



June 3, 2016

## **Important Notice: Limited-Time Extension of the Statute of Limitations With Respect to Refunds of Corporate and Individual Income Tax Paid**

The purpose of this notice is to inform taxpayers of two limited-time exceptions to the general statute of limitations for requesting a refund of corporate and individual income tax. These exceptions exist as a result of the enactment of Session Law 2016-5, signed by Governor McCrory on May 11, 2016, and Session Law 2016-6, signed by Governor McCrory on June 1, 2016.

### ***1. Deferred Federal Taxation of Certain Debt (Affects Both Corporate and Individual Income Taxpayers)***

**Background:** Income from the discharge of indebtedness (“COD”) is generally includable in federal gross income unless it is excludable under provisions of the Internal Revenue Code (“Code”). The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) enacted subsection 108(i) of the Code to allow a C corporation or any other person who issued a debt instrument in connection with the conduct of a trade or business to reacquire the debt instrument and elect to defer the taxation of the income arising from the COD. The election applied to indebtedness reacquired in 2009 or 2010. If the taxpayer elected to defer the income, it was generally required to be included in gross income ratably over a five-year period beginning in 2014 unless there is an accelerating event, in which case it would be required to be included sooner.

During the 2009 legislative session, the North Carolina General Assembly elected to decouple from (not follow) this provision, thereby requiring inclusion of COD resulting from the reacquisition of a debt instrument in North Carolina taxable income in the year the debt was discharged. It did so by updating the State’s reference to the Internal Revenue Code from May 1, 2008 to May 1, 2009<sup>1</sup> and amending the corporate income tax law<sup>2</sup> and the individual income tax law<sup>3</sup> to require an addition for the amount of income deferred from federal taxable income under Code section 108(i)(1). Because the taxpayer would be paying State tax on the discharge of indebtedness in 2009 or 2010, a deduction was needed for the tax years 2014 and later to prevent the taxpayer from being double-taxed when the deferred income was reported for federal purposes. The corporate

<sup>1</sup> G.S. 105-228.90(b)(1b), as amended by Session Law 2009-451, section 27A-6.(a)

<sup>2</sup> G.S. 105-130.5(a)(21), as enacted by Session Law 2009-451, section 27A-6.(c)

<sup>3</sup> G.S. 105-134.6(b)(20), as enacted by Session Law 2009-451, section 27A-6.(f)

income tax law<sup>4</sup> and the individual income tax law<sup>5</sup> were also amended to permit a deduction for the amount of income included in federal gross income in tax years 2014 and later because of the election to defer.

As part of the individual income tax simplification actions included in Session Law 2013-316, G.S. 105-134.6 was repealed and G.S. 105-153.5 was enacted in its place. The new statute did not include the corresponding individual income tax deduction to prevent double taxation of the COD income effective for taxable years beginning on or after January 1, 2014. Therefore, an individual who deferred the federal income taxation of the COD until tax year 2014 would be double-taxed on that income. The corporate deduction in G.S. 105-130.5(b)(25) was not impacted by the individual income tax simplification actions; therefore, corporations who deferred the federal income taxation of the COD until tax year 2014 were not double-taxed on that income.

As stated above, the Code generally allowed for the deferral of the COD income until tax year 2014. However, the Code requires an acceleration of the reporting of the deferred income in the case of the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer, the cessation of business by the taxpayer, or similar circumstances. In those cases, any item of income or deduction which was deferred has to be included in gross income in the taxable year in which such event occurs. Therefore, any corporate or individual income taxpayer who was required to include in income the previously deferred income in tax years 2009 through 2013 would be double-taxed on that income because the deductions in North Carolina corporate and individual income tax law applied only to tax years beginning on or after January 1, 2014.

**Legislative Changes:** Session Law 2016-5 included two provisions to prevent the double taxation of income from cancellation of indebtedness. First, a new individual income tax deduction<sup>6</sup> was added for the amount of deferred COD income included in federal adjusted gross income for tax years beginning on or after January 1, 2014. Second, the deductions in corporate income tax law<sup>7</sup> and individual income tax law<sup>8</sup> enacted in 2009 to prevent double taxation for tax years beginning on or after January 1, 2014 were amended so that those deductions apply to tax years beginning on or after January 1, 2009.

