2015-2016 General Assembly

HOUSE BILL 97: 2015 Appropriations Act, Secs. 32.13, 32.14, 32.14A, and 32.15: Corporate Income and Franchise Tax Changes

Committee:		**Date:**	
Introduced by:		**Prepared by:**	Cindy Avrette Staff Attorney
Analysis of:	Secs. 32.13, 32.14, 32.14A, and 32.15 of S.L. 2015-241		

SUMMARY:* *Secs. 32.13, 32.14, 32.14A, and 32.15 of S.L. 2015-241, as amended by Secs. 10.1 and 10.2 of S.L. 2015-268, make the following corporate income tax and franchise tax changes:

- ***Reduces the corporate income tax rate to 3%, effective for the taxable year that begins January 1 following the fiscal year in which the amount of net General Fund tax collected equals or exceeds $20,975,000,000.***
- ***Expands the corporate income tax base by eliminating antiquated, obsolete, and special tax deductions, effective for taxable years beginning on and after January 1, 2016.***
- ***Phases-in single sales factor apportionment over three years, starting with taxable years beginning on or after January 1, 2016 and directs the Revenue Laws Study Committee to study market-based sourcing.***
- ***Simplifies the calculation of the franchise tax by conforming more closely to net worth as determined by generally accepted accounting principles, effective for franchise tax returns due in 2017. Increases the minimum franchise tax from $35 to $200 and increases the maximum franchise tax on holding companies from $75,000 to $150,000; both rate changes are effective for franchise tax returns due in 2017.***
- ***Repeals the State privilege tax on banks, effective June 30, 2016.***

CURRENT LAW, BILL ANALYSIS, AND EFFECTIVE DATE:

CORPORATE INCOME TAX RATE REDUCTION & TAX BASE EXPANSION

Section 32.13, as amended by Section 10.1(f) and (h) of S.L. 2015-268, makes changes to the corporate income tax rate and tax base. The changes are effective for taxable years beginning on or after January 1, 2016.

S.L. 2013-316 reduced the corporate income tax rate from 6.9% to 6% for taxable year 2014, and from 6% to 5% for taxable year 2015. The act provided for additional rate reductions in taxable year 2016 and 2017 if specified triggers were met. The triggers are based on the amount of net General Fund tax collected in a fiscal year, less any large one-time, nonrecurring revenue adjustments. On August 6, 2015, the Secretary of Revenue confirmed that the net General Fund tax collections for fiscal year 2014-15, as adjusted, exceeded the target amount of $20.2 billion and the corporate income tax rate for taxable year 2016 would be 4%. Section 32.13(a) codifies this rate change.

The corporate rate could fall from 4% to 3% for taxable year 2017 if the net General Fund tax revenue collected for fiscal year 2015-16, less the necessary adjustments, equals or exceeds $20.975 billion.[1] Section 32.13(b) removes the specific reference to fiscal year 2015-16 and provides that the corporate rate will fall to 3%, effective for the taxable year beginning on January 1 following the fiscal year in which the trigger is met. The consensus revenue forecast anticipates the trigger will be met in fiscal year 2015-16 and the budget availability for the biennium assumes the corporate income tax rate will be 3% for taxable years beginning on or after January 1, 2017.

Section 32.13(c) repeals the following corporate income tax adjustments, effective for taxable years beginning on or after January 1, 2016:

105-130.5(b)(6) 105-130.10	A deduction for amortization in excess of depreciation allowed under the Code on the cost of any sewage or waste treatment plant, and facilities or equipment used for purposes of recycling or resource recovery of or from solid waste, or for purposes of reducing the volume of hazardous waste. The larger deduction was allowed, at the option of the corporation, in lieu of any depreciation allowance. The deduction was originally enacted in 1939; air-cleaning devices were added in 1969; and recycling facilities were added in 1975. The 2013 Tax Expenditure Report does not note any estimate for this deduction.
105-130.5(b)(7)	A deduction for depreciation of emergency facilities acquired prior to January 1, 1955. The deduction was enacted in 1955. The 2013 Tax Expenditure Report notes less than $100,000 in revenue loss from this deduction.
105-130.5(b)(12)	A deduction of the reasonable expenses, in excess of deductions allowed under the Code, paid for reforestation and cultivation of commercially grown trees. The deduction was enacted in 1979. The 2013 Tax Expenditure Report notes less than $100,000 in revenue loss from this deduction.
105-130.5(b)(13)	A deduction of eligible income of an international banking facility to the extent included in determining federal taxable income. An international banking facility allows depository institutions in the United States to offer deposit and loan services to foreign residents and institutions. The deduction was enacted in 1981. The 2013 Tax Expenditure Report notes less than $100,000 in revenue loss from this deduction.
105-130.5(b)(15)	A deduction for the amount paid as marketing assessments on tobacco grown by a corporation in North Carolina. The deduction was enacted in 1985. The federal provisions on which the marking assessments were based, 7 U.S.C. 1445-2, were repealed in the American Jobs Creation Act of 2004 for 2005 and subsequent crops.
105-130.5(b)(18)	A deduction of earnings on a trust for settlement of an agreement by two or more manufacturers with the State for potential claims against the manufacturers. The deduction was created in 1999 for the National Tobacco Settlement Fund, which was established to distribute funds from tobacco companies to tobacco growers and allotment holders. The interest, investment earnings, and gain of a qualified settlement fund are generally included in taxable income. The tobacco companies agreed to contribute to the Fund each year through 2010, but this was superseded by the 2004 Tobacco Buyout.

[1] Section 10.1(f) corrected the dollar notation from $20,975,000 to $20,975,000,000.

105-130.5(b)(19)	A deduction for the amount paid to a taxpayer from the Hurricane Floyd Reserve Fund. The deduction was enacted in 1999. The Hurricane Floyd Reserve Fund no longer exists. The corresponding individual income tax was repealed in S.L. 2013-316 as obsolete.
105-130.5(b)(22)	A deduction for the amounts paid to taxpayers for hurricane relief from the Disaster Relief Reserve Fund. The deduction was enacted in 2005, effective for taxable years beginning on or after January 1, 2004.[2] Qualified disaster mitigation payments made under the federal Robert T. Stafford Disaster Relief and Emergency Assistance Act or the federal National Flood Insurance Act are not included in income for federal or State tax purposes. Qualified disaster mitigation payments do not include income replacement payments. These payments are taxable. Payments to farmers for crop losses would be an example of a taxable payment. State law provided that payments received to replace income would not be taxable. The repeal of this deduction means these payments will be taxable. S.L. 2013-316 repealed the similar deduction allowed for individual income taxpayers.
105-130.5(c)(5)	A deduction for interest earned on deposits at the Federal Home Loan Bank of Atlanta. This deduction applied to a savings and loan association. The deduction was enacted in 1989. The 2013 Tax Expenditure Report notes less than a \$100,000 revenue loss associated with this deduction.

Sections 32.13(d) and 32.13(e) ensure that all corporate taxpayers are treated the same in regards to the deductions not allowed for expenses related to nontaxable income. A taxpayer may not deduct expenses related to income that is not taxed. Sometimes it is difficult to determine the amount of expenses that are attributable to nontaxable income, especially in the case of subsidiary dividends. In 2002, the General Assembly provided clarity to the expense attribution law as it applied to deductible dividends.[3] As part of that legislation, it provided limits on the potential tax liability by capping the amount of related expenses that must be netted from deductible dividends to 15% for most corporate taxpayers. The legislation provided different limitations on the potential tax liability for bank holding companies and electric power holding companies in recognition that federal law required them to have multiple subsidiaries.[4] Section 32.13(e) repeals the statute that provided different limitations for bank holding companies and electric power holding companies and Section 32.13(d) makes conforming changes to the general law so that it applies equally to all corporate taxpayers. The change is effective for taxable years beginning on or after January 1, 2016.

