North Carolina Department of Revenue

Beverly Eaves Perdue
Governor

Kenneth R. Lay
Secretary

October 15, 2010

[redacted]

Re: Request for a Private Letter Ruling -- Service Income from Sources outside North Carolina

Dear [redacted]:

This letter is in response to your letter dated [redacted]. According to your letter, you are the sole shareholder and employee of a subchapter S corporation, and you anticipate retiring and moving your business to North Carolina. In consideration of your contemplated move to this State, you requested that the North Carolina Department of Revenue provide clarification as to whether you are required to pay an income tax on commissions earned from activities conducted while your business was located and operated outside of North Carolina.

The determination as to how the commissions will be taxed in North Carolina hinges on the state of your residency. An individual shareholder of an S corporation is required to take into account his pro rata share of an S corporation's net income in the manner provided under Section 1366 of the Internal Revenue Code subject to certain adjustments. G.S. 105-134.5 defines North Carolina taxable income. A resident of North Carolina is subject to tax on all income received from all sources. Nonresidents and part-year residents must prorate to determine the amount of federal taxable income (as adjusted by the required State additions and deductions that impact gross income) that is subject to North Carolina individual income tax.

For nonresidents, the numerator of the proration percentage includes the taxpayer's gross income (as adjusted by the applicable additions and deductions) derived from North Carolina sources and is (1) attributable to ownership of any interest in real or tangible personal property in this State, (2) derived from a business, trade, profession, or occupation carried on in this State, or (3) derived from gambling activities in this State. The denominator of the proration percentage is the taxpayer's federal gross income, adjusted by the required State additions and deductions impacting gross income.

For part-year residents, the numerator is a sum of (1) all income received during the period the individual was a legal resident and (2) the income derived from North Carolina sources during the part of the tax year the individual was a non-resident, as adjusted by the State applicable additions and deductions (for differences between federal and State law) impacting gross income. Importantly, your inquiry concerns the taxability of commissions received by the S Corporation that flows through to the shareholder at the individual income tax level. If none of this income was derived from North Carolina sources, then none would be subject to individual income tax during the period the taxpayer was a nonresident. However, as previously explained, all income from all sources is subject to individual income tax to a resident of North Carolina.

Relief through a "tax credit for income taxes paid to other states by individuals" is provided to North Carolina residents under G.S. 105-151 for income that has also been taxed by another state or country. This tax credit is computed on the Form D-400TC, the individual income tax credit summary form.

In addition to the personal income tax levied at the shareholder level, the S Corporation itself is subject to the general business franchise tax imposed under G.S. 105-122. All active and inactive domestic corporations, and all foreign corporations with a Certificate of Authority to do business, or which are in fact doing business in this State, are subject to the annual franchise tax levied under the statute. The basis of the tax is total or allocated capital stock, surplus and undivided profits. The basis is the same for both domestic and foreign corporations. Every corporation permitted to apportion its net income for income tax purposes under the provisions of G.S. 105-130.4 must apportion its capital stock, surplus and undivided profits for franchise tax purposes through use of the same fraction computed for apportionment of its apportionable income under G.S. 105-130.4. Regardless of the actual amount of capital stock, surplus and undivided profits, the amount determined for purposes of this tax cannot be less than fifty-five percent (55%) of appraised ad valorem tax value of all tangible property plus value of intangible property in North Carolina, nor less than the actual investment in tangible property in North Carolina.

Under the provisions of G.S. 105-130.4, a corporation must have taxable business activity in another state pursuant to Public Law 86-272 in order to apportion or allocate its net income or net loss outside of this State. Even if the state in which the taxable activity is conducted does not exercise its jurisdiction to impose the tax, as in your case, a corporation may still apportion its net income or net loss to this State under the aforementioned statute. If a corporation has the right to apportion its income pursuant to the statute, it must apportion its income as prescribed unless the corporation is authorized to use an alternative factor by the Secretary of Revenue. Specifically, subsection (l)(3)(c) of the statute requires a corporation that receives its receipts from services to source those receipts to North Carolina if the services are performed in this State. Since the commissions in question were earned from activities that were conducted outside North Carolina, those receipts should be rightfully excluded from the numerator of the sales factor in computing your apportionment percentage.

Please note that the statement in the Q&A section of our website refers to a domestic corporation's inability to apportion its income. A domestic corporation that does not have taxable business activities in at least one other state must report 100% of its sales to this State. North Carolina does not have a "throwback rule" for multistate corporations that apportion income pursuant to the statutes, provided the corporation is taxable in at least one other state. Therefore, for purposes of computing the apportionment factor to be applied to the franchise capital stock base, you may exclude the commissions earned outside of this State from the numerator of your sales factor pursuant to the statute mentioned above.

This ruling is based solely on the facts submitted to the Department of Revenue for consideration of the transactions described. If the facts and circumstances given are not accurate, or if there are other facts that were not disclosed that might cause the Department to reach a different conclusion, then the taxpayer requesting this ruling may not rely on it. A letter ruling is not equivalent to a Technical Advice Directive that generally affects a large number of taxpayers. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material aspect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that this document is not to be cited as precedent and that a change in statute, a regulation, or case law could void this ruling.

Very truly yours,

[redacted]