

1997

NORTH CAROLINA

CORPORATION FRANCHISE AND INCOME TAX INSTRUCTIONS

Important 1997 Changes

- Reference to the Internal Revenue Code Updated.**
G.S. 105-228.90 (b)(1a) was amended to update the reference to the Internal Revenue Code from March 20, 1996 to January 1997, including any provisions enacted as of that date which become effective on or after that date. (Effective May 16, 1997)
- Filing Extension Granted Without Payment of 100% of Tax Due.**
G.S. 105-263, G.S. 105-129 and G.S. 105-130.17(d) were rewritten to grant a filing extension even if the request is not accompanied by a payment of the taxes due. The extension of time for filing a franchise tax return, or an income tax return does not extend the time for paying the tax due. The penalty for failure to pay the tax will be applied to payments received after the original due date. In addition, interest is accrued from the original due date to the date the tax is paid. (Effective January 1, 1998)
- Corporate Annual Report to be filed with the Department of Revenue.**
G.S. 55-16-22 was rewritten to provide that each corporation authorized to transact business in this State shall file a corporate annual report with the Department of Revenue and remit a twenty dollar (\$20.00) fee by the due date of the corporation's income and franchise tax return. The following are not required to file an annual report with the Department of Revenue: 1) Insurance Companies, 2) Limited Liability Companies and 3) Non-profit Corporations. (Effective January 1, 1998, and applies to tax years ending on or after December 31, 1997)
- Withholding from Certain Payments to Foreign Corporations Required.**
Article 4A of Chapter 105 of the General Statutes was amended to require withholding from certain payments to nonresidents in order to prevent nonresidents from avoiding North Carolina income tax. (Effective January 1, 1998)
- Tax Credits for New and Expanding Business Amended.**
Several changes were made to the New and Expanding Business Tax Credits as enacted in the 1996 Second Extra Session of the North Carolina General Assembly. Taxpayers claiming the Business Property Tax Credit are required to enter the total cost of business property placed in service during the current taxable year provided on page 1 of the Income and Franchise tax return. For a detailed description of all revisions made to both Article 3A and 3B of G.S. 105 along with computational worksheets, see the North Carolina Tax Credit Summary Form For Credits Under the William S. Lee Quality Jobs and Business Expansion Act.
- Deductible Dividends**
All corporations are allowed to deduct dividends received from corporations in which at the close of the year it owns more than 50% of the outstanding voting stock. Attribution of expenses is not required. (See CTAM 97-14 dtd 9-15-97)

FORM REQUIRED

Form CD-401S is used for North Carolina S corporations.

WHO MUST FILE

Every corporation doing business in this State which has filed or will file as an S corporation with the Internal Revenue Service under an approved federal election must file this form and report its activities as an S corporation for North Carolina income tax purposes.

TIME AND PLACE FOR FILING

The due date for returns filed by an S corporation is the 15th day of the third month following the close of the income year. Returns should be filed with the North Carolina Department of Revenue, P. O. Box 25000, Raleigh, North Carolina 27640-0500 or at one of the Department's local offices.

PAYMENT OF TAXES

The S corporation liability for franchise tax is payable to the North Carolina Department of Revenue at the time the return is due to be filed. Any income tax payment made on behalf of shareholders included in a composite return is also due and payable at the time the return is due to be filed.

EXTENSION OF FILING DATE

An extension of time to file the franchise and income tax return may be granted for seven (7) months provided the extension application is received timely.

NOTE: A properly filed federal extension does not constitute a North Carolina extension. Without a valid extension, a return filed after the statutory due date will be delinquent and subject to all applicable penalties provided by law.

PENALTIES

A franchise and income tax return filed after the statutory due date or after the approved extended due date will incur a penalty for failure to file of five percent (5%) for each month or fraction of a month delinquent, with a minimum penalty of \$5.00 and a maximum penalty of twenty-five percent (25%) of the tax.

Additionally, a penalty of ten percent (10%) will be assessed for failure to timely pay any tax shown due with a return and on other remittances not timely made within thirty days.

A corporation may be subject to other additional penalties as prescribed by G. S. 105-236 of the North Carolina Revenue Laws when it is established that failure to comply with such laws is the result of negligence, fraud, etc.

INTEREST

Interest at the rate established by G. S. 105-241.1 of the North Carolina Revenue Laws is due and payable with all payments of tax not remitted by the due date established by statute. The rate is established semiannually by the Secretary.

