A TIME FOR ACTION: REFORMING THE NORTH CAROLINA TAX CODE*

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The economic recession has forced almost all states to make difficult budget decisions, including cuts to education funding and other essential government services. North Carolina is no exception. Faced with a projected $4.6 billion budget shortfall, the General Assembly last year cut services, increased taxes, and yet still had to rely on federal recovery funds to balance the budget. While the depth of the recession may have made last year's budget shortfall to some extent unavoidable, the state's outdated and volatile tax system exacerbated its magnitude. This Article examines the shortcomings of North Carolina's existing tax structure. It then suggests alternatives to modernize the state's tax system and stabilize tax revenues. These suggestions include broadening the sales tax base to include more services and closing existing corporate income tax loopholes. Reforms to the North Carolina tax system are long overdue. This Article provides a pathway to improving that system and calls for legislators to enact long-term solutions to the problems hampering North Carolina's existing tax code. Ultimately, failure to do so will risk the state's ability to continue providing much-needed services and educational opportunities to its citizens.

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INTRODUCTION

North Carolina's fiscal health is faltering. A lack of revenue caused lawmakers to appropriate approximately $660 million less toward public education and $760 million less toward health and human services in 2010 than necessary to continue 2009-level services.[1] These spending cuts have real consequences for the lives of many of the state's most vulnerable citizens.[2] Nevertheless, the cuts were driven by the fact that the state collected $3 billion less than it expected in tax revenue during fiscal year 2009,[3] and faced a projected $4.6 billion shortfall in 2010 unless it reduced spending.[4]

The most obvious factor in the state's lower-than-expected revenues for 2009 was the so-called "Great Recession,"[5] which

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1. Elaine Mehia, Meg Graywiehe & Stephen Jackson, North Carolina Budget & Tax Center, *The 2009–2011 State Budget: Trifecta of Spending Cuts, Tax Increases and Federal Aid Used to Address Historic Shortfall*, BTC REPORTS (N.C. Budget & Tax Center, Raleigh, N.C.), Sept. 2009, at 1, 7–12, *available at* http://www.ncjustice.org/sites/default/files/BTC%20Reports%20-%20The%202009-2011%20State%20Budget-WEB.pdf. *See generally* N.C. GEN. ASSEMBLY, JOINT CONFERENCE COMMITTEE REPORT ON THE CONTINUATION, EXPANSION AND CAPITAL BUDGETS, 202, 1st Sess. (2009), *available at* http://www.ncga.state.nc.us/fiscalresearch/budget_legislation/budget_legislation_pdfs/2009_JointConferenceCommitteeReport_SB202_2009_08_03.pdf (detailing the differences between the 2009 and 2010 North Carolina state budget).

2. *Effects of State Budget Cuts Trickle Down to Taxpayers*, WOSCTV.COM, Dec. 21, 2009, http://www.wsoctv.com/news/22029914/detail.html; *see also* Nicholas Johnson, Phil Oliff & Erica Williams, *An Update on State Budget Cuts*, UPDATE (Ctr. on Budget & Pol'y Priorities, Washington, D.C.), Mar. 8, 2010, at 1, *available at* http://www.cbpp.org/files/3-13-08sfp.pdf ("The cuts enacted in at least 45 states plus the District of Columbia in 2008 and 2009 occurred in all major areas of state services, including health care (29 states), services to the elderly and disabled (24 states and the District of Columbia), K-12 education (29 states and the District of Columbia), higher education (39 states), and other areas.").

3. North Carolina collected $16.8 billion in tax revenue in fiscal year 2009, which ran from July 1, 2008 through June 30, 2009. Pol'y Analysis & Statistics Div., N.C. Dep't of Revenue, Statistical Abstract of North Carolina Taxes tbl.2 (2009) http://www.dornc.com/publications/abstract/2009/index.html [hereinafter Statistical Abstract] (follow "Part II" hyperlink; then follow "Table 2" PDF hyperlink). The state budgeted for $19.8 billion in tax revenue for that same period. OFFICE OF STATE BUDGET & MGMT., SUMMARY OF RECOMMENDATIONS 2009–2010, at 26 (2009), *available at* http://www.osbm.state.nc.us/new_content/historical_budget_data.pdf. The state collected $1.3 billion more in tax revenues in fiscal year 2008 than in fiscal year 2009. *Id.*

4. BARRY BOARDMAN & EVAN RODEWALD, N.C. GEN. ASSEMBLY FISCAL RES. DIV., REVISED REVENUE AND BUDGET OUTLOOK 9 (2009), http://www.ncga.state.nc.us/fiscalresearch/generalfund_outlook/generalfund_outlook_pdfs/2009%20Outlooks/Revised%20Revenue%20and%20Budget%20Outlook%20FER%2020090505v2.pdf.

5. Catherine Rampell, *"Great Recession": A Brief Etymology*, ECONOMIX, Mar. 11, 2009, http://economix.blogs.nytimes.com/2009/03/11/great-recession-a-brief-etymology/.

adversely affected tax collections in practically every state.[6] Even so, the recession impacted North Carolina more heavily than many other states[7] in part because of the state's antiquated, Depression-era tax system.[8] Recognizing that North Carolina's outdated tax code exacerbated the revenue shortfall brought about by the recession, leaders in the General Assembly proposed substantial tax reforms during the 2009 legislative session.[9] Ultimately, however, lawmakers failed to reach consensus on any major reform and instead enacted several temporary tax increases that closed the immediate budget gap but failed to address the tax code's underlying problems. Even with those tax increases and the substantial spending cuts mentioned above, legislators still had to rely on $1.4 billion of federal stimulus funds to balance the budget for 2010.[10]

So far, fiscal 2010 tax revenues look comparable to 2009.[11] Economists, including the state's chief economist, project that the

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6. *See* NAT'L GOVERNORS ASS'N & NAT'L ASS'N OF STATE BUDGET OFFICERS, FISCAL SURVEY OF STATES, at vii (2009), *available at* http://www.nasbo.org/Publications/FiscalSurvey/tabid/65/Default.aspx ("States will have faced $256 billion in budget gaps between fiscal 2009 and fiscal 2011.").

7. *See* U.S. CENSUS BUREAU, STATE GOVERNMENT TAX COLLECTIONS IN 2009, at 1 (2010), *available at* http://www2.census.gov/govs/statetax/2009stcreport.pdf (showing that North Carolina had the fourteenth largest percentage drop in tax collections among the states between 2008 and 2009).

8. The last major reform to the North Carolina tax system occurred in the 1930s with the enactment of the state sales tax. *See* Summary of Remarks by Dr. Charles D. Liner, *History of State and Local Tax Policy in North Carolina*, *in* INTERIM REPORT TO THE 1999 GENERAL ASSEMBLY OF NORTH CAROLINA, 2000 REGULAR SESSION, at Exhibit B 1, 1 (2001), *available at* http://ia301513.us.archive.org/2/items/northcarolinatax00nort/northcarolinatax00nort.pdf ("If for no other reason, we need to study our tax history because our tax structure is now almost 70 years old.").

