2015-2016 General Assembly

HOUSE BILL 117: North Carolina Competes Act, Parts III-VI: Sales Tax Changes

Committee: **Date:**
Introduced by: **Prepared by:** Trina Griffin and Cindy Avrette, Staff Attorneys
Analysis of: Parts III through VI of 2015-259

SUMMARY: Parts III through VI of S.L. 2015-259 make the following sales tax changes:

- ***Datacenter Infrastructure Act. - Part III creates a sales tax exemption for datacenters investing at least $75M within a 5-year period for sales of datacenter equipment and electricity located and used at the datacenter. The exemption becomes effective January 1, 2016, and applies to sales made on or after that date.***
- ***Sales Tax Relative to Aviation. - Part IV (i) extends for 4 years the sales tax refund available to interstate passenger air carriers for sales tax paid on fuel in excess of $2.5M; (ii) exempts from sales tax fuel sold to an interstate air business for use in a commercial aircraft, effective January 1, 2016, taxes remaining sales of aviation gasoline and jet fuel at 7%, and earmarks the revenue from the tax to the Division of Aviation, Department of Transportation; (iii) increases the sales tax rate on aircraft and tax qualified jet engines at 4.75% with a maximum tax of $2,500, effective October 1, 2015; and (iv) exempts service contracts and repairs, maintenance, and installation services on qualified aircraft and qualified jet engines from sales tax, effective October 1, 2016.***
- ***Exempt Motor Vehicle Service Contracts from Sales Tax. - Part V exempts service contracts on motor vehicles from sales tax. As part of the budget bill, S.L. 2015-241 (H97), sales tax is imposed on repair, maintenance, and installation services. The taxation of this service mitigates the need to impose the tax on service contracts and eases the administrative issues associated with the sales tax on service contracts for motor vehicles. This Part becomes effective March 1, 2016.***
- ***Extend Sales Tax Preference for Motorsports Parts and Fuel. - Part VI, as amended by S.L. 2015-261, extends the current sales tax preferences for motorsports from January 1, 2016, to January 1, 2020, and clarifies the current sales tax on race engines and service contracts on items used by a professional motorsports racing team.***

PART III. DATACENTER INFRASTRUCTURE ACT

Since 2006, an eligible Internet datacenter may receive a sales tax exemption for electricity and certain business property that is located and used at the datacenter. An eligible Internet datacenter is one that is used primarily by a business engaged in software publishing or an Internet activity, that is comprised of structures located on contiguous parcels of land that are commonly owned by the operator of the facility, is located in a development tier one or two area, and has a written determination provided by the Secretary of Commerce that at least $250 million in private funds has been or will be invested in the property. To be eligible for the exemption, the business property must be capitalized for tax purposes under the Code and must be used for the provision of services related to the business of the primary user

of the datacenter; used for the generation, transmission, transformation, distribution, or management of electricity; or used to provide related computer engineering or computer science research.[1]

There were two other tax benefits available to certain datacenters, but those benefits have expired.[2]

Part III creates a similar, but not identical, sales tax exemption for datacenter support equipment and electricity used by a "qualifying datacenter." Datacenter support equipment is property that is capitalized for tax purposes under the Code and used for one of the following purposes:

- The provision of a service or function included in the business of an owner, user, or tenant of the qualifying datacenter.
- The generation, transformation, transmission, distribution, or management of electricity. The list of examples included in this purpose is more extensive than the list in G.S. 105-164.13(55).
- HVAC and mechanical systems. This property is not specifically listed in G.S. 105-164.13(55).
- Hardware and software for distributed and mainframe computers and servers, data storage devices, network connectivity equipment, and peripheral components and equipment. This property is not specifically listed in G.S. 105-164.13(55).
- The provision of related computer engineering or computer science research.

To qualify for the sales tax exemption created in this Part, a taxpayer not only has to meet an investment threshold, but also wage and health insurance standards. The taxpayer must provide health insurance for its full-time jobs and meet the wage standard that existed as part of the Article 3J tax credits.[3] The wage standard differs depending on the tier designation of the county in which the facility is located. There is no wage standard for a tier one area; the wage standard for a tier two or tier three area is equal to the lesser of 110% of the average weekly wage for all insured private employers in the State and 90% of the average weekly wage for all insured private employers in the county.[4] The taxpayer must invest at least $75 million in private funds has been or will be invested by one or more owners, users, or tenants of the datacenter within five years of the date the initial investment is made. Initial investments made on or after January 1, 2012, may be included to meet the investment threshold. The Secretary of Commerce must make a written determination that this investment threshold has been or will be met.

