

Revised SALT Alert! 2015-26: North Carolina Tax Reform Enacted

On September 18, 2015, North Carolina Governor McCrory signed the long-delayed budget bill (House Bill 97), which includes significant tax reform affecting business taxpayers. Certain corporate and franchise tax changes included in House Bill 97 were to be repealed if **House Bill 117 (the North Carolina Competes Act) and House Bill 943 (the Connect North Carolina Bond Act of 2015) were not ratified before January 1, 2016**. As of September 30, 2015, the North Carolina General Assembly's website indicates both of these bills have been ratified.¹

Contingent Corporate Income Tax Rate Reduction

In 2013, legislation was enacted that reduced North Carolina's then-current 6.9 percent corporate income tax rate to 6.0 percent for tax years beginning on or after January 1, 2014 and to 5.0 percent for tax years beginning on or after January 1, 2015. Further one percent reductions were to be implemented if tax revenues collected in the 2014-2015 and 2015-2016 fiscal years exceeded specified revenue threshold amounts. Most recently, the Department of Revenue announced that based on collections in the fiscal year ending June 30, 2015, the rate will be reduced to 4.0 percent for tax years beginning on or after January 1, 2016.

House Bill 97 calls for a further rate reduction to 3.0 percent for any tax year that begins on or after January 1 of any calendar year when the amount of net General Fund taxes collected in the preceding fiscal year ending June 30 exceeds \$20,975,000,000.

Phased-In Single Sales Factor Apportionment

Currently, most North Carolina corporate taxpayers apportion their income to the state using a three-factor, double-weighted sales formula. House Bill 97 phases in single-sales factor apportionment over three years. For tax years beginning on or after January 1, 2016, the sales factor is weighted three times (i.e., 60 percent weighting). For tax years beginning on or after January 1, 2017, the sales factor is weighted four times (two-thirds weighting). Single sales factor apportionment is fully effective for tax years beginning on or after January 1, 2018.

Special apportionment provisions for entities such as railroad companies, telephone companies, motor carriers, telegraph companies, and air or water transportation companies remain in place.

Market-Based Sourcing Study and Required Informational Reporting for Certain Taxpayers

A number of states that have moved to single-sales factor apportionment have also adopted market-based sourcing rules for service and intangible related receipts. House Bill 97 requires the North Carolina Revenue Laws Study Committee to study the potential adoption of market-based sourcing. To aid with this effort, each corporate taxpayer with apportionable income greater than \$10 million and a North Carolina apportionment

percentage less than 100 percent is required to file an informational report with the North Carolina Department of Revenue.

The information report is due on the original due date for the corporate taxpayer's 2015 tax year return (i.e., the fifteenth day of the fourth month following the close of the tax year). No extension of time to file the information report is provided within the statute, even if the taxpayer otherwise extends its corporate income and franchise tax return. The Secretary of Revenue may impose a \$5,000 penalty for failure to timely file the informational report.

The informational report must show the calculation of the taxpayer's 2014 sales factor using certain market-based sourcing provisions outlined in the bill. Specifically, for purposes of the informational report, the following rules apply:

- Receipts from the sale, rental, lease, or license of real property will be attributed to North Carolina if and to the extent the real property is located in the state;
- Receipts from the rental, lease, or license of tangible personal property will be attributed to North Carolina if and to the extent the tangible personal property is located in the state;
- Receipts from sales of services will be attributed to North Carolina if and to the extent the service is delivered to a location in the state;
- Receipts from intangible property that is rented, leased, or licensed will be attributed to North Carolina if and to the extent the property is used in the state. Intangible property utilized in marketing a good or service to a consumer is used in North Carolina if that good or service is purchased by a consumer in the state;
- Receipts from the sale of intangible property will be attributed to North Carolina if and to the extent the property is used in North Carolina. A contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is "used in North Carolina" if the geographic area includes all or part of North Carolina;
- Receipts from intangible property sales that are contingent on the productivity, use, or disposition of the intangible property shall be treated as receipts from the rental, lease, or licensing of the intangible property as provided above.

All other receipts from the sale of intangible property not specifically addressed will be excluded from numerator and denominator of the sales factor entirely for purposes of the information report. To assist in determining North Carolina apportionment, taxpayers are directed to use the Multistate Tax Commission's model market-sourcing regulations. The Department of Revenue may publish additional market-based sourcing guidelines consistent with the Multistate Tax Commission's regulations.

