SENATE BILL 257:
Appropriations Act of 2017, Part 38:
Finance Provisions

2017-2018 General Assembly

Committee:		**Date:**	July 27, 2017
Introduced by:		**Prepared by:**	Trina Griffin
Analysis of:	Part 38 of S.L. 2017-57		Staff Attorney

OVERVIEW: Part 38 of S.L. 2017-94 contains the following finance provisions:

Individual Income Tax

- ***Lowers the personal income tax rate from 5.499% to 5.25%, effective for taxable years beginning in 2019.***
- ***Increases the standard deduction to $20,000 for married filing jointly taxpayers and to $10,000 for single filers, effective for taxable years beginning in 2019.***
- ***Changes the standard deduction for head of household filers to an amount that is 75% of the amount for married filing jointly taxpayers, effective for taxable years beginning in 2019.***
- ***Changes the child credit to a tiered child deduction, effective for taxable years beginning in 2018.***

Corporate Income Tax

- ***Reduces the corporate income tax rate from 3% to 2.5% rate, effective for taxable years beginning in 2019.***

Franchise Tax

- ***Reduces the franchise tax rate for S corporations by applying a flat $200 on the first $1 million of the calculated base, applicable to the calculation of franchise tax reported on the 2018 and later corporate income tax returns.***

Sales Tax

- ***Exempts from sales tax distribution equipment, and accessories, attachments, or repair parts for distribution equipment, sold to a large fulfillment facility, effective July 1, 2017.***
- ***Repeals the 1%/$80 privilege tax applicable to mill machinery and certain other manufacturing and industrial equipment and establishes a sales tax exemption for this equipment, effective July 1, 2018. It also directs the Revenue Laws Study Committee to study this area of law to provide more guidance to taxpayers and the Department of Revenue about what constitutes "mill machinery," how to define "manufacturing," and how to incorporate the body of Departmental administrative law in this area into the statutes.***
- ***Exempts from sales tax repair or replacement parts for a ready mix concrete mill, regardless of whether the mill is freestanding or affixed to a motor vehicle, effective July 1, 2018.***
- ***Provides a sales tax refund for building materials, supplies, and equipment sold to a business that receives a JDIG award prior to June 30, 2019, for a "transformative project," which is a project that requires an investment of $4 billion in private funds and creates at least 5,000 eligible positions.***

Renewable Energy Tax Credit

- ***Allows certain biomass resource-related projects to claim the renewable energy tax credit if it had a certain minimum level of completion prior to January 1, 2016, and it was placed in service prior to May 5, 2017.***

CURRENT LAW & BILL ANALYSIS

SECTION 38.1: LOWER PERSONAL INCOME TAX RATE

In 2014, North Carolina moved to a flat tax rate system for personal income tax. The tax rate in 2014 was 5.8%. The rate has gradually decreased over time to 5.499%, where it stands today. Section 38.1 of the act further reduces this rate to 5.25%.

This section becomes effective for taxable years beginning on or after January 1, 2019.

SECTION 38.2: INCREASE STANDARD DEDUCTION

Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions and will choose the method that gives them the lower taxable income. The standard deduction is a dollar amount that reduces taxable income and eliminates the need to itemize actual deductions, such as medical expenses, charitable contributions, and taxes, on Schedule A. Approximately 65-70% of North Carolina taxpayers take the standard deduction. A taxpayer's whose State taxable income is equal to or less than the standard deduction amount does not owe any State income taxes.

Section 38.2 of the act would increase the standard deduction as follows:

Filing Status	Current Deduction Amount	Proposed Deduction Amount
Married, filing jointly/surviving spouse	$17,500	$20,000
Head of household	$14,000	$15,000
Single	$8,750	$10,000
Married, filing separately	$8,750	$10,000

This section also changes the amount of the standard deduction for head of household filers to an amount equal to 75% of the standard deduction for married filing jointly filers. Currently, the standard deduction at the State level for head of household filers is 80% of the deduction for married filing jointly taxpayers. At the federal level, the head of household deduction amount is 73.622% of the married filing jointly amount.

