DIRECTIVE

Subject: Deduction for Net Business Income
Tax: Individual Income Tax
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(This Directive replaces PD-12-2, dated June 4, 2012. It corrects an error contained in one of the previous examples and adds clarifying language.)

This directive addresses a new deduction available for taxpayers who include net business income in federal adjusted gross income (AGI) as reported on the North Carolina individual income tax return. The law allows a deduction of up to $50,000 of net business income included in AGI that is not considered passive under the Internal Revenue Code (IRC). In the case of a married couple filing a joint return where both spouses report a net business income, the maximum dollar amount applies separately to each spouse’s net business income included in AGI, not to exceed a total of $100,000 (maximum $50,000 each). This deduction is available for tax years beginning on or after January 1, 2012.

Net Business Income That is Not Considered Passive

Net business income that is not considered passive is the aggregate of all business incomes and losses (excluding passive incomes and passive losses) reported on federal Schedules C, E, and F. In the case of income or loss reported on Schedule E Part II, business income or loss that is not considered passive is computed by subtracting from Nonpassive income all Nonpassive loss and deductions allowed under IRC Section 179 or otherwise allowed with respect to income that is not considered passive.

Passive Income and Passive Loss

For purposes of this deduction, passive income means the income generated from the conduct of an activity of a trade or business that satisfies the definition in IRC Section 469. Likewise, a passive loss means the loss generated from the conduct...
of an activity of a trade or business that satisfies the definition in IRC Section 469. Treasury Regulation §1.469, provides official interpretation on when income or loss is considered passive.

**Frequently Asked Questions**

The examples listed below provide answers to the specific facts presented and any variation of the facts may result in a different determination.

Q. Does net business income that is not considered passive include income from individually owned rental property reported on federal Schedule E?

A. Maybe. IRC Section 469 contains specific requirements with respect to whether income from rental property is passive. Whether income from individually owned rental property is net business income that is not considered passive depends on the characterization of the income under IRC Section 469.

**Example:** Taxpayer reports a net gain of $60,000 from rental income on federal Schedule E, in which he participated during the tax year, but did not meet the criteria to be considered a real estate professional. Because the taxpayer did not materially participate in the rental activity as a real estate professional, the rental activity is considered a passive activity under IRC Section 469 and, therefore, the deduction is not allowed. However, had the taxpayer materially participated in the rental activity as a real estate professional, the rental activity would not be considered a passive activity under IRC Section 469 and the taxpayer would be entitled to the deduction.

Q. Does net business income that is not considered passive, include rental real estate income from a pass-through entity as reported on federal Schedule E?

A. Maybe. IRC Section 469 contains specific requirements with respect to whether income from rental property is passive. Whether rental real estate income from a pass-through entity is net business income that is not considered passive depends on the material participation of the individual taxpayer/owner.

**Example:** If a pass-through entity derives all of its income from rental real estate activity and the individual taxpayer/owner materially participates in the management of the activity to the degree necessary to be considered a real estate
professional, the income from this activity is not considered passive under IRC Section 469 and the taxpayer/owner is entitled to the deduction. However, if the taxpayer/owner does not meet the requirements of IRC Section 469 to be considered a real estate professional, then the income from this activity is considered passive and the taxpayer/owner is not entitled to the deduction.

Q. Does net business income from an S corporation that is not considered passive include wages paid to the owner of the S corporation? How does that factor in determining the deduction?

A. Net business income is determined after any deduction for wages paid to an owner.

Example: Taxpayer is a 25% shareholder of an S corporation from which he receives nonpassive income. Taxpayer reports $25,000 of nonpassive income on federal Schedule E resulting from $25,000 of ordinary business income shown on federal Form 1120S K-1. The $25,000 is the shareholder’s portion of the $240,000 total income less $140,000 shown as wages paid as reported on the federal Form 1120S ($240,000 - $140,000 = $100,000 x 25% = $25,000). The $140,000 wages paid, as shown on federal Form 1120S, includes wages paid to the shareholder. In this example, Taxpayer may claim a net business income deduction of $25,000.

Q. When is business income or loss “passive”?

A. IRC Section 469 defines when income or loss is considered passive. Guidance adopted for that Section, Treasury Regulation §1.469, provides further detail on when income or loss is considered passive.

Q. Taxpayer reports a net profit of $60,000 from a nonpassive business activity on federal Schedule C and a partnership loss of $70,000 from a nonpassive business activity on federal Schedule E. Is this taxpayer entitled to a deduction?

A. No. The taxpayer does not have net business income because the nonpassive business income is offset by the nonpassive business loss.

Q. Taxpayers are a married couple filing jointly. Mr. Taxpayer reports a net loss of $60,000 from a nonpassive business activity on federal Schedule C
and Mrs. Taxpayer reports partnership income of $70,000 from a nonpassive business activity. Are taxpayers entitled to a deduction?

A. Yes. Taxpayers may claim a net business income deduction of $50,000 against the nonpassive income from Mrs. Taxpayer’s partnership income. Although Mr. Taxpayer sustained a net loss from a nonpassive business activity, for a married couple filing jointly, the maximum dollar amount of the deduction is applied separately to each spouse’s net business income included in AGI, not to exceed $50,000 per spouse.

Q. Taxpayers are a married couple filing jointly. Mr. Taxpayer reports a net profit of $20,000 from a nonpassive business activity on federal Schedule C and Mrs. Taxpayer reports a net profit of $60,000 from an unrelated nonpassive business activity on federal Schedule C. What deduction is available to taxpayers?

A. Taxpayers are entitled to claim a net business income deduction of $70,000. ($20,000 for husband and $50,000 for wife)

Q. Taxpayers are a married couple filing jointly. Mr. Taxpayer owns 60% of a single pass-through entity and Mrs. Taxpayer owns the other 40%. Mr. Taxpayer reports $60,000 of nonpassive income from the pass-through entity. Mrs. Taxpayer reports wages of $20,000 and nonpassive income of $40,000 from the pass-through entity on federal Schedule E. What deduction is available to taxpayers?

A. Taxpayers are entitled to claim a net business income deduction of $90,000. ($50,000 for husband and $40,000 for wife)