2013-2014
REVENUE LAWS STUDY COMMITTEE

REPORT TO THE 2015-2016
GENERAL ASSEMBLY OF NORTH CAROLINA
2015 SESSION

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*All of the meeting handouts, including Power Point presentations, may be accessed online in PDF format at the Revenue Laws Study Committee website: http://www.ncleg.net/committees/revenuelaws

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

Senator Bill Rabon, Co-Chair ***Representative Julia C. Howard, Co-Chair***

January 13, 2015

TO THE MEMBERS OF THE 2014 GENERAL ASSEMBLY:

The Revenue Laws Study Committee submits to you for your consideration its report pursuant to G.S. 120-70.106.

Respectfully Submitted,

Sen. Bill Rabon, Co-Chair Rep. Julia C. Howard, Co-Chair

2013-2014

REVENUE LAWS STUDY COMMITTEE

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[1] Resigned 04-08-2014.

[2] Appointed 05-06-2014, to fill the unexpired term of Senator Dan Clodfelter. A former advisory member to the Committee.

PREFACE

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.[1] Committee members may be legislators or citizens. The Co-Chairs for 2013-2014 are Senator Bill Rabon and Representative Julia Howard.

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.[2] 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:

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[1] 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.

[2] 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.

http://www.ncleg.net/DocumentSites/committees/revenuelaws/Homepage/index.html.

COMMITTEE PROCEEDINGS

Last year the Revenue Laws Study Committee recommended an omnibus tax law changes bill to the 2014 General Assembly, House Bill 1050 and Senate Bill 763. The General Assembly enacted House Bill 1050, S.L. 2014-3. The omnibus bill did the following:

- It addressed questions and concerns surrounding the Tax Simplification and Reduction act enacted by the General Assembly in 2013, S. L. 2013-316.
- It replaced the corporate income tax deduction for net economic loss with a deduction for State net loss.
- It substantially changed the applicability of the sales tax laws to retailer-contractors, such as the major home improvement stores, when they are engaged in a performance contract rather than a retail sale.
- It enhanced the collection enforcement capabilities of the Department of Revenue by requiring a person to file all State tax returns and pay all State taxes to receive and hold an ABC permit.
- It provided for the central assessment of mobile telecommunications property by the State.
- It modified and repealed local privilege license taxes.
- It set the License Plate Agent transaction rate for the collection of property tax under the Tax & Tag Together program.
- It imposed an excise tax on vapor products.
- And made many other technical, clarifying, and administrative changes to the tax laws.

The Revenue Laws Study Committee met four times after the adjournment of the 2014 Regular Session of the North Carolina General Assembly. Appendix B contains a copy of the Committee's agenda for each meeting. All of the materials distributed at the meetings may be viewed on the Committee's website.[1] The Committee considered a broad array of issues. It considers 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.

REVENUE LAWS TECHNICAL CHANGES

After passage of the House Bill 1059 early in the 2014 Session, the companion bill, Senate Bill 763, became the primary vehicle for additional revenue laws technical changes and passed the Senate in late July. However, a number of substantive provisions were added to the bill on the House floor, in which the Senate did not concur. The non-roll call changes were then put into House Bill 1224 and the roll call technical changes were put into House Bill 189. Neither of those bills passed. The Committee reviewed these technical changes at the October 14, 2014, meeting and decided to recommend them to the 2015 General Assembly.

Legislative Proposal #1 incorporates the Revenue Laws technical changes that were circulated during the 2014 Session in Senate Bill 763, House Bill 1224, and House Bill 189, or some combination thereof. In addition to those changes, the Committee decided to make a few additional technical, clarifying, and administrative changes and they are included in Legislative Proposal #1.

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[1] http://www.ncleg.net/committees/revenuelaws

The Tax Simplification and Reduction Act and Utility Rates

The Tax Simplification and Reduction Act, S.L. 2013-316, included electricity and piped natural gas in the State sales tax base while repealing the utility franchise tax on electricity and the excise tax on piped natural gas. Section 4.2(a) of the Act directed the Utilities Commission to adjust the rates of electricity and piped natural gas to reflect the repeal of the utility franchise tax and the excise tax on piped natural gas. The Act also reduced the corporate income tax rate. However, the Act did not direct the Utilities Commission to take any action on utility rates related to the reduction in corporate income tax rates.

In May of 2014 the Commission issued an order directing utilities to adjust rates to reflect the repeal of the utility franchise tax, the repeal of the excise tax on piped natural gas, and the reduction in the corporate income tax rate. Dominion Power and PSNC Energy both appealed this order, on the grounds that the Act did not direct the Commission to take action related to the reduction in the corporate income tax rate.

In October of 2014 the Commission reversed its first order. The Commission authorized the utilities not to reduce their rates related to the changes in the corporate income tax rate, and authorized any utility that had previously reduced rates for this reason to recover those funds from customers. No utility has taken this step of seeking to recover these funds from customers. Except for Dominion Power, all of the retail electric and piped natural gas utilities are passing on the savings from the reduction in the corporate income tax rates to their customers.

The Committee discussed this issue at its November 18th meeting and expressed its agreement with the initial order of the Utilities Commission. Section 4 of Legislative Proposal #1 clarifies the intent of the General Assembly regarding the impact of the Tax Reduction Act on utility rates. This provision would direct the Commission to adjust utility rates to reflect the reduction in the corporate income tax rate and would also direct the Commission to impose interest on any refunds issued to utility customers as a result of reduction in the corporate income tax rate.

Contract with a Farmer

Prior to July 1, 2014, a person received a sales tax exemption on building materials, supplies, fixtures, and equipment if the facility for which the materials and equipment were purchased was used for a farm purpose. The person purchasing the tangible personal property did not need to be a farmer to qualify for the exemption. The only qualification was the use of the property.

Effective July 1, 2014, a person who farms must qualify to be exempt from paying sales tax on tangible personal property used for farm related purchases. To qualify, a farmer must average $10,000 or more a year over a three-year period. Under the law change, the multiple sales tax exemptions related to farming were consolidated into one statute, G.S. 105-164.13E, and a person has to be a qualifying farmer to purchase the property exempt from sales tax.

The Department of Revenue issued a notice on November 18, 2014, that purchases of tangible personal property used to fulfill a lump-sum contract with a qualifying farmer would be subject to sales tax. The Committee discussed this unintended consequence at its meeting on December 9, 2014. The Committee approved an amendment to G.S. 105-164.13E to provide that tangible personal property purchased to fulfill a contract with a person who holds a qualifying farmer exemption certificate or a conditional farmer exemption certificate is exempt from sales and use tax to the same extent as if purchased directly by the person who holds the exemption certificate. This change is included in Section 13 of Legislative Proposal #1.

