

AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SALT



SUBJECT

NORTH CAROLINA ISSUES CORPORATION INCOME TAX PROPOSED MARKET-BASED SOURCING RULES AND MAKES CHANGES TO THE SALES/USE TAX THAT IMPACT REPAIR, MAINTENANCE, AND INSTALLATION SERVICES

SUMMARY

Recently, North Carolina Governor Pat McCrory (R) signed S.B. 726, 2015-2016 Sess. (N.C. 2016), S.B. 729, 2015-2016 Sess. (N.C. 2016), and H.B. 1030, 2015-2016 Sess. (N.C. 2016) into law. Together, these rules (i) propose market-based sourcing rules for Corporation Income Tax purposes and require the Department of Revenue to issue related proposed regulations; (ii) create sales and use tax exemptions related to certain repair, maintenance, and installation (“RMI”) services; (iii) make various changes to the Individual Income Tax; and (iv) update the state’s Internal Revenue Code (“IRC”) conformity date.

DETAILS

Corporation Income and Franchise Tax

Market-Based Sourcing – H.B. 1030 requires the Department to prepare proposed regulations related to the proposed market-based sourcing rules for services, intangibles, and banks found in H.B. 1030. Under the proposed non-bank market-based sourcing rules, sales from services are sourced to the state of delivery, sales from intangibles are sourced to the state of use, and reasonable approximation is allowed where the market for a receipt cannot otherwise be determined under the rules. Under the proposed bank market-based sourcing rules, each receipt type (e.g., sales, interest, fees, penalties, etc.) is sourced according to specific rules.

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The Department must submit the proposed regulations to the Rules Review Commission on or before January 20, 2017, and accept comments on them for at least 90 days after publication. The Commission must then deliver the regulations approved by the Department to the Codifier of Rules, who must then enter them into the Administrative Code when the General Assembly enacts the proposed statutory rules and directs the Codifier to do so. At that time, the regulations will become effective.

Exclusions from Sales Factor - Under S.B. 729, effective for taxable years beginning on or after January 1, 2016, North Carolina excludes the following items from the calculation of the sales factor for apportionment purposes:

- ▶ Gross receipts attributable to the notional principal amount of a swap contract or similar financial derivative that generates the cash flow traded in the swap agreement;
- ▶ Dividends treated as foreign source under IRC § 862 (net of related expenses);
- ▶ Subpart F inclusions under IRC § 951;
- ▶ Foreign indirect tax credit gross-up amounts under IRC § 78; and
- ▶ Dividends excluded for federal income tax purposes.

Qualified Air Freight Forwarder Apportionment - Also effective for taxable years beginning on or after January 1, 2016, S.B. 729 requires a corporation engaged in a freight forwarding business that is primarily carried on with an affiliated air carrier to apportion its income using the revenue ton mile fraction of its affiliated air carrier.

New Franchise Tax Base Effective Date - S.B. 729 clarifies that the new Franchise Tax base enacted in 2015 is effective for taxable years beginning on or after January 1, 2017, and applies to Franchise Tax reported and paid with 2016 and later Corporation Income Tax returns. See the [BDO SALT alert](#) that discusses the new Franchise Tax base.

Sales and Use Tax

RMI Services - Effective January 1, 2017, H.B. 1030 amends the definition of RMI services to clarify that those taxable services include certain refinishing, cleaning, inspection, and monitoring services. However, H.B. 1030 specifically exempts the following RMI services from sales and use tax:

- ▶ Legally required inspection services;
- ▶ Services provided by a related member;
- ▶ Certain services performed to resolve an issue that was part of a real property contract;
- ▶ Real property cleaning services;
- ▶ Services on roads, driveways, parking lots, and sidewalks;
- ▶ Snow and waste removal services, excluding portable toilet waste removal services;
- ▶ Home inspection services to prepare real property for sale;
- ▶ Landscaping services;
- ▶ Clothing alteration and repair services, excluding the alteration and repair of belts and shoes;
- ▶ Pest control services;
- ▶ Moving services; and
- ▶ Self-service car washes.

Real Property Contracts - Also effective January 1, 2017, H.B. 1030 repeals the rule that deemed someone engaged in retail trade could not be a real property contractor and, thus, provides nontaxable status to services performed by a real property contractor. In addition, H.B. 1030 amends the definition of a real property contract to limit the term to contracts involving capital improvements to real property.

Under H.B. 1030, North Carolina provides rules for a mixed real property and RMI services contract. Specifically, effective January 1, 2017, if the price of the taxable RMI services under such a contract does not exceed 10 percent of the contract price, then North Carolina treats the entire contract as a non-taxable real property contract. Otherwise, North Carolina treats the RMI services as performed under a separate contract.

