1998
NORTH CAROLINA
S–CORPORATION FRANCHISE AND INCOME TAX INSTRUCTIONS

Important 1998 Changes

1. **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 January 1997 to September 1, 1998, including any provisions enacted as of that date which become effective on or after that date. (Effective October 2, 1998)

2. **Economic Loss Carryforward Increased from Five to Fifteen Years**
   G.S. 105–130.8 and G.S. 105–130.5(b) was amended to increase the number of years a net economic loss may be carried forward from five to fifteen years. The fifteen year carryforward is effective for tax years beginning on or after January 1, 1999 and applies to losses incurred for tax years beginning on or after January 1, 1993. A loss that is more than five (5) years old may offset no more than fifteen percent (15%) of any taxable income before the remaining portion may be carried forward. For years beginning on or after January 1, 2002, the percentage limitation is repealed.

3. **Changes to Article 3A Tax Credits under the "Economic Opportunity Act of 1998"**
   Several changes were made to the New and Expanding Business Tax Credits as enacted in the 1996 Session of the North Carolina General Assembly. Chapter 105 was amended to add section 105–129.3A authorizing enhanced incentives for a business that locate within a Development Zone. G.S. 105–129.6 was amended to add subsection (a1) providing that a taxpayer must pay the Department of Commerce a fee of seventy–five dollars ($75.00) when filing an application. For a detailed description of all revisions made to Article 3A of Chapter 105 along with revised computational worksheets, see the North Carolina tax credit forms for the computation of "William S. Lee Quality Jobs and Business Expansion Act".

4. **Trusts Allowed as Shareholders**
   G.S. 105–131.1 through G.S. 105–131.8 were rewritten to conform with previous Internal Revenue Service changes allowing trusts to be shareholders in S corporations. (Effective August 17, 1998)

5. **Changes on Nonresident Withholding from Certain Corporations**
   Several changes were made to G.S. 105–163, the withholding statutes, which relate to the withholding of certain payments to foreign corporations. Changes include an increase in the dollar threshold amount for required withholding of nonresidents from six hundred dollars ($600.00) to one thousand–five hundred dollars ($1500.00) and amends the definition of a contractor to include "nonresident entities that provide for the performance in this State for compensation of any personal services in connection with a performance, an entertainment, an athletic event, a speech, or the creation of a film, radio, or television program." (Amendments to G.S. 105–163.1(2) are effective retroactive to January 1, 1998.)

6. **Taxation of Savings and Loan Associations**
   G.S. 105–228.22 through G.S. 105–228.27 was recodified to move the provisions concerning taxation of savings and loan institutions from Article 8D to the regular corporate income and franchise tax statutes found in Articles 3 and 4 of Chapter 105 of the North Carolina Revenue Laws. Savings and loan institutions retain the two specific adjustments formerly found under Article 8D (the supervisory fees tax credit and the deduction of interest on deposits with FHLB). Savings and loan institutions formerly filing Form CD–301 must now file Form CD–405. (Effective August 14, 1998)

7. **Motor Carriers Subject to Franchise Tax**
   Due to modifications made to G.S. 20–97 by the 1997 session of the North Carolina General Assembly, motor carriers are no longer exempt from the State franchise tax imposed by G.S. 105–122. Motor carriers formerly filing Form CD–406 must now file Form CD–405 or CD–401S whichever is applicable. (Effective January 1, 1998)

GENERAL INSTRUCTIONS

Tax Rates
The franchise tax rate is $1.50 per $1000 of Capital Stock, Surplus, and Undivided Profits or other alternative base described on pages 4 and 5. The minimum franchise tax is $35.00 with no maximum except for qualified holding companies. The corporate income tax rate for composite filers is based on current individual income tax rates.

Form Required
Form CD–401S is used for North Carolina S corporations.

