



HOUSE BILL 1030: Senate Finance Provisions in the 2016 Appropriations Act.

2016-2017 General Assembly

Committee: House Finance – For Discussion Only
Introduced by:
Analysis of: Sixth Edition

Date: June 7, 2016
Prepared by: Finance Team

SUMMARY: *Part XXXVIII of the Sixth Edition of House Bill 1030, the 2016 Appropriations Act, makes the following tax law changes:*

- *Increases the standard deduction by \$2,000 over two years for taxpayers filing a joint return, and a comparable amount for taxpayers filing separately, single, and head of household. This provision would become effective for taxable years beginning on or after January 1, 2016.*
- *Allows parts and accessories of specialized equipment used to unload and process bulk cargo at a ports facility to qualify for the 1%/\$80 mill machinery tax rate, effective retroactively to July 1, 2013.*
- *Implements the use of market-based sourcing for multistate income tax apportionment, effective for taxable years beginning on or after the later of (i) the first taxable year in which the corporate income tax rate is 3%, or (ii) January 1, 2018.*
- *Makes several changes to the taxation of repair, maintenance, and installation services, enacted last year, in order to treat similar transactions the same, to identify taxable transactions more clearly, and to provide a grace period for retailers who provide repair, maintenance, and installation services. Specifically, it would exempt from taxation real property contracts for capital improvements, which would include most installations into real property, and it would tax repair and maintenance services to real property, including pest control service, certain cleaning services, swimming pool maintenance, and home warranties. These changes would become effective January 1, 2017, and apply to sales made on or after that date.*
- *Provides an effective cap of \$25,000 on the amount of sales and use tax payable on a RMI service provided for a boat or aircraft, effective July 1, 2016.*
- *Repeals the \$17.6 million State contribution that is allocated to all 100 counties as part of the 2% local option sales tax revenue.*
- *Continues to allow a property tax exemption for contiguous tracts of land donated to nonprofits which were previously used for commercial or industrial purposes and significantly damaged by fire or explosion.*

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BILL ANALYSIS:

INCREASE ZERO TAX BRACKET

Section 38.1 would increase the standard deduction by \$2,000 over two years for taxpayers filing a joint return, and a comparable amount for taxpayers filing separately, single, and head of household. This provision would be effective for taxable years beginning on or after January 1, 2016.

The House version of the budget would increase the standard deduction amount by \$2,000 over four years, beginning in 2017.

REDUCE TAXATION OF MILL MACHINERY

Section 38.2 would include parts and accessories of specialized equipment used to unload and process bulk cargo at a ports facility as part of the Article 5F tax base, effective retroactively to July 1, 2013.

The House version of the budget would make the same change. In addition to this change, the House budget would expand the 1%, \$80 excise tax under Article 5F to secondary metal recyclers, precious metal processors (retroactively effective for tax years 2010-2016); metal fabricators; and ready-mix concrete mills. The House budget would also repeal Article 5F AND exempt the machinery and equipment from sales tax, effective July 1, 2016.

MARKET-BASED SOURCING

Section 38.4 would implement the use of market-based sourcing for multistate income tax apportionment, effective for taxable years beginning on or after the later of (i) the first taxable year in which the corporate income tax rate is 3%, or (ii) January 1, 2018. Under this provision, a multi-state corporation would calculate the sales factor based on the percentage of income attributed to consumption of products and services in the North Carolina marketplace, not based on production costs in North Carolina. North Carolina is phasing-in single sales factor apportionment for all multi-state corporations; the phase-in will be complete in 2018.

There is no comparable provision in the House budget.

SALES TAX CHANGES

Section 38.5 contains the following sales tax changes:

Repair, Maintenance, and Installation Services

OVERVIEW: This section would make several changes with respect to the imposition of sales tax on repair, maintenance, and installation services, which was enacted last year, in order to treat similar transactions the same, to identify taxable transactions more clearly, and to provide a grace period for retailers who provide these services. The current sales tax on repair, maintenance, and installation services treats similar transactions differently, depending on the classification of the person providing the service and whether the service is for real property or tangible personal property.

There is no provision in the House budget addressing the 2015 sales tax expansion to repair, maintenance, and installation services.

EFFECTIVE DATE: Except as otherwise provided, this section would become effective January 1, 2017, and apply to sales made on or after that date.

CURRENT LAW: Effective March 1, 2016, the General Assembly made three sales tax law changes:

- Repealed the sales tax exemption for installation charges in conjunction with the sale of tangible personal property.

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- Expanded the sales tax base to include repair, maintenance, and installation services. (RMI services)
- Expanded the sales tax base to include service contracts on tangible personal property, regardless of whether the tangible personal property is attached to real property.

The sales tax base expansion to RMI services would have expanded the number of people responsible for collecting and remitting the sales tax. To reduce the number of new retailers, the legislation provided that a person who only provides RMI services would not be required to collect and remit the sales tax. It also provided that a person who acts as both a retailer and a real property contractor, commonly referred to as a retailer-contractor, could not be a contractor for sales tax purposes if the majority of the person's gross receipts were derived from retail trade.

