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TO: Smith Anderson Clients

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RE: Summary of 21st Century Tax Rate Reduction and Modernization Plan

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This memorandum summarizes the business tax reforms included in the tax reform proposal released by the Senate Finance Committee on April 22, 2009. The details of the proposal have not been made public and no bill to implement the proposal has been introduced. Because of the limited amount of information available, this summary is necessarily incomplete and includes a number of extrapolations from the Finance Committee's release. In addition, except in a very few instances which we have noted, the proposal does not include specific effective date provisions. This summary also does not discuss the significant changes to the personal income tax law included in the proposal.

Executive Summary

The proposal includes major business-related changes to the sales tax, franchise tax and corporate income tax.

The sales tax changes include:

- eliminating agricultural exemptions for large farms
- eliminating the diesel fuel exemption for railroads
- replacing the existing preferential rate and cap applicable to manufacturing equipment with an exemption for depreciable property
- taxing digitally delivered products currently taxed only if delivered in tangible form

- taxing a number of currently untaxed consumer services
- eliminating refunds for large charities
- Reducing the sales tax rate to 6%

The franchise tax changes include:

- Extending the franchise tax base by subjecting LLCs and other limited liability entities to the tax.
- Eliminating the alternative franchise tax bases.

The corporate income tax changes include:

- Reducing the rate to 4.5%
- Eliminating almost all credits against the tax
- Adopting a throwout rule in applying the sales tax apportionment factor for sales untaxed in the destination state
- Conforming to most, but not all, provisions of recent federal tax legislation.

Sales Tax Changes

<u>Changes to Exemptions</u>

Agricultural Exemptions

The proposal would limit the existing “farm exemptions” to small farms. The reference to farm exemptions presumably refers to the “Agricultural Group” exemptions contained in N.C. Gen. Stat. § 105-164.13. These exemptions include exemptions for fertilizer, farm machinery, fuel, electricity, veterinary supplies, insecticides, and certain building materials used in farm buildings.

Under the proposal, farms with gross receipts of less than $1 million would remain entitled to the full benefit of the farm exemptions. Farms with gross receipts of $1 million or more but less than $2.5 million would be pay tax on 50% of the sales price of the exempt articles. Farms with gross receipts of $2.5 million or more would not be entitled to any exemption for these items.

Railroad Diesel Fuel Tax Exemption

The proposal would eliminate the sales tax exemption for sales of diesel fuel to railroad companies for use in rolling stock.

Depreciable Property Exemption

Mill machinery, i.e., equipment used in the manufacturing process, is currently exempt from the sales tax and subject instead to a special privilege tax with a rate of 1% and an $80 per article cap.

The proposal would repeal the sales tax exemption for manufacturing equipment along with the special mill machinery privilege tax, thus subjecting manufacturing equipment to the sales tax.

The proposal apparently would repeal other equipment exemptions and preferential rates such as those currently available for recycling facility property and datacenter machinery and equipment.

The proposal includes a new sales tax exemption for depreciable property. The exemption would apparently extend to all tangible personal business property eligible for depreciation under the Code, regardless of whether such property is used in the manufacturing process. This new exemption would presumably be broad enough to exempt manufacturing equipment, recycling facility equipment and datacenter equipment that is depreciable. It would not cover nondepreciable manufacturing equipment parts and accessories that are currently taxed at the preferential rate and cap. These items would therefore be subject to tax at the full sales tax rate.

Taxation of Digital Products

The proposal would subject "digital products and click throughs" to the sales tax. This would presumably cover the same products covered in Senate Bill 487, i.e., audio and video downloads, ring tones, digital books and electronically delivered software. Custom computer software would presumably remain exempt.

Taxation of Services

Warranties, installations and repairs to tangible personal property

Under current law, separately stated charges for repairing and installing personal property are exempt from tax. Extended service warranties not included in the purchase price of tangible personal property are also not taxable. The proposal would subject all these services to tax.

Movies and Live Entertainment

Under current law, a 1% gross receipts tax is imposed on motion picture exhibitions and a 3% gross receipts tax is imposed on live entertainments such as athletic contests, circuses and exhibitions. The proposal would repeal these gross receipts taxes and subject movies and live entertainments to the sales tax.

Recreational Services

The proposal includes a line item for "recreation and entertainment." The scope of this part of the proposal is unclear, but presumably involves subjecting amusement park admissions, health club memberships and other recreational activities to the sales tax.

Real Estate and Personal Services

The proposal would extend the sales tax to personal services and services related to real property. Personal services would presumably include personal grooming, pet-sitting services, catering and interior decorating services. Services relating to real property would presumably include landscape maintenance, maid and janitorial services. The tax would presumably apply to services provided to business as well as residential customers.

Storage and moving

The proposal would subject storage and moving services to the sales tax.

Building repairs and alterations

The proposal would tax "building repair and alteration" services to tax but would not tax services related to new construction. The scope of this proposal is uncertain.