**Time Period in Which to Request a Refund:** The above changes mean that a corporate income taxpayer may have an overpayment of corporate income tax for tax years 2009 through 2013 and an individual income taxpayer may have an overpayment of individual income tax for tax years 2009 through 2015. Generally, the statute of limitations for a refund would have expired for tax years prior to 2013. However, the legislation extended

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<sup>4</sup> G.S. 105-130.5(b)(25), as enacted by Session Law 2009-451, section 27A.6.(d)

<sup>5</sup> G.S. 105-134.6(c)(13), as enacted by Session Law 2009-451, section 27A.6.(e)

<sup>6</sup> G.S. 105-153.5(b)(10), as enacted by Session Law 2016-5, section 2.1.(b)

<sup>7</sup> G.S. 105-130.5(b)(25), as amended by Session Law 2016-5, section 1.9.(a)

<sup>8</sup> G.S. 105-134.6(b)(20), as amended by Session Law 2016-5, section 2.4.(a)

the statute of limitations for a refund of the State income tax paid on the deferred COD income to July 1, 2016 for those tax years that would otherwise be barred.<sup>9</sup>

*Example:* In 2009 Company XYZ, a calendar-year taxpayer, reacquired debt of \$1,000,000 by paying the holder of the debt \$800,000. Company XYZ elected to defer including the COD of \$200,000 in federal income beginning in 2014. As required under North Carolina law, Company XYZ reported an addition to federal taxable income of \$200,000 on its 2009 North Carolina C corporation return.

In 2010, Company XYZ ceases business. It is required to accelerate the inclusion of the deferred COD income and includes \$200,000 in federal taxable income. Although Company XYZ made an addition to federal taxable income for the COD income on its 2009 North Carolina return, the North Carolina law in place in 2010 did not allow Company XYZ to deduct the COD income from federal taxable income on its 2010 North Carolina return.

As a result of the law changes described above, Company XYZ may amend its 2010 North Carolina return and deduct the COD income from federal taxable income. The statute of limitations for a refund of the overpayment of tax for tax year 2010 would generally have expired on April 15, 2014. However, as a result of Session Law 2016-5, XYZ Company has until July 1, 2016 to file an amended return requesting a refund of the overpayment of North Carolina income tax for the tax year 2010.

## **2. *Exclusion From Gross Income for Amounts Received by a Wrongfully Incarcerated Individual (Affects only Individual Income Taxpayers)***

**Background:** The Protecting Americans From Tax Hikes Act of 2015 (“PATH”), P.L. 114-113, enacted section 139F of the Internal Revenue Code to allow wrongfully incarcerated individuals to exclude from federal gross income amounts received for civil damages, restitution, or other monetary awards related to the incarceration. The exclusion applies to amounts paid by the federal government or a state government and applies to amounts paid in any year. The Act also waived the federal statute of limitations for refunds for one year from December 18, 2015, the date of enactment of the Act.

North Carolina had a similar provision in tax years 1997 through 2013. The law authorized a deduction from federal gross income for the amount paid to the taxpayer by the State as compensation for pecuniary loss suffered by reason of erroneous conviction and imprisonment.<sup>10</sup> That deduction was repealed effective for taxable years beginning on or after January 1, 2014.

**Legislative Changes:** Session Law 2016-6 included two provisions regarding the exclusion from gross income for amounts received by a wrongfully incarcerated

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<sup>9</sup> Session Law 2016-5, section 6.1