The distinctions put into the law to reduce the number of retailers from the base expansion to RMI services treated similar transactions differently, based on the classification of the provider. These distinctions have created confusion in the application of the new law.

SECTION ANALYSIS:

Treat Similar Transactions the Same

This section would treat similar transactions the same by defining a retailer as anyone who provides RMI services for both real and tangible personal property. Removing these distinctions would mean that all professions that provide RMI services would be retailers and that RMI service for an item attached to real property would be treated the same as the repair or maintenance would be treated if it was provided under a service contract for that item. The removal of the distinction also means the sales tax base would be more far-reaching than it currently is because many RMI services are provided by real property contractors.

Exclude Capital Improvements

To keep the sales tax base similar to its current application, this section would exclude from the definition of RMI service, tangible personal property installed by a real property contractor under a contract to perform construction or reconstruction with respect to a capital improvement to real property. The section would define a capital improvement to be new construction or renovation of a building, structure, or fixture on land. Factors to consider in determining whether a contract is for the performance of a capital improvement to real property includes the method of attachment for the property installed, the degree of customization of the property installed, and the value added by or the useful life of the property installed. The section would define the term "real property" to include a manufactured home or a modular home that is placed on a permanent foundation.

The section specifically provides that contracts for the following transactions are capital improvements, and the installation and construction of these items would not be subject to sales tax:

- New construction and enlargement of an existing structure.
- Removal of items from real property, such as asbestos and construction material.
- Performance of work that requires a permit under the State Building Code.
- Installation of equipment that is attached to real property and that is capitalized for income tax purposes under the Code.
- Installation of a new unit or system, such as a HVAC system or a new roof.
- Construction and maintenance of a road, parking lot, or sidewalk.

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- Landscaping services.

Clarification of RMI Services to Tangible Personal Property

The current definition of RMI service is to keep or attempt to keep tangible personal property in working order to avoid break-down and prevent repairs and to restore tangible personal property to proper working order. To restore property to working order oftentimes involves cleaning the property. Based on DOR's interpretation of the word "restore," car washes involving personal service are currently taxable when performed by a retailer.

The definition of RMI service also includes installing or applying tangible personal property (except tangible personal property applied by a real property contractor). These words sometimes involve actions one does not necessarily consider "installation", such as hemming a pair of pants or laminating services. Based on DOR's interpretation of "installation," clothing alterations are taxable when performed by a retailer.

Car Washes and Clothing Alterations. – The section would clarify that the types of services included in the notice sent to taxpayers by the Department of Revenue are taxable -- services to "clean, monitor, alter, inspect, modify, or change property or a motor vehicle." Therefore, car washes and any alteration to tangible personal property, including clothing alterations, would be taxable under the section. The tax on car washes is further expanded to include self-service car washes.

Removal of Waste. – The section would provide that the maintenance of tangible personal property includes the removal of waste from tangible personal property or a motor vehicle.

Towing Services. – The section would exempt all towing services from sales tax. Under the current application of the law, towing provided as part of a repair and maintenance service is included in the sales price of that RMI service. A similar exemption may need to be considered for storage of a motor vehicle waiting to be repaired. Under the current application of the law, the storage fee would be part of the cost of the repair and would be subject to sales tax.

Expansion of RMI Services to Real Property

There is an inconsistency and lack of clarity in the current law regarding the repair and maintenance of real property. The tax on repair and maintenance services only applies to tangible personal property and not real property. However, the definition of a service contract includes the repair and maintenance of tangible personal property regardless of whether the property becomes a part of or is affixed to real property. The waters are further muddied if the repair of real property involves the installation of tangible personal property. For example, if an HVAC company performs a stand-alone repair of an air conditioning system, it would not be taxable because it would be the repair of real property. However, if the repair involves the installation of a new part, it might be taxable depending upon whether the business is a real property contractor. Moreover, if the same repair is performed under a service contract, it would be taxable to the extent the HVAC company is considered a retailer.

This section would extend the tax on the repair and maintenance services to real property, with certain exceptions. Specifically, the following services to real property would be taxable:

- Pest control
- Cleaning services such as carpet cleaning, window washing, gutter cleaning, pressure washing (but not house cleaning and janitorial services).
- Swimming pool maintenance
- Home warranties

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The section would also ensure that the repair or maintenance of an item is treated the same as the provision a repair or maintenance of the same item under a service contract.

Exempt Certain RMI Services from Tax

The following services, which otherwise fall within the definition of "repair, maintenance, and installation services," are exempt from tax under this section:

- A fee or charge for an inspection required by law. For example, a fee imposed to have a motor vehicle inspected.
- Service performed by a related member. A person is a related member if at least 50% of its value is owned by the entity for which it is providing the RMI service; in this instance, the service is more analogous to a service provided by an employee than a retailer.
- Service performed to resolve an issue that was part of a capital improvement if the services are performed within six months of the completion of the improvement or within six months of a new structure being occupied for the first time. This exemption would include repair services a contractor may have to provide for "punch list" items required of a purchaser of a new structure.
- RMI service for roads, parking lots, and sidewalks. This exemption would treat the repair and maintenance of these items the same as the construction of them. These items are most often State or county-owned in nature and commercial property.
- Removal of items from real property that may be provided on an as-needed basis rather than under a real property contract. Examples include garbage, grease, and debris. The removal of items from tangible personal property or a motor vehicle would be subject to tax.
- Home inspections.
- House cleaning and janitorial services. This exemption would NOT include maintenance services that are not provided as part of an interior cleaning service package. A service that cleans or waxes floors, cleans carpet, or washes windows would be subject to sales tax as a RMI service.