These changes are effective for taxable years beginning on or after January 1, 2019.

SECTION 38.4: CONVERT CHILD TAX CREDIT TO A DEDUCTION

North Carolina provides a child tax credit of up to $125 per child for a taxpayer who is allowed a federal child tax credit under section 24 of the Code. The amount of the State child tax credit varies based upon the adjusted gross income and filing status of the taxpayer. For married filing jointly, the credit amount is $125 for AGI up to $40,000; $100 for AGI up to $100,000; and $0 for taxpayers whose AGI is over $100,000. Section 38.4 makes several changes related to the child tax credit. Whether a taxpayer would see a benefit from the changes will vary depending upon each taxpayer's specific circumstances.

- It converts the credit to a deduction. A credit reduces a taxpayer's tax due on a dollar for dollar basis; however, the credit cannot be used to reduce a taxpayer's liability below zero. Section 38.4

would change the credit to a deduction of up to $2,500 per child; a tax deduction reduces a taxpayer's taxable income, to which the tax rate is applied.

- It expands the number of taxpayers who could benefit from the deduction by increasing the AGI limit from $100,000 to $120,000. It also provides five deduction amounts, as opposed to the current two credit amounts. For married filing jointly, the deduction amounts and AGI brackets are as follows:

AGI	Deduction Amount
Up to $40,000	$2,500
Over $40,000 – Up to $60,000	$2,000
Over $60,000 – Up to $80,000	$1,500
Over $80,000 – Up to $100,000	$1,000
Over $100,000 – Up to $120,000	$500
Over $120,000	0

SECTION 38.5: LOWER CORPORATE INCOME TAX RATE

In S.L. 2013-316, the General Assembly began reducing the corporate income tax rate.[1] The legislation reduced the rate from 6.9% to 6% for 2014 and to 5% for 2015. It also enacted a rate reduction trigger based upon net General Fund tax collections. General Fund revenues exceeded the trigger amounts for 2015 and 2016, and accordingly the corporate income tax rate fell to 4% for 2016 and 3% for 2017. Section 38.5 continues this rate reduction by reducing the rate to 2.5% for 2019. This section also codifies the existing corporate income tax rate of 3% by repealing the trigger, since it has been met, and changing the statutory tax rate to 3% for 2017.

SECTION 38.6: LOWER FRANCHISE TAX FOR S CORPORATIONS

S Corporations currently pay franchise tax[2] at a rate of $1.50 per $1,000 of net worth. Section 38.6 reduces this amount to a flat rate of $200 on the first $1,000,000 of net worth and $1.50 for every $1,000 of net worth over $1,000,000. This change is effective for taxable years beginning on or after January 1, 2019, and is applicable to the calculation of franchise tax reported on 2018 and later corporate tax returns.[3]

SECTION 38.8: EXEMPT MILL MACHINERY FROM TAX AND STUDY

This section has two parts: the first part is a sales tax exemption and the second part is a study.

Sales Tax Exemption. – Under current law, purchasers of mill machinery pay tax at a preferential rate of 1% of the purchase price with an $80 cap. This privilege tax (as opposed to a sales tax) is set out in Article 5F of Chapter 105. Section 38.8 of the act repeals Article 5F and moves the provisions contained therein to the sales tax exemption statute.[4] With one exception described below, there are no

[1] Corporate income tax revenue contributed $912 million to the State's General Fund for Fiscal Year 2016-17; that represents approximately 5% of General Revenue.
[2] Franchise tax revenue contributed $552 million to the State's General Fund for Fiscal Year 2016-17.
[3] Roughly 95% of S-corporations in NC have a net worth of less than $1,000,000.
[4] Since the new sales tax exemption provisions in Section 38.8 do not become effective until July 1, 2018 and the existing Article 5F provision for "a large manufacturing and distribution facility" expires on July 1, 2018, this provision is not being moved into the sales tax exemption statute.

substantive changes to the language; the only modifications that have been made are those necessary to make the provisions fit the sales tax exemption statute and to eliminate unnecessary language.

