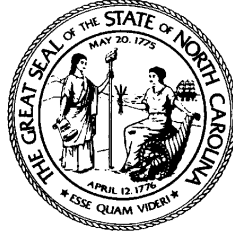


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# North Carolina Department of Revenue

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## **DIRECTIVE**

**Subject:** Effect of Separately Stated Items of Income on Income Tax Returns Filed By Pass-through Entities  
**Tax:** Corporate and Individual Income  
**Law:** G.S. 105-131.7; G.S. 105-154  
**Issued By:** Corporate, Excise, and Insurance Tax Division;  
Personal Taxes Division  
**Date:** February 16, 2004  
**Number:** CD-04-1

This Directive addresses changes to Form 4797, Form 1065, and Form 1120S recently announced by the Internal Revenue Service and the effect of those changes on North Carolina S corporation and partnership income tax returns. If you have questions about the filing of S corporation returns, you may call the Corporate, Excise and Insurance Tax Division at (919) 733-8510. Questions about the filing of partnership returns and individual shareholder or partner income tax returns may be directed to the Personal Taxes Division at (919) 733-3565. You may also write to either of the Divisions at P.O. Box 871, Raleigh, N.C. 27602-0871.

### **Change in Method of Reporting Certain Income on Federal Income Tax Returns**

Effective with income tax returns for the tax year 2003, the Internal Revenue Service has changed how pass-through entities and their owners report dispositions of Code Section 1231 property for which a Section 179 expense deduction was passed through to the entity's owners.

In prior years, pass-through entities reported gains and losses from the sale, exchange, or other disposition of Section 1231 property on Form 4797 filed with the entity's income tax return. The gain or loss was determined by including recapture of the Section 179 deduction without regard to whether the individual owners to which the expense deduction was attributed actually received full benefit of the deduction. The gain or loss on Form 4797 was attributed to the individual owners and reported as part of the owner's share of the net income of the pass-through entity on Schedule K-1.

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As revised, if the pass-through entity had previously passed through a Section 179 expense deduction on Section 1231 property being sold, exchanged, or disposed of, the gain or loss is no longer included on the entity's Form 4797 nor reported as part of the owner's share of the net income of the entity on Schedule K-1. Instead, the disposition is separately stated on the K-1 and included on the individual owner's Form 4797. As a result, the gain or loss is still included in the owner's federal taxable income but it is not included as part of the owner's share of the pass-through entity's income.

### **Effect on North Carolina Income Tax Returns for 2003**

Pursuant to G.S. 105-131.7, an S corporation incorporated or doing business in North Carolina must file an annual North Carolina S corporation tax return (Form CD-401S) showing the amount of income attributable to this State and the amount of income not attributable to this State for each shareholder. S corporations may, and in some cases are required to, file composite returns for the corporation's nonresident shareholders and to remit the tax due on behalf of those shareholders. Similarly, G.S. 105-154 requires a partnership doing business in this State to file a North Carolina partnership tax return (Form D-403) showing each partner's distributive share of the partnership's net income. The managing partner of the partnership is required to include with the return payment of the tax due on each nonresident partner's share of the partnership's net income. A nonresident shareholder or partner is not required to file a North Carolina individual income tax return if the S corporation or partnership pays tax on the owner's behalf unless the owner has other income from North Carolina sources.

The change in the manner of reporting dispositions of Section 1231 property by pass-through entities on the federal returns has no impact on resident owners because the entity does not pay tax on behalf of resident owners. Furthermore, the resident owners use federal taxable income, which includes the separately stated income, as the starting point in determining North Carolina taxable income. However, the change impacts nonresident owners on whose behalf a pass-through entity pays tax. Although the separately stated income item is still income from the pass-through entity and subject to the requirement for the pass-through entity to pay tax on behalf of the nonresident owner, North Carolina's forms do not provide a means to pay tax on this income because the forms were completed prior to the Department becoming aware of the change. As a result, an S corporation or managing partner that properly completes the forms would pay tax on the nonresident owner's share of the pass-through entity's net income that is not separately stated and no tax would be paid on the separately stated income. If the nonresident owner does not file an individual income tax return, the separately stated income will escape taxation. Therefore, a nonresident owner will be required to file a 2003 individual income tax return even if the

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pass-through entity has paid tax on the owner's behalf if the pass-through entity has attributed to that owner any separately stated income. Because the individual income tax return starts with federal taxable income, the separately stated income will not escape taxation. The nonresident owner may claim credit on the individual income tax return for any tax paid on the owner's behalf by the pass-through entity. A copy of the information provided by the entity verifying the amount of tax paid on the owner's behalf must be attached to the owner's return.

### **Income Tax Returns for 2004 to be Revised**

The Department plans to modify the 2004 S corporation and partnership forms so that income separately stated for federal income tax purposes is included in the calculation of tax to be paid by an S corporation or by a partnership on behalf of its nonresident owners. Consequently, a nonresident individual shareholder or partner will not be required to file a North Carolina individual income tax return in future years if the owner's only income attributable to North Carolina is from a pass-through entity that has paid income tax on behalf of the nonresident owner.