SMITH ANDERSON TAX ALERT

Tax Provisions in the 2017 Budget Bill

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The General Assembly released today the Proposed Conference Committee Substitute (the "Conference Bill") for Senate Bill 257, the state budget bill. The Conference Bill is expected to be approved by the General Assembly later this week and sent to the Governor.

The Conference Bill includes the following tax provisions, each of which is discussed further below:

- Personal Income Tax Changes
  - The personal income tax rate would decrease from 5.499% to 5.25% in 2019.
  - The standard deduction would be increased in 2019.
  - The child tax credit would be converted to a deduction in 2018.
- Corporate Income and Franchise Tax Changes
  - The corporate income tax rate would decrease from 3% to 2.5% in 2019.
  - The franchise tax rate for S corporations would be capped at $200 for the first $1 million of franchise tax base beginning with the 2019 franchise tax year.
- Mill Machinery and Sales Tax Changes
  - The mill machinery tax would be repealed July 1, 2018.
  - Items currently subject to the mill machinery tax would be exempt from the sales tax.
  - A study would be undertaken to consider the proper scope of the mill machinery exemption.
  - A new sales and use tax exemption would be provided for sales of repair or replacement parts to ready-mix concrete mills, effective July 1, 2018.
  - A targeted sales tax exemption would be provided for a large fulfillment facility, effective July 1, 2017.
  - A sales tax refund would be provided for taxpayers receiving JDIG grants for "transformative projects," effective July 1, 2017.
- Renewable Energy Tax Credit Changes
  - The delayed repeal of the renewable energy tax credit for certain projects that were at least 50% complete by the end of 2015 would be extended from January 1, 2017 to May 5, 2017 with respect to property using for biomass resources.

The Conference Bill differs significantly from both the Senate and House versions of the budget bill. Most notably, the Senate bill would have adopted market-based sourcing for apportioning receipts from services and intangibles. No such provisions are included in the Conference Bill. As a result, if the Conference Bill is enacted, multi-state taxpayers will continue to use the income-producing activities method of sourcing service receipts despite the full implementation of single sales factor apportionment in 2018. In addition, the Conference Bill omits the following provisions that were included in the House bill: (i) an increase in the cap on the itemized deductions for mortgage interest and property taxes, (ii) a reduction in the franchise tax rate, and (iii) a sales tax refund for R&D supplies. These omissions, together with the delayed rate reductions, makes the repeal of the mill machinery tax the most immediately significant feature of the Conference Bill.

PERSONAL INCOME TAX CHANGES

Rate Reduction

The Conference Bill would reduce the personal income tax rate form 5.499% to 5.25% for taxable years beginning on or after January 1, 2019.[1] The Senate bill had provided for a rate reduction to 5.35% effective in 2018, while the House bill did not include a rate reduction.

Increase in Standard Deduction

The Conference Bill would increase the standard deduction from $17,500 to $20,000 for joint filers, from $14,000 to $15,000 for heads of households, and from $8,750 to $10,000 for single filers and married taxpayers filing separately. These changes would be effective for taxable years beginning on or after January 1, 2019.[2] Both the Senate and House bills included increases in the standard deduction that would have been effective in 2018.

Conversion of Child Care Tax Credit

The Conference Bill follows the Senate bill in repealing the child care tax credit and replacing it with a deduction, effective for taxable years beginning on or after January 1, 2018. The existing credit is $125 for all taxpayers but is reduced to $100 for joint filers with over $40,000 in AGI and to zero for joint filers with AGI over $100,000. Similar phase outs are provided for other types of filers. The deduction included in the Conference Bill would start at $2,500 and would be reduced to $2,000 for joint filers with over $40,000 in AGI, to $1,500 for joint filers with over $60,000 in AGI, to $1,000 for joint filers with over $80,000 in AGI, to $500 for joint filers with over $100,000 in AGI and to zero for joint filers with over $120,000 in AGI. Again, similar phase outs are provided for other types of filers.[3]

CORPORATE INCOME AND FRANCHISE TAX CHANGES

Corporate Income Tax Rate Reduction

In 2015, the General Assembly reduced the corporate income tax rate form 5% to 4% and provided for a further decrease to 3% if a General Fund revenue target was met. That rate reduction trigger was met, and the rate dropped to 3% in 2017. The Conference Bill would reduce the rate to 2.5% for taxable years beginning on or after January 1, 2019.[4] The Senate bill had provided for a phased reduction to 2.5% over two years, while the House bill had not included a corporate income tax rate reduction.

Cap on Franchise Tax for Small S Corporations

Under current law, both C and S corporations are subject to the franchise tax at the same rates, while LLCs generally are not subject to the franchise tax but are subject to a $200 annual report fee. The Conference Bill would subject S Corporations to a flat $200 franchise tax on the first $1 million of franchise tax base. The normal rate of $1.50 per $1,000 of tax base would apply to an S corporation's tax base in excess of $1 million. This change is effective for taxable years beginning on or after January 1, 2019 and is applicable to calculation of the franchise tax reported on the 2018 (and later) corporate income tax return.[5] A similar provision had been included in the Senate bill, while the House bill would have reduced the franchise tax rate to $1.40 per $1,000 for both C and S corporations.

