

HOUSE FINANCE COMMITTEE BRIEFING

February 7, 2017
Finance Committee Staff

Presentation Overview

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- Introduction to the Finance Committee
- Overview of General Fund Revenue Sources
- Personal Income Tax
 - ▣ Overview
 - ▣ Tax Reform Highlights
- Corporate Income & Franchise Tax
 - ▣ Overview
 - ▣ Tax Reform Highlights
- Sales Tax
 - ▣ Overview
 - ▣ Session Highlights
- Sales Tax-Related Issues
 - ▣ Local Option Sales Tax
 - ▣ 1%/\$80 Tax on Manufacturing Equipment

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Introduction to the Finance Committee

Trina Griffin, Legislative Analysis Division

Finance Committee Staff

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Legislative Analysis Division 200 LOB; 733-2578

- Cindy Avrette
- Trina Griffin
- Greg Roney
- Nick Giddings

Legislative Drafting Division 401 LOB; 733-6660

- Dan Ettefagh

Fiscal Research Division 203 and 206 LOB; 733-4910

- Barry Boardman
- Emma Turner
- Rodney Bizzell
- Jonathan Tart
- Denise Canada
- Brian Slivka

Bills that must be referred to Finance

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House Rule 38

- ☐ Raises revenue
- ☐ Reduces revenue
- ☐ Levies a tax
- ☐ Authorizes levy of tax, assessment, or fee
- ☐ Authorizes issuance of bonds

Senate Rule 42

- ☐ Levying taxes
- ☐ In any manner affects taxing power of State or its subdivisions
- ☐ Imposing or raising fees or other revenues payable to the State, agencies, licensing boards, or any of its subdivisions
- ☐ Providing for bond issues

Bills NOT required to go to Finance

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- Civil penalties, criminal fines, forfeitures
- Relating to fees charged by a nongovernmental entity



Resources

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□ NCGA website

□ Committee Website

□ Summaries of Substantive Legislation



The screenshot shows the top section of the North Carolina General Assembly website. On the left, the text "NCGA" is displayed in large white letters, with "NORTH CAROLINA GENERAL ASSEMBLY" below it. To the right of the text is the official seal of the North Carolina General Assembly. On the far right, there is a search area with four rows of input fields and "Go" buttons. The first row is for a "FULL SITE SEARCH" with the placeholder "type search criteria". The second row is for "SEARCH BILL TEXT" with a dropdown for "2017-2018 Session" and the placeholder "type search criteria". The third row is for "FIND A BILL" with a dropdown for "2017-2018 Session" and the placeholder "enter bill # (e.g., S253)". The fourth row is for "VIEW MEMBER INFO" with a dropdown for "Select a member...". Below the search area is a horizontal navigation bar with links: HOME, HOUSE, SENATE, ABOUT THE LEGISLATURE, AUDIO, CALENDARS, COMMITTEES, LEGISLATION/BILLS, WHO REPRESENTS ME?, and CITIZEN'S G.

FULL SITE SEARCH:	type search criteria	Go
SEARCH BILL TEXT:	2017-2018 Session ▼ type search criteria	Go
FIND A BILL:	2017-2018 Session ▼ enter bill # (e.g., S253)	Go
VIEW MEMBER INFO:	Select a member... ▼	Go

HOME HOUSE SENATE ABOUT THE LEGISLATURE AUDIO CALENDARS COMMITTEES LEGISLATION/BILLS WHO REPRESENTS ME? CITIZEN'S G

Welcome to the official web site of the North Carolina General Assembly. Use this web site as a tool to track bills, find and communicate with your state House and Senate members, and to follow chamber activity, meetings and issues before the General Assembly.

