

# Tax Alert:

## Major tax legislation enacted during the short session of the 2015-2016 North Carolina General Assembly

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By William W. Nelson  
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This alert summarizes the major tax provisions included in legislation passed by the 2015-2016 North Carolina General Assembly in its short session, which concluded earlier this month.

The most widely discussed tax changes passed during the short session included changes conforming to recent federal tax legislation, an increase in the standard deduction for individuals, a proposed implementation of market-based sourcing for corporate apportionment purposes, and revisions to the sales taxation of repair, maintenance, and installation (RMI) services.

However, the legislature made a number of other important changes as well.

The discussion below briefly summarizes each major change and indicates the effective date and the ratified bill number (for unsigned bills) or session law number (for bills already signed by the Governor) of the enacting legislation. Readers should note that ratified bills not yet signed by the Governor will become effective only when signed, or if the Governor fails to veto them within 30 days after adjournment.

## About

This document was prepared by William W. Nelson, a partner at Smith Anderson Law. William Nelson practices in the area of Federal and State taxation at Smith Anderson, is a fellow of the American College of Tax Counsel, and is the author of the Commerce Clearing House 2016 Guidebook to North Carolina Taxes. If you would like more information, please contact him directly.



William Nelson  
919.821.6760  
wnelson@smithlaw.com



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# 01 IRC CONFORMITY

Each year the General Assembly updates the reference to the Internal Revenue Code (IRC) found in Chapter 105 of the General Statutes in order to conform to recent federal tax legislation. This year, the IRC reference has been updated from January 1, 2015 to January 1, 2016. S 726; S.L. 2016-6 (effective June 1, 2006). As a result, North Carolina generally conforms to IRC amendments made by the Protecting Americans from Tax Hikes (“PATH”) Act of 2015. However, North Carolina decouples from the PATH Act in the following ways:

- North Carolina requires 85% of federal bonus depreciation to be added back to income for North Carolina purposes.
- North Carolina continues to use lower dollar and investment limitations for expensing deductions under IRC § 179 and continues to require an add-back of 85% of the difference between the deduction amounts calculated using the federal and the state limitations.
- North Carolina does not allow mortgage insurance premiums to be deducted as qualified residence interest.
- North Carolina does not allow income from the cancellation of qualified principal residence indebtedness to be excluded from income.
- North Carolina does not permit qualified charitable distributions from an IRA by a person who has attained age 70 ½ to be excluded from income (but does allow a charitable deduction for such distributions).
- North Carolina does not allow a deduction for qualified tuition and related expenses.





# 02

## Personal Income Tax Changes

### INCREASE IN THE STANDARD DEDUCTION

The General Assembly has increased the standard deduction over two years by \$2,000 for taxpayers filing a joint return and surviving spouses (\$1,000 in each of 2016 and 2017), \$1,600 for heads of households (\$800 each year) and \$1,000 for single taxpayers and married taxpayers filing separately (\$500 each year). H 1030, §38.1 (effective upon enactment).

### ADDITIONAL ITEMIZED DEDUCTION

Subject to certain limitations, North Carolina itemizers may deduct the repayment of an amount included in income in an earlier year under a claim of right, provided the repayment was taken into account in computing adjusted gross income (AGI) in the year of deduction. S 729; S.L. 2016-5, §2.1 (effective retroactively to taxable years beginning on or after January 1, 2014).

### ADDITIONAL DEDUCTIONS

Two deductions that were repealed in 2013 have been restored:

- Under IRC §108(i)(1), a taxpayer that realized cancellation of debt (COD) income by reacquiring its own debt instrument in 2009 or 2010 may defer recognition of the income for four years (for reacquisitions in 2010) or five years (for reacquisitions in 2009) and then recognize the income ratably over a five year period. Amounts included in income for federal purposes under this provision may be deducted in computing North Carolina taxable income. S 729; S.L. 2016-5, §2.1.(b) (effective retroactively for taxable years beginning on or after January 1, 2014).

- If a taxpayer's federal ordinary and necessary business expense deductions are reduced because the taxpayer claimed a federal credit with respect to an expense in lieu of a deduction, the taxpayer may deduct the expense for North Carolina purposes as long as North Carolina does not allow a similar credit. S 729; S.L. 2016-5, §2.1.(c) (effective for taxable years beginning on or after January 1, 2016).