ELECTION TO BE S CORPORATION

There is no separate election to be made for a corporation which is or wishes to be an S corporation for North Carolina income tax purposes.

There is no provision to elect a different filing status for state purposes, each S corporation must file as an S corporation for state income tax purposes.

TERMINATION OF ELECTION

The S corporation election will terminate for North Carolina purposes at the same time and for the same taxable period(s) such termination is effective for federal filing purposes.

FRANCHISE TAX

Enactment of the S Corporation Law for income tax purposes will not affect the franchise tax liability of corporations doing business and/or incorporated or domesticated in this State. Refer to Form CD- 415, Corporation Franchise and Income Tax Instructions for specific information.

NONRESIDENT SHAREHOLDERS - COMPOSITE RETURN

If the S corporation has shareholders who are nonresidents of North Carolina, it may file on their behalf a composite return reflecting the state taxable income of each nonresident and the amount of tax due. A remittance for the total tax due on behalf of nonresident shareholders must be made with the return when filed. A nonresident shareholder is not required to file a North Carolina Individual income tax return if the only income in North Carolina is reported by the S corporation.

NONRESIDENT SHAREHOLDERS AGREEMENT

S corporations with nonresident shareholders are required to submit with the first North Carolina S corporation return an agreement from each such shareholder. In the agreement, Schedule N, CD- 401S, the nonresident agrees to be subject to the individual income tax laws of this state and to be liable for the tax on the pro rata share of S corporation income attributable to such individual in this state. A separate agreement is required for each nonresident including a separate agreement for each owner if the stock is jointly owned.

NOTE Effective for taxable years beginning on or after January 1, 1991, an S corporation that fails to timely file the shareholder agreement(s) of nonresident shareholders, will become liable for income tax at the rate established by G. S. 105-134.2(a)(3) on the portion of North Carolina income attributed to those shareholders not complying with this requirement. The tax rate for each shareholder is 6% of the first \$12,750; 7% of the amount over \$12,750 to \$60,000; and 7.75% of the amount over \$60,000.

LIST OF SHAREHOLDERS

The name, address, percentage of ownership, etc. of each shareholder must be submitted with the North Carolina S corporation return on Schedule K. See additional specific instructions relative to this schedule for furnishing other required information.

STOCK AND INDEBTEDNESS BASIS AND ADJUSTMENTS

A resident shareholder's basis in the stock of an S corporation and any indebtedness of the corporation owed to the shareholder is determined as of the later of the date the stock is acquired, the effective date of the federal S election or the date the shareholder became a resident. Such basis must be adjusted in the manner and to the extent required under Section 1011 of the Code except adjustment to the pro rata share of income under North Carolina law are taken into account and any adjustment under Section 1367 of the Code for taxable years beginning prior to January 1, 1989 are disregarded. Amounts allowed as losses and nontaxable distributions will also affect the stock and indebtedness basis. Additional information relating to stockholder's basis is available from the Individual Tax Division.

A nonresident shareholder's basis for stock and indebtedness of an S corporation initially will be zero. Subsequent adjustments to such basis may be made as provided under Section 1367 of the Code except the adjustments are limited to the nonresident pro rata share of income attributed to North Carolina. In all situations, the amount of losses taken into account by shareholders cannot exceed the combined adjusted basis in the stock and indebtedness of the S corporation.

DISTRIBUTIONS

Resident shareholders will realize taxable income from distributions which are characterized as a dividend or as gain on sale or exchange of property under Section 1368 of the Code. The provisions of G.S. 105-131.6(c) and G.S. 105-134.7 of the Individual Income Tax Act must also be considered in this determination.

Distribution of money by the corporation with respect to its stock during a post termination transition period to a resident shareholder will not be taxable to the shareholder to the extent such distribution is applied against and reduces the adjusted basis of stock in accordance with Section 1371(c) of the Code. **CAUTION** - Any distribution referred to under or by reference to the North Carolina S Corporation Act, Section 1378 and 1371 of the Code must use the adjusted basis of stock determined under the North Carolina law; and, the accumulated adjustment account maintained for each resident shareholder is equal to and adjusted in the same manner as under the Code except (1) such account shall be modified as provided in G. S. 105-131.3(b)(1) of the North Carolina Law and (2) the amount of the S corporation's federal accumulated adjustment account in existence at January 1, 1989 shall be ignored for this purpose but shall be considered accumulated earnings and profits of the corporation.

