

## North Carolina enacts significant tax law changes

### Overview

On September 18, 2015, Governor Pat McCrory signed House Bill 97 (H.B. 97),<sup>1</sup> which includes the following modifications to North Carolina law:

- Amends mechanism for potential future corporate income tax rate reduction from 4 percent to 3 percent
- Phases in single sales factor apportionment over three years beginning in 2016, replacing the existing double-weighted sales factor apportionment for both income and franchise tax
- Requires certain corporate taxpayers to file a market-based sales factor sourcing informational report with the North Carolina corporate income tax return for the 2015 taxable year
- Adds an intercompany interest expense addback provision with corresponding exceptions
- Replaces the capital stock, surplus, and undivided profits element of the franchise tax capital base with an apportioned net worth tax measure
- Expands the sales and use tax base to include repair, maintenance, and installation services

H.B. 97 included a provision for the automatic repeal of the tax law changes discussed in this Tax Alert (other than the sales tax changes) unless two other bills, House Bill 117 (H.B. 117) and House Bill 943 (H.B. 943), were ratified prior to January 1, 2016.<sup>2</sup> H.B. 117 was ratified on September 24, 2015; H.B. 943 was ratified on September 30, 2015.<sup>3</sup>

This Tax Alert summarizes the more significant North Carolina tax law changes contained in H.B. 97, which have various effective dates as specified in the discussion that follows. This Tax Alert also notes that the corporate income tax rate will be reduced from 5 percent to 4 percent for taxable years beginning on or after January 1, 2016. This rate reduction was not part of H.B. 97, but instead was attributable to North Carolina having met a specified tax revenue target.

### Corporate income tax rate reduction

Enacted in 2013, H.B. 998 reduced the corporate income tax rate to 6 percent (from 6.9 percent) for taxable years beginning on or after January 1, 2014, and to 5 percent for taxable years beginning on or after January 1, 2015, through December 31, 2016. H.B. 998 also amended N.C. Gen. Stat. §105-130.3 to add a corporate income tax rate reduction mechanism whereby if a net General Fund tax revenue target was met for fiscal year 2014-2015, the tax rate would drop to 4 percent for taxable years beginning on or after January 1, 2016.<sup>4</sup> On August 6, 2015, the Secretary of Revenue announced that North Carolina had met the net General Fund tax revenue target for fiscal year ending June 30, 2015, and thus a 4 percent corporate income tax rate will apply for taxable years beginning on or after January 1, 2016.<sup>5</sup>

<sup>1</sup> Ch. SL 2015-241 (H.B. 97, signed by Governor Pat McCrory on Sept. 18, 2015). A copy of the adopted law is accessible [here](#).

<sup>2</sup> H.B. 97, Sec. 32.21A.

<sup>3</sup> See legislative record for H.B. 117, available [here](#) (last visited on Oct. 1, 2015); and legislative record for H.B. 943, available [here](#) (last visited on Oct. 1, 2015). Note that in North Carolina, a bill is deemed to be ratified when it has been signed by the presiding officer of each of the two legislative houses. See, North Carolina General Assembly, *How a law is Made*, item 7, available [here](#) (last visited Oct. 1, 2015). That ratification contemplates an act separate from the signature of a bill by the Governor is supported by the statement that immediately follows the recorded "History" of H.B. 117 and H.B. 943: "Note: a bill listed on this website is not law until passed by the House and the Senate, *ratified*, and, if required, signed by the Governor." See, Legislative record for H.B. 117, available [here](#), last visited on Oct. 1, 2015; and for H.B. 943, available [here](#), last visited on Oct. 1, 2015 (emphasis added).

<sup>4</sup> An Act to Simplify the North Carolina Tax Structure and to Reduce Individual and Business Tax Rates, General Assembly of North Carolina, Session 2013, House Bill 998 available [here](#). See Secs. 2.1.(a)–2.2.(c).

