SMITH ANDERSON TAX ALERT

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Senate Bill 628

Two previous Tax Alerts (June 20 and June 30, 2017) summarized the major tax legislation enacted during the North Carolina General Assembly's regular 2017 session. One important bill, Senate Bill 628 ("S 628"), which included many changes requested by the Department of Revenue ("DOR"), remained in conference as the regular session ended and was held over until the session reconvened in August. With minor additional changes, the bill was enacted and signed by the Governor on August 11. This Tax Alert summarizes the most significant provisions of S 628. In addition to the changes discussed below, S 628 made numerous technical corrections, clarifying, conforming and modernizing changes to North Carolina's tax statutes, and this Alert does not attempt to describe each such change.[1]

PERSONAL INCOME TAX CHANGES

Nonresident Income from Partnerships

A nonresident's North Carolina taxable income is his federal adjusted gross income with North Carolina modifications multiplied by a fraction. The denominator of the fraction is the nonresident's gross income with North Carolina modifications, and the numerator is the nonresident's modified gross income derived from North Carolina property or from a trade or business carried on here.[2] If the nonresident is a partner in a partnership that operates in North Carolina and one or more other states, the nonresident must include in the numerator his distributive share of the partnership's income apportioned to North Carolina.[3] The new law provides that the numerator must also include any guaranteed payments made by the partnership to the nonresident partner. In addition, the partnership's North Carolina information return must disclose any guaranteed payments made to each partner.[4] The legislation includes a finding that these changes "clarify the intent of existing law and do not represent a change in the law." As a result, they are given unlimited retroactive effect and, as a practical matter, apply to any open year.[5]

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[1] In addition to the legislation discussed in this and the two previous Tax Alerts, the 2017 General Assembly enacted several bills making minor amendments to Chapter 105. Specifically, S.L. 2017-6 and S.L. 2017-102 made minor corrections or nonsubstantive changes in terminology; S.L. 2017-87 simplified the procedure for obtaining a local ABC permit; S.L. 2017-108 expanded the types of receipts that can be used to satisfy the gross income requirement for agricultural land to qualify for present use valuation and provided a process for farmers with sales tax conditional exemptions to apply for a one-year extension; S.L. 2017-128, S.L. 2017-299, S.L. 2017-186 and S.L. 2017-203 modified the exemptions to the prohibition against disclosing tax information; S.L. 2017-151 subjected massage and bodywork therapists to privilege license taxes; S.L. 2017-434 provided sales tax exemptions for sales of investment coins, investment bullion and non-coin currency; and S.L. 2017-206 adjusted the compensation of Property Tax Commission members.

[2] G.S. §105-153.4(b).

[3] *Id*.

[4] S.L. 2017-204, §1.9.

[5] S.L. 2017-204, §1.9.(g).

Cancer Donations

The new law permits an individual entitled to a personal income tax refund to elect o contribute all or part of the refund to the state Department of Health and Human Services to be used for the early detection of breast and cervical cancer. The change is effective for the 2017 through 2020 taxable years. The Secretary is directed to revise the personal income tax return to provide for the election. The election is irrevocable once the return is filed.[6]

FRANCHISE TAX CHANGES

Restoration of Indebtedness Deduction

In calculating the alternative franchise tax base based on a taxpayer's "total actual investment in tangible property" in North Carolina, corporations were historically permitted to deduct "any indebtedness incurred and existing by virtue of the purchase of any real estate and any permanent improvements made thereon."[7] This deduction was repealed effective for taxable years beginning on or after January 1, 2017.[8] The deduction has been restored in a more limited version, effective for taxable years beginning on or after January 1, 2020 (reported on the 2019 income tax return). The new deduction is limited to indebtedness "specifically incurred and existing solely for and as a result of the purchase" of real property and permanent improvements.[9]

Holding Companies

Holding companies are subject to a minimum franchise tax of $200 and a maximum franchise tax of $150,000.[10] A company is a holding company if it satisfies either an asset test or an income test. Under the asset test, a company is a holding company if its assets are limited to "ownership interests" in corporations in which it owns more than 50% of the "outstanding voting stock or voting capital interests." Under the income test, a company is a holding company if more than 80% of its taxable income is derived from corporations in which it owns more than 50% of the "voting stock or voting capital interests." The income test has been changed to refer to taxable income derived from corporations in which the taxpayer owns more than 50% of the "outstanding voting stock, voting capital interests or ownership interests."[11] The franchise tax definition of "corporation" includes a number of special entities including LLCs that have elected to be taxed as corporations and thus do not have ownership interests represented by shares. The prior definition's inclusion of the concept of "voting capital interest" reflected this fact. The new law adds the concept of "ownership interests" to the income test. This is apparently intended to allow the test to be satisfied by taking into account subsidiaries in which the taxpayer has a

[6] S.L. 2017-204, §6.2; G.S. §105-269.8.
[7] G.S. §105-122(d) (2015).
[8] *See* S.L. 2015-241, §32.15.(d).
[9] S.L. 2017-204, §1.3; G.S. §105-122(d)(3).
[10] G.S. §105-120.2(b).
[11] S.L. 2017-204; G.S. §105-120.2(c).

majority economic interest but not voting control. This change was effective August 11, 2017.[12] Note that the asset test was not amended. Thus, while the asset test is satisfied if the taxpayer's assets are limited to "ownership interests" in controlled subsidiaries, control is still determined by reference to voting control.