9. N.C. SENATE FIN. COMM., 21ST CENTURY TAX RATE REDUCTION AND MODERNIZATION PLAN 3–4 (2009), *available at* http://www.ncchamber.net/docs/Advo/SenateTaxReformProposal_042209.pdf; *see also* Brian Balfour, *Senate Tax Plan to Raise Taxes $1.7 Billion While Offering Numerous Changes*, JOHN WILLIAM POPE CIVITAS INSTITUTE, Apr. 28, 2009, http://www.jwpcivitasinstitute.org/media/publication-archive/policy-brief/senate-tax-plan-raise-taxes-1-7-billion-while-offering-numero ("[T]he Senate's proposal includes perhaps the most drastic changes to North Carolina's tax structure in 70 years.").

10. U.S. GOV'T ACCOUNTABILITY OFFICE, RECOVERY ACT (NORTH CAROLINA) NC-2 (2009), *available at* http://161.203.16.70/recovery/pdfs/2009-september/gao-recovery-sept-2009-nc-appendix.pdf.

11. As of November 2009, year-to-date tax revenues were slightly lower than at the same time in 2008. OFFICE OF THE STATE CONTROLLER, STATE OF NORTH CAROLINA GENERAL FUND MONTHLY FINANCIAL REPORT 3 (2009), *available at* http://www.ncosc.net/pdfs/nov09.pdf. In particular, individual income tax revenues were approximately $250 million (6.2%) lower through November 2009 as compared to November 2008. *Id.* The situation is not as startling as in fiscal 2009, however, because the budgeted tax and non-tax revenues for fiscal 2010 are approximately $2.4 billion less than for fiscal 2009. *Id.*

unemployment problems and other effects of the recession will be felt throughout 2010 and may extend substantially longer.[12] In other words, the present economic situation could linger, perhaps for years. Despite the prospect of an extended economic malaise, the General Assembly's 2009 budget-saving tax increases are only temporary. They expire in 2011.[13] By then, the state will have used all of its federal stimulus funds, and there is no guarantee that the federal government will again step in with additional funds to rescue state budgets. With no assurance that the federal government will provide future rescue funds, and with the possibility of a looming budget crisis in fiscal year 2011–2012, the need for substantive tax reform is more pressing now than at any other time in recent history.[14]

12. Barry Boardman, Chief Economist, N.C. Gen. Assembly, Remarks at the NCACC Tax and Finance Steering Committee Meeting 14 (Nov. 17, 2009), *available at* http://www.ncacc.org/committees/tax/09_1117_ppt.ppt ("For the state, the intensity of the recession may be easing, but a robust recovery is not on the foreseeable horizon."); *see also* Elizabeth McNichol & Nicholas Johnson, *Recession Continues to Batter State Budgets; State Responses Could Slow Recovery*, UPDATE (Ctr. on Budget and Pol'y Priorities, Washington, D.C.), Feb. 25, 2010, at 1, 4, *available at* http://www.cbpp.org/files/9-8-08sfp.pdf ("As we look ahead to 2011 and beyond, even as the economy appears to be moving in the direction of recovery, states' fiscal prospects remain extremely weak."); Nat'l Governor's Ass'n, State Fiscal Update 2 (Feb. 2010) http://www.nasbo.org/LinkClick.aspx?fileticket=qiFQdi7tlbU%3d&tabid=38 ("States foresee fiscal year 2011, which starts for most states July 1, 2010, to be the most difficult to date, and few see fiscal year 2012 much better.").

13. Current Operations and Capital Improvements Appropriations Act of 2009, 2009-4 N.C. Adv. Legis. Serv. 284, 500–01, §§ 27A.1(a)–(b) (LexisNexis) (sunset for corporate and individual income tax surcharges is set for taxable years beginning on or after January 1, 2011); 2009-4 N.C. Adv. Legis. Serv. 284, 502, § 27A.2 (one percent sales tax increase scheduled to expire July 1, 2011). North Carolina is not alone in enacting temporary tax increases. *See* Nicholas Johnson, Catherine Collins & Ashali Singham, *State Tax Changes in Response to the Recession*, UPDATE (Ctr. on Budget and Pol'y Priorities, Washington, D.C.), Mar. 8, 2010, at 4, *available at* http://www.cbpp.org/files/3-8-10sfp.pdf ("Of the $30 billion in new taxes [enacted by states in fiscal year 2008–2009], as much as $20 billion will expire by December 2011—some even sooner.").

14. *See* BARRY BOARDMAN, N.C. GEN. ASSEMBLY FISCAL RES. DIV., GENERAL FUND REVENUE REPORT AND ECONOMIC OUTLOOK 13 (2010), http://www.ncga.state.nc.us/fiscalresearch/generalfund_outlook/generalfund_outlook_pdfs/2010%20Outlooks/General_Fund_Revenue_Outlook_2010_01_13.pdf. ("A looming issue on the horizon will be the FY 2011-12 revenue picture. Temporary taxes are set to expire, fiscal stimulus money dries up, and early projections indicate revenue growth will not be sufficient to close the gap."). The General Assembly recognized the need for long-term reform in its 2009 budget bill, which provides that "[t]he President Pro Tempore of the Senate and the Speaker of the House of Representatives authorize the Finance Committees of the Senate and the House and other designated members to meet during the interim to study and recommend legislation to reform North Carolina's sales and income tax structure in order to broaden the tax base and lower the State's tax rates." 2009-4 N.C. Adv. Legis. Serv. 284, 520, § 27A.7 (LexisNexis).

Part I of this Article explains the structural shortcomings of North Carolina's current tax system. Part II then examines the changes to the state tax code enacted by the 2009 General Assembly and explains why those changes fail to address the problems plaguing North Carolina's tax system. The Article concludes by presenting alternatives to improve the state tax code.

I. PROBLEMS WITH THE EXISTING TAX STRUCTURE

North Carolina's three major revenue sources—the individual income tax, the sales tax, and the corporate income tax—all suffer from significant shortcomings. In general terms, each of these taxes applies too high a rate to too narrow a base. This combination of high rates and narrow tax bases has resulted in an unpredictable and volatile tax system that serves the interests of neither the taxpayers nor the legislators responsible for crafting the state's budget. Problems with each of the state's major revenue sources are detailed below.