IRC UPDATE

On December 19, 2014, Congress enacted the Tax Increase Prevention Act of 2014, retroactive for the taxable year beginning January 1, 2014. The legislation includes the following provisions that will impact State tax calculations and revenue collections in the current year to the extent North Carolina conforms to these provisions:

- Increased Section 179 expensing[1]
- Mortgage insurance premium as interest deduction
- Income exclusion for discharge of residence indebtedness
- Income Exclusion for IRA distributions to charity by a person who is age 70.5 or older
- Qualified tuition and expenses deduction
- Teacher deduction for up to $250 in classroom supplies

At its final meeting, the Committee heard a staff presentation outlining the cost of conformity for each provision totaling $73 million. A proposed draft was distributed for discussion that would update the reference to the Code, but decouple from each of the provisions listed above with the exception of the teacher expense deduction. After some discussion, the Committee moved to adopt Legislative Proposal #2.

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[1] Bonus depreciation is another IRC update item the Committee has typically considered. North Carolina has never conformed to the federal bonus depreciation schedule. The tax reform and simplification legislation in 2013, S.L. 2013-316, contained a provision permanently decoupling from federal bonus depreciation. That explains why bonus depreciation is not included in this list. The cost of conforming to the federal bonus depreciation schedule would be more than $200 million.

ROLLOVER CONTRIBUTIONS INTO QUALIFYING *BAILEY* PLANS

A question appeared in the newspaper column *Money Matters* asking whether it was true a person could avoid paying as much as $116,000 in State income tax by transferring an IRA rollover valued at more than $2 million into a Bailey vested State retirement plan. The answer was yes.

G.S. 105-153.5 exempts from State income tax the amount received during the taxable year from one or more State, local, or federal government retirement plans to the extent the amount is exempt from tax pursuant to a court order in settlement of one or more of three cited cases. These cases are commonly referred to as the *Bailey* case. A person is a member of the *Bailey* class if the person vested in one or more of the governmental retirement plans on or before August 12, 1989. The exemption applies to not only any defined benefits the retiree receives but also to any income distributed to the retiree from a supplemental retirement income plan, such as a 401(k) or a 457 plan.

The exemption originates from a U.S. Supreme Court case decided in 1989, *Michigan v. Davis.* Prior to 1989, many states, including North Carolina, provided state employees a retirement benefit in the form of an exemption from paying state income tax on their retirement income received from a state retirement plan. The U.S. Supreme Court ruled those tax exemptions violated the principle of intergovernmental immunity because the states did not provide a similar exemption for federal retirement income. States had to choose between exempting all governmental retirement income or taxing it. North Carolina chose to grant a $4,000 income tax exemption for government retirement benefits.

Vested State employees sued the State arguing the change in the law was an unconstitutional impairment of contract. The N.C. Supreme Court ruled in favor of the

State employees in *Bailey v. North Carolina*. Based on a trial court Order Approving Class Action Settlement on October 7, 1998, any governmental employee who vested prior to August 12, 1989, does not pay State income tax on retirement benefits received from a government retirement plan. The Court issued several subsequent orders resolving questions about eligibility. One of the orders, issued in November 1998, held that participants in the State's Supplement Retirement Income Plan, (a 401(k) plan), or the State's Deferred Compensation Plan, (a 457 plan), are vested in the plan as of August 12, 1989, if they contributed to the plan by that date. If a person is vested in the plan, then all future withdrawals from the plan are exempt from tax.

In 2002, the federal laws with respect to pension portability became much more flexible. The changes provided that contributions into most types of retirement plans could be rolled over into another retirement plan or IRA. The Department of Revenue issued Directive PD-03-1 to address the tax consequences of rolling over amounts from non-qualifying *Bailey* retirement accounts into a qualifying *Bailey* retirement account. Under that directive, issued on June 30, 2003, the Department advised that if a *Bailey* retirement account included rollover contributions from a non-qualifying *Bailey* retirement account that only a portion of the distributions received would be exempt from State income tax. The Department based its directive on the rationale used by Superior Court Judge Jack A. Thompson in his Order Regarding the Optional Retirement Program (ORP) for State Institutions of Higher Education, signed on November 19, 1999. This Order addressed when a participant in the ORP is vested and how to determine the portion of the retirement benefits in the ORP that are subject to future income tax exemption under the *Bailey* settlement. This position was also consistent with the treatment of distributions from the Thrift Savings Plan when a participant in the Plan was "vested" in the employee component but not in the employer fixed percentage component as of August 12, 1989. A copy of Directive PD-03-1 may be found in Appendix D.

After the issuing of Directive PD-03-1, the Department received several questions about its decision to tax a portion of a distribution from a qualifying tax-exempt *Bailey* retirement account that included rollover contributions from IRAs or other retirement plans. The Department sought an opinion from the North Carolina Attorney General. The Advisory Opinion issued by the Attorney General's Office advised that all benefits from state-created and state-administered plans should be treated as exempt from State income taxes if paid to persons vested in those plans as of August 12, 1989, regardless of the source of the funds. The AG's opinion noted that the heart of the *Bailey* decision is the principle that the State entered into a contract with members and retirees of various State-created retirement plans, and part of that contract was that the benefits paid from those plans would be exempt from tax. Nothing in *Bailey* suggested that the contract for a tax exemption is limited to specific benefits contained in statutes or plan documents as of August 12, 1989. The opinion acknowledged that federal laws have enhanced the benefits available through ***Bailey*** accounts, including their investment options and portability; however, it advised that a plan's particular source of funding does not prevent the nature of its distribution from qualifying as benefits that are tax exempt under the *Bailey* decision.

The Department issued a new Directive in accordance with the AG's opinion, PD-04-1. A copy of Directive PD-04-1 may be found in Appendix E. Upon the issuance of the new Directive, the number of *Bailey* eligible participants choosing to make rollover contributions into their *Bailey* eligible plan increased from less than 200 in the beginning of 2004 to more than 1,400 in 2006. The number of *Bailey* eligible participants making rollover contributions into a *Bailey* eligible plan has plateaued since 2007. In 2013, 441 *Bailey* plan participants made *Bailey* eligible rollovers totaling $21,516,823. The present value of the tax exemption for these 2013 rollovers, using a 5.75% personal income tax rate, is $1.2 million. It is difficult to estimate the fiscal impact of the tax exemption for a given year because these rollover amounts are not subject to tax until the recipient receives a distribution.

Members of the Committee expressed dismay over the tax strategy that allows a person to exempt from State income tax distributions from a private retirement plan that would otherwise be taxable except for the fact the person rolled the funds over into a State government *Bailey* plan. The Committee looked at various alternatives to eliminate this tax-planning strategy that allows a person to avoid paying tax that would otherwise be due and payable. Steven Long, an attorney with Parker Poe Adams & Bernstein, who specializes in pension law, spoke to the Committee and suggested one alternative would be to prohibit rollovers into a *Bailey* account. Under federal law, sponsors of a 401(k) or a 457 plan must allow rollovers out of the plan but are not required to accept rollover contributions into their plans. Although employers are not required to accept rollovers into their defined contribution plans, almost all of them do. The Committee decided this policy alternative would not be good pension policy, and it would not address the tax avoidance of past rollover contributions.

