AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

NORTH CAROLINA ENACTS RELATED PARTY INTEREST ADDBACK, PHASES IN SINGLE SALES FACTOR APPORTIONMENT, AND IMPOSES SALES TAX ON REPAIR, MAINTENANCE, AND INSTALLATION SERVICES

SUMMARY

On September 18, 2015, North Carolina Governor Pat McCrory signed into law H.B. 97, 2015-2016 Session ("H.B. 97"), which, for Corporation Income Tax purposes, includes a related party interest addback provision, implements the phase-in of single factor apportionment, imposes a market-based sourcing informational reporting requirement, and reduces the Corporation Income Tax rate to 4 percent. In addition, H.B. 97 modifies the Franchise Tax base and increases the minimum Franchise Tax to $200 and the maximum Franchise Tax on holding companies to $200,000. Lastly, H.B. 97 imposes sales and use tax on repair, maintenance, and installation services, and it makes changes to the Individual Income Tax standard deductions, itemized deductions, and tax rate.

DETAILS

Corporation Income Tax

Related Party Interest Addback. Effective for taxable years beginning on or after January 1, 2016, North Carolina requires an addback to the federal taxable income starting point for net interest expense to a "related member" to the extent it exceeds 30 percent of the taxpayer's adjusted taxable income. However, North Carolina allows a deduction for 100 percent of net interest expense to a related member if the related member:

- Is subject to North Carolina Corporation Income Tax;
- Pays a net income or gross receipts tax to another state with respect to the interest income;

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- Is organized under the laws of a foreign country that has an income tax treaty with the U.S. and the country taxes interest income at a rate that at least equals the Corporation Income Tax rate; or
- Is a bank.

For these purposes, North Carolina adopts the definition of "related member" used for purposes of the current royalty expense addback provision.

Single Sales Factor Phase-In. For taxable years beginning in 2016, the sales factor of the current three factor property, payroll, and sales apportionment fraction is triple-weighted. Currently, the sales factor is double-weighted. For taxable years beginning in 2017, the sales factor is quadruple-weighted. Starting with taxable years beginning in 2018, North Carolina adopts single sales factor apportionment. This provision also applies to Franchise Tax.

Market-Based Sourcing Informational Reporting. While the new law does not modify the current sales sourcing provisions, a taxpayer that has more than $10 million in apportionable income must file an information return showing the calculation of the 2014 apportionment factor using market-based sourcing. See the following table for sales sourcing under this provision.

RECEIPT FROM …	SOURCE TO NORTH CAROLINA IF …
… Sale, rental, lease or license of real property	… To the extent property located in North Carolina
… Rental, lease or license of tangible personal property	… To the extent property located in North Carolina
… Sale of service	… If delivered to a location in North Carolina
… Rented, leased or licensed intangible property	… To the extent property is used in North Carolina
… Sale of intangible property - contract right, government license or similar intangible that authorizes the holder to conduct a business activity in a specific geographic area	… The geographic area includes all or part of North Carolina
… Sale of intangible property - sales contingent on productivity, use or disposition of the intangible property	… Treat as rented, leased or licensed intangible property
… Sale of intangible property - other	… Exclude from numerator and denominator of sales factor

The information return is due at the same time as the 2015 Corporation Income Tax return. A $5,000 penalty applies for failure to timely file this return (subject to reduction or waiver at the discretion of the Department of Revenue).

Rate Reductions. Effective for taxable years beginning on or after January 1, 2016, North Carolina reduces its Corporation Income Tax Rate to 4 percent from 5 percent. The rate reduction is due to North Carolina meeting its state revenue target set by a 2013 law. If North Carolina meets the $29,975,000,000 revenue target in this new law for a fiscal year, the rate must be reduced to 3 percent for the taxable year that begins on the following January.

Franchise Tax

Tax Base Changes. For taxes due on or after January 1, 2017, the measure of the tax, which is currently based on capital stock, surplus and undivided profits, is instead based on net worth. Net worth for these purposes is a taxpayer's total assets (determined without regard to the deduction for accumulated depreciation, depletion or amortization), less total liabilities, the difference of which is subject to the following adjustments:

- A deduction for accumulated depreciation, depletion and amortization as determined for federal income tax purposes;
- An addition for indebtedness owed to a parent, subsidiary or affiliate corporation, or a non-corporate entity of which a corporation or affiliated group of corporations owns, directly or indirectly, more than 50 percent of the capital interests (subject to a proportional deduction if the creditor corporation borrowed capital from a source other than a parent, subsidiary or affiliate corporation);
- A deduction for indebtedness owed to it by a parent, subsidiary or affiliated corporation subject to the Franchise Tax to the extent it has been added by the debtor corporation; and
- A deduction for the cost of treasury stock.

Also for taxes due on or after January 1, 2017, in addition to certain other deductions, North Carolina no longer allows the deduction from the investment in North Carolina tangible property measure of the tax for debts existing for North Carolina real estate.

Minimum and Maximum Tax Increases. For taxes due on or after January 1, 2017, the minimum tax increases from $35 to $200. In addition, the maximum tax that may be imposed on a holding company in the event the net worth measure of the tax applies (i.e., and not the appraised value of or investment in North Carolina tangible property measure) increases from $75,000 to $150,000.

Sales and Use Tax

Effective March 1, 2016, North Carolina expands the sales and use tax base to include the sales price or gross receipts derived from repair, maintenance, and installation services, unless purchased for resale. For these purposes, repair, maintenance, and installation services include services related to:

- Keeping tangible personal property in working order;
- Restoring tangible personal property to working order;
- Troubleshooting the source of a problem for the purpose of determining what is needed to restore tangible property to working order; and
- Installing tangible personal property (but not tangible personal property installed by a real property contractor pursuant to a real property contract).

Also effective March 1, 2016, North Carolina excludes from the application of sales tax: (i) a person that operates solely as a real property contractor; and (ii) a person whose only business activity is providing repair, maintenance, and installation services, and who does not derive the majority of its revenue from retailing tangible personal property, digital property, or services to consumers.

Individual Income Tax

Effective for taxable years beginning on or after January 1, 2016, the individual income tax standard deduction amounts are increased slightly and, for purposes of calculating itemized deductions, North Carolina allows a deduction for medical and dental expenses equal to the deduction taken for federal income tax purposes under I.R.C. § 213. In addition, effective for taxable years beginning on or after January 1, 2015, the individual income tax rate is reduced to 5.499 percent from 5.75 percent.

BDO INSIGHTS

- The phase in of single sales factor apportionment and the 1 percent rate reduction under H.B. 97 reflects North Carolina's desire to create a more favorable income tax environment for multistate corporations headquartered or with significant operations in the state. It would be unfortunate, however, if these same changes impede North Carolina from meeting the revenue goal which, if met, would further reduce the Corporation Income Tax rate.
- Taxpayers that have not historically charged sales tax on repair, maintenance and installation services taxable under H.B. 97 should implement procedures to ensure the collection and remittance of sales and use tax on such services.
- As drafted, the enactment of the Corporation Income Tax (except for the 4-percent rate, which, as noted, was enacted under a separate 2013 law), Franchise Tax and Individual Income Tax changes under H.B. 97 is pending the ratification of H.B. 117, 2015-2015 Regular Session and H.B. 943, 2015-2016 Regular Session prior to January 1, 2016. H.B. 117 and H.B. 943 were ratified on September 24, 2015, and September 30, 2015, respectively. Thus, putting aside any unforeseen circumstances, H.B. 97 should be enacted as planned.