A. *The Overworked Individual Income Tax*

For the last fifteen years, North Carolina has received on average approximately fifty percent of the state's tax revenues from the individual income tax.[15] Other states derive only thirty-four percent of their total tax revenues from the individual income tax.[16] Most states rely on more stable sources of revenue—like the sales tax or property tax—for a greater proportion of their overall tax collections.[17] North Carolina's disproportionate dependence on the individual income tax makes the state's revenue stream relatively volatile. When salary cuts,[18] job losses,[19] and investment losses[20] occur, as they have in the most recent recession, tax revenues fall more precipitously in North

15. *See id.*

16. U.S. CENSUS BUREAU, *supra* note 7, at 1.

17. *See id.*

18. Kathleen Madigan, *More Firms Cut Pay to Save Jobs*, WALL ST. J., June 9, 2009, at A4 (stating that more than half of human resources executives surveyed said their companies had instituted salary cuts or freezes in an effort to cut costs).

19. North Carolina's seasonally adjusted unemployment rate rose from 6.1% in June 2008 to 11% in June 2009. DAVID T. MCCOY, N.C. OFFICE OF THE STATE CONTROLLER, NORTH CAROLINA FINANCIAL HIGHLIGHTS: FISCAL YEAR END JUNE 30, 2009, at 4, http://www.ncosc.net/financial/popular09_.pdf. Revenues derived from the state individual income tax fell by approximately $2 billion between fiscal year 2007–08 and fiscal year 2008–09. *Id.* at 8.

20. S. Mitra Kalita, *Americans See 18% of Wealth Vanish*, WALL ST. J., Mar. 13, 2009, at A1 (reporting that U.S. households' net worth tumbled by $11 trillion in 2008).

Carolina than in states that depend less on the individual income tax.[21]

In addition to the state's overdependence on the individual income tax, North Carolina is one of only nine states that calculates income taxes by starting with federal taxable income rather than federal adjusted gross income.[22] Federal taxable income is a narrower base than adjusted gross income. Taxpayers calculate their adjusted gross income by deducting from gross income only above-the-line deductions.[23] In contrast, taxpayers calculate their federal taxable income by reducing their gross income by both above- and below-the-line deductions.[24]

By starting with a narrower tax base, North Carolina has to apply a higher tax rate to generate the same amount of revenue as other states.[25] North Carolina's top marginal income tax rate (7.75%) is the highest in the Southeast.[26] It is the thirteenth highest in the nation.[27] The high rate puts North Carolina at a competitive disadvantage in attracting high-earning individuals (and the businesses for which they work) to the state.[28]

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21. U.S. CENSUS BUREAU, *supra* note 7, at 1 (noting a dramatic decrease in tax revenue in several states in 2009).

22. Fed'n of Tax Adm'rs, State Personal Income Taxes: Federal Starting Points (Feb. 2010), http://www.taxadmin.org/fta/rate/stg_pts.pdf.

23. I.R.C. § 62 (2006).

24. I.R.C. § 63(a). A taxpayer may also calculate federal taxable income by taking the standard deduction. I.R.C. § 63(b). Above-the-line deductions are those set forth in I.R.C. § 62 and include trade and business deductions as well as deductions for alimony payments, moving expenses, interest payments on education loans, and health savings account contributions. Below-the-line deductions are all other deductions.

25. *See* Tax Found., State Individual Income Tax Collections Per Capita, Fiscal Year 2007, http://www.taxfoundation.org/files/indincome_state_collfy07-20090205.pdf (ranking North Carolina twelfth among states with respect to income tax collections per capita).

26. *See* STATISTICAL ABSTRACT, *supra* note 3, at tbl.22 (follow "Part III" hyperlink; then follow "Table 22" PDF hyperlink). As of January 1, 2010, other southeastern states' top marginal rates were:

Alabama	5%
Georgia	6%
South Carolina	7%
Tennessee	No income tax on earned income
Virginia	5.75%

Fed'n of Tax Adm'rs, State Individual Income Taxes (Feb. 2010), http://www.taxadmin.org/FTA/rate/ind_inc.pdf.

27. Fed'n of Tax Adm'rs, *supra* note 26.

28. *See* Barry W. Poulson & Jules Gordon Kaplan, *State Income Taxes and Economic Growth*, 28 CATO J. 53, 67 (2008) ("[H]igher marginal tax rates [have] a negative impact on economic growth in the states.").

North Carolina's individual income tax is also less progressive than in many other states.[29] North Carolina has a relatively low standard deduction[30] and few tax brackets (only three: 6%, 7%, 7.75%).[31] As a result, lower and middle class North Carolinians typically pay more in income taxes than similarly situated residents of other states. A recent study by the Institute on Taxation and Economic Policy found that only six states require their poorest residents to pay a higher proportion of their earnings in income taxes than North Carolina.[32]

B. The Constantly-Increasing Sales Tax

North Carolina's sales tax rate remained constant at three percent from its inception in 1933[33] through 1991.[34] Since 1991, however, the General Assembly has increased the sales tax rate numerous times to maintain revenues in the face of a continuously eroding sales tax base. Lawmakers have enacted five increases in the sales tax rate over the last twenty years, including the most recent one percent increase during the 2009 legislative session.[35] The state sales tax rate is presently set at 5.75%.[36]

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29. *See* Tax Admin., 2009 State Tax Revenue, http://www.taxadmin.org/fta/rate/09taxbur.html (last visited Apr. 11, 2010) (showing North Carolina as having the twenty-second highest total taxes as a percentage of personal income among the states).

30. North Carolina's standard deduction is not indexed for inflation, like the federal standard deduction. *See* N.C. GEN. STAT. § 105-134.6(c)(4) (2009); *see also* Tax Found., State Individual Income Tax Rates 2009, http://www.taxfoundation.org/files/state_ind_income_rates-20090710.pdf (noting that only ten states have lower standard deduction amounts than North Carolina).

31. *See* N.C. GEN. STAT. § 105-134.2(a).

32. CARL DAVIS ET AL., INST. ON TAX'N AND ECON. POL'Y, WHO PAYS? A DISTRIBUTIONAL ANALYSIS OF THE TAX SYSTEMS IN ALL 50 STATES 83 (3d ed. 2009), *available at* http://www.itepnet.org/whopays3.pdf.

33. Eric Gooch, N.C. Dep't of Revenue, Sales and Use Taxes, Presentation to the Tax Fairness Study Commission (Jan. 13 & Apr. 6, 1988) *in* SYNOPSIS OF STATE AND LOCAL TAX MATERIAL PRESENTED TO TAX FAIRNESS STUDY COMMISSION, at IV-9 (June 1988).

34. INST. OF GOV'T, UNIV. OF N.C. AT CHAPEL HILL, STATE AND LOCAL GOVERNMENT RELATIONS IN NORTH CAROLINA: THEIR EVOLUTION AND CURRENT STATUS 58–59, 61 (Charles D. Liner ed., 2d ed. 1995) (giving brief historical context to the enactment of the sales tax).