VISIT INSIDE INFO

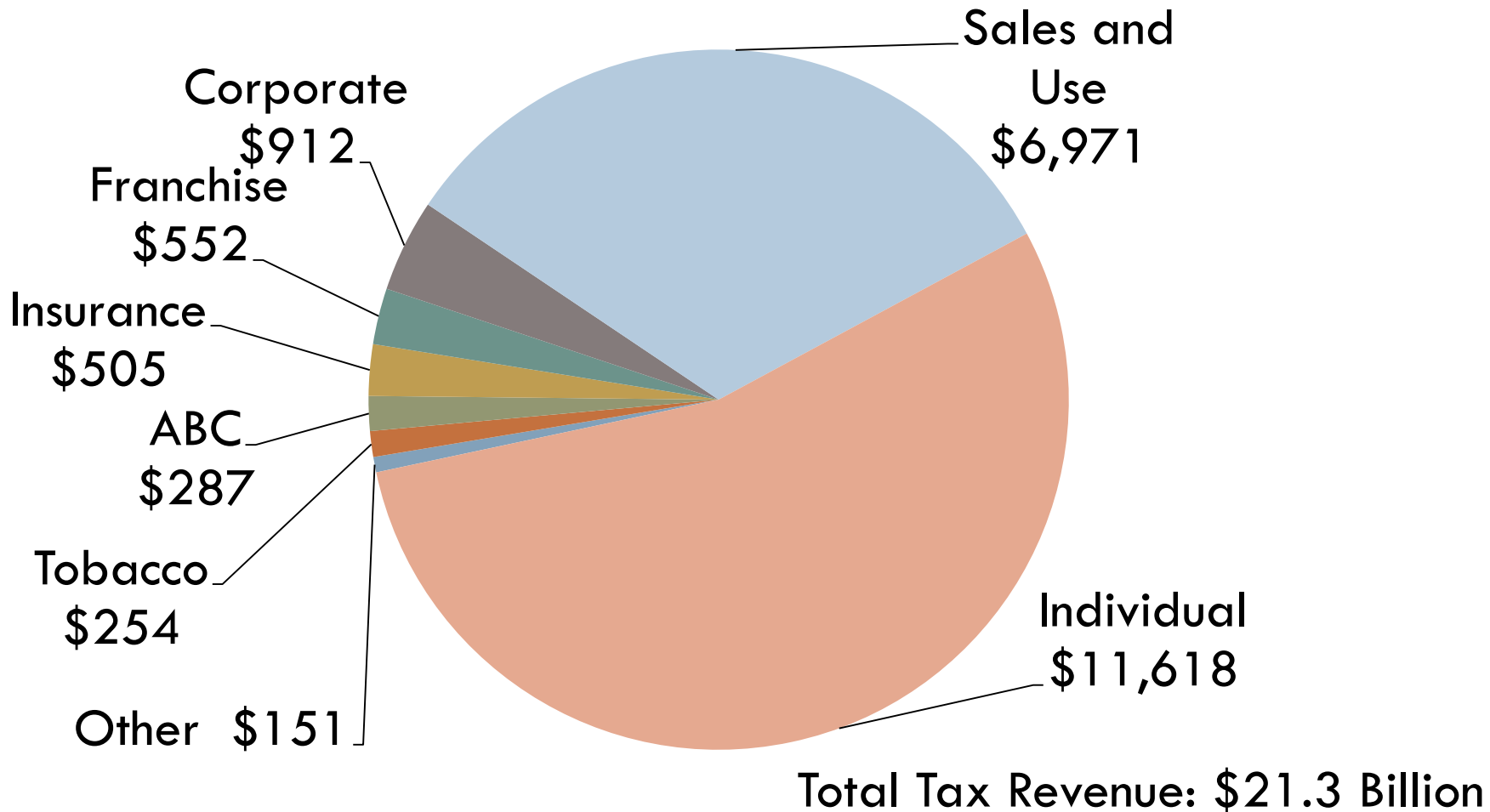
NCGA Division Lin

- Legislative Library

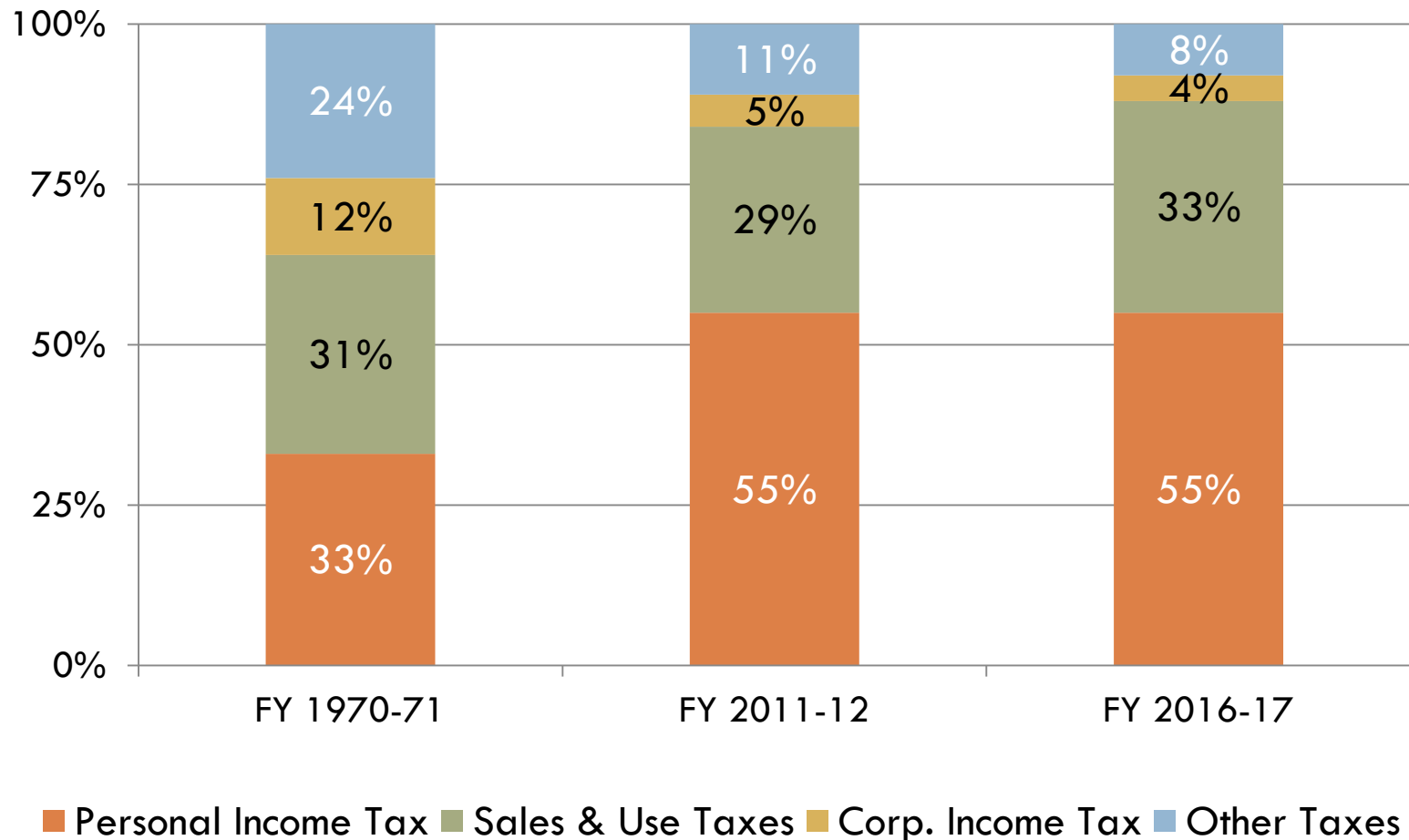
OVERVIEW OF GENERAL FUND REVENUE SOURCES

Cindy Avrette
Legislative Analysis Division

General Fund Tax Revenue by Source, \$ In Millions, FY 2016-17



North Carolina's Changing Tax Structure



Source: North Carolina General Assembly Fiscal Research Division

Tax Changes Effective 2014-2017

Personal and Corporate Taxes

- Personal taxes
 - ▣ Estate tax repeal
 - ▣ Lower, flat rate
 - ▣ Elimination of personal exemptions
 - ▣ Increase in standard deduction
 - ▣ Limitation on itemized deductions
- Business taxes
 - ▣ Lower rate
 - ▣ Elimination of tax incentives
 - ▣ Single sales factor
 - ▣ Simplification