The Committee considered a second alternative that may be found in Legislative Proposal #3. The bill draft would limit the tax exemption for retirement plan distributions from a qualifying *Bailey* account to the portion of the distribution attributable to a State, local, or federal government retirement plan. The portion of a distribution from a qualifying *Bailey* account that is attributable to a rollover from a private retirement account would be taxable. The draft provides that the portion of a distribution that is taxable would be determined in accordance with the methodology used by Superior Court Judge Jack A. Thompson in his Order Regarding the Optional Retirement Program for State institutions for Higher Education, signed on November 19, 1999. The bill draft essentially codifies the Department's first directive on this issue, PD-03-1.

OTHER ISSUES CONSIDERED BY THE REVENUE LAWS STUDY COMMITTEE

The Committee reviewed many other issues during this interim, but it did not recommend any changes relative to those issues.

Accrual Basis of Sales Tax Reporting

During the December 9th meeting, the Committee heard a staff presentation on the accrual basis of reporting sales tax liability. The presentation distinguished the time that sales tax accrues and is due to the State from the time that revenue accrues using an example of a business transaction with accounting entries based on Generally Accepted Accounting Principles.

Sales tax is accrued to the State and should be recognized on a taxpayer's books when sales tax liability is incurred. Sales tax liability is incurred and thus accrued when there is a taxable transaction, even if revenue is not accrued at that time because the taxpayer has not fulfilled its obligation to the customer. Taxpayers reporting sales tax on the accrual basis are required to report and remit sales tax on the tax return for the period during which sales tax liability is accrued.

Sharing Economy

At its November 18th meeting, the Committee heard an overview of the various regulatory and tax issues associated with two types of businesses that are part of the "sharing economy," a term coined to describe business models based upon the peer-to-peer sharing of assets and resources. The first type of business discussed was the short-term rental industry, which has been popularized by Airbnb, an Internet platform that connects homeowners with potential guests seeking to rent out a room or an entire home as an alternative to traditional lodging establishments. The second type of business discussed was digital dispatch services, like Uber and Lyft, which are app-based taxi services. These companies provide an Internet platform connecting passengers with available and proximate drivers who are independent contractors of the dispatch service. Given that these businesses are relatively new business models, the law tends to lag behind in terms of addressing them. To the extent they fall within gaps of a pre-existing regulatory scheme, the more traditional, established industries with whom they compete argue this creates an uneven playing field.

Turning to the short-term rental industry, the increase in popularity of peer-to-peer travel sites has resulted in a number of regulatory and tax issues, culminating in an uneven playing field argument by the traditional lodging industry. Under current law, a person who rents his house to transients for more than 15 days of the year is considered a retailer and is obligated to collect and remit sales tax and occupancy tax on the rental. The lodging industry is concerned that there is a high degree of undercompliance by homeowners who rent their homes on sites like Airbnb. Undercompliance also means that the State and local governments are missing out on a potential revenue source. Since this is a compliance issue rather than an imposition issue, the question arises as to whether there is a more effective manner to collect the tax, such as requiring the Internet platform to remit the tax rather than the homeowner. Arguably, the current law may already require this. A "facilitator" is a person who is not a rental agent and who contracts with a provider of an accommodation to market the accommodation and to accept payment from the consumer. Facilitators have reporting and remittance obligations to the retailers with whom they contract based on the portion of the sales price the consumer pays the facilitator over and above the amount for a room charged to the facilitator by the retailer. While these requirements may apply to peer-to-peer travel sites, they were directed at online travel companies when enacted in 2010; peer-to-peer travel sites may or may not fit neatly within the current statutory scheme.

The General Assembly could choose to amend the statutes to more specifically require sites like Airbnb to collect sales and occupancy tax. The issue raised by that course of action is whether these businesses have constitutional nexus with this State such that a collection and remittance requirement would be enforceable. A business must have a physical presence in a state in order for that state to require the business to collect the state's sales tax. With lodging rentals, the question is whether a business that provides an Internet platform for homeowners to list their real property for short-term rental in North Carolina meets the physical presence test. As with most constitutional questions, until there is case law on point, the answer is often unclear. However, the nexus issue does not prevent the General Assembly from passing legislation along these lines; the issue is whether the legislation would actually result in increased collections.

Finally, a third issue related to the tax arena is the desire of online travel companies and peer-to-peer travel sites to have a central point of collection for occupancy tax. Currently, occupancy tax is collected at the local level by the unit of government that levies it, which means that there are over 150 collectors of the occupancy tax. Unlike the nexus issue, which cannot be resolved legislatively, the administrative issue could be. While central collection would ease compliance for these companies, it would also generate new responsibilities and expense for the Department of Revenue, and it would remove a responsibility that certain local governments may very well want to maintain.

The other side of the "uneven playing field" coin is the regulatory aspect. At the meeting, representatives of the lodging industry voiced concern that homeowners do not have to comply with the health and safety regulations that traditional hotels and bed and breakfasts do. Current law exempts establishments with four or fewer lodging units and private homes that occasionally offer lodging.

The Committee next heard presentations explaining digital dispatch services including presentations by two services operating in the State: Uber and Lyft. Section 9 of House Bill 272, S.L. 2014-108, directed the Revenue Laws Study Committee to "study the registration requirements, fees, and penalties applicable to for hire passenger vehicles, including for hire passenger vehicles directed by digital dispatching services." The term "digital dispatching services" appears in the General Statutes but is not defined. The term is understood to refer to services where the service operates an app that matches customers and drivers similar to a limousine service. A more widely used term for the service is Transportation Network Companies (TNC). Uber is the world's largest TNC and operates in 10 cities in the State: Asheville, Charlotte, Winston-Salem, High Point, Greensboro, Chapel Hill, Durham, Raleigh, Fayetteville, and Wilmington.

TNC, like Uber and Lyft, are national companies that recruit drivers to join their networks either full-time or part-time. The drivers are independent contractors and operate their own passenger cars. Customers download the TNC's app to a smartphone; create an account using a credit card, and request transportation on the TNC's app using GPS to fix their location. The TNC sets the price for transportation. The TNC bills the customer's credit card making the transaction cashless between the customer and the driver. The charges for transportation are based on service fees, distance, and time. TNC vary their charges based on supply and demand and increase fares during peak times, called surge pricing.