CORPORATE INCOME TAX CHANGES

Apportionment Changes

- *Definition of Apportionable Income*. "Apportionable income" was defined under prior law as all income apportionable under the United States Constitution.[13] This definition has been amended, effective for taxable years beginning on or after January 1, 2017, to clarify that apportionable income includes income arising from activities in the regular course of the taxpayer's trade or business and income from tangible and intangible property that is or was related to the operation of the taxpayer's business.[14] The new language was taken from the Multistate Tax Commission's most recent version of the Uniform Division of Income for Tax Purposes Act and is a somewhat broader articulation of the DOR's interpretation of "business income" set out in CD-01-1 (2001).

- *Apportionment of Railroad Company Income*. Railroad companies apportion their income using a fraction based on their "railroad operating revenue," which, under prior law, was determined from records kept in accordance with standard classification of accounts prescribed by the Interstate Commerce Commission.[15] This standard has been replaced with a requirement that records be kept in accordance with GAAP.[16] This change is effective for taxable years beginning on or after January 1, 2017.[17]

- *Apportionment of Telephone and Telegraph Company Income*. The special rules for apportioning the income of telephone and telegraph companies have been repealed, effective for taxable years beginning on or after January 1, 2017.[18] Henceforth any such companies will apportion their income using the generally applicable rules.

- *Apportionment of Pipeline Company Income*. Special rules for apportioning the income of a petroleum-based liquids pipeline company have been enacted, effective for taxable years beginning on or after January 1, 2017. Such a pipeline company must apportion its receipts from transportation using a fraction based on the company's "barrel miles" in North Carolina over "barrel miles" everywhere. A barrel mile is defined as one barrel of liquid transported one mile.[19] These changes codify existing practice.[20]

[12] S.L. 2017-204, §1.3.(d).
[13] *See* former G.S. §105-130.4(a)(1).
[14] S.L. 2017-204, §1.5.
[15] *See* former G.S. §105-130.4(m).
[16] S.L. 2017-204, §1.5.
[17] S.L. 2017-204, §1.5.(c).
[18] S.L. 2017-204, §1.5.(a); G.S. §105-130.4(n) and (q).
[19] S.L. 2017-204, §1.5; G.S. §105-130.4(s2).
[20] T. Griffin, *Explanation of Senate Bill 628* (June 22, 2017).

Interest Expense Limitation

Beginning in 2016, North Carolina limited the corporate income tax deduction for net interest paid to a related party to the greater of 15% of adjusted taxable income or the taxpayer's proportionate share of interest paid by the related party group to unrelated lenders.[21] The 15% of adjusted taxable income provision has been repealed.[22] As a result, the deduction for net interest paid to a related party may never exceed the payer's proportionate share of the group's interest expense to unrelated lenders. In addition, the new law provides that the DOR may not apply the IRC § 385 covered debt instrument rules promulgated by the Treasury Department in 2016 to determine whether an instrument is a debt instrument for purposes of the net interest deduction.[23] These rules are effective for taxable years beginning on or after January 1, 2017.[24]

GROSS PREMIUMS TAX CHANGES

Article 8B of Subchapter I of Chapter 105 levies a gross premiums tax on insurance companies. The rate of tax is 2.5% for workers compensation insurance premiums and 1.9% for other insurance premiums. An additional rate of 0.74% applies to premiums for property coverage contracts.[25] The new law provides that the additional rate on property coverage contracts "is a special purpose assessment based on gross premiums and not a gross premiums tax."[26] The purpose of this amendment is to prohibit property insurers from including the gross premiums tax paid as a result of the additional rate on property coverage contracts in the calculation of their total gross premiums tax for purposes of determining the ceiling on certain business and energy tax credits. This amendment was effective August 11, 2017.[27] A special provision protects insurers who included the additional rate on property coverage contracts in calculating business and energy tax credits for years before 2017.[28]

HISTORIC REHABILITATION CREDIT CHANGES

The credit for restoring non-income-producing historic structures permits a transferee of the structure to claim the credit if the transfer takes place before the structure is placed in service.[29] This provision has been amended, effective for taxable years on or after January 1, 2017, to provide that the transferee can claim the credit only if the transferor provides the transferee with documentation detailing the amount of rehabilitation expenses incurred and the amount of the credit.[30]

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[21] *See* former G.S. §105-130.7B.
[22] S.L. 2017-204, §1.6.
[23] *Id*.
[24] S. 628, §1.6.(c).
[25] G.S. §105-228.5(d).
[26] S.L. 2017-204, §1.11.(a); G.S. §105-228.5(d)(3).
[27] S.L. 2017-204, §7.2.
[28] S.L. 2017-204, §1.11.(b).
[29] G.S. §105-129.106(b).
[30] S.L. 2017-204, §1.4.