<sup>10</sup> G.S. 105-134.6(b)(14), as enacted by Session Law 1997-388, section 4

individual. First, the North Carolina General Assembly updated North Carolina's reference to the Internal Revenue Code from January 1, 2015 to January 1, 2016.<sup>11</sup> As a result, North Carolina's individual income tax law follows the federal tax laws included in PATH, including the exclusion from gross income for amounts received by a wrongfully incarcerated individual, unless State law specifically decouples from the federal provisions. The law did not decouple from the exclusion so wrongfully incarcerated individuals are allowed to exclude from income amounts received for civil damages, restitution, or other monetary awards related to the incarceration paid by the federal government or a state government for any year in which such amounts were received. Because North Carolina law had provided a similar exclusion for amounts paid by the State in tax years 1997 through 2013, the General Assembly also amended the law to require a taxpayer to make an addition on the State return for tax years prior to January 1, 2014 for amounts received as a result of wrongful incarceration excluded on the federal return to the extent that those amounts were deductible on the State return under G.S. 105-134.6(b)(14).<sup>12</sup>

**Time Period in Which to Request a Refund:** The above changes mean that an individual income taxpayer may have an overpayment of individual income tax for any tax year. Generally, the statute of limitations for a refund has expired for tax years prior to 2013. However, the legislation extended the statute of limitations for a refund of the State income tax paid on income paid to a wrongfully incarcerated individual to December 18, 2016 for those tax years that would otherwise be barred.<sup>13</sup>

*Example:* John Doe, a resident of North Carolina, is incarcerated in federal prison in 2007. In 2010, it is determined that Mr. Doe was wrongfully incarcerated and he is released. He receives \$75,000 from the federal government for his wrongful incarceration. He includes the \$75,000 payment in federal taxable income in 2010. Because the payment was not from the North Carolina government, Mr. Doe is not entitled to the deduction from federal taxable income on his 2010 North Carolina return and, therefore paid both federal and State income tax on the \$75,000 payment.

As a result of the provisions in PATH, Mr. Doe may amend his 2010 federal return to exclude the \$75,000 payment from federal taxable income. As a result of the law changes explained above, North Carolina follows the federal income exclusion. The statute of limitations for a refund of the overpayment of tax for tax year 2010 would generally have expired on April 15, 2014. However, as a result of Session Law 2016-6, Mr. Doe has until December 18, 2016 to file an amended return requesting a refund of the overpayment of North Carolina income tax for the tax year 2010.

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<sup>11</sup> G.S. 105-228.90(b)(1b), as amended by Session Law 2016-6, section 1

<sup>12</sup> G.S. 105-153.5(c2)(4), as enacted by Session Law 2016-6, section 4

<sup>13</sup> Session Law 2016-6, section 5.(a)

### ***How to Request a Refund***

Corporate income taxpayers affected by Issue 1 (COD) of this Notice may file the claim for refund by filing an amended corporate income tax return for the tax year in which the deferred income was included in federal taxable income. The amended return must be filed within the statute of limitations<sup>14</sup> or, if the statute of limitations has expired, by July 1, 2016. Use Form CD-405 and fill in the applicable circle to indicate that the return is an amended return. Form CD-405 may be downloaded by visiting the Department's website at <http://www.dor.state.nc.us/downloads/corporate.html>.

Individual income taxpayers affected by either Issue 1 (COD) or Issue 2 (wrongful incarceration) of this Notice may file the claim for refund by filing an amended individual income tax return for the tax year in which the deferred income or the amounts received due to a wrongful incarceration were included in federal gross income. The amended return for Issue 1 must be filed within the statute of limitations or, if the statute of limitations has expired, by July 1, 2016. The amended return for Issue 2 must be filed within the statute of limitations or, if the statute of limitations has expired, by December 18, 2016. For tax years prior to tax year 2009 and for tax years 2012 through 2014, the amended return form was Form D-400X. For tax years 2009 through 2011, the amended return form was Form D-400X-WS. For tax year 2015, use Form D-400, fill in the applicable circle to indicate that the return is an amended return, and complete and attach Form D-400, Schedule AM. The amended return forms may be downloaded by visiting the Department's website at <http://www.dornc.com/downloads/individual.html>.

Corporate and individual income taxpayers can call the Department at 1-877-252-3052 (toll-free) to request amended return forms by mail. Taxpayers can also call that phone number for additional information or assistance in completing the amended return.

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<sup>14</sup> G.S. 105-241.6