SENATE BILL 557: Various Finance Law Changes.

2019-2020 General Assembly

Committee:		**Date:**	November 15, 2019
Introduced by:		**Prepared by:**	Trina Griffin
Analysis of:	S.L. 2019-246		Staff Attorney

OVERVIEW: S.L. 2019-246 makes the following finance law changes[1]:

- ***Increases the standard deduction by 7.5%, from $20,000 to $21,500 for MFJ, effective for taxable years beginning on or after January 1, 2020.***
- ***Expands the definition of "holding company" for franchise tax purposes, effective for taxable years beginning on or after January 1, 2020.***
- ***Requires a multistate corporation to calculate its sales factor, for apportionment purposes, based on the percentage of income attributed to the consumption of products and services in the North Carolina marketplace, effective for taxable years beginning on or after January 1, 2020.***
- ***Obligates a "marketplace facilitator" that meets the same threshold applicable to remote retailers to calculate, collect, and remit sales tax on a third-party seller's behalf, effective February 1, 2020.***
- ***Directs the Revenue Laws Study Committee to review certain tax sunset provisions.***
- ***Requires the Department of Revenue to update its electronic tax systems to store and recognize power of attorney registrations to ensure that notices are simultaneously sent to both the taxpayer and the person designated in the taxpayer's power of attorney.***

CURRENT LAW, BILL ANALYSIS, AND EFFECTIVE DATES:

SECTION 1: INCREASE STANDARD DEDUCTION

Section 1 increases the standard deduction by 7.5% for all filing statuses, effective for taxable years beginning on or after January 1, 2020. Specifically, it increases the standard deduction by $1,500 for married filing jointly taxpayers, to $21,500; by $1,125 for head of household taxpayers, to $16,125; and by $750 for single taxpayers, to $10,750.

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 tax. The standard deduction is a dollar amount that reduces taxable income and eliminates the need to itemize actual deductions, such as mortgage interest, medical expenses, or charitable deductions. Taxpayers whose taxable income falls below the standard deduction amount do not owe State income tax on their income.

SECTION 2: EXPAND DEFINITION OF HOLDING COMPANY

[1] Most of the changes in this act were originally included in House Bill 966, the 2019 Appropriations Act.

Section 2 expands the definition of holding company, effectively capping the franchise tax on that holding company at $150,000. The purpose of the holding company cap is to prevent the taxation of assets that are included in the net worth of the subsidiary, and indirectly in the net worth of the parent company by virtue of its investment in the holding company. The new definition of holding company is tightly drawn:[2]

- More than 80% of the holding company's assets must be copyrights, patents, and trademarks, or more than 80% of its gross income must come from royalties and license fees.
- The holding company must be 100% directly owned by a parent corporation that includes in its net worth franchise tax base an investment in the holding company.
- The parent company must be a manufacturer who generates revenues in excess of $5 billion from the goods it manufactures.

This section is effective for taxable years beginning on or after January 1, 2020, and applies to the calculation of franchise tax reported on the 2019 and later corporate income tax returns.

SECTION 3: USE MARKET-BASED SOURCING FOR MULTISTATE INCOME TAX APPORTIONMENT

A company that does business in more than one state must pay income tax to each of the states in which it has nexus. Each state has a method for determining how much of a multistate company's income is taxable in that state. The method of apportionment may vary from state to state but is typically based on one or more of the following three factors: sales, property, and payroll. Most states give greater weight to the sales factor in their apportionment formula because it arguably makes a state a more attractive place for a multistate company that provides products to expand its property and payroll. If those factors are ignored in calculating a state's corporate tax, then the company can hire employees or build a plant without incurring additional state tax on its corporate profits. In 2015, North Carolina enacted legislation to phase-in single sales factor apportionment.[3]

When North Carolina enacted legislation in 2015 to phase-in single sales factor apportionment, it also directed the Revenue Laws Study Committee to study the calculation of the sales factor using market-based sourcing for all multistate companies, including those that provide services.[4] Under prior North Carolina law, the sales factor for companies that provide services was determined based on the percentage of business activities conducted in a state, which is generally measured by the amount of labor costs and capital investment incurred in a state to provide the services. This method of sourcing sales, coupled with single sales factor apportionment, did not provide the same incentive to a multistate company that provides services to locate in North Carolina as it did to one that provides products.