PROPERTY TAX CHANGES

Unregistered Motor Vehicles

Under North Carolina's "Tax and Tag Together" program, registered motor vehicles are taxed at the time registration is renewed based on the ownership, situs and value of the vehicle at that time.[31] Taxes on these vehicles are collected by the DMV as part of the registration renewal process. Unregistered vehicles are generally required to be listed as of January 1 following the expiration of registration and are taxed based on their ownership, situs and value on that date.[32] Taxes on these vehicles are collected by the counties. Specifically, the county assessor is required to send a tax notice to the owner of an unregistered vehicle by September 1 of the year in which the vehicle was listed.[33] If a previously unregistered vehicle is registered before the end of the year for which it was listed, the vehicle is taxed as a registered vehicle (i.e., at the time of registration) and any tax assessed for the fiscal year in which the vehicle was listed is released or refunded.[34] This leaves a gap in the taxation of the vehicle for the unregistered period. The tax for this period is determined by (i) calculating the tax due on the vehicle based on its value and the tax rate, (ii) dividing this tax amount by twelve and (iii) multiplying the result by the number of months in the unregistered period.[35] Under prior law, in performing the first step of this calculation, the vehicle value was the value as of January 1 of the year in which the registration expired.[36] This rule has been amended so that the value to be used is the value of the vehicle at the time the taxes for the gap period are computed.[37] Under prior law, the tax for the unregistered period was due on the first day of the second month following the issuance of the tax notice for the unregistered period.[38] The amendment provides that the taxes are due by September 1 following the notice date and that interest begins to accrue if taxes are not paid by January 6 following the due date.[39] These changes are effective for taxes imposed for taxable years beginning on or after July 1, 2017.[40]

Mobile/Modular Classrooms

A new property tax exemption has been enacted for mobile classrooms or modular units occupied by a school and used exclusively for educational purposes regardless of who owns the property. A "school" for this purpose includes a public school, a private nonprofit school, a charter school, a regional school and a community college.[41] This change is effective for taxes imposed for taxable years beginning on or after July 1, 2018.[42]

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[31] *See* G.S. §105-330.2.
[32] *See* G.S. §105-330.2(a1) and 105-330.3.
[33] *See* G.S. §105-330.5(c).
[34] G.S. §105-330.3(a1)(1).
[35] *See* G. S. §105-330.3(a1)(2).
[36] G.S. §105-330.3(a1)(2)a.
[37] S.L. 2017-204, §5.1.(a).
[38] G.S. §105-330.3(a1)(2)d.
[39] S.L. 2017-204, §5.1.(a).
[40] S.L. 2017-204, §5.1.(b).
[41] S.L. 2017-204, §5.4.(a); G.S. §105-275(49).
[42] S.L. 2017-204, §5.4.(b).

SALES TAX CHANGES

Repair, Maintenance and Installation ("RMI") Services

The following clarifying changes have been made to the taxation of RMI services, all effective retroactively to January 1, 2017.[43]

- *Diagnostic Services*. RMI services include diagnostic services to identify the source of a problem,[44] but inspection fees required by law are exempt from tax.[45] The new law clarifies that diagnostic services are taxable services even if they include activities that may lead to the issuance of an inspection report.[46]

- *Installation Services*. RMI services include services to install, connect, adjust or position personal property.[47] The new law gives examples of such services that might otherwise be considered to be nontaxable as real property contracts. These include the installation of carpet, flooring, floor coverings, windows, doors, cabinets, countertops that replace similar existing items, as well as floor refinishing, which would otherwise not seem to fall within the purview of an "installation."[48]

- *Multiple Similar Items*. The new law provides that the replacement of multiple items of a like kind – such as multiple windows – is a single taxable RMI service. [49]

Real Property Contracts

While RMI services are generally taxable, services performed by a "real property contractor" pursuant to a "real property contract" are nontaxable.[50] A real property contract is defined as a contract whereby a real property contractor agrees to perform "construction, reconstruction or remodeling with respect to a capital improvement to real property."[51] The following changes have been made to the rules governing the taxation of real property contractors.

- *Definitions in General*. The definitions of the key terms "construction," "reconstruction," "remodeling" and "capital improvement" have been moved out of the real property contract section (section 105-164.4H) into the general sales tax definition section (G.S. §105-164.3).[52] This change is effective retroactively to January 1, 2017.

[43] S.L. 2017-204,§2.13.
[44] G.S. §105-164.3(33*l*).
[45] G.S. §105-164.13(61a)a.
[46] S.L. 2017-204, §2.1.
[47] G.S. §105-164.3(33*l*)d.
[48] S.L. 2017-204, §2.1; G.S. §105-164.3(33*l*)d.
[49] S.L. 2017-204, §2.1; G.S. §105-164.3(33*l*)d.
[50] G.S. §§105-164.4(a)(16) and 105-164.3(33i).
[51] G.S. §105-164.3(33a).
[52] S.L. 2017-204, §§2.1 and 2.4.(a).

- *Definition of Capital Improvements.* The definition of "capital improvement" has been changed in the following ways, effective retroactively to January 1, 2017:[53]

    - *Removal Services*. Under prior law, a capital improvement was defined to include the removal of items from real property, such as debris, construction materials and asbestos as well as excavation activities. The new law repeals this provision from the definition of capital improvement. However, the sales tax law continues to include an exemption for the removal of waste, trash, debris and similar items from real or personal property.[54]

    - *Tenant Improvements*. Under prior law, a tenant improvement could qualify as a capital improvement only if title to the improvement vested in the owner immediately upon installation. This requirement has been repealed.

