



HOUSE BILL 1030: Finance Provisions in 2016 Appropriations Act.

2016-2017 General Assembly

Committee:	House Finance. If favorable, re-refer to Appropriations	Date:	May 17, 2016
Introduced by:	Reps. Dollar, L. Johnson, Lambeth, McGrady	Prepared by:	Trina Griffin
Analysis of:	PCS to First Edition H1030-CSMCxr-26		Committee Counsel

SUMMARY: *The Finance provisions in the 2016 Appropriations Act are as follows:*

- *Set the insurance regulatory fee at 6.5% for 2017, which is the same rate that has been in place for the last two years.*
- *Increase the standard deduction by \$2,000 over four years in \$500 increments for MFJ taxpayers and by \$1,000 over four years in \$250 increments for single taxpayers, beginning with the 2017 tax year.*
- *Reduce the taxation of mill machinery and other machinery and equipment currently subject to the 1%/\$80 privilege tax by repealing that tax and exempting the machinery and equipment from sales tax, effective July 1, 2016.*
- *Expand the preferential tax treatment of certain machinery and equipment by adding provisions for the following:*
 - *Secondary metal recyclers and precious metal processors - Retroactive 1%/\$80 treatment from 2010-2016; sales tax exemption beginning July 1, 2016.*
 - *Parts, accessories, or attachments for equipment that is currently eligible for a company located at a ports facility – Retroactive 1%/\$80 treatment from 2013-2016; sales tax exemption beginning July 1, 2016.*
 - *Metal fabricators that manufacture metal products for their own use – Sales tax exemption beginning July 1, 2016.*
 - *Repair parts and replacement parts for ready-mix concrete mills, regardless of whether they are attached to a motor vehicle – Sales tax exemption beginning July 1, 2016.*

CURRENT LAW & BILL ANALYSIS:

SET INSURANCE REGULATORY FEE

Section 23.1 sets the rate for the insurance regulatory charge at 6.5% for 2017. The rate has remained at 6.5% for the past two years (for 2015 and 2016). The insurance regulatory charge was first enacted in 1991 to defray the State's cost of regulating the insurance industry. The charge is a percentage of each insurance company's gross premiums tax liability. The General Assembly must set the rate for this charge each year.

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INCREASE ZERO TAX BRACKET

CURRENT LAW: Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions and will choose the method that gives them the lower tax. The standard deduction is a dollar amount that reduces taxable income and eliminates the need to itemize actual deductions, such as medical expenses, charitable contributions, and taxes, on Schedule A. Approximately 65-70% of North Carolina taxpayers take the standard deduction.

In 2015, the General Assembly increased the standard deduction from \$15,000 to \$15,500 for married filing jointly taxpayers and from \$7,500 to \$7,750 for single taxpayers, beginning with the 2016 taxable year.

BILL ANALYSIS: Section 38.1 of the bill would further increase the standard deduction by \$500 for married filing jointly taxpayers and \$250 for single taxpayers in each of the next four years, beginning with the 2017 tax year.

Filing Status	2017	2018	2019	2020
Married, filing jointly	\$16,000	\$16,500	\$17,000	\$17,500
Head of Household	\$12,800	\$13,200	\$13,600	\$14,000
Single	\$8,000	\$8,250	\$8,500	\$8,750
Married, filing separately	\$8,000	\$8,250	\$8,500	\$8,750

REDUCE MILL MACHINERY TAX

Prior to 1961, sales of mill machinery to a manufacturer were exempt from sales tax. In 1961, the exemption was repealed, and the equipment was subjected to a reduced rate of sales tax – 1% of the sales price with a cap of \$80 per article. In 2001, the preferential sales tax rate was converted to a privilege tax paid by the purchaser (Article 5F).

Expansion Items. – The following four items would be expansions of the current 1%/\$80 tax treatment for certain machinery and equipment. The first two provisions are retroactive and would impact outstanding items under review or subject to assessment by the Department of Revenue.

