)

- Deductions (b) (cont'd)
 - (8) Total Capital Loss taken in year realized without limitation.**
 - (9) Certain RIC undistributed capital gains
 - (11) Expenses disallowed because of federal income tax credits**
 - (11a) Expenses disallowed because of ERC Payroll Credit (S.L. 2022-6 retroactive to 2020)**
 - (12) Reforestation & Cultivation Expense of commercially grown trees
 - (14) Federal basis deduction of certain assets related to tax credits
 - (16) Natural gas surcharges
 - (17) 911 Charges included in Federal taxable income
 - (20) Royalty Payments subject to addback by payor (§105-130.7A)**
 - (23) Captive REIT Dividend Received

North Carolina

Net Income Tax (Article 4) (§105-130.5)

- Deductions (b) (cont'd)
 - (27) Bonus Depreciation (§105-130.5B)**
 - (28) Interest expense subject to addback by payor (§105-130.7B)**
 - (29) Payments from State Emergency Response & Disaster Fund
 - (30) IRC §1400Z-2(a) Gain Deferral included previously
 - (31) Economic Incentives Received (§§ 143B-437.012 or Part 2G or Part 2 H of Article 10 of Chapter 143B)
 - (31a) Business Recovery Grant Program
 - (32) 20% of Addback required under (a)(31) not otherwise disallowed by §105-130.7B

North Carolina

Net Income Tax

- Other Adjustments(c)
- (1) Bond Premium Amortization
- (2) Adjustments to account for federal/state basis differences
- **(3) Adjustment of expenses related to nontaxable income.**
Dividends limited to 15% of the dividends.
- (4) Adjustments related to IRC §111 (tax benefit rule)

Other Adjustments (e)

- Any recapture of depreciation required under the IRC must be included in State net income to the extent required for federal income tax purposes.

North Carolina

Net Income Tax - (§105-130.5A)

Secretary's Authority to Adjust Net Income or Require Combined Return

(a) Authority to review intercompany transactions

- Transactions must:

- Have economic substance
- Fair market value based on IRC §482

(b) Authority to addback, eliminate or otherwise adjust and Authority to force full unitary combination

(c) Authority to come to agreement with taxpayer who desires to voluntarily redetermine income

S.L. 2021-180 created §105-241(a)(5) – Department can ask for any financial or tax information and if such information is not timely provided, the Department can take appropriate action including forcing combination.

North Carolina

Net Income Tax

Royalty Income Reporting Option (§105-130.7A)

Facts: Intangible Holding Company (IHC) receives royalties from related North Carolina taxpayer (Opco)

Option 1: IHC files in North Carolina and reports royalty income. IHC also subject to franchise tax. Apportionment based on royalties received. Opco receives deduction for royalty payments made.

Option 2: IHC files in North Carolina but does NOT report royalty income. IHC still subject to franchise tax and would compute the apportionment factor the same way as Option 1. Opco adds back royalty payment deduction.

Observation: Option 1 may be better overall result if Opco has higher NC apportionment factor.

North Carolina

Net Income Tax - Net Interest Expense Addback (§105-130.7B)

Net Interest Expense = Intercompany interest expense – intercompany interest income.

Exceptions to addback if recipient:

- (1) subject to North Carolina income tax,
- (2) subject to income tax or gross receipts tax in another separate company state
- (3) organized in foreign country which has comprehensive tax treaty with United States and that country taxes the intercompany interest income at a rate equal to or greater than North Carolina's income tax rate.
- (4) Related member is a bank
- (5) Interest has already been disallowed by IRC 163(j) (S.L. 2021-180)

Proportionate share – to the extent that a portion of the intercompany interest expense can be shown to leave the group even if through a related intermediary, it does not have to be added back.

North Carolina

Net Operating Losses (§105-130.8 and 130.8A)

- Historical Perspective
- Net Economic Losses – Pre 2015
- Net Operating Losses – Post 2014
- Mergers and Acquisitions occurring before 2015 are subject to the old restrictive rules only for years pre 2015. For years after 2014, those losses are subject to less restrictive requirements of IRC 381 and 382.