    - *Utility Installations*. Under prior law, utility installations qualified as a capital improvement. Under the new law, utility installations qualify only if installed on land, rights-of-way or easements owned by a utility.

    - *Fixture Installations*. Under prior law, installation of a fixture or equipment qualified as a capital improvement only if it was capitalized and depreciated. Under the new law, the installation of a fixture that is expensed under IRC §179 can also qualify.

    - *Painting and Wallpapering*. Under prior law, painting and wallpapering qualified as a capital improvement. Under the new law, painting and wallpapering can qualify only if they are not incidental to an RMI service.

    - *System Installations*. Under prior law, the replacement or installation of certain systems qualified as a capital improvement. These included septic tank, roofing, plumbing, electrical, commercial refrigeration, irrigation, and sprinkler systems. The new law adds siding systems to this list and clarifies that the repair, replacement or installation of electrical or plumbing components, water heaters, gutters and similar individual items that are not part of construction, reconstruction or remodeling do not qualify. In addition, under prior law, the replacement or installation of a ventilation system or unit qualified as a capital improvement. Under the new law, only the replacement or installation of ventilation systems are covered.

    - *Individual Items*. The new law provides that a capital improvement does not include the repair, replacement or installation of gas logs, water heaters, pool

[53] *Cf*. former G.S. §105-164.4H(e)(1) with new G.S. §105-164.3(2c). For the effective date, see S.L. 2017-204, §2.13.
[54] G.S. §105-164.13(61a)f.

heaters and similar individual items that are not part of new construction, reconstruction or remodeling.

- *Patios and Decks*. Under the new law, the replacement or installation of patios and decks are specifically listed as capital improvements.

- *Punch List Items*. Under prior law, the sales tax law included a specific exemption for the correction of punch list items under a real property contract within certain time limits.[55] The new law repeals this exemption[56] but adds such corrections to the definition of a capital improvement.

- *Landscaping Services*. Landscaping services are considered capital improvements to real property and so are not taxable. The definition of "landscaping" has been broadened to include any service that modifies living elements on land and narrowed to exclude services to plants in pots or indoors. In addition, the reference in the prior definition to the application of pesticides as an example of landscaping services has been deleted.[57]

- *Catch-all Provision*. The new law adds a new catch-all item to the definition of capital improvement that covers any addition or alteration to real property that is permanently affixed or installed and that is not specifically listed in the definition of RMI services.

- *Definition of Remodeling*. Under prior law, "remodeling" was defined as the process of improving or updating a permanent building, structure or fixture on land or major portions thereof and includes a renovation.[58] Under the new law, the term is defined as a transaction comprised of multiple services to restore, alter, or update real property that would otherwise be taxable as RMI services if sold separately.[59] The term includes a substantial change in in the internal structure or design of one or more rooms or areas within a room. It does not include a single RMI service. It also does not include an RMI service and another RMI service incidental to the first. This is apparently intended to prevent taxpayers from breaking up a single RMI service into separate components in order to create "multiple services" constituting a remodeling. Examples include repairing sheetrock and then applying paint to the repair. The new law also clarifies that a renovation means the same thing as a remodeling.[60] This change is effective retroactively to January 1, 2017.[61]

[55] G.S. §105-164.13(61a).
[56] S.L. 2017-204, §2.6.
[57] S.L. 2017-204, §2.1; G.S. §105-164.3(16e).
[58] *See* former G.S. §105-164.4H(e)(4).
[59] S.L. 2017-204, §2.1; G.S. §105-164.3(33i).
[60] S.L. 2017-204, §2.1; G.S. §105-164.3(33k).
[61] S.L. 2017-204, §2.13.

- *Definition and Treatment of Mixed Transaction Contracts*. A mixed transaction contract is a contract that includes a real property contract for a capital improvement and RMI services. These contracts are taxed entirely as real property contracts (so that the RMI services are not taxable) unless the sales price allocated to RMI services exceeds a stated threshold, in which case the RMI services are separately taxed.[62] The new law clarifies that a contract that includes a real property contract for a capital improvement and RMI services related to the capital improvement is not a mixed transaction contract.[63] Such a contract would merely be a real property contract and allocation of the sales price between the two elements would never be required. In addition, the new law raises the threshold from 10% to 25%, so that the entire contract is taxed as a real property contract unless the price allocated to the RMI services exceeds 25%.[64] This change is effective retroactively to January 1, 2017.[65]

- *Substantiation*. The new law includes a provision stating that since services to real property will generally be taxable RMI services unless they are part of a real property contract, such services will be treated as taxable unless someone substantiates that the services are rendered under a real property contract or a mixed transaction contract or that another exemption applies. An affidavit of capital improvement is the normal way of substantiating that a service is rendered under a real property contract or a mixed transaction contract, but other records may be used as well.[66] This change is effective retroactively to January 1, 2017.[67]

- *Joint Liability*. Where a retailer-contractor subcontracts all or a part of a real property contract to a subcontractor, the retailer-contractor, subcontractor, property owner and any lessee of the property are jointly and severally liable for the tax due from the subcontractor on its purchases in fulfillment of the contract.[68] This provision has been moved from the section dealing with real property contracts to the use tax liability section in order to put all the liability provisions in one place.[69] This change is effective retroactively to January 1, 2017.[70]

