



SENATE BILL 257: Finance Provisions in the Appropriations Act of 2017.

2017-2018 General Assembly

Committee:	House Finance. If favorable, re-refer to Pensions and Retirement. If favorable, re-refer to Appropriations	Date:	May 30, 2017
Introduced by:	Sens. Brown, Harrington, B. Jackson	Prepared by:	Trina Griffin
Analysis of:	PCS to Fourth Edition S257-CSSVxf-31		Committee Co-Counsel

OVERVIEW: *The Proposed Committee Substitute for S257 contains the following finance provisions:*

Individual Income Tax Changes

- *Increases the standard deduction by \$1,000 for married filing jointly taxpayers and surviving spouses, by \$800 for heads of household, and by \$500 for single and married filing separately taxpayers. This change would become effective for taxable years beginning on or after January 1, 2018.*
- *Increases from \$20,000 to \$22,000 the cap of the mortgage expense and property tax deduction for itemizers, effective for taxable years beginning on or after January 1, 2019.*

Franchise Tax Changes

- *Reduces the franchise tax rate from \$1.50 to \$1.40 per one thousand dollars of the required base.*

Sales Tax Changes

- *Repeals the 1%/\$80 privilege tax applicable to mill machinery and certain other manufacturing and industrial equipment and establishes a sales tax exemption for this equipment, effective July 1, 2017. It also directs the Revenue Laws Study Committee to study this area of law to provide more guidance to taxpayers and the Department of Revenue about what constitutes "mill machinery," how to define "manufacturing," and how to incorporate the body of Departmental administrative law in this area into the statutes.*
- *Exempts from sales tax repair or replacement parts for a ready mix concrete mill, regardless of whether the mill is freestanding or affixed to a motor vehicle.*
- *Exempts from sales tax distribution equipment, and accessories, attachments, or repair parts for distribution equipment, sold to a large fulfillment center.*
- *Creates a sales tax refund for small and rural research and development businesses, capped at \$20,000 per year per eligible business, and \$15 million in the aggregate, as follows:*
 - *A "small research and development business" could apply for 100% refund of sales and use taxes paid for research and development supplies.*

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- *A "rural research and development business" would have the option of applying for either: 100% of sales and use taxes paid for research and development supplies or 50% of the State portion of all sales and use taxes paid during the year, not just those taxes paid on research and development-related items.*

Property Tax Changes

- *Delays from July 1, 2017, to July 1, 2018, the effective date of House Bill 2, Provide Certain Property Tax Relief, if the bill becomes law.*

Highway Use Tax Changes

- *Provides that, for a period of two years, the proceeds of the 8% tax on short-term leases or rentals of motor vehicles shall be credited to the Highway Fund rather than the General Fund.*

Fee-Related Changes

- *Prohibits a city, a county, or any water and/or sewer authority or district from imposing a fee on a low-income housing development for the future expansion of a water and sewer system.*
- *Provides for a number of other fee-related changes in the areas of HHS, JPS, Transportation, and ANER, which are described in the chart below.*

SUMMARY OVERVIEW

Part 38 of the Proposed Committee Substitute for Senate Bill 257 constitutes the House Finance package and is explained first in this Bill Analysis.

Other provisions in the PCS are those required under House Rule 38 to be referred to Finance and include a number of fee changes within various agencies, the setting of the rate for the insurance regulatory charge, which is essentially a tax, and a temporary diversion of the tax proceeds collected on short-term car rentals and leases from the General Fund to the Highway Fund. These provisions are set out in a chart following the summary of Part 38.

There are also three retirement and pension provisions included in this PCS. However, they are not summarized in this Bill Analysis, but will be addressed in the Pensions & Retirement Committee.

PART 38: CURRENT LAW & BILL ANALYSIS

SECTION 38.2: INCREASE STANDARD DEDUCTION

Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions and will choose the method that gives them the lower taxable income. The standard deduction is a dollar amount that reduces taxable income and eliminates the need to itemize actual deductions, such as medical expenses, charitable contributions, and taxes, on Schedule A. Approximately 65-70% of North Carolina taxpayers take the standard deduction. A taxpayer's whose State taxable income is equal to or less than the standard deduction amount does not owe any State income taxes.

Section 38.2 of the bill would increase the standard deduction as follows:

Married, filing jointly/surviving spouse	from \$17,500 to \$18,500
Head of household	from \$14,000 to \$14,800
Single	from \$8,750 to \$9,250
Married, filing separately	from \$8,750 to \$9,250

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This section would become effective for taxable years beginning on or after January 1, 2018.

