

# North Carolina Legislative and Judicial Update

Presented by Michael Boykin  
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# Agenda

- Corporate Income/Franchise Tax Legislative Update
  - Corporate Income Tax Phase-Out
  - 163(j) Catch-up and Hurricane Ian Relief
  - Corporate Franchise Tax Simplification
  - Corporate Income and Franchise Tax Intercompany Interest Expense Addback Changes
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- Individual Income Tax Legislative Update
  - Individual Income Tax Rate Reduction and Other Changes
  - Enactment of Elective Pass-Through Entity Tax
- Judicial Update
  - *Philip Morris USA vs. Department of Revenue (Parts 1 and 2)*

# *Corporate Tax Legislative Update*



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# Corporate Income Tax Phase-Out

- S.B. 105, enacted November 18, 2021, contained many provisions that impacted both corporate and individual taxpayers in the state.
- Legislation was enacted that phases out the corporate income tax rate over five years:
  - *2.25% for tax years beginning in 2025,*
  - *2% for tax years beginning in 2026,*
  - *1% for tax years beginning in 2028 , and*
  - *0% for tax years beginning after 2029.*
- The legislation was silent with respect to the tax rate applicable for tax years beginning in 2027; the tax rate may be intended to remain at 2% for tax years beginning in that year. Likewise, while the legislation addresses tax years beginning “after” 2029 (i.e., 2030 and beyond), the 1% tax rate may be intended to apply to tax years beginning in 2029.
- The legislation also did not address unused deferred tax assets such as the net operating loss (NOL) deduction or credit carryforwards.
- The state’s general conformity to the Code was also updated to April 1, 2021, including any provisions enacted as of that date that become effective either before or after that date, unless specifically modified.

# 163(j) Catch-Up and Hurricane Ian Relief

- North Carolina generally conforms to the interest expense disallowance provisions of IRC sec. 163(j). However, North Carolina did not conform to the Cares Act which increased the limit of deductible interest expense from 30% of taxpayer's adjusted taxable income to 50% as permitted for federal income tax purposes. Accordingly, taxpayers were required to modify state taxable income for the difference in the calculation utilizing the 30% versus 50% limitation.
- However, legislation was enacted to allow taxpayers required to add back the section 163(j) deductions allowed under the CARES Act to deduct 20% of such amounts in each of the first five years beginning with the 2021 tax year.
- The legislation also provides that amounts disallowed under IRC Section 163(j) are not subject to the state's addback for related-party interest expense.
- Lastly, both the IRS and the N.C. Department of Revenue (NCDOR) announced on Friday, Oct. 7, that federal and state tax relief is available to victims of Hurricane Ian in North Carolina. Neither agency will assess certain late filing and late payment penalties for licenses, returns, or payments due from Sept. 28, 2022, through Feb. 15, 2023,

# Corporate Franchise Tax Simplification

- North Carolina has historically required taxpayers to calculate the franchise tax on three separate bases: 1) a corporation's apportioned net worth; 2) 55% of the appraised value for ad valorem tax purposes of all real and tangible personal property in the state; or 3) 100% of the corporation's total actual investment in tangible property in the state. The taxpayer was required to pay the tax on the base that resulted in the highest tax.
- S.B. 105 simplified the imposition of the franchise tax so that, for tax years beginning on or after January 1, 2023, and applicable to the calculation of franchise tax reported on the 2022 and later corporate income tax return, the franchise tax is only imposed on a corporation's net worth.
- The legislation does potentially impact historic franchise tax planning utilized by several taxpayers.

