



**HOUSE BILL 1030:
2016 Appropriations Act, Sec. 38.5:
Sales Tax Changes**

2015-2016 General Assembly

Committee:		Date:	August 4, 2016
Introduced by:		Prepared by:	Cindy Avrette
Analysis of:	Sec. 38.5 of S.L. 2016-94		Legislative Analyst

OVERVIEW: *Sec. 38.5 of S.L. 2016-94, as amended by Part XI of S.L. 2016-123, does the following:*

- *Provides a grace period for retailers who provide repair, maintenance, and installation services. This part of the section became effective July 14, 2016, and the relief provided for related transactions applies retroactively to January 1, 2015.*
- *Amends the sales tax on repair, maintenance, and installation services to treat similar transactions the same and to identify taxable transactions more clearly. In treating similar transactions the same, the act expands the sales tax base to include repair and maintenance of real property. This part of the section becomes effective January 1, 2017.*
- *Allows a use tax exemption equal to the amount of the installation charges and sales price of, or gross receipts derived from, the repair, maintenance, and installation services that exceed \$25,000 for a boat, aircraft, or qualified jet engine. This part of the section became effective July 1, 2016.*
- *Repeals the \$17.6 million State contribution to local sales and use tax revenue distributed to counties and cities, effective for fiscal years beginning on or after July 1, 2016. The contribution would have become effective July 1, 2016; thus, the repeal nullifies the contribution before it became effective.*
- *Allows a sales tax exemption for products made of more than 75% recycled material by weight if the products are sold for use in an accepted wastewater dispersal system. The exemption becomes effective October 1, 2016.*

**SALES AND USE TAX ON REPAIR, MAINTENANCE, AND INSTALLATION SERVICES,
SUBSECTIONS (a) – (l)**

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- Repealed the sales tax exemption for installation charges in conjunction with the sale of tangible personal property.
- Expanded the sales tax base to include repair, maintenance, and installation services ("RMI service"), with certain exclusions.
- 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.

Karen Cochrane-Brown
Director



Legislative Analysis
Division
919-733-2578

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These changes created distinctions between various types of transactions that have caused the following concerns:

- **Retailer vs. Non-Retailer** – Expanding the sales tax base to include all RMI services would have significantly increased the number of people responsible for collecting and remitting sales tax. To reduce the number of new retailers, the current law states that a person who only provides RMI services is not required to collect and remit the sales tax. It also provides that a person who acts as both a retailer and a real property contractor, commonly referred to as a retailer-contractor, cannot be a contractor for sales tax purposes if the majority of the person's gross receipts are derived from retail trade. These distinctions put into the law to reduce the number of retailers from the base expansion treats similar transactions differently, based on the classification of the provider. These distinctions have created confusion in applying the new law.
- **Interpretational Issues ("restore" = clean; "apply tangible personal property" = clothing alterations)** – 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. Based on the Department of Revenue's (DOR) interpretation of the word "restore",¹ RMI service may include a service that involves cleaning tangible personal property, such as a car wash.² 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 that one would not necessarily consider "installation", such as hemming a pair of pants or laminating paper. Based on DOR's interpretation of "installation," clothing alterations are taxable when performed by a retailer.
- **Inconsistency regarding repair and maintenance of 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 applies only to tangible personal property and not to 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, the repair would not be taxable because it would be the repair of real property. However, if the repair involves installing 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 that the HVAC company is a retailer. An HVAC company may be a retailer if more than 50% of its revenues are derived from service contracts, since the gross receipts derived from a service contract are subject to sales tax.

BILL ANALYSIS: To address the aforementioned confusion, Section 38.5 of S.L. 2016-94 does the following:

- **Establishes a 10-month grace period and authorizes the Secretary of Revenue to compromise a retailer's liability with regard to RMI services for 6 years** – Section 38.5(a) provides that a retailer is not liable for an undercollection of sales and use tax if the retailer made a good faith effort

¹ [DOR Directive on Repair, Maintenance, and Installation Services. SD-16-2.](#)

² Under current law, a self-service car wash is not taxable. A car wash provided by a person who is not a retailer is not taxable. However, a car wash provided by a person who is a retailer is taxable.

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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.

Under current law, the Secretary of Revenue may compromise a taxpayer's liability for a collectible tax debt³ when the Secretary determines that the compromise is in the State's best interest and makes one or more findings listed in G.S. 105-237.1. One of the findings enumerated in G.S. 105-237.1 includes that the taxpayer is a retailer and that the assessment is for sales or use tax that 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) adds another finding to the list: the assessment is for sales or use tax that the retailer failed to collect or pay as a result of the change in the definition of retailer or the sales tax base expansion to service contracts, RMI services, or sales transactions for a person in retail trade. This finding applies to assessments for any reporting period beginning March 1, 2016, and ending December 31, 2022.