Sections 32.13(d) and 32.13(f) close a loophole some corporations have attempted to use to artificially reduce their North Carolina taxable income through interest expense deductions on loans from affiliates

---

[2] The Governor created the Disaster Relief Reserve Fund for the purpose of providing assistance and relief needed as a result of natural disasters. North Carolina was struck by six hurricanes in 2004. Hurricanes Alex, Bonnie, Charlie, and Jeanne brought flooding and wind damage to the Eastern Region of the State; Hurricanes Frances and Ivan dumped heavy rains in the Western Region of the State resulting in landslides, flooding, and the death of at least 11 people.

[3] S.L. 2002-136.

[4] Prior to January 1, 2016, the cap on the amount of related expenses that must be netted from deductible dividends for a bank holding company was 20%, instead of 15%, but the maximum amount of additional tax that a bank holding company and its related companies had to pay as a result of expense netting was capped at \$11 million per corporate family. Bank holding company corporate families that reached the maximum tax cap of \$11 million were allowed a tax credit equal to \$2 million. For all other bank holding company corporate families, the credit was equal to the amount of tax reduction that would result if the bank holding companies were subject to a 15% cap rather than a 20% cap. Electric power holding companies were allowed a tax credit equal to one-half of the additional tax that each had to pay as a result of expense netting.

and related members by limiting the amount of the deduction to a "qualified interest expense" amount. The qualified interest expense amount is the amount of net interest expense paid or accrued to a related member in a taxable year, not to exceed 30% of the taxpayer's adjusted taxable income. This limitation does not apply to interest paid or accrued to a related member if one or more of the following applies:

- Tax is imposed by the State on the related member.
- 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 that country taxes the interest income at a rate equal to or greater than this State.
- The related member is a bank holding company, a bank, a savings bank, a savings and loan association, or a trust company.

Section 32.13(d) requires a taxpayer to add to federal taxable income the excess of the 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. It then allows the taxpayer to deduct from federal taxable income the amount of qualified interest expense. Section 32.13(f) defines how to calculate the amount of qualified interest expense. This change is effective for taxable years beginning on or after January 1, 2016.

PHASE-IN SINGLE SALES FACTOR APPORTIONMENT

Section 32.14, as amended by Section 10.1(c) of S.L. 2015-268, phases in single sales factor apportionment over three years as follows:

- For taxable year 2016, the sales factor will be tripled weighted.
- For taxable year 2017, the sales factor will be quadruple weighted.
- For taxable years 2018 and thereafter, the sales factor will be the only apportionment factor.

A corporation that does business in more than one state must pay income tax to each of the states in which it has nexus. The U.S. Supreme Court cases have upheld the right of states to tax the income of multistate corporations so long as the income is fairly sourced to the taxing state. The conventional method used by states to determine how much of a corporation's income should be taxed in each state has been the apportionment formula, which is used to derive an apportionment percentage. Generally speaking, a taxpayer multiplies its taxable income by its apportionment percentage to determine the amount of its income sourced to a particular state. The state's corporate income tax rate is then applied to the corporation's income apportionable to that state.

In the 1960s, most states began to adopt an apportionment formula based on or substantially similar to the Uniform Division of Income for Tax Purposes Act (UDITPA).[5] The UDITPA formula is a composite of three factors: a property factor, a payroll factor, and a sales factor. Under UDITPA, the sum of the three factors is divided by three, resulting in a taxpayer's apportionment percentage. The purpose of the three factors is to give a reasonable approximation of the share of a company's profit that arises from doing business in a state, based on both the demand for company output in the state (sales factor) and the production activity in which it engages in the state (property and payroll factors).

[5] UDITPA dates back to 1957.

