

# NORTH CAROLINA GENERAL ASSEMBLY



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## REVENUE LAWS STUDY COMMITTEE

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**REPORT TO THE  
2019 SESSION  
of the  
2020 GENERAL ASSEMBLY  
OF NORTH CAROLINA**

**MAY 13, 2020**

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# LETTER OF TRANSMITTAL

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**REVENUE LAWS STUDY COMMITTEE**  
*State Legislative Building*  
*Raleigh, North Carolina 27603*

*Representative Julia C. Howard, Co-Chair*

*Senator Paul Newton, Co-Chair*

**May 13, 2020**

TO THE MEMBERS OF THE 2019 REGULAR SESSION  
OF THE 2020 GENERAL ASSEMBLY

**The REVENUE LAWS STUDY COMMITTEE, respectfully submits the following report to the 2019 Regular Session of the 2020 General Assembly.**

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Rep. Julia C. Howard (Co-Chair)

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Sen. Paul Newton (Co-Chair)

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# COMMITTEE MEMBERSHIP

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2019-2020

**President Pro Tempore of the Senate**  
**Appointments:**

Sen. Paul Newton (Co-Chair)

Sen. Ralph Hise (Vice-Chair)  
Sen. Jerry W. Tillman (Vice-Chair)  
Sen. Harry Brown  
Sen. Ben Clark  
Sen. Chuck Edwards  
Sen. Milton F. "Toby" Fitch, Jr.  
Sen. Kathy Harrington  
Sen. Bill Rabon  
Sen. Terry Van Duyn

**Committee Assistants:**

Cameron Dawson

**Research Division:**

Cindy Avrette, Staff Attorney  
Nicholas Giddings, Staff Attorney  
Trina Griffin, Staff Attorney  
Greg Roney, Staff Attorney  
Melissa Zbikowski, Research Assistant

**Speaker of the House of Representatives**  
**Appointments:**

Rep. Julia C. Howard (Co-Chair)

Rep. Stephen M. Ross (Vice-Chair)  
Rep. Kelly M. Alexander, Jr.  
Rep. Dana Bumgardner  
Rep. Becky Carney  
Rep. Chris Humphrey  
Rep. Robert T. Reives, II  
Rep. Mitchell S. Setzer  
Rep. John Szoka  
Rep. Harry Warren  
Rep. John Hardister (Advisory Member)  
Rep. Kelly E. Hastings (Advisory Member)  
Rep. Keith Kidwell (Advisory Member)  
Rep. David R. Lewis (Advisory Member)

**Bill Drafting Division:**

Dan Ettafagh, Staff Attorney

**Fiscal Research Division:**

Rodney Bizzell, Fiscal Analyst  
Barry Boardman, PhD, Economist  
Denise Canada, Fiscal Analyst  
Jonathan Tart, Fiscal Analyst

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# COMMITTEE PROCEEDINGS

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The Revenue Laws Study Committee is established in Article 12L of Chapter 120 of the General Statutes to serve as a permanent legislative commission to review issues relating to taxation and finance. Before it was created as a permanent legislative commission in 1997, the Revenue Laws Study Committee was a subcommittee of the Legislative Research Commission. It has studied the revenue laws every year since 1977. The Committee consists of 20 members, 10 appointed by the President Pro Tempore of the Senate and 10 appointed by the Speaker of the House of Representatives.<sup>1</sup> Committee members may be legislators or citizens. The Co-Chairs for 2019-2020 are Representative Julia Howard and Senator Paul Newton.

In its study of the revenue laws, G.S. 120-70.106 gives the Committee a very broad scope, stating that the Committee "may review the State's revenue laws to determine which laws need clarification, technical amendment, repeal, or other change to make the laws concise, intelligible, easy to administer, and equitable." A copy of Article 12L of Chapter 120 of the General Statutes is included in Appendix A.<sup>2</sup> A committee notebook containing the Committee minutes and all information presented to the Committee is filed in the Legislative Library and may also be accessed online at the Committee's website: <http://www.ncleg.net/DocumentSites/committees/revenuelaws/Homepage/index.html>.

