



# HOUSE BILL 994: Sales Tax of RMI Clarified/Other Tax Chngs.

2016-2017 General Assembly

<b>Committee:</b>	House Finance	<b>Date:</b>	June 16, 2016
<b>Introduced by:</b>		<b>Prepared by:</b>	Trina Griffin and Greg Roney
<b>Analysis of:</b>	PCS to First Edition H994-CSSVxr-55		Committee Co-Counsel

**SUMMARY:** *The Proposed Committee Substitute (PCS) for House Bill 994 has 4 parts:*

- *Part I would clarify the application of the sales and use tax on repair, maintenance, and installation services and provide a grace period for the undercollection of that tax.*
- *Part II would enact the North Carolina New Markets Jobs Act that provides a State-level 25% tax credit for equity and debt investments in Tier 1 or 2 counties qualifying for the federal New Markets Tax Credit.*
- *Part III would allow counties and municipalities to exchange tax information for purposes of administering a tax.*
- *Part IV would exempt from sales and use tax materials that are used in an "accepted wastewater dispersal system" so that they are treated in the same way as materials used in conventional wastewater systems, which are currently exempt from tax.*

## PART I. SALES TAX CHANGES

**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- Repealed the sales tax exemption for installation charges in conjunction with the sale of tangible personal property.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 services)
- 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.

### Issues with the Current Law

1. *Retailer vs. Non-Retailer* - The sales tax base expansion to RMI services would have expanded the number of people responsible for collecting and remitting the sales tax. To reduce the number of new retailers, the legislation provided that a person who only provides RMI services would not be required to collect and remit the sales tax. It also provided that a person who acts as both a retailer and a real property contractor, commonly referred to as a retailer-contractor, could not be a contractor for sales tax purposes if the majority of the person's gross receipts were derived from retail trade. The distinctions put into the law to reduce the number of retailers from the base expansion to RMI services treated similar transactions differently, based on the classification of the provider. These distinctions have created confusion in the application of the new law.
2. *Interpretational Issues ("restore" = clean; "apply tangible personal property" = clothing alterations)* – The current definition of RMI service is to keep or attempt to keep tangible

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personal property in working order to avoid break-down and prevent repairs and to restore tangible personal property to proper working order. To restore property to working order oftentimes involves cleaning the property. Based on DOR's interpretation of the word "restore," car washes involving personal service are currently taxable when performed by a retailer. 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 one does not necessarily consider "installation", such as hemming a pair of pants or laminating services. Based on DOR's interpretation of "installation," clothing alterations are taxable when performed by a retailer.

3. *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 only applies to tangible personal property and not 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, it would not be taxable because it would be the repair of real property. However, if the repair involves the installation 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 the HVAC company is considered a retailer.

**BILL ANALYSIS:** This Part would do the following:

- **Establish a 10-month grace period and authorize the Secretary of Revenue to compromise a retailer's liability with regard to RMI services for 6 years** – The bill would provide that a retailer is not liable for an undercollection of sales and use tax if the retailer made a good faith effort 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 tax that is collectible when the Secretary determines that the compromise is in the best interest of the State and makes one or more findings listed in G.S. 105-237.1. One of those factors includes that the taxpayer is a retailer and that the assessment is for sales or use tax 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. The bill would include a factor for the expansion of the sales tax base to RMI service. This factor would exist for six years. This is the same period of time that the factor exists for the sales tax base expansion items that were effective January 1, 2014.

It would also allow a retailer-contractor who under-paid use tax on an item to offset the amount of tax owed by any over-collection of sales tax remitted on a related transaction. This remedy is effective retroactive to January 1, 2015; that is the effective date of the tax law changes applicable to real property contracts.

- **Treat similar transactions the same** – It would treat similar transactions the same regardless of who performs the service. Removing this distinction would mean that all businesses that provide taxable RMI services would be retailers. As a practical matter, this would have the effect of taxing more repair and maintenance services to real property since most of the businesses that perform these services are not retailers under current law.

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- **Exclude capital improvements** – Installations into real property, and some significant repairs, would not be taxable if the service is a "capital improvement." Factors to consider in determining whether a contract is for the performance of a capital improvement to real property are:
  1. The method of attachment for the property installed.
  2. The degree of customization of the property installed.
  3. The value added by or the useful life of the property installed.

The bill specifically identifies the following as capital improvements, and the installation and construction of these items would not be subject to sales tax:

- New construction and enlargement of an existing structure.
  - Removal of items from real property, such as asbestos and construction material.
  - Performance of work that requires a permit under the State Building Code.
  - 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.
  - Installation of roofing, septic tank, plumbing, electrical, commercial refrigeration, irrigation, and sprinkler systems.
  - Installation of an HVAC unit or system.
  - Installation of roads, driveways, parking lots, and sidewalks.
  - Landscaping services.
- **Clarify the taxability of certain RMI services with respect to tangible personal property** – The bill would exempt the following services with respect to tangible personal property:
    - Car Washes
    - Clothing Alterations
    - Towing Services
    - Storage of a motor vehicle
- **Exempt Certain RMI Services from Tax** - The following services, which otherwise fall within the definition of "repair, maintenance, and installation services," would be 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.
    - RMI service for roads, parking lots, and sidewalks. This exemption would treat the repair and maintenance of these items the same as the construction of them. These items are most often State or county-owned in nature and commercial property.