SECTION 38.3: INCREASE MORTGAGE INTEREST & PROPERTY TAX DEDUCTION CAP

To deduct mortgage interest and property taxes, a taxpayer must itemize their deductions, rather than take the standard deduction. North Carolina capped the amount of mortgage interest and property taxes a taxpayer could deduct in 2014 at \$20,000, regardless of a taxpayer's filing status. Section 38.3 would increase the deduction cap to \$22,000.

This section would become effective for taxable years beginning on or after January 1, 2019.

SECTION 38.6: REDUCE FRANCHISE TAX RATE

The franchise tax is imposed on C corporations and S corporations for the privilege of engaging in business in this State.¹ The tax does not apply to a business organized as a limited liability company, unless the LLC elects to be taxed as a corporation for franchise tax purposes, or to a general partnership or sole proprietorship.

The rate of tax is \$1.50 per \$1,000, and it applies to the highest of the following three bases², subject to a minimum tax of \$200:

- Net worth apportioned to the State
- Book value of property in the State
- 55% of appraised value of property in the State

Section 38.6 would reduce the franchise tax rate to \$1.40 per \$1,000 of the required base. The rate reduction would become effective for taxable years beginning on or after January 1, 2019, and would be applicable to the calculation of franchise tax reported on the 2018 and later corporate tax returns.

SECTION 38.8: EXEMPT MILL MACHINERY FROM TAX & STUDY

Sales Tax Exemption. – Under current law, purchasers of mill machinery pay tax at a preferential rate of 1% of the purchase price with an \$80 cap. This privilege tax (as opposed to a sales tax) is set out in Article 5F of Chapter 105. Section 38.8 of the bill would repeal Article 5F and move all provisions contained therein to the sales tax exemption statute. With one exception described below, there are no substantive changes to the language; the only modifications that have been made are those necessary to make the provisions fit the sales tax exemption statute and to eliminate unnecessary language.

Under current law, service contracts on Article 5F items and the repair, maintenance, and installation of Article 5F items are exempt from tax. This treatment would remain the same once the items are moved into the sales tax exemption statute; services on these items would continue to be exempt from tax.

One substantive change in this section is the creation of a sales tax exemption for repair or replacement parts for a ready-mix concrete mill, regardless of whether the mill is freestanding or affixed to a motor vehicle, to a company that primarily sells ready-mix concrete. Currently, purchases by ready-mix concrete manufacturers of mill machinery, equipment, parts, and accessories that are used directly in the manufacture of ready-mix concrete for sale are subject to the 1%/\$80 tax. However, once a ready-mix concrete mill becomes part of a truck, it is part of a motor vehicle; and a motor vehicle is not considered mill machinery. Repair parts and accessories to a motor vehicle are subject to State and local sales tax.

¹ The tax applies to holding companies as well, which are corporations that receive at least 80% of their income from subsidiaries. The maximum franchise tax for holding companies is \$150,000.

² Most taxpayers use the first base.

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The repeal of Article 5F and the corresponding sales tax exemptions would become effective July 1, 2017.

Revenue Laws Study. – Although the bill transitions the treatment of mill machinery from a preferential rate of privilege tax to a sales tax exemption, many unresolved issues remain with regard to this area of law. Among them, the statute does not specifically define a "manufacturing industry" or "mill machinery." Because the statute does not define these terms, it has raised questions as to whether a company is a manufacturer, for example, if it engages in multiple activities, only one of which may be manufacturing. It also raises questions as to whether a particular piece of equipment is "mill machinery" if it has dual purposes, only one of which is to manufacture goods. Over the years, the Department of Revenue has, through a combination of administrative rule, case law, and interpretation of the Secretary, developed guidance and criteria to determine the application of the tax. The criteria have not always been consistent or clear to taxpayers. Moreover, this body of administrative law is not codified in the statutes.

Subsection (e) of this section would direct the Revenue Laws Study Committee to study these issues in order to provide more guidance and specificity to both taxpayers and the Department of Revenue. This subsection would become effective when the bill becomes law.