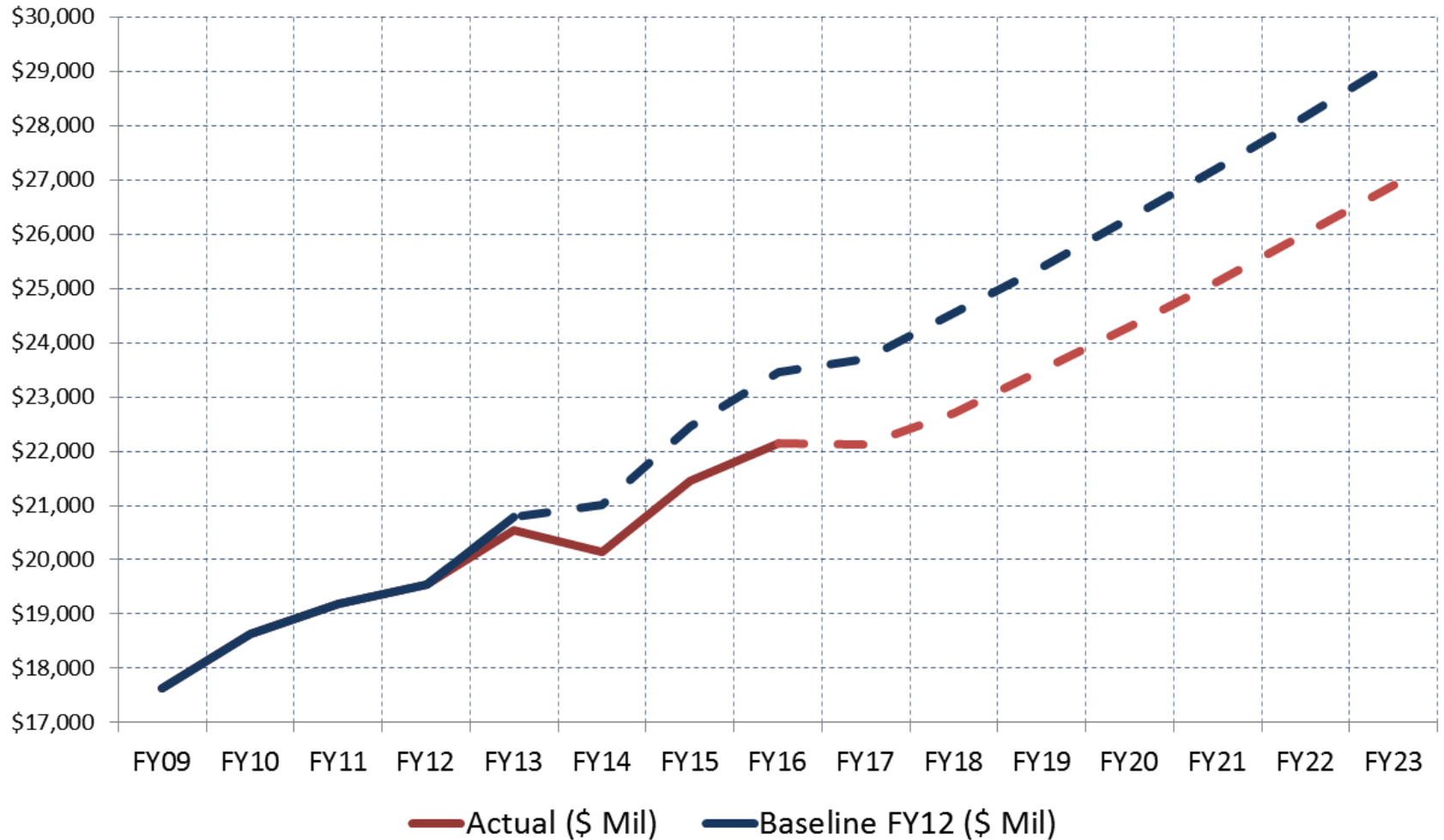
Sales Taxes

- Expansion of tax base by repealing exemptions
 - ▣ Elimination of exemptions
 - ▣ Income threshold for farm exemption
 - ▣ Cap on nonprofit refund
- Expansion of tax base to services
 - ▣ Entertainment charges
 - ▣ Electricity & piped natural gas
 - ▣ Service contracts
 - ▣ Repair, maintenance, and installation services (RMI)

Estimated Revenue Changes

Tax Law Changes From FY 2012-13 Through FY 2015-16, Estimated impact on FY17*	
	FY 2016-17
Personal Income Tax	(\$1,101.0)
Sales & Use Tax	\$567.1
Corporate Income Tax	(\$804.1)
Other Tax, Non-Tax, and Transfers	(\$216.2)
Total Fiscal Impact (millions)	(\$1,554.2)
*Estimates based on Fiscal Notes and Memos at the time of enactment, plus updates to support data	

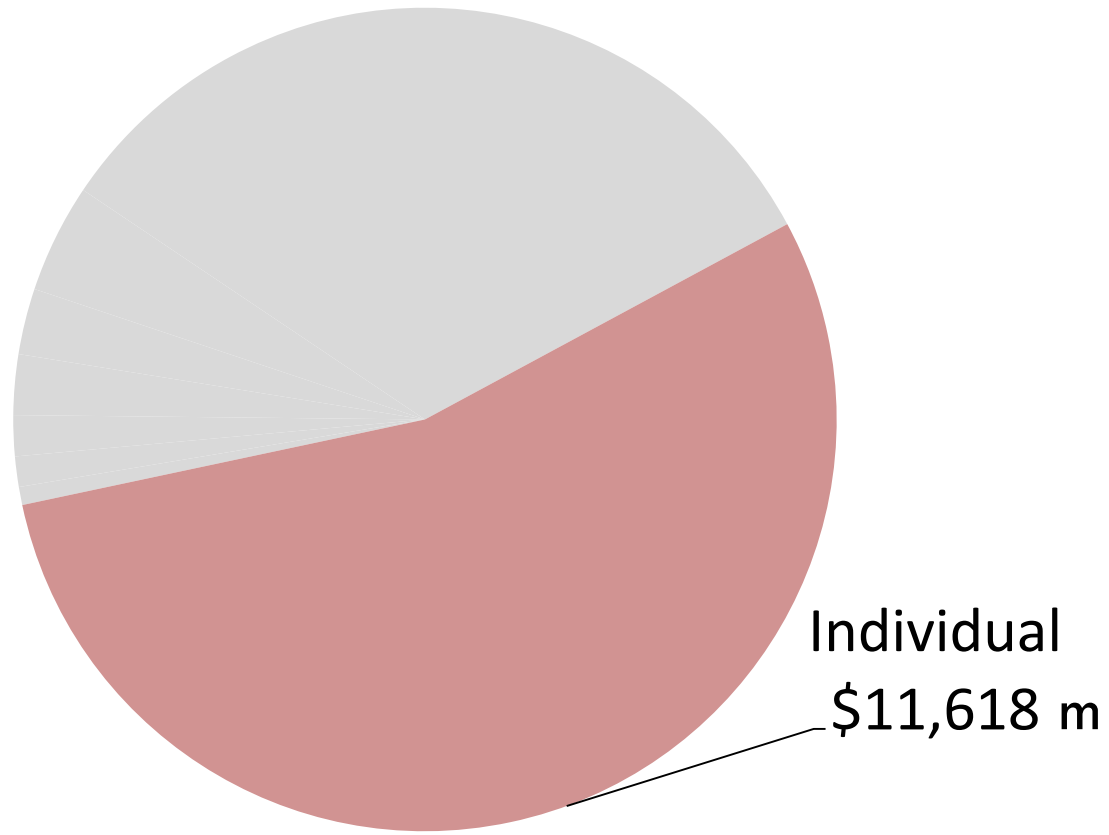
General Fund Revenue



PERSONAL INCOME TAX

- OVERVIEW
- TAX REFORM HIGHLIGHTS

General Fund Revenue Source: Individual Income Tax, FY 2016-17



Most states start with Federal Taxable Income or Federal Adjusted Gross Income

Federal Taxable Income

- 6 states use as a starting point
- Represents income after all federally allowed deductions
 - ▣ Personal exemptions
 - ▣ Itemized deductions or standard deduction

Federal Adjusted Gross Income

- 29 states use as a starting point
- Represents income after 'above the line' deductions
 - ▣ Business related expenses
 - ▣ Few non-business related expenses