Traditional taxi and limousine services are regulated by local government under G.S. 160A-304. House Bill 74, S.L. 2013-413, Regulatory Reform Act of 2013, excluded "digital dispatching services" from the authorization to regulate traditional taxi and limousine services. While TNC operate without local oversight, State-level laws apply to all "Vehicles transporting persons for compensation" under G.S. 20-4.01(27)(b) which defines "For hire passenger vehicles." For hire vehicles have special license plates and must carry $1.5 million of continuous (24/7) liability insurance. Cars dispatched by TNC are not complying with the requirements for insurance and license plates.

TNC have a new business model compared to traditional taxis and limousines. Vehicles are not solely devoted to commercial operation. The TNC model introduces the concept of switching between commercial operation and private operation when drivers decide they want to work and turn on the TNC's app. The existing law is based on vehicles dedicated to commercial use requiring continuous (24/7) commercial insurance coverage.

The Committee heard presentations from Uber and Lyft and discussed the major issues surrounding the TNC business model including compliance with existing State law, background checks for drivers, fares, commercial license plates, and insurance.

TaxiTaxi also presented to the Committee, offering the perspective of a traditional taxi company that complies with State and local regulations that apply to for hire vehicles. The President of TaxiTaxi told the Committee that TNC should comply with the same regulations and carry the same liability insurance as traditional taxi companies.

The Committee heard a presentation from the Property Casualty Insurers Association of America (PCI). PCI offered background about the exclusion in private passenger car insurance policies for commercial operation, called the livery exclusion. Uber and Lyft voluntarily provide insurance while private cars are operating at the direction of the TNC. The exact types of losses within the policies and the coverage amounts vary between each TNC because no uniform rules apply – unless the statewide for hire rules are found to apply.

The Committee actively questioned the presenters and heard policy arguments about TNC and the underlying issues of TNC's business model, such as background checks for drivers, fares, commercial license plates, and insurance requirements. The Committee did not recommend specific action on this issue. Both Co-Chairs commented that the regulatory issues presented by TNC services are not related to the mission of the Revenue Laws Study Committee.

Sales Tax on Internet Access Service

The Internet Tax Freedom Act was enacted by Congress in 1998. The Act prohibits states from imposing sales tax on internet access service. In 2005, Congress expanded the definition of "internet access service" to include telecommunications services purchased to provide internet access service. The moratorium on the taxation of internet access service was extended my Congress multiple times. At the time of the December meeting of the Committee, the moratorium was set to expire on December

11, 2014. The Committee recommended that the statutes be amended to provide notice of 90 days to providers if the Act was allowed to expire. Congress ultimately extended the Act until October 1, 2015.

Worker Misclassification

At the October 14th meeting, the Revenue Laws Study Committee heard from staff and State agencies about the problem of worker misclassification. Worker misclassification occurs when an employer incorrectly classifies a worker as an independent contractor rather than an employee, avoiding the expense of payroll taxes (Social Security, Medicare and Unemployment Insurance). In addition, employers are not required to withhold income taxes for independent contractors.

McClatchy News published a series of articles on worker misclassification in September of 2014. The series used public information available from government-subsidized housing projects to determine the number of workers on the projects who were misclassified. According to the data, 35% of 8,713 workers were incorrectly treated as independent contractors in the projects dating back to 2009. The news reports applied the 35% misclassification rate to construction industry in NC to estimate the total amount of unpaid state and federal taxes.

The estimated impact of unpaid state income and unemployment insurance taxes was $134 million. The amount of unpaid federal income and payroll taxes was $333 million for a total impact of $467 million. These amounts assume that the 35% misclassification rate found in the subsidized housing projects was the same for the construction industry as a whole in North Carolina. It also assumes that the employees treated as independent contractors paid no taxes as required for workers receiving a 1099 statement of income received from an employer.

The Committee heard from three State agencies about their efforts to reduce the rate of worker misclassification: the Department of Revenue; the Division of Employment Security; and the Industrial Commission. In addition, the Committee heard a presentation from the Government Data Analytics Center (GDAC), which collects and analyzed data to help agencies more easily identify worker misclassification problems.

The Department of Revenue indicated that they currently have adequate resources to manage worker misclassification through information sharing with the Internal Revenue Service and internal compliance initiatives. The Division of Employment Security uses leads from other employers, claimants and GDAC to identify potential misclassification cases. When a case is identified, the agency applies IRS standards to determine whether employees should be classified as employees rather than independent contractors. When a claimant is incorrectly classified as an independent contractor, the employer is notified and billed for unemployment insurance taxes and the claimant is paid benefits if eligible.

The Industrial Commission works with other agencies, including GDAC, to identify instances in which worker's compensation insurance is not provided to employees when required. Efforts are focused on historically problematic industries, including construction and health care. All agencies agreed they have necessary resources devoted to reducing the rate of worker misclassification and no further action was recommended by the Committee.

State and Local Government Responsibility

Over the past several years the General Assembly has considered legislation that would either amend distributions of tax revenues to local governments or would amend the authority of local governments to impose local taxes. When legislation is considered that would impact local revenue, questions would often arise as to what are the fiscal responsibilities of the local governments. To start to address these questions, the Committee heard from Kara Millonzi, Associate Professor of Public Law and Government and the UNC-CH School of Government on local government functions in the State. At the December meeting of the Committee Ms. Millonzi discussed government structure in the State, what services and functions each level of local government are required to provide, and the sources of local government revenue.

Permanent License Plates

S.L. 2014-96 directed the Revenue Laws Study Committee to review the requirements and eligibility for permanent registration plates and to examine the costs incurred by the Division of Motor Vehicles to administer permanent registration plates. In 2011, the General Assembly directed the Program Evaluation Division to evaluate the effectiveness and efficiency of state-owned passenger and non-passenger vehicles. Part of that effort included an analysis of the State's permanent license plates issued to non-state entities. At its November 18 meeting, Pamela Taylor, Principal Program Evaluator, Program Evaluation Division, provided the Committee with a brief overview of the history of this issue and the current law. Prior to 2012, several entities were eligible to receive these permanent license plates including counties and municipalities, emergency rescue and fire departments, church buses, and certain nonprofit groups. The Program Evaluation Division report identified over 120,000 permanent license plates registered to non-state entities and found that 4,200 had been issued to entities not specifically identified in statute (N.C. Gen. Stat. § 20-84(b)). Based on the report's recommendations, Session Law 2012-159 limited eligibility for permanent registration plates to governmental entities and community colleges because these entities had been clearly defined by law and were serving public purposes. The law required all existing silver permanent plates for non-state entities to be cancelled and re-issued under new eligibility rules. As of September 2013, 103,394 orange and black plates had been issued to non-state entities. In 2014, the General Assembly clarified the law to allow DMV to issue permanent plates to motor vehicles owned by three additional entities—nonprofit corporations authorized to operate a charter school, federally recognized tribes, and sanitary districts. This presentation was informational, and the Committee did not take any action on this issue.