A taxpayer that fails to make the level of investment required for qualification forfeits the exemption and is required to repay all taxes, with interest, avoided as a result of the forfeited exemption. Similarly, a taxpayer that does satisfy the investment amount, but fails to use the property or electricity at the eligible facility forfeits the exemption with respect to that particular property or electricity. The past taxes and interest are due 30 days after the date of the forfeiture.

This section becomes effective for purchases made on or after January 1, 2016.

PART IV. SALES TAX RELATIVE TO AVIATION

Part IV addresses several sales tax issues related to aviation.

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[1] The General Assembly enacted G.S. 105-164.13(55) in S.L. 2006-66, Section 24.17. In January of 2007, Google announced its decision to invest $600 million in a new facility in Caldwell County in Lenoir, North Carolina. In July 2009, Apple announced its decision to invest $1 billion in a new facility in Catawba County in Maiden, North Carolina.

[2] G.S. 105-164.14A(a)(3) provided a sales tax refund for information technology companies in a tier one area for machinery and equipment. This preference expired January 1, 2014. G.S. 105-187.51C imposed a 1% excise tax, in lieu of a State and local sales tax, on certain equipment and machinery. This preference expired July 1, 2015.

[3] The statute references G.S. 143B-437.08A; it should have referenced G.S. 105-129.83.

[4] Unlike the existing sales tax exemption for an eligible Internet datacenter, a qualifying datacenter may locate in a tier three area and qualify for the sales tax exemption.

Expiring sales tax refund for interstate passenger air carrier with a hub in NC

An interstate passenger air carrier with a hub in the State is allowed a sales tax refund of State and local sales tax paid on fuel in excess of $2.5 million.[5] The General Assembly enacted the refund provision in 2004, effective January 1, 2005, with a sunset that has been extended several times. The refund tax benefit is repealed for purchases made on or after January 1, 2016. This Part does not extend the refund provision. Instead, the act creates a sales tax exemption for aviation gasoline and jet fuel sold to an interstate air business for use in a commercial aircraft. The exemption is effective for sales made on or after January 1, 2016. It expires for sales made on or after January 1, 2020.

The newly created exemption is broader than the current refund provision; it is available to all interstate air businesses at all airports in the State. The exemption mirrors the existing sales tax exemption for tangible personal property sold to an interstate air business that becomes a component part of a commercial aircraft during its maintenance, repair, or overhaul. For purposes of these two exemptions, a commercial aircraft is defined as one that has a certified maximum take-off weight of more than 12,500 pounds and is regularly used to carry for compensation passengers, commercial freight, or individual addressed letters and packages. An interstate air business is one or more of the following:

- An interstate air courier. – A person whose primary business is the furnishing of air delivery of individually addressed letters and packages for compensation, in interstate commerce, except by the United States Postal Service.
- An interstate freight air carrier. – A person whose primary business is scheduled freight air transportation, as defined in the North American Industry Classification System adopted by the United States Office of Management and Budget, in interstate commerce.
- An interstate passenger air carrier. – A person whose primary business is scheduled passenger air transportation, as defined in the North American Industry Classification System adopted by the United States Office of Management and Budget, in interstate commerce. Charter flights, by definition, do not appear to be an interstate passenger air carrier.

Section 4.1(e) makes an adjustment to the threshold amount of sales tax an interstate passenger air carrier must pay on fuel before it qualifies for the sales tax refund for the period beginning July 1, 2015. The amount of sales tax on fuel that must be remitted before the refund provision applies is $2.5 million for a 12-month period. The refund provision expires January 1, 2016, thus creating a 6-month refund period. This section makes a corresponding reduction in the threshold amount to $1.25 million for that 6-month period beginning July 1, 2015, and ending December 31, 2015.