In 2016, the General Assembly did not enact market-based sourcing principles but it directed the Department of Revenue to adopt rules regarding the implementation and administration of market-based sourcing principles based on proposed statutory changes that followed market-based sourcing principles.[5]

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[2] Reynolds American Inc. meets the new definition of holding company.
[3] Prior to 2016, North Carolina used a double-weighted sales factor apportionment. At least 25 states use single-sales factor apportionment and an additional 14 states give greater weight to the sales factor in their apportionment formulas. States that adopt single sales factor apportionment usually adopt a market-based calculation of the sales factor. At least 30 states have adopted market-based sourcing.
[4] S.L. 2015-241, House Bill 97.
[5] S.L. 2016-94, House Bill 1030.

Section 3 enacts the market-based sourcing principles proposed in the 2016 legislation with a few modifications.[6]

Here is a general description of the income apportionment concept enacted by this section, coupled with the single sales factor legislation, for a company that does business in North Carolina and in other states:

Percentage of Income Taxed by North Carolina = Total Income Multiplied By a Ratio:

$$\frac{\text{Consumption in North Carolina of a Company's Products and Services}}{\text{Total Consumption of the Company's Products and Services}}$$

The section provides different sourcing principles for electric power companies, banks, and wholesale content distributors:

- Electric power companies will continue to source their receipts using a calculation based on the value of real and personal property owned or rented and used in this State.
- Banks will continue to source their receipts using a similar market-based calculation as applied under prior North Carolina law.
- Wholesale content distributors will apportions their income based on the commercial domicile of their customers. If the customer is a business customer, the income will be sourced based on the commercial domicile of the business. If the customer is an individual that directly subscribes with the wholesale content distributor, the income will be sourced based on the billing address of the individual customer. In no event may the amount of income sourced to the State be less than 2% of the wholesale content distributor's total domestic gross receipts from advertising and licensing activities. A wholesale content distributor is a company that creates and produces movies and television shows. They receive licensing fees from cable, satellite, and internet streaming companies in return for the rights to offer the shows to consumers as well as advertising revenue from advertisers. Under prior practice, as a result of a private letter ruling[7], wholesale content distributors were only required to apportion their income to North Carolina if a contract was executed in North Carolina to give a company the rights to offer their shows. The special apportionment principles allowed for wholesale content distributors is the result of a compromise agreed upon by the industry.

Section 3 also makes the following administrative changes:

- It directs the NC Utilities Commission to adjust the rates for public utilities for the tax changes made by this section. Each utility must calculate the cumulative net effect of the tax changes and file the calculations with proposed rate changes to reflect the net prospective tax changes in utility customer rates within 60 days of the enactment of this act. Any adjustments required to existing tax assets or liabilities reflected in the utility's books and records required by the tax changes shall be deferred and reflected in customer rates in either the utility's next rate case, or earlier if deemed appropriate by the Commission.
- It directs the Codifier of Rules to enter the rules adopted on January 4, 2017, and approved by the Rules Review Commission on February 16, 2017, into the Administrative Code on the effective date of this act, November 8, 2019. The rules apply to taxable years beginning on or after January 1, 2020.

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[6] The general market-based sourcing principles proposed in 2016 would have applied to electric power companies and wholesale content distributors. This legislature provides different sourcing principles for them.

[7] DOR private letter ruling.

- It directs the Department of Revenue to amend the rules adopted on January 4, 2017, and approved by the Rules Review Commission on February 16, 2017, based on the changes made by this act.

