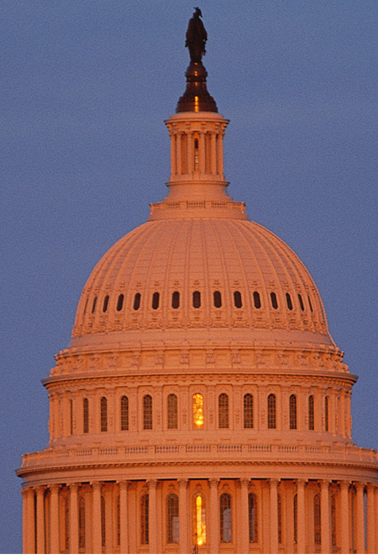
KPMG

TaxNewsFlash

United States



No. 2021-466
November 30, 2021

North Carolina: Tax changes in budget legislation

The governor of North Carolina on November 18, 2021, signed a long-delayed budget bill that includes several significant income tax and franchise tax changes.

Read **Senate Bill 105** [PDF 3.9 MB]

Corporate income tax phase-out

The legislation lays the groundwork to eliminate the current 2.5% state corporate income tax by 2030.

- For tax years beginning on or after January 1, 2025, the rate is reduced to 2.25%.
- For tax years beginning on or after January 1, 2026, the rate is reduced to 2%.
- For tax years beginning on or after January 1, 2028, the rate is reduced to 1%.
- For tax years beginning on or after January 1, 2030, the rate is reduced to 0%.

Franchise tax base changes

Currently, the corporate franchise tax base is based on the greater of three calculations—a proportion of the corporation's net worth, 55% of the corporation's appraised value, or the corporation's actual investment in tangible property in the state. Effective for tax years beginning on or after January 1, 2023 (applicable to the calculation of franchise tax reported on the 2022 return), the franchise tax will be determined solely by measuring the net worth of a corporation.

Conformity update and corporate tax base changes

The budget bill updates the state's conformity to the Internal Revenue Code (IRC) as enacted as of April 1, 2021. Previously, North Carolina was tied to the IRC as in effect on May 1, 2020.

In addition, North Carolina was one of the few states that decoupled from the federal provisions allowing taxpayers to deduct expenses paid with forgiven Paycheck Protection Program (PPP) loan proceeds. Effective for tax years beginning on or after January 1, 2023, the budget bill revises language requiring an addback for the amount of any expense deducted under the IRC to the extent that payment of the expense resulted in forgiveness of a covered loan pursuant to a provision (section 1106(b)) of the CARES Act, and the income associated with the forgiveness is excluded from gross income pursuant to section 1106(i) of the CARES Act. As revised, an addback is required for the amount of any expense deducted under the IRC to the extent that the expense is allocable to income that is either wholly excluded from gross income or exempt from corporate income tax.

Under North Carolina law, for the 2019 and 2020 tax years, an addition modification is required for the amount of the IRC section 163(j) limitation that exceeds the amount allowed under the IRC as in effect on January 1, 2020, as calculated on a separate entity basis. The budget bill adds a sentence stating that an addback for the CARES Act-related IRC section 163(j) amount is not required to the extent the interest expense was added back under another provision (e.g., the state's general intercompany interest expense disallowance statute). In addition, taxpayers that make the IRC section 163(j) decoupling addition for the 2019 and 2020 tax years are allowed a subtraction for 20% of the IRC section 163(j) addition amount (assuming the amount was not required to be added back the intercompany interest expense disallowance statute). For taxpayers that made the IRC section 163(j) decoupling addition for the 2019 and 2020 tax years, the subtraction modification is to be made for each of the first five tax years beginning with the 2021 tax year.

Finally, the budget bill modifies the intercompany interest expense disallowance provisions to provide an additional exception to interest expense addback if the interest amount paid or accrued to a related member has already been disallowed under IRC section 163(j).

Individual income tax

The budget bill reduces the individual (personal) income tax rate incrementally over a period of years from the 2021 rate of 5.25% to 3.99% for tax years beginning after 2026.

In addition, the legislation increases the amount of the standard deduction (from $21,500 to $25,500 for married taxpayers filing jointly) and creates a new "child deduction" for taxpayers who are eligible for the federal child tax credit. The maximum amount of the child deduction is $3,000, but the allowable deduction decreases based on adjusted gross income (AGI) and filing status and phases out for incomes (married filing jointly) over $140,000. These changes are effective for tax years beginning on or after January 1, 2022.

