

GENERAL ASSEMBLY OF NORTH CAROLINA
1987 SESSION

CHAPTER 1089
HOUSE BILL 2389

AN ACT TO PROVIDE FOR SPECIAL TAX TREATMENT OF SUBCHAPTER S
CORPORATIONS.

The General Assembly of North Carolina enacts:

Section 1. Article 4 of Chapter 105 of the General Statutes is amended by adding after Division I a new Division to read:

"DIVISION I-S. S CORPORATION INCOME TAX.

"§ 105-131. **Title; definitions; interpretation.**—(a) This Division of the income tax Article shall be known and may be cited as the S Corporation Income Tax Act.

- (b) For the purpose of this Division, unless otherwise required by the context:
- (1) 'Business income' means items of income, loss, deduction or credit arising from transactions and activity in the regular course of the S Corporation's trade or business, and includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the S Corporation's regular trade or business operations.
 - (2) 'Code' means the Internal Revenue Code of 1986, as enacted as of January 1, 1988, and includes any provisions enacted as of that date which become effective either before or after that date.
 - (3) 'C Corporation' means a corporation that is not an S Corporation and is subject to the tax levied under Division I of this Article.
 - (4) 'Department' means the Department of Revenue.
 - (5) 'Net income' or 'net loss' shall be the same as the S Corporation's taxable income, as defined in the Code.
 - (6) 'Nonbusiness income' means all items of income, loss, deduction, or credit of the S Corporation other than business income.
 - (7) 'Post-termination transition period' means that period defined in section 1377(b)(1) of the Code.
 - (8) 'Pro rata share' means the share determined with respect to an S Corporation shareholder for a taxable period in the manner provided in section 1377(a) of the Code.
 - (9) 'S Corporation' means a corporation for which a valid election under section 1362(a) of the Code is in effect.
 - (10) 'Secretary' means the Secretary of Revenue.
 - (11) 'Taxable period' means any taxable year or portion of a taxable year during which a corporation is an S Corporation.

(c) Except as otherwise expressly provided or clearly appearing from the context, any term used in this Division shall have the same meaning as when used in a comparable context in the Code, or in any statute relating to federal income taxes, in effect during the taxable period. Due consideration shall be given in the interpretation of this Division to applicable sections of the Code in effect and to federal rulings and regulations interpreting such sections, except where the Code, ruling, or regulation conflicts with the provisions of this Division.

"§ 105-131.1. Taxation of an S Corporation and its shareholders.—(a) An S Corporation shall not be subject to the tax levied under G.S. 105-130.3.

(b) Each shareholder's pro rata share of an S Corporation's net income or net loss, to the extent apportioned and allocated to this State pursuant to G.S. 105-130.4, shall be taken into account by the shareholder in the manner and subject to the adjustments provided in G.S. 105-131.2 and section 1366 of the Code and shall be subject to the tax levied under Division II of this Article.

"§ 105-131.2. Apportionment, allocation, adjustment, and characterization of income.—(a) Allocation of Net Income. The net income of an S Corporation shall be allocated and apportioned to this State as provided in G.S. 105-130.4.

(b) Allocation of Shareholder's Pro Rata Share.

- (1) The pro rata share of each resident and nonresident shareholder in the business income of the S Corporation apportioned to this State under subsection (a) of this section shall, for purposes of G.S. 105-131.1(b), be taken into account by the shareholder subject to the adjustments in determining State net income as provided in G.S. 105-130.5.
- (2) The pro rata share of each resident shareholder in (i) the business income of the S Corporation not apportioned to this State under subsection (a) above, and (ii) the entire nonbusiness income of the S Corporation, shall, for purposes of G.S. 105-131.1(b), be taken into account by the shareholder subject to the adjustments in determining State net income for items exempt from taxation in the State under G.S. 105-141(b).
- (3) The pro rata share of each nonresident shareholder in the nonbusiness income of the S Corporation allocated to this State under subsection (a) above, shall, for purposes of G.S. 105-131.1(b), be taken into account by the shareholder subject to the adjustments in determining State net income as provided in G.S. 105-130.5.

(c) Characterization of Income. S Corporation items of income, loss, deduction, and credit taken into account by a shareholder pursuant to G.S. 105-131.1(b) shall be characterized for purposes of this Division as though received or incurred by the S Corporation and not its shareholder.

"§ 105-131.3. Basis and adjustments.—(a) The initial basis of a resident shareholder in the stock of an S Corporation and in any indebtedness of the corporation owed to that shareholder shall be determined, as of the later of the date the stock is acquired, the effective date of the S Corporation election, or the date the shareholder became a resident of this State, as provided under the Code.

(b) The basis of a resident shareholder in the stock and indebtedness of an S Corporation shall be adjusted in the manner and to the extent required by section 1011 of the Code except that:

- (1) Any adjustments made to the S Corporation's business income and nonbusiness income pursuant to G.S. 105-131.2 shall be taken into account; and
- (2) Any adjustments made pursuant to section 1367 of the Code for a taxable period during which this State did not measure S Corporation shareholder income by reference to the corporation's income shall be disregarded.