# Intercompany Interest Addback Changes – Income Tax

- For corporate income tax purposes, a corporation has only been able to deduct the amount of qualified interest expense from a related member for tax years beginning on or after January 1, 2016.
- For tax years beginning on or after January 1, 2017, qualified interest expense is defined as the following:
  - *The amount paid or accrued directly to or through a related member to an ultimate payer, divided by;*
  - *The total net interest expense of all related members paid or accrued directly through a related member to the same ultimate payer, multiplied by;*
  - *The interest amount paid or accrued by the ultimate payer to an unrelated party. Amounts distributed, paid, or accrued through a related member that is not treated as interest for North Carolina income tax purposes does not qualify.*
- Generally, if intercompany interest expense isn't considered to be "qualified interest expense," the corporation is not entitled to a deduction for state income tax purposes.
- Recent legislation (H.B. 83), clarifies that a corporation cannot claim a deduction by creating multiple layers of affiliated debt that meets one of the exceptions from the limitation when, in the end, the ultimate payee is a related member that would not have met the exception.

# Intercompany Interest Addback Changes – Franchise Tax

- North Carolina has traditionally required corporations to make an addition modification for the amount of affiliated indebtedness owed to a parent, subsidiary, affiliate, or noncorporate entity if the corporation or affiliated group directly or indirectly owns 50% or more of the noncorporate entity.
- However, for tax years beginning on or after January 1, 2021, and applicable to the 2020 and later tax returns, a corporation must include an addition to the net worth tax base for the amount of affiliated indebtedness owed that created net interest expense but that does not create qualified interest expense.
- While the provision is considered taxpayer friendly, it has resulted in increased tax for some taxpayers.



# Market Based Sourcing Update

- North Carolina requires taxpayers to apportion income and net worth to the state utilizing a single sales factor – starting in tax year 2020, the state enacted market sourcing of receipts from services and intangibles - under these provisions, services are generally sourced to North Carolina if and to the extent the service is delivered to a location in North Carolina.
- The state has issued significant administrative guidance to assist taxpayers with their analysis of how to apply the new provisions.
- Potentially most important, in those situations when a taxpayer cannot determine the state to which a sale should be sourced, the administrative guidance issued by the Department provides for reasonable approximation – any change in methodology from year to year must be disclosed.

*Individual Income  
Tax Legislative  
Update*



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# Individual Income Tax Changes

- North Carolina imposes its personal income tax at a flat 5.25% rate. S.B. 105 lowered the rate as follows:
  - *4.99% for tax years beginning in 2022,*
  - *4.75% for tax years beginning in 2023,*
  - *4.6% for tax years beginning in 2024,*
  - *4.5% for tax years beginning in 2025,*
  - *4.25% for tax years beginning in 2026, and*
  - *3.99% for tax years beginning after 2026.*

# Individual Income Tax Changes

- S.B. 105 raised the standard deduction and child deduction amounts, effective for tax years beginning on or after January 1, 2022.
- The legislation also eliminated the tax on military pension income, effective for tax years beginning on or after January 1, 2021.
- The legislation also created a separate NOL provision for personal income tax purposes with a 15-year carryforward, effective for tax years beginning on or after January 1, 2022. There are transition rules for utilizing federal NOL carryforwards that were not absorbed in tax years beginning prior to January 1, 2022.

# Pass-Through Entity Tax Legislation

- The legislation also enacted a provision whereby a partnership or S corporation can make an irrevocable annual election to pay an entity-level tax on its timely filed return, effective for tax years beginning on or after January 1, 2022 in order to provide partners and shareholders a federal income tax benefit.
- Tax reform enacted in 2017 capped an individual's itemized tax deduction for state taxes paid to \$10,000 (includes state income, property, personal property, etc.). For states that have enacted a PTET, the pass-through entity making the election will pay tax at the entity level.
- The IRS has issued guidance that, for any entity making the election, the following 3 benefits are realized:
  - *The partnerships and S corporations may deduct state income tax payments at the entity level;*
  - *These payments are not taken into account separately in determining the partner's or shareholder's own federal income tax liability; and*
  - *The payments are not taken into account in determining an individual's \$10,000 itemized tax deduction cap.*