- *Manufactured and Modular Homes.* The sales tax applies to sales of modular homes. The new law clarifies that the tax applies even if the sale is part of a real property contract.[71] In addition, under prior law, manufactured homes and modular homes were included in the definition of real property (and so could be the subject of a real property contract) only if they were placed on a permanent foundation.[72] The new law clarifies that

[62] G.S. §105-164.4H(d).
[63] S.L. 2017-204, §2.1; G.S. §105-164.3(20b).
[64] S.L. 2017-204, §2.4.(b); G.S. §105-164.4H(d).
[65] S.L. 2017-204, §2.13.
[66] S.L. 2017-204, §2.4.(b); G.S. §105-164.4H(a1).
[67] S.L. 2017-204, §2.13.
[68] *See* former G.S. §105-164.4H(b1).
[69] S.L. 2017-204, §2.4.(a) and (c); G.S. §105-164.6(b).
[70] S.L. 2017-204, §2.13.
[71] S.L. 2017-204, §2.2; G.S. §105-164.4(a)(1a).
[72] *See* former G.S. §105-164.3(33d).

manufactured and modular homes qualify as real property as long as they are on land, deleting the requirement of a permanent foundation.[73] This change is effective retroactively to January 1, 2017.[74]

Freestanding Appliances

The new law provides that a "freestanding appliance" is always taxed as tangible personal property.[75] Thus, the sale of a freestanding appliance is taxable even if the sale is part of a real property contract. A freestanding appliance is defined as a machine operated by gas or electricity and the term includes dishwashers, washing machines, clothes dryers, refrigerators, freezers, microwaves and slide-in or drop-in ranges.[76] This change is effective retroactively to January 1, 2017.[77] Installation charges for installing a freestanding appliance as part of a real property contract, however, remain exempt.[78]

Service Contracts

The following changes to the taxation of service contracts are effective retroactively to January 1, 2017.[79]

- *Conditional Services*. The sale of a service contract to provide repair and maintenance services for tangible personal property is generally taxable.[80] While a service contract does not include a single RMI service,[81] the new provides that a service contract does include a contract where the obligor may provide an RMI service as a condition of the contract.[82]

- *Bundled Services*. Under prior law, the bundled transaction provisions included a special rule for bundled service contracts involving taxable and nontaxable services. Under this special rule, the purchase price was allocated between the taxable and nontaxable services.[83] This provision has been repealed[84] so that the general bundled transaction rules will apply to bundled service contracts. Under these general rules, an allocation is still required to be made, but if the amount allocable to the taxable services is not more than 10% of the total price the entire contract is nontaxable. [85] Similar rules have been enacted for "mixed service contracts."[86] A mixed service contract is a service contract

[73] S.L. 2017-204, §2.1.
[74] S.L. 2017-204, §2.13.
[75] S.L. 2017-204, §2.2; G.S. §105-164.4(a)(1).
[76] S.L. 2017-204, §2.1; G.S. §105-164.3(1d).
[77] S.L. 2017-204, §2.13.
[78] G.S. §105-164.13(60c).
[79] S.L. 2017-204, §2.13.
[80] G.S. §105-164.4I.
[81] G.S. §105-164.3(38b).
[82] S.L. 2017-204, §2.1; G.S. §105-164.3(38b).
[83] *See* former G.S. §105-164.4D(a)(6).
[84] S.L. 2017-204, §2.5.(a).
[85] *See* G.S. §105-164.4D(a)(2) and (3).
[86] S.L. 2017-204, §2.5.(b); G.S. §105-164.4I(ai).

involving real property that includes at least one taxable and one nontaxable service. This special rule was enacted because transactions involving real property or services to real property do not qualify as bundled transactions under the Streamlined Sales Tax Agreement.

- *Motor Vehicle Service Contracts*. A "motor vehicle service contract" is excluded from the definition of a service contract and so is not taxable.[87] The definition of "motor vehicle service contract" has been amended. Under prior law, the term included a service contract for a motor vehicle (or for components, systems or accessories of a motor vehicle) if the contract was sold (i) by motor vehicle dealer or (ii) by a motor vehicle service agreement company or (iii) by anyone on behalf of a motor vehicle service agreement company. Under the new definition, a contract sold on behalf of a motor vehicle service agreement company will not qualify unless it is sold by a dealer on behalf of the motor vehicle service agreement company.[88]

- *Service Contracts Involving Wastewater Systems*. An exception to the taxation of service contracts has been enacted for contracts to provide a certified operator for a wastewater system.[89]

- *Exemptions*. The list of exempt service contracts has been moved from the section dealing with service contracts (section 105-164.4I) to the general sales tax exemption section (section 105-164.13).[90]

Incentive and Nonprofit Refunds

- *Commercial Interstate Carriers*. Commercial interstate passenger and freight carriers are allowed a refund of sales taxes paid on the purchase of railway cars and locomotives, fuel, lubricants and accessories for a motor vehicle, railroad car, locomotive or airplane.[91] This refund provision has been expanded, retroactively to March 1, 2016, to cover service contracts and RMI services for a motor vehicle, railroad car, locomotive or airplane.[92]

- *Nonprofit Refund Cap*. The annual $31.7 million cap on nonprofit sales tax refunds has been clarified to state that the cap applies with respect to the state's fiscal year rather than the nonprofit's fiscal year.[93] This change was effective August 11, 2017.[94]

[87] G.S. §105-164.4I(b)(6).
[88] S.L. 2017-204, §2.1; G.S. §105-164.3(23a).
[89] S.L. 2017-204, §2.5.(b); G.S. §105-164.4I(c).
[90] S.L. 2017-204, §§2.5.(a) and 2.6; G.S. §§105-164.13(61), (61a)a, *l*, and m, and (65).
[91] G.S. §105-164.14(a).
[92] S.L. 2017-204, §2.7.
[93] S.L. 2017-204, §2.9.(b); G.S. §105-164.14(b).
[94] S.L. 2017-204, §2.13.