35. *See* Cindy Avrette, Research Div., N.C. Gen. Assembly, *Historical Overview*, *in* STUDY OF NORTH CAROLINA'S TAX STRUCTURE: OVERVIEW OF NORTH CAROLINA SALES TAX, at slide 19 (2009), http://www.ncleg.net/documentsites/committees/jhsfctr/Meeting%20Documents/11-3-2009%20Meeting/Overview%20of%20NC%20Sales%20Tax.pdf.

36. 2009-4 N.C. Adv. Legis. Serv. 284, 501, § 27A.2(b) (LexisNexis). In addition, all counties charge at least another 2% in local sales tax, meaning that the combined state and local sales tax rate in most of North Carolina is 7.75%. It is slightly higher in Mecklenburg

Recent increases in the sales tax rate have been necessary to prevent a drop in tax revenues that otherwise would have occurred because of changing spending patterns. Since its enactment, the state's sales tax has applied primarily to the purchase and sale of tangible goods.[37] Over the last several decades, however, consumer spending has shifted away from the purchase of tangible goods and toward the consumption of services. In 1970, tangible goods accounted for thirty-nine percent of household spending; services comprised thirty-one percent.[38] By 2007, these spending patterns reversed completely with spending on tangible goods falling to thirty-one percent of household spending while services rose to forty-five percent.[39]

North Carolina's sales tax has failed to adjust to this change in consumer spending patterns, with the result that the sales tax base has gradually eroded over time. In other words, consumers are spending proportionately less of their money on items that are subject to the state sales tax. Consequently, the General Assembly has continually had to increase the sales tax rate to prevent a drop in revenues brought in by the tax.

The Federation of Tax Administrators maintains a list of 168 services potentially subject to state sales taxation.[40] In its most recent survey of states, North Carolina taxed thirty services.[41] On average, states tax fifty-seven services, and thirty-two states tax more services than North Carolina.[42] A handful of states tax more than 150 services.[43]

Lawmakers' attempts to increase the sales tax rate to keep up with the eroding tax base have failed. In 1970, the sales tax comprised

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and a handful of other counties. N.C. Dep't of Revenue, Important Notice: State and Local Sales and Use Tax Rate Change Issues (Oct. 2009), http://www.dornc.com/taxes/sales/impnotice1009_2.pdf.

37. *See* N.C. GEN. STAT. § 105-164.4(a)(1) (2009) (applying the sales tax to "each item or article of tangible personal property that is sold at retail").

38. *See* MICHAEL MAZEROV, CTR. ON BUDGET & POL'Y PRIORITIES, EXPANDING SALES TAXATION OF SERVICES: OPTIONS AND ISSUES 13 (2009), http://www.cbpp.org/files/8-10-09sfp.pdf.

39. *See id.*

40. *FTA Survey of Services Taxation—Update*, BY THE NUMBERS (Fed'n of Tax Adm'rs, Washington, D.C.), July 2008, at 2, http://www.taxadmin.org/fta/pub/services/btn/0708.pdf.

41. *Id.*

42. *Id.*

43. Tax Admin., Number of Services Taxed by Category and State (July 2007), http://www.taxadmin.org/fta/pub/services/btn/0708.html#table. (Hawaii—160, New Mexico—158, Washington—158).

thirty percent of the state's total tax revenues;[44] in 1990, twenty-seven percent.[45] Despite the five increases in the rate since 1991, over the last decade the sales tax comprised an average of only twenty-six percent of the state's tax revenues.[46] The decline in the proportion of revenues brought in by the sales tax has caused a greater reliance on the individual income tax, with all its attendant problems described above.

C. The Unpredictable Corporate Income Tax

North Carolina's corporate income tax has become a completely unpredictable source of revenue. Corporate tax revenues swing wildly, as evidenced by a year-over-year comparison of net collections: up sixteen percent in 1999; down twenty-six percent in 2001; up fifty-two percent in 2005; down twenty-five percent in 2009.[47] General economic conditions undoubtedly play a prominent role in these fluctuations. The effect of general economic conditions is exacerbated, however, by the prevalence of income-shifting, tax-avoidance strategies employed by large multi-state corporations.

North Carolina's corporate income tax statutes require multi-state businesses to file separate tax returns for affiliated corporations.[48] This means that if a business has an affiliate incorporated in North Carolina and another incorporated in Delaware, each of these affiliates files separate tax returns with North Carolina, assuming that they both have sufficient contacts with the state to create "tax nexus."[49] If the Delaware affiliate has no tax nexus with North Carolina, it is not required to file a return with the state.[50] North Carolina's separate reporting requirement contrasts with the approach taken by most other states, which requires that affiliated companies file a combined tax return if they are engaged in a unitary

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44. N.C. DEP'T OF REVENUE, TAX RESEARCH DIV., STATISTICS OF TAXATION 17 tbl.6 (1972).

45. OFFICE OF THE N.C. AUDITOR, SINGLE AUDIT REPORT: FISCAL YEAR ENDED JUNE 30, 1990, at 91 (1990).

46. *See* STATISTICAL ABSTRACT, *supra* note 3, at tbl.2 (follow "Part II" hyperlink; then follow "Table 2" PDF hyperlink).

47. *Id*. at tbl.21 (follow "Part III" hyperlink; then follow "Table 21" PDF hyperlink).

48. N.C. GEN. STAT. § 105-130.14 (2009) (stating that no corporation shall file a consolidated return unless specifically directed to do so by the Secretary of Revenue).

49. "Tax nexus" requires that a corporation have a "sufficient connection or relationship with the state" for the state to tax it. RICHARD D. POMP & OLIVER OLDMAN, 3 STATE & LOCAL TAXATION 10-7 to -8 (3d ed. 1998).

50. N.C. GEN. STAT. § 105-130.14.

business, so long as at least one of those affiliates has tax nexus with the state.[51]

North Carolina's separate reporting requirement creates the opportunity for multi-state corporations to shift income away from entities subject to North Carolina's relatively high corporate income tax[52] and into affiliates organized in low-tax states. For example, parent corporations have previously caused their North Carolina subsidiaries to enter into lease agreements with affiliates incorporated in low-tax states.[53] The North Carolina corporations then claim deductions for payments made to the out-of-state affiliates. If the out-of-state affiliates have no tax nexus with North Carolina, the out-of-state affiliates need not pay taxes to North Carolina on the lease payments received from the North Carolina corporations. This strategy reduces the amount of the North Carolina corporations' taxable income, effectively narrowing the corporate income tax base in North Carolina.

Strategies like the leasing arrangement described above would not work if North Carolina required combined, rather than separate, reporting. Under a combined reporting requirement, corporations operating a "unitary business"[54] must file a combined tax return even though one or more out-of-state affiliates, standing alone, lacks tax nexus with the state.[55] This effectively eliminates the income-shifting strategy described above because the incomes of both the North Carolina corporation and the out-of-state affiliate would be reported

51. *See* 2007–2008 REVENUE LAW STUDY COMM., REPORT TO THE 2009 GENERAL ASSEMBLY OF NORTH CAROLINA 8 n.8 (2009) (listing twenty-two states that had adopted combined reporting as of February 2009). Since that time, Wisconsin has also adopted combined reporting, bringing the total number of states requiring combined reporting up to twenty-three. *See* WIS. STAT. § 71.255(2) (2009).