# Pass-Through Entity Tax Legislation

- Under the North Carolina legislation, The tax is applied on the entity's North Carolina taxable income at the personal income tax rate. North Carolina taxable income is computed using each partner/shareholder's share of income or loss attributable to the state, plus each resident partner/shareholder's share of income or loss not attributable to the state.
- Partners may deduct their distributive share of income from the taxed partnership to the extent it was included in the partnership's North Carolina taxable income. Likewise, S corporation shareholders may deduct the amount of their pro rata share of income from the taxed S corporation to the extent included in the S corporation's North Carolina taxable income.
- The following entities are not eligible to make the pass-through entity tax election:
  - *A publicly traded partnership that is described in section 7704(c) of the Code;*
  - *A partnership that has at any time during the taxable year a partner who is not one of the following:*
    - (1) *An individual.*
    - (2) *An estate.*
    - (3) *A trust described in section 1361(c)(2) of the Code.*
    - (4) *An organization described in section 1361(c)(6) of the Code.*

# Pass-Through Entity Tax Legislation

- An eligible entity must make the election by the due date of the pass-through entity's income tax return, including extensions. The election can be revoked as long as it is revoked prior to the filing of the North Carolina return.
- An electing pass-through entity must make estimated state tax payments on a quarterly basis. However, no estimated payments are due for the 2022 tax year – any payments made are considered voluntary.
- An individual taxpayer that is an owner of an electing PTE may deduct the amount of the taxpayer's share of income from the electing PTE to the extent it was included in the PTE's North Carolina taxable income and the taxpayer's adjusted gross income.
- Accordingly, because the individual taxpayer gets a deduction for the amount of income included in the PTE's North Carolina taxable income, a resident individual is not allowed a credit for income taxes paid to another state on their behalf.

# Pass-Through Entity Tax Legislation

- Professionals have identified significant limitations in North Carolina's PTET as currently enacted:
- *North Carolina significantly differs from most states in the treatment of the Owner's income on the North Carolina individual tax return:* by enacting a provision utilizing a deduction rather than credit mechanism, there is a risk of double taxation for resident owners of electing PTEs because no credit for taxes paid to other states is allowed. There is also a lack of parity with other states since most have chosen to enact legislation utilizing a credit mechanism.
- *Owners' eligibility for credit for income taxes paid in other states is dependent on the type of PTE:* The DOR's current interpretation is that owners of an S corporation can get a credit for taxes paid to another state while partners do not which does not conform to the intent of the provision.
- *Certain partnerships are ineligible to become a Taxed PTE:* Examples include tiered partnerships or partnerships owned by corporations.



# *Judicial Update*



# North Carolina – Office of Administrative Hearing

## **Philip Morris USA, Inc. vs. NC Department of Revenue, North Carolina Office of Administrative Hearings, No, 20 REV 04215 (12/30/21)**

- The North Carolina Office of Administrative Hearings found that the franchise tax deduction for receivables made to affiliated corporations violated the dormant Commerce Clause because it allowed a deduction only regarding affiliates doing business in North Carolina.
- There was a burden on interstate commerce that was not applicable to intrastate commerce and, therefore, the deduction denial was unconstitutional as applied to this taxpayer.
- The Department is currently in the process of appealing the decision.

# Philip Morris Part 2

## **Philip Morris USA, Inc. vs. NC Department of Revenue, N.C. Super. Ct., No. 21 CVS 16006 (09/29/22)**

- The North Carolina Superior Court Sept. 29 affirmed the corporate income tax assessment against Philip Morris USA, Inc.
- Taxpayer petitioned the Office of Administrative Hearings' (OAH) decision in favor of the Department of Revenue (DOR) concerning a dispute regarding a tax credit afforded to manufacturers of cigarettes for exportation (Export Credit). The statute authorizing the Export Credit was amended effective Jan. 1, 2005, and the dispute was whether the amended statute prevented Taxpayer from generating Export Credit in excess of \$6 million annually.
- The superior court noted: 1) the amended statute limited the amount of Export Credit Taxpayer could generate in a single year, as well as the amount it could claim in a year, to \$6 million; and 2) the DOR didn't provide erroneous advice on which Taxpayer reasonably relied.



# Thank you

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