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

One substantive change in this section is the creation of a sales tax exemption for repair or replacement parts for a ready-mix concrete mill, regardless of whether the mill is freestanding or affixed to a motor vehicle, to a company that primarily sells ready-mix concrete. Currently, purchases by ready-mix concrete manufacturers of mill machinery, equipment, parts, and accessories that are used directly in the manufacture of ready-mix concrete for sale are subject to the 1%/$80 tax. However, once a ready-mix concrete mill becomes part of a truck, it is part of a motor vehicle; and a motor vehicle is not considered mill machinery. Repair parts and accessories to a motor vehicle are subject to State and local sales tax.

The repeal of Article 5F and the corresponding sales tax exemptions become effective July 1, 2018.

<u>Revenue Laws Study.</u> – Although the act transitions the treatment of mill machinery from a preferential rate of privilege tax to a sales tax exemption, many unresolved issues remain with regard to this area of law. Among them, the statute does not specifically define a "manufacturing industry" or "mill machinery." Because the statute does not define these terms, it has raised questions as to whether a company is a manufacturer, for example, if it engages in multiple activities, only one of which may be manufacturing. It also raises questions as to whether a particular piece of equipment is "mill machinery" if it has dual purposes, only one of which is to manufacture goods. Over the years, the Department of Revenue has, through a combination of administrative rule, case law, and interpretation of the Secretary, developed guidance and criteria to determine the application of the tax. The criteria have not always been consistent or clear to taxpayers. Moreover, this body of administrative law is not codified in the statutes.

Subsection (e) of this section directs the Revenue Laws Study Committee to study these issues in order to provide more guidance and specificity to both taxpayers and the Department of Revenue. This subsection became effect when the act became law on June 28, 2017.

SECTION 38.9: SALES TAX EXEMPTION FOR FULFILLMENT FACILITIES

Under current law, "mill machinery" is subject to tax at the preferential rate of 1% of the purchase price with an $80 cap. In order to qualify for the preferential rate, the machinery and equipment must be used in the production process of manufacturing tangible personal property for sale. Generally speaking, "manufacturing" begins when the item is withdrawn from its first point of storage and ends when the item is removed at the end of the manufacturing process and placed in finished goods storage. "Distribution equipment," which is used for the movement of manufactured products within storage warehouses, shipping rooms, and other finished product storage areas and for the removal of products for sale or shipment, is considered to be outside the manufacturing process. Therefore, absent a specific exemption, distribution equipment does not normally qualify as mill machinery.

Since 2001, the General Assembly has expanded the preferential treatment for certain equipment to attract or maintain various industries as long as the equipment is capitalized for tax purposes under the Code by a company "primarily engaged" in certain kinds of business activities. The types of businesses eligible for the 1%/$80 rate on certain machinery and equipment are as follows:

- A major recycling facility. (2005)
- A research and development company in the physical, engineering, and life sciences. (2006)
- A software publishing company. (2007)

- An industrial machinery refurbishing company. (2008)
- A large manufacturing and distribution facility.[5] (2011)
- A company located at a ports facility for waterborne commerce. (2013)

This section provides a sales tax exemption for distribution equipment purchased by large customer fulfillment facilities under criteria similar to the current provision for "large manufacturing and distribution facilities." A "large fulfillment facility" is a facility used primarily for receiving, inventorying, sorting, repackaging, and distributing finished retail products for the purpose of fulfilling customer orders. Examples could include an Amazon distribution center, which fulfills orders on behalf of third party vendors, or a Walmart fulfillment center, which fulfills orders placed online for its own merchandise.

To qualify, the facility must invest at least $100 million in real and tangible personal property within five years of the first property investment, as certified by the Department of Commerce, and must maintain an employment level of 400 people. There is a forfeiture provision in the event the employment level at the facility drops below 400.

Examples of equipment used in the distribution process would include automated storage and retrieval systems, conveyor and sortation systems, storage systems, racking and mezzanine systems, automated packaging systems, labeling and scanning equipment, and forklifts and other powered equipment.