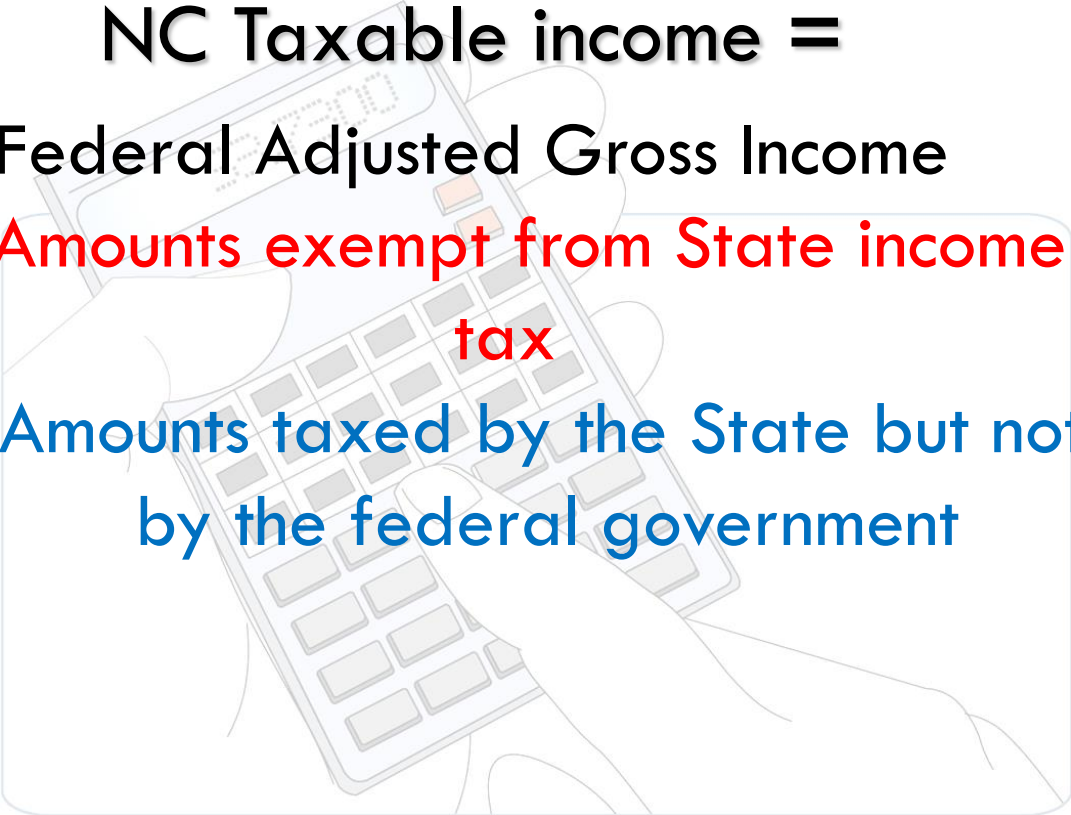
Internal Revenue Code Update

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- We start the NC income tax calculation with federal adjusted gross income by referencing and conforming to the current version of the Internal Revenue Code.
- Each year the conforming date must be updated (conform currently to the IRC enacted as of 1/1/16, need legislation to change it to 1/1/17).
- Renewing conformity to the Internal Revenue Code annually instead of permanently allows the General Assembly to review federal legislation to determine if there are specific federal provisions it does not want to conform to (often referred to as “decoupling”).
- No significant federal tax legislation has been enacted this year that requires decoupling consideration by the General Assembly.

Calculating NC Taxable Income

Federal
taxable
income

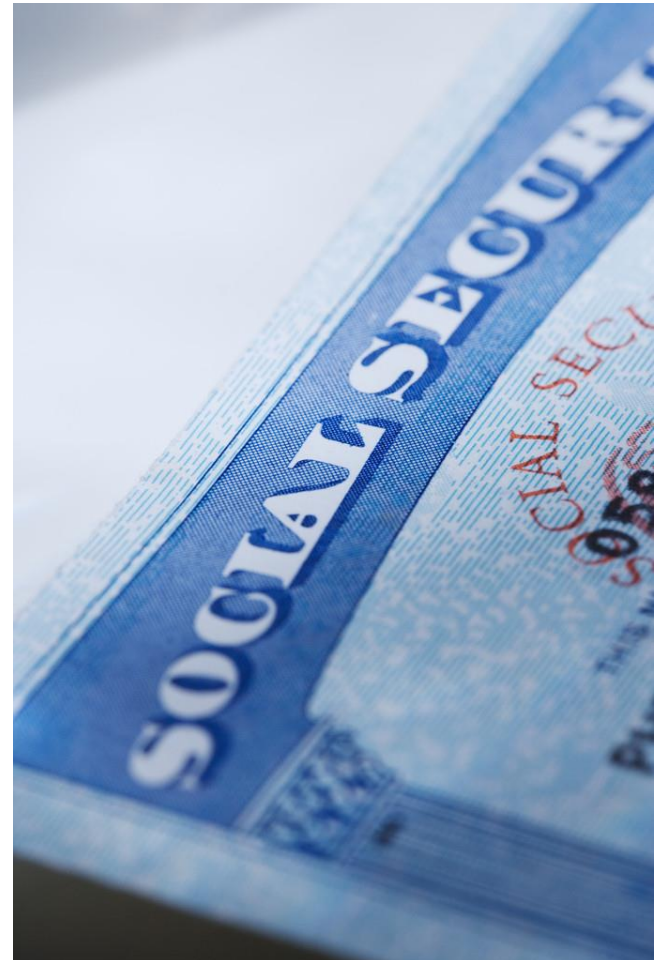

$$\begin{aligned} \text{NC Taxable income} = & \\ & \text{Federal Adjusted Gross Income} \\ & - \text{Amounts exempt from State income tax} \\ & + \text{Amounts taxed by the State but not} \\ & \quad \text{by the federal government} \end{aligned}$$

PIT Tax Adjustments

Examples of NC adjustments to federal adjusted gross income

State Tax Exemptions: Social Security

- Full exemption
 - ▣ SSI benefits in excess of federal limit = Other states
 - ▣ 15 states tax SSI to some extent
 - 5 follow federal practice
 - ▣ 26 states fully exempt

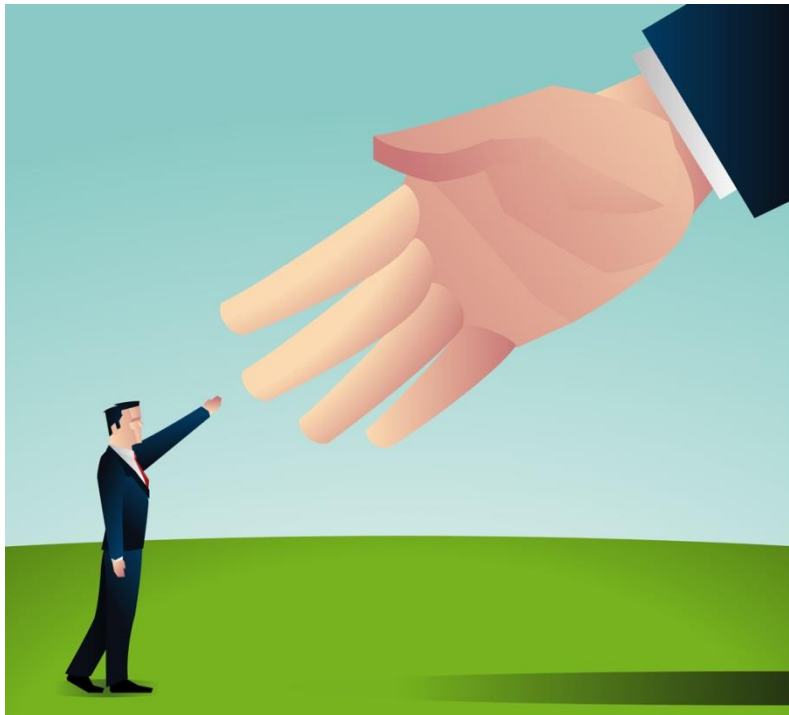


State Tax Exemptions: Federal Law

- Interest on US obligations
- Income from an Indian tribe



State Tax Exemption: Contractual



Government retirement
income received by
employees vested in
retirement system by
August 12, 1989

State Tax Exemptions: Practice

- Interest on NC and local government obligations and obligations of a nonprofit educational institution chartered in NC