FAA policy that revenue from tax on aviation fuel must be used for aviation purposes

On November 7, 2014, the Federal Aviation Administration (FAA) adopted an amendment to its policy on Federal requirements for the use of proceeds from taxes on aviation fuel.[6] The action confirmed the FAA's long-standing policy that airport operators who accept Federal assistance must use tax revenue from sales of aviation fuel at airports for airport related purposes. Failure to do so could result in a loss of federal funds. Each state must have an action plan as to how it plans to comply with the FAA policy by December 8, 2015; and it must be in compliance with the policy by December 8, 2017.

North Carolina has included sales tax revenue collected on fuel sold at airports in its State and local sales and use tax base for decades without restricting its use to aviation purposes. Under the FAA policy, taxes enacted prior to 1987 are grandfathered and are not subject to the use restriction. Of the State sales

[5] S.L. 2005-435, Section 61. The General Assembly enacted the refund provision to encourage US Airways to maintain a hub at Charlotte Douglas International Airport.
[6] Federal Register at 64 FR 7696 on February 16, 1999 ("Revenue Use Policy")

tax rate of 4.75%, 3% is grandfathered but the remaining 1.75% must be in compliance with the FAA policy. Of the local sales tax rate, 2% is grandfathered but any local option sales taxes imposed since 1987 are not. Rather than trying to administratively account for the tax revenue derived from the grandfathered rates and the revenue derived from the remainder of the sales tax levies, Section 4.1(b) simplifies the process by imposing the combined general rate of sales tax on aviation gasoline and jet fuel[7] and using all of the proceeds from the tax for aviation purposes. Most of the sales tax on aviation gasoline and jet fuel is attributable to purchases made by interstate air businesses, and those purchases are exempt from sales tax, as provided under Section 4.1(c) of this act.

Changing the sales tax rate on aviation gasoline and jet fuel to the combined general rate means there will not be a local tax rate on aviation gasoline and jet fuel.[8] Under Section 4.1(d), all of the revenue derived from the sales tax on aviation gasoline and jet fuel is transferred to the Highway Fund within 75 days after the end of the fiscal year and is appropriated to the Division of Aviation of the Department of Transportation for prioritized capital improvements to public airports and time-sensitive aviation capital improvement projects for economic develop purposes. This change becomes effective January 1, 2016.

Sales tax exemptions for qualified aircraft and qualified jet engines

Section 4.2(a) defines a qualified aircraft as an aircraft with a maximum take-off weight of more than 9,000 pounds but not in excess of $15,000 pounds and it defines a qualified jet engine as an engine certified pursuant to Part 33 of Title 14 of the code of Federal Regulations. HondaJet, and the engine used in a HondaJet, meets these definitions. HondaJet is manufactured in Greensboro, North Carolina.

Section 4.2(d) exempts parts and accessories for use in the repair or maintenance of a qualified aircraft or a qualified jet engine from sales tax. Section 4.2(c) exempts a service contract on a qualified aircraft and on a qualified jet engine from sales tax. A service contract is defined as a warranty agreement, a maintenance agreement, a repair contract, or a similar agreement or contract by which the seller agrees to maintain or repair tangible personal property.[9]

The sales tax exemptions became effective October 1, 2015.

Sales tax rate and cap on boats, aircraft, and qualified jet engines

The State sales tax rate on boats and aircraft is 3%, with a cap of $1,500. There is no local sales tax on boats or aircraft. Section 4.2(b) increases the sales tax rate on aircraft to the general rate, which is currently 4.75%. It also increases the sales tax cap on aircraft from $1,500 to $2,500.

Under the Streamlined Sales Tax Agreement, a taxing jurisdiction must have uniform tax rates and may not have caps or thresholds unless the state assumes the administrative responsibility in a manner that places no additional burden on the retailer.[10] Aircraft and boats are two exceptions to that provision. A qualified jet engine does not fall within one of the exceptions. To afford similar tax treatment for qualified aircraft and qualified jet engines, Section 4.2(e) allows the purchaser of a qualified jet engine to pay the use tax through a direct pay permit in lieu of the sales tax, and provides that the maximum use tax would be $2,500. The use of a direct pay permit places the administrative burden of the cap on the

[7] Section 5.1(b) would impose the combined general rate of tax on the gross receipts derived from aviation gasoline and jet fuel. The combined general rate of 7% is the general rate (4.75%) plus the highest authorized local option sales tax rate available to all counties (2.25%).