SECTION 38.9: SALES TAX EXEMPTION FOR FULFILLMENT CENTERS

Under current law, "mill machinery" is subject to tax at the preferential rate of 1% of the purchase price with an \$80 cap. In order to qualify for the preferential rate, the machinery and equipment must be used in the production process of manufacturing tangible personal property for sale. Generally speaking, "manufacturing" begins when the item is withdrawn from its first point of storage and ends when the item is removed at the end of the manufacturing process and placed in finished goods storage. "Distribution equipment," which is used for the movement of manufactured products within storage warehouses, shipping rooms, and other finished product storage areas and for the removal of products for sale or shipment, is considered to be outside the manufacturing process. Therefore, absent a specific exemption, distribution equipment does not normally qualify as mill machinery.

Since 2001, the General Assembly has expanded the preferential treatment for certain equipment to attract or maintain various industries as long as the equipment is capitalized for tax purposes under the Code by a company "primarily engaged" in certain kinds of business activities. The types of businesses eligible for the 1%/\$80 rate on certain machinery and equipment are as follows:

- A major recycling facility. (2005)
- A research and development company in the physical, engineering, and life sciences. (2006)
- A software publishing company. (2007)
- An industrial machinery refurbishing company. (2008)
- A large manufacturing and distribution facility.³ (2011)
- A company located at a ports facility for waterborne commerce. (2013)

This section would provide a sales tax exemption for distribution equipment purchased by large customer fulfillment centers under criteria similar to the current provision for "large manufacturing and distribution facilities." A "large fulfillment center" is a facility used primarily for receiving, inventorying, sorting, repackaging, and distributing finished retail products for the purpose of fulfilling customer orders. Examples could include an Amazon distribution center, which fulfills orders on behalf of third party vendors, or a Walmart fulfillment center, which fulfills orders placed online for its own merchandise.

³ This provision is set to expire on and after July 1, 2018.

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To qualify, the facility must invest at least \$100 million in real and tangible personal property within five years of the first property investment, as certified by the Department of Commerce, and must maintain an employment level of 400 people.

Examples of equipment used in the distribution process would include automated storage and retrieval systems, conveyor and sortation systems, storage systems, racking and mezzanine systems, automated packaging systems, labeling and scanning equipment, and forklifts and other powered equipment.

This section contains a forfeiture provision identical to the existing provision for "large manufacturing and distribution facilities" in the event the employment level at the facility drops below 400.

SECTION 38.10: SALES TAX REFUND FOR RESEARCH AND DEVELOPMENT SUPPLIES

This section creates a new sales tax refund for small and rural research and development businesses, effective for sales made on or after July 1, 2018. The maximum total amount of refunds allowed to all eligible businesses in a calendar year would be capped at \$15 million.

SMALL RESEARCH AND DEVELOPMENT BUSINESSES

Definition. – A "small research and development business" must meet the following criteria:

- It is either a corporation or a limited liability company.
- It is either:
 - Engaged primarily in research and development, or
 - Certified by a university located in this State as performing under a licensing agreement for the purpose of commercializing technology developed at the university.
- It employs 200 or fewer full-time employees.
- It has annual gross receipts, combined with annual receipts of all related persons, not in excess of \$5 million.
- It spent the greater of \$10,000 or 3% of its annual receipts on in-house research expenses. The term "in-house research expenses" includes wages paid to an employee for engaging in or in the direct supervision or support of qualified research and amounts paid for supplies used in the conduct of qualified research.

Refund Amount. – 100% of the State and local sales and use taxes paid by it in the previous calendar year for research and development supplies used or consumed solely in this State, capped at \$20,000 per business.

Research and Development Supplies. – Tangible property, exclusive of property subject to the allowance for depreciation, used in the conduct of qualified research. Generally speaking, the term "qualified research" means research undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. The overall purpose of the research must relate to a new or improved function, performance, reliability or quality, and not style, taste, cosmetic, or seasonal design factors. "Qualified research" does not include research after commercial production, adaptation or duplication of existing business components, certain surveys or market research, internal computer software, foreign research, social sciences, or funded research.

RURAL RESEARCH AND DEVELOPMENT BUSINESS

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Definition. – A "rural research and development business" must meet all of the criteria for a small research and development business, plus it must incur more than 50% of its in-house research expenses in a development tier one or two area in the calendar year for which the refund is claimed.

Refund Amount. – A rural research and development business would have the option of applying for either of the following, capped at \$20,000 per business:

- 100% of the State and local sales and use taxes paid by it in the previous calendar year for research and development supplies used or consumed solely in this State.
- 50% of the State share of all sales and use taxes paid by the business in the previous calendar year, which would not be limited to research and development supplies.