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Tax Reform

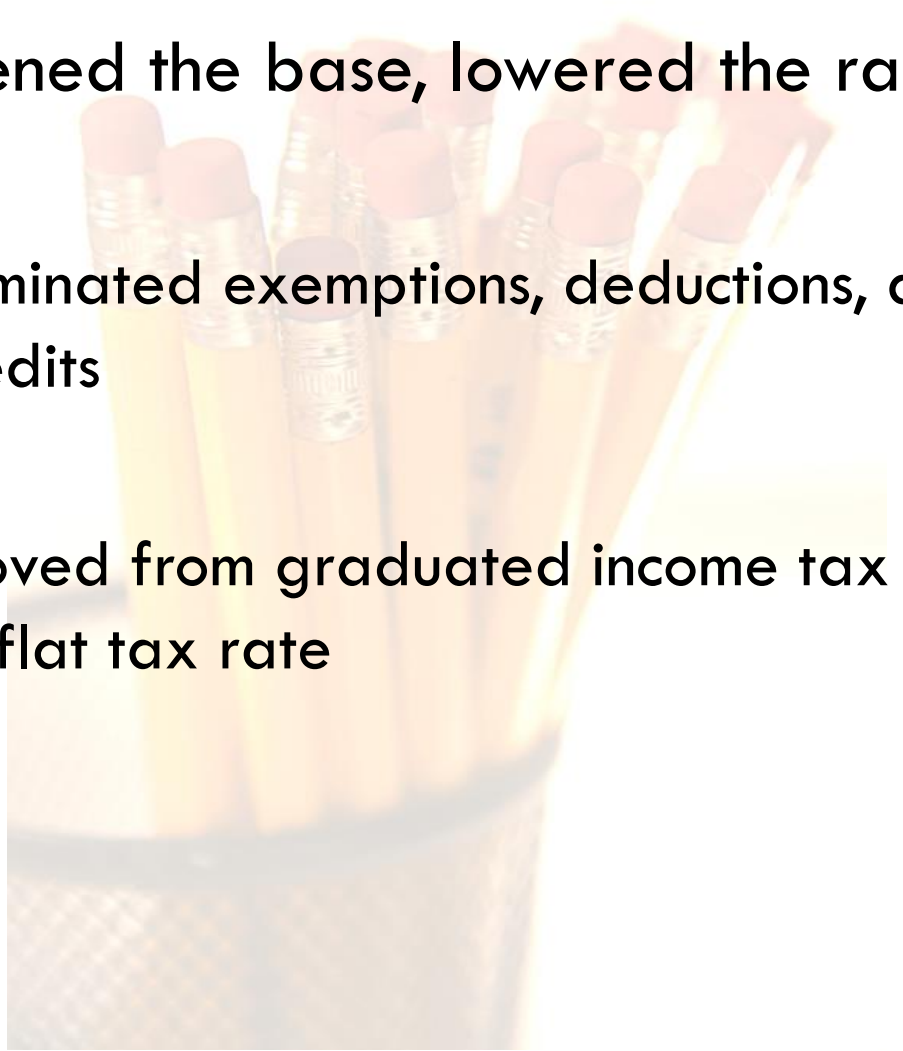
Personal Income Tax Highlights

Personal Income Tax Reform

Personal Income Tax

Broadened the base, lowered the rates

- Eliminated exemptions, deductions, and credits
- Moved from graduated income tax rates to flat tax rate



PIT Itemized Deduction Changes

- 2013
 - ▣ Substantially the same as federal itemized deductions
- 2014
 - ▣ Eliminated all itemized deductions but three
 - ▣ Three remaining itemized deductions:
 - Charitable contributions
 - Home mortgage interest + Property taxes paid on real estate, capped at \$20,000
- 2015
 - ▣ Additional itemized deduction for Medical and Dental Expenses
 - ▣ Unlimited; no cap

PIT Base: Before and After Reform

Tax Base Before

Standard Deduction	Personal Exemption	Child Tax Credit
\$6,000	\$2,000	\$100
For Married Filers	per Person	For All Taxpayers
More if taxpayer Is 65 years or Older or blind	\$2,500 if income Is less than \$100,000	

Credits & Deductions Available

Tax credits for earned income tax, child care, adoption expenses, non-itemized charitable expenses, disability, property taxes on farm machinery

Deductions for retirement income, social security income, severance income, certain bond obligation interest, long-term care insurance, \$50,000 business deduction, parental savings trust fund, firefighter & rescue squad, erroneous conviction, qualified sale of a manufactured home community

Tax Base After

Standard Deduction	Personal Exemption	Child Tax Credit
\$17,500	None	\$125
For Married Filers		Enhanced Credit Amount For MFJ If AGI is less than \$40,000

Credits & Deductions Available

Tax credit for children

Deduction for social security income, Bailey retirement income, limited itemized deductions, certain bond obligation interest

PIT Rate Changes

- 2013
 - ▣ Graduated rates
 - ▣ Range from 6% to 7.75%
- 2014
 - ▣ Flat rate
 - ▣ 5.8%
- 2015 & 2016
 - ▣ 5.75%
- 2017
 - ▣ 5.499%