SECTION 4: MARKETPLACE FACILITATORS & OTHER FACILITATORS

MARKETPLACE FACILITATORS

BACKGROUND: Prior to last year, a state could not require a remote retailer to collect sales and use tax on behalf of the state if the retailer did not have a physical presence in that state. On June 21, 2018, the United States Supreme Court held in *South Dakota v. Wayfair, Inc.* that a retailer without a physical presence in a state may be required to collect and remit sales tax if it has an economic nexus with that state. The Court found that a South Dakota statute requiring remote retailers with gross sales in excess of $100,000 or at least 200 transactions sourced to that State to collect and remit sales tax met the "substantial nexus" standard required under the Constitution. The Court sided with South Dakota because the State showed that the requirement was not overly burdensome for interstate sellers. The majority made note of the fact that South Dakota's law was not retroactive and provided a safe harbor for smaller remote vendors. The Court also noted that South Dakota was a member of the Streamlined Sales and Use Tax Agreement, which standardizes taxes across states to lower compliance costs, requires state-level tax administration, and provides Internet vendors with access to sales tax administration software paid for by the State.

On August 7, 2018, the Department of Revenue issued a directive requiring retailers that meet either threshold to register and begin collecting and remitting sales tax beginning the later of November 1, 2018, or 60 days after meeting the threshold. On March 20, 2019, the Governor signed S.L. 2019-6 into law, which codified the Department's directive.

Many states are relying on the principles espoused in *Wayfair* as the basis for legislation that would require "marketplace facilitators" to collect and remit sales tax. At least 22 states and the District of Columbia have enacted a marketplace provision, either through administrative rule or legislation, and many other states have legislation pending.

A "marketplace facilitator" is a person that contracts with third parties to sell goods and services on its platform, which could be a physical space or an Internet website or application, in exchange for some form of consideration, which typically takes the form of facilitation fees or a percentage of the sales. The most widely known marketplace facilitators are businesses like Amazon, eBay, Etsy, and Walmart. Some of these entities make both direct sales from their own inventory of goods and services and sales of third party items, while some only sell third party items. Of note, third party sales constituted 58% of Amazon's sales in 2018 as compared to 3% in 1999.

CURRENT LAW: Under current law, a remote retailer is required to collect and remit sales and use tax to this State if, in the previous or current calendar year, it made gross sales of more than $100,000 sourced to this State or it made 200 or more separate sales transactions sourced to this State. Prior to the change in this section, there was no provision in the law requiring a marketplace facilitator to collect sales tax on sales of third party goods or services.

ANALYSIS: Section 4 of the act obligates a marketplace facilitator that meets the same threshold applicable to remote retailers to calculate, collect, and remit sales tax on a third-party seller's behalf. This section becomes effective February 1, 2020, and applies to sales occurring on or after that date.

Having a marketplace facilitator provision is a more cost effective way to collect the tax and increases collections because the aggregation of third-party sales on a single, large-scale marketplace provides the requisite nexus for a collection obligation that the remote retailers do not necessarily have individually, and it allows the State to collect from a single entity rather than from each third party seller in that marketplace.

Threshold. – A marketplace facilitator is only required to collect and remit sales tax to this State if it meets a threshold. The threshold is the same that applies to remote retailers. The facilitator must, in the previous or current calendar year, make gross sales in excess of $100,000 sourced to this State or 200 or more separate transactions sourced to this State. For purposes of determining whether the threshold is met, a facilitator is required to include all sales, including direct sales to customers as well as sales made on behalf of all marketplace sellers.

The act also clarifies that remote retailers must include their marketplace facilitated sales when determining whether they meet the threshold and are, therefore, required to collect tax on their direct sales sourced to this State.