Ports Facility. – Section 38.2.1(a) would expand the current 1%/\$80 provision for a company located at a ports facility for waterborne commerce. Currently, said company can purchase, at the 1%/\$80 tax rate, machinery and equipment that is used to unload or facilitate the unloading or processing of bulk cargo to make it suitable for delivery to and use by manufacturing facilities.

This provision would allow the company to purchase parts, accessories, or attachments used to repair, maintain, or upgrade the machinery and equipment at the 1%/\$80 rate as well. The expansion is retroactive to July 1, 2013, which is when the ports provision originally became effective.

Secondary Metal Recyclers and Precious Metal Processors. – Section #38.2.1(b) would provide the 1%/\$80 treatment for equipment purchased by secondary metal recyclers and precious metal processors. Under current law, some, but not all, of a secondary metal recycler's equipment is eligible for the 1%/\$80 tax. Generally speaking, equipment must be an integral part of transforming raw materials into a new and different product in order to be eligible. Equipment that only cuts or sorts, for example, is not necessarily eligible. This provision would allow the treatment for

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equipment that gathers, obtains, and converts ferrous or nonferrous metals into products of potential economic value, including equipment that sorts, cuts, classifies, cleans, bales, wraps, shreds, shears, or changes the physical form of the metals. It would not apply to equipment that transports the converted products from the establishment. New subdivision (57a) would also exempt electricity and fuel used by secondary metal recyclers from sales and use tax if the primary activity at the facility is recycling.

This provision would also provide the 1%/\$80 treatment for equipment used by a precious metals processor. Under current law, this equipment would not be eligible to the extent the tangible personal property being processed is not owned by the company processing it.

This provision would become effective for purchases made on or after July 1, 2010.

Metal Fabricators. – New subdivision (5k) would exempt from sales tax the sale of equipment, attachments, and repair parts to a company that is engaged in the fabrication of metal work that has annual gross receipts of at least \$8 million dollars derived from the fabrication. The rate would apply to equipment and repair parts that are capitalized by the company for tax purposes under the Code and that are used at the establishment to create metal products for use by the company. Under this bill, a company would not be required to be "primarily engaged" in the fabrication of metal products. Also, the equipment would qualify regardless of whether it is primarily used to manufacture items for sale. Historically, this rate has been afforded to companies that manufacture a finished product for sale as distinguished from a company that manufactures an item for its own use in the fulfillment of a performance contract.

This provision would become effective July 1, 2016.

Concrete Mills. – New subdivision (5m) would exempt from sales tax repair or replacement parts for a ready-mix concrete mill, regardless of whether the mill is freestanding or affixed to a motor vehicle, to a company that primarily sells ready-mix concrete. Currently, purchases by ready-mix concrete manufacturers of mill machinery, equipment, parts, and accessories that are used directly in the manufacture of ready-mix concrete for sale are subject to the 1%/\$80 tax. However, once a ready-mix concrete mill becomes part of a truck, it is part of a motor vehicle; and a motor vehicle is not considered mill machinery. Repair parts and accessories to a motor vehicle are subject to State and local sales tax.

This provision would become effective July 1, 2016.

Repeal Article 5F and Exempt Existing Provisions from Sales Tax.

Section 38.2.2 would repeal Article 5F and move the current provisions to the sales tax exemption statute. There are no substantive changes to the language of the provisions; the only modifications that have been made are those necessary to make the provisions fit the sales tax exemption statute and to eliminate unnecessary language. The expansion items mentioned above are included as well.

Under current law, service contracts on Article 5F items and the repair, maintenance, and installation of Article 5F items are exempt from tax. This treatment would remain the same once the items are moved into the sales tax exemption statute. These services would continue to be exempt from tax.

The repeal of Article 5F and the sales tax exemptions would become effective July 1, 2016.

LEGISLATIVE HISTORY: The 1%/\$80 cap per article classification for certain machinery and equipment was enacted in 1961 as a preferential rate of sales tax, which was among other sales and use tax changes made at the same time, including the elimination the wholesale tax, and was a means of ameliorating the fiscal impact of those changes. It is not clear why the rate of 1% with a maximum of

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\$80 per article was chosen; perhaps it was because that was the same preferential rate imposed on motor vehicles and airplanes in 1955 when the \$15.00 per article limitation that applied to every item sold was repealed. However, since its enactment in 1955, the rate applicable to motor vehicles and airplanes has increased, but the rate applicable to certain machinery and equipment has remained the same since 1961.

