

## RESOURCES

# North Carolina Department of Revenue Provides New Guidance on the New North Carolina Net Business Income Deduction For 2012

**Background.** In the summer of 2011, the North Carolina legislature enacted **new** N.C.G.S. 105-134.6(b)(22), which allows for a new personal income tax deduction of up to \$50,000 of net “business income” received during the year for North Carolina tax purposes. The new deduction applies beginning with the 2012 tax year.

The term “business income” does not include income that is considered “passive” under the federal tax code. And, if both spouses receive “business income” during the year, the maximum dollar amounts apply separately, so the married couple can deduct up to \$100,000 of net business income for North Carolina tax purposes beginning in 2012.

**NCDOR Issues a New Directive to Interpret the New Individual Income Tax Deduction for Net Business Income.** Many practitioners have long wondered how the new deduction rules would apply for our closely-held business clients. Fortunately, on June 11, 2012, the NCDOR issued a new Directive (No. PD-12-2) interpreting the new “Net Business Income Tax Deduction” for North Carolina income tax purposes. The Directive provides answers in a “frequently asked questions” (FAQ) format and provides some guidance on how the new Net Business Income deduction will operate.

In this Directive, the Department of Revenue made the following observations:

**1. S Corporation Wages Are Not “Business Income” of an S Corporation.** First, the Directive states that, for purposes of determining the net business income of an S Corporation, wages paid to the S Corporation owners are **not** considered to be net business income.

Example:

The taxpayer is a 25% shareholder of an S corporation from which he receives non-passive income. The taxpayer reports \$25,000 of the non-passive income on his Schedule E resulting from \$25,000 of ordinary income as shown on his Form 1120-S K-1. The \$25,000 is the shareholder’s portion of \$240,000 total S corporation income, less \$140,000 of wages paid to the S Corporation owner and to other employees (S corporation net income of \$100,000).

Answer:

In this example, the total non-passive income of the S Corporation is \$100,000 (\$240,000 total income minus \$140,000 of wages). In this example, the taxpayer may claim a net business income tax deduction of only \$25,000, even though the S Corporation shareholder also received wages from his S Corporation. In other words, the wages paid to the S corporation shareholder by the S corporation will **not** count as “net business income.”

**2. Next, the Directive advises that all of the taxpayer’s net business income and net business losses must be aggregated *before* determining the net business income tax deduction for the year .**

Example:

The Taxpayer reports a net profit of \$60,000 from a non-passive business activity on his federal Schedule C and a

partnership loss of \$70,000 from a non-passive business activity on his federal Schedule E. Is the taxpayer entitled to any net business income deduction?

Answer:

No. If non-passive losses exceed non-passive income, the taxpayer is not entitled to any net business income deduction for the year.

**3. However, the Directive also provides that non-passive income from one spouse is *not reduced* by the non-passive loss of the other spouse .**

Example:

Taxpayers are a married couple filing jointly. Mr. Taxpayer reports a net loss of \$60,000 from a non-passive business activity on his federal Schedule C and Mrs. Taxpayer reports partnership income of \$70,000 from a non-passive business activity on Schedule E.

Question:

Are the taxpayers entitled to a deduction?

Answer:

Here, the Department advises that the Taxpayers may claim a net business income deduction of \$50,000 against Mrs. Taxpayer's non-passive partnership income. That is because the maximum dollar amount of the deduction is applied separately to each spouse. So in this example, although Mr. Taxpayer suffered a loss from a non-passive activity, the Taxpayers may claim a net business income tax deduction of \$50,000 against the non-passive income from Mrs. Taxpayer's partnership income, since Mr. Taxpayer's sustained net loss is not offset against Mrs. Taxpayer's non-passive income.

**4. Fourth, the Directive again advises how the \$50,000 maximum dollar amount deduction is applied separately to non-passive income for each spouse of two spouses filing a joint return where both spouses have non-passive income.**

Example:

Taxpayers are a married couple filing jointly. Mr. Taxpayer reports a net profit of \$20,000 from his non-passive business activity on his federal Schedule C and Mrs. Taxpayer reports a net profit of \$60,000 from an unrelated non-passive business activity on federal Schedule C.

Question:

What deductions are available to the taxpayers?

Answer:

The answer is that the taxpayers are entitled to claim a net business income deduction of \$70,000 (\$20,000 for husband and \$50,000 for wife).

**5. And finally, the Directive also makes it clear that married taxpayers may be entitled to net business income tax deductions for non-passive income generated through the *same* pass-through business entity.**

Example:

Taxpayers are a married couple filing jointly. Mr. Taxpayer owns 60% of a pass-through entity and Mrs. Taxpayer owns the other 40%. Mr. Taxpayer reports \$60,000 of non-passive income from the pass-through activity and Mrs. Taxpayer reports \$40,000 of income from the pass through entity on federal Schedule E.

Question:

What is the deduction available to the taxpayers?

Answer:

The answer here is the taxpayers are entitled to claim a net business deduction of \$90,000 (\$50,000 for husband and \$40,000 for wife).

**Conclusion.** Although many other questions remain about application of the new rules to specific client situations, the North Carolina Department of Revenue has provided some clarity as to how the new rules will operate.

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