<sup>5</sup> See *Important Notice: Reduction in Corporate Tax Rate pursuant to N.C. Gen. Stat. § 105-130.3C*, issued by the North Carolina Department of Revenue (Aug. 6, 2015).

H.B. 97 amends N.C. Gen. Stat. §105-130.3 to provide that if the amount of the net General Fund tax collected in a fiscal year exceeds \$20,975,000,000, the corporate income tax rate will be further decreased to 3 percent effective for the taxable year that begins on the following January 1.<sup>6</sup>

#### **Phase-in of single sales factor apportionment**

H.B. 97 replaces the current double-weighted sales factor formula in the following fashion for both the corporate income tax and the franchise tax:

- Implementing a 60 percent weighted sales factor under the statutory apportionment formula effective for taxable years beginning on or after January 1, 2016.<sup>7</sup>
- Implementing a 66 percent weighted sales factor under the statutory apportionment formula effective for taxable years beginning on or after January 1, 2017.<sup>8</sup>
- Implementing a 100 percent weighted sales factor under the statutory apportionment formula effective for taxable years beginning on or after January 1, 2018.<sup>9</sup>

#### **Required reporting of a market-based sales factor sourcing calculation**

H.B. 97 provides that each multistate corporate taxpayer with apportionable income greater than \$10 million is required to file, as part of its 2015 corporate income tax return, an informational report with the Department of Revenue showing the calculation of the taxable year 2014 sales factor using market-based sourcing. The 2014 sales factor is required to be computed based on the market-based provisions outlined in H.B. 97 (e.g., sales of services are to be sourced based on the “deliver-to” location) as well as the model market-sourcing regulations promulgated by the Multistate Tax Commission.<sup>10</sup> The informational report must include the following:

- The corporation’s apportionment percentage used on the corporation’s 2014 North Carolina corporate tax return,
- The corporation’s 2014 apportionment percentage as calculated under the market-based sourcing rules provided in H.B. 97,
- The corporation’s primary industry code under North American Industry Classification System (NAICS), and
- Any other information prescribed by the Secretary of the Department of Revenue.<sup>11</sup>

The informational report will be due at the time the corporate taxpayer’s income tax return is due for the 2015 taxable year under N.C. Gen. Stat. §105-130.17(b). A potential nonfiling penalty of \$5,000 may be assessed for failure to file the informational report.<sup>12</sup>

#### **Addback for net interest expense paid to a related member**

Effective for taxable years beginning after January 1, 2016, an addition modification is required to be made to federal taxable income for the amount of “net interest expense” paid to a related member.<sup>13</sup> “Net interest expense” is defined as “the excess of interest paid or accrued by the taxpayer to a related member during the taxable year over the amount of interest from a related member includible in the gross income of the taxpayer for the taxable year.”<sup>14</sup>

H.B. 97 also adds a corresponding deduction for “qualified interest expense,”<sup>15</sup> defined as “the amount of net interest expense paid or accrued to a related member in a taxpayer year not to exceed thirty percent ... of the taxpayer’s adjusted taxable income.”<sup>16</sup> The limitation on the qualified interest expense deduction does not apply to interest paid or accrued to a related member if:

- North Carolina corporate income tax is imposed on the related member with respect to the interest income,

<sup>6</sup> H.B. 97, Sec. 32.13.(b), amending N.C. Gen. Stat. §105-130.3C. H.B. 998 had initially amended N.C. Gen. Stat. §105-130.3 to provide that if a net General Fund tax revenue target was met *for fiscal year 2015-2016*, the corporate income tax rate would drop to 3 percent for taxable years beginning on or after January 1, 2017. H.B. 97 amended this corporate tax rate reduction provision to eliminate the reference to fiscal year 2015-2016.

<sup>7</sup> H.B. 97, Sec. 32.14.(a), amending N.C. Gen. Stat. §105-130(4)(i).

<sup>8</sup> H.B. 97, Sec. 32.14.(b), amending N.C. Gen. Stat. §105-130(4)(i).

