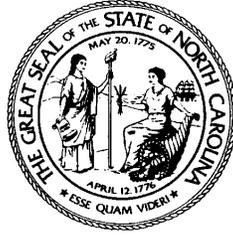


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# North Carolina Department of Revenue

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## **DIRECTIVE**

**Subject:** Apportionment and Allocation of Income by a Multistate Partnership  
**Tax:** Individual Income Tax  
**Law:** G.S. 105-134.5 (for tax years beginning before January 1, 2014);  
G.S. 105-153.4 (for tax years beginning on or after January 1,  
2014); G.S. 105-154; G.S. 105-130.4  
**Issued By:** Income Tax Division - Personal Taxes Section  
**Date:** October 10, 2014  
**Number:** PD-14-02

The purpose of this Directive is to announce a change in the Department of Revenue's ("Department") policy regarding the apportionment and allocation of income by a multistate partnership.

### **Law**

G.S. 105-154(c) requires a partnership to file a North Carolina partnership income tax return if the partnership is (i) doing business in North Carolina and (ii) required to file a federal partnership income tax return. The partnership income tax return must reflect the partnership's gross income, the deductions allowed under the Internal Revenue Code, and the adjustments required under G.S. 105-153.5 and G.S. 105-153.6 (G.S. 105-134.6, G.S. 105-134.6A, and G.S. 105-134.7 for tax years beginning before January 1, 2014). The return must also reflect each partner's distributive share of the partnership's net income. The partnership must also furnish to each partner any information necessary for the partner to properly file a North Carolina income tax return. A partnership uses Form D-403 to file a North Carolina partnership income tax return and Form NC K-1 (for Form D-403) to provide information to its partners.

G.S. 105-154(c) does not address cases where the partnership does business in both North Carolina and one or more other states. However, the portion of the multistate partnership's income that is subject to North Carolina income tax is essential information for a partner that is a corporation or who is a nonresident individual to be able to properly file a North Carolina income tax return.

By way of analogy, a corporation having income from business activities which is taxable both within and outside of North Carolina allocates and apportions its net income under the provisions of G.S. 105-130.4. Also by way of analogy, a

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nonresident individual determines his North Carolina taxable income by multiplying his federal adjusted gross income, as adjusted under G.S. 105-153.5 and G.S. 105-153.6, by a fraction, the denominator of which is the taxpayer's gross income, as adjusted, and the numerator of which is the amount of that gross income, as adjusted, that is derived from North Carolina sources (G.S. 105-153.4(b)). To calculate the numerator of the fraction, a nonresident individual partner's portion of his distributive share of a multistate partnership's income that is derived from North Carolina sources is determined by multiplying the partnership's total net income by the ratio calculated under the corporate apportionment formula in G.S. 105-130.4 (G.S. 105-153.4(d)).

G.S. 105-130.4(i) sets out a general apportionment formula consisting of the entity's property factor, payroll factor, plus twice the sales factor. G.S. 105-130.4(j) through (l) define those factors. G.S. 105-130.4(m) through (s1) set out specific apportionment formulas for certain industries and capital intensive corporations. G.S. 105-130.4(t1) authorizes a corporation that believes that the statutory apportionment formula allocates a greater portion of its income to North Carolina tax than is reasonably attributable to business or earnings in this State to make a written request with the Secretary of Revenue for permission to use an alternative apportionment method.<sup>1</sup>

### **Prior Policy**

The Department had several discussions with multistate partnerships in 1990 where a partnership's activities in North Carolina were segregated from activities in other states and the partnership maintained separate accounts for each activity. The Department requested an opinion from the Office of the Attorney General as to whether (1) a partnership could request an alternative apportionment method under G.S. 105-130.4 or (2) the Department had rule-making authority under G.S. 105-262 and G.S. 105-264 to require or allow a partnership to use a separate accounting apportionment method to determine the portion of the partnership's income attributable to North Carolina.

Based on the opinion of the Attorney General, the Individual Income Tax Division issued a memorandum on July 2, 1991 to advise that the law did not permit partnerships to request permission to use an alternative apportionment formula. The memorandum further advised that, where a partnership's business operations in North Carolina were unified and integrated with business operations in other states (commonly referred to as "apportionable income"), the partnership must determine the earnings attributable to this State under the apportionment formula applicable to corporations. However, if the partnership's business operations in North Carolina were not integrated and were segregated from business activities in other states (commonly referred to as "nonapportionable income"), the partnership must separately account for the

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<sup>1</sup> G.S. 105-130.4(t1) was enacted effective January 1, 2008. Prior to January 1, 2008, this authority was under the purview of the Augmented Tax Review Board.