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<sup>1</sup> The Speaker of the House of Representatives appointed a ninth, non-voting advisory member in 2007. In S.L. 2009-574, the General Assembly expanded the legislative membership of the Committee from 16 members to 20 members. In 2009, the Speaker appointed a twelfth non-voting advisory member. In 2013, the Speaker appointed five non-voting advisory members and the Senate appointed two.

<sup>2</sup> The General Assembly established a permanent subcommittee under the Revenue Laws Study Committee to study and examine the property tax system in S.L. 2002-184, s. 8. However, subcommittee members were not appointed and the subcommittee did not function from 2004 through 2010. In S.L. 2011-266, s.1.15, the General Assembly repealed the subcommittee. The full Committee continues to review the property tax system and recommend changes to it.

The Revenue Laws Study Committee met four times after the adjournment of the 2019 Regular Session of the 2020 General Assembly on January 14, 2020. The following is a brief summary of the Committee's proceedings. Detailed minutes and information from each Committee meeting are available in the Legislative Library. Appendix D contains a copy of the Committee's agenda for each meeting. The materials distributed at the meetings may be viewed on the Committee's website: <http://www.ncleg.net/committees/>. The Committee received numerous requests from legislators, taxpayers, the Department of Revenue, and interest groups to study various issues of tax policy and tax administration. The Committee considered many issues but was unable to take up all the issues suggested to it. The Committee considered all proposed tax changes in light of general principles of tax policy and as part of an examination of the existing tax structure as a whole.

### **2019 FINANCE CHANGES**

During the Committee's meeting on January 29, 2020, the Revenue Laws Committee heard an overview of the State and local revenue sources from Emma Turner, Fiscal Research Division, and a presentation from Nick Giddings, Legislative Analysis Division, covering the tax changes made during the 2019 Session of the North Carolina General Assembly. [State and Local Revenue Overview](#). [Revenue Laws 2019 Finance Changes Presentation](#).

### **IRC UPDATE**

North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.<sup>3</sup> The General Assembly determines each year whether to

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<sup>3</sup> North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

*(footnote continued)*

update its reference to the Code.<sup>4</sup> Updating the reference makes recent amendments to the Code applicable to the State to the extent that State law previously tracked federal law. Maintaining conformity with federal tax law simplifies tax reporting because a taxpayer will not need to account for differing federal and State treatment of the same asset.

Congress enacted Public Law 116-94 on December 20, 2019. The Committee reviewed the tax changes made by that legislation at its meeting on February 12, 2020 and recommended at the March 11, 2020 meeting to conform to the changes made to the medical expense deduction and to decouple from three other "extenders".

Congress enacted Public Law 116-136 on March 27, 2020. The Committee reviewed the tax changes made by that legislation at its meeting on May 13, 2020 and recommended that the State decouple from these changes at this time. Part I of Legislative Proposal #1 contains the Committee's IRC Update recommendations.

## **VARIOUS SALES TAX CHANGES**

### **Clarification of Taxability of Certain Digital Property**

During the Committee's meeting on February 12, 2020, Trina Griffin of the Legislative Analysis Division, presented to the Committee an update on digital property tax and online learning: [Digital Property Tax and Online Learning Presentation](#).

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<sup>4</sup> The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation ... shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would ... be invalidated as an unconstitutional delegation of legislative power."

In 2017, 15% of college students were enrolled in completely online courses. North Carolina is a member of the streamline tax agreement called the Streamlined Sales and Use Tax Agreement (SST). The SST arose out of issues created by the difficulty of imposing state and local taxes on digital purchases of products and services made across state lines, particularly when the business involved in the transaction does not have a physical presence in the state where the purchase was made. Member states are not required to tax digital products, nor do member states have to align their tax policies with everything in the agreement. States do not have to tax all of the digital products that other states choose to tax and they can also tax additional items that are not taxed in other states. States cannot impose a tax on an online version of a service if the equivalent of the offline version is not taxed per federal legislation. North Carolina made a change to this taxation last year. The General Assembly passed a bill that made it clear that there does not have to be an actual, tangible version of the digital product.

The UNC system raised questions about the impact it would have over how their online courses would be taxed since they would be considered audio/visual digital taxable products. Members were asked to think about how they would want to define the courses, what other conditions should be added to those courses, and how broad to make to law to avoid violating federal law.