<sup>9</sup> H.B. 97, Sec. 32.14.(c), amending N.C. Gen. Stat. §105-130(4)(i).

<sup>10</sup> H.B. 97, Sec. 32.14A.(b) and (c).

<sup>11</sup> H.B. 97, Sec. 32.14A.(d).

<sup>12</sup> H.B. 97, Sec. 32.14A.(e).

<sup>13</sup> H.B. 97, Sec. 32.13.(d), adding N.C. Gen. Stat. §105-130.5(a)(25).

<sup>14</sup> H.B. 97, Sec. 32.13.(f), adding N.C. Gen. Stat. §105-130.7B(b)(3).

<sup>15</sup> H.B. 97, Sec. 32.13.(d), adding N.C. Gen. Stat. §105-130.5(b)(28).

<sup>16</sup> H.B. 97, Sec. 32.13.(f), adding N.C. Gen. Stat. §105-130.7B(b)(4).

- The related member pays a net income tax or gross receipts tax to another state with respect to the interest income,
- The related member is organized under the laws of a foreign country that has a comprehensive income tax treaty with the United States (and meets other requirements), or
- The related member is a bank.<sup>17</sup>

### Franchise tax base changes/tax increase

Historically, North Carolina has levied an annual franchise tax on a corporation doing business in North Carolina on the greatest of the following three measures: (i) the taxpayer's apportioned issued and outstanding capital stock, surplus, and undivided profits; (ii) 55 percent of the appraised value as determined for ad valorem taxation of the taxpayer's real and tangible personal property in North Carolina; or (iii) the taxpayer's total actual investment in tangible personal property in North Carolina.<sup>18</sup> Effective January 1, 2017, for taxes due on after that date, H.B. 97 replaces the capital stock, surplus, and undivided profits element (item (i) above) of the franchise tax computation with an apportioned net worth measure.<sup>19</sup> The amended statute provides that net worth is a corporation's "[t]otal assets without regard to the deduction for accumulated depreciation, depletion, or amortization less its total liabilities, computed in accordance with generally accepted accounting principles as of the end of the corporation's taxable year."<sup>20</sup> A deduction is allowed for accumulated depreciation, depletion, or amortization in accordance with the method used for federal income tax purposes.<sup>21</sup> H.B. 97 also expands the addback of affiliated indebtedness relative to the net worth tax computation to include indebtedness owed to a "noncorporate entity" in which the corporation or an affiliated group of corporations owns directly or indirectly more than 50 percent of the capital interests of the noncorporate entity.<sup>22</sup> The addition for indebtedness continues to apply for amounts owed to a parent, a subsidiary, or an affiliate.<sup>23</sup>

H.B. 97 also eliminates the taxpayer's ability to remove indebtedness incurred and existing for the purchase of real estate from the investment in tangible property base.<sup>24</sup>

Additionally, the new law increases the minimum franchise tax from \$35 to \$200 for each corporation for the privilege of carrying on, doing business, and/or the continuance of articles of incorporation or domestication in North Carolina.<sup>25</sup> The bill also increases the holding company maximum tax from \$75,000 to \$150,000 to the extent that the company is paying on the net worth tax base.<sup>26</sup>

### Sales and use tax changes

Effective March 1, 2016, H.B. 97 expands the sales and use tax base to include repair, maintenance, and installation services and consequently repeals the exemption for separately stated installation labor.<sup>27</sup> As defined, "repair, maintenance, and installation services" include a number of different types of activities, but do not include installing or applying tangible personal property by a real property contractor pursuant to a real property contract.<sup>28</sup> The new law also provides several exemptions to the tax associated with repair, maintenance, and installation services.<sup>29</sup>

Additionally, H.B. 97 amends the definition of a real property contractor to exclude persons engaged in retail trade.<sup>30</sup> The new law also adds a definition for "retail trade," defined as:

a trade in which the majority of revenue is from retailing tangible personal property, digital property, or services to consumers. The term includes activities of a person properly classified in NAICS sector 44-45, buying goods

<sup>17</sup> *Id.*

<sup>18</sup> N.C. Gen. Stat. §105-122(d).