COMMITTEE RECOMMENDATIONS AND LEGISLATIVE PROPOSALS

The Revenue Laws Study Committee makes the following recommendations to the 2015 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.

1. Revenue Laws Technical Changes.
2. IRC Update.
3. Rollovers into Qualifying Bailey Plans.

LEGISLATIVE PROPOSAL #1

AN ACT TO MAKE TECHNICAL AND CLARIFYING CHANGES TO VARIOUS REVENUE LAWS, AS RECOMMENDED BY THE REVENUE LAWS STUDY COMMITTEE.

LEGISLATIVE PROPOSAL #1

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2015 REGULAR SESSION OF THE 2015 GENERAL ASSEMBLY

AN ACT TO MAKE TECHNICAL AND CLARIFYING CHANGES TO VARIOUS REVENUE LAWS AS RECOMMENDED BY THE REVENUE LAWS STUDY COMMITTEE.

SHORT TITLE: Revenue Laws Technical Changes.

PRIMARY SPONSORS:

BRIEF OVERVIEW: This legislative proposal makes technical corrections and clarifying changes to the tax statutes largely based on recommendations of the Department of Revenue.

FISCAL IMPACT: See Fiscal Analysis Memorandum

EFFECTIVE DATE: Except as otherwise provided, this proposal would become effective when it becomes law.

A copy of the proposed legislation and a bill analysis begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2015

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BILL DRAFT 2015-TDxz-5 [v.5] (10/13)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/9/2015 10:52:06 AM

Short Title: Revenue Laws Technical Changes. (Public)

Sponsors: (Primary Sponsor).

Referred to:

A BILL TO BE ENTITLED

AN ACT TO MAKE TECHNICAL AND CLARIFYING CHANGES TO VARIOUS REVENUE LAWS, AS RECOMMENDED BY THE REVENUE LAWS STUDY COMMITTEE.

The General Assembly of North Carolina enacts:

SECTION 1.(a) Section 7.2(a) of S.L. 2014-3 reads as rewritten:

"**SECTION 7.2.(a)** This act shall not be construed to affect the interpretation of any statute that is the subject of a State tax audit ~~pending as of the effective date of this act~~ for taxable years beginning before January 1, 2015, or litigation that is a direct result of such audit."

SECTION 1.(b) Section 7.3 of S.L. 2014-3 reads as rewritten:

"**SECTION 7.3.** This Part becomes effective January 1, 2015, and applies to withdrawals of items from inventory for contracts entered into on or after that date, sales on or after that ~~date~~ date, and contracts entered into on or after that date."

SECTION 2.(a) Section 8.1(c) of S.L. 2014-3 reads as rewritten:

"**SECTION 8.1.(c)** With respect to the change in this section regarding the rental of a private residence, cottage, or similar accommodation that is rented for fewer than 15 days in a calendar year and that is listed with a real estate broker or agent, the following provisions apply:

(1) A retailer is ~~not~~ liable for an overcollection ~~or undercollection~~ of sales tax or occupancy tax for the rental of such an accommodation that is occupied or available to be occupied for nights beginning June 14, 2012, and ending June 30, 2014, and must remit the tax collected.

(2) A retailer is not liable for an undercollection of sales tax or occupancy tax for the rental of such an accommodation that is occupied or available to be occupied for nights beginning June 1, 2014, and ending June 30, 2014, if the retailer ~~has~~ made a good-faith effort to comply with the law and collect the proper amount of ~~tax and has, due to the change under this section, overcollected or undercollected the amount of sales tax or occupancy tax that is due. This subsection applies only to the period beginning June 14, 2012, and ending July 1, 2014.~~ tax."

SECTION 2.(b) This section becomes effective June 1, 2014.

SECTION 3. Section 14.26 of S.L. 2014-3 is repealed.

SECTION 4.(a) Section 4.29(a) of S.L. 2013-316 reads as rewritten:

"**SECTION 4.2.(a)** ~~Pursuant to G.S. 62-31 and G.S. 62-32, the~~ The Utilities Commission must adjust the rate set for the following utilities:

(1) Electricity to reflect the repeal of G.S. 105-116 and the resulting liability of electric power companies for the tax imposed under ~~G.S. 105-122 and for~~G.S. 105-122, the increase in the rate of tax imposed on sales of electricity under ~~G.S. 105-164.4.~~G.S. 105-164.4, and the reduction in the corporate income tax rate imposed under G.S. 105-130.3.

(2) Piped natural gas to reflect the repeal of Article 5E of Chapter 105 of the General Statutes, the repeal of the credit formerly allowed under G.S. 105-122(d1), ~~and~~ the resulting liability of companies for the tax imposed on sales of piped natural gas under ~~G.S. 105-164.4.~~ G.S. 105-164.4, and the reduction in the corporate income tax rate imposed under G.S. 105-130.3.

(3) Public water and wastewater companies to reflect the repeal of G.S. 105-116 and the resulting liability of public water and wastewater companies under G.S. 105-122, and the reduction in the corporate income tax rate imposed under G.S. 105-130.3."

SECTION 4.(b) The Utilities Commission must order a utility to add interest to money refunded to its customers for refunds resulting from the reduction of the corporate income tax rate as provided in section 1(a) of this act. The interest rate applied to the refund must be set in accordance with G.S. 62-130.

SECTION 4.(c) Subsection (a) of this section is effective January 1, 2014. The remainder of this section is effective when it becomes law and applies to refunds issued on or after that date.

SECTION 5.(a) G.S. 105-113.35(d) reads as rewritten:

"(d) Manufacturer's Option. – A manufacturer who is not a retail dealer and who ships tobacco products other than cigarettes to either a wholesale dealer or retail dealer licensed under this Part may apply to the Secretary to be relieved of paying the tax imposed by this section on the tobacco products. A manufacturer who ships vapor products to either a wholesale dealer or retail dealer licensed under this Part may apply to the Secretary to be relieved of paying the tax imposed by this section on the vapor products shipped to either a wholesale dealer or retail dealer. Once granted permission, a manufacturer may choose not to pay the tax until otherwise notified by the Secretary. To be relieved of payment of the tax imposed by this section, a manufacturer must comply with the requirements set by the Secretary.

Permission granted under this subsection to a manufacturer to be relieved of paying the tax imposed by this section applies to an integrated wholesale dealer with whom the manufacturer is an affiliate. A manufacturer must notify the Secretary of any integrated wholesale dealer with whom it is an affiliate when the manufacturer applies to the Secretary for permission to be relieved of paying the tax and when an integrated wholesale dealer becomes an affiliate of the manufacturer after the Secretary has given the manufacturer permission to be relieved of paying the tax.