[8] Under the Streamlined Sales Tax Agreement, the tax base must be uniform in the taxing jurisdiction. To maintain a local uniform tax base, and meet the FAA use restrictions, would be administratively difficult. There is also some uncertainty how the FAA use restrictions would apply to local sales tax levies. The elevation of the tax to a State tax, and the use of all the proceeds from the tax for aviation-related purposes, eliminates many of these issues.

[9] Under the Streamlined Sales and Use Tax Agreement, a state may enact a product-based exemption.

[10] Section 323 of the Streamlined Sales and Use Tax Agreement.

State and on the purchaser, not on the retailer. A person who purchases a qualified jet engine under a direct pay permit must file a return and pay the tax due monthly.

Generally, if an item is subject to tax at the State general rate, it is included in the local sales tax base. The only exceptions to this general rule are purchases of modular homes and manufactured homes. These items are only subject to the State sales tax, not the local sales tax. Section 4.2(f) adds aircraft and qualified jet engines to this exception.

The changes made by this Part became effective October 1, 2015.

PART V. EXEMPT MOTOR VEHICLE SERVICE CONTRACTS FROM SALES TAX

Effective January 1, 2014, service contracts for motor vehicles became subject to sales tax. A service contract is defined as a warranty agreement, a maintenance agreement, a repair contract, or a similar agreement or contract by which the seller agrees to maintain or repair tangible personal property. The implementation of this change has been difficult for dealerships to administer. Sometimes it is unclear whether the repair or maintenance is performed under a service contract. If a repair is made under a service contract, the parts are not taxable; but if the repair is not under a service contract, the part is taxable. Sometimes dealers are uncertain how to distinguish between taxable parts and exempt parts. It is also difficult to know when a service contract may be taxable if it is sold for a vehicle that will be titled out-of-state. Under the sales tax sourcing rules, it is taxable in the state where it may first be used.

Effective March 1, 2016, the sales tax base will include the repair and maintenance of tangible personal property. The expansion of the sales tax base to include repair and maintenance services means that the service will be taxed similarly regardless of whether a person has the repair or maintenance work performed under a service agreement or as an individual transaction. This Part seeks to simplify the administration of sales tax as it relates to service contracts on motor vehicles by exempting a service contract on a motor vehicle from sales tax at the time the contract is purchased, and by taxing the service at the time it is provided, regardless of whether the service is provided under a service contract. The change becomes effective March 1, 2016. The fiscal impact of this change is not expected to be significant since repair and maintenance services provided under a service contract, and the cost of the tangible personal property used to fulfill a service contract, will be taxed at the time the service is provided.

Section 5(a) exempts service contracts on motor vehicles from sales tax. Generally, service contracts on items that are exempt from sales tax are also exempt from sales tax. Motor vehicles are the exception to this general rule. Motor vehicles are exempt from sales tax because they are subject to the highway use tax; however, G.S. 105-164.4I(b)(1) specifically excludes from the sales tax exemption a service contract on a motor vehicle, thus subjecting those service contracts to sales tax. This section removes the specific exclusion and by doing so exempts from sales tax a service contract on a motor vehicle.

Section 5(c) provides that repair and maintenance services provided for a motor vehicle are subject to sales tax, regardless of whether the service is provided under a service contract. Generally, repair and maintenance services provided for an item that is exempt from sales tax is also exempt from sales tax. This section removes repair and maintenance services on motor vehicles from this sales tax exemption.

Section 5(c) also amends the sales tax exemption for items used to maintain or repair tangible personal property pursuant to a taxable service contract. Under this exemption, the item is exempt from sales tax if the purchaser of the taxable service contract is not charged for the item. The intent of the amendment is to clarify that sales and use tax would apply to an item used to maintain or repair a motor vehicle.[11]

[11] The language as drafted has caused confusion and needs to be clarified.

Section 5(b) maintains the long-standing policy that the cost to repair or maintain a motor vehicle under a manufacturer's warranty or a dealer's warranty is exempt from sales tax. The cost of those warranties is included in the price of the vehicle and subject to highway use tax. The repairs and maintenance performed under those warranties are easily identifiable transactions.