This section became effective July 1, 2017, and applies to sales made on or after that date.

SECTION 38.9A: SALES TAX REFUND FOR TRANSFORMATIVE PROJECTS

The General Assembly has enacted a number of economic incentive refunds over the years, including refunds for passenger air carriers, major recycling facilities, motorsports teams, analytical services businesses, and railroad intermodal facilities.

Section 38.9A allows the owner or lessee of a business that qualifies as a "transformative project" to apply for a refund of sales and use tax paid for building materials, building supplies, fixtures, and equipment that become part of the real property of the facility. A "transformative project" is a newly defined term within the JDIG statutes,[6] defined as "a project for which the agreement requires that a business invest at least four billion dollars ($4,000,000,000) in private funds and create at least 5,000 eligible positions. While there was no public committee discussion of a particular company that this provision was aimed at enticing, this News & Observer article published shortly before the passage of the budget speculated that Foxconn, a Chinese smartphone assembler, might be considering North Carolina as a possible site location. In late July, the company announced it would build a $10 billion plant in Wisconsin.

This section became effective July 1, 2017, and applies to purchases made on or after that date.

SECTION 38.13: RENEWABLE ENERGY TAX CREDIT EXTENSION

The credit for investing in renewable energy property expired on January 1, 2016. In 2015, the General Assembly made an exception by providing a delayed effective date of January 1, 2017, for projects that had achieved a minimum percentage of completion on or before January 1, 2016.

Section 38.13 of the act also provides a delayed sunset for certain projects utilizing biomass resources. In order for a project utilizing biomass resources to qualify for the credit under the alternate delayed sunset, the taxpayer must have incurred a minimum percentage of costs and completed a minimum

[5] This provision expires on and after July 1, 2018.
[6] Enacted by Section 15.15A of the budget, S.L. 2017-57.

percentage of the physical construction of the project prior to January 1, 2016, and placed the project into service on or before May 5, 2017. The percentage varies based on the total size of megawatt capacity (less than 65 megawatts = 80%; 65 megawatts or more = 50%). The taxpayer must have also timely filed an application for an extension and paid an application fee prior to October 1, 2015.

Under current law, the credit for investing in renewable energy property applies to biomass equipment, hydroelectric generators, solar energy equipment, wind equipment, and geothermal heat pumps and equipment. The amount of the credit for investing in renewable energy property is 35% of the cost of the property placed in service. In the case of renewable energy property that services a single-family dwelling, the credit must be taken for the taxable year in which the property is placed in service. For all other renewable energy property, the credit must be taken in five equal installments, beginning with the taxable year in which the property is placed in service. The amount of the credit is subject to certain limits depending on the type of property and whether the property is placed in service in a residential or nonresidential setting.

The credit is subject to the following caps:

TYPE OF PROPERTY	MAXIMUM CREDIT
Non-residential property.	$2,500,000 per installation.
Residential property:	
• Solar energy equipment for domestic water heating. The act clarifies that the credit also applies to solar energy equipment for pool heating.	$1,400 per dwelling unit.
• Solar energy equipment for active space heating, combined active space and domestic hot water systems, and passive space heating.	$3,500 per dwelling unit.
• Geothermal heat pumps and equipment.	$8,400 per installation.
• All other renewable energy property for residential purposes.	$10,500 per installation.

The credit may be taken against the franchise tax, the income tax, or the gross premiums tax. The taxpayer must elect the tax against which the credit will be claimed when the credit is taken. The election is binding, and any carryforwards of the credit must be taken against the same tax.

The renewable energy tax credit has the following limitations and conditions:

- The renewable energy tax credit may not exceed 50% of the tax against which it is claimed for the taxable year. Any unused portion of the credit may be carried forward for the succeeding five years.
- A taxpayer that claims any other credit allowed with respect to renewable energy property may not take the renewable energy tax credit with respect to the same property.
- A taxpayer may not take the renewable energy tax credit if the taxpayer leases the property from another person, unless the taxpayer obtains the lessor's written certification that the lessor will not claim a credit with respect to this property.