If a person is both a manufacturer of cigarettes and a wholesale dealer of tobacco products other than cigarettes and the person is granted permission under G.S. 105-113.10 to be relieved of paying the cigarette excise tax, the permission applies to the tax imposed by this section on tobacco products other than cigarettes. A cigarette manufacturer who becomes a wholesale dealer after receiving permission to be relieved of the cigarette excise tax must notify the Secretary of the permission received under G.S. 105-113.10 when applying for a license as a wholesale dealer."

SECTION 5.(b) This section becomes effective June 1, 2015.

SECTION 6. G.S. 105-129.16A reads as rewritten:

"**§ 105-129.16A. Credit for investing in renewable energy property.**

(a) Credit. – ~~If a taxpayer that has constructed, purchased, or leased renewable energy property places it in service in this State during the taxable year, the taxpayer is allowed a credit equal to thirty-five percent (35%) of the cost of the property.~~ A taxpayer that has constructed, purchased, or leased renewable energy property is allowed a credit equal to thirty-five percent (35%) of the cost of the property if the property is placed in service in this State during the taxable year. In the case of renewable energy property that serves a nonbusiness purpose, the credit must be taken for the taxable year in which the property is placed in service. For all other renewable energy property, the entire credit may not be taken for the taxable year in which the property is placed in service but must be taken in five equal installments beginning with the taxable year in which the property is placed in service. Upon request of a taxpayer that leases renewable energy property, the lessor of the property must give the taxpayer a statement that describes the renewable energy property and states the cost of the property. No credit is allowed under this section to the extent the cost of the renewable energy property was provided by public funds. For the purposes of this section, "public funds" does not include grants made under section 1603 of the American Recovery and Reinvestment Tax Act of 2009.

…."

SECTION 7. Section 1.1(a) of S.L. 2014-3 is rewritten to read:

"**SECTION 1.1.(a)** G.S. 105-130.5(b), as amended by Section 14.3 of this act, reads as rewritten:

"(b) The following deductions from federal taxable income shall be made in determining State net income:

…

(4) ~~Losses in the nature~~ Any unused portion of a net economic loss as allowed under G.S. 105-130.8A(e).~~losses sustained by the corporation in any or all of the 15 preceding years pursuant to the provisions of G.S. 105-130.8. A corporation required to allocate and apportion its net income under the provisions of G.S. 105-130.4 shall deduct its allocable and apportionable net economic loss only from total income allocable and apportionable to this State pursuant to the provisions of G.S. 105-130.8~~ This subdivision expires for taxable years beginning on or after January 1, 2030.

(4a) A State net loss as allowed under G.S. 105-130.8A. A corporation may deduct its allocable and apportionable State net loss only from total income allocable and apportionable to this State.

…."

SECTION 8.(a) G.S. 105-134.6A, as amended by S.L. 2014-3, reads as rewritten:

"(h) Definitions. – ~~For purposes of this section, a "transferor" is an~~ The following definitions apply in this section:

(1) Transferor. – An individual, partnership, corporation, S Corporation, limited liability company, or an estate or trust that does not fully distribute income to its ~~beneficiaries, and an "owner in a transferor" is a~~ beneficiaries.

(2) Owner in a transferor. – One or more of the following of a transferor:

a. A partner, shareholder, ~~member, or beneficiary~~ or member.

b. A beneficiary subject to tax under Part 2 or 3 of Article 4 of this ~~Chapter of a transferor.~~ Chapter."

SECTION 8.(b) G.S. 105-153.6, as amended by S.L. 2014-3, reads as rewritten:

"(h) Definitions. – ~~For purposes of this section, a "transferor" is an~~ The following definitions apply in this section:

(1) Transferor. – An individual, partnership, corporation, S Corporation, limited liability company, or an estate or trust that does not fully distribute income to its ~~beneficiaries, and an "owner in a transferor" is a~~ beneficiaries.

(2) Owner in a transferor. – One or more of the following of a transferor:

a. A partner, shareholder, ~~member, or beneficiary~~ or member.

b. A beneficiary subject to tax under Part 2 or 3 of Article 4 of this ~~Chapter of a transferor.~~ Chapter."

SECTION 8.(c) Subsection (a) of this section is effective for taxable years beginning on or after January 1, 2013. Subsection (b) of this section is effective for taxable years beginning on or after January 1, 2014. The remainder of this section is effective when it becomes law.

SECTION 9.(a) Notwithstanding G.S. 105-163.15, the Secretary of Revenue may not impose interest with respect to an underpayment of income tax to the extent the underpayment was created or increased by the changes made in Section 2.2 of S.L. 2014-3. Notwithstanding G.S. 105-163.8, a withholding agent is not liable for the amount of tax the agent fails to withhold to the extent the amount of tax not withheld was created or increased by the changes made in Section 2.2 of S.L. 2014-3.

SECTION 9.(b) This section is effective when it becomes law and applies to taxable years beginning on or after January 1, 2014, and before January 1, 2015, and to payroll periods beginning on or after January 1, 2014, and before January 1, 2015.

SECTION 10. G.S. 105-164.3(35), as amended by Section 14.7 of S.L. 2014-3, reads as rewritten:

"**§ 105-164.3. Definitions.**

The following definitions apply in this Article:

…

(35) Retailer. – ~~A person engaged in business of any of the following:~~ Any of the following persons:

a. ~~Making~~ A person engaged in business of making sales at retail, offering to make sales at retail, or soliciting sales at retail of tangible personal property, digital property, or services for storage, use, or consumption in this State. When the Secretary finds it necessary for the efficient administration of this Article to regard any sales representatives, solicitors, representatives, consignees, peddlers, or truckers as agents of the dealers, distributors, consignors, supervisors, employers, or persons under whom they operate or from whom they obtain the items sold by them regardless of whether they are making sales on their own behalf or on behalf of these dealers, distributors, consignors, supervisors, employers, or persons, the Secretary may so regard them and may regard the dealers, distributors, consignors, supervisors, employers, or persons as "retailers" for the purpose of this Article.

b. ~~Delivering,~~ A person engaged in business of delivering, erecting, installing, or applying tangible personal property for use in this State, regardless of whether the property is permanently affixed to real property or other tangible personal property.

c. ~~Making~~ A person engaged in business of making a remote sale, if one of the conditions listed in G.S. 105-164.8(b) is met.

d. A person, other than a facilitator, required to collect the tax levied under G.S. 105-164.4(a)."

SECTION 11. G.S. 105-164.4G, as enacted by S.L. 2014-3, reads as rewritten:

"**§ 105-164.4G. Entertainment activity.**

…

(f) Exemptions. – The sale at retail and the use, storage, or consumption in this State of the following gross receipts derived from an admission charge to an entertainment activity are specifically exempt from the tax imposed by this Article:

…

(g) Sourcing. – ~~Admission~~ An admission charge to an entertainment activity is sourced to the location where admission to the entertainment activity may be gained by a person. When the location where admission may be gained is not known at the time of the receipt of the gross receipts for an admission charge, the sourcing principles in G.S. 105-164.4B(a) apply."

