North Carolina Tax Reform – Are You and Your Company Ready?

Written By Lee C. Hodge (lch@wardandsmith.com)

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The North Carolina General Assembly is poised to modernize the state's tax code to reflect its current services-based economy. You and your company need to be prepared for the changes that appear to be coming your way.

Overview

The North Carolina General Assembly appears ready to focus on tackling tax reform during the General Assembly's upcoming 2013 "long" session. While previous state leaders have advocated reforming the state's tax code in a number of different ways, none of these previous efforts has resulted in any significant changes to the way North Carolina generates tax revenue. However, the current leaders of the General Assembly have made reforming the state's tax code one of their top priorities. Legislative leaders argue that the state's current taxing system is based on an antiquated set of assumptions applicable when North Carolina's economy was based on textile and other forms of manufacturing and, as a result, stifles economic growth in our post-industrial, services-oriented world. As explained in more detail in this article, their solution is to broaden the application of the state's sales tax and lower the state's personal and corporate income tax rates. They are confident that these changes will better reflect the services-based nature of North Carolina's modern economy and create an environment where businesses will flourish. You and your company need to be aware of the changes that appear to be coming your way so that your voice can be heard during the upcoming tax reform debate and you can begin planning for the changes in state taxation.

North Carolina's Current Tax Code

North Carolina's current tax code relies on personal income, corporate income, and sales taxes to generate the lion's share of the tax revenue taken in by the state on an annual basis. Of these different tax regimes, the personal income tax currently generates a majority of the revenue, with the sales tax and corporate income tax generating lesser, but still substantial, amounts.

North Carolina's personal income tax currently applies to income received by North Carolina residents and is imposed on a graduated rate scale that begins at 6% and increases to 7.75% as the amount of taxable income increases. The state's corporate tax currently applies to income generated by a business from North Carolina-based sources and is imposed at a flat rate of 6.9%. The state's sales tax currently applies to sales and certain leases of tangible personal property such as computer equipment, desks, and similar items. The state portion of the sales tax is imposed at a flat rate of only 4.75%, but each county is authorized to impose an additional amount of sales tax on purchases and leases of tangible personal property within each county's respective jurisdictional boundaries.

North Carolina's personal income, corporate income, and sales tax provisions are replete with tax exemptions and other special rules that have been put in place over time to benefit specific policies or industries after heavy lobbying from proponents of the policies and participants in each of those industries. Legislative leaders argue that these special exemptions and rules make the state's tax code incomprehensible and unworkable for the large majority of the state's business owners and taxpayers.

A couple of examples of these exemptions and special rules include a 35% tax credit for qualified investments in certain renewable energy systems and a $1,500 cap on the sales tax applicable to aircraft or boats purchased in North Carolina, regardless of their actual sales price.

Additionally, legislative leaders argue that the state's top personal income tax rate of 7.75% and flat 6.9% corporate tax rate are so much higher than those of other states in the southeastern United States that companies choose to do business in states other than North Carolina in order to take advantage of those lower tax rates.

The Proposal – Lower the Personal and Corporate Rates and Broaden the Application of the Sales Tax

While legislative leaders have not provided any specific details on their tax reform initiatives, it is clear that the guiding principle will be to lower the state's personal and corporate income tax rates while broadening the categories of transactions to which the state's sales tax applies, accompanied by a possible increase in the sales tax rate.

The leaders have indicated their belief that a move to a consumption-based taxing system would better reflect the current nature of North Carolina's economy, which has moved from a manufacturing base to a services base. They also feel that such a system would enable the state to make more accurate tax revenue projections, which would aid in the crafting of the state's budget on an on-going basis.

As with any other legislative initiative, there will be winners and losers if the state's tax code is reformed. One clear result of the proposed tax reform initiative will be the imposition of sales tax on service transactions that currently are not taxed. For example, information technology companies that render consulting services to other companies will have to charge and collect sales tax with respect to these service transactions. They will also be charged, and will have to pay, sales tax on their purchase of legal, accounting, consulting, and other services.

Another clear result of the proposed tax reform initiative will be the removal of certain deductions, exemptions, and credits from the state's tax code to which taxpayers have become accustomed and which are used to guide their personal and business behavior. Of course, the beneficiaries of those tax benefits likely will engage in lobbying efforts to protect them. However, each company and each industry will have to analyze the details of each specific tax reform proposal to determine whether its total tax liability will change if the proposal is implemented.

Strategy – Be Prepared and Engage in the Tax Reform Debate

It will be imperative that your company and industry engage in the tax reform debate in North Carolina in order to protect your company's bottom line. To effectively respond to any tax reform proposal, you first need to understand how the state's tax code currently impacts your company. This process requires input from your company's accountants, employees, and lawyers. Only by first determining the provisions of the current tax code that increase and/or decrease your company's tax liability can you position your company to influence leaders of the General Assembly to keep in place the provisions of the state's tax code that decrease your company's tax liability and to avoid new provisions that will increase it.

Summary

The leaders of North Carolina's General Assembly have made reforming North Carolina's tax code one of their top priorities for the General Assembly's 2013 "long" session. This will not be an easy task, but the leaders are confident that moving to a consumption-based tax system will better enable the state to attract and retain businesses. There likely will be several competing tax reform proposals, each of which will probably include some provisions that will benefit you and/or your business, and some which may hurt one or the other, or both. In order to protect your and/or your business's bottom line, it is imperative that you analyze the current and proposed tax provisions so that you can effectively engage in the tax reform debate and seek to protect tax provisions that are beneficial to you and/or your company.

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