Related Member Interest Disallowance

Under current law, a taxpayer is required to add back royalty payments made to a related member and deducted as an expense if the recipient excludes the royalty income from its North Carolina income tax base. Effective for tax years beginning on or after January 1, 2016, House Bill 97 provides for an additional addback to federal taxable income in the amount of "net interest expense" paid to a related member. "Net interest expense" is defined as the excess of interest paid or accrued by the taxpayer to a related member during the taxable year over the amount of interest from a related member includible in the gross income of the taxpayer for the taxable year.

A deduction will be allowed for "qualified interest" paid or accrued to a related member. "Qualified interest" is the net interest expense paid or accrued to a related member subject to a limitation of 30 percent of the taxpayer's "adjusted taxable income." "Adjusted taxable income" is the state net income of the taxpayer determined without regard to the interest expense deduction or other adjustments the Secretary may require.

The 30 percent limitation does not apply if one of the following exists:

- North Carolina corporate income tax is imposed on the related member with respect to the interest;
- The related member pays a net income tax or gross receipts tax to another state with respect to the interest expense;
- The related member is organized under the laws of a foreign country that has a comprehensive income tax treaty with the U.S., and that country taxes the interest income at a rate equal to or greater than North Carolina; or,
- The related member is a bank.

A “bank” includes one or more of the following, or a subsidiary or affiliate of one or more of the following:

- Bank holding company as defined in the federal Bank Holding Company Act of 1956, as amended;
- One or more of the following entities incorporated or chartered under the laws of North Carolina another state, or the United States:
 - A bank as defined in N.C. Gen. Stat. §53C-1-4;
 - A savings bank as defined in N.C. Gen. Stat. §54C-4;
 - A savings and loan association as defined in N.C. Gen. Stat. §54B-4;
 - A trust company as defined in N.C. Gen. Stat. §53C-1-4.

Nothing in the revised law limits the Secretary’s authority to adjust a taxpayer’s net income as it relates to payments or charges by a parent, subsidiary, or affiliated corporation that are in excess of fair compensation in an intercompany transaction under N.C. Gen. Stat. §105-130.5(a)(9). In addition, the Secretary continues to have general authority to adjust under N.C. Gen. Stat. §105-130.5A.

In sum, to compute the net interest disallowance, a taxpayer will: (1) add back all interest expense paid or accrued to a related member to the extent it exceeds the interest that is received from a related member that is included in gross income; and (2) deduct “qualified interest” which is all interest paid or accrued to a related member, but not to exceed 30 percent of adjusted taxable income of the taxpayer UNLESS the qualified interest meets one of the four exceptions in which case that interest expense is not subject to the 30 percent limitation.

Changes to Adjustments to Federal Taxable Income

Effective for tax years beginning on or after January 1, 2016, House Bill 97 repeals a number of adjustments to federal taxable income. Notably, N.C. Gen. Stat. §105-130.6A, which requires adjustments for expenses related to dividends is repealed entirely. In its place, N.C. Gen. Stat. §105-130.5(c)(3) is revised to provide that, for dividends received that are not subject to North Carolina income tax, the adjustment for expenses may not exceed an amount equal to 15 percent of the dividends.

Other repealed deductions include:

- N.C. Gen. Stat. §105-130.5(b)(6), which allows a deduction for amortization in excess of depreciation allowed under the IRC on the cost of any sewage or waste treatment plant, and facilities or equipment used for the purposes of recycling or resource recovery of or from solid waste, or for the purposes of reducing the volume of hazardous waste generated;
- N.C. Gen. Stat. §105-130.5(b)(7), which allows a deduction for depreciation of emergency facilities acquired prior to January 1, 1955;

- N.C. Gen. Stat. §105-130.5(b)(12), which allows a deduction for reasonable expenses, in excess of deductions allowed under the IRC, paid for reforestation and cultivation of grown trees, etc.;
- N.C. Gen. Stat. §105-130.5(b)(13), which allows a deduction for the eligible income of an international banking facility to the extent included in determining federal taxable income;
- N.C. Gen. Stat. §105-130.5(b)(15), which allows a deduction for the amount paid as marketing assessments on tobacco grown by the corporation in North Carolina;
- N.C. Gen. Stat. §105-130.5(b)(18), which allows a deduction for interest, investment earnings, and gains of a trust, the settlors of which are two or more manufacturers that signed a settlement agreement with North Carolina to settle existing and potential claims;
- N.C. Gen. Stat. §105-130.5(b)(19), which allows a deduction for the amount paid to the taxpayer from the Hurricane Floyd Reserve Fund;
- N.C. Gen. Stat. §105-130.5(b)(22), which allows a deduction for the amount paid to the taxpayer from the Disaster Relief Reserve Fund; and,
- N.C. Gen. Stat. §105-130.5(c)(5), which allows a deduction by savings and loan associations of interest earned on deposits at the Federal Home Loan Bank of Atlanta, or its successor.