North Carolina

Net Income Tax - Rate

S.L. 2021-180 Income Tax Rate Phase Out

The Bill eliminates the current 2.5% Corporate Income Tax by a phased lowering of the rate beginning in 2025. The new rates are as follows:

2021: 2.5%

2016: 2%

2022: 2.5%

2027: 2%

2023: 2.5%

2028: 1%

2024: 2.5%

2029: 1%

2025: 2.25%

2030: 0%

North Carolina

Franchise Tax (Article 3)

- Tax Period (§105-114)
- Taxpayers (§105-114)
- Any entity taxed as a corporation for federal income tax purposes:
 - Corporations
 - LLC's
 - Partnerships
 - S Corporations
 - Qualified Subchapter S Subs (TAM 97-13)

North Carolina

Franchise Tax (Article 3)

- Tax Base (§105-122); Greater of
 1. Apportioned net worth
 - a. Assets less liabilities
 - b. Adjust: Accumulated Depreciation, Amortization, Depletion – Tax v Book
 - c. Less: Subsidiary retained earnings exclusion – NCAC 5B.1104
 - d. Plus: Affiliated Indebtedness Addback unless the indebtedness produces qualified interest expense as defined in §105-130.7B(b)(4) (**S.L. 2022-13** modification effective on 2022 Return)
 - e. Apportionment factor same as income tax

S.L. 2021-180 Eliminated Investment in Tangible Property base and Assessed Value base beginning 2023 Franchise tax reported on 2022 Corporate Income Tax Return

S.L. 2022-13 “The net worth of a foreign entity filing a federal income tax return is based on the value of assets deemed to be in the United States.”

North Carolina

Franchise Tax (Article 3)

- LLC Treatment (§105-114.1)
 - Disregarded LLC's or those treated as partnerships
 - Flow-Up Provision
 - No Double Counting

North Carolina

Franchise Tax (Article 3)

- Holding Company Limitation (§105-120.2)
 - Limitation - \$150,000 but only related to apportioned net worth
 - Definition
 - ❖ >80% of ordinary gross income from >50% owned subs, or
 - ❖ Only asset on the books is investment in sub, or
 - ❖ it meets the definition of a corporation for which 80% of its assets are copyrights, patents or trademarks and 80% of its gross income is from royalties and license fees and which is owned 100% owned by certain manufacturers (applicable starting with 2019 Corporate Tax Return):
 - NAICS Codes 31 through 33
 - Generates Revenues > \$5 Billion from goods it manufactures, and
 - Includes in its net worth an investment in a subsidiary that owns copyrights, patents or trademarks

North Carolina

Franchise Tax (Article 3)

- Short Period Returns (§105-122(e))
 - Credit for overlap period from previous return
 - Example:
 - 2020 NC Return filed with \$100 of Franchise tax (related to 2021)
 - Short period of 1/1/21 – 4/30/21 created because of ownership change
 - When return filed for that first short period, \$200 of Franchise tax is computed before credit
 - Credit of $8/12 \times \$100 = \67 is allowed against the \$200.

North Carolina

Apportionment

- Single Factor Sales (§105-130.4)
- Sales Excluded (§105-130.4(a)(7))
 - Casual Sales
 - Dividends to the extent not within taxable income
 - Allocated Income
 - Exempt Receipts (e.g. U.S. Government Interest, N.C Municipal Bond Interest)
 - Return of principal on investments

North Carolina

Apportionment

- Sourcing
 - Tangible Personal Property – ultimate destination
 - Services – Market Sourcing
 - Election to continue to use income-producing-activity if carryforward loss
 - Intangible Income
 - Wholesale Content Distributor (§105-130.4A)
 - Business Customer – Commercial Domicile
 - Individual Customer – Billing Address
 - Banks (§105-130.4B)

North Carolina

Late Payment Penalties (§105-236(a)(4))

- 2% per month to a total of 10% effective 7/1/22
- Previously, it was a flat 10%

Last Filing Penalties (§105-236(a)(3))

- 5% against total liability per month that return is late up to max of 25%

North Carolina

Good Compliance Waiver

- Abatement of penalty can be granted 1 time every 3 years per type of tax
- Income and Franchise considered 1 type
- Good compliance is defined by having paid in all the tax you are deemed to owe plus interest.
- Assessment & Interest can be paid with request to abate penalty
- Form 5500 should be used
- Caution: Not generally applicable to “Collection Fee”

North Carolina

Contingent Events (§105-241.6(b)(5))

- Litigation, State Audit or Other Event prevents accurate refund claim to be filed.
- Provide notice to the Department prior to expiration of normal statute of limitations. Notice should identify:
 - the contingent event
 - the type of tax
 - the return impacted
 - the basis of the refund
 - the estimated amount of the refund
- Period to file refund claim will be extended to 6 months from the time the contingent event has been resolved.

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Questions?

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