#### **ADDITIONS TO FEDERAL AGI**

Two new additions to federal AGI for purposes of computing North Carolina taxable income have been enacted:

- Federal AGI must be increased by any federal NOL carryover to the current year that is not absorbed in the current year but carried forward to future years. S 729; S.L. 2016-5, §2.2.(a) (effective for taxable years beginning on or after January 1, 2016).
- Federal AGI must be increased by the amount of any prior year deductions for contributions to the state's 529 plan to the extent such amounts were withdrawn from the plan and used for non-qualified purposes unless the non-qualified use was due to the beneficiary's death or disability. S 729; S.L. 2016-5, §2.2.(a) (effective for taxable years beginning on or after January 1, 2016).

#### **LIMITATION ON ADD-BACK OF COD INCOME FROM QUALIFIED PERSONAL RESIDENCE INDEBTEDNESS**

As noted above, North Carolina does not allow income from the cancellation of qualified principal residence indebtedness to be excluded from income, and any such income excluded from federal gross income must be added back in computing North Carolina taxable income. Under new legislation, if the taxpayer is insolvent, the addback is limited to the amount of such income that exceeds the amount by which the taxpayer is insolvent. S 803, §1.2 (effective upon enactment).

## 03

## CORPORATE INCOME AND FRANCHISE TAX CHANGES

### MARKET-BASED SOURCING

Last year, the General Assembly approved a phase-in of single sales factor apportionment for multistate corporations. Single sales factor apportionment will be fully phased in in 2018. The move to single sales factor apportionment obviously draws attention to how the sales factor is calculated. The sales factor is intended to represent the contribution of the market state or states to the production of the taxpayer's income. Under current law, gross receipts from sales of tangible personal property are sourced to where the property is delivered to the customer. This "destination principle" is consistent with a market-based approach. North Carolina's existing rules for sourcing gross receipts from services and intangibles, however, are not based on the location of the customer and thus are not always consistent with a market approach. There was considerable expectation that the General Assembly would enact market-based sourcing for services income and income from intangibles this year.

The General Assembly did not adopt market-based sourcing legislation during the short session. Instead, the legislature enacted legislation proposing market-based sourcing rules and directed the Department of Revenue (DOR) to promulgate rules to implement market-based sourcing on an expedited basis. Specifically, the DOR is directed to prepare proposed rules by January 20, 2017. The DOR must accept comments on the proposed rules for at least 90 days after publication. The proposed rules will not become effective unless and until the General Assembly takes further action to enact market-based sourcing legislation. H 1030, §38.4 (effective upon enactment).

This rulemaking procedure recognizes the complexity and difficulty of crafting appropriate market-based sourcing rules for different industries. The proposed market-based sourcing legislation included in H 1030 includes several pages of detailed rules for banks. It is expected that taxpayers in other industries may also wish to have the General Assembly enact detailed sourcing rules tailored to their businesses rather than leaving the matter entirely to the DOR's discretion. Requiring the DOR to propose rules before final passage of market-based sourcing legislation will allow such taxpayers to request that the General Assembly address inequities or unintended consequences in the proposed rules prior to final adoption.





## OTHER APPORTIONMENT-RELATED CHANGES

The General Assembly has enacted several other apportionment-related changes:

- A corporation engaged in the air freight forwarding business carried on primarily with an affiliated air carrier must apportion its income using the same revenue ton mile fraction as the affiliated air carrier. S 729; S.L. 2016-5, §1.3(a) (effective for taxable years beginning on or after January 1, 2016).
- For purposes of calculating the sales factor, sales do not include:
  - ▷ Gross receipts attributable to the notional principal amount of a swap contract or similar derivative;
  - ▷ Foreign source dividends included in federal taxable income but subtracted in calculating state net income;
  - ▷ Subpart F inclusions under IRC §951;
  - ▷ Foreign indirect tax credit gross-up amounts under IRC §78;
  - ▷ Dividends excluded for federal income tax purposes. S 729; S.L. 2016-5, §1.6.(a) (effective for taxable years beginning on or after January 1, 2016).

## ROYALTY REPORTING OPTION

Under current law, if a corporation pays royalties to an affiliate in another state for the use of intangibles in North Carolina, the payor may elect to deduct the royalties if the payee includes the royalties in its North Carolina income. Alternatively, the payee may exclude the royalties from North Carolina income if the payor adds the royalties back into its North Carolina income. The General Assembly has provided that a corporation's election to add royalty payments back to income and exclude them from the income of the payee does not prevent the payee from having nexus in North Carolina or permit the payee to exclude the royalty payments from its sales factor for apportionment purposes. S 729; S.L. 2016-5, §1.5 (effective May 11, 2016).

## QUALIFIED INTEREST EXPENSE

Under 2015 legislation, if a corporation makes net interest payments to affiliates, it may deduct such net interest only to the extent the net interest does not exceed 30% of the taxpayer's adjusted gross income. There are several exceptions to the 30% limitation, including an exception where the recipient of the interest "pays" tax to another state on the interest income. New legislation makes several changes to the qualified interest expense rules.