SECTION 38.11: PROHIBIT WATER AND SEWER IMPACT FEES/LOW-INCOME HOUSING

This section would prohibit the imposition of water and sewer impact fees related to the future expansion of the water or sewer system or both, on a low-income housing development to which the North Carolina Housing Authority allocates a federal tax credit under section 42 of the Internal Revenue Code. The rationale for the prohibition is, in part, to help developers manage the cost of these projects given that they are limited in the amount of debt they can carry and still meet operating costs due to the fact that rents are restricted to below market rates in these developments.

G.S. 153A-331 and G.S. 160A-372 authorize cities and counties, as part of their subdivision ordinances, to require developers to provide: (1) street right of ways (ROWs), street construction, or fees in lieu, (2) dedication of utility ROWs, (3) dedication of parkland or fees in lieu, (4) construction of community service facilities, (5) reservation of school sites for later purchase.

County and city public enterprise statutes also authorize certain fees and charges related to public enterprise functions.⁴

Several local acts, listed in subsection (d) of this section, authorize various additional fees and charges related to new construction.

NC courts have ruled there is no implied local government authority to charge school impact fees in several cases, including *Lanvale Properties, LLC v. County of Cabarrus*, 366 N.C. 142 (2012).

Most recently, the NC Supreme Court ruled that there is no implied local government authority to assess water and sewer impact fees on new development unless specifically authorized. *Quality Built Homes Inc. and Stafford Land Company, Inc. v. Town of Carthage*, 789 S.E.2d 454 (2016).

SECTION 38.12: MODIFY DISABLED VETERAN PROPERTY TAX CHANGES

House Bill 2, which passed the House unanimously and is currently in Senate Rules, would increase the disabled veteran property tax homestead exclusion from \$45,000 to \$100,000 and would reimburse local governments for the revenue lost from valuations above \$45,000. It would also create a new unlimited property tax homestead exclusion for the unmarried surviving spouse of an emergency personnel officer killed in the line of duty. The current bill has an effective date of July 1, 2017.

This section would delay the effective date to July 1, 2018, because it is unlikely that it could be implemented until next year.

⁴ Chapter 160A, Article 16; Chapter 153A, Article 15.

FEES AND OTHER PROVISIONS

Section	Area	Short Title	Description
2.2	GF Avail.	Short-Term Lease or Rental Proceeds	Credits, for two years, proceeds of the 8% tax on short-term rentals and leases of motor vehicles to the Highway Fund instead of the General Fund. The Senate budget diverts \$10 million of the proceeds of the 8% tax from the General Fund to the Highway Fund in perpetuity.
11H.3	HHS	Provider Application and Recredentialing Fee	Requires each provider applying to enroll in Medicaid to submit a \$100 application fee. The fee will be required every 5 years at recredentialing.
11H.24	HHS	Supplemental Payment Assessment	Increases hospital assessment to fund a new physicians UPL supplemental plan. No amounts budgeted during biennium.
13A.3	ANER	Modify License Fees Required to Hunt, Fish, or Trap	Allows WRC to increase fees at rate of total inflation since last fee increase (previously was average inflation over preceding 5 years).
15.19	ANER	Industrial Commission Case Management Systems	Allows Industrial Commission to retain revenue up to \$1.2m from the compromise settlement fee for the replacement of the case management system.
18B.5	JPS	Digital Forensics Included in Court Costs	Adds a \$600 criminal court cost when the State Lab or local labs do digital forensic work leading to the conviction. Similar to other Lab court costs.
18B.10	JPS	Eliminate Access to Civil Justice Funds	Eliminates the allocation of part of the General Court of Justice court cost to the NC State Bar for Access to Civil Justice. The impact is an increase in GF receipts from court costs.
22.1	GEN GOV	Insurance Regulatory Charge	Sets the rate for the insurance regulatory charge at 6.5% for 2018. The rate has remained at 6.5% for the past 3 years (2015, 2016, 2017). The insurance regulatory charge was first enacted in 1991 to defray the State's cost of regulating the insurance industry. The charge is a percentage of each insurance company's gross premiums tax liability. The General Assembly must set the rate for this charge each year.
34.32	TRANSP	DMV/Hearing Fee	Amends Section 34.9 of S.L. 2014-100 to require DMV to implement a hearing fee

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		Implementation Revisions	schedule by January 1, 2018, to recover a portion of the direct and indirect costs incurred by the Hearings Unit. Estimated revenue is \$2.15M in FY 2017-18 and \$4.3M in FY 2018-19.
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