Rate Comparison Before Tax Reform

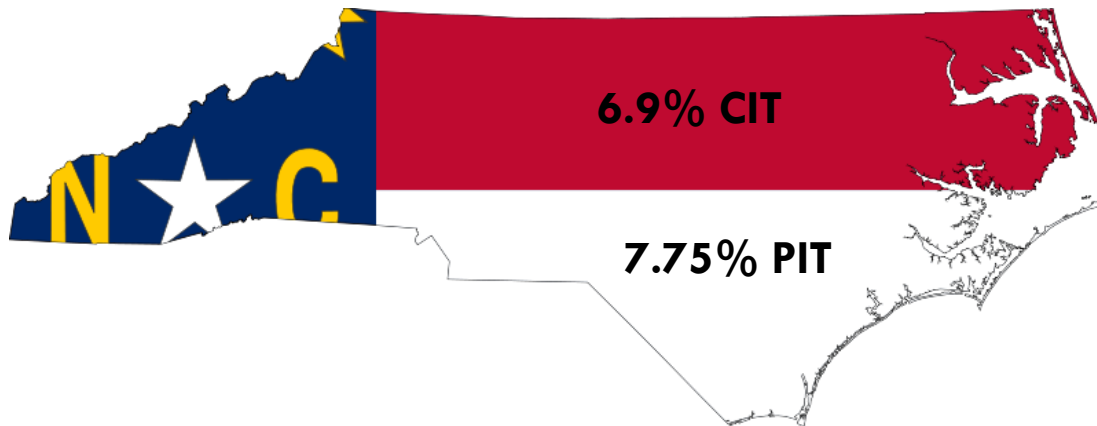
5% CIT
7% PIT



6% CIT
5.75% PIT



6% CIT
6% PIT



2013 Taxable Year

Rate Comparison After Tax Reform

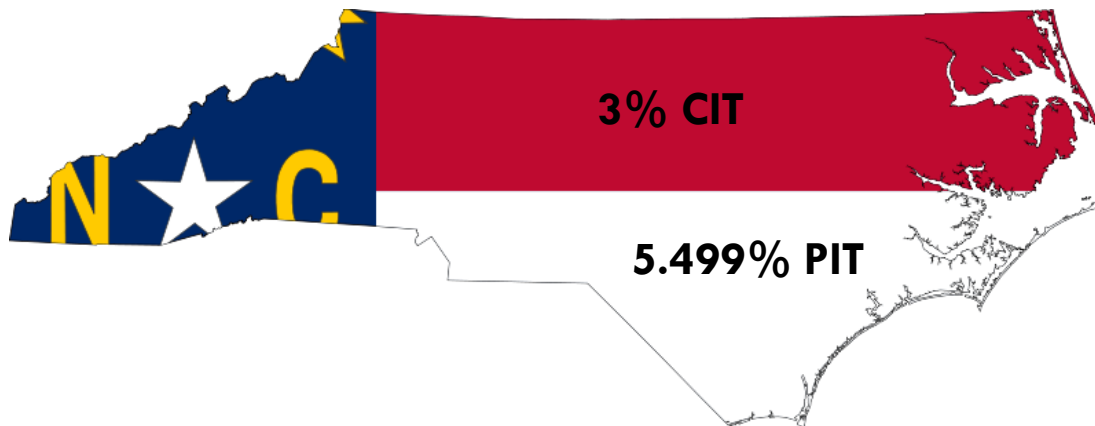
5% CIT
7% PIT



6% CIT
5.75% PIT



6% CIT
6% PIT

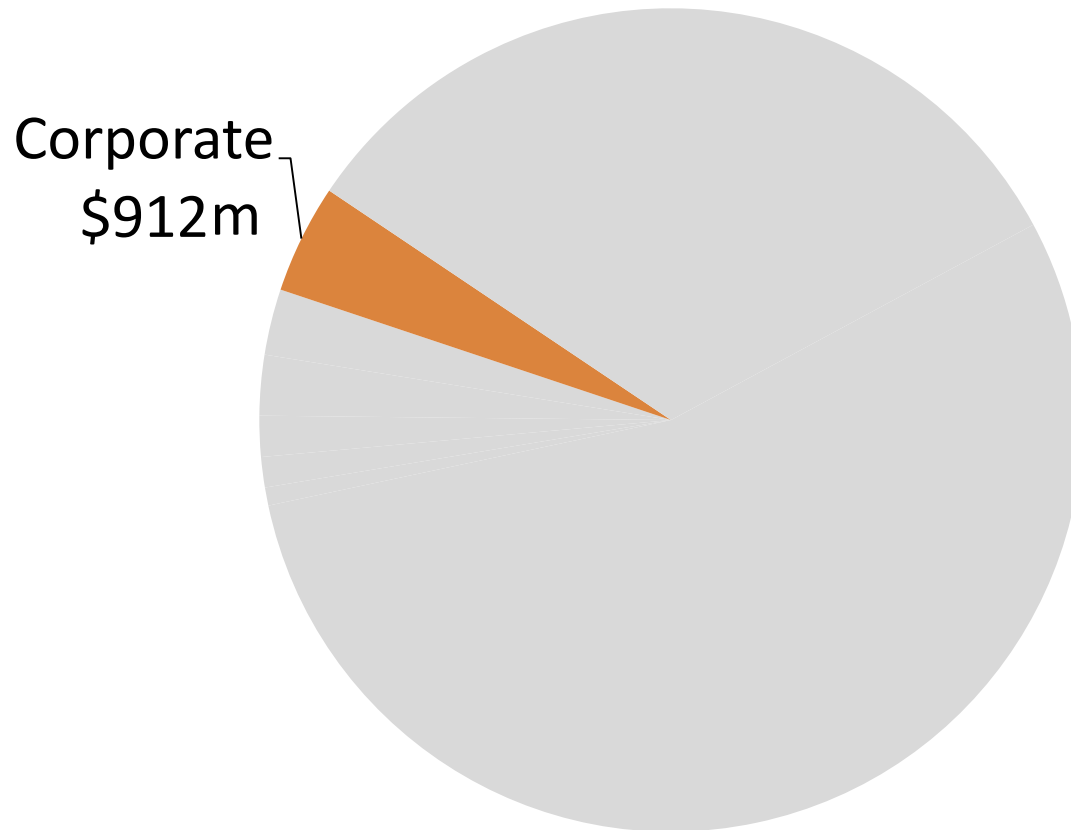


2017 Taxable Year

CORPORATE INCOME TAX

- OVERVIEW
- TAX REFORM HIGHLIGHTS

General Fund Revenue Source: Corporate Income Tax, FY 2016-17



Corporate Income Taxpayers

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- 75,000 returns, but only 1 / 3 of filers pay tax.
- 2/3 of corporate income tax collections come from about 300 large companies.
- Corporations with NC taxable income of over \$1 million pay 85-90% of the total corporate income tax revenue, but they make up less than 3% of the corporations filing returns.

Computing NC Taxable Income

- Start with federal taxable income
- Adjust for differences in federal and state law (similar to personal income tax, IRC Update)
- Apply apportionment % if corporation is multi-state
- Apply 3% tax rate.

Apportionment

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- When a corporation operates in multiple states, a state can only tax a percentage of the income.
- Example: Ollie Manufacturing, Inc. does business in 20 states and has \$40 million in income. Absent an apportionment requirement, Ollie's \$40 million could be taxed 20 times.
- States have some policy discretion regarding the apportionment method used. Before tax reform, NC used a method that considered the share of Ollie's employees and operations located in NC.

NC Apportionment Formula Change

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Starting in 2018, NC uses sales/revenue factor apportionment. This provides an economic incentive for manufacturing companies like Ollie to expand and create jobs in NC. Example: Ollie, Inc. operates in 20 states and has \$40M in income. 50% of Ollie's employees and capital investment are in NC. 10% of Ollie's goods are sold to NC consumers.

Income before apportionment:	\$40M
Income apportioned to NC:	10%
Income taxed in NC:	\$4M

Only 10% of Ollie's income is taxed by NC even though 50% of operations and employees are located in NC.

Comparison of Sales/Revenue Factor based on type of business

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If Ollie Sales Goods

% of income NC taxes is equal to the % of goods delivered to NC consumers.

50% of Ollie's operations are conducted in NC, and 10% of goods are delivered to NC consumers. **10%** of Ollie's income is taxed by NC.

Economic Incentive for Ollie to locate and expand in NC. After an expansion in NC, if 75% of Ollie's operations are conducted in NC, **10%** of Ollie's income is taxed

If Ollie Provides Services

% of income NC taxes is **not** equal to the % of services provided to NC consumers.

50% of Ollie's operations are conducted in NC, and 10% of goods are delivered to NC consumers. **50%** of Ollie's income is taxed by NC.

Not an economic development incentive. After an expansion in NC, if 75% of Ollie's operations are conducted in NC, **75%** of Ollie's income is taxed by NC.

2016 General Assembly directed the Department of Revenue to develop hypothetical rules to treat Ollie the service provider the same way it now treats Ollie the goods seller ("market sourcing").