In recent years, states have moved away from the three-factor formula towards a formula weighted more heavily by sales. A single sales factor arguably makes a state a more attractive place for businesses to expand their property and payroll because if those factors are ignored in calculating a state's corporate tax, then a business can hire employees or build a plant without incurring additional state tax on its corporate profits. The more weight given to the sales factor the more the formula tends to favor home-state industries that have a concentration of their total facilities in a state but sell their products all over the country. In a chart published by the Federation of Tax Administrators, only 9 states are using a three-factor formula for the 2015 taxable year. Twelve states use a double weighted sales factor formula and most states that impose corporate income tax have moved to a single sales factor formula.[6]

North Carolina shifted to a double-weighted sales factor apportionment formula in 1988 at the request of RJR Nabisco.[7] In 2009, North Carolina provided single sales factor apportionment formula for capital intensive corporations at the request of Apple.[8] North Carolina also allows single sales factor apportionment for public utility companies and for excluded corporations.[9]

Sections 32.14(a) through 32.14(c) phase-in single sales factor apportionment over a three-year period, beginning in 2016. Section 32.14(d) repeals the statutory provisions related to the property and payroll factors[10], effective January 1, 2018, because they will no longer be necessary. Likewise this section repeals the special apportionment rules that currently allow single sales factor apportionment for capital intensive corporations, public utilities, and excluded corporations[11] and it repeals definitions that are no longer necessary.[12] All multi-state corporations will not benefit from a single sales factor apportionment formula. The majority of North Carolina businesses are not multi-state corporations that apportion income and any change in the formula will neither benefit nor disadvantage them.

STUDY MARKET-BASED SOURCING

Section 32.14A, as amended by Section 10.2 of S.L. 2015-268, directs the Revenue Laws Study Committee to study the calculation of the sales factor using market-based sourcing.[13] The more reliant the apportionment formula is on a business' sales, the greater attention that is given to how sales are sourced to the state. Sales of services may be sourced using different methodologies. One methodology is the cost of performance. A service is an in-state service if the greater proportion of the service is performed in the state. North Carolina uses a pro-rated methodology: sourcing is proportional based on the percentage of income-producing activity occurring in-state. And another methodology is market-based sourcing where revenue is assigned based on the location of either the customer's address or where the customer receives the benefit from the service.

---

[6] Surrounding states: TN has recently enacted single sales factor apportionment; SC and GA have single sales factor apportionment; and VA has single sales factor apportionment for certain industries. (Federation of Tax Administrators, February 2015)

[7] RJR Nabisco had plans for a large automated bakery in the Garner area. After the change was adopted, RJR Nabisco was bought out and forced to cut back on capital expenditures. The company never built the plant.

[8] Apple built its East Coast data center in Maiden, NC. To receive the single sales factor apportionment formula, it had to invest at least $1 billion in the infrastructure hub and employs at least 50 full-time employees.

[9] An excluded corporation is corporation engaged in business as a building or construction contractor, a securities dealer, or a loan company or a corporation that receives more than fifty percent (50%) of its ordinary gross income from intangible property.

[10] G.S. 105-130.4(j) and (k).

[11] G.S. 105-130.4(r) and (s1).

[12] Section 10.1(c) of S.L. 2015-268 corrects a statutory reference: G.S. 105-130.4(a)(4) which defines a "public utility" is the term that needs to be repealed, not (a)(9) which defines the term "State".

[13] Section 10.2 of S.L. 2015-268 rewrote Section 32.14A in its entirety. The substance of the provision did not change; the revisions clarified the intent, the process, and the model rules upon which the informational return should be based.

Most states that have adopted single sales factor apportionment formulas have also adopted market-based sourcing. The Department of Revenue recommends that North Carolina consider market-based sourcing. To help the General Assembly determine the effect of market-based sourcing on corporate taxpayers, Section 32.14A(b) requires each corporate taxpayer with apportionable income greater than $10 million and a North Carolina apportionment percentage less than 100% to file an informational report with the Department of Revenue showing the calculation of the taxable year 2014 sales factor using market-based sourcing rules based on the model market-sourcing regulations drafted by the Multi-State Tax Commission. The informational report is due at the time corporate taxpayer's return is due for the 2015 taxable year; a taxpayer may not request an extension of time to file the informational report. The Secretary may assess a civil penalty of $5,000 for failure to file the informational return.