Sales Tax on Admissions

A new exemption to the sales tax on admission charges has been enacted, retroactive to January 1, 2014, for events sponsored by a farmer that take place on farmland. To qualify for the exemption, the farmer must hold a qualifying farmer sales tax exemption certificate (i.e., the farmer must derive a minimum amount of income from farming activities), and the farmland must be enrolled in the present use valuation program.[95] This exemption applies to activities such as corn mazes and pumpkin patch events, which are not considered to fall within the definition of a taxable entertainment event.[96]

Exemptions

The following sales tax exemptions have been expanded or clarified:

- *Medical Equipment and Supplies*. The exemption for medical equipment and supplies has been clarified to ensure the exemption covers human blood (including whole blood, plasma and derivatives), human tissue, eyes, DNA and organs.[97] This change was effective August 11, 2017.[98]

- *Aircraft*. RMI services and service contracts on qualified aircraft and qualified jet engines are exempt. A qualified aircraft is one with a maximum take-off weight of between 9,000 and 15,000 pounds.[99] This exemption has been expanded to cover RMI services and service contracts on any aircraft with a gross take-off weight of more than 2,000 pounds. This change is effective for sales made on or after July 1, 2019.[100]

Souring Rules

Section 105-164.4B sets forth rules for determining where a sale takes place. For instance, over the counter sales are sourced to the seller's business location, and the sale of goods that are shipped are sourced to the place of receipt. Of course, sales of services are more difficult to source than sales of goods. The new law clarifies that if none of the other sourcing rules apply, the sale of a service is sourced to the place where the buyer can potentially first make use of the service.[101] This change is effective retroactively January 1, 2017.[102]

Effective Date of Tax Rate Changes

Section 105-164.15A sets forth rules for determining the effective date of a tax change. Generally,

[95] S.L. 2017-204, §2.10; G.S. §105-164.4G(f).
[96] T. Griffin, *Explanation of Senate Bill 628* (June 22, 2017).
[97] S.L. 2017-204, §2.9.(a); G.S. §105-164.13(12).
[98] S.L. 2017-204, §2.13.
[99] G.S. §§105-164.13(61a) and 105-164.3(33a).
[100] S.L. 2017-204, §2.12.
[101] S.L. 2017-204, §2.3; G.S. §105-164.4B(a).
[102] S.L. 2017-204, §2.13.

for items billed on a periodic basis, a new tax or a tax rate increase applies to the first billing period that is at least 30 days after enactment of the change and that starts on or after the effective date of the change. For items not billed on a periodic basis, a tax change applies to amounts received for items provided on or after the effective date. However, amounts received for items provided under a lump sum or unit-price contract entered into or awarded before the effective date (or pursuant to a bid made before the effective date) are not subject to the change and are effectively grandfathered under the pre-change law.[103] The new law changes this grandfather provision. It no longer applies to lump-sum or unit-price contracts generally. Instead, the grandfather rule is limited to real property contracts for capital improvements.[104] This change is effective retroactively January 1, 2017.[105]

Collection of Tax on RMI Services for Boats and Aircraft

The owner of a boat, aircraft or qualified jet engine may obtain a direct pay permit entitling it to purchase property and RMI services for the boat, aircraft or engine without tax. The owner is subject to use tax on such purchases, but is entitled to a use tax exemption for amounts in excess of $25,000.[106] The new law provides that in lieu of obtaining a direct pay permit, the owner may elect to have the seller collect and remit the tax on its behalf.[107] This change was effective August 11, 2017.[108]

Sales Tax Base Expansion Relief Provisions

The following provisions have been enacted to mitigate the impact of the expansion of the sales tax base in recent years.

- *Prepaid Items*. A real property contractor is considered the consumer of tangible personal property used in fulfilling a real property contract. The real property contractor thus pays tax on tangible personal property used to fulfill the contract at the time of purchase and does not collect tax from the real property owner when the tangible personal property passes to the owner pursuant to the contract. A real property contactor may also perform taxable RMI services with respect to real property. In this case the contractor must collect tax on the RMI services and on any tangible personal property transferred to the customer as part of the service.[109] If the taxpayer performing RMI services uses property on which it has already paid tax, it must nevertheless collect tax on the item from the RMI customer and is not allowed any credit or refund for the tax already paid on the property.[110] The new law provides that if the Secretary determines that a taxpayer paid tax on a product used in a taxable RMI service with respect to real property, the DOR will allow the