Most notably, the percentage limitation is lowered from 30% to 15%. However, the limitation does not apply to the taxpayer's proportionate share of interest paid or accrued directly or indirectly to an unrelated third party during the year. Thus, interest paid to a financing affiliate should be fully deductible in most cases. In addition:

- The new law clarifies that net interest expense is determined on an aggregate basis rather than separately for each affiliate.
- The rule that the limitation does not apply if the payee "pays" tax on the interest income to another state is replaced with a rule that limitation does not apply if another state "imposes" a tax on the interest on the hands of the payee.
- The new law provides that interest eliminated by combined or consolidated reporting does not qualify as interest that is subject to tax in the other state. S 729; S.L. 2016-5, §1.8 (effective for taxable years beginning on or after January 1, 2016).

#### FRANCHISE TAX CHANGES

In addition to the apportionment changes described above, which affect the apportionment of the franchise tax base as well as income, the legislature has made the following franchise tax changes:

- The legislature has clarified the effective date of the new net worth franchise tax base enacted in 2015. The 2015 legislation provided that the new base was to be effective for taxes due on or after January 1, 2017. The 2016 legislation clarifies that the new base is effective for 2017 franchise taxes reported and paid with the 2016 corporate income tax returns. S 729; S.L. 2016-5, §1.7 (effective May 11, 2016).
- The special franchise tax for mutual burial associations is repealed. S 729; S.L. 2016-5, §1.1(a) (effective for franchise taxes due on or after April 1, 2017).



## 04

CREDIT  
CHANGES

The 25% production credit allowed to taxpayers that construct and place in service commercial renewable fuel processing facilities generally expired on January 1, 2014. However, the credit was previously extended until January 1, 2017, for a taxpayer that had signed a commitment letter

with the Department of Commerce on or before September 1, 2013, and that had begun construction by the end of 2013. The delayed sunset for these grandfathered facilities has been extended to January 1, 2020. S 770 (effective upon enactment).



# 05 SALES TAX CHANGES

## RMI SERVICES

The sales tax definition of taxable RMI services has been changed to clarify that such services include cleaning, refinishing, and inspection and monitoring services (other than real property security services).

In addition, the following services have been specifically exempted from tax:

- Legally required inspection services;
- Services provided to certain affiliated parties;
- Services related to real property punch-list items;
- Cleaning services with respect to real property (other than cleaning services related to the taxable rental of an accommodation or to pools, fish tanks, and similar aquatic features);
- Services on roads, driveways, parking lots, and sidewalks;
- Removal services such as waste and snow removal (other than removal of waste from portable toilets);
- Home inspection services to prepare real property for sale;
- Landscaping services;
- Clothing alteration and repair services (other than rental clothing alteration and repair or alteration and repair of belts and shoes);
- Pest control services;
- Moving services;
- Self-service car washes. H 1030, §38.5 (effective January 1, 2017).

### EXEMPT SERVICE CONTRACTS

Service contracts for the provision of the exempt RMI services listed above are also exempt. In addition, service contracts sold by motor vehicle dealers or by or on behalf of a motor vehicle service agreement company are also exempt. H 1030, §38.5.(h) (effective January 1, 2017).

### DIRECT PAY PERMITS

A direct pay permit permits the holder to purchase goods and services free of sales tax. Instead, the holder is liable for a use tax on purchases made using the permit. New legislation authorized the issuance of direct pay permits for the purchase of tangible personal property, digital property, or RMI services for a boat, aircraft, or qualified jet engine. In addition, the holder of such a permit is entitled to a use tax exemption for separately stated installation charges purchased with the permit and for gross receipts from the provision of RMI services for a boat, aircraft, or qualified jet engine to the extent such charges and receipts exceed \$25,000. H 1030, §38.5.(m) (effective July 1, 2016).

### REAL PROPERTY CONTRACTS

Under current law, labor associated with performing a real property contract is not taxable unless the contractor is considered to be engaged in retail trade. A contractor is considered engaged in retail trade based on its NAICS classification or the volume of its retail sales. This has the result of making the same services taxable or not taxable

depending on who is performing the contract. New legislation makes three fundamental changes to the current rules:

- The rule that someone engaged in retail trade cannot be a real property contractor has been repealed. Thus, services performed by a real property contractor under a real property contract will be nontaxable regardless of the volume of the contractor's retail sales or the contractor's NAICS classification.
- The definition of a real property contract has been amended to limit the term to contracts involving capital improvements to real property. Capital improvements are defined generally as the construction, reconstruction or remodeling of a building, structure, or fixture. The definition includes a non-exclusive list of services considered to qualify as capital improvements. These include most services for which a building permit is required and services on most projects capitalized for tax or accounting purposes.
- Special rules have been provided for real property contracts that also include the provision of RMI services. If the price of the RMI services is less than 10% of the total contract price, then the entire contract is treated as a real property contract. If the price of the RMI services equals or exceeds this 10% threshold, then the RMI services are treated as a separate contract on which the contractor must collect sales tax. H 1030, §38.5 (effective January 1, 2017).