FRANCHISE TAX INSTRUCTIONS

Schedules A, C, D, and E of Form CD- 401S - These schedules pertain to the corporation franchise tax base and the amount of tax liability. There is no difference between an S corporation and a C corporation with respect to the franchise tax requirement, liability, etc. Although it may appear that some of the "net worth" accounts are different due to the labels placed on certain accounts, etc. the fundamental concept of determining the taxable values from the corporation's assets less definite and accrued legal liabilities will prevail for all corporations subject to the "general business" franchise tax.

In addition to this instruction, additional assistance may be received from the instruction Form CD- 415, Corporation Franchise and Income Tax Instructions used by all other corporations filing franchise tax returns.

Tax Rate - As indicated by the form, the tax rate for computing the franchise tax liability is \$1.50 per \$1,000 of taxable base, and the taxable base is the greatest of the three bases determined by following Schedule C, D, and E of the form and the instructions applicable to each schedule discussed in Form CD- 415, the North Carolina Revenue Laws and the Rules and Regulations available upon request to the North Carolina Department of Revenue.

The minimum franchise tax is \$35.00.

SUSPENSION OF CORPORATE CHARTER

In order to maintain Articles of Incorporation or Certificate of Authority in a current and good standing status most corporations must file a franchise tax return and pay the tax due for each taxable period. The tax is prepaid for the ensuing taxable period and failure to meet this requirement will result in suspension of the "Articles" or "Certificate" in this state. Also, the failure to file other tax returns and/or pay all taxes due can lead to the suspension of the corporate charter in North Carolina.

DOING BUSINESS

Every corporation with a taxable nexus in this state is required to file a franchise tax return for each taxable period even if the business is not incorporated in this state nor is required to secure a Certificate of Authority from the North Carolina Secretary of State. The doing business requirements of Revenue Laws are not the same as the qualification requirements under the incorporation laws. A corporation which is doing business for income tax purposes will also be liable for franchise tax in most all instances. The three conditions which will require a franchise tax return are:

1. Incorporated in North Carolina
2. Certificate of Authority in North Carolina
3. Doing business in North Carolina

S CORPORATION NET INCOME

Caution - A North Carolina S corporation does not have taxable income and is therefore not subject to the tax levied on other corporations doing business in this state. This law applies even when the S corporation has taxable income for federal income tax purposes. However, there may exist a liability on the S corporation with regard to certain shareholders. Circumstances requiring and/or permitting a remittance from the S corporation are discussed below.

FORM CD-401S AND SCHEDULES RELATED TO INCOME

Many corporations will not need to complete most of the schedules relating to the income of the S corporation provided a complete copy of Federal Form 1120S is attached as part of the return. Please refer to Schedule F, Guide To Form CD- 401S on the return, for the required schedules to be completed for the filing situation of the S corporation.

The following instructions relating to the specific schedules are not intended to be inclusive but should serve as general information and have application under most circumstances.

Schedule B - Computation of Income Tax For Composite Return AND for payment of the Annual Report fee.

This schedule is utilized by a corporation filing a composite return on behalf of nonresident shareholders. A composite return is the combining on the corporate form the total tax due based on the pro rata share of taxable income of electing nonresident shareholders attributable to North Carolina. Nonresident shareholders of a corporation filing a composite return who have filed an agreement form (Schedule N) are entitled to the same privileges afforded a North Carolina individual taxpayer. The composite return filing is not available for resident shareholders of North Carolina.

ANNUAL REPORT FEES

Effective for taxable years ending on or after 12- 31- 97, G.S. 55- 16- 22 was rewritten to move the collection of the Annual Report Fee previously remitted by corporations to the Secretary of State's office to the Department of Revenue. All domestic S corporations, as well as, all foreign S corporations authorized to transact business in North Carolina must, on an Annual Basis, complete form CD 479, and remit a twenty dollar (\$20.00) fee. The annual report form, CD 479 must be completed in its entirety and attached to the front page of the completed CD 401S form. Remittance of the annual report fee and any franchise and/or income tax shown due (line 32, schedule B) should be remitted to the Department of Revenue when filing the return. Failure to submit the annual report form with the tax return may result in an administrative dissolution of the Corporate articles or Certificate of Authority by the Secretary of State's office as prescribed by statute. (See 1997 Changes)

Note: For instructions on how to complete the annual report, see the Check List for Business Corporations Annual Report.