Information Services

The proposal would tax information subscription and retrieval services, such as LEXIS/NEXIS, regardless of the mode of delivery.

<u>Changes to Non-profit Refunds</u>

Under current law, nonprofit charitable organizations pay sales tax on their purchases but are entitled to semiannual refunds of sales taxes paid on tangible personal property used in their charitable work. The proposal would cap the amount of the refunds available to such organizations. The proposal does not specify the amount of the cap, but the cap would most significantly affect larger nonprofits such as hospitals and universities.

<u>Rate Reduction</u>

The current state sales tax rate is 4.5% and all counties levy an additional 2.25% local sales tax for a combined rate of 6.75% (eight counties levy a 2.5% local tax for a combined rate in these counties of 7%).

The proposal would reduce the state sales tax rate to 3.75% producing a combined rate of 6% (or 6.25%). The rate reduction would be effective for sales made on or after May 1, 2010.

Corporate Franchise and Income Tax

Franchise Tax Changes

Extension of Franchise Tax to all Limited Liability Entities

Under current law, noncorporate entities, such as limited liability companies and limited partnerships are not subject to the franchise tax. The only current exceptions to this rule are that LLCs that elect to be taxed as corporations are subject to the franchise tax and a corporation that controls an LLC is treated as owning the LLC's assets for purposes of computing the corporation's franchise tax liability.

The proposal would subject all LLCs, limited partnerships and limited liability partnerships to the franchise tax, leaving only businesses conducted as sole proprietorships and general partnerships exempt from the franchise tax. This change will be of particular interest to professional firms and joint ventures organized as LLCs.

Simplification of Franchise Tax Base

Under current law, the franchise tax is computed on the basis of the largest of (1) the corporation's capital stock, surplus and undivided profits (essentially, its shareholders' equity), (2) 55% of the appraised value of the corporation's real and tangible personal property in North Carolina, and (3) the corporation's total actual investment in tangible property in North Carolina.
The proposal would replace the three alternative franchise tax bases with a single owner's equity or balance sheet base.

Corporate Income tax Changes

Reduction in Corporate Income Tax Rate

The current rate of 6.9% would be reduced first to 5.8% and then to 4.5% over a two year period.

Repeal of Credits

The proposal would eliminate *all* tax credits available to offset corporate income, franchise or gross premiums taxes. These include all job creation credits, worker training credits, investment and construction credits, manufacturing credits, donation credits, development zone project credits, and historic structure and mill rehabilitation credits. In addition, the credit against the gross premiums tax for payments of assessments by insurance companies to the North Carolina Insurance Guaranty Association would be repealed.

The only credits that would remain are the R&D credit, the low-income housing credit and credits granted as part of an incentive package, such as the major recycling facility credit.

Combined Reporting

Before the commencement of this legislative session, the General Assembly's Revenue Laws Study Committee had considered a proposal backed by the Department of Revenue to require corporations engaged in a unitary business to file a combined report. The proposal does not include a provision requiring combined reporting.

Changes to Apportionment Formula - Adoption of Throwout Rule

For purposes of apportioning both a corporation's franchise tax base and business income, North Carolina currently employs a limited throwback rule under which sales to a state where the taxpayer is taxable only on nonbusiness income are included in the numerator of the North Carolina apportionment factor.

The proposal would replace North Carolina's limited throwback rule with a throwout rule. Under a throwout rule, sales to customers in states where the taxpayer is not taxed (whether s a result of a lack of nexus or because the destination state does not assert its jurisdiction) are excluded from both the numerator and denominator of the apportionment factor. The result is to apportion the taxpayer's income from the sale among all the states where the corporation actually pays tax.

IRC Conformity

The proposal would apparently conform to the changes made to the Internal Revenue Code by the Emergency Economic Stabilization Act of 2008 ("EESA"), which provided favorable depreciation rules for certain classes of property including qualified leasehold improvements, restaurant improvements, qualified retail improvements, farming business machinery, motorsports facilities, biomass ethanol plant property and Indian reservation property. The EESA also included favorable expensing provisions for environmental remediation costs, film and television production costs and qualified refinery property.

The proposal would also apparently partially conform to the amendments to the Code made by the American Recovery and Reinvestment Act of 2008 ("ARRA"), which provided for the deferred recognition of certain cancellation of indebtedness income, the extension of generous section 179 expense deduction limitations and the extension of the 50% bonus depreciation deduction for property placed in service before 2010. The proposal would apparently conform to the ARRA except that the 50% bonus depreciation deduction for property placed in service in 2009 would apparently be limited to 50% of 85% of the property's adjusted basis.

Privilege Taxes

The proposal would eliminate all state and local privilege license taxes such as those currently imposed on attorneys, accountants and other professionals, finance companies, publishers of newsprint publications and installment paper dealers.

William W. Nelson is a Partner in Smith Anderson's Tax Group

A link to his bio is provided here.