Franchise Tax Base Changes

Effective for taxes due on or after January 1, 2017, House Bill 97 makes a number of changes to North Carolina's franchise tax. Currently, for general corporate franchise tax purposes, a taxpayer's franchise base is the greatest of the following: (1) the amount of issued and outstanding capital stock, surplus and undivided profits apportioned to North Carolina; (2) 55 percent of the appraised value of all real and tangible personal property within North Carolina; and (3) total actual investment in tangible property within North Carolina.

Under House Bill 97, the franchise tax is imposed on a corporation's net worth, rather than the amount of issued and outstanding capital stock, surplus and undivided profits, apportioned to North Carolina. "Net worth" is defined as a corporation's "total assets" without regard to the deduction for accumulated depreciation, depletion, or amortization less the corporation's total liabilities, computed in accordance with GAAP as of the end of the corporation's taxable year. "Total assets" equals the sum of all cash, investments, furniture, fixtures, equipment, receivables, intangibles, and any other items of value owned by a person or a business entity. If the corporation does not maintain its books and records in accordance with GAAP, then its net worth is computed in accordance with the accounting method used for federal tax purposes as long as the method fairly reflects the corporation's net worth for franchise tax purposes.

Once a corporation's "net worth" is determined, certain adjustments are made. First, a deduction is allowed for accumulated depreciation, depletion, and amortization determined in accordance with the method used for federal income tax purposes.

Second, similar to the current law, an addition is required for indebtedness owed to a parent, a subsidiary, or an affiliate corporation (including limited liability companies taxed as corporations). House Bill 97 also requires an addition for indebtedness owed to a noncorporate entity in which the corporation or an affiliated group of corporations owns directly or indirectly more than 50 percent of the capital interests of the noncorporate entity. The amount required to be added back to the corporation's net worth may be further adjusted if part of the capital of the creditor is capital borrowed from a source other than a parent, a subsidiary, or an affiliate. The debtor corporation may deduct a proportionate part of the indebtedness based on the ratio of the borrowed capital of the creditor to the total assets of the creditor. For purposes of this adjustment, borrowed capital does not include

indebtedness incurred by a bank arising out of the receipt of a deposit and evidenced by a certificate of deposit, a passbook, a cashier's check, a certified check, or other similar document. If the creditor corporation is subject to North Carolina franchise tax, the creditor corporation may deduct the amount of indebtedness owed to it by a parent, subsidiary, or affiliated corporation to the extent that such indebtedness has been included in the debtor corporation's tax base.

Third, a corporation may deduct the cost of treasury stock.

Once the net worth base is determined, it is apportioned to North Carolina using the apportionment fraction it applies in apportioning its income under the general corporation income tax. If an entity is subject to franchise tax, but not corporation income tax, net worth is to be apportioned according to the fraction that it would be required to apply if it were subject to the income tax.

House Bill 97 did not change the current franchise tax rate; franchise tax will be imposed at a rate of \$1.50 per \$1,000 of net worth. However, House Bill 97 increases the minimum franchise tax from \$35 dollars to \$200. Furthermore, the net worth franchise tax base cannot be less than 55 percent of the appraised value of all real and tangible personal property within North Carolina, or total actual investment in tangible property within North Carolina. The definition of "total actual investment in tangible property" has been revised to exclude a deduction for indebtedness incurred and existing by virtue of the purchase of any real estate and any permanent improvements made thereon and a deduction for reserves for the entire cost of certain air and water pollution control facilities.

For purposes of the special franchise tax imposed on holding companies under N.C. Gen. Stat. §105-120.2, the minimum tax is likewise increased to \$200 and the current \$75,000 holding company franchise tax cap is increased to \$150,000.

