This Bill Analysis reflects the contents of the bill as it was presented in committee.

SENATE BILL 526: Job Creation and Tax Relief Act of 2015

2015-2016 General Assembly

Committee:	Senate Re-ref to Finance. If fav, re-ref to Commerce	**Date:**	April 21, 2015
Introduced by:	Sens. Rucho, Rabon, Tillman	**Prepared by:**	Cindy Avrette Dan Ettefagh Committee Counsel
Analysis of:	First Edition		

SUMMARY: Senate Bill 526 does the following:

- ***Part I. Individual income taxes. – The bill substitutes a zero tax rate for taxpayers who would otherwise claim a standard deduction. The zero tax rate brackets exceed the current standard deduction amount. It also reduces the flat rate over a two-year period.***
- ***Part II. Franchise tax. – The bill simplifies the tax base, reduces the tax rate, increases the minimum tax, and increases the maximum tax applicable to holding companies.***
- ***Part III. Corporate income taxes. – The bill reduces the corporate income tax rate over two years, repeals a limit on a bank's income tax liability resulting from expense attribution to nontaxed income, and simplifies the tax base by eliminating various deductions.***
- ***Part IV. Apportionment Changes. – The bill phases-in single sales factor apportionment over a two-year period using market-based sourcing rules.***
- ***Part V. JDIG Modifications. – The bill modifies the Job Development Investment Grant program to place greater emphasis on large projects and rural counties.***

PART I. INDIVIDUAL INCOME TAX CHANGES

Part I of the bill reduces individual income tax in two ways over a two-year period. It reduces the flat income tax rate applicable to taxable income over a two-year period and it substitutes a zero tax bracket for taxpayers who would otherwise claim a standard deduction.

Tax Rate. In taxable year 2014, North Carolina replaced its marginal tax rates with a flat tax rate of 5.8%. The rate for the 2015 taxable year is 5.75%. Part I of the bill would continue the reduction of the flat tax rate applicable to individual taxable income:

- Taxable year 2016, the rate would be 5.625%.
- Taxable year 2017 and thereafter, the rate would be 5.5%.

Zero Bracket. A taxpayer has the option of claiming the standard deduction or itemizing deductions. The standard deduction ensures that at least some income is not subject to income tax. The amount of the standard deduction varies depending upon the taxpayer's filing status. This bill would accomplish the same purpose of ensuring at least some income is not subject to income tax by substituting a zero tax rate for taxpayers who would otherwise claim a standard deduction. A taxpayer that chooses to itemize deductions for State income tax purposes would continue to pay State income tax on the first dollar of taxable income. The chart below shows the applicability of the zero tax rates and how it compares to the current standard deduction amounts:

This bill analysis was prepared by the nonpartisan legislative staff for the use of legislators in their deliberations and does not constitute an official statement of legislative intent.

	Married Filing Jointly	Head of Household	Married Filing Separately	Singe
Standard deduction for 2015 taxable year	$15,000	$12,000	$7,500	$7,500
Zero tax rate for 2016 taxable year	Up to $17,500	Up to $14,000	Up to $8,750	Up to $8,750
Zero tax rate for 2017 taxable year and thereafter	Up to $20,000	Up to $16,000	Up to $10,000	Up to $10,000

PART II: FRANCHISE TAX CHANGES

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. The tax does not apply to businesses organized as a limited liability company[1], partnerships, and sole proprietorships are exempt from the franchise tax, but they are subject to a $200 annual report filing fee.[2]

The rate of tax is $1.50 per $1,000, subject to a minimum tax of $35. Part II of the bill reduces the tax rate to $1.35 and 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. The bill would increase the maximum tax to $200,000.

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.
- 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.

Part II of the bill retains all three bases, but it simplifies the first base by using the corporation's net worth as computed in accordance with generally accepted accounting principles, subject to following adjustments:

- A deduction for accumulated depreciation and amortization, determined in accordance with the method used for federal income tax purposes.
- An addition for indebtedness the corporation owes to a parent, a subsidiary, or an affiliate.
- A deduction for the cost of treasury stock.

The changes made by this Part are effective for taxable years beginning on or after January 1, 2016, and for which taxes are due on or after that date.

Technical Consideration. If the franchise tax changes should coincide with the corporate income tax changes, then the franchise tax effective date should be for taxable years beginning on or after January

[1] A LLC that elects to be taxed as a corporation is subject to the franchise tax.
[2] The annual report filing fee for C corporations and S corporations is $25, or $18 if the business files electronically.