[103] G.S. §105-164.15A(a).
[104] S.L. 2017-204, §2.4.(d). See also the similar change made by S.L. 2017-204, §2.4.(e) to G.S. §105-468.1.
[105] S.L. 2017-204, §2.13.
[106] G.S. §105-164.27A(a3).
[107] S.L. 2017-204, §2.11.
[108] S.L. 2017-204, 2.13.
[109] *See* G.S. §105-164.4(a)(16).
[110] *See* NCDOR, *Important Notice* (December 22, 2016).

taxpayer to offset the tax liability on the RMI services with the tax paid on the product. The taxpayer must be able to support the amount of tax originally paid. This provision is effective retroactively to January 1, 2017 and expires on July 1, 2018. This not only provides relief for taxpayers with tax-paid inventory on hand on January 1, 2017, but effectively provides taxpayers who purchase items for use in performing RMI services with respect to real property an option – until July 1, 2018 - to buy such items tax-free and collect tax on such items from their customers when the RMI services are performed or to pay tax on the purchase of such items and offset the tax to be collected from their customers by the amount of this tax. The Revenue Laws Study Committee is directed to study whether this option should be made permanent.[111]

- *Grace Period*. The new law prohibits the DOR from taking any action to assess any tax due for a filing period beginning on or after March 1, 2016 and ending before January 1, 2018 in various circumstances arising from taxpayer mistakes in complying with the recent expansion of the sales tax base. To be eligible for this relief, the taxpayer must not have received specific written advice on the compliance issue from the DOR. In addition, this grace period does not prevent the DOR from assessing use taxes on the purchasers of goods or services on which the seller erroneously failed to collect tax. Further, the grace period does not prevent the DOR from assessing taxpayers for sales taxes they collected but failed to remit, or, generally, for taxes on amounts included in the definition of "sales price" on which the taxpayer erroneously failed to collect tax.[112]

- *Abatement and Waiver of Tax and Penalty on Vacation Rental Linen Charges*. The sales tax applies to the gross receipts from the rental of an accommodation.[113] The DOR has taken the position that these gross receipts include charges for vacation rental linens. Where a linen rental company rents linens to a property management company, that rental is itself a taxable rental of tangible personal property.[114] When the property manager then charges the vacationer for the same linens as part of the accommodation rental, the same linens are subject to tax twice. The failure of some members of the vacation rental industry to collect tax on both transactions has led to a number of audits and assessment. The new law permits the Secretary to abate 90% of the amount of such an assessment and waive all associated penalties for periods ending before January 1, 2018. To be eligible for the abatement and waiver the taxpayer must (i) have remitted all collected taxes, (ii) not have been informed of the issue in a prior audit, (iii) not have requested a private letter ruling on the issue from the DOR, and (iv) request an abatement within 45 days of a proposed assessment along with its written request for departmental review of the proposed assessment.[115]

[111] S.L. 2017-204, §2.8.(a) and (b).
[112] S.L. 2017-204, §2.8.(c).
[113] G.S. §105-164.4F.
[114] G.S. §105-164.4(a)(1).
[115] S.L. 2017-204, §2.8A.

COMPLIANCE AND ADMINISTRATIVE CHANGES

Annual Report

Under current law, corporations are required to file an annual report. The report may be filed with the Secretary of State by the 15th day of the fourth month following the end of the corporation's fiscal year. Alternatively, the report may be filed with the Secretary of Revenue by the due date of the corporation's return taking into account any extensions.[116] Most corporations file their annual reports with the Secretary of Revenue along with their tax returns.[117] These procedures have been amended to eliminate the Secretary of Revenue filing option. Henceforth, all annual reports must be filed with the Secretary of State by the 15th day of the fourth month following the end of the corporation's fiscal year. The report may be filed in paper or electronic form.[118] This change was effective August 11, 2017.[119]

Filing Extensions

The DOR has been directed to study the feasibility of allowing a federal extension of time to file an income tax return to serve as an application for a corresponding state extension. The DOR is required to submit its findings to the Revenue Laws Study Committee by January 1, 2018.[120]

Identity Theft

Under a new law, a person who knowingly obtains, possesses or uses certain identifying information of another person, living or dead, with the intent to use that information in a fraudulent submission to the DOR is guilty of a class G felony (or a class F felony if the person whose identifying information is used suffers any financial harm). This change applies to offenses committed on or after December 1, 2017.[121]

Credit Card Information

Under the IRC, a financial institution must file an annual return identifying the payees of credit card transactions it processed and the gross amount of credit card payments made to each such payee.[122] The new law requires any financial institution making such a federal return to file a similar return with the DOR. The return must be submitted electronically if requested by the Secretary.[123] This change was effective August 11, 2017.[124]

[116] G.S. §55-16-22.
[117] T. Griffin, *Explanation of Senate Bill 628* (June 22, 2017).
[118] S.L. 2017-204, §1.13.
[119] S.L. 2017-204, §7.2.
[120] S.L. 2017-204, §1.14.
[121] S.L. 2017-204, §3.1; G.S. §105-236(a)(9b).
[122] *See* IRC §6050W.
[123] S.L. 2017-204, §3.2.
[124] S.L. 2017-204, §7.2.

Review of Proposed Assessments and Refund Denials

The following changes have been made to the procedures governing proposed assessments and refund denials, all effective August 11, 2017.[125] In addition to these changes, see the discussion below regarding taxpayer inaction during the department review period.