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- Removal of items from real property that may be provided on an as-needed basis rather than under a real property contract. Examples include garbage, grease, and debris.
  - Home inspections.
  - House cleaning and janitorial services.
  - Building cleaning services
  - Landscaping services
  - Car washes
  - Alteration services
  - Pest control
- **Clarify the taxability of motor vehicle service contracts** - 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. This section would define a service contract on a motor vehicle as 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. The section would then specifically exempt a motor vehicle service contract from sales tax.
  - **Direct DOR to issue guidance** - Lastly, the bill would direct the Department of Revenue to issue written guidance to taxpayers relative to the tax law changes made in this section within 120 days of the enactment of this act. The effective date of the tax law changes would be January 1, 2017. The purpose of this section is to give taxpayers and interested parties time to learn of the changes and to be educated regarding the changes before the tax changes become effective.

**EFFECTIVE DATE:** Section 1.1 would become effective when the act becomes law. Section 1.1(c) applies is effective retroactively to January 1, 2015. The remainder of the sales tax changes would become effective January 1, 2017.

## PART II. NORTH CAROLINA NEW MARKETS JOBS ACT

**CURRENT LAW:** The State does not currently have a tax credit program modeled after the federal New Markets Tax Credit (NMTC).

**BILL ANALYSIS:** Part II of the PCS would create a State-level tax credit that generally follows the federal New Markets Tax Credit (NMTC) under §45D of the Internal Revenue Code (IRC). The NMTC provides a 39% tax credit to investors who commit capital for a 7-year term in the form of loans or equity investment to borrowers in low-income communities.

The State tax credit would be available for investments receiving the federal credit, acting as an incentive to attract the federally-credited investments to the State. The credit is not available for investments that meet the federal definitions but are made by investors who are not participants in the federal program.

North Carolina levies insurance premium tax upon insurers for the privilege of engaging in the business of providing insurance in this State. The bill would allow a tax credit to insurers paying the gross premium tax. To receive tax credits, the insurers must participate with qualified community development entities.

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The PCS would allow a tax credit against the gross premium tax equal to 25% of the amount invested through federally-recognized development entities in small businesses. The statewide total investment that could qualify for the tax credit is \$100 million with a maximum investment in any one business of \$5 million, yielding \$25 million in tax credits annually.

The tax credit equals 25% of the investment and is claimed in the second year of the 7-year credit period. The federal credit is 39% of the investment and is claimed over the 7-year credit period. Investments could receive both the federal credit (39%) and State credit (25%), totaling 64% tax credit.

Qualifying investments must be made in a qualified active low-income community business (QALICB) that does not receive 15% or more of its annual revenue from the rental or sale of real estate and meets the following requirements:

- Definition of a QALICB under IRC §45D includes any corporation, nonprofit corporation, or partnership if
  - At least 50% of the total gross income is derived from the active conduct of a qualified business within any low-income community.
  - A substantial portion of the use of the tangible property is within any low-income community.
  - A substantial portion of the services performed by employees are performed in any low-income community.
  - Less than 5% of the average of the aggregate unadjusted bases of the property is attributable to collectibles.
  - Less than 5% of the average of the aggregate unadjusted bases of the property is attributable to nonqualified financial property.
- US Small Business Administration (SBA) size eligibility standards that govern small business status under federal programs. The SBA sets size standards by NAICS codes. Depending on their NAICS code, small businesses must satisfy either the size limit or the employee limit:
  - Number of employees (50 to 1,500).
  - Revenues (\$0.75 million to \$550 million).

The PCS imposes 2 State-level requirements more restrictive than the federal requirements:

- Investments must be in Tier 1 or Tier 2 counties.
- Net benefit test based on economic modeling (discussed below).

The PCS imposes a net benefit test using economic modeling to demonstrate a positive economic impact over a 10-year period exceeding 110% of the tax credits earned on the initial investment. Specifically, a revenue impact assessment prepared using a "nationally recognized third-party independent economic forecasting method" must demonstrate (over a 10-year period) State and local tax revenue generated by the project exceeding 110% of the tax credits. No penalty applies if the forecasted economic impact does not occur or if investment is reinvested after the initial investment.

The program would be administered by the Department of Commerce.

**EFFECTIVE DATE:** This Part would become effective July 1, 2016, and apply to qualified equity investments made on or after that date.

## PART III. LOCAL GOVERNMENT TAX INFORMATION EXCHANGE

**CURRENT LAW:** Local tax records that contain information about a taxpayer's income or receipts are not public records and local government employees are prohibited from disclosing this information unless the disclosure is for one of the following:

- (1) To comply with a court order or a law.
- (2) Review by the Attorney General or a representative of the Attorney General.
- (3) To sort, process, or deliver tax information on behalf of the county, as necessary to administer a tax.
- (4) To exchange information with a regional public transportation authority or a regional transportation authority created pursuant to Article 26 or Article 27 of Chapter 160A of the General Statutes, when the information is needed to fulfill a duty imposed on the authority or on the county.
- (5) To exchange information with the Department of Revenue, when the information is needed to fulfill a duty imposed on the Department or on the county.
- (6) To include on a property tax receipt the amount of property taxes due and the amount of property taxes deferred on a residence classified under G.S. 105-277.1B, the property tax homestead circuit breaker.

**BILL ANALYSIS:** Part III of the bill would allow a county to disclose to the finance officer of any municipality located within the county tax information in the possession of the county, as necessary to administer a tax. It would also allow a municipality to disclose to the finance officer of the county in which the municipality is located tax information in possession of the municipality, as necessary to administer a tax.

**EFFECTIVE DATE:** This Part would become effective when the act becomes law.

## PART IV. SALES TAX EXEMPTION FOR MATERIALS USED IN ACCEPTED WASTEWATER DISPERSAL SYSTEMS

**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:** Part IV of the bill would exempt from sales tax the sale of products that are more than 75%, by weight, of recycled materials when 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.

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**EFFECTIVE DATE:** This Part would become effective October 1, 2016, and apply to sales made on or after that date.