Key Definitions. –

- ***Marketplace.*** – A physical or electronic place, forum, platform, application, or other method by which a marketplace seller sells or offers to sell items, the delivery of or first use of which is sourced to this State. While most discussion of the marketplace facilitator issue tends to refer to Internet retailers or "platforms" that sell third-party items, a marketplace could also be a physical place.
- ***Marketplace facilitator.*** – A person that, directly or indirectly and whether through one or more affiliates, does both of the following:
  1. Lists or otherwise makes available for sale a marketplace seller's items through a marketplace owned or operated by the marketplace facilitator.
  2. Does one or more of the following:
     - Collects the sales price or purchase price of a marketplace seller's items or otherwise processes payment.
     - Makes payment processing services available to purchasers for the sale of a marketplace seller's items.
     - Transmits the offer or acceptance for the sale of the items.
- ***Marketplace seller.*** – A person that sells or offers to sell items through a marketplace regardless of any of the following:
  - Whether the person has a physical presence in this State.
  - Whether the person is registered as a retailer in this State.
  - Whether the person would have been required to collect and remit sales and use tax had the sales not been made through a marketplace.
  - Whether the person would not have been required to collect and remit sales and use tax had the sales not been made through a marketplace.

  The purpose of these qualifications is to make clear that a marketplace's facilitator's remittance obligations are not contingent on the nexus or threshold status of a marketplace seller. Specifically, if a marketplace seller has nexus with this State and would otherwise be required to register and collect sales tax, the marketplace facilitator is, nevertheless, the retailer if the seller's items are being sold through its marketplace, assuming the marketplace facilitator meets the threshold.

  The reverse is also the case. If a remote retailer does not have nexus with this State and, therefore, is not required to collect sales tax for sales made directly to North Carolina customers, the marketplace facilitator may nevertheless be required to collect sales tax on behalf of the seller for those sales if the marketplace facilitator meets the threshold.

Payment of Tax. – A person that meets the definition of a "marketplace facilitator" and meets the economic nexus threshold will be considered the retailer for all marketplace facilitated sales it makes and will be required to collect and remit sales and use tax to this State. The facilitator will be subject to all requirements and procedures that apply to retailers generally.

Relief from Liability. – The act gives the Secretary of Revenue the ability to provide a marketplace facilitator with relief from liability if the facilitator can satisfactorily demonstrate that the failure to collect the correct amount of tax was due to incorrect information given to the facilitator by the seller.

Report. – A marketplace facilitator will be required, within 10 days after the end of each calendar month, to report to each marketplace seller for whom it makes marketplace facilitated sales the gross sales and the number of separate transactions sourced to this State. The purpose of this report is to help a marketplace seller determine whether they have nexus with this State by virtue of their marketplace facilitated sales and are, therefore, required to collect and remit on any direct sales they may have.

Limitation. – Currently, North Carolina recognizes "facilitators" in three other sales tax contexts: the rental of accommodations, the sale of admission to entertainment activities, and the sale of service contracts. The marketplace facilitator provisions in this act do not apply to these other facilitators. However, as a practical matter, there are situations in which these other facilitators are considered to be the "retailer" for particular transactions, and their collection and remittance obligations are set out in separate statutes.

OTHER FACILITATORS

Subsections (d) through (k) of this section make changes to the statutes that govern other types of facilitated transactions. Each of these statutes contains a defined term for a "facilitator," yet each definition of the same word is different. With the addition of a "marketplace facilitator," this section modifies these statutes to more specifically denominate the various facilitators to avoid confusion.

Specifically:

- This section creates a new defined term for an **"admission facilitator"** for purposes of the sales tax that applies to the gross receipts derived from admission charges to an entertainment activity and makes conforming changes throughout the statute, but it does not make any substantive changes as it relates to admissions.
- This section creates a new defined term for a **"service contract facilitator"** for purposes of the sales tax that applies to service contracts and makes conforming changes throughout the statute, but it does not make any substantive changes as it relates to service contracts.
- In addition, all of the definitions currently located in each of the three statutes are being relocated to the global definitions section for Article 5.