1, 2017, since the franchise tax is remitted for the privilege of doing business in the coming year, while the corporate income tax is remitted for business that took place in the preceding year. (G.S. 105-114(a)(3)).

PART III. CORPORATE INCOME TAX CHANGES

Rate Changes. Part III reduces the corporate income tax rate over two years from 5% to 4.5% for the 2016 taxable year and from 4.5% to 4% for the 2017 taxable year and thereafter.

In 2013, the General Assembly reduced the corporate income tax from 6.9% to 6% for the 2014 taxable year and 5% for the 2015 taxable year. In addition to these rate reductions, the law provided for a potential 1% rate reduction for taxable year 2016 if net General Fund tax collections for fiscal year 2014-15 meet the statutory target amount of $20,200,000,000 and a potential 1% rate reduction for taxable year 2017 if net General Fund tax collections for fiscal year 2015-16 meet the statutory target amount of $20,975,000,000. It is not anticipated that the rate triggers will be met for fiscal 2014-15 or for fiscal year 2015-16. This bill would repeal the statute that contains the trigger because the statute is obsolete and no longer necessary.

Repeal Limit on Tax Liability of Banks re: Expense Attribution from Nontaxed Income. Corporations are required to attribute a portion of their interest expense deductions to nontaxed income, like certain dividends. The resulting income tax liability for bank holding companies cannot exceed $11,000,000. This bill would repeal the $11,000,000 limit.

Interest Expense Reporting Option. In 2001, the General Assembly enacted G.S. 105-130.7A to enhance corporate compliance with taxes on trademark income. This statute did not change what was already considered taxable but merely enhanced compliance with the State tax on income generated from using trademarks and added a reporting option to the income tax statute. Specifically, G.S. 105-130.7A restates that a company's receipts from royalty payments for the use of trademarks in North Carolina are income from doing business in North Carolina. It provides adjustments to assure full and fair accountability of this income in relationship to where it is actually earned. In cases where the recipient of the North Carolina royalty income is unrelated to the payer, the recipient is required to pay tax on the income to North Carolina. In cases where the recipient and the payer are related, they have an option on how the income is reported to North Carolina. Either the payer can deduct the North Carolina royalty payments on its North Carolina return and the recipient can include them on its North Carolina return, or the payer can add them to its North Carolina income and the recipient can deduct them on its North Carolina return. In 2006, the royalty payment reporting option was expanded to include patents and copyrights.

This bill would allow the reporting option to include interest expense received from a related member.

Simplify Corporate Income Tax Base. The bill would simplify the corporate income tax base by eliminating the following adjustments to federal taxable income:

- Deduction for amortization of air cleaning devices. The devices would be subject to the federal tax depreciation schedules.
- Deduction for depreciation of emergency facilities acquired prior to January 1, 1955.
- Deduction for losses realized on the sale of assets that is not allowed under section 1211(a) of the Code. Under the Code, the losses from the sales or exchanges of capital assets are allowed only to the extent of gains from such sales and exchanges.
- Deduction for expenses, in excess of deductions allowed under the Code, for reforestation and cultivation of commercially grown trees.

- Deduction for eligible income of an international banking facility.
- Deduction for amount paid during the income year as a marketing assessment on tobacco grown in North Carolina.
- Deduction for interest, investment earning, and gains of a trust re: to the tobacco settlement agreement.
- Deduction for amounts paid from the Hurricane Floyd Reserve Fund.
- Deduction for amounts paid from the Disaster Relief Reserve Fund for hurricane relief.

PART IV. SINGLE SALES FACTOR APPORTIONMENT AND MARKET BASED SOURCING

Part IV of the bill would phase in single sales factor apportionment over a two year period, and move to market based sourcing of sales.

Single sales factor apportionment. 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 source income 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 state. The state's corporate income tax rate is 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).[3] 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 are 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).

In recent years, states have moved away from the three-factor formula towards a formula weighted more heavily by sales. 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. North Carolina shifted to a double-weighted sales factor apportionment formula in 1988 at the request of RJR Nabisco.[4] In 2009, North Carolina provided single sales factor apportionment formula for capital intensive corporations at the request of Apple.[5] North Carolina also allows single sales factor apportionment for public utility companies and for excluded corporations.[6]

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 formula similar to North

---

[3] UDITPA dates back to 1957.

[4] 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.

[5] 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.

[6] 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.