Legislative Proposal #2 would do the following:

- Allow nonprofit and governmental entities to apply for a State and local sales tax refund for sales tax paid on certain digital property, to the same extent as allowed for local school administrative units.
- Clarify that the economic nexus threshold applies only to remote marketplace facilitators. Marketplace facilitators that have a physical presence in North Carolina are required to collect and remit sales tax on the first dollar of sales sourced to this State.

- Clarify that a digital code is taxed in the same manner as the certain digital property for which the digital code relates.
- Require marketplace facilitators who transact retail sales of prepared food and beverage to collect and remit local meals tax to the taxing city or county and codifies into the General Statutes the existing definition of "prepared food and beverages" used by the five localities with a meals tax.

### *Auctioneers and Estate Sales*

On March 11, 2020, the Committee heard a presentation from Trina Griffin, Legislative Analysis Division, covering sales and use tax changes for auctioneers and estate sale companies. Currently, auctioneers who buy or acquire tangible personal property by consignment or otherwise that they sell at retail must register with the Department of Revenue and collect and remit sales tax on the sales. This longstanding principle has remained unchanged for many years, but the passage of the marketplace facilitator provision has resulted in a re-examination of some aspects of this industry.

Legislative Proposal #2 would do the following:

- Expand on the sales tax exemption with respect to the purchase of certain animals by qualifying farmers to include livestock. "Livestock" is defined to mean cattle, sheep, goats, swine, horses, and mules. The current exemption applies only to baby chicks and poults.
- Authorize the Secretary of Revenue of compromise the liability of an auctioneer with respect to the sale of livestock at auction for which the auctioneer failed to collect sales tax if the taxpayer can demonstrate a good faith effort to comply with the tax laws, which would include being registered as a retailer by July 1, 2020. This ability to compromise liability

would apply only to tax due for a reporting period ending prior to July 1, 2020. This provision recognizes that there may have been some confusion or lack of clarity in the auctioneer industry with respect to sales tax collection obligations and gives the Secretary flexibility in the event an auctioneer is assessed for failure to collect. However, by no later than April 1, 2020, all auctioneers will have been notified by the Department, through both email and regular mail, as to their registration and collection obligations.

- Provide a five-month grace period to businesses that conduct tag sales or estate sales at either a person's home or farm without risk of assessment by the Department for failure to collect tax. The intent is to afford these businesses who previously did not have to collect tax with additional time to come into compliance with the marketplace facilitator provision that became effective February 1, 2020

### **Large Fulfillment Facilities**

On March 11, 2020, Ms. Griffin's presentation also covered the law relating to fulfillment centers. In 2017, the General Assembly enacted a sales and use tax exemption for certain equipment purchased by a "large fulfillment facility." A large fulfillment facility is a facility used primarily for receiving, inventorying, sorting, repackaging, and distributing finished retail products for the purpose of fulfilling customer orders. 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. There is a forfeiture provision in the event the employment level at the facility drops below 400.

Legislative Proposal #2 would expand the sales tax exemption for equipment, accessories, attachments, and repair parts purchased by a large fulfillment facility to include the following:

- When these items are purchased by a contractor or subcontractor if the purchase is for use in the performance of a contract with the facility.
- Equipment used for baling previously used packaging for resale, sanitizing as required by federal law, and material handling.

The Proposal also provides a limited refund provision in the event a large fulfillment facility makes purchases of this equipment prior to July 1, 2020, when the exemption would become effective.

## **LOCAL OPTION SALES TAX (LOST)**

### **Modernizing the LOST Distribution**

During the Committee's meeting on January 29, 2020, Denise Canada, Fiscal Research Division, presented an overview of the State sales tax laws, and how the LOST piggybacks the State sales tax and how LOST is distributed among the counties and cities. [Overview of State and Local Sales and Use Tax](#). During the Committee's meeting on February 12, 2020, Denise Canada, Fiscal Research Division, and Ernest Irving, North Carolina Department of Revenue, presented on distribution of LOST and possible steps for modernizing the distribution formula. They stated up front that the options presented were just a few of countless possibilities and that the presentation did not serve as an endorsement of any given option. [Modernizing the State's Local Sales Tax Distribution](#).

