

E. Attribution of Expenses to Nontaxable Income and to Nonapportionable Income and Property (G.S. 105-130.4, G.S. 105-130.5, G.S. 105-130.6A) (17 NCAC 05C.0304)

1. Direct Expenses

All expenses directly connected with the production of income that is not subject to tax in this State are required to be used to compute the net amount of such untaxed income.

2. Interest Expense

When a corporation earns income which is not taxed by this State (see examples), and/or holds property that does or will produce untaxed income, and incurs interest expense, **which is not specifically related to any particular income or property**, it must attribute a portion of the interest expense to such untaxed income and property in determining taxable income reported to this State. The formula for computing the amount of interest expense to be attributed to untaxed income and property is as follows:

- a. Assets
 - i. Value on the tax return balance sheet of assets that produce or which would produce untaxed income *
 - ii. Value of all assets on the tax return balance sheet**
 - iii. Determine the ratio or percentage of *i* to *ii*
- b. Income
 - i. Gross Untaxed Income
 - ii. Total Gross Profits
 - iii. Determine the ratio or percentage of *i* to *ii*
- c. Total of the ratios or percentages determined in *a* and *b* above.
- d. Divide total of *c* by 2
- e. Apply average percentage determined in *d* to the total interest expense on the return filed in this State.

Examples of untaxed income:

- Dividend income classified as nonapportionable (G.S. 105-130.4)
- Interest income classified as nonapportionable (G.S. 105-130.4)
- Interest income earned on United States obligations (see 3 below) and State of North Carolina obligations
- Other nonapportionable income and/or exempt income

*When the equity method of accounting is used, the increase or decrease in value as result of such accounting may be excluded from this value.

**Equity included in this value may be excluded and the reserve for depreciation reflected on the balance sheet may be restored to the asset value.

3. Expense Connected With Interest Income From United States Obligations

Under G.S. 105-130.5 (b) (1), interest income from obligations of the United States or its possessions is excludable from North Carolina taxable income to the extent such income is included in federal taxable income. Since federal taxable income is in effect

a net income, expenses incurred in producing the exempt income must be determined and subtracted from the gross amount earned during a taxable period before the deduction is made in computing the state taxable income. The basis for requiring this adjustment to exempt income is based on federal case law. (First National Bank of Atlanta v. Bartow County Board of Tax Assessors, 470 U.S. 583, 84 L. Ed. 2d 535 (1985) and supported by an advisory opinion of the North Carolina Attorney General.)

In the computation of expenses related to income from United States obligations, the formula described above in Item 2 may be used with respect to interest expense.

4. Expenses Related to Dividends Received

For corporations other than bank holding companies or electric power holding companies, the amount of expenses attributed to dividends is limited to fifteen percent (15%) of the dividends. For bank holding companies, the amount of expenses attributed to dividends is limited to twenty percent (20%) of the dividends. For electric power holding companies, the amount of expenses attributed to dividends is limited to fifteen percent (15%) of the company's total interest expenses.

The additional tax that a bank holding company and its related companies must pay as the result of attributing expenses to dividends received shall not exceed eleven million dollars (\$11,000,000). If the attribution of expenses results in additional tax of more than eleven million dollars (\$11,000,000) to the bank holding company group, the group may reduce the attributed expenses so that the additional tax effect is eleven million dollars (\$11,000,000).

The members of the group may allocate the reduction among themselves at their discretion. Each member of the group that has dividends for the year and is required to file a North Carolina return must provide a schedule with its return that lists each member of the group that has dividends, the amount of the dividends, whether that member is a bank holding company, and the amount of expenses attributed to that member in order to reach the cap of eleven million dollars (\$11,000,000). If a member's return is later adjusted so that the tax effect of the attribution of expenses for the group falls below eleven million dollars (\$11,000,000), the Department may increase the amount of attributed expenses for any member of the group to bring the additional tax back to the maximum. The Department may assess any additional tax due within three years of the date on which the member's return was changed that resulted in the group falling below the maximum tax effect.

The members of a bank holding company are allowed a tax credit for a portion of the additional tax liability. This tax credit can be allocated among the group at their discretion. If the bank holding company group pays the maximum additional tax liability of eleven million dollars (\$11,000,000), the credit is two million dollars (\$2,000,000). If the bank holding company group does not pay an additional eleven million dollars (\$11,000,000), the credit is equal to the additional tax the group paid by attributing expenses of up to twenty percent (20%) of dividends instead of fifteen percent (15%) of dividends. The credit is taken in four equal annual installments. For the additional tax paid for tax year 2001, the credit is taken beginning with the tax year 2003. For all other tax years, the credit is taken beginning in the following tax year.

An electric power holding company is allowed a credit equal to one-half of the additional tax paid as a result of attributing expenses to dividends received. The electric power

holding company may claim the credit against its own tax liability or may elect to allocate the credit among the members of its affiliated group. If the electric power holding company claims the credit against its own tax liability, the credit is allowed in the following tax year. If the electric power company elects to allocate the credit among the members of its affiliated group, the credit must be taken in four equal installments beginning in the following tax year or the taxable year for which the taxpayer's final return is due for 2004, whichever is later.

The credits allowed for bank holding companies and electric power holding companies can be taken against either the corporate income or franchise tax. However, the credit may be claimed against only one of the taxes. Each taxpayer must elect the tax against which the credit will be taken when filing the return on which the first installment of the credit is claimed. This election is binding. All installments and carryforwards of the credit must be taken against the same tax.

In order for a member of an affiliated group to take a credit, each member of the affiliated group that is required to file a corporate income tax or franchise tax return must attach a schedule to its return that shows for every member of the group the amount of the credit taken by it, the tax against which it is taken, and the amount of the resulting tax. In addition, each member must provide any other documentation required by the Secretary.

A credit allowed in this section may not exceed the amount of the tax against which it is taken for the taxable year reduced by the sum of all credits allowable, except tax payments made by or on behalf of the taxpayer. Any unused portion of the credit may be carried forward to succeeding tax years.

5. Other Expenses Attributed to Nontaxable Income and to Nonapportionable Income and Property

In the determination of expenses other than interest expense attributed to untaxed income, the procedure set forth in the Federal Code for determining expenses related to foreign source income generally referred to as stewardship and supportive expenses may be used to determine the expenses allocated to untaxed income and property producing or which would produce untaxed income.

Alternatively, an income formula as outlined above in Item 2 of this subsection may be used to determine the amount of supportive function expenses attributable to untaxed income. In the determination of "supportive function expenses", direct expenses incurred exclusively in a specific identifiable taxable or nontaxable activity should be determined and excluded before application of the attribution percentage to expenses. If direct expenses are determinable for a particular activity resulting in an accurate computation of the net income or loss from such activity, the values of this activity are to be removed from the two ratios when computing the attribution percentage.