SECTION 12. G.S. 105-164.13, as amended by Section 6.1(f) of S.L. 2014-3, reads rewritten:

"**§ 105-164.13. Retail sales and use tax.**

The sale at retail and the use, storage, or consumption in this State of the following tangible personal property, digital property, and services are specifically exempted from the tax imposed by this Article:

…

(8a) Sales to a small power production facility, as defined in 16 U.S.C. § 796(17)(A), of fuel and piped natural gas used by the facility to generate electricity.

…

(10) Sales of the following to commercial laundries or to pressing and dry cleaning establishments:

a. Articles or materials used for the identification of garments being laundered or dry cleaned, wrapping paper, bags, hangers, starch, soaps, detergents, cleaning fluids and other compounds or chemicals applied directly to the garments in the direct performance of the laundering or the pressing and cleaning service.

b. Laundry and dry-cleaning machinery, parts and accessories attached to the machinery, and lubricants applied to the machinery.

c. ~~Fuel, other than electricity,~~ Fuel and piped natural gas used in the direct performance of the laundering or the pressing and cleaning service. The exemption does not apply to electricity.

…

(57) ~~Fuel and~~Fuel, piped natural gas, and electricity sold to a manufacturer for use in connection with the operation of a manufacturing facility. The exemption does not apply to electricity used at a facility at which the primary activity is not manufacturing.

…."

SECTION 13.(a) G.S. 105-164.13E reads as rewritten:

"§ 105-164.13E. Exemption for farmers.

(a) Exemption. – A qualifying farmer is a person who has an annual ~~gross~~ income from farming operations for the preceding taxable year of ten thousand dollars ($10,000) or more ~~from farming operations~~ or who has an average annual ~~gross~~ income from farming operations for the three preceding taxable years of ten thousand dollars ($10,000) or ~~more from farming operations.~~ more. For purposes of this section, the term "income from farming operations" means sales plus any other amounts treated as gross income under the Code from farming operations. A qualifying farmer includes a dairy operator, a poultry farmer, an egg producer, a livestock farmer, a farmer of crops, and a farmer of an aquatic species, as defined in G.S. 106-758. A qualifying farmer may apply to the Secretary for an exemption certificate number under G.S. 105-164.28A. The exemption certificate expires when a person fails to meet the income threshold for three consecutive taxable years or ceases to engage in farming ~~operations.~~operations, whichever comes first.

The following tangible personal property, digital property, and services are exempt from sales and use tax if purchased by a qualifying farmer and for use by the farmer in farming operations. For purposes of this section, an item is used by a farmer for farming operations if it is used for the planting, cultivating, harvesting, or curing of farm crops or in the production of dairy products, eggs, or animals:

(1) ~~Fuel and~~Fuel, piped natural gas, and electricity that ~~is~~ are measured by a separate meter or another separate device and used for a purpose

other than preparing food, heating dwellings, and other household purposes.

(2) Commercial fertilizer, lime, land plaster, plastic mulch, plant bed covers, potting soil, baler twine, and seeds.

(3) Farm machinery, attachment and repair parts for farm machinery, and lubricants applied to farm machinery. The term "machinery" includes implements that have moving parts or are operated or drawn by an animal. The term does not include implements operated wholly by hand or motor vehicles required to be registered under Chapter 20 of the General Statutes.

(4) A container used in the planting, cultivating, harvesting, or curing of farm crops or in the production of dairy products, eggs, or animals or used in packaging and transporting the farmer's product for sale.

(5) A grain, feed, or soybean storage facility and parts and accessories attached to the facility.

(6) Any of the following substances when purchased for use on animals or plants, as appropriate, held or produced for commercial purposes. This exemption does not apply to any equipment or devices used to administer, release, apply, or otherwise dispense these substances:

a. Remedies, vaccines, medications, litter materials, and feeds for animals.

b. Rodenticides, insecticides, herbicides, fungicides, and pesticides.

c. Defoliants for use on cotton or other crops.

d. Plant growth inhibitors, regulators, or stimulators, including systemic and contact or other sucker control agents for tobacco and other crops.

e. Semen.

(7) Baby chicks and poults sold for commercial poultry or egg production.

(8) Any of the following items concerning the housing, raising, or feeding of animals:

a. A commercially manufactured facility to be used for commercial purposes for housing, raising, or feeding animals or for housing equipment necessary for these commercial activities. The exemption also applies to commercially manufactured equipment, and parts and accessories for the equipment, used in the facility.

b. Building materials, supplies, fixtures, and equipment that become a part of and are used in the construction, repair, or improvement of an enclosure or a structure specifically designed, constructed, and used for housing, raising, or feeding animals or for housing equipment necessary for one of these commercial activities. The exemption also applies to commercially manufactured equipment, and parts and accessories for the equipment, used in the enclosure or a structure.

(9) A bulk tobacco barn or rack, parts and accessories attached to the tobacco barn or rack, and any similar apparatus, part, or accessory used to cure or dry tobacco or another crop.

(b) Conditional Exemption. – A person who does not meet the definition of a qualifying farmer in subsection (a) of this section may apply to the Department for a conditional exemption certificate under G.S. 105-164.28A. A person with a conditional exemption certificate is allowed to purchase items exempt from sales and use tax to the same extent as a qualifying farmer under subsection (a) of this section. To receive a conditional exemption certificate under this subsection, the person must certify that the person intends to engage in farming operations, as that term is described in subsection (a) of this section, and that the person will timely file State and federal income tax returns that reflect income and expenses incurred from farming operations during the taxable years that the conditional exemption certificate applies.

A conditional exemption certificate issued under this subsection is valid for the taxable year in which the certificate is issued and the following two taxable years, provided the person to whom the certificate is issued provides copies of applicable State and federal income tax returns to the Department within 90 days following the end of each taxable year covered by the conditional exemption ~~certificate.~~ certificate and provided the person is engaged in farming operations. A conditional exemption certificate issued under this subsection may not be extended or renewed beyond the original three-year period. The Department may not issue a conditional exemption certificate to a person who has had a conditional exemption certificate issued under this subsection during the prior 15 taxable years.

A person who purchases items with a conditional exemption certificate must maintain documentation of the items purchased and copies of State and federal income tax returns that reflect activities from farming operations for the period of time covered by the conditional exemption certificate for three years following the expiration of the conditional exemption certificate. The Secretary may require a person who has a conditional exemption certificate to provide any other information requested by the Secretary to verify the person met the conditions of this subsection. A person who fails to provide the information requested by the Secretary in a timely manner or who fails to meet the requirements of this subsection becomes liable for any taxes for which an exemption under this subsection was claimed. The taxes become due and payable at the expiration of the conditional exemption certificate, and interest accrues from the date of the original purchase. Additionally, where the person does not timely provide the information requested by the Secretary, the misuse of exemption certificate penalty in G.S. 105-236(a)(5a) applies to each seller identified by the Department from which the person made a purchase."