Corporations Required to File
Every corporation doing business in North Carolina and every inactive corporation chartered or domesticated here must file an annual franchise and income tax return using the name reflected by the corporate charter if incorporated in this State or certificate of authority if incorporated outside this State. A franchise tax is imposed on corporations for the privilege of doing business in this State even though the activities are exempt from the income tax under P.L. 86–272 (see definitions page 8). For a corporation that is subject to both income tax and franchise tax, its apportionment factor is the same for both taxes. For a corporation that is subject to franchise tax but not income tax, its apportionment factor for computing the amount of franchise tax due is the same factor that would be used if its activities that are protected by P.L. 86–272 were subject to income taxes in this State. Corporations which are statutorily exempt and the conditions under which certain other corporations may qualify for exemption. For specific information, refer to the Franchise Tax and Corporate Income Tax Rules and Bulletins.

Check–the–Box Filing Requirements
North Carolina follows the federal treatment for income tax purposes for selection of entities under the federal check–the–box regulations. Qualified Subchapter S Subsidiaries must file separate franchise tax returns. (CTAM–97–13) Limited Liability Companies are not subject to the franchise tax imposed by G. S. 105–122.

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 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.

Franchise and Income Tax Credits

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

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

Computational worksheets for all new expanding tax credits are enclosed in this booklet. (see Forms CD 478 A–F)

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 – Schedule N

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. A schedule N is available from the Department or at the Department's website – http://www.dor.state.nc.us/DOR.

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.

INSTRUCTIONS FOR THE COMPUTATION OF FRANCHISE TAX

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.

Tax Bases

Franchise tax is computed by applying the tax rate of $1.50 per $1,000 to the largest of the following three bases:

(1) Capital Stock, Surplus, and Undivided Profits (Schedule C)

In addition to the items listed in the schedule, include stock subscribed, deferred taxes and all other surplus, reserves, deferred credits, inventory valuation reserves including amounts deferred as result of a LIFO valuation method (LIFO reserves) and liabilities except: (a) reserve for depreciation permitted for income tax purposes; (b) accrued taxes; (c) dividends declared; (d) definite and accrued legal liabilities (accounts, notes, mortgages payable, etc.). Deferred income resulting from customer advances for goods or services may be excluded from this base provided; (1) there exists a definite legal liability to render such service or deliver such goods; (2) no part of such advances has been reported or is reportable for income tax purposes; and (3) all related costs and expenses are reflected in the balance sheet as assets. Deferred income net of related deferred income taxes arising from the usual installment sale is not deductible since the corresponding liability would have been discharged at the time of delivery.

Indebtedness owed to a parent, subsidiary, or affiliated corporation is considered a part of the debtor corporation's capital and must be added to the debtor corporation's capital stock, surplus and undivided profits. If the creditor corporation has borrowed a part of its capital from outside sources (i.e., sources other than a parent, subsidiary, or affiliated corporation), the debtor corporation may exclude a proportionate part of the debt determined on the basis of the ratio of the creditor corporation's capital borrowed from outside sources to the creditor corporation's total assets.

The creditor corporation, if subject to the tax, can deduct from its Capital Stock, Surplus, and Undivided Profits the amount of indebtedness owed to it by a parent, subsidiary, or affiliated corporation to the extent that such indebtedness has been added by the debtor corporation on a return filed with this State.

Note: The exclusion permitted the debtor corporation and the deduction permitted the creditor corporation are applicable only to indebtedness owed to or due from a parent, subsidiary, or affiliated corporation.

The term "indebtedness" includes all loans, credits, goods, supplies or other capital of whatsoever nature furnished by a parent, subsidiary, or affiliated corporation. The terms "parent," "subsidiary," and "affiliate" have the meanings specified in G. S. 105–130.6.

The capital stock base may be reduced by the excess of assets of an international banking facility employed outside the United States over liabilities of such corporation owed to foreign persons.

(2) **Investment in Tangible Property in North Carolina (Schedule D)**

Include all tangible assets located in North Carolina at book value (original purchase price less reserve for depreciation permitted for income tax purposes). In addition to the types of property listed in the schedule, include all other tangible property owned such as supplies and tools. LIFO valuation is not permitted for inventories.