Section 38.5(c) allows a retailer-contractor who underpaid use tax to offset the amount of tax owed by any overcollection of sales tax remitted on a related transaction. G.S. 105-164.11(a)(2) allows an overcollection of sales tax to offset the undercollection of use tax if the tax is due on a related transaction. Under prior law, this off-setting tax remedy was not allowed for a retailer-contractor who collected sales tax on transactions where G.S. 105-164.4H specifically prescribed that the retailer-contractor was the consumer of the tangible personal property when the retailer-contractor was acting as a real property contractor. This change reverses the law by making this remedy effective retroactive to January 1, 2015, the effective date of the tax law changes applicable to real property contracts.

- **Treats similar transactions the same** – The changes made by Section 38.5 treat similar transactions the same regardless of who performs the service. It removes the "retail trade" test, and it removes the prohibition against a retailer-contractor acting as a real property contractor for sales tax purposes. It expands the sales tax base to include the repair and maintenance of real property; thus removing the distinction between repairing real property in accordance with a service contract, which is currently taxable, as opposed to making a similar repair upon request, which is not currently taxable. Removing these distinctions will increase the number of businesses that will be required to register as retailers to collect and remit sales tax.
- **Excludes capital improvements** – Tangible personal property or digital property installed or applied by a real property contractor under a real property contract for a capital improvement is not a retail sale of RMI services and will not be subject to sales tax. In these transactions, the real property contractor is the consumer of the tangible property, digital property, or services that the real property contractor purchases, installs, or applies for others to fulfill a real property contract. As the consumer, the real property contractor pays sales tax on the items purchased at retail to fulfill the real property contract unless a statutory exemption applies. G.S. 105-164.4H defines a capital improvement as new construction, reconstruction, remodeling, or renovation of a permanent building, structure, or fixture on land that becomes part of the real property or is permanently installed or applied to the real property so that the removal would cause material damage to the property or article. The act specifically identifies the following as capital improvements:
 - Removal of items from real property, such as asbestos, debris, and construction material. This would include the removal of dumpster used at a construction site.

³ A collectible tax debt is an assessment of tax that becomes collectible under G.S. 105-241.22.

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- Performance of work that requires a permit under the State Building Code, other than repair or replacement of electrical components, gas logs, water heater, and similar individual items that are not part of new construction, reconstruction, or remodeling.
- Installation of underground utilities.
- Installation of equipment that is attached to real property so that the removal of the item would cause physical, functional, or economic damage to the property and that is capitalized under the Code, Generally Accepted Accounting Principles, or International Financial Reporting Standards.
- Replacement or installation of roofing, septic tank, plumbing, electrical, commercial refrigeration, irrigation, and sprinkler, or other similar system.
- Replacement or installation of an HVAC unit or system.
- Replacement or installation of roads, driveways, parking lots, and sidewalks.
- Landscaping services.
- Painting or wallpapering.

Although the statute defines a capital improvement and enumerates a list of capital improvements, there may still be instances where it is unclear whether a contract is a real property contract for the construction, reconstruction, or remodeling with respect to a capital improvement to real property. The term "capital improvement" does not necessarily include the replacement of a fixture in or on a building or structure, nor does it include a single RMI service. For example, a contract for the replacement of a countertop may not be considered a real property contract for a capital improvement unless the replacement is part of a remodeling. If the replacement is not considered a real property contract for a capital improvement, then the installation of the countertop would be subject to sales tax.

- **Clarifies the taxability of certain RMI services with respect to tangible personal property and to exempt certain RMI services from tax** – Section 38.5 amends the definition of RMI services to include the cleaning, washing, or polishing property. The following services, which otherwise fall within the definition of RMI services, are exempt from tax:
 - 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 12 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.
 - Cleaning of real property. Examples of cleaning real property are power-washing, window cleaning, and janitorial services.
 - Services on roads, driveways, parking lots, and sidewalks. This exemption ensures similar tax treatment for the repair and maintenance of these items as is provided for the construction

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of them. These items are most often State or county-owned in nature and commercial property.

- Removal of waste, trash, debris, grease, snow, and other similar items from real property or tangible personal property. This exemption ensures similar tax treatment regardless of whether the removal is provided upon request or under a real property contract. The exemption does not include the removal of waste from portable toilets.
 - Home inspections related to the preparation for or the sale of real property.
 - Landscaping services. This exemption ensures similar tax treatment for landscaping services regardless of whether the service is provided upon request or under a real property contract.
 - Alteration or repair of clothing. The exemption does not include alteration or repair of belts and shoes.
 - Pest control service.
 - Moving services.
 - Self-service car washes.
 - RMI services purchased by a qualifying farmer and for use by the farmer in farming operations.
- **Clarifies the taxability of motor vehicle service contracts and the storage and towing of 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. Section 38.5 defines "motor vehicle service contract" and exempts a motor vehicle service contract from sales tax. A motor vehicle service contract is 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. This section also exempts the storage of a motor vehicle and towing services, provided the charge is separately stated on the invoice or other documentation given to the customer at the time of the sale. The exemption ensures similar tax treatment for storage and towing costs incurred as part of RMI services and the use of these services standing alone.
 - **Direct DOR to issue guidance and effective date** – Section 38.5(1) directs the Department of Revenue to issue written guidance to taxpayers relative to the RMI services tax law changes by November 15, 2016. The effective date of the tax law changes is January 1, 2017.