## BASE EXPANSION AMNESTY/COMPROMISE PROVISIONS

Recognizing the difficulty many taxpayers face in complying with the sales tax base expansion that began in 2015, the General Assembly has provided the following palliative measures:

- Taxpayers are not liable for under-collecting sales tax as a result of the 2015 sales tax base expansion to RMI services, as long as the retailer made a good faith effort to comply with the law. The amnesty applies to the period from March 1 through December 31, 2016. H 1030, §38.5.(a) (effective upon enactment).
- The DOR is authorized to compromise the liability of a taxpayer with respect to reporting periods beginning March 1, 2016, and ending December 31, 2022, where the taxpayer failed to collect sales tax as a result of the changes in the definition of “retailer” or the expansion of the sales tax base to service contracts, RMI services, or the sales of persons engaged in retail trade as long as the taxpayer made a good faith effort to comply with the law. H 1030, §38.5.(b) (effective upon enactment).
- Under the 2015 sales tax base expansion, if a real property contractor improperly collects sales tax on items for which the contractor was liable for a use tax, the sales tax collected is treated as an erroneous collection which must be remitted to the Secretary. The 2015 legislation provided that the contractor could not apply the over-collection to offset its use tax liability. This prohibition has been repealed, retroactively, to January 1, 2015. §38.5.(d) (effective upon enactment).

## ADDITIONAL EXEMPTIONS

The following additional sales tax exemptions have been enacted:

- Any property or services purchased for resale under an exemption certificate or direct pay permit. H 1030, §38.5.(i) (effective January 1, 2017);
- Separately stated installation charges that are part of the sales price of tangible personal property purchased by a real property contractor to fulfill a real property contract. H 1030, §38.5.(i) (effective January 1, 2017);
- Separately stated installation charges that are derived from RMI services and installation charges purchased by a real property contractor to fulfill a real property contract (this exemption also covers installation charges by a retailer-contractor when performing a real property contract). H 1030, §38.5.(i) (effective January 1, 2017);
- Separately stated storage services for a motor vehicle. H 1030, §38.5.(i) (effective January 1, 2017);
- Separately stated towing services. H 1030, §38.5.(i) (effective January 1, 2017);
- RMI services purchased by qualifying farmers. H 1030, §38.5.(j) (effective January 1, 2017);
- Sales of products that are made of more than 75% recycled materials when the products are sold for use in an accepted wastewater dispersal system. H 1030, §38.5.(p) (effective October 1, 2016);
- Packaging items associated with food or prepared food provided under a prepaid meal plan. S 803, §2.5 (effective January 1, 2017);
- Fuel, piped natural gas, and electricity sold to secondary metal recyclers. H 1030, §38.2.(c) (effective July 1, 2016).



### USE TAX EXPANSION

Under current law, the use tax is imposed on tangible personal property or digital property purchased for storage, use, or consumption in North Carolina. The term “storage” had been defined to exclude (i) holding property for subsequent exclusive use outside the state and (ii) incorporating the property into manufactured article subsequently used exclusively outside the state. These exclusions have been repealed so that storage means holding the property in North Carolina for any period of time except as inventory. S 729; S.L. 2016-5, §3.2 (effective January 1, 2017).

### SALES TAX ON ADMISSIONS

Under current law, the sales tax on admissions is imposed on either the venue operator or the sponsor of the entertainment if that person receives the admission charges directly from the purchaser. New legislation also subjects any other person that receives gross receipts from admissions sold at retail to the tax. S 729; S.L. 2016-5, §3.4 (effective May 11, 2016).

### NONPROFIT SALES

Current law includes an exemption for sales by certain charitable organizations where the proceeds are contributed directly or indirectly to the state or a state agency. This exemption has been repealed. S 729; S.L. 2016-5, §3.9 (effective January 1, 2017).

### LIMITATION ON EXEMPTION FOR FUEL AND PNG

Under current law, fuel and piped natural gas sold to a manufacturer for use at a manufacturing facility is exempt. New legislation provides that the exemption does not apply if the fuel or gas is used solely for comfort heating at a facility where no manufacturing occurs. S 729; S.L. 2016-5, §3.10 (effective January 1, 2017).