Repeal of the Bank Privilege Tax (N.C. Gen. Stat. §105-102.3)

Effective July 1, 2016, the bank privilege tax is repealed.

Sales Tax Base Expansion and Other Changes

Effective for sales occurring on or after March 1, 2016, retailers are subject to privilege tax (sales and use tax) on the sales price of or gross receipts derived from repair, maintenance, and installation services. A retailer does not include a person if: (1) the person solely operates as a real property contractor, or (2) the person's only business activity is providing repair, maintenance, and installation services where the person's activities do not otherwise meet the definition of a retail trade. "Retail trade" is a trade in which the majority of revenue is from retailing tangible personal property, digital property, or services to consumers. The term includes activities of a person properly classified in NAICS sector 44-45, buying goods for resale, and rendering services incidental to the sale of merchandise. The term typically includes maintaining an inventory and may include the provision of repair, maintenance, and installation services. Not all activities provided in this subdivision are required for a trade to be considered retail trade.

Interestingly, House Bill 97 excludes from the definition of a retailer a person whose only business activity is providing repair, maintenance, and installation services where the person's activities do not otherwise meet the definition of a retail trade. The definition of retail trade is broad, but generally captures persons that, in addition to providing services, sell tangible personal property or maintain inventory. Collectively, these provisions could be interpreted as requiring only those persons also engaged in selling tangible personal property (in addition to providing services) as being subject to the tax on repair, maintenance and installation services.

“Repair, maintenance, and installation services” include the following activities:

- Keeping or attempting to keep tangible personal property or a motor vehicle in working order to avoid breakdown and prevent repairs;
- Calibrating, restoring, or attempting to calibrate or restore tangible personal property or a motor vehicle to proper working order or good condition including replacing or putting together what is torn or broken;
- Troubleshooting, identifying, or attempting to identify the source of a problem for the purpose of determining what is needed to restore tangible personal property or a motor vehicle to proper working order or good condition; and,
- Installing or applying tangible personal property except tangible personal property installed or applied by a real property contractor pursuant to a real property contract.

However, sales or use tax does not apply to repair, maintenance and installation services (1) provided for an item that is covered under a tax exempt service contract, (2) purchased for resale, or (3) used to maintain or repair tangible personal property or a motor vehicle pursuant to a service contract that is subject to sales tax if the purchaser of the contract is not charged for the item.²

Historic Preservation Tax Credit

The tax credit for preserving historic structures expired for expenses that occurred after January 1, 2015. House Bill 97 creates a similar credit under N.C. Gen. Stat. §105-129.100 effective January 1, 2016, which applies to qualified rehabilitation expenditures or expenses incurred on or after that date. The new credit will be allowed to taxpayers that are entitled to a federal income tax credit under IRC §47 (Rehabilitation Credit). The credit is equal to the base amount, any development tier bonus and targeted investment bonus that may apply. The “base amount” is the percentage of qualified rehabilitation expenditures at the following levels:

- For expenses up to \$10 million, the rate is 15 percent;
- For expenses over \$10 million and up to \$20 million, the rate is 10 percent.

“development tier bonus” is an amount equal to 5 percent of qualified rehabilitation expenditures not exceeding \$20 million if the certified historic structure is located in a development tier one or two area. The “targeted investment bonus” is an amount equal to 5 percent of qualified rehabilitation expenditures not exceeding \$20 million if the certified historic structure is located on an eligible targeted investment site. The amount of credit with respect to qualified rehabilitation expenditures for an income-producing certified historic structure may not exceed \$4.5 million.

Next Steps

Because House Bills 117 and 943 are now ratified, as required, the corporate income and franchise taxes changes included in House Bill 97 will become effective as contemplated. Taxpayers should consider the effect of these changes as well as obtaining the information necessary to file the market-based sourcing report required next year.

Contacts

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Footnotes

¹ After a North Carolina bill passes both houses, it is enrolled. A clean copy, including all amendments, is prepared, with space for the signatures of the two presiding officers, and the governor, if necessary. The enrolled copy is taken

to each presiding officer during the daily session. Each officer signs the enrolled copy. When the second signature is affixed, the bill is said to have been ratified. After that, the bill is presented to the Governor for signature.

² There appears to be an issue with the drafting of the legislation with respect to this provision. It appears, however, the intent is that repair, maintenance and installation services provided pursuant to a service contract that is subject to tax would not be taxable if there is no charge for the service.

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