Carolina and more than 21 states have moved to a single sales factor formula.7 This bill would phase-in a single sales factor apportionment formula in North Carolina over two years:

- For taxable year 2016, four times the sales factor
- For taxable year 2017, single sales factor

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 tax on its corporate profits. All companies 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 not benefit them.

Market Based Sourcing. 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.

Several states that have adopted single sales factor apportionment formulas have also adopted market-based sourcing. Sixteen state use market-based sourcing. The Department of Revenue recommends that North Carolina consider market-based sourcing. This bill would adopt market-based sourcing of sales other than sales of tangible personal property.

PART V. JDIG MODIFICATIONS

JDIG is a discretionary program of the State that provides funds to incentivize new or expanding business to create jobs in the State. The amount of the JDIG incentive to a company is equal to a percentage between 10% to 75% of the personal income tax withholdings generated by the eligible created positions.[8] If the business is in a tier 2 or 3 area, the incentive paid to the business is automatically reduced by 15% or 25%, respectively, and that portion is diverted into the Utility Account. The JDIG agreement can be for a term of up to 12 years. The amount that can be committed in JDIG grants has generally been capped at $15M per calendar year; however, the current cap is based on the 2013-15 biennium and is $22.5M, and the cap for 7/1/15 through 12/31/15 is $7.5M. Presuming a use of $1M of the allowed cap for a period and a term of 12 years, a $1M commitment would be paid each year of the 12-year term if the company met all required metrics, for a total commitment of $12M. The authority to enter new JDIG agreements is currently set to expire 1/1/16.

Part V of the bill makes modifications to the JDIG program, as follows:

1. It identifies a special category of projects as "high-yield projects" if the company will invest at least $1B in private funds and will create at least 2,500 jobs. In a year when a high-yield project is acquired, the traditional JDIG calendar year cap of $15M is, for that year, increased to $30M. If the company meets the minimum requirements for investment and job creation and if the

---

[7] Surrounding states: TN has a double-weighted sales apportionment formula. SC and GA have a single sales factor apportionment formula. VA has a double weighted/sales formula. (Federation of Tax Administrators, February 2015)

[8] The amount of the incentive paid to a company is automatically decreased by 25% or 15% for tier 3 and tier 2 projects, respectively, with that percentage going to the Utility Account for infrastructure projects that are reasonably expected to create jobs in economically distressed counties (i.e. tier 1 and 2 counties).

company then meets all metrics of the performance agreement for three consecutive years, the JDIG award is augmented for subsequent years in the following ways:

a. The calculation of the award can be increased from 75% of the withholdings associated with the created, eligible positions to 100% of those withholdings.

b. The limitation on the term of the agreement is increased from 12 years to 20 years.

c. The requirement that diverts a portion of the grant from the business to the Utility Account is eliminated.

If the high-yield project fails to meet performance metrics after receiving the augmented award in any year, the augmented benefits expire and the company cannot, thereafter, regain the augmented benefits.

2. It addresses concerns about temporal distributions of JDIG awards during a single calendar year by making the $15M annual cap available in calendar quarter installments of $3.75M. Amounts within a single calendar year not utilized in a quarter roll over to the next quarter. This limitation does not apply to an award made to a high-yield project.

3. It addresses concerns about geographic distributions of JDIG awards in the following ways:

   a. It categorizes as major market communities the 3 counties with the highest average weekly wage for insured private employers.[9]

   b. It limits the amount of JDIG awards to major market communities to no more than twice the percentage of the community's population as compared to the State population. This limitation does not apply to an award made to a high-yield project.

   c. It converts the flat maximum percentage of withholdings that can be used to calculate the JDIG award from 75% to a tiered maximum percentage equal to 80% for tier 1, 70% for tier 2, 60% for tier 3, and 50% for major market communities.

   d. It modifies the minimum job creation requirements for JDIG projects from 10 jobs for tier 1 and 20 jobs for tiers 2 and 3 to 25 jobs for tier 1, 50 for tier 2, 200 for tier 3, and 250 for major market communities.

   e. It adds a wage standard requirement not currently in place for JDIG that requires the created jobs to pay an average weekly wage equal to or greater than a percentage of the average wage for all insured private employers in the county. The applicable percentage is 100% for tier 1, 110% for tier 2, 115% for tier 3, and 125% for major market communities.

4. The bill extends the authority to enter new JDIG agreements from 1/1/16 to 1/1/18.

[9] Currently, the counties that are major market communities are the counties of Wake, Mecklenburg, and Durham.