With respect to accommodations, this section makes the following substantive changes:

- ***Definition Change.*** – It modifies the definition of **"accommodation facilitator."** Under current law, an accommodation facilitator is a person who contracts with a provider of an accommodation to market and accept payment for the accommodation; it specifically excludes a rental agent. Historically, rental agents have been viewed differently than "facilitators" though descriptions of what they do are very similar. Generally speaking, a rental agent contracts with a property owner to rent the owner's residential property as an accommodation and is usually the person who interacts with and accepts payment from the renter. Rental agents tend to be considered as

providing more of a "person-to-person" service compared to an online travel company, such as Expedia, which is an internet platform through which customers can rent hotel rooms. In North Carolina, a rental agent is always considered the retailer for purposes of accommodation rentals, but that is not the case with accommodation facilitators. Facilitators typically send the portion of the sales price that they owe the provider and any tax due on that portion to the provider once the customer has occupied the room, and the provider is considered the retailer of the transaction.

Since North Carolina originally enacted its accommodation facilitator provision, new types of accommodation models, like Airbnb and VRBO, have entered the market space, and the ruling in the *Wayfair* case has eliminated physical presence concerns that previously limited the State's ability to collect from these facilitators. Given the changes in the landscape and to be more consistent with the treatment of marketplace facilitators, the act modifies the definition of "accommodation facilitator" to include a person that lists an accommodation for rental on a forum, platform, or other application for a fee or other consideration and real estate brokers.

- ***Specifies Who the Retailer Is.*** – It more specifically describes the conditions under which a person is considered the retailer for the rental of an accommodation. Generally, the provider of the accommodation is considered the retailer unless it has contracted with an accommodation facilitator who collects payment or a deposit at the time of the reservation, in which case the facilitator is considered the retailer. For the most part, this preserves the current framework but expands the remittance obligation when an online travel company or other accommodation facilitator collects and processes payment at the time the reservation is made (as opposed to merely collecting credit card information to hold a reservation).
- ***Exemption.*** – Under prior law, the rental of a private residence for fewer than 15 days in a calendar year is exempt from sales tax unless the rental is listed with a rental agent or real estate broker. Under the act, the exemption does not apply if the accommodation is rented by a facilitator who is considered the retailer, which means the facilitator collects payment or a deposit at the time of the reservation; this includes a rental agent.
- ***Report.*** – The act requires an accommodation facilitator to file an annual report with the Secretary of Revenue for rentals for which it is not considered the retailer. The report must include the property owner's name and mailing address, the physical location of the accommodation, rental activity detail, the gross receipts derived from the rentals, and any other information deemed necessary by the Department.

Subsection (*l*) updates the recordkeeping statute to address the types of records that facilitators and real property contractors must keep.

Subsection (m) makes various technical and stylistic changes to the definitions section and makes various conforming changes to address the addition of marketplace facilitators as retailers.

SECTION 5: REVENUE LAWS STUDY OF TAX SUNSET PROVISIONS

Section 5 directs the Revenue Laws Study Committee to review any tax provision set to expire within one year of the beginning of the next regular session of the General Assembly to determine whether the sunset needs to be extended.

SECTIONS 6-8: TECHNICAL CHANGES

Section 6 makes a technical correction to conform statutory language.

Section 7 clarifies that the tax changes made in Section 3.9(g) of S.L. 2019-169 (regarding property management contracts) apply to existing contracts. Many property management contracts are multi-year contracts, and this clarification ensures that those contracts do not need to be renegotiated. This section became effective when the act became law and applies retroactively to July 26, 2019.

Section 8 makes a technical correction to the definition of "gross sales" in G.S. 105-164.3(12) to clarify that all digital property, not just digital property subject to tax, is included in the definition of "gross sales" for purposes of determining whether a retailer must collect sales and use tax.

SECTION 8.1: DOR/SEND NOTICES TO TAXPAYER'S POWER OF ATTORNEY

Section 8.1 requires the Department of Revenue to update its electronic tax systems to store and recognize power of attorney registrations to ensure that notices generated by the Department are simultaneously sent to both the taxpayer and the person designated in the taxpayer's power of attorney registration. It further requires the Department to report to the Joint Legislative Oversight Committee on General Government, by January 31, 2020, on its progress in updating its electronic tax systems to store and recognize power of attorney registrations.

EFFECTIVE DATE: Except as otherwise provided, this act became effective when it became law on November 8, 2019.