MILL MACHINERY AND SALES TAX CHANGES

Repeal of Mill Machinery Tax

Article 5F of Subchapter I of Chapter 105 of the General Statutes currently imposes a 1% tax with an $80 per article cap on mill machinery purchased by a manufacturing industry or plant and certain equipment purchased by (i) major recycling facilities, (ii) certain R&D companies, (iii) certain software publishers, (iv) certain industrial machinery refurbishers, (v) certain port facility handlers, (vi) certain secondary metals recyclers, (vi) certain precious metal extractors and (vii) certain metal work fabricators.

The Conference Bill would repeal Article 5F effective July, 2018.[6] The Conference Bill would also repeal, as deadwood, the sales and use tax exemptions available under current law for items taxable under Article 5F.[7] A similar provision was included in the House bill.

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[1] Conference Bill § 38.1.
[2] Conference Bill § 38.2.
[3] Conference Bill § 38.4.
[4] Conference Bill § 38.5.
[5] Conference Bill § 38.6.
[6] Conference Bill § 38.8.(a).
[7] Id. See also Conference Bill §38.8.(b) repealing the exemption for service contracts on items taxed under Article 5F.

Sales Tax Exemption for Mill Machinery

The Conference Bill would provide sales and use tax exemptions for all the items previously subject to tax under Article 5F, also effective July 1, 2018.[8] It should be noted that the language of these new sales tax exemptions is substantively identical to the language of the existing Article 5F provisions, except that one requirement currently applicable to purchases by R&D companies, software publishers industrial machinery refurbishers would be eliminated. Under current law items purchased by these taxpayers are covered by Article 5F only if they would be considered mill machinery if they were purchased by a manufacturing industry or plant.[9] A similar provision was included in the House bill.

Revenue Law Study Committee Study

The Conference Bill follows the House bill in including a provision acknowledging that the legislature has never defined the terms "manufacturing industry or plant" or "mill machinery" and that the Department of Revenue has developed a substantial body of administrative interpretations of these terms. The bill would direct the Revenue Laws Study Committee to study "ways in which to clarify the scope of the sales and use tax exemption for mill machinery" by "modernizing and further defining the statutory language and by incorporating existing administrative interpretations of the Department of Revenue, to the extent the General Assembly desires to maintain those interpretations." The Committee "may," but apparently would not be required, to report its findings and any recommended legislation to the 2018 Regular Session of the 2017 General Assembly.[10]

Sales Tax Exemption for Ready-mix Concrete Mills

The Conference Bill would enact a new sales and use tax exemption for sales of repair or replacement parts for a ready-mix concrete mill, whether the mill is freestanding or affixed to a motor vehicle, if the purchaser is primarily engaged in the sale of ready-mix concrete.[11] A similar provision was included in the House bill.

Exemption for Large Fulfillment Centers

The Conference Bill includes a sales tax exemption for sales of equipment, including accessories, attachments and repair parts, sold to a "large fulfillment facility" and used at the facility in the distribution process. The exemption would not apply to electricity. A "large fulfillment facility" would be defined as a facility used primarily for receiving, inventorying, sorting, repackaging and distributing finished retail products for the purpose of fulfilling customer orders. To qualify, the Secretary of Commerce must have certified that at least $100 million in private funds will be invested in the project within a five-year period and that at least 400 people will be employed at the facility. The exemption would be forfeited if the investment and employment requirements were not satisfied. This provision would become effective to July 1, 2017.[12] A similar provision was included in the House bill.

Refund for Transformative Projects

The Conference Bill includes a modification to the State's Job Development Investment Grant ("JDIG") program to provide additional incentives for "transformative projects." A transformative project is defined as a project requiring an investment of at least $4 billion and the creation of at least 5,000 jobs.[13] In addition, the bill provides that the owner or lessee of a business that receives a JDIG grant for a transformative project would be entitled to a refund of sales tax paid or indirectly incurred on building materials, building supplies, fixtures and equipment that become a part of the real property of the facility. This provision would become effective July 1, 2017.[14] Neither the House nor Senate budget bills included a similar provision.

RENEWABLE ENERGY TAX CREDIT CHANGES

The General Assembly repealed North Carolina's renewable energy tax credits, effective January 1, 2016 but extended the sunset to January 1, 2017 for 65 megawatt or larger projects that were 50% complete by January 1, 2016 and for smaller projects that were 80% complete by that date. The Conference Bill would further extend the

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[8] Conference Bill §38.8.(c).
[9] See G.S. §§105-187.51B(a)(2)c, 105-187.51B(a)(3)c, and 105-187.51B(a)(4)c.
[10] Conference Bill §38.8.(e).
[11] Conference Bill §38.8.(c), adding new G.S. §105-164.13(5i).
[12] Conference Bill §38.9.
[13] Conference Bill §15.15A.
[14] Conference Bill §38.9A.

sunset to May 5, 2017 for renewable energy property using renewable biomass resources that qualified for the first extension.[15] Neither the House nor Senate budget bills included a similar provision.

[15] Conference Bill § 38.13.