

AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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### SUBJECT

## NORTH CAROLINA ENACTS LEGISLATION IMPACTING INTANGIBLE HOLDING COMPANIES

### SUMMARY

On May 11, 2016, North Carolina Governor Pat McCrory (R) signed S.B. 729, which, for taxable years beginning after December 31, 2015, decreases the Corporation Income Tax related member interest expense deduction from 30 percent to 15 percent, and effectively establishes a conduit exception. S.B. 729 also requires a taxpayer that receives a royalty payment from a related member to include the receipt in the sales factor even if the payer and the recipient elects to exclude the payment from the recipient's income.

### DETAILS

#### *Related Member Interest Expense Deduction*

Prior to the enactment of S.B. 729, under H.B. 97, which was enacted September 18, 2015, the related party interest expense deduction was simply limited to 30 percent of the taxpayer's taxable income. Under S.B. 729, the amount of related party interest expense is limited to the greater of: (i) 15 percent of the taxpayer's taxable income; or (ii) the taxpayer's proportionate share of interest paid or accrued to a person who is not a related member during the same taxable year. As noted, this provision is effective for taxable years beginning after December 31, 2015.

#### *Conduit Exception*

Under S.B. 729, proportionate share of interest for purposes of the related member interest expense deduction limitation is defined to mean the amount of the taxpayer's net interest expense paid to (or through to) a related member that pays the interest to an unrelated member, divided by the total net interest expense of all related members that is paid to (or through to) the same related member that pays the interest to an unrelated member,

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multiplied by the interest paid to an unrelated member by the related member that pays the interest to an unrelated member. Thus, the proportionate share of interest limitation effectively creates a conduit exception where the related member interest expense exceeds the 15-percent limitation, and payment of the related member interest can be traced to an unrelated member.

### *Sales Factor*

Where a taxpayer elects to add-back a deduction for related party royalty expense and exclude the related income from the recipient (i.e., in lieu of taking the deduction and including the payment in the income of the recipient), under S.B. 729, the recipient may not exclude the royalty payments from its calculation of sales under S.B. 729. This provision is effective May 11, 2016.

## BDO INSIGHTS

- ▶ While a reduction in the related member interest expense deduction limitation to 15 percent may adversely affect some taxpayers, taxpayers who can trace payment of the interest expense to an unrelated member may find the law change more beneficial.
- ▶ The provision related to the requirement to include related party royalty payments in the sales factor, even where the income itself is excluded from the tax base, appears to be a codification of existing Department policy.
- ▶ Since the new law was enacted on May 11, 2016, North Carolina Corporation Income Tax taxpayers should assess what, if any, impact these law changes may have on their existing deferred tax balances, and adjust accordingly as of the enactment date.

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