

F. Capital Stock, Surplus and Undivided Profits Base (G.S. 105-122(b) & (c))

1. Based on the Year End Balance Sheet

This base is determined from the corporation's books and records, as reflected by its balance sheet, used for financial accounting purposes, as of the close of the income year immediately preceding the due date of the return.

2. Surplus Defined

The term "surplus" for franchise tax purposes has a broader and more inclusive meaning than the generally accepted accounting definition. It includes, in addition to the balance sheet surplus, all liabilities, reserves and deferred credits.

3. Items Includable and Excludable

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

The following items are *excludable* from capital stock, surplus and undivided profits in arriving at the net base:

- a. Cost of treasury stock.
- b. Definite and accrued legal liabilities.
- c. Accrued taxes.
- d. Reserve for depreciation permitted for income tax purposes.
- e. Dividends declared.
- f. Reserves for cost of any air-cleaning device or sewage or waste treatment plant, including waste lagoons, and pollution abatement equipment certified by the Department of Environment and Natural Resources or the Environmental Management Commission. Reserves for cost should be net of any depreciation on the equipment excluded from the base.
- g. Cost of purchasing and installing equipment or constructing facilities for the purpose of recycling or resource recovering of or from solid waste certified by the Department of Environment and Natural Resources. Cost should be net of any depreciation on the equipment and facilities excluded from the base.
- h. Cost of constructing facilities of any private or public utility built for the purpose of providing sewer service to residential and outlying areas. Cost should be net of any depreciation on the facility excluded from the base.

- i. Cost of equipment and facilities acquired for the purpose of reducing the volume of hazardous waste generated. Cost should be net of any depreciation on the equipment and facilities excluded from the base.
- j. If a corporation is, in the opinion of the Secretary of Revenue, qualified under the United States Code Annotated Title 26, Section 851 as a “Regulated Investment Company” or “Real Estate Investment Trust” and elects to be treated as such for North Carolina tax purposes it shall be allowed to exclude the aggregate market value of its investments in stocks, bonds, debentures, or other securities or evidences of debt of other corporations, partnerships, individuals, municipalities, governmental agencies, or governments.
- k. All assets of an international banking facility which are employed outside the United States less all liabilities owed to foreign persons by the facility.
- l. The corporation’s investment in an LLC if the corporation is required to include a percentage of the LLC’s income, assets, liabilities, and equity in the corporation’s franchise tax calculation under G.S. 105-114.1.

The following items are *includable*:

- a. Capital stock subscribed.
- b. Appraisal surplus.
- c. Reserve for bad debts.
- d. Deferred income (except as explained above).
- e. Deferred taxes.
- f. Contingent liabilities.
- g. Inventory valuation reserves.
- h. LIFO “reserves”.
- i. All other reserves and allocations: also, credit items (not exempted above) which do not represent definite and accrued legal liabilities. In determining whether an item is a liability that has been incurred, the Department follows IRC Section 461(h) which states: “...in determining whether an amount has been incurred with respect to an item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.”
- j. Percentage of LLC income, assets, liabilities, and equity under G.S. 105-141.1. For additional information on the filing requirements for members of LLCs, see Subsection J “Corporate Members of LLCs” and Item 5, Subsection L “Corporations Conditionally or Partially Exempt” in this section.

4. Exclusion of Retained Earnings by Parent Corporation (17 NCAC 05B.1104)

A parent corporation may exclude any retained earnings of existing subsidiary corporations that it has capitalized or otherwise recorded on its books, through an equity method of accounting.

5. Investment in Subsidiary (17 NCAC 05B.1105)

No reduction of the capital stock base is allowed for the investment in a subsidiary.

6. Borrowed Capital Treatment (Debtor Corporation)

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 tax base.

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 in computing the amount to be added determined on the basis of the ratio of the creditor corporation's capital borrowed from outside sources to the creditor corporation's total assets.

Example: ABC Corporation owes to its parent XYZ Corporation, \$200,000. XYZ's capital borrowed from outside sources is \$75,000 and its assets total \$300,000.

Indebtedness owed to XYZ Corporation				\$200,000
Less proportionate part:				
<u>XYZ's borrowed capital</u>	<u>\$ 75,000</u>			
XYZ's total assets	\$300,000	x	\$200,000 =	<u>50,000</u>
Net amount to be <i>added</i> by ABC Corporation				\$150,000

XYZ Corporation is *entitled to deduct* \$150,000, the net amount added by ABC Corporation, from its capital stock, surplus and undivided profits.

7. Borrowed Capital Treatment (Creditor Corporation)

The creditor corporation, if subject to the tax, can deduct 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 organization. If the corporations have different income years, the creditor corporation shall deduct the amount of indebtedness added back by the parent, subsidiary, or affiliate on the return immediately preceding that of the creditor.

8. Exclusion Provision Limited to Indebtedness Owed (17 NCAC 05B.1108)

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. These provisions do not apply where the indebtedness is merely endorsed or guaranteed.

9. Equity Capital Not Deductible (17 NCAC 05B.1109)

The equity capital of a wholly owned subsidiary does not represent "indebtedness" owed to a parent corporation which the parent is entitled to deduct from its franchise tax base.

10. Reciprocal Indebtedness Between Affiliates (17 NCAC 05B.1110)

A corporation which owes indebtedness to a parent, subsidiary or affiliated corporation and at the same time is owed indebtedness by the same parent, subsidiary or affiliated corporation may net the payable and receivable for purposes of the indebtedness

computation. If the indebtedness is owed to one corporation and the receivable is due from another corporation, each amount must be treated separately.

11. Indebtedness Defined

The term “indebtedness” as used under G.S. 105-122(b) includes all loans, credits, goods, supplies or other capital of whatever nature furnished by a parent, subsidiary or affiliated corporation. The terms “parent,” “subsidiary” and “affiliate” have the meanings specified in General Statutes Section 105-130.6.

12. Borrowed Capital Defined

The term “borrowed capital” as used under G.S. 105-122(b) includes all loans, credits, goods, supplies, or other capital of whatsoever nature furnished by a source other than a parent, subsidiary or affiliated corporation.

13. Creditor Corporation Defined

The creditor corporation is considered to be the parent, subsidiary, or affiliated corporation to which the indebtedness is directly owed.

14. Cash Basis Corporations (17 NCAC 05B.1115)

Corporations using the cash basis method of accounting for income tax purposes may not compute the capital stock, surplus and undivided profits base by this method. Assets and liabilities must be accrued and reported for franchise tax purposes.