North Carolina Appropriations Act of 2017—Important Tax Changes

John Iannotti, Partner | State & Local Tax

The North Carolina General Assembly has announced an agreement on its much discussed and greatly anticipated fiscal 2018 budget, including significant changes to its tax statutes. The compromise budget has passed the Senate and House and has been sent to Governor Roy Cooper. The governor has 10 days to sign or veto the bill. In the event the governor vetoes the budget bill, the legislature has sufficient votes in both the House and Senate to override the veto.

The budget package continues North Carolina's tax policy trend of reducing personal and corporate income tax rates and eliminating sales taxes on some business inputs. The major changes to income taxes are delayed until 2019. There are several important modifications to the sales tax effective on July 1, 2018. A cap on the franchise tax for some Subchapter S corporations will apply to the filing of the 2018 corporate tax return. While viewed by some as not as sweeping as those enacted in prior years, these changes are nonetheless substantially beneficial to middle and lower income taxpayers and will eliminate some taxes on business inputs. The reaction of the governor cannot be predicted at this time, although the budget does contain raises for teachers and state employees that were actively sought by the governor.

Individual Income Tax

A major tax reduction would take effect for individuals effective in 2019 where the tax rate would be reduced from 5.499% to 5.25% and the standard deduction would increase to $20,000 (joint filers), $15,000 (head of household), and $10,000 (single and married filing separate) respectively. The child care credit would be replaced with a tiered child deduction, effective in 2018, that would impact qualifying tax returns slightly more than the existing tax credit.

Corporate Income Tax

Effective for tax years beginning on or after January 1, 2019, the corporate income tax rate would be reduced from 3% to 2.5%.

A provision was previously enacted (HB1030 (S.L. 2016-94)) calling for North Carolina to source gross receipts from services on a "market" basis for apportionment purposes pending the General Assembly's enactment of regulations drafted by the Department of Revenue and approved by the Rules Review Commission in February 2017. The ratification of these regulations was removed from this budget package; thus, North Carolina will continue to source service receipts on a pro-rata cost of performance on the basis of where the income producing activity occurs.

Corporate Franchise Tax

S corporations would be entitled to a reduction of their franchise tax with a flat $200 rate on the first $1 million of their calculated tax base effective with the filing of their 2018 corporate tax return. At the current tax rate of $1.50 per thousand of tax base, their savings could be as much as $1,300 per year.

No other changes to the franchise tax were included in this budget bill. Prior Senate and House bill drafts that had proposed for the repeal of the alternate two prongs of the franchise tax (55% of appraised value and actual investment in North Carolina tangible property) and for reductions in the franchise tax rate from the current $1.50 per thousand were not included.

Sales & Use Tax

The most immediate impact of the changes will result from addition of certain fulfillment centers to the list of entities that qualify for an exemption from sales tax on purchases of equipment, accessories, and repair parts, effective July 1, 2017. To qualify for the exemption, a taxpayer must invest a minimum of $100 million in real and tangible personal property over a 5 year period and attain an employment level of 400 within 5 years after being placed in service.

Beginning July 1, 2018, the long awaited repeal of the Article 5F privilege tax on machinery and equipment becomes effective. Commensurate with the repeal of Article 5F, the same industries that met its qualifications will receive a full exemption from the state sales tax. The repeal of the confusing 1% tax on certain equipment was supported by the NC Department of Revenue because of administration difficulties. Manufacturers, major recyclers, research and development companies, software publishers, machinery refurbishers, metal processors, precious metal extractors and sheet metal fabricators, all of whom previously qualified for the Article 5F tax and were therefore exempt from the sales tax on equipment purchases, will all be completely exempt from any tax on qualifying purchases. Equipment mounted on ready mix concrete trucks and certain fulfillment centers have also been added to the list of equipment that will qualify for the full sales tax exemption.

In an attempt to provide clarity and better guidance regarding the treatment of manufacturing and processing equipment, the Revenue Laws Study Committee is directed to study ways in which to clarify the scope of the manufacturing exemption, to modernize the language, and incorporate the Department of Revenue's previous administrative guidance, to the extent the General Assembly wishes to maintain those interpretations.

Taxpayers are also advised to closely watch the progress of Senate Bill 628, passed by the Senate and slated for consideration by the House. This bill contains many important clarifications of the sales tax changes involving repairs, maintenance, and installation services that were enacted in 2015 and 2016.

John Iannotti
Partner, State & Local Tax
tax@dhg.com