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income earned in this State. The Department also amended subsection (b) of administrative rule T17 NCAC Chapter 6B .3513 effective October 1, 1991 and revised the partnership return form (Form D-403) and instructions (Form D-403A) for tax year 1991 to reflect the policy stated in the memorandum.<sup>2</sup>

### **Revised Policy**

The Department has recently reviewed its position on apportionment and allocation of partnership income. The Department has determined that the requirement in G.S. 105-153.4(d) to use the ratio calculated under the corporate apportionment formula in G.S. 105-130.4 necessarily includes use of an alternative apportionment method approved by the Secretary as well as use of the statutory apportionment formulas set out in G.S. 105-130.4(i) and G.S. 105-130.4(m) through (s1). The Department has also concluded that it imprudently exercised its authority under G.S. 105-262 and G.S. 105-264 when it required or allowed partnerships to separately account for business activities that were segregated from other business activities. Finally, the Department has determined that in many cases a partnership misconstrued the Department's guidance by segregating a portion of its apportionable income because it employed a method of accounting that clearly reflected the income of a specific activity.

As a result of the review, the Department will revise its partnership income tax return form and instructions for 2014 to remove provisions for reporting income from segregated activities. The Department believes that, under a constitutionally sound apportionment method, income from unitary business activities is apportionable and income from an activity that is not part of the unitary business activities is allocated to the business situs of the activity. Consequently, the partnership tax return form will also be revised to include a line for reporting nonapportionable income from North Carolina sources and a line for reporting apportionable income subject to North Carolina's apportionment factor.

If a partnership believes that the statutory apportionment formula attributes a greater portion of its income to North Carolina tax than is reasonably attributable to its business in this State, it may make a written request with the Secretary of Revenue for permission to use an apportionment formula that it believes is a better method to attribute its income to North Carolina. The procedures set forth in administrative rule T17 NCAC Chapter 5D .0107 through .0115 for a corporation to request an alternative apportionment formula will also apply to a partnership seeking an alternative apportionment formula.

The Department will also propose to amend or repeal subsection (d) of administrative rule T17 NCAC Chapter 6B .3513 to reflect the revised policy.

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<sup>2</sup> Subsection (b) of T17 NCAC Chapter 6B .3513 was renumbered as subsection (d) effective June 1, 1993.

## **Effective Date of Policy Change**

Effective for tax years beginning on or after January 1, 2014, a partnership that (1) is doing business in both North Carolina and one or more other states and (2) has corporate or nonresident individual partners shall determine the portion of the corporate or nonresident individual partners' shares of the partnership's distributive net income subject to tax in North Carolina by using the allocation and apportionment provisions in G.S. 105-130.4. A partnership will no longer separately account for income from segregated activities that are part of the partnership's unitary business unless the Secretary of Revenue has authorized the use of an alternative apportionment formula.

## **Impact on Prior-Year Returns**

A partnership filing an original partnership income tax return for a tax year that begins before January 1, 2014 after the date of this Directive may use either the former policy or the revised policy in completing its return. The partnership cannot request an alternative apportionment formula for tax years beginning before January 1, 2014.

If a partnership filed an original partnership income tax return for a tax year that begins before January 1, 2014 prior to the date of this Directive and separately accounted for income from segregated activities that are part of the partnership's unitary business on that return, the Department will not adjust the partnership return upon examination to reflect the revised policy. However, the partnership may elect to amend its return to reflect the revised policy. The election to correct distributive net income subject to tax in North Carolina will be binding on each corporate or nonresident individual partner. Any refunds or additional tax due as a result of the amended return is subject to the statute of limitations for refunds (G.S. 105-241.6) or assessments (G.S. 105-241.8).

The Department will continue to adjust a partnership income tax return for a tax year that begins before January 1, 2014 if the partnership separately accounted for income from segregated activities and the Department determines that the activities were both part of the partnership's unitary business and integrated with the partnership's other business activities. Income from activities that were both part of the partnership's unitary business and integrated with the partnership's other business activities has consistently been considered part of the partnership's apportionable income.

## **Questions**

Questions about this Directive may be directed to the Income Tax Division - Personal Taxes Section at (919) 814-1066.