A deduction from the tangible property base is allowed for indebtedness incurred and existing by virtue of the purchase or permanent improvement of real estate located in North Carolina. The deductible amount cannot exceed the book value (cost less depreciation) of the real estate acquired or improvements made. Debts incurred in the purchase of personal property are not deductible even though the funds borrowed are secured by a lien against real estate. Indebtedness owed to a parent, subsidiary, or affiliated corporation constitutes a part of the debtor corporation's capital and, therefore, cannot be deducted from the tangible property tax base (except to the extent explained below) even though such indebtedness was incurred in the purchase or permanent improvement of real estate. The extent to which such indebtedness can be deducted is the amount of the total debt excluded by the debtor corporation from its capital stock, surplus and undivided profits base by application of the creditor corporation's borrowed capital ratio.

(3) **Appraised Valuation of Property in North Carolina (Schedule E)**

(Values to be determined as of dates specified in Schedule E of the return.) 55% of appraised value of all property listed for county ad valorem tax in North Carolina. This value also includes the appraised value of all vehicles for which the county tax assessor has issued a billing during the income tax year. Show value at 55% of appraised value, not book value.

Air or Water Pollution Abatement and Recycling and Resource Recovering Facilities

A corporation may deduct from the Capital Stock, Surplus, and Undivided Profits base, schedule C and the Investment in Tangible Property tax base, schedule D, the cost of any air cleaning device or sewage or waste treatment plant and pollution abatement equipment described in G. S. 105–122(b). The cost of purchasing and installing equipment or constructing facilities for purpose of recycling or resource recovering of or from solid waste or for the purpose of reducing the volume of hazardous waste generated may also be deducted from these bases. Such deductions shall be allowed only upon certification from the Office of Water and Air Resources, or in the case of recycling and resource recovering facilities, the Department of Health and Human Services, that such facilities, and equipment comply with the respective requirements of those offices.

Cash Basis S Corporations

S corporations using the cash basis method of accounting for income tax purposes may not compute the Capital Stock, Surplus, and Undivided Profits base, schedule C, by this method. Assets and liabilities must be accrued and reported for franchise tax purposes.

Change of Income Year

A change of income year automatically establishes a new franchise year. A combination return is required for the short income period. Credit is allowed against the franchise tax on the short–period return to the extent that the new franchise year overlaps the old franchise year. For example, a corporation changes its income year from one ending July 31 to one ending November 30. Franchise tax due on its short–period return would be computed in the following manner:

Net franchise tax per short–period return		$ 75.00
Less credit:		
Net franchise tax paid on combination return filed for income year immediately preceding short period	$ 60.00	
Less: Months in short period / Months in year $\frac{4}{12}$ X $ 60.00	20.00	40.00
Net franchise tax due on short–period return		$ 35.00

A schedule showing computation of above described credit should be attached to the franchise and income tax return.

Mergers

Since franchise tax is prepaid, a special computation is sometimes required to prevent a duplication of tax when two, or more, corporations with different income years merge or otherwise transfer the entire assets from one corporation to the other. For specific information and the procedure for making the computation, refer to the Franchise Tax and Corporate Income Tax Rules and Bulletins.

New Corporations

A new S corporation (newly incorporated, newly domesticated out–of–state corporation and other corporation commencing business in the state) is required to file within seventy–five (75) days following the close of its first income year of twelve (12) months or less a combined franchise and income tax return with this Department. The taxable year for a new corporation in this State is presumed to end the calendar month preceding the month of incorporation unless otherwise established by the filing of the required return indicating the taxable year adopted. In no case may the first taxable year exceed twelve months unless it is clearly shown that the corporation has adopted a method of accounting using the 52–53 weeks reporting period.

A franchise and income tax return is due annually so long as the corporation remains incorporated, domesticated or continues to do business in this State.

Inactive Corporations

A S corporation which is inactive and without assets is subject annually to a minimum franchise tax of $35. A return is required containing a statement of the status of the corporation. Failure to file this return and pay the minimum tax will result in suspension of the articles of incorporation or certificate of authority. Any corporation which intends to dissolve or withdraw through suspension for nonpayment of franchise tax should indicate its intention in writing to the Department.