INCOME TAX CREDITS

The following is a listing of recently enacted franchise and income tax incentives for new and expanding businesses:

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| * Investment Tax Credit | * Job Creation Tax Credit |
| * Worker Training Tax Credit | * Research and Development Tax Credit |
| * Business Property Tax Credit | * Central and Administrative Office Property Tax Credit |

(Computational worksheets for all new expanding tax credits are available from the Department)

Schedule F - Guide to Form CD- 401S

The S corporation should complete only the schedules as indicated for the filing situation. All corporations are required to complete the franchise tax schedules A, C, D, and E.

Schedule G - Net Income Before State Adjustments

The primary purpose of this schedule is for composite returns or for those situations when the total net income of the S corporation may be needed or more useful in computing the shareholder's pro rata share of such income reportable to North Carolina. For example, if a composite return is filed for nonresident shareholders it may be more feasible to determine the total income of the S corporation for proration purposes than it will be to compute the pro rata portion of each type of income and certain deductions. Another example may involve multistate S corporations with nonresident shareholders. The schedule may also serve as a means for reconciling the reportable income between state and federal shareholder returns.

CAUTION - In the event separate treatment of any item of income, deduction, etc. on this schedule would affect the tax liability of the shareholder, the utilization of Schedule G will be limited. In this context, for shareholder's tax purposes the following items may require further documentation.

Nonresident shareholders of an S corporation receiving dividend income may be entitled to a deduction for those dividends excludable from corporate net taxable income under G.S. 105- 130.5 and/or G. S. 105- 130.4 of the Corporate Income Tax Law. The effect of this exclusion may be accomplished by completing Schedule G and Hof this form before applying the shareholder's ownership percentage to determine the pro rata share of total net income attributable to North Carolina. Or, if the S corporation has operations in more than one state and is subject to an income tax determined by application of apportionment and allocation rules, the dividend income may be classified as nonbusiness and allocated to the commercial domicile of the corporation in which case Schedule J will be used for such computation.

Charitable Contribution - line 8 - Amounts contributed to qualified donees as defined under Code Section 170 are deductible for state income tax purposes within

certain statutory limitations pertaining to corporations. Also, under corporate law only certain contributions to the State of North Carolina or its instrumentalities and to educational institutions located in this State are unlimited. Due to different limitations and law applicable to shareholders, the S corporation should inform each of their shareholders of deductible contributions via the Form 1120S, K- 1 or other means if the amount is different for state tax purposes.

Section 179 Expense Deduction - line 9 - Since this is also a pass through item it may be entered in this schedule only in those instances when total net income of the S corporation is needed as discussed above.

NOTE: In situations where differences may occur when two laws such as the corporation law and the Individual Income Tax Law are in effect relative to the tax liability of any taxpayer, the requirements of the levying statute will normally prevail over the law requiring informational reporting.

Schedule H - Computation of State Net Income

Line 1 of this schedule may be from Schedule G. If the S corporation has only ordinary income or loss, the amount from federal Form 1120S would be appropriate for this line. Lines 2 and 4 provide for additions and deductions of amounts normally not considered in the computation of federal net income but may be reportable for corporate tax purposes under state law. G. S. 105- 130.5 of the Corporate Income Tax Law is referenced under the S corporation Income Tax Law and under the Individual Income Tax Law, G. S. 105- 131.2(a) and G. S. 105- 134.6(a) respectively for the purpose of providing guidance when adjustments are to be made for differences that exist between federal and state law. This schedule lists some of the differences but is not inclusive. Form CD- 415, instructions for regular corporations, lists all the provisions of G. S. 105- 130.5.

An S corporation operating entirely within North Carolina with nonresident shareholders may use this schedule and Schedule K of this form to determine the pro rata share of net income reportable to this state by such taxpayer.

Schedule I & J - Computation of Apportionment Factors and Nonbusiness Income

An S corporation with business activity in North Carolina and another state which constitutes doing business for corporate income tax purposes will be subject to the same provisions for allocation and apportionment purposes as a C corporation. The concept of determining total net income as in Schedule G and H and further applying the procedures outlined in this schedule is one means of computing the amount attributed to North Carolina and the amount reportable by each shareholder to this state. Further specific instructions on apportionment are contained in Form CD- 415, Instructions for Corporate Franchise and Income Tax Returns.