52. North Carolina has a flat 6.9% corporate income tax rate. N.C. GEN. STAT. § 105-130.3.

53. *See* Wal-Mart Stores East, Inc. v. Hinton, 676 S.E.2d 634, 638–40 (N.C. App. 2009) (describing an affiliate leasing strategy); *see also* A&F Trademark, Inc. v. Tolson, 167 N.C. App. 150, 152–53, 605 S.E.2d 187, 189 (2004) (noting that affiliated companies entered into a trademark licensing arrangement in an effort to shift income out of North Carolina).

54. The determination of whether corporations are engaged in a "unitary business" varies to some extent from state to state, but the U.S. Supreme Court has offered guidance as to the scope of this concept in a series of cases. *See* Container Corp. of Am. v. Franchise Tax Board, 463 U.S. 159, 178 (1983) ("The prerequisite to a constitutionally acceptable finding of unitary business is a flow of *value*, not a flow of goods."); Mobil Oil Corp. v. Comm., 445 U.S. 425, 438 (1980) (observing that a unitary business is characterized by "functional integration, centralization of management, and economies of scale").

55. *See* JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION 8-186 (3d ed. 1999) ("Combined reports . . . or the determination of a taxpayer's liability on a combined basis, may include corporate affiliates that are not taxable by the state.").

to North Carolina. As a result, the deduction taken by the North Carolina corporation for the lease payment would be cancelled out by the income recognized by the out-of-state affiliate for receiving that same payment. In other words, combined reporting removes the incentive to shift income out of state, since that income will still be reported to the state.

The N.C. Department of Revenue has taken aggressive and, to date, relatively successful audit and litigation positions against income-shifting techniques like the leasing strategy described above.[56] Nevertheless, North Carolina's separate reporting requirement allows corporate taxpayers to continue to create new strategies as they attempt to move taxable income out of the state. Litigation efforts by the Department of Revenue and targeted statutory fixes enacted by the General Assembly to address specific income-shifting strategies[57] inevitably fall a step behind, as nimble corporate taxpayers constantly devise new strategies to reduce the amount of their income subject to North Carolina's relatively high (6.9%) corporate tax rate. Until the General Assembly enacts a combined reporting requirement, the Department of Revenue will continue to play a cat-and-mouse game of trying to keep up with the latest income-shifting strategy invented by sophisticated multistate corporations.

II. TAX CHANGES ENACTED BY THE 2009 GENERAL ASSEMBLY

In response to the $4.6 billion budget shortfall projected in 2010, the General Assembly last year enacted several tax increases. The most significant of these were (1) a one percent hike in the sales tax rate[58] and (2) a "surtax" on the income taxes of high-earning

56. *See Hinton*, 676 S.E.2d at 654 (holding that the Department of Revenue may force combined reporting when confronted with the affiliate leasing strategy described above); *A&F Trademark*, 167 N.C. App. at 162, 605 S.E.2d at 195 (holding that tax nexus exists when a corporation licenses trademarks and associated goodwill from its out-of-state affiliate); *see also* Mark Johnson, *State Resolves Corporate Tax Issues*, NEWS & OBSERVER (Raleigh, N.C.), Jan. 5, 2010, http://www.newsobserver.com/2010/01/05/269332/state-resolves-corporate-tax-issues.html?storylink=mirelated (stating that North Carolina's "corporate resolution initiative," targeting multi-state corporations accused of shifting income out of North Carolina, brought in $427 million in December 2009—$277 million more than expected).

57. *See* N.C. GEN. STAT. § 105-130.7A (2009) (addressing the trademark licensing situation involved in *A&F Trademark* by stating that "[r]oyalty payments received for the use of trademarks in this State are income derived from doing business in this State").

58. Current Operations and Capital Improvements Appropriations Act of 2009, 2009-4 N.C. Adv. Legis. Serv. 284, 501, §§ 27A.2(a)–(b) (LexisNexis).

individuals and all corporate taxpayers.[59] The surtax requires single taxpayers with taxable incomes in excess of $60,000 to increase the income taxes they would otherwise pay by an additional two percent; single taxpayers with taxable incomes of more than $150,000 face a three percent surtax.[60] So, for example, if a single taxpayer has taxable income of $75,000, the taxpayer would typically pay $5,235 in income taxes to North Carolina.[61] The surtax requires the taxpayer to pay an additional $105 to the state.[62] Married couples with taxable incomes of more than $100,000 will have to increase the income taxes they pay to the state by an additional two percent; those with taxable incomes of more than $250,000 must pay three percent more.[63] The corporate income tax surcharge requires all corporations to pay three percent more in taxes.[64]

These tax increases are expected to have a significant impact on tax revenues over the next two years. The one percent sales tax increase is expected to bring in an additional $803 million in 2010 and slightly over $1 billion in 2011.[65] The individual and corporate income tax surcharges are anticipated to generate a combined $196 million in 2010 and $203 million in 2011.[66]

While these tax increases responded to the pressing budget crisis faced by the state last year, they fail to confront the underlying problems with the state's tax system. The individual income tax surcharge only further deepens the state's dependence on the already overworked income tax. Increasing the sales tax rate for the fifth time in the last two decades fails to account for the shift in consumer spending that has created the need for so many recent rate increases. In addition, due to an overall reduction in consumer spending caused by the recession, sales tax revenues so far in fiscal year 2010[67] have

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59. *Id.* Two other tax increases enacted during the 2009 legislative session were the so-called "Amazon" tax—a tax on Internet downloads and "click-through" purchases—and increases in the excise tax on alcohol and tobacco products. 2009-4 N.C. Adv. Legis. Serv. 284, 502–18, §§ 27A.3–A.5.

60. 2009-4 N.C. Adv. Legis. Serv. 284, 500–01, § 27A.1(b).

61. N.C. Dep't of Revenue, Income Tax Surtax (2009), http://www.dornc.com/taxes/individual/surtax.html.

62. *Id.*

63. *Id.* For example, if married taxpayers filing a joint return have North Carolina taxable income of $150,000, their income tax owed is $10,538 and their surcharge is $211 (2% of $10,538). *Id.*

64. 2009-4 N.C. Adv. Legis. Serv. 284, 500, § 27A.1(a).

65. *Id.* at 288, § 2.2(a).