<sup>19</sup> H.B. 97, Sec. 32.15.(b), amending N.C. Gen. Stat. §105-120.2(a).

<sup>20</sup> H.B. 97, Sec. 32.15.(d), amending N.C. Gen. Stat. §105-122(b).

<sup>21</sup> H.B. 97, Sec. 32.15.(d), amending N.C. Gen. Stat. §105-122(b)(1).

<sup>22</sup> H.B. 97, Sec. 32.15.(d), amending N.C. Gen. Stat. §105-122(b)(2).

<sup>23</sup> *Id.*

<sup>24</sup> H.B. 97, Sec. 32.15.(d), amending N.C. Gen. Stat. §105-122(d).

<sup>25</sup> *Id.*

<sup>26</sup> H.B. 97, Sec. 32.15.(b), amending N.C. Gen. Stat. §105-120.2(b).

<sup>27</sup> H.B. 97, Sec. 32.18.(b), adding N.C. Gen. Stat. §105-164.4(a)(15), and H.B. 97, Sec. 32.18.(d), repealing N.C. Gen. Stat. §105-164.13(49).

<sup>28</sup> H.B. 97, Sec. 32.18.(a), adding N.C. Gen. Stat. §105-164.3(33d).

<sup>29</sup> H.B. 97, Sec. 32.18.(e), amending N.C. Gen. Stat. §105-164.13. The exemptions include: (1) repair, maintenance, and installation services provided for an item for which a service contract on the item is exempt from tax under N.C. Gen. Stat. §105-164.41; (2) repair, maintenance, and installation services purchased for resale; and (3) repair, maintenance, and installation services used to maintain or repair tangible personal property or a motor vehicle pursuant to a taxable service contract if the purchaser of the contract is not charged for the item.

<sup>30</sup> H.B. 97, Sec. 32.18.(a), amending N.C. Gen. Stat. §105-164.3(33a).

for resale, and rendering services incidental to the sale of merchandise. The term typically includes maintaining an inventory, and may include the provision of repair, maintenance, and installation services. Not all activities provided in this subdivision are required for a trade to be considered retail trade.<sup>31</sup>

### ASC 740 treatment

Pursuant to ASC 740, "Income Taxes," companies are required to account for the effect of a change in income tax law in the period that includes the enactment date of that law change. As noted previously, H.B. 97 included a provision for the automatic repeal of the tax law changes discussed in this Tax Alert (other than the sales tax changes) unless two other bills, H.B. 117 and H.B. 943, were ratified prior to January 1, 2016. H.B. 117 was ratified on September 24, 2015, and H.B. 943 was ratified on September 30, 2015. As H.B. 97 was signed by the governor on September 18, 2015, and both H.B. 117 and H.B. 943 have been ratified as of September 30, the enactment of H.B. 97 is a third quarter event for financial statement purposes for calendar year taxpayers.

This Tax Alert also highlights the reduction of the corporate income tax rate from 5 percent to 4 percent for taxable years beginning on or after January 1, 2016. As noted previously, this rate reduction was not part of H.B. 97. Instead, the rate reduction was attributable to North Carolina having met a specified tax revenue target that was announced on August 6, 2015. Thus, the rate reduction is a third quarter event for financial statement purposes for calendar year taxpayers.

### Other changes included in H.B. 97

H.B. 97 reduces the individual income tax rate from 5.75 percent to 5.499 percent for tax years beginning on or after January 1, 2017.<sup>32</sup> The new law makes additional tax law changes that are beyond the scope of this Tax Alert.

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<sup>31</sup> H.B. 97, Sec. 32.18.(a), adding N.C. Gen. Stat. §105-164.3(35b).

<sup>32</sup> H.B. 97, Sec. 32.16.(c), amending N.C. Gen. Stat. §105-153.7(a).