Business Tax Base: Before and After Reform

Tax Base Before

Local privilege license taxes

Privilege tax on banks

Credits & Deductions Available

Tax credits for ports charges, recycling oyster shells, renewable fuels, work opportunity, interactive digital media, Article 3J, qualified business venture, film, renewable energy, historic and mill rehabilitation, low income housing, research & development, construction of dwelling units for handicapped, real property donations, conservation tillage equipment, gleaned crops, and construction of poultry composting facility,

Deductions for amortization in excess of depreciation allowed under the Code on the cost of sewage or waste treatment plant, air cleaning devices, recycling facilities, emergency facilities acquired before 1955, reforestation and cultivation of commercially grown trees; eligible income of an international banking facility, tobacco marketing assessments, settlement agreements, hurricane assistance, interest earned on deposits by a savings and loan association

Tax Base After

Credits & Deductions Available

Historic rehabilitation, miscellaneous others that are administrative in nature

Corporate Income Tax Rate Changes

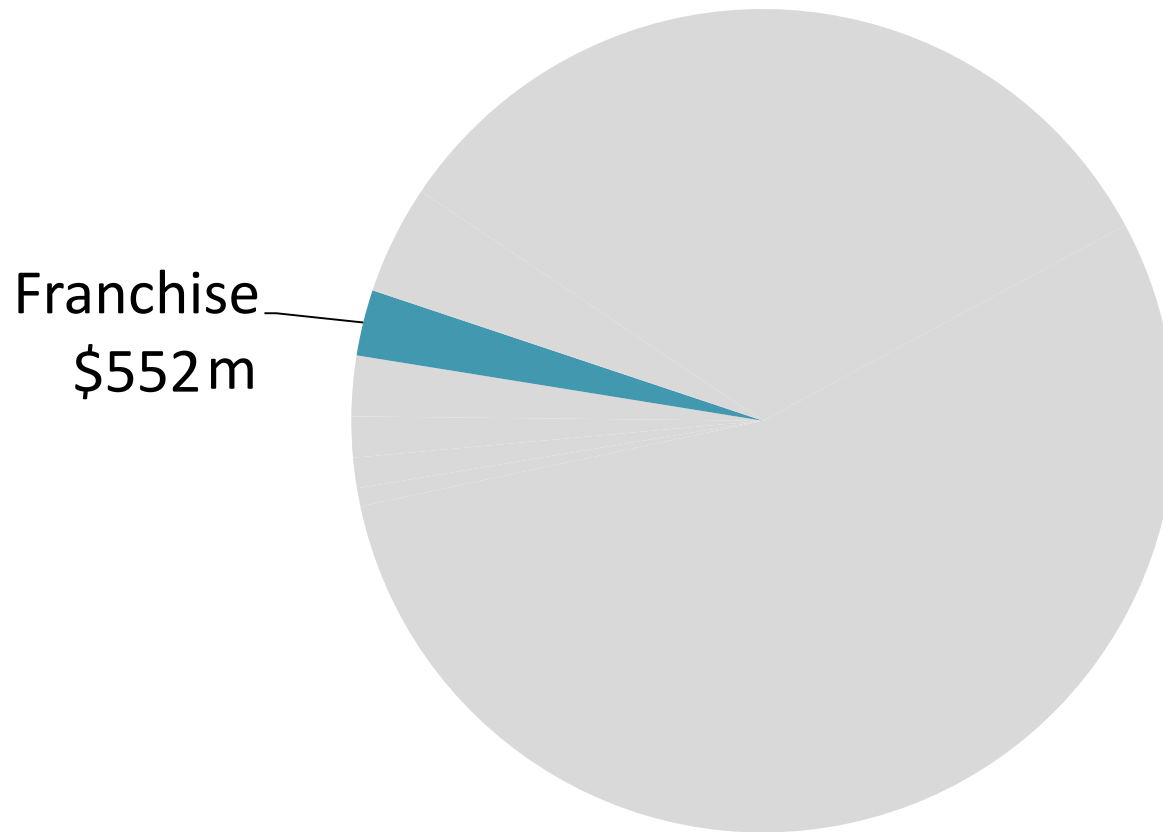
- 6.9%
 - ▣ 2013 tax rate
- 6%
 - ▣ 2014 tax rate
- 5%
 - ▣ 2015 tax rate
- 4%
 - ▣ 2016 tax rate
- 3%
 - ▣ 2017 tax rate



FRANCHISE TAX

- OVERVIEW
- TAX REFORM HIGHLIGHTS

General Fund Revenue Source: Franchise Taxes, FY 2016-17



Franchise Tax



- Tax imposed for:
 - ▣ The privilege of engaging in business
 - ▣ The benefit and protection received from the government and laws of NC in doing business

Who pays Franchise Tax?

- C corporations (about 75,000)
- S corporations (about 150,000)
- Limited liability companies (LLC), partnerships, sole proprietorships are exempt from tax
 - An LLC pays \$200 annual report filing fee in lieu of Franchise Tax

Franchise Tax Base

Tax rate is .15% (\$1.50 per \$1,000). The rate is applied to the highest of three alternate bases:

- Net Worth apportioned to NC using the apportionment percentage determined for income tax
- Book value of NC real and tangible personal property, less outstanding debt created to acquire or improve the real property
- 55% of the appraised value of NC real and tangible personal property

Franchise Tax Reform Highlights



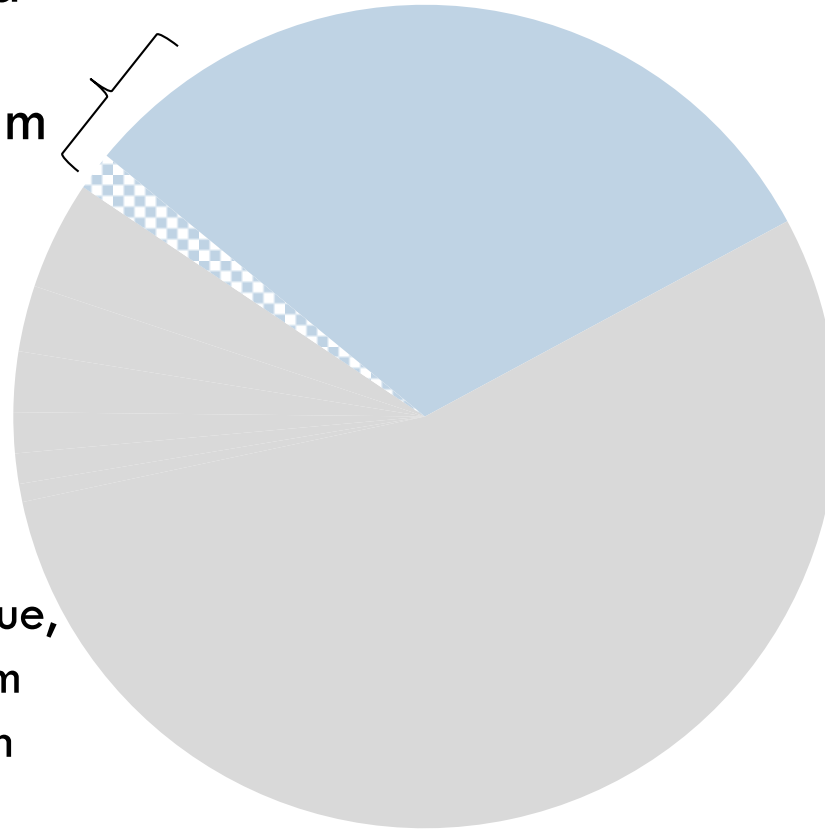
- Simplified calculation to tie more closely to net worth as determined for accounting purposes
- Increased minimum tax from \$35 to \$200
- Increased maximum tax on holding companies from \$75,000 to \$150,000

SALES TAX

- OVERVIEW
- SALES TAX ON RMI SERVICES

General Fund Revenue Source: Sales & Use Taxes, FY 2016-17

Sales and
Use
\$6,970 m



Of the \$6.97 billion in Sales & Use tax revenue, approximately \$322 m is from base expansion in 2015 and 2016.