USE TAX EXEMPTION FOR RMI SERVICES PROVIDED FOR BOATS, AIRCRAFT, AND QUALIFIED JET ENGINES SUBSECTIONS (m) - (n)

CURRENT LAW: Effective March 1, 2016, the General Assembly repealed the sales tax exemption for installation charges in conjunction with the sale of tangible personal property and expanded the sales tax base to include RMI services. The sales and use tax rate on boats is 3% with a maximum tax of \$1,500. The sales and use tax rate on aircraft and qualified jet engines purchased with a direct pay certificate is 4.75% with a maximum tax of \$2,500. However, the sales and use tax rate on RMI services provided for a boat, aircraft, or qualified jet engine is the combined State and applicable local rate, ranging from 6.75% to 7.25%, with no maximum tax.

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BILL ANALYSIS: Section 38.5(m) provides an effective cap on the amount of sales and use tax payable on a RMI service provided for a boat or aircraft. Under the Streamlined Sales and Use Tax Agreement, North Carolina may either tax a service or exempt a service from sales tax; it may not impose a cap on the amount of sales tax payable. However, under the Streamlined Sales and Use Tax Agreement, a State can allow a cap on the amount of sales and use tax payable if the burden of administering the cap is removed from the retailer.⁴ This section provides that a purchaser of a RMI service provided for a boat or aircraft 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 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 remain subject to the combined State and local sales tax rate with no cap.

EFFECTIVE DATE: This change became effective July 1, 2016, and applies to purchases of repair, maintenance, installation services purchased on or after that date.

REPEAL STATE CONTRIBUTION THAT IS ALLOCATED TO COUNTIES AS PART OF THE 2% LOCAL OPTION SALES TAX SUBSECTION (o)

CURRENT LAW: Last session, the General Assembly provided an additional \$84.8 million to 79 counties beginning in fiscal year 2016-17. The percentage of this amount that is allocated to a particular county is set by statute in G.S. 105-524. The amount allocated to a county is distributed between the county and its municipalities. A county must use its allocation for public schools, community colleges, or economic development purposes. One-twelfth of the additional revenue allocated to a county or municipality for a fiscal year is distributed as part of the local unit's sales tax revenue, beginning with the September 2016 distribution of sales tax revenue.

The amount of additional revenue distributed to the 79 counties is adjusted annually; the percentage of the amount allocated to each county remains constant. Beginning in fiscal year 2017-18, the additional revenue to be allocated to the 79 counties will be the distribution amount for the prior fiscal year (in this case, \$84.8 million) adjusted by the percentage change in the total collection of local sales and use tax for the preceding fiscal year (in this case, the percentage change in total local sales tax revenue collected in FY16-17 compared to the amount collected in FY15-16).

A State contribution of \$17.6 million was enacted last session as part of the legislation to distribute additional sales tax revenue to certain counties. The State contribution is distributable to all counties and municipalities as part of their local sales tax revenue under Articles 39, 40, and 42. The purpose of the State contribution was to make 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 to certain counties.

BILL ANALYSIS: New data regarding the sales tax base expansion indicates local revenues from the sales tax base expansion to RMI services will exceed the \$84.8 million distributed to 79 counties. Therefore, the State contribution is not needed, and Section 38.5(o) repeals the contribution.

⁴ See Section 323 of the Streamlined Sales and Use Tax Agreement. [SSTA, as amended through May 4, 2016.](#)

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EFFECTIVE DATE: The repeal became effective for fiscal years beginning on or after July 1, 2016. Under S.L. 2015-241, the contribution would have become effective for fiscal years beginning on or after July 1, 2016; thus, the repeal of the contribution nullifies the contribution before it became effective.

SALES TAX EXEMPTION FOR MATERIALS USED IN ACCEPTED WASTEWATER DISPERSAL SYSTEMS SUBSECTION (p)

CURRENT LAW: A conventional wastewater system uses washed natural stone or gravel to distribute effluent to soil via one or more trenches. Washed gravel or crushed stone sold by a quarry is exempt from sales tax because it falls within the exemption for products of forests and mines sold by the producer in their original or unmanufactured state.

An "accepted wastewater dispersal system" uses an alternative filtration material -- an engineered geosynthetic aggregate, which is made mostly of recycled materials. The sale of this material to companies that manufacture these alternative wastewater dispersal systems is subject to sales tax.

BILL ANALYSIS: Section 38.5(p) exempts from sales tax the sale of products made of more than 75% recycled materials by weight if the products are sold for use in an accepted wastewater dispersal system as defined in G.S. 130A-343.

An "accepted wastewater dispersal system" means any subsurface wastewater dispersal system, other than a conventional wastewater system, that meets all of the following conditions:

- Has been previously approved as an innovative wastewater dispersal system by DHHS.
- Has been in general use in this State as an innovative wastewater dispersal system for more than five years.
- Has been approved by the Commission for general use or use in one or more specific applications.

EFFECTIVE DATE: The exemption becomes effective October 1, 2016, and applies to sales made on or after that date.