(c) Contract with a Farmer. – A qualifying item listed in subdivisions (5), (8), and (9) of subsection (a) of this section purchased to fulfill a contract with a person who holds a qualifying farmer exemption certificate or a conditional farmer exemption certificate issued under G.S. 105-164.28A is exempt from sales and use tax to the same extent as if purchased directly by the person who holds the exemption certificate. A contractor that purchases one of the items allowed an exemption under this section must provide an exemption certificate to the retailer that includes the name of the agricultural exemption certificate holder and the agricultural exemption certificate number issued to that holder.

(d) Definition. – For purposes of this section, the term "taxable year" has the same meaning as defined in G.S. 105-153.3.'

SECTION 13.(b) This section becomes effective July 1, 2014. A contractor who paid sales and use tax on an item exempt from sales and use tax pursuant to G.S. 105-164.13(c), as enacted by this section, may request a refund from the retailer and the retailer may, upon issuance of the refund or credit, request a refund for the overpayment of tax under G.S. 105-164.11(a)(1).

SECTION 14. G.S. 105-164.16A, as enacted by S.L. 2014-3, reads as rewritten:

"**§ 105-164.16A. Reporting ~~option~~ for prepaid meal plans.**

(a) Reporting Option. – This ~~section~~ subsection provides a ~~taxpayer~~ retailer that offers ~~to sell~~ a prepaid meal ~~plan~~ plan subject to the tax imposed by G.S. 105-164.4 with an option concerning the method by which the sales tax will be remitted to the Secretary and a return filed under G.S. 105-164.16. When the retailer enters into an agreement with a food service contractor by which the food service contractor agrees to provide food or prepared food under a prepaid meal plan, and the food service contractor with whom the retailer contracts is also a retailer under this Article, the retailer may include in the agreement that the food service contractor is liable for ~~collecting~~ reporting and remitting the sales tax due on the gross receipts derived from the prepaid meal plan on behalf of the retailer. The agreement must provide that the tax applies to the allocated sales price of the prepaid meal plan paid by or on behalf of the person entitled to the food or prepaid food under the plan and not the amount charged by the food service contractor to the retailer under the agreement for the food and prepared food for the person.

A retailer who elects this option must report to the food service contractor with whom it has an agreement the gross receipts a person pays to the retailer for a prepaid meal plan. The retailer must send the food service contractor the tax due on the gross receipts derived from a prepaid meal plan. Tax payments received by a food service contractor from a retailer are held in trust by the food service contractor for remittance to the Secretary. A food service contractor that receives a tax payment from a retailer must remit the amount received to the Secretary. A food service contractor is not liable for tax due but not received from a retailer. A retailer that does not send the food service contractor the tax due on the gross receipts derived from a prepaid meal plan is liable for the amount of tax the retailer fails to send to the food service contractor.

(b) Basis of Reporting. – A retailer must report gross receipts derived from a prepaid meal plan on an accrual basis of accounting for purposes of this Article, notwithstanding that the retailer reports tax on the cash basis for other sales at retail and notwithstanding that the revenue has not been recognized for accounting purposes."

SECTION 15. G.S. 105-164.29(a), as amended by Section 14.9(b) of S.L. 2014-3, reads as rewritten:

"(a) Requirement and Application. – Before a person may engage in business as a retailer or a wholesale merchant or when a facilitator is liable for tax under G.S. 105-164.4F, the person must obtain a certificate of registration. To obtain a certificate of registration, a person must register with the Department. A person who has more than one business is required to obtain only one certificate of registration for each legal entity to cover all operations of each business throughout the State. An application for registration must be signed as follows:

(1) By the owner, if the owner is an individual.

(2) By a manager, member, or company official, ~~partner,~~ if the owner is ~~an association, a partnership,~~ a limited liability company.

(2a) By a manager, member, or partner, if the owner is a partnership.

(3) By an executive officer or some other person specifically authorized by the corporation to sign the application, if the owner is a corporation. If the application is signed by a person authorized to do so by the corporation, written evidence of the person's authority must be attached to the application."

SECTION 16. G.S. 105-241.6(b)(5) reads as rewritten:

"(b) Exceptions. – The exceptions to the general statute of limitations for obtaining a refund of an overpayment are as follows:

…

(5) Contingent Event. – The period to request a refund of an overpayment may be extended as provided in this subdivision if an event or condition prevents the taxpayer from possessing the information necessary to file an accurate and definite request for a refund of an overpayment under this Chapter:

a. If a taxpayer is subject to a contingent event and files written notice with the Secretary, the period to request a refund of an overpayment is six months after the contingent event concludes.

~~b.~~ ~~For purposes of this subdivision,~~ For purposes of this subdivision, a "contingent event" means litigation or a ~~State~~ state tax audit initiated prior to the expiration of the statute of limitations under subsection (a) of this section, the pendency of which prevents the taxpayer from possessing the information necessary to file an accurate and definite request for a refund of an overpayment under this Chapter.

~~c.~~ ~~For purposes of this subdivision, "notice to the Secretary" means written notice~~ The written notice to the Secretary must be filed ~~with the Secretary~~ prior to expiration of the statute of limitations under subsection (a) of this section for a return or payment in which a contingent event prevents a taxpayer from filing a definite request for a refund of an overpayment. The notice must identify and describe the contingent event, identify the type of tax, list the return or payment affected by the contingent event, and state in clear terms the basis for and an estimated amount of the overpayment.

~~d.~~b. ~~A~~ If a taxpayer ~~who~~ contends that an event or condition other than ~~litigation or a State tax audit~~ a contingent event, as defined in this subdivision, has occurred that prevents the taxpayer from filing an accurate and definite request for a refund of an overpayment within the period under subsection (a) of this

~~section~~section, the taxpayer may submit a written request to the Secretary seeking an extension of the statute of limitations allowed under this subdivision. The request must establish by clear, convincing proof that the event or condition is beyond the taxpayer's control and that it prevents the taxpayer's timely filing of an accurate and definite request for a refund of an overpayment. The request must be filed within the period under subsection (a) of this section. The Secretary's decision on the request is final and is not subject to administrative or judicial review.

SECTION 17.(a) G.S. 105-338(c), as amended by Section 11.1(e) of S.L. 2014-3, reads as rewritten:

"(c) Certain Property of Bus Line, Motor Freight Carrier, ~~Airline, and Mobile Telecommunications~~ and Airline Companies. –