Sections 5(e) and (f) clarify that the highway use tax does not apply to the sales price of a service contract if the charge is separately stated on the document given to the purchaser at the time of the sale, lease, or rental of the motor vehicle.

This Part becomes effective when the sales tax base expansion to maintenance and repair services becomes effective, March 1, 2016.

PART VI. SALES TAX PREFERENCES FOR MOTORSPORTS PARTS AND FUEL

This Part clarifies the applicability of sales and use tax to certain items purchased by professional motorsports racing teams and extends the sales tax refunds applicable to professional motorsports teams for four years.

Engines for professional motorsports racing teams are often leased and the lease provides for an engineer to install, operate, fine tune, and monitor the performance of the engine. Under a final Revenue agency decision in 1997, an engine service program agreement for a professional motorsports racing team was determined to not constitute the lease or purchase of tangible personal property because the agreement provided for an engineer. Since then, an engine leased to a professional motorsports racing team as part of an engine service program has not been subject to sales tax. The General Assembly changed the definition of the term "lease or rental" in 2003 to conform to the definition of the term in the Streamlined Sales Tax Agreement. Under the current definition of "lease or rental", the term does not include the provision of tangible personal property along with an operator for a fixed or indeterminate period of time if the operator is necessary for the equipment to perform as designed.[12] The operator must do more than maintain, inspect, or set up the tangible personal property. Since 2003, it appears the Ruling has conflicted with the plain meaning of the statute since the engineer does not operate the race vehicle. However, the Department of Revenue has continued to abide by its 1997 final Revenue agency decision, and it has sought clarification from the General Assembly on this issue.

Subsection (a) defines the term "operator" to provide greater clarity as to the types of lease or rentals that are subject to sales and use tax. Subsection (b)[13] codifies the 1997 final Revenue agency decision and the Department's current practice by exempting from sales and use tax the sale, lease, or rental of an engine to a professional motorsports racing team or a related member of a team for use in competition in a sanctioned race series. Section 5(b) of S.L. 2015-261 also exempts from sales and use tax an engine or a part to build or rebuild an engine for the purpose of providing an engine under an agreement to a professional motorsports racing team or a related member of a team for use in competition in a sanctioned race series so that all similar transactions will be treated the same. Under current law, if the underlying property subject to a service contract is exempt from sales tax, then the service contract on that item is also exempt from sales tax. [14] Therefore, this change in the law means that a service contract on the sale, lease, or rental of an engine to a professional motorsports racing team or a related member of a team for use in competition in a sanctioned race series is exempt from sales and use tax. The changes became effective when the bill became law, September 30, 2015, and they expire January 1, 2020.

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[12] An example of this type of transaction is the lease or rental of a crane with a person that will operate the crane.
[13] As amended by Section 5(a) of S.L. 2015-261.
[14] G.S. 105-164.4I(b)(1).

In 2005, the General Assembly enacted two sales tax refunds applicable to professional motorsports racing teams. The refund provisions have been extended several times; they were scheduled to expire January 1, 2016. Subsection 6(d) of this act extends the following refunds to January 1, 2020:

- Refund equal to the amount of sales and use tax paid on aviation fuel used to travel to or from a motorsports event in this State, from this State to a motorsports event in another State, or to this State from a motorsports event in another State.
- Refund equal to 50% of the sales tax paid on tangible personal property that comprises part of a professional motorsports vehicle, other than tires or accessories.

G.S. 105-164.4I(b)(3) exempts a service contract on an item purchased by a professional motorsports racing team from sales tax if the team may receive a sales tax refund on that item. As noted above, a professional motorsports racing team may receive a sales tax refund on any tangible personal property that comprises part of a professional motorsports vehicle, other than tires or accessories. Subsection 6(c) does three things, and the changes became effective when the act became law on September 30, 2015, and apply retroactively to January 1, 2014, which is the date the sales tax on service contracts and the exemption for these items became effective:

- It conforms the language in G.S. 105-164.4I with the language in G.S. 105-164.14A by noting that the item may be purchased by either the professional motorsports racing team or by a related member of a team.
- It lists the major types of tangible personal property that comprise a professional motorsports vehicle and for which a service contract on the item would be exempt from sales tax.
- It sunsets the exemption in four years, January 1, 2020.