66. *Id.*

67. Fiscal year 2010 runs from July 1, 2009 through June 30, 2010. *See* DAVID T. MCCOY, NORTH CAROLINA FINANCIAL HIGHLIGHTS FISCAL YEAR END JUNE 30, 2009, at 1 (2009), www.ncosc.net/financial/popular09_.pdf.

failed to meet projections. As of January 2010, net sales tax collections were $120 million short of expectations and, when adjusted to take into account the increased rate, were approximately eleven percent behind 2009 collections.[68]

But perhaps the most troubling aspect of the sales and income tax increases enacted by the 2009 General Assembly is that they are both scheduled to sunset in 2011.[69] Consequently, unless the economy recovers before then, North Carolina legislators will again find themselves facing an all-too-familiar situation: confronted with a looming budget shortfall and an inadequate, antiquated tax system to deal with it.

III. THE WAY FORWARD

To provide for greater stability in its tax revenues, North Carolina must reduce its dependence on the individual income tax and derive a higher percentage of its revenue from a more reliable and broad-based sales tax. By broadening the sales tax base, the General Assembly could maintain overall revenue levels while reducing rates for both the income tax and the sales tax. This would make the state more competitive in attracting high-earning individuals. In addition, the General Assembly should enact a combined reporting requirement for multi-state corporations. Eliminating separate reporting would reduce the volatility of the corporate income tax and increase tax equity between large and small corporations.

A. Reducing Reliance on the Individual Income Tax by Broadening the Sales Tax Base

In fiscal year 2009, North Carolina derived approximately forty-seven percent of its total tax revenues from the individual income tax.[70] Only six states depended more heavily on the individual income tax than North Carolina.[71] North Carolina and these other income-tax-dependent states all faced substantial budget shortfalls in 2009. Figure 1 shows the source of revenues for each of these states in 2009, as well as their 2009 budget shortfalls as a percentage of their General Funds:

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68. BOARDMAN, *supra* note 14, at 3.
69. The corporate and individual income tax surtaxes are scheduled to sunset for taxable years beginning on or after January 1, 2011. 2009-4 N.C. Adv. Legis. Serv. 284, 500, § 27A.1(a).
70. BOARDMAN, *supra* note 14, at 1; U.S. Census Bureau, *supra* note 7, at 1.
71. U.S. Census Bureau, *supra* note 7, at 1.

Figure 1. State Government Tax Collections: 2009

Source of Tax Revenues (as % of total tax revenues)[72]						
	Property	**General Sales**	**Selective Sales**	**Individual Income**	**Corporate Income**	**Other**
Colorado		24.46	13.54	50.71	3.80	7.49
Connecticut		25.45	16.52	49.33	3.43	5.26
Georgia	0.51	33.00	10.54	48.52	4.32	3.10
Massachusetts		19.92	10.37	54.40	9.19	6.13
New York		17.03	14.09	56.65	6.81	5.42
North Carolina		24.22	16.91	46.64	4.40	7.82
Virginia	0.19	20.82	13.17	55.05	3.91	6.85
Average	0.35	23.56	13.59	51.61	5.12	6.01

	Budget Gap (as a % of General Fund)[73]
Colorado	14.2
Connecticut	15.5
Georgia	11.5
Massachusetts	18.5
New York	13.2
North Carolina	14.9
Virginia	13.8

On average, these seven states derived more than twice as much of their tax revenues from the individual income tax (51.61%) than from their next largest revenue source, the sales tax (23.56%).[74]

In contrast, the five states with the smallest budget gaps in fiscal year 2009 had relatively balanced sources of tax revenue. Figure 2 shows the sources of revenue for these states least affected by the recession, as well as their budget gaps (as a percentage of general fund) for fiscal year 2009:

72. Andrew J. Haile, State Government Tax Collections: 2009 (on file with the North Carolina Law Review).

73. ELIZABETH MCNICHOL & NICHOLAS JOHNSON, CTR. FOR BUDGET & POL'Y PRIORITIES, RECESSION CONTINUES TO BATTER STATE BUDGETS; STATE RESPONSES COULD SLOW RECOVERY 10 (2010), http://www.cbpp.org/files/9-8-08sfp.pdf.

74. *See* figure 1.

Figure 2. State Government Tax Collections: 2009

Source of Tax Revenues (as % of total tax revenues)[75]						
	Property	**Sales**	**Selective Sales**	**Individual Income**	**Corporate Income**	**Other**
Arkansas	9.82	37.04	13.19	29.98	4.64	5.34
Kansas	1.20	33.27	12.21	40.80	5.54	6.98
Louisiana	0.64	29.59	20.49	29.36	6.12	13.79
Oklahoma		26.50	12.20	31.18	4.20	25.92
South Dakota		56.72	24.52		3.66	15.11
Average (excluding South Dakota)	3.89	31.6	14.52	32.83	5.12	11.92

	Budget Gap (as a % of General Fund)[76]
Arkansas	2.4
Kansas	2.9
Louisiana	3.7
Oklahoma	1.7
South Dakota	2.2

Excluding South Dakota, which has no individual income tax, the states with the smallest budget gaps on average derived approximately the same proportion of their tax revenues from both the individual income tax (32.83%) and the general sales tax (31.60%).[77] In other words, the states least impacted by the recession had relatively balanced sources of revenue, while the states that relied most heavily on the individual income tax suffered major budget gaps.

To stabilize its revenues, North Carolina must shift some of its overall tax burden away from the individual income tax and onto a broadened sales tax base. Those states with broad-based sales taxes that apply to services as well as goods fared better than the most income tax-dependent states in 2009. Hawaii, New Mexico, and Washington have the broadest sales tax bases of any states.[78] They suffered budget gaps in fiscal 2009 of 7.3%, 7.5%, and 8.5%,

75. Haile, *supra* note 72.
76. MCNICHOL & JOHNSON, *supra* note 73, at 10.
77. *See* figure 2.
78. Based on a 2007 survey where officials from each state were asked to identify the taxable status of 168 different services, Hawaii taxes 160 services and New Mexico and Washington each tax 158 services. Fed'n of Tax Adm'rs, FTA Survey of Services Taxation—Update, at 2 (July 2008), http://www.taxadmin.org/fta/pub/services/btn/0708.pdf.

respectively,[79] substantially lower than the revenue shortfalls faced by the states that relied most heavily on individual income taxes.

North Carolina currently taxes relatively few services.[80] The state should broaden its sales tax base by applying the tax to more services. Which services to tax will almost certainly devolve into a political battle, as service providers that have previously benefited from the exclusion of their services from the sales tax will seek to maintain this competitive advantage.[81] Despite inevitable political pressures, however, legislators should determine which services to tax with two primary goals in mind: administrative ease and avoidance of tax "pyramiding."