### RECORDKEEPING

Under current law, taxpayers are required to keep sales tax records for three years. The three-year limitation has been repealed. S. 729; S.L. 2016-5, §3.15 (effective May 11, 2016).



# 06

## MILL MACHINERY TAX CHANGES

The 1% mill machinery tax with its \$80 per article cap, and the related sales tax exemption for articles subject to the mill machinery tax, have been expanded to include the following additional items:

- Certain specialized equipment (and related parts and accessories) used to unload and process bulk cargo at a ports facility;
- Certain capitalized equipment used by certain metal recyclers, metal fabricators, and precious metal extractors. H 1030 (effective retroactively to July 1, 2013).

Notably, efforts to repeal the mill machinery tax altogether as an inefficient tax on business inputs were not successful.

# 07

## HIGHWAY USE TAX CHANGE

Under current law, the 3% Highway Use Tax is capped at \$2,000 for recreational vehicles. New legislation provides that a park model RV is considered a recreational vehicle entitled to the \$2,000 cap. The sales tax law has also been amended to clarify that a park model RV is a motor vehicle exempt from sales tax. S 729; S.L. 2016-5, §3.19 (effective July 1, 2016).

## 08

**PROPERTY TAX  
CHANGES**

Under prior law, when present-use value property lost its present use classification because it was conveyed by gift to a nonprofit, the United States, the state, or a political subdivision of the state, no deferred taxes were triggered and the lien for deferred taxes was extinguished.

Under new legislation, this exception has been modified to account for cases where the property is conveyed in a bargain sale. Specifically, if the property is conveyed at or below its present use value, then no deferred taxes are due and the lien is extinguished, just as under prior law. However, if the property is conveyed at more than its present use value, then a portion of the deferred taxes is triggered equal to the lesser of the deferred taxes, or the deferred taxes multiplied by a fraction the numerator, of which the sales price is in excess of the present use value and the denominator of which is true value of the property in excess of the present use value. H 533; S.L. 2016-76, §1 (effective for taxable years beginning on or after July 1, 2016).

## 09

**ADMINISTRATIVE  
CHANGES****REFUND CLAIMS**

Under prior law, a taxpayer whose refund claim was denied because the DOR determined the statute of limitations had run before the claim was filed was not permitted to contest the DOR's denial through a contested case proceeding before the Office of Administrative Hearings (OAH). New legislation permits the taxpayer to seek review of the DOR's denial in such cases through a contested case proceeding. If the OAH (or a court in review of an OAH decision) determines that the claim was timely filed, then the claim is remanded to the DOR for consideration on the merits. H 533; S.L. 2016-76, §2 (effective June 30, 2016).

Under a special rule, a taxpayer whose claim was denied by the DOR as outside the statute of limitations before the enactment date of the new law may nevertheless file a contested case proceeding as long as the proceeding is filed within 60 days of the enactment date (i.e., by August 29, 2016). This special procedure appears to be available regardless of how long ago the refund was denied.



## WRITTEN DETERMINATIONS

Under new legislation, the DOR is required to publish redacted copies of all written determinations on its website within 90 days of the issuance of such determinations. Moreover, within 120 days of enactment, the department must publish redacted copies of all written determinations issued since January 1, 2010. While such reacted determinations may not be relied upon by other taxpayers, they will nevertheless provide taxpayers and their advisors with a great deal of additional information about the DOR's interpretation of the tax laws.

Written determinations for this purpose include:

- Private letter rulings;
- Alternative apportionment rulings;
- Advice regarding whether a corporation would be subject to a redetermination of its income or to combined reporting because of intercompany transactions;
- Voluntary agreements entered into between a corporation and the DOR to permit alternative filing methodologies as a result of intercompany transactions. S 481, §5 (effective upon enactment).

## TRUST FUND TAXES

Under prior law, the period of limitation for assessing a responsible person of a business entity for trust fund taxes expired one year after the period of limitations for assessing the business entity. New legislation provides that where the business entity has contested the assessment, the limitation period for assessing the responsible person is extended until one year after the tax becomes collectible from the business entity. S 729; S.L. 2016-5, §5.1 (effective May 11, 2016).

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For more information about any of these legislative changes, please contact Mr. Nelson at [wnelson@smithlaw.com](mailto:wnelson@smithlaw.com) or 919-821-6760. You can learn about Smith Anderson's Tax Group here: [www.smithlaw.com/practices-tax.html](http://www.smithlaw.com/practices-tax.html).