Dissolution or Withdrawal of Corporate Rights

Since franchise taxes are paid in advance or at the beginning of the income year, corporations are not subject to franchise tax after the end of the income year in which articles of dissolution or withdrawal are filed with the Secretary of State unless they engage in business activities not reasonably incidental to winding up their affairs. Although the final income return must be filed on a combination franchise and income tax return form, the schedules relating to franchise tax should be disregarded. This applies, however, only to those corporations officially filing articles of dissolution or withdrawal with the Secretary of State of North Carolina.

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.

INSTRUCTIONS FOR THE COMPUTATION OF S CORPORATION NET INCOME

Caution – A North Carolina S corporation does not have taxable income and is therefore not subject to the income 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 the tax form for specific instructions on completing each tax schedule.

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.

Computation of Income Tax for Composite Filers AND for Payment of the Annual Report Fee – Schedule B

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 except for insurance companies, limited liability companies, nonprofit corporations, and professional associations 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. **Note: For instructions on how to complete the annual report, see the Check List for Business Corporations Annual Report found on the reverse side of Form CD–479.**

Net Income Before State Adjustments – Schedule F

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 rate 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 F and G of 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.

Computation of State Net Income – Schedule G

Line 1 of this schedule may be from Schedule F. 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.

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

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 F and G 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.

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.

Multistate S Corporations

A S corporation having "business income" from business activity which is taxable both within and without this State is required to apportion its State net income or net loss as computed above, as herein provided. For purposes of allocation and apportionment, a S corporation is taxable in another state if (i) the corporation's business activity in that state subjects it to a net income tax or a tax measured by net income, or (ii) that state has jurisdiction based on the corporation's business activity in that state to subject the corporation to a tax measured by net income regardless of whether that state exercises its jurisdiction. For purposes of this section, 'business activity' includes any activity by a corporation that would establish a taxable nexus pursuant to 15 United States Code § 381.

COMPUTATION OF APPORTIONMENT FACTORS

All business income of S corporations other than public utilities and excluded corporations shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four. Provided, that if the sales factor does not exist, the denominator is the existing factors; and, if a property or a payrolls factor does not exist, the denominator is the existing factors plus one.

Property Factor

The property factor is a fraction, the numerator of which is the average value of the S corporation's real and tangible personal property owned or rented and used in this State during the income year and the denominator of which is the average value of all the S corporation's real and tangible personal property owned or rented and used during the income year. The numerator includes not only inventories actually located in North Carolina but also inventories in transit with a North Carolina destination.

Property owned by the S corporation is valued at its original cost. Property rented by the S corporation is valued at eight times the net rent paid during the current income year. Net annual rent is the annual rent paid by the corporation less any annual rent received by the corporation from subrentals except that subrentals shall not be deducted when they constitute business income. Any property under construction or any property which had not been actually used or operated in the corporation's business during the income year and any property the income from which constitutes nonbusiness income shall be excluded in the computation of the property factor.

The average value of property shall be determined by averaging the values at the beginning and end of the income year, but in all cases the Secretary may require the averaging of monthly or other periodic values during the income year if required to reflect properly the average value of the corporation's property. A corporation which ceases its operation in this State before the end of its income year for any reason whatsoever shall use property values as of the first day of the income year and the last day of its operations in this State in determining the average value of property, but the Secretary may require averaging of monthly or other periodic values during the income year.

Payroll Factor

The payroll factor is a fraction, the numerator of which is the total compensation paid in this State during the income year by the S corporation and the denominator of which is the total compensation paid everywhere during the income year. All compensation paid to general executive officers and all compensation paid in connection with nonbusiness income shall be excluded in computing the payroll factor. General executive officers shall include the chairman of the board, president, vice–presidents, secretary, treasurer, comptroller, and any other officer serving in similar capacities. Compensation is paid in this State if:

(1) the individual's service is performed entirely within the State; or

(2) the individual's service is performed both within and without the State, but the service performed without the State is incidental to the individual's service within the State; or

(3) some of the service is performed in this State and (A) the base of operations, or, if there is no base of operations, the place from which the service is directed or controlled is in this State, or (B) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this State.

