Tax Insights
from State and Local Tax
Services

North Carolina updates IRC conformity, requires Section 174A modifications, retroactively amends franchise tax calculation

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In brief

What happened?

Legislation (S.B. 595) enacted on July 2 updates North Carolina conformity to the IRC through the date of the One Big Beautiful Bill Act's (OBBBA's) enactment and requires modifications with respect to Section 174A expensing of domestic R&E expenditures. Among other changes, the legislation also seeks to retroactively change the franchise tax net worth calculation with respect to intercompany debt and establishes a new process for reporting a partnership's federal adjustments.

On July 23, the North Carolina Department of Revenue (Department) issued Important Notice: Impact of Recently Enacted Laws on North Carolina Individual and Corporate Income Tax Returns.

[S.B. 595, enacted 7/2/2026; Important Notice: Impact of Recently Enacted Laws on North Carolina Individual and Corporate Income Tax Returns, updated 7/29/2026]

Why is it relevant?

North Carolina's IRC update impacts the 2025 tax year, and a recent Department of Revenue notice provides guidance to taxpayers filing original or amended North Carolina tax returns. The franchise tax change could impact current intercompany debt arrangements and create liabilities for prior years.

Actions to consider

Taxpayers should consider the impact of North Carolina's conformity and required modifications, including with respect to federal R&E expenditure treatment and elections. Taxpayers also should consider the potential impact of franchise tax changes on planning that may have been put in place regarding intercompany debt.

In detail

IRC conformity update

The legislation updates the definition of the IRC to mean the IRC as enacted as of July 5, 2025 (updated from January 1, 2023), "including any provisions enacted as of that date that become effective either before or after that date." Filing guidance provided by the Department (updated on July 29) provides that an individual or corporation whose North Carolina taxable income is impacted by the legislation for a tax year beginning on or before January 1, 2026, should file (or amend) the applicable North Carolina tax return.

IRC Section 174A modifications

The legislation provides that a taxpayer that takes a deduction for domestic R&E expenditures under Section 174A(a) must add to the taxpayer's federal taxable income 80% of the amount taken for that year. Those taxpayers may deduct 25% "of the add-back in each of the first four taxable years following the year the taxpayer is required to include the add-back in income." The legislation states that these adjustments do not result in a difference in basis of the affected assets for state and federal income tax purposes.

The legislation states that the purpose of this provision "is to decouple from the allowance of full first-year expensing of domestic research and experimental expenditures under Section 70302" of the OBBBA. Under guidance provided by the Department of Revenue, the above adjustment is required (1) "for taxable years beginning on or after January 1, 2022, for taxpayers that elect for federal income tax purposes the retroactive application of IRC section 174A(a) of the Code for a taxable year beginning in 2022, 2023, and 2024" and (2) "for taxable years beginning on or after January 1, 2025, for taxpayers that do not make the election."

Observation: The legislation and Department's Notice do not specifically address the "catch-up" election to deduct remaining unamortized amounts in 2025 (or 2025 and 2026) under OBBBA Section 70302(f)(2). This election is separate from the election for eligible small businesses to retroactively apply Section 174A(a) for those prior periods.

Observation**:** This modification is similar to North Carolina's existing state adjustment related to Sections 168(k) and (n). Specifically, any taxpayer who takes a special accelerated depreciation deduction under Section 168(k) or (n) must add back 85% of that amount to its federal taxable income.

Twenty percent of the disallowed amount is then allowed to be deducted in each of the first five tax years following the year in which the amount is added back.

Note that the legislation does not discuss what happens if a corporation merges or is acquired that has Section 174A-related adjustments to be made in future years. The Department of Revenue may issue administrative guidance to address these situations.

Franchise tax determination of net worth

The legislation strikes a net worth deduction available to a creditor corporation for intercompany debt to the extent that such debt was added to net worth by the affiliated debtor corporation. This change is retroactive to tax years beginning on or after January 1, 2021, and is applicable to the calculation of franchise tax reported on the 2020 and later corporate income tax returns.

Observation: As a result of this change, affiliated groups will no longer be able to net out intercompany lending arrangements between affiliated debtors and creditors that are both subject to the North Carolina franchise tax. The legislation seeks to apply this change retroactively, although the change strikes through the deduction rather than clarifies the provision's language.

Reporting federal partnership adjustments

Part II of the legislation establishes new state procedures for reporting federal partnership adjustments. The changes are effective for tax years beginning on or after January 1, 2026, and apply to federal partnership adjustments that become final on or after that date. A federal adjustment may arise from either a partnership-level IRS audit or an administrative adjustment request.

A partnership doing business in North Carolina must file a state income tax return reflecting the adjustment and notify its direct partners within 90 days after the adjustment becomes final. Each taxable direct partner then must report its share of the adjustment, after applying applicable North Carolina modifications, and pay any resulting state tax within six months.

Alternatively, an audited partnership can make an irrevocable election to report and pay the resulting North Carolina tax at the partnership level on behalf of its partners. The election is available only for adjustments arising from a partnership-level audit and is unavailable for administrative adjustment requests, partnerships that elected North Carolina taxed-partnership treatment for the reviewed year, and partnerships that were not required to file in North Carolina because they were not doing business in the state. The partnership-level calculation excludes adjustments allocated to exempt partners and applies separate North Carolina tax rates and allocation or apportionment rules to corporate partners, nonresident individual and grantor-trust partners, and resident individual and grantor-trust partners.

The statute also addresses tiered partnerships, collection if an electing partnership fails to pay, the authority of the state partnership representative, and special assessment and refund limitation periods.

Let's talk

To discuss the potential implications of this legislation and guidance on your business, please contact:

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