Many service providers also sell tangible goods, which are already subject to the sales tax. For example, currently when a mechanic performs work on an automobile, the sales tax applies to parts sold by the auto shop but not to any services performed on the car. This results in an itemized bill setting out the amounts owed for parts and service separately in order to tax the parts but not the service. The sales tax could be extended to services of this type without causing significant administrative problems, since the service provider already charges sales tax for the tangible goods it sells. Taxing providers of both goods and services will facilitate the shift to a broader tax base because the merchants affected will already have experience in collecting and remitting the sales tax.

In addition, legislators should attempt to avoid taxing business inputs, as the burden for taxes on those inputs may ultimately pass through to end consumers.[82] For example, many businesses receive legal services, which are currently excluded from the sales tax. If the sales tax were extended to legal services, businesses paying taxes on those services would most likely pass their increased cost on to their end consumers. This means that end consumers could be forced to

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79. MCNICHOL & JOHNSON, *supra* note 73, at 10 tbl.4.

80. *See* Fed'n of Tax Adm'rs, *supra* note 78, at 2 (noting that of the 168 services in the survey, North Carolina taxes thirty).

81. *See* James Francis, *The Florida Sales Tax on Services: What Really Went Wrong?*, *in* THE UNFINISHED AGENDA FOR STATE TAX REFORM 129–45 (Steven D. Gold ed., 1988), *available at* http://www.leg.state.vt.us/jfo/Tax%20Commission/FL%20Sales%20Tax%20on%20Services.pdf (describing the political factors involved in Florida's failed attempt in 1987 to expansively tax services).

82. This principle was recognized in a report issued in 1991 by the North Carolina Economic Future Study Commission, which stated that "[t]he State sales tax should apply to goods and services purchased by individuals for personal use; services purchased primarily by businesses should not be included in the base of the tax." ECON. FUTURE STUDY COMM'N, FISCAL REALITIES FOR THE 90'S: REPORT OF THE ECONOMIC FUTURE STUDY COMMISSION 17 (1991).

bear multiple layers of sales tax—the tax on the product or service ultimately purchased and the tax on the business input used in getting to that end product or service, legal fees in this example. This layering of taxes on the end consumer is known as "tax pyramiding." The General Assembly should target services used primarily by end consumers, rather than services used by businesses, as a way of reducing the likelihood that end consumers will suffer from pyramiding and be forced to bear multiple layers of the sales tax.

By broadening the sales tax base to include services, the General Assembly would relieve some of the state's dependence on the income tax and, depending how broadly the sales tax base were extended, could potentially reduce the rates of the sales tax and income tax while still maintaining current revenue levels. A reduction in rates, particularly for the income tax, would make the state more attractive to high-earning individuals. Alternatively, the state could keep income tax rates the same but increase the standard deduction or exemption amounts so that fewer North Carolinians need to file income tax returns with the state. This would improve the progressivity of the state income tax. In either case, broadening the sales tax base will reduce the current over-dependence on the individual income tax and better balance North Carolina's sources of tax revenue. Deriving a greater share of tax revenues from the sales tax will also stabilize the state's revenues, as the sales tax has proven less volatile than the individual income tax.[83]

B. *Stabilizing the Corporate Income Tax*

Twenty-three states have eliminated the need to constantly combat corporate income-shifting strategies by requiring affiliated corporations engaged in a unitary business to file combined, rather than separate, tax returns.[84] By requiring unitary businesses to file combined returns, these states have removed the incentive to shift

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83. *See* Press Release, U.S. Census Bureau, Census Bureau Reports State Government Tax Collections Decrease $67 Billion in 2009 (Mar. 23, 2010), *available at* http://www.census.gov/Press-Release/www/releases/archives/governments/014633.html (stating that among all states individual income tax collections were down 11.8% in 2009, as compared to 5.4% for general sales tax collections). *See generally* Joseph Hasleg, Replacing Missouri's Income Tax Would Reduce Revenue Volatility, http://showmeinstitute.org/publication/id.173/pub_detail.asp (stating that from 1965 to 2006, annual income tax collections in the state of Missouri were 50% more volatile than sales tax collections) (last visited Apr. 29, 2010).

84. MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, A MAJORITY OF STATES HAVE NOW ADOPTED A KEY CORPORATE TAX REFORM—"COMBINED REPORTING" 1 (Apr. 3, 2009), http://www.cbpp.org/files/4-5-07sfp.pdf.

income out of corporations operating in the state and into affiliates located in lower-tax jurisdictions.

Numerous North Carolina legislative commissions and study groups have previously called for the General Assembly to adopt combined reporting.[85] Motivating these calls has been the recognition that "[b]usiness tax planning strategies . . . account for part of the decline in corporate tax revenues as a percentage of overall tax revenues [and] North Carolina's requirement that a corporation file as a separate entity enables many of these strategies."[86] To date, however, the legislative study commissions' calls for combined reporting have gone unheeded.[87]

The "strategies" to reduce corporate taxes that result from the separate reporting requirement are numerous:

> Firms can engage in blatant manipulation of the transfer price [for goods or services between affiliated entities] to shift income to or from a particular firm for tax or other reasons. In addition to selling tangible goods and services to manipulate profits, businesses are able to shift income to states with lower taxes by licensing intangible assets, such as patents and trademarks, selling management services, or loaning money to related firms. In many cases, a separately-incorporated entity will provide specialized services to operating entities that perform the business's basic functions, such as wholesaling or retailing. If the operating company is located in a separate reporting state, and the licensing company is located in a no-tax state, the business reduces taxable profits in the operating firm

85. *See, e.g.*, 2007–2008 REVENUE LAWS STUDY COMM., REPORT TO THE 2009 GENERAL ASSEMBLY OF NORTH CAROLINA 2009 SESSION 6 (2009), *available at* http://www.ncleg.net/documentsites/legislativepublications/Study%20Reports%20to%20the%202009%20NCGA/Revenue%20Laws.pdf ("The Revenue Laws Study Committee recommended to the 2007 Session of the General Assembly that the State consider changing how a corporation determines its net income" by moving to combined reporting); State & Local Fiscal Modernization Comm'n, Final Recommendations Rankings (Apr. 16, 2007), http://www.ncleg.net/DocumentSites/committees/FiscalModernization/Comission%20Meetings/April%2016/Final%20Recommendation%20Rankings.pdf (recommending that the General Assembly "[b]roaden the corporate income tax base by enacting a combined reporting regime for related entities"); N.C. GOVERNOR'S COMM'N TO MODERNIZE STATE FINS., FINAL REPORT 12 (2002), *available at* http://digital.ncdcr.gov/cdm4/document.php?CISOROOT=/p249901coll22&CISOPTR=3408&REC=1 (recommending that the state "[s]implify taxation by moving to combined reporting by related entities, as required at the federal level").

86. 2007–2008 REVENUE LAWS STUDY COMM., *supra* note 85, at 7.