The current formula uses two main elements as the basis for distribution – point-of-sale and per capita. Urban counties and high-tourism counties often prefer the point-of-sale method, which distributes the revenue collected in a manner proportionate to where

the purchases were made. The per capita method distributes the sales tax revenue collected based on the number of residents in the county, a method preferred among more rural counties. Over time, the General Assembly has layered new policy decisions on top of older ones, resulting in many "redistributions" stacked together.

The presentation shared formulaic changes that could simplify the distribution, modernize it to use current data, and be more transparent. It suggested that many of the existing redistributions could be eliminated if the formula added two additional elements: one based upon property tax data and one based upon an equity factor allocation which would allocate a small percentage of the total local sales tax revenue to every city and county based on the county's population. The updated formula that staff presented would consist of allocating 60% on a point-of-sale basis, 30% on a per capita basis, 7% on an ad valorem basis, and 3% on an equity basis. While there would be some losses and some gains at the individual county level, the change would be minimal. All individual county losses would be within 5%, and all individual county gains would be within 10% of the current allocation they receive.

Members engaged in a discussion regarding *ad valorem* rates and whether steps should be taken to modernize the formula. Ernest Irving agreed to provide figures of yearly estimates to the Committee. During the Committee's meeting on March 11, 2020, Ernest Irving, North Carolina Department of Revenue, and Denise Canada, Fiscal Research Division, provided a follow up handout with the [Yearly Estimates of Local Sales Tax Distributions to the Counties, with Options for Modernization](#) and were available for follow up questions. The Committee did not choose to make any recommendations for adjusting the LOST distribution formula to the 2020 Session but did express a desire to continue its study.

### **LOST Flexibility**



The Committee heard a presentation from Trina Griffin, Legislative Analysis Division, on flexibility for LOST. Counties are seeking additional revenue for various projects, such as school construction and renovations, infrastructure upgrades, road construction and street improvements, dredging and beach nourishment, and economic development. However, most counties are not levying their maximum LOST authority. Counties have authority to levy a 2% LOST, under Articles 39, 40, and 42 collectively. All counties levy this 2% and share it with their municipalities. Counties have authority to levy an additional  $\frac{1}{4}$ -cent or  $\frac{1}{2}$ -cent LOST under Article 43, but only for public transit purposes. Most counties do not have public transit needs large enough to justify this levy. Counties may also levy an additional  $\frac{1}{4}$ -cent under Article 46 for any public purpose with a referendum. Forty-two counties have enacted this LOST, but 34 counties have had failed attempts to enact the unrestricted tax and 24 counties have never attempted to enact the unrestricted tax.

The Committee did not choose to make any recommendations to LOST flexibility for the 2020 Session. It noted that if the goal is to enable counties to more aptly use this additional sales tax authority, then one proposal would be to make the following adjustments:

- **SHIFT OR UNRESTRICT UNUSED TAXING AUTHORITY.** Article 43 of Chapter 105 authorizes a local sales and use tax for financing public transportation systems. Rate of tax varies based on county:  $\frac{1}{2}\%$  - Durham, Forsyth, Guilford, Mecklenburg, Orange, and Wake. These counties may only levy  $\frac{1}{2}$ -cent for this purpose; no option to levy  $\frac{1}{4}$ -cent. Counties currently levying are Durham, Mecklenburg, Orange, and Wake.  $\frac{1}{4}\%$  - All other counties (94) with no counties levying. In recent years, there have been legislative attempts to create an alternative “restricted use” local sales tax for public education, shift unused taxing authority under Art. 43 to Art.

46, which would provide additional general purpose revenue, and provide a combination of both, with a maximum rate limitation.

- SPECIFY BALLOT QUESTION. Article 46 authorizes levy of ¼-cent local sales and use tax if approved in a referendum; 42 counties levy this tax. The ballot question is set in statute and cannot be modified without legislation. Current question does not specify purpose and, therefore, tax proceeds may be used for any public purpose. In recent years, there have been legislative attempts to provide specified purpose in ballot question, including public education/school construction, infrastructure upgrades/maintenance, beach nourishment/dredging, road construction/street improvements, economic development, and public safety.