In 2001, in response to the requirement of the Streamlined Agreement that states simplify their sales tax rates, the General Assembly repealed the 1% sales tax rate and \$80 per article cap imposed on mill machinery and replaced it with a privilege excise tax having the same rate (Article 5F of Chapter 105).

Since 2001, the Article has been expanded for specific types of industries by taxing machinery and equipment at the lower rate, so long as it is capitalized for tax purposes under the Code by a company "primarily engaged" in certain kinds of business activities. This criterion is undefined, and the Department is often faced with having to make a determination whether a company is primarily engaged in the named activity. The Department has generally interpreted it to mean that over 50% of the revenues generated at the establishment are derived from the named activity. The types of businesses eligible for the 1%/\$80 rate on certain machinery and equipment are as follows:

- A major recycling facility. (2005)
- A research and development company in the physical, engineering, and life sciences. (2006)
- A software publishing company. (2007)
- A datacenter. (2007)
- An industrial machinery refurbishing company. (2008)
- A company located at a ports facility for waterborne commerce. (2013)

BACKGROUND: The original statute in Article 5F (G.S. 105-187.51) imposes the rate on a manufacturing industry or plant that purchases mill machinery or mill machinery parts and accessories. However, the statute does not specifically define a "manufacturing industry" or "mill machinery." Because the statute does not define these terms, it has raised questions as to whether a company is a manufacturer, for example, if it engages in multiple activities, only one of which may be manufacturing. It also raises questions as to whether a particular piece of equipment is "mill machinery" if it has dual purposes, only one of which is to manufacture goods. Over the years, the Department of Revenue has, through a combination of administrative rule, case law, and interpretation of the Secretary, developed guidance and criteria to determine the application of the tax. The criteria have not always been consistent or clear to taxpayers, but one aspect that has remained consistent is that the rate applies to equipment that manufactures goods for sale.

Most states provide a sales and use tax exemption for machinery and equipment used directly and exclusively in manufacturing or processing tangible personal property for sale. The exemption (or reduced rate) is intended to help eliminate taxation on business inputs where the end product that is being manufactured is ultimately taxed. However, this seemingly straightforward exemption is one of the greatest sources of complexity in sales tax law and has generated innumerable court cases in virtually all states. The exemption creates two major questions: what constitutes "manufacturing" and does equipment involved in certain activities, such as testing, research and development, repair and maintenance, storage, or transport, qualify as "equipment used in manufacturing."

What constitutes "manufacturing"? - Manufacturing comprises so many different activities that the definition, interpretation, and application of the term varies from state to state. For example, all manufacturing probably includes some processing or fabrication, but not all fabrication or processing is manufacturing. Similar questions arise over refining, assembly, and construction. In *East Tex. Motor Freight Lines v. Frozen Foods Express*, 351 U.S. 49 (1956), the U.S. Supreme Court stated that

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"manufacturing implies a change...there must be a transformation; a new and different article must emerge, having a distinctive name, character, or use." In *Appeal of Clayton-Marcus Co., Inc.*, 286 N.C. 215, 223-26, 210 S.E. 2d 199, 205-07 (1974), the North Carolina Supreme Court stated that "producing a finished good not for sale but rather for one's own use is not manufacturing." However, attempts to follow this guiding principle have produced mixed results.

What constitutes "equipment used in manufacturing"? - Most states require that, in order to qualify for this exemption or preferential rate, machinery and equipment must be used directly, exclusively, primarily, or some combination thereof, in manufacturing tangible personal property for sale. Again, how those terms are defined varies from state to state. Primary use is generally defined as more than 50% of the machine or equipment's use must be in manufacturing or production. In most states, manufacturing begins when the item is withdrawn from its first point of storage and ends when the item is removed at the end of the manufacturing process and placed in finished goods storage. Most states consider the shipping and receiving areas to be outside the manufacturing process.