Sales Factor

The sales factor is a fraction, the numerator of which is the total sales of the S corporation in this State during the income year, and the denominator of which is the total sales of the corporation everywhere during the income year. The receipts from any casual sale of property shall be excluded from both the numerator and the denominator of the sales factor. Where a S corporation is not taxable in another state on its business income but is taxable in another state only because of nonbusiness income, all sales shall be treated as having been made in this State.

Sales of tangible personal property are in this State if the property is received in this State by the purchaser. In the case of delivery of goods by common carrier or by other means of transportation, including transportation by the purchaser, the place at which the goods are ultimately received after all transportation has been completed shall be considered as the place at which the goods are received by the purchaser. Direct delivery into this State by the taxpayer to a person or firm designated by a purchaser from within or without the State shall constitute delivery to the purchaser in this State.

Other sales are in this State if:

(1) the receipts are from real or tangible personal property located in this State; or

(2) the receipts are from intangible property and are received from sources within this State; or

(3) the receipts are from services and the income–producing activities are in this State.

Direct Allocation of Nonbusiness Income

Rents and royalties from real or tangible personal property, gains and losses, interest, dividends, patent and copyright royalties, and other kinds of income, <u>if such income items are non–business income</u>, less related expenses are required to be allocated to the state of commercial domicile. (A detailed explanation of nonbusiness income is contained in Corporation Income Tax Rules and Bulletins. Copies are available upon request.)

S Corporation Shareholder Schedule – Schedule K

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 C corporations, 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 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.

Balance Sheets – Schedule L

The balance sheets should agree with the corporation's books and records. Retained Earnings (line 24) 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.

Reconciliation of Income (Loss) Per Books With Income (Loss) Per Return – Schedule M–1

S corporations with total assets on schedule L, line 15, column (d), of $25,000 or more must complete schedule M–1, Reconciliation of Income per Books with Income per Return.

Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed – 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 Internal Revenue Code 1368.

Agreement of Nonresident Shareholder – Schedule N

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. (see Nonresident Shareholders' Agreement on page 4)

<u>PUBLIC UTILITY CORPORATIONS AND EXCLUDED CORPORATIONS</u>

Special apportionment provisions apply to the business income of public utility corporations and excluded corporations. The respective tax statutes should be consulted for specific allocation requirements. Motor carriers and telephone companies must complete the Computation of Apportionment Factor for Certain Public Service Corporations Worksheet. (see worksheet below) Other public service corporations and excluded corporations compute the apportionment percentage as provided in schedule I, Part III of the North Carolina S Corporation Franchise and Income Tax Return.

Motor Carriers

All business income of a motor carrier of property or passengers shall be apportioned by multiplying the income by a fraction, the numerator of which is the number of vehicle miles in this State and the denominator of which is the total number of vehicle miles of the company everywhere.

Telephone Companies

All business income of a telephone company shall be apportioned by multiplying the income by a fraction, the numerator of which is gross operating revenues earned in this State plus other revenue items attributed to this State specifically listed in G.S. 105–130.4(n) and the denominator of which is the total gross operating revenue from all business done by the company everywhere less uncollectible revenue.

Excluded Corporations

All business income of an "excluded corporation" (see definitions) shall be apportioned by multiplying the income by the sales factor. (see Part III of schedule I)

Contractors

A multistate building or construction contractor shall use a one factor sales (gross receipts) formula to apportion its business income to this State. A building or construction contractor is a business so classified under the North American Industry Classification System published by the Office of Management and Budget. (see Part III of schedule I)