(c) The initial basis of a nonresident shareholder in the stock of an S Corporation and in any indebtedness of the corporation to that shareholder shall be zero.

(d) The basis of a nonresident shareholder in the stock and indebtedness of an S Corporation shall be adjusted as provided in section 1367 of the Code, except that adjustments to basis shall be limited to the business income and nonbusiness income taken into account by the shareholder pursuant to G.S. 105-131.1(b).

(e) The basis of a shareholder in the stock of an S Corporation shall be reduced by the amount allowed as a loss or deduction pursuant to G.S. 105-131.4(c).

(f) The basis of a resident shareholder in the stock of an S Corporation shall be reduced by the amount of any cash distribution that is not taxable to the shareholder as a result of the application of G.S. 105-131.6(b).

"§ 105-131.4. Carryforwards; loss limitation.—(a) Carryforwards from an S Corporation shall be restricted in the manner provided in section 1371(b) of the Code.

(b) The aggregate amount of losses or deductions of an S Corporation taken into account by a shareholder pursuant to G.S. 105-131.1(b) may not exceed the combined adjusted bases, determined in accordance with G.S. 105-131.3, of the shareholder in the stock and indebtedness of the S Corporation.

(c) Any loss or deduction that is disallowed for a taxable period pursuant to subsection (b) of this section shall be treated as incurred by the corporation in the succeeding taxable period with respect to that shareholder.

- (d) (1) Any loss or deduction that is disallowed pursuant to subsection (b) of this section for the corporation's last taxable period as an S Corporation shall be treated as incurred by the shareholder on the last day of any post-termination transition period.
- (2) The aggregate amount of losses and deductions taken into account by a shareholder pursuant to subdivision (1) of this subsection may not exceed the adjusted basis of the shareholder in the stock of the corporation (determined in accordance with G.S. 105-131.3 at the close of the last day of any post-termination transition period and without regard to this subsection).

"§ 105-131.5. Part-year resident shareholder.—If a shareholder of an S Corporation is both a resident and nonresident of this State during any taxable period, the shareholder's pro rata share of the S Corporation's business income and nonbusiness income determined pursuant to G.S. 105-131.2 shall be further prorated between the

shareholder's periods of residence and nonresidence, in accordance with the number of days in each period.

"§ 105-131.6. Distributions.—(a) Subject to the provisions of subsection (c) of this section, a distribution made by an S Corporation with respect to its stock to a resident shareholder shall be taxable to the shareholder under Division II of this Article only to the extent that the distribution is characterized as a dividend or as gain from the sale or exchange of property pursuant to section 1368 of the Code.

(b) Subject to the provisions of subsection (c) of this section, any distribution of money made by a corporation with respect to its stock to a resident shareholder during a post-termination transition period shall not be taxable to the shareholder under Division II of this Article to the extent the distribution is applied against and reduces the adjusted basis of the stock of the shareholder in accordance with section 1371(e) of the Code.

(c) In applying sections 1368 and 1371(e) of the Code to any distribution referred to in this section:

- (1) The term 'adjusted basis of the stock' means the adjusted basis of the shareholder's stock as determined under G.S. 105-131.3; and
- (2) The accumulated adjustments account maintained for each resident shareholder shall be equal to, and shall be adjusted in the same manner as, the corporation's accumulated adjustments account defined in section 1368(e)(1)(A) of the Code, except that:
 - a. The accumulated adjustments account shall be modified in the manner provided in G.S. 105-131.3(b)(1); and
 - b. The amount of the corporation's federal accumulated adjustments account that existed on the day this State began to measure the S Corporation shareholders' income by reference to the income of the S Corporation shall be ignored and shall be treated for purposes of Divisions I and II of this Article as additional accumulated earnings and profits of the corporation.

"§ 105-131.7. Returns; shareholder agreements; mandatory withholding.—(a) An S Corporation incorporated or doing business in the State shall file with the Department an annual return, on a form prescribed by the Secretary, on or before the due date prescribed for the filing of C Corporation returns in G.S. 105-130.17. The return shall show the name, address, and social security or federal identification number of each shareholder, the allocations and apportionments of income to this State with respect to each shareholder as determined under G.S. 105-131.2, and such other information as the Secretary may require.

(b) The Department shall permit S Corporations to file composite returns and to make composite payments of tax on behalf of some or all nonresident shareholders. The Department may permit S Corporations to file composite returns and make composite payments of tax on behalf of some or all resident shareholders.

(c) An S Corporation shall file with the Department, on a form prescribed by the Secretary, the agreement of each nonresident shareholder of the corporation (i) to file a return and make timely payment of all taxes imposed by this State on the shareholder with respect to the income of the S Corporation, and (ii) to be subject to personal

jurisdiction in this State for purposes of the collection of any unpaid income tax, together with related interest and penalties, owed by the nonresident shareholder. If the corporation fails to timely file an agreement required by this subsection on behalf of any of its nonresident shareholders, then the corporation shall at the time specified in subsection (d) of this section pay to the Department on behalf of each nonresident shareholder who fails to execute such an agreement an amount equal to seven percent (7%) of the shareholder's pro rata share of the S Corporation's net income apportioned and allocated to this State pursuant to G.S. 105-130.4 and adjusted pursuant to G.S. 105-131.2.