### **TAX AND FINANCE PROVISIONS WITH SUNSETS**

On March 11, 2020, the Revenue Laws Committee heard a presentation from Cindy Avrette, Legislative Analysis Division, regarding the sunsets on tax and finance provisions. [Tax and Finance Provisions with Sunsets](#). The provisions covered by this review included the following:

1. G.S. 105-237.1(a)(6): Compromise of Liability, sunset date: July 1, 2020
2. G.S. 105-275(7a): Property Classified and Excluded from the Tax Base, sunset date: July 1, 2021
3. G.S. 105-277.9A: Reduced Assessment for Improved Property in Certain Roadway Corridors, sunset date: July 1, 2021
4. G.S. 105-269.8: Contribution of tax refund to the Cancer Prevention and Control Branch of the Division of Public Health, sunset date: January 1, 2021

5. G.S. 160A-239.1: Special Assessment District (SAD) Revenue Bond authority, sunset date: July 1, 2020
6. G.S. 153A-210.1: Special Assessment District (SAD) Revenue Bond authority, sunset date: July 1, 2025
7. G.S. 153A-210.1(a1): Special Assessment District (SAD) Revenue Bond authority, sunset date: July 1, 2022

The Committee agreed that the first three sunset provisions had served their intended purpose and did not need to be extended. The Committee agreed to extend the ability of taxpayers to donate all or a portion of their tax refund to the Cancer Prevention and Control Branch of the Division of Public Health. The sunset extension is contained in Legislative Proposal #1.

The Committee raised questions about the special assessment district revenue bond authority and the differing sunset dates between the county's authority and the municipal authority. Sam Watts, North Carolina Department of State Treasurer, explained the bonding authority and the high interest rates and administrative costs usually associated with it. He noted there have been two cities that have used the authority, Morrisville and Hillsborough, and that no new deals were pending. The members asked if the municipalities had any comments or concerns. Erin Wynia, Chief Legislative Counsel, North Carolina League of Municipalities, responded that this bonding authority is uniquely made for large projects. She acknowledged that it has not widely used and expressed her concern that the sunset might prevent municipalities from using this authority in situations where it may prove useful. The League would like the municipal 2025 sunset to remain. The Committee decided to extend the county sunset to the same date as currently exist for the municipal authority, July 1, 2025. The extension of this sunset date is incorporated into Legislative Proposal #1.

## **REVENUE LAWS TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES**

The Revenue Laws Study Committee is charged with reviewing the State's revenue laws to determine which laws need clarification, technical amendment, repeal, or other change to make the laws concise, intelligible, easy to administer, and equitable. The Department of Revenue submitted a list of tax law changes for the Committee to consider. The Legislative Proposal consists of many of the recommendations submitted to the Committee by the Department. The Committee reviewed a proposal at its February meeting, and another proposal at its March meeting. The Committee posted both proposals on its website and invited interested parties to review them and to contact the Committee's staff with any questions, concerns, or suggestions. The two proposals were combined, along with the IRC Update bill draft and the tax sunset extensions, into Legislative Proposal #1.

### **KAESTNER OVERVIEW**

The Committee heard an educational presentation from Greg Roney, Legislative Analysis Division, on the recent US Supreme Court case of *NCDOR v. Kaestner*. [Overview of US Supreme Court Decision in Kaestner Presentation](#). The US Supreme Court held that a trust lacked sufficient connection for the State to tax the trust's income where the beneficiary lived in the State but the trustee, records, and investments were located outside of the State. The US Supreme Court focused on three factors: (1) the beneficiary received no trust income, (2) the beneficiary had no right to demand trust income, and (3) the beneficiary was uncertain to ever receive a specific share of trust income. The US Supreme Court did not define what connection, in addition to the presence of a beneficiary, would allow a state to tax the income of a trust. Income from property with a physical presence

in a state, such as land and tangible personal property, is subject to tax by the state where the property is physically located. After the Kaestner decision, State law remains valid because the decision held State law unconstitutional "as applied" to the facts in the case. The NC Department of Revenue is processing refund claims where trusts claim that the Kaestner analysis applies and the State lacks sufficient connections to tax the trust's income.

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## FINDINGS AND RECOMMENDATIONS

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The Revenue Laws Study Committee makes the following recommendations to the 2020 General Assembly. The proposal is followed by an explanation and, if it has a fiscal impact, a fiscal memorandum, indicating any anticipated revenue gain or loss resulting from the proposal.

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