The S corporation law requires that the provisions of the corporate income tax law, G. S. 105- 130.4 be followed for computing the amount of income, loss and deductions attributable to North Carolina. The general instructions, law and regulation relating to this subject should be followed for S corporations involved in multistate activities.

Schedule K - S Corporation Shareholder Schedule

Most S corporations filing a return should complete certain portions of this schedule without regard to federal return supporting information which can be attached. However, if all shareholders are filing North Carolina individual returns to report their pro rata share of S income, and no tax credit is available to the shareholder, completion of Schedule K is not necessary provided a complete copy of Form 1120S is attached.

Shareholder Information - The information as indicated by the form under this heading should be furnished for each taxpayer who was a shareholder during the year.

Column (a) - The percentage of ownership in the corporation is essential information and should be furnished for all shareholders. Rules of ownership are established under the Code. Also, indicate if the shareholder is an officer.

Column (b) - It will be necessary in some situations to compute a combined net income from the shareholder's Schedule K- 1 of the federal Form 1120S. This column can be used in all situations if you wish to reflect a summary of the corporation's activity as a more feasible means for making any of the required adjustments under state law.

Column (c) - North Carolina Adjustments - Under G. S. 105- 131.2 of the S corporation Income Tax Law, the pro rata share of each shareholder's income attributable to North Carolina is subject to the C corporation adjustments under G. S. 105- 130.5. Refer to this statute or CD- 415, Instructions, for various adjustments to federal taxable income. If the number of items subject to adjustment are too numerous, attach a separate schedule detailing the adjustments.

Column (d) - If it is necessary and/or more convenient, determine the amount of the total income attributable to North Carolina for each shareholder under this column. It will be necessary to complete this column and column (e) when a composite return is filed for nonresident shareholders or if a nonresident shareholder has failed to execute an agreement, (Schedule N).

Column (e) - Income Tax Paid for Shareholder - This column will be necessary only when composite returns are filed and when returns for which the corporation is liable for paying the tax are required because of the corporation's failure to secure and file nonresident agreements. The tax rate for composite returns covering nonresident shareholders who have properly executed and filed the agreement of liability for North Carolina income tax with the first S corporation return in this state will be at the individual rates on the amount of taxable income determined as if an individual return was filed.

The tax rate for a corporation with nonresident shareholders who have not executed and filed the agreement of liability will be at the single individual tax rate applied to each shareholder's pro rata share of the S corporation's net income attributable to North Carolina as reflected by its return for the taxable year.

Column (f) - Resident shareholders are entitled to two types of tax credits against the individual income tax liability. (1) A pro rata share of any credit for which the corporation is eligible, and (2) A pro rata share of corporate income tax paid to other states which do not permit the S corporation election.

Nonresident shareholders are only entitled to a pro rata share of any tax credit for which the corporation is eligible.

The amount of credit attributed to each shareholder should be listed separately by type of credit in this column.

Schedule L - Balance Sheets

The balance sheets should agree with the corporation's books and records.

Line 23. Retained Earnings - The total amount from all accounts of retained earnings should be entered on this line. Included are North Carolina accumulated adjustments account (NCAAA), N.C. Adjustments account, and shareholders undistributed taxable income previously taxed (also called previously taxed income (PTI)). Also included are the accounts of appropriated and unappropriated retained earnings accumulated in years prior to 1989 when the corporation was required to file as a C corporation for North Carolina income tax purposes.

Schedule M- 1 - S corporations with total assets on Schedule L, Line 14, column (d), of \$25,000 or more must complete Schedule M- 1, Reconciliation of Income per Books with Income per Return.

Schedule M- 2 - All corporations must maintain the "accumulated adjustments account" (AAA) for federal and state purposes. The computation of the North Carolina accumulated adjustments account and N.C. adjustments account is made using the same procedures as the federal computation applying the North Carolina amounts. See instructions for federal form 1120S and federal Code 1368.

Schedule N - Agreement of Nonresident Shareholder - This schedule is a separate form that should be completed by each nonresident shareholder of an S corporation and submitted by the S corporation as part of the first return filed in this state as an S corporation. Also see above under general information.

The Department of Revenue has printed 10,000 copies of this public document at a cost of \$172.60 or .02 per copy.