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2018 Legislative Preview

North Carolina Legislative Preview: Resolving the Sourcing Issue?

Deciding whether to conform to the recent federal tax changes is the most significant tax issue that the North Carolina Legislature is likely to face during the 2018 session, a state tax policy expert said.

Any actions that lawmakers take in 2018 will be determined in part by the state's fiscal condition and the impact of the 2017 federal tax law (Pub. L. No. 115-97), signed by President Donald Trump Dec. 22, said William W. Nelson, a partner with Smith, Anderson, Blount, Dorsett, Mitchell & Jernigan LLP in Raleigh. The general fund collections for the first quarter of the current fiscal year were $62.1 million (1.2 percent) below the revenue target.

The sourcing of certain business income likely will be a focus of discussion in 2018.

North Carolina ''will no doubt continue to face decisions about whether to adopt market-based sourcing for service income and income from intangibles,'' Nelson said. State lawmakers have deferred on that decision so far, but as single-sales-factor apportionment will be fully implemented in 2018, ''the sourcing issue will have to be resolved at some point,'' he told Bloomberg Tax.

Another issue that the Legislature potentially could consider in 2018 is a broadening of sales tax exemptions for business inputs, Nelson said. During the past legislative session, North Carolina repealed its 1 percent tax on machinery and exempted mill machinery purchases from its sales tax. The Legislature ''has recognized the economic distortion caused by subjecting business inputs to the sales tax'' and could broaden such exemptions, Nelson said.

Addressing Federal Changes The effect of the federal tax law on North Carolina's personal income tax ''may not be great,'' as the state's levy isn't impacted by federal rate changes, and its starting point for computing taxable income is the federal adjusted gross income, according to Nelson. The federal law likely will have a bigger potential impact on North Carolina's corporate income tax system, as the state's taxable income for corporations is based on federal taxable income, he said.

Although North Carolina has ''dramatically reduced'' its personal income tax rate over the past few years, the 2017 federal tax law's limitation on the federal deduction of state and local taxes could put pressure on the state to lower its rate even further, Nelson told Bloomberg Tax. The law allows taxpayers to deduct up to $10,000 of property taxes, and state and local income or sales taxes. There was previously no limit on the amount of state and local taxes that could be deducted—and many high-tax states are exploring options to combat the slashed tax break.

In addition, the ''provision providing a lower effective tax rate for business income received from pass-through entities might encourage North Carolina to consider providing some form of state tax relief to small business owners,'' Nelson said.

The federal tax law makes significant changes to the calculation of corporate federal taxable income, Nelson said. These include the addition of deferred foreign earnings in taxable income as part of the repatriation transition tax and the addition of ''global intangible low-taxed income'' or ''GILTI'' earned by a taxpayer's foreign subsidiaries in the taxpayer's federal taxable income. North Carolina will need to determine whether it wants to conform to these federal changes, he said.

Schorr Johnson, a spokesman for the state Department of Revenue, told Bloomberg Tax that his department's top priorities for the upcoming year are information security and enhancing customer service. North Carolina is participating in the Multistate Tax Commission's voluntary disclosure initiative for online marketplace sellers, under which the state will assert no liability for past taxes except for sales and use taxes or withholding taxes that were collected but not remitted, he said.

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