Repair, Maintenance, & Installation

Section 32.18,
S.L. 2015-241

Section 38.5,
S.L. 2016-94



2015: Expand Sales Tax Base to RMI Services

- Repealed the sales tax exemption for installation charges in conjunction with the retail sale of TPP
- Expanded the sales tax base to include repair, maintenance, and installation (RMI) services
- Expanded the sales tax base to include service contracts on TPP, regardless of whether the TPP is attached to real property

Effective March 1, 2016



- Policy intent:
No new retailers
 - ▣ Test of retail trade
 - ▣ Retailer-contractor
- Policy consequence:
Similar transactions taxed differently
 - ▣ Classification of provider
 - ▣ Classification of property: TPP or real property

Is a Labor Charge Taxable?

- Retail sale + installation of TPP
 - ▣ YES
- RMI of TPP
 - ▣ Retailer – YES
 - ▣ Not a retailer – No
- RMI of TPP to be installed in or attached to real property
 - ▣ Retailer – YES
 - ▣ Retailer-Contractor – Maybe
 - If engaged in retail trade, yes
 - If not engaged in retail trade, no
 - ▣ Real Property Contractor – NO
 - ▣ Person who only provides RMI services – NO

2016: Treat Transactions the Same

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- ❑ Removed restriction that provided a retailer-contractor could not be a real property contractor if engaged in retail trade
- ❑ Removed exception that allowed a person whose only business activity was providing RMI services to be a non-retailer
- ❑ Treat RMI service of TPP attached to real property the same as service contract on TPP attached to real property

Effective January 1, 2017



Is a Labor Charge Taxable?

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Capital Improvement -- NO

- **By definition**, the tax does not apply to the gross receipts derived from a contract by a real property contractor to perform construction, reconstruction, or remodeling with respect to a **capital improvement**

RMI Service -- YES

- Provided more clarity to the definition
- Eliminated differences
 - ▣ RMI
 - ▣ Service contract to provide RMI
- Provided exemptions

Capital Improvement (CI)

Generally

- Addition or alteration to real property
- Permanently installed or applied so removal causes material damage
- Does NOT include replacement of a fixture unless it is part of remodeling
- Does NOT include a single RMI service

List

- Removal of waste & debris
- Building permit
- Installation of underground utilities
- Installation of equipment or fixtures that is attached to real property and that is capitalized
- Landscaping & roads
- Replacement or installation of specified systems

Definition of RMI Services

- Keep in working order to avoid breakdown, deterioration, repairs
 - ▣ Clean, wash, polish
- Calibrate, **refinish**, restore to proper working order or good condition
 - ▣ Replacing or putting together what is torn or broken
- Troubleshoot or identify the source of a problem
- Install, apply, **connect, adjust, or set into position**
- **To inspect or monitor**

RMI = Service Contract for RMI

- Obligor under a contract agrees to maintain, **monitor, inspect**, or repair **digital property** or tangible personal property **for a period of time or some other defined measure**, regardless of whether the property becomes part of or is applied to real property
 - ▣ Includes service contract for pool, fish tank, or other aquatic features
 - ▣ Does not include a single RMI service
- Bundling of two or more services, one of which is taxable
 - ▣ Allocate price for taxable service



Mixed Transactions: CI & RMI



- 10% Rule
 - ▣ Does cost of RMI exceed 10% of real property contract?
 - ▣ Yes, allocate portion that is RMI
 - ▣ No, treat as part of RP contract
- Affidavit of CI
 - ▣ Blanket use
 - ▣ Single use
 - ▣ Keep with records

Exemptions ~ Capital Improvement List

- Fee for inspection required by law
- Services provided by a related member
- Services performed to resolve an issue that was part of a real property contract within 12 months of occupation
- Cleaning of real property
- Alteration and repair of clothing, except belts, shoes, & when it is part of rental charges
- Services on roads, driveways, parking lots, and sidewalks
- Removal of waste, trash, debris (except portable toilets)
- Home inspections related to sale of property
- Landscaping
- Pest control
- Moving services
- Self-service car washes

Change is Never Easy or Flawless

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- Distinguishing taxable and nontaxable transactions
- Clarifying taxable and nontaxable transactions
- Implementing new business practices

Links to Helpful Information

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- ❑ <http://www.dornc.com/taxes/sales/rmi.html>
- ❑ <http://www.dornc.com/taxes/sales/realpropertycontractors.html>
- ❑ <http://www.dornc.com/taxes/sales/servicecontracts.html>

Grace Periods Offer Safeguards

- Not liable for undercollection of sales or use tax on RMI
 - ▣ March 1, 2016, through December 31, 2016
- Authority for Secretary of Revenue to compromise tax liability on RMI
 - ▣ March 1, 2016, through December 31, 2022









OTHER TAX HIGHLIGHTS

- LOCAL OPTION SALES TAX
- 1%/\$80 EXCISE TAX

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LOST

Local Sales Tax Rates and Distributions

Article	Rate	Purpose	Distribution	Levied By
1 st 1 cent Art. 39		Any lawful purpose	Point of collection; shared with cities	100 counties
1 st ½ cent Art. 40		70% - general 30% - school capital	Per capita; shared with cities	100 counties
2 nd ½ cent Art. 42		40% - general 60% - school capital	Point of collection; shared with cities	100 counties
¼ cent Art. 46		Any lawful purpose	Point of collection; distributed to County only.	31 counties
½ cent or ¼ cent Art. 43	 or 	Public transportation	Per capita - Among county and cities in county that operate a public transportation system	4 counties

Local Option Sales Taxes

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- The local sales and use tax rate ranges from 2% to 2.75%, depending upon the county.
- 94 counties could levy a maximum of 2.5%
 - ▣ 29 of these levy at 2.25%
 - ▣ 65 of these levy at 2.0%
 - ▣ No county is levying the 1/4¢ public transportation tax
- 6 counties could levy a maximum of 2.75%
 - ▣ 2 of these levy at 2.0% (Forsyth & Guilford)
 - ▣ 2 of these levy at 2.5% (Mecklenburg and Wake*)
 - ▣ 2 of these levy at 2.75% (Durham and Orange)

*Wake County's local rate will rise from 2.0% to 2.5% on April 1, 2017.

Relevance for 2017 Session

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- Any expansion or reduction of the sales tax base impacts local revenues.
- Interest remains in giving counties flexibility within current overall cap.

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Tax on Manufacturing Equipment

1%/\$80 Tax on “Mill Machinery”



Gasoline engines, pumps



Motors, pulleys, conveyors, mixing tanks

Gloves, boots, hair nets, lab coats



Hand tools, cables, lathes, saws, welding machines



Forklifts, cranes



Repair parts and accessories

2016 Changes

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- *Expand Taxation of Mill Machinery, S.L. 2016-94, Sec. 38.2*
 - ▣ *Parts & accessories for equipment at a ports facility*
 - ▣ *Secondary metal recyclers*
 - ▣ *Precious metal extractors*
 - ▣ *Metal fabrication*

The Future of the 1%/\$80 Tax

- Consider definitions for “manufacturing,” “manufacturer,” “manufacturing equipment.”
- Identify the beginning and ending points of the manufacturing process.
- Provide threshold for being a manufacturer or degree to which equipment must be used for manufacturing.
- Address whether a product must be produced for sale.



QUESTIONS?