Service contract on motor vehicles

Effective March 1, 2016, a service contract on a motor vehicle became exempt from sales tax while the RMI service provided under a service contract on a motor vehicle became subject to tax. An issue arose as to what a service contract on a motor vehicle was. This section would define a service contract on a motor vehicle as a contract for the repair and maintenance of a motor vehicle or any part, component, or accessory for a motor vehicle sold by a motor vehicle dealer or by or on behalf of a motor vehicle service agreement company. The section would then specifically exempt a motor vehicle service contract from sales tax.

Grace period

Under current law, the Secretary of Revenue may compromise a taxpayer's liability for tax that is collectible when the Secretary determines that the compromise is in the best interest of the State and makes one or more findings listed in G.S. 105-237.1. One of those factors includes that the taxpayer is a retailer and that the assessment is for sales or use tax the retailer failed to collect or pay on an item included in the expansion of the sales tax base to service contracts, admission charges, and real property contracts. Section 38.5(b) would include a factor for the expansion of the sales tax base to RMI service. This factor would exist for six years. This is the same period of time that the factor exists for the sales tax base expansion items that were effective January 1, 2014.

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Section 38.5(a) would also provide that a retailer is not liable for an undercollection of sales and use tax if the retailer made a good faith effort to comply with the law that imposes a sales tax on RMI service for the period beginning March 1, 2016, and ending December 31, 2016.

Section 38.5(c) would allow a retailer-contractor who under-paid use tax on an item to offset the amount of tax owed by any over-collection of sales tax remitted on a related transaction. G.S. 105-164.11(a)(2) allows retailers to offset an under-collection of use tax with an over-collection of sales tax remitted on a related transaction; however, this remedy was not available to a retailer-contract. This remedy is effective retroactive to January 1, 2015; that is the effective date of the tax law changes applicable to real property contracts.

Lastly, subsection (k) of this section would direct the Department of Revenue to issue written guidance to taxpayers relative to the tax law changes made in this section within 120 days of the enactment of this act. The effective date of the tax law changes would be January 1, 2017. The purpose of this section is to give taxpayers and interested parties time to learn of the changes and to be educated regarding the changes before the tax changes become effective.

Cap on RMI Tax for Boats and Aircraft

This section would provide an effective cap on the amount of sales and use tax payable on a RMI service provided for a boat or aircraft, effective July 1, 2016. Under the Streamlined Sales and Use Tax Agreement, North Carolina can either tax a service or exempt a service from sales tax; it cannot impose a cap on the amount of sales tax payable. To accomplish the objective, the section provides that a taxpayer may apply for a direct pay permit from the Department of Revenue. A direct pay permit allows the purchaser of the service to be exempt from paying the tax to the retailer, and the permit holder agrees to pay the applicable amount of tax due to the Department of Revenue. Under the direct pay permit, there is a use tax exemption for any RMI service on a boat or aircraft that exceeds \$25,000. That means the maximum amount of State use tax on a transaction would be \$1,187.50; the maximum amount of local use tax due would be \$25,000 multiplied by the applicable local sales tax rate. The full cost of any parts used to make the repair would continue to be subject to the State and local sales tax.

There is no comparable provision in the House budget.

Repeal of State Contribution Allocated as Part of LOST Revenue

This section would also repeal the \$17.6 million State contribution that is allocated to all 100 counties as part of the 2% local option sales tax revenue. The State contribution was enacted last session as part of the legislation to distribute additional sales tax revenue to certain counties. The purpose of the State contribution was to provide additional revenue for the distribution to those 79 counties such that the total distribution would be equal to \$84.8 million. The State contribution made up the difference between what the sales tax base expansion to RMI services was estimated to generate for local sales tax revenue and the \$84.8 million distribution. New data regarding the sales tax base expansion indicates local revenues from the base expansion exceed the \$84.8 million distributed to certain counties. Therefore, the State contribution is not needed.

There is no comparable provision in the House budget.

PROPERTY TAX EXCLUSION EXEMPTION

Section 38.6 would continue to allow a property tax exemption for contiguous tracts of land donated to nonprofits which were previously used for commercial or industrial purposes and significantly damaged by fire or explosion.

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This exemption was enacted in response to the explosion of the ConAgra plant in June 2009. The plant site was given to the Town of Garner, and the Town created the Garner Economic Development Corporation to maintain and develop the damaged property in order to market or put it up for sale. Under current law, the property tax exemption expires July 1, 2016. This section would extend the sunset until July 1, 2021. The property tax exemption will not apply to the property once it is leased or sold.

There is no comparable provision in the House budget.