Other Notable Sales and Use Tax Changes - H.B. 1030 and S.B. 729 also make the following notable changes to the sales and use tax law:

- ▶ *Exempt Service Contracts* - Effective January 1, 2017, H.B. 1030 exempts service contracts sold by a motor vehicle dealer, or by or on behalf of a motor vehicle service agreement company, for a motor vehicle or related components, accessories, and systems.
- ▶ *Direct Pay Permits* - Effective July 1, 2016, H.B. 1030 authorizes the Department to issue a direct pay permit for separately stated installation charges related to the purchase of tangible personal property and digital property, and the gross receipts from the provision of RMI services, for a boat, qualified jet engine, or aircraft. The permit entitles the holder to a use tax exemption to the extent the amount of installation charges and receipts from RMI services exceed \$25,000.
- ▶ *Use Tax Expansion* - Effective January 1, 2017, S.B. 729 expands the definition of storage to include holding property in the state for any period of time, but excepts property held as inventory.

Individual Income Tax

H.B. 1030 and S.B. 729 together make the following changes to the Individual Income Tax:

- ▶ *Standard Deductions* - H.B. 1030 phases-in modest increases to the standard deduction for each of the filing statuses over a two year period, beginning with the 2016 taxable year.
- ▶ *Claim of Right Deduction* - S.B. 729 allows an itemized deduction for the repayment of an amount included in income in an earlier year under a claim of right, retroactively effective to taxable years beginning on or after January 1, 2014.
- ▶ *C.O.D. Income* - Retroactive to tax years beginning on or after January 1, 2014, S.B. 729 allows a deduction for the amount of cancellation of indebtedness income included in federal taxable income under IRC § 108(i)(1), which relates to the deferral and ratable inclusion of income arising from business indebtedness discharged by the reacquisition of a debt instrument.
- ▶ *Expenses Related to Federal Credits* - Beginning with the 2016 taxable year, S.B. 729 allows a deduction for the amount that a federal expense deduction is reduced if the taxpayer claimed a federal credit instead of the deduction, provided the state does not allow a similar credit.
- ▶ *Federal NOLs* - Beginning January 1, 2016, S.B. 729 requires an addition to the federal adjusted gross income starting point for any federal net operating loss carried over to the current year that the taxpayer does not use and carries over to future taxable years.
- ▶ *Parental Savings Trust Fund Withdrawals* - Beginning January 1, 2016, S.B. 729 requires an addition to the federal adjusted gross income starting point for an amount deducted in a prior year to the extent the amount was withdrawn from the Parental Savings Trust Fund of the State Education Assistance Authority and not used to pay for qualified higher education expenses of the beneficiary, unless the non-qualified use was made without penalty under IRC § 529 due to the beneficiary's death or disability.

Other Notable Changes

H.B. 1030, S.B. 726 and S.B. 729 together make the following changes to North Carolina tax law:

- ▶ *IRC Conformity* - Effective June 1, 2016, S.B. 726 updates North Carolina's IRC conformity date from January 1, 2015, to January 1, 2016, for income and other tax purposes.
- ▶ *Mill Machinery Tax* - Retroactive to July 1, 2013, H.B. 1030 expands the one-percent Mill Machinery Tax (and the related sales tax exemption) to include purchases of certain specialized equipment used to unload and process bulk cargo at a ports facility. In addition, effective July 1, 2016, H.B. 1030 subjects certain specialized equipment used by certain metal recyclers, metal fabricators, and precious metal extractors to the tax.

Intangible Holding Companies - S.B. 729 makes law changes that impact intangible holding company structures for Corporation Income Tax purposes. See the [BDO SALT alert](#) that discusses these law changes.

BDO INSIGHTS

- ▶ The proposed market-based sourcing rules, along with this year's market-based sourcing information report requirement and North Carolina's phase-in of single sales factor apportionment formula, creates an expectation that the state will eventually adopt market-based sourcing for sales from services and intangibles. While the market-based sourcing rules are only proposed at this point in time, taxpayers should consider the impact that the proposed market-based sourcing rules may have on them for tax planning purposes.
- ▶ As noted, North Carolina cannot adopt the proposed statutory market sourcing rules as the standard sourcing methodology until enacted (and the proposed regulations required to be prepared by the Department will not be effective until then). It is expected that the enactment of the proposed statutory market sourcing rules will be deferred until the next legislative session, which will convene on January 11, 2017.
- ▶ Taxpayers affected by the clarification that the sales and use tax on RMI services includes refinishing, cleaning, inspection, and monitoring services may find relief due to the exemptions provided in the legislation that are effective January 1, 2017. However, as of the same date, taxpayers may need to update their sales and use tax systems to report and pay tax in accordance with the changes under H.B. 1030.

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