The legislation also allows a deduction for certain military pension income received during the year effective for tax years beginning on or after January 1, 2021.

The budget bill also revises several itemized deductions and AGI modifications including charitable contributions, discharge of principal residence indebtedness, discharge of student debt, unemployment compensation, and business-related expenses for food and beverages provided by a restaurant. These provisions have varying effective dates, with at least one (the addback of unemployment compensation) being retroactive to the 2020 tax year.

The budget bill creates a separate state net operating loss (NOL) deduction for individual taxpayers, effective for tax years beginning on or after January 1, 2022. A North Carolina NOL may be carried forward for 15 tax years. For nonresidents, the NOL computation includes only income and deductions derived from a business carried on in North Carolina in the year of the loss. In computing the amount of the NOL, losses from sales or exchanges of capital assets may not exceed the amount of gains from sales or exchanges of capital assets. Similarly, losses that are not attributable to the taxpayer's trade or business are allowed only to the extent of gross income not derived from the trade or business. Small business stock gains may not be excluded from the computation. Further, no deduction is allowed for the North Carolina child deduction or the IRC section 199A deduction of income from a qualified trade or business. Transition rules apply to federal NOL carryforwards that had not been fully utilized by January 1, 2022.

Pass-through entity tax

Like other states that have enacted an elective pass-through entity tax as a state and local tax (SALT) deduction cap "workaround," North Carolina's budget bill includes provisions that permit certain partnerships and S corporations to elect to pay an income tax at the entity level. For tax years beginning on or after January 1, 2022, the elective tax is paid at the North Carolina income tax rate, which is set at 4.99% for tax years beginning in 2022. (As detailed above, that rate will be reduced in future tax years.) The election must be made on the entity's timely filed annual return and becomes irrevocable once the due date of the return, including extensions, has passed. Entities that are not allowed to make the election include publicly traded partnerships and partnerships that, at any time during the taxable year, have a partner that is not an individual, estate, certain trusts (as described in IRC section 1361(c)(2)), or an exempt organization as described in IRC section 1361(c)(6). Thus, a partnership with a partner that is a corporation or another partnership (or other entity treated as a partnership for federal income tax purposes) will not be permitted to make the pass-through entity tax election. A partnership or S corporation that makes the election is no longer required to make withholding payments on behalf of its nonresident partners or shareholders.

The tax base of the electing pass-through entity for resident partners and shareholders includes all the distributive or pro rata share of income, whether sourced to North Carolina or not. For nonresident partners and shareholders, only the distributive or pro rata share of income that is sourced to North Carolina is included in the entity's tax base. Separately stated federal deductions are not included in the pass-through entity tax base, although separately stated items of income appear to be included. The computation of the tax base includes various North Carolina adjustments, including the IRC decoupling amendments as described above.

Taxes paid by an electing partnership to other states are taken by the partnership as a credit against the partnership's North Carolina elective tax. Electing S corporations are allowed a credit against the North Carolina pass-through entity tax for income taxes imposed by and paid to another state or country on income attributable to resident shareholders in the North Carolina pass-through entity tax base. Partners and shareholders of an electing pass-through entity are not permitted to include taxes paid to other states by the pass-through entity in the owner's computation of the tax credit for income taxes paid to other states.

The partner or shareholder will exclude its distributive or pro-rata share of income and loss that was included in the passthrough entity's tax base. The legislation provides that a partner or shareholder's basis in the pass-through entity will continue to be computed as if the pass-through entity did not elect to pay the pass-through entity tax.

Late-payment penalties

The legislation reduces the failure-to-pay penalty for tax due from a flat 10% of the amount of tax in question to 2% of the amount of tax if the failure is for not more than one month, with an additional 2% for each additional month, not to exceed 10% in the aggregate. This change applies with respect to tax assessed on or after July 1, 2022.

For more information, contact a KPMG State and Local Tax professional:

Nikki Emanuel Jarrell | +1 704 335 5344 | nemanuel@kpmg.com

Adam McLamb | +1 704 371 8216 | amclamb@kpmg.com

David Tucker | +1 704 371 8247 | dtucker@kpmg.com

Frank Harrell | +1 980 859 8807 | fharrell@kpmg.com

kpmg.com/socialmedia

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.