



➤ **SUBJECT**

**NORTH CAROLINA PASSES TAX REFORM: THE TAX SIMPLIFICATION AND REDUCTION ACT OF 2013**

➤ **SUMMARY**

North Carolina legislators finally reached a compromise with regard to tax reform after months of debate and numerous proposals. The North Carolina legislature passed House Bill 998, The Tax Simplification and Reduction Act of 2013 (H.B. 998 or the “Act”),<sup>1</sup> which Governor Pat McCrory signed into law on July 24, 2013. The Act generally reduces income taxes for both corporations and individuals, and expands the scope of the sales and use tax to include certain services.

The Act includes the following changes to North Carolina’s tax regime:

- Replaces the graduated personal income tax rate regime with a flat tax rate;
- Repeals numerous personal income tax modifications and credits against personal income taxes;
- Repeals the estate tax, applicable to the estates of decedents dying after 2012;
- Reduces the corporate income tax rate;
- Extends the research and development credit an additional two years while allowing other incentive tax credits to sunset as scheduled;
- Modifies the sales and use tax rates applied to sales of manufactured and modular homes;
- Extends the sales tax to certain services and repeals certain sales and use tax exemptions effective January 1, 2014; and
- Caps the state gas tax rate beginning October 1, 2013, until June 30, 2015.

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<sup>1</sup> H.B. 988 was passed on July 17, 2013. The text of the Act may be viewed at [ncleg.net/Applications/BillLookup/LoadBillDocument.aspx?SessionCode=2013&DocNum=6936&SeqNum=0](http://ncleg.net/Applications/BillLookup/LoadBillDocument.aspx?SessionCode=2013&DocNum=6936&SeqNum=0).

## ➤ DETAILS

### *Personal Income Tax Changes*

North Carolina's individual income tax has a graduated rate structure with individual income taxed at progressively higher percentages.<sup>2</sup> The Act replaces North Carolina's graduated personal income tax rates with a flat tax of 5.8 percent during the 2014 taxable year and 5.75 percent for post-2014 taxable years. Currently the personal income tax rates range from six percent to 7.75 percent. While the Act eliminates the personal exemption, it increases the standard deduction from \$3,000 to \$7,500 for single taxpayers or married taxpayers filing as single; from \$4,400 to \$12,000 for single taxpayers filing as head of household; and from \$6,000 to \$15,000 for married taxpayers filing jointly.<sup>3</sup>

The Act maintains the unlimited deductibility of charitable contributions and caps the personal residence mortgage interest and real property tax deduction on primary residences at \$20,000. Effective beginning with the 2014 taxable year, the Act repeals the \$50,000 deduction for net business income, the deduction of retirement income and severance wages, contributions to the Parental Savings Trust Fund of the State Education Assistance Authority, fire fighters, rescue squad workers, educator expenses, and compensation for erroneous conviction and imprisonment. The Act retains the exemption for social security income from state taxes.

The Act also increases the personal income tax child care credit from \$100 to \$125 for joint filers making up to \$40,000. Credits scheduled to sunset in 2014 including the long-term care insurance credit, earned income refundable tax credit and adoption expenses credit, sunset as scheduled under the Act in 2014. However, the Act eliminates numerous other credits, including the credits for child care, certain employment-related expenses, the disabled, educational expenses, taxes paid on certain federal retirement benefits, certain real property donations, and charitable contributions by non-itemizers.

### *Estate Tax Changes*

The Act repeals the state's estate tax effective retroactively for estates of decedents dying on or after January 1, 2013. Previously, North Carolina imposed an estate tax when a federal estate tax was imposed on the estate, and likewise matched the federal estate tax exemption of \$5.25 million per person.<sup>4</sup>

### *Corporate Income Tax Changes*

The Act also reduces the current 6.9 percent corporate income tax rate to six percent for taxable years beginning on or after January 1, 2014, and to five percent for taxable years beginning on or after January 1, 2015. The rate will be further reduced to four percent in 2016 and to three percent for post-2016 taxable years provided that specified revenue growth targets are reached. If the targets are not reached each

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<sup>2</sup> N.C.G.S. Sec. 105.134.2(a).

<sup>3</sup> North Carolina's current standard personal income tax deduction may be found at N.C.G.S. Sec. 105-134.6(a2).

<sup>4</sup> N.C.G.S. Sec. 105.32.2.

year, the corporate income tax rate will remain at the five percent rate effective starting in 2015.