FRANCHISE TAX BASE CHANGES

Section 32.15, as amended by Section 10.1(a) of S.L. 2015-268,[14] simplifies the calculation of the franchise tax base, eliminates obsolete and antiquated deductions, and increases the minimum and maximum tax amounts. The changes become effective for franchise tax returns due in 2017.

The franchise tax is one of North Carolina's oldest taxes. It originated in 1849 as a tax on the capital stock of a corporation. Today the tax is imposed on C corporations and S corporations for the privilege of engaging in business in this State. The tax does not apply to a business organized as a limited liability company, [15] unless the LLC elects to be taxes as a corporation for franchise tax purposes, or to a general partnership or sole proprietorship.

The rate of tax is $1.50 per $1,000, subject to a minimum tax of $35. Section 32.15(d), in G.S. 105-122(d), increases the minimum tax to $200. A holding company is a corporation that receives at least 80% of its income from subsidiaries. Current law provides a maximum tax of $75,000 for holding companies. Section 32.15(b) increases the maximum tax to $150,000. These rate changes are effective for franchise tax returns due in 2017.

The tax rate applies to the highest of three bases. Most taxpayers use the first base. The three bases are:

- Capital stock, surplus, and undivided profits apportioned to North Carolina using the apportionment percentage determined for income tax purposes. In determining a taxpayer's capital base, no reservation or allocation from surplus or undivided profits is allowed for liabilities unless those liabilities are definite and accrued.
- Book value of North Carolina real and tangible personal property, less outstanding debt created to acquire or improve the real property.
- 55% of the appraised value of North Carolina real and tangible personal property.

Section 32.15(d) significantly simplifies the first base by using the corporation's net worth as computed in accordance with generally accepted accounting principles. A key difference between the capital base calculation and the new net worth base calculation is the allowance of a reservation or allocation from profits for contingent liabilities. The net worth base is subject to following adjustments:

- A deduction for accumulated depreciation and amortization, determined in accordance with the method used for federal income tax purposes.

[14] Section 10.1(a) of S.L. 2015-268 corrects a typographical error. The word "is" should be "as".
[15] An LLC is subject to a $200 annual report filing fee. The annual report filing fee for C corporations and S corporations is $25, or $18 if the business files electronically.

- An addition for indebtedness the corporation owes to a parent, a subsidiary, an affiliate, or a noncorporate entity in which the corporation or an affiliated group of corporations owns directly or indirectly more than 50% of the capital interests of the noncorporate entity.[16]
- A deduction for the cost of treasury stock.[17]

Under prior law, a taxpayer had to add to its capital stock base all indebtedness owed to a parent, subsidiary, or affiliated corporation. A corporation is a parent of another corporation when it controls the other corporation. A corporation is a subsidiary of another corporation when it is subject to control by the other corporation. A corporation is an affiliate of another corporation when both are controlled by the same parent corporation. The amount added back to the debtor corporation's capital stock base could be reduced if any part of the capital of the creditor corporation is capital borrowed from a source other than a parent, subsidiary, or affiliate. If the creditor corporation is also subject to North Carolina franchise tax, the creditor corporation was allowed to deduct from its capital stock base the amount of any debt owed to it to the extent the debt has been included in the franchise tax base of the debtor corporation.[18] Section 32.15(d) requires a taxpayer to add to its net worth base not only indebtedness owed to a parent, subsidiary, or affiliated corporation, but also indebtedness owed to a noncorporate entity in which it owns more than 50% of the noncorporate entity's capital interests. The change addresses a tax planning strategy used by some taxpayers to reduce their North Carolina franchise tax liability.