(d) The agreements required to be filed pursuant to subsection (c) of this section shall be filed at the following times:

- (1) At the time the annual return is required to be filed for the first taxable period for which the S Corporation becomes subject to the provisions of this Division; and
- (2) At the time the annual return is required to be filed for any taxable period in which the corporation has a nonresident shareholder on whose behalf such an agreement has not been previously filed.

(e) Amounts paid to the Department on account of the corporation's shareholders under subsections (b) and (c) shall constitute payments on their behalf of the income tax imposed on them under Division II of this Article for the taxable period.

"§ 105-131.8. Tax credits.—(a) Each shareholder of an S Corporation shall be allowed as a credit against the tax imposed by Division II of this Article in an amount equal to the shareholder's pro rata share of the tax credits described in G.S. 105-130.22 through G.S. 105-130.39 for which the S Corporation is eligible."

Sec. 2. G.S. 105-130.13 is repealed.

Sec. 3. G.S. 105-141(a) is amended by adding at the end a new subdivision to read:

"(23) The taxpayer's pro rata share of an S Corporation's net income taken into account by the taxpayer as provided in G.S. 105-131.1(b)."

Sec. 4. G.S. 105-147(7) reads as rewritten:

"(7) Dividends from stock issued by any corporation to the extent herein ~~provided.~~ provided, except that no deduction shall be allowed for dividends issued with respect to a taxable period during which the corporation is an S Corporation subject to the provisions of Division I-S of this Article. As soon as may be practicable after the close of each calendar year, the Secretary of Revenue shall determine from each corporate income tax return filed with him during such year, and due from the filing corporation during such year, the proportion of the entire net income or loss of the corporation allocable to this State under the provisions of G.S. 105-130.4, except as provided herein; if a corporation has a net taxable income in North Carolina and a net loss from all sources wherever located, or, if a corporation has a net loss in North Carolina and a net income from all sources wherever located, the Secretary shall require the use of the allocation fraction determined

under the provisions of G.S. 105-130.4. A taxpayer who is a stockholder in any such corporation shall be allowed to deduct from his gross income the same proportion of the dividends received by him from such corporation during his income year ending at or after the end of such calendar year. Provided that notwithstanding any other provision of this subdivision, a taxpayer who is a stockholder in a holding company as defined in G.S. 105-130.7(5) shall determine the deductible portion of dividend received from such holding company as provided therein. No deduction shall be allowed for any part of any dividend received by such taxpayer from any corporation which filed no income tax return with the Secretary of Revenue during such calendar year. Dividends received by a taxpayer from stock in any insurance company of this State taxed under the provisions of G.S. 105-228.5 shall be deductible from the gross income of such taxpayer, and a proportionate part of any dividends received from stock in any foreign insurance corporation shall be deductible, such part to be determined on the basis of the ratio of premiums reported for taxation in this State to total premiums collected both in and out of the State. Dividends received on shares of capital stock owned in a stock-owned savings and loan association taxed under Article 8D of this Chapter shall be deductible. A taxpayer shall be allowed to deduct such proportionate part of dividends received by him from a regulated investment company and real estate investment trust as defined in G.S. 105-130.12 as represents and corresponds to income received by such regulated investment company and real estate investment trust which would not be taxed by this State if received directly by the North Carolina resident. In no case shall the total amount of dividends that are deducted from a taxpayer's gross income as a result of the application of the provisions of this subdivision be in excess of fifteen thousand dollars (\$15,000) for the taxable year, except that for taxable years beginning on or before June 30, 1990, this limitation shall not apply to dividends received from a corporation for which with respect to a taxable period during which a valid election to be taxed under Subchapter S of Chapter 1 of the Code is was in effect."

Sec. 5. G.S. 105-130.3 reads as rewritten:

"§ 105-130.3. Corporations.—Every corporation doing business in this State shall pay annually an income tax equivalent to seven percent (7%) of its net income or the portion thereof allocated and apportioned to this ~~State.~~ State, except that an S Corporation subject to the provisions of Division I-S of this Article shall not be subject to the tax levied by this section.

The net income or net loss of such corporation shall be the same as 'taxable income' as defined in the Code subject to the adjustments provided in G.S. 105-130.5.

If the entire business of the corporation is done within this State or if the corporation is not taxable in another state within the meaning of subsection (b) of G.S. 105-130.4,

the tax shall be measured by the entire net income of the corporation for the income year.

If the business of the corporation is taxable both within and without this State, its entire net income or net loss shall be allocated and apportioned in accordance with the provisions of G.S. 105-130.4."

Sec. 6. This act is effective for taxable years beginning on or after July 1, 1990.

In the General Assembly read three times and ratified this the 8th day of July, 1988.