The Act also extends the research and development credit until January 1, 2016, but allows other incentive tax credits to sunset as scheduled, including the credit for investment in renewable energy property which sunsets January 1, 2016. The Act also repeals a credit for developing certain interactive digital media or digital platforms effective January 1, 2014.

### **Corporate Franchise Tax - No Change**

The corporate franchise tax remained unchanged under the Act, despite having been expected to undergo significant reform, inasmuch as virtually all of the tax reform proposals had included numerous changes to the tax. The Act's only change to the franchise tax was to repeal the tax as it applies to electric power companies effective July 1, 2014,<sup>5</sup> and instead tax electricity under the state sales tax. Instead, the Act directed the Revenue Laws Study Committee to study the "simplification of the franchise tax base calculation and the elimination of the franchise tax," and report its findings along with recommended legislation to the 2014 Regular Session of the 2013 General Assembly when it convenes again next year.

### **Sales and Use Tax Changes**

The state sales and use tax rate for manufactured homes and on modular homes, currently imposed at two percent and 2.5 percent, respectively,<sup>6</sup> will increase to the general rate of 4.75 percent effective January 1, 2014, under the Act. However, both manufactured and modular homes under the Act will be excluded from the one percent local sales and use tax as of January 1, 2014.

The Act also extends the state's sales tax to "service contracts," defined as warranty agreements, maintenance agreements, repair contracts or other agreements, or contracts to maintain or repair tangible personal property, effective January 1, 2014. Moreover, electricity and piped natural gas will no longer be subject to North Carolina gross receipts or excise taxes but instead will be subject to the sales and use tax at the combined general sales and use tax rate, effective for gross receipts billed on or after July 1, 2014.<sup>7</sup> The combined general sales and use tax rate is the state general rate (4.75 percent) plus the sum of the rates of the authorized local sales and use taxes for every county in North Carolina, resulting in a combined tax rate between 6.75 percent and 7.5 percent.<sup>8</sup>

In addition, the privilege tax on admissions to places of entertainment is repealed. However the sales tax under the Act is now expanded to include admissions to entertainment activities, including charges for live performances, movies, and museums, effective January 1, 2014. The Act also repeals certain sales tax holidays

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<sup>5</sup> Currently, North Carolina imposes a gross receipts franchise tax on electric power companies at 3.22 percent of the total gross receipts received from the sale of electricity, electric lights, current, or power. See N.C.G.S. Sec. 105-116(a).

<sup>6</sup> N.C.G.S. Secs. 105-164.4(a)(1a) and 105-164.4(a)(8).

<sup>7</sup> In addition to the gross receipts franchise tax on electric power companies (fn. 5, *supra*), North Carolina currently imposes an excise tax on piped natural gas received in lieu of a sales and use tax based on monthly therm volumes of piped natural gas received by the end user of the gas. See N.C.G.S. Sec. 105-187.41.

<sup>8</sup> The combined sales and use tax rates most recently published by the North Carolina Department of Revenue were effective April 1, 2013, a copy of which can be viewed at [www.dornc.com/taxes/sales/salesrates\\_4-13.html](http://www.dornc.com/taxes/sales/salesrates_4-13.html).

and repeals exemptions for bakery thrift shops, certain newspaper sales, nutritional supplements sold by chiropractic physicians, and meals served to students in private educational or student organization dining rooms, effective January 1, 2014.

Finally, the Act installs a cap on the North Carolina gas tax beginning October 1, 2013, until June 30, 2015, at 37.5 cents per gallon. The tax rate on motor fuel recently rose on July 1, 2013, from 37.5 cents per gallon to 37.6 cents per gallon.<sup>9</sup>

## ➤ INSIGHTS

North Carolina tax reform has been discussed and debated for many years. The Act reduces individual and corporate income tax rates and limits deductions while broadening the sales tax base to include some services. The Act moves North Carolina towards consumption-based taxes while the reduced income-based tax rates make the state more rate-competitive with its neighbors.

North Carolina taxpayers should evaluate the impact that the Act may have on their future tax liabilities. Please contact your trusted advisor at Williams Overman Pierce, LLP if you would like to discuss North Carolina's tax reform or would like assistance in evaluating the Act's impact on your future North Carolina tax liabilities.

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<sup>9</sup> N.C.G.S. 105-449.80. The motor fuels tax rates most recently published by the North Carolina Department of Revenue were effective June 15, 2013, a copy of which can be viewed at [www.dor.state.nc.us/taxes/motor/rates.html](http://www.dor.state.nc.us/taxes/motor/rates.html).