- *Proposed Refund Denials Based on the Statute of Limitation*. When the DOR proposes to deny a refund request, it must issue a notice to the taxpayer stating the basis for the proposed denial.[126] The law has been amended to require the DOR to follow the same procedure when it denies a refund request as outside the statute of limitations.[127]

- *Form of Request for Departmental Review*. A taxpayer who objects to a proposed assessment or proposed denial of a refund request may request departmental review of the proposed denial by filing a request for review. The new law requires this request to be on a form prescribed by the Secretary and to include an explanation of the request for review.[128] The taxpayer is free, however, to raise other objections during the administrative process.[129] However, a failure to include any explanation in the request could be fatal if the failure is not corrected before the running of the period for filing the request.[130]

- *Request for Review of Failure to Pay Penalties*. A request for review of a proposed assessment is also considered a request for review of a failure to pay penalty based on the assessment, and a taxpayer who does not request review of a proposed assessment may not request review of a failure to pay penalty based on the assessment.[131] The DOR typically assesses the failure to pay penalty by a notice issued after the notice of proposed assessment of the underlying tax. The new law clarifies that failure to request review of the proposed assessment of the underlying tax prevents a taxpayer from requesting review of the penalty even though the penalty is assessed by such a separate notice.[132]

Taxpayer Inaction during Departmental Review Period

Under prior law there was a simple procedure for obtaining departmental review of a proposed assessment or proposed denial of a refund request. A taxpayer seeking departmental review would file a request for review, and the DOR was required to grant the request, schedule a conference or request additional information. If the DOR and the taxpayer could not reach agreement, the DOR was required to send a notice of final determination. Absent mutual agreement, the period between the filing of the request for review and the issuance of the final

[125] S.L. 2017-204, §7.2.

[126] G.S. §105-241.7d.
[127] S.L. 2017-204, §4.1.(a).
[128] S.L. 2017-204, §4.1.(b); G.S. §105-241.11(a).
[129] S.L. 2017-204, §4.1.(d); G.S. §105-241.13(b).
[130] *See* G.S. §105-241.12
[131] G.S. §105-241.11(c).
[132] S.L. 2017-204, §4.1.(b).

determination could not exceed nine months. If the DOR scheduled a conference and the taxpayer failed to appear, the proposed assessment or refund denial would become final.[133] The new law complicates this procedure in an apparent attempt to help the DOR clear its docket of inactive cases.

- *Taxpayer Failure to Respond to Request for Additional Information*. If (1) the DOR requests additional information and the taxpayer does not respond within the response period (which must be at least 30 days) and (2) the DOR resends the request and the taxpayer again fails to respond within the response period (which again must be at least 30 days), the DOR may send the taxpayer a "notice of inaction." The proposed assessment or refund request denial becomes final ten days after the issuance of this notice if the taxpayer does not respond to the notice, and the matter may proceed to collection.[134]

- *Adjustment of Tax Due or Refund Claimed*. In addition to granting a taxpayer's request for review or requesting additional information, the DOR is given the alternative of adjusting the amount of tax due or refund owed. A conference would be scheduled only if these actions do not resolve the matter. [135]

- *Payment of Proposed Assessment*. Third, if a taxpayer requests a review of a proposed assessment but then pays the amount due (or the adjusted amount due if the DOR makes an adjustment) the DOR is not required to take any further action unless the taxpayer requests in writing a continuation of departmental review.[136]

These changes were effective August 11, 2017 and apply to requests for review filed on or after that date. The changes also apply to requests pending on August 11, 2017 if the DOR reissues a request for additional information, allows the taxpayer time to respond by the requested response date and provides notice to the taxpayer that failure to respond will be treated as inaction.[137]

Appeal of Contested Case Proceedings

A taxpayer may appeal a final decision in a contested case proceeding to the Business Court. The law has been amended to permit the DOR, as well as the taxpayer, to appeal a contested case decision to the Business Court.[138] This amendment is retroactive to 2012 and applies to contested cases commenced on or after that date.[139]

[133] *See* former G.S. §§105-241.11, 105-241.13 and 105-241.14.
[134] S.L. 2017-204, §§4.1.(c) and (d) and 4.2; G.S. §§105-241.13(a), 105-241.13A(a) and 105-241.22(2).
[135] S.L. 2017-204, §4.1.(d); G.S. §105-241.13(a)(2) and (b).
[136] S.L. 2017-204, §4.1.(d); G.S. §105-241.13 (a1).
[137] S.L. 2017-204, §4.9.
[138] S.L. 2017-204, §4.1.(e); G.S. §105-241.16.
[139] S.L. 2017-204, §4.9.

Voidable Transactions

Under North Carolina's fraudulent conveyance statute (the North Carolina Uniform Voidable Transfers Act), a transfer that renders the transferor insolvent may be set aside if the transferor does not receive adequate value in exchange. The law has been amended to clarify that tax payments, and other payments made to the state or its political subdivisions are not voidable transfers.[140] This change is believed to be a response to attempts by certain creditors to clawback debtors' tax payments into the debtors' estates so as to make them available to satisfy the creditors' claims. This change was effective August 11, 2017.

[140] S.L. 2017-204, §3.3; G.S. §§39-23.1(14) and 39.23.8(e)(3).