87. *See infra* note 93 and accompanying text.

without imposing taxes on the firm located in the licensing state.[88]

The N.C. Department of Revenue and General Assembly have sought to prevent particular instances of these strategies through litigation and targeted statutory fixes,[89] but a case-by-case approach to combating tax avoidance is inevitably a costly and ineffective proposition. A move to combined reporting, on the other hand, would eliminate the opportunities and incentive to abuse the separate reporting regime.

In addition to preventing multistate corporations from shifting their income to other states, combined reporting would level the playing field between large, multistate corporations and small businesses operating only in North Carolina. These smaller, often family-owned businesses, lack the means to engage in sophisticated multistate tax planning. As a result, they are unable to gain the same tax advantage as their larger competitors. The need to ensure that sophisticated, multi-state corporations and smaller, family-owned corporations both bear their fair share of the state's corporate income tax burden has been recognized by the General Assembly's Revenue Laws Study Committee, which has expressed its support for combined reporting as a means of "provid[ing] a more level playing field for all businesses, both those that operate only in North Carolina and those that operate in multiple states."[90]

And yet, despite the numerous calls and sound, equitable reasons for adopting combined reporting, the General Assembly has failed to act. Almost certainly this is because of the substantial opposition to combined reporting presented by major multistate corporations operating in North Carolina.[91] Opponents to combined reporting typically argue that it will cause businesses to leave the state and will stunt economic development.[92] With more than half of the states that

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88. William F. Fox, Matthew N. Murray & LeAnn Luna, *How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?*, 58 NAT'L TAX J. 139, 145 (2005) (citations omitted).

89. *See supra* notes 52–54 and accompanying text.

90. *See* 2007–2008 REVENUE LAWS STUDY COMMITTEE, *supra* note 85, at 9–10.

91. *See* N.C. Chamber, N.C. Chamber Position on Combined Reporting (Nov. 19, 2008), http://www.ncleg.net/DocumentSites/committees/revenuelaws/2007-2008/Meeting%20Documents/Meetings%20for%20Report%20to%202009%20Session/19%20November%202008/NC%20Chamber%20Position%20on%20Combined%20Reporting.pdf (listing 34 major corporations operating in North Carolina as publicly opposing the enactment of combined reporting).

92. *See id.* (stating that the enactment of combined reporting in North Carolina would "have a chilling effect on the State's economic development climate"); *see also* COUNCIL

collect a corporate income tax now requiring combined reporting,[93] however, this argument rings hollow; particularly so when several of the states that have adopted combined reporting are the largest and most economically developed, such as New York and California.[94] Moreover, a 2009 study undertaken by the Center on Budget and Policy Priorities found that the vast majority of North Carolina's largest manufacturers have operations, and in many instances headquarters, in combined reporting states.[95] This indicates that combined reporting has not prevented these businesses, despite their protestations, from locating or continuing to operate in combined reporting states.

Moving from separate to combined reporting would stabilize the corporate income tax base by eliminating income-shifting strategies used by multistate corporations. It would enhance equity between large and small corporations, since large corporations would no longer be able to take advantage of tax-avoidance strategies generally unavailable to smaller corporations. Moreover, numerous states have used combined reporting for decades, and others have more recently moved to combined reporting,[96] without the resulting problems predicted by combined-reporting opponents. Now is the time for the General Assembly to heed the clear and consistent call to enact combined reporting.

CONCLUSION

The last major overhaul of North Carolina's tax system occurred in the early 1930s, in the midst of the Great Depression. At that time, North Carolina became one of the earliest states in the nation to enact a sales tax.[97] That forward-thinking reform ensured that the state had sufficient revenues to create the physical and educational

ON STATE TAXATION, COMBINED REPORTING: UNDERSTANDING THE REVENUE AND COMPETITIVE EFFECTS OF COMBINED REPORTING 2 (2008) ("Economic theory, empirical studies, and economic simulation modeling all suggest that switching from separate filing to combined reporting will have a negative impact on a state's economy.").

93. *See* MAZEROV, *supra* note 84, at 1.

94. *Id.*

95. MICHAEL MAZEROV, MOST LARGE NORTH CAROLINA MANUFACTURERS ARE ALREADY SUBJECT TO "COMBINED REPORTING" IN OTHER STATES: FEARS OF JOB LOSS FROM REDUCING CORPORATE TAX AVOIDANCE ARE UNWARRANTED 1 (Jan. 15, 2009), http://www.cbpp.org/files/1-15-09sfp-sum.pdf ("At least 60 of the 75 largest North Carolina manufacturers maintain a facility in at least one state that mandates combined reporting and therefore are subject to income taxes that implement this policy.").

96. *See* MAZEROV, *supra* note 95, at 2 (showing states that enacted combined reporting before 1985 and those that enacted it between 2004 and 2009).

97. *See* Liner, *supra* note 8, at 7.

infrastructure that eventually changed North Carolina from one of the poorest states in the nation to a model of economic growth and development.[98]

The state is now at a crossroads similar to the one it faced almost eighty years ago. Years of inaction by the General Assembly have resulted in a tax system that is out of balance and modeled on antiquated notions of consumer spending and single-state corporate activity. Each of the state's major taxes applies too high a rate to too narrow a base, leading to significant instability in revenues. It is time for an update.

In 1991, the Economic Future Study Commission wrote:

> Modernization . . . requires that the State tax system be made more responsive to future growth of income and consumption in North Carolina. If this goal is not achieved, then the General Assembly will be forced to resort time and again to *ad hoc* measures to increase revenues or curtail spending. By their nature, *ad hoc* revenue and expenditure adjustments under severe budget pressure are unlikely to contribute to tax equity or tax modernization, except by accident.[99]

These words could have been written just last year to summarize the General Assembly's decision to enact temporary tax increases to deal with a pressing budget gap exacerbated by the state's outdated tax system. Unlike that short-term fix, the proposals set forth in this Article are intended to create a more stable, balanced, and equitable tax system for years to come.

The stakes involved in the discussion of whether to undertake a substantial tax reform are momentous. Ultimately, this debate will determine whether the state can continue to provide essential services and world-class educational opportunities to its citizens.[100] Without real reform, the current economic conditions portend more ad hoc tax increases and spending cuts in response to future budget crises. The General Assembly showed great foresight by enacting the state sales tax in the 1930s. It is again time for such forward-thinking reforms to ensure the state's economic future.

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98. *See id.* at 1.

99. ECON. FUTURE STUDY COMM'N, FISCAL REALITIES FOR THE 90'S: REPORT OF THE ECONOMIC FUTURE STUDY COMMISSION 16 (1991).

100. *See* Chris Fitzsimon, Op-Ed, *Sinking State Revenues More Bad News for Important Services*, NEWS & RECORD (Greensboro, N.C.), Mar. 28, 2010, at H2 ("The Charlotte-Mecklenburg School Board last week voted to lay off 600 teachers. Officials in Wake County Schools are scrambling to identify more jobs to eliminate to find $20 million in budget reductions.").