DEFINITIONS

(1) Business income means income arising from transactions and activity in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation's regular trade or business operations. G.S. 105–130.4(a)(1)
(2) Nonbusiness income means all income other than business income. G.S. 105–130.4(a)(5)
(3) Compensation means wages, salaries, commissions and any other form of remuneration paid to employees for personal services. G.S. 105–130.4(a)(3)
(4) Excluded corporation means any corporation engaged in business as a building or construction contractor, a loan company, a securities dealer, or any other company which receives more than 50 per cent of its ordinary gross income from investments in and/or dealing in intangible property. G.S. 105–130.4(a)(4)
(5) Commercial domicile means the principal place from which the trade or business of the taxpayer is directed or managed. G.S. 105–130.4(a)(2)
(6) Sales means all gross receipts of the corporation except receipts from any casual sale of property and any nonbusiness income receipts. G.S. 105–130.4(a)(7)
(7) Casual sale of property means the sale of any property which was not purchased, produced or acquired primarily for sale in the corporation's regular trade or business. G.S. 105–130.4(a)(8)
(8) State means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof. G.S. 105–130.4(a)(9)
(9) Public utility means any corporation that is subject to control of one or more of the following entities: the North Carolina Utilities Commission, the Federal Communications Commission, the Interstate Commerce Commission, the Federal Power Commission, or the Federal Aviation Agency; and that owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, the transportation of goods or persons, or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil, oil products, or gas. The term also includes a motor carrier of property whose principal business activity is transporting property by a motor vehicle for hire over the public highways of this State. G.S. 105–130.4(a)(6)
(10) Franchise tax "doing business" means each and every act, power, or privilege exercised or enjoyed in this State, as a incident to, or by virtue of the powers and privileges granted by the laws of this State. G.S. 105–114(b)(3)
(11) Income tax "doing business" means (a) the operation of any business enterprise or activity in North Carolina for economic gain, including, but not limited to, the following;

(1) the maintenance of an office or other place of business in North Carolina;
(2) the maintenance in North Carolina of an inventory of merchandise or material for sale, distribution or manufacture, regardless of whether kept on the premises of the taxpayer or in a public or rented warehouse
(3) the selling or distributing of merchandise to customers in North Carolina directly from a company–owned or operated vehicle when title to the merchandise is transferred from the seller or distributor to the customer at the time of the sale for distribution;
(4) the rendering of a service to clients or customers in North Carolina by agents or employees of a foreign corporation;
(5) the owning, renting, or operating of business or income–producing property in North Carolina including, but not limited to, the following;
- (A) Realty;
- (B) Tangible personal property;
- (C) Trademarks, tradenames, franchise rights, computer programs, copyrights, patented processes, licenses.

(b) Corporations who are partners in a partnership or joint venture operating in North Carolina are considered to be "doing business".
(c) the performance of any of the following business activities in North Carolina (interstate motor carriers only):
(1) The maintenance of an office in the State;
(2) The operation of a terminal or other place of business in the State;
(3) Having an employee working out of the office or terminal of another company;
(4) Dropping off or gathering up shipments in the State.

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COMPUTATION OF APPORTIONMENT FACTOR FOR CERTAIN PUBLIC SERVICE CORPORATIONS WORKSHEET (Schedule I – Part IV)

A. Vehicle Miles Factor – for corporations whose business is the operation of a motor carrier of property and/or passengers.

1. Number of vehicle miles traveled in North Carolina . . . . ____________
2. Total number of vehicle miles traveled everywhere . . . . ____________
3. Percentage of mileage to N.C. factor (divide line 1 by line 2; enter amount here and on page 4, schedule I, Part IV) . . . . _ _ _._ _ _ _%

B. Gross Operating Revenue Factor – for corporations whose income is derived from the operation of a telephone company.

1. **Gross Operating Revenues in North Carolina**
   a. Gross operating revenue from local service in N.C. . . . . ____________
   b. Gross operating revenue from toll services within North Carolina . . . . ____________
   c. North Carolina portion of revenue from interstate toll services . . . . ____________
   d. Gross operating revenues in NC from other services . . . . ____________
   e. Total gross operating revenues assignable to North Carolina (sum of lines 1a through 1d) ____________
   f. Less: North Carolina uncollectible revenue (____________)
   g. Total adjusted gross operating revenues assignable to North Carolina . . . . ____________
2. **Gross Operating Revenues Everywhere**
   a. Total gross operating revenues . . . . ____________
   b. Less: Total uncollectible revenue . . . . (____________)
   c. Total adjusted gross revenues everywhere . . . . ____________
3. Gross operating revenue factor (divide line 1g by line 2c; enter amount here and on page 4, schedule I, Part IV) . . . . _ _ _._ _ _ _%