Sections 32.15(c) and 32.15(d) repeal deductions from the calculation of capital stock found to be antiquated or obsolete. These deductions are similar to the deductions eliminated from the corporate income tax base by Section 32.13(c) of this act. The repealed deductions are as follows:

105-122(b)(4)	A deduction from capital stock for investments in pollution abatement equipment. The deduction was enacted in 1955 sewage or waste treatment plant pollution abatement equipment. Air cleaning devices and air pollution abatement equipment were added in 1967. There is no estimate available for its revenue impact.
105-122(b)(5)	A deduction from capital stock for investments in hazardous waste abatement equipment. The deduction was enacted in 1975. There is no estimate available for its revenue impact.
105-122(b)(6)	A deduction from capital stock for the cost of constructing facilities used to provide sewer services to residential and outlying areas. The deduction was enacted in 1967. There is no estimate available for its revenue impact.
105-122(b)(8)	The capital base of an international banking facility may be reduced by the excess of the amount of all assets employed outside the United States over liabilities owed to foreign person. The deduction was enacted in 1981. There is no estimate available for its revenue impact.

[16] Prior to franchise tax returns due in 2017, the adjustment for indebtedness applied only to indebtedness owed to another corporate entity.

[17] Section 32.15(c) repeals G.S. 105-122(b)(7), treasury stock, because the statute is rewritten to codify the deduction as G.S. 105-122(b)(3).

[18] Some taxpayers argue that the deduction allowed for a creditor corporation to the extent the debt has been included in the franchise tax base of the debtor corporation is unconstitutional since it does not allow a similar deduction if the debtor corporation is not subject to North Carolina franchise tax. This constitutional argument also exists for this change since a noncorporate entity is not subject to franchise tax.

105-122(d)	A deduction from tangible property investments of reserves for depreciation and any indebtedness incurred by virtue of the purchase of any real estate and any improvements. This deduction was enacted in 1947. There is no estimate available for its revenue impact. A deduction from tangible property investments of the cost of an air-cleaning device or sewerage or waste treatment plant. The deduction for sewerage or waste treatment was enacted in 1955; air-cleaning device and pollution abatement equipment were added in 1967. There is no estimate available for its revenue impact. A deduction from tangible property investments for the cost of constructing facilities built to provide sewer service to residential and outlying areas. This deduction was enacted in 1967. There is no estimate available for its revenue impact.
105-122(d1)	A deduction of eligible income of an international banking facility to the extent included in determining federal taxable income. An international banking facility allows depository institutions in the United States to offer deposit and loan services to foreign residents and institutions. The deduction was enacted in 1981. The 2013 Tax Expenditure Report notes less than $100,000 in revenue loss from this deduction.

Sections 32.15(e) and 32.15(f) makes conforming changes by deleting the phrase "capital stock, surplus, and undivided profits" and substituting the phrase "net worth".

REPEAL OF PRIVILEGE TAX ON BANKS

Section 32.13(g) repeals the privilege tax on banks, effective June 30, 2016.[19] The General Assembly repealed the excise tax on banks in 1973 and replaced it with a privilege tax so banks would be taxed more similarly to other corporations. The General Assembly repealed most of the privilege license taxes imposed on businesses in 1996. The authority of local governments to impose a privilege license tax on businesses was repealed in 2013. Generally, the privilege taxes have been found to be outmoded and inefficient. The privilege tax on banks is levied at a rate equal to $30 for each $1 million of total assets and generates about $12 million annually. The changes made by Section 32.13(e) of this act to tax banks in the same manner as other corporations will result in an increased tax burden on banks of an estimated $21 million. The repeal of the privilege tax helps to offset this tax burden and advances the policy decision to tax banks in the same manner as other corporations.

[19] Section 10.1(h) of S.L. 2015-268 changed the effective date of the repeal from July 1, 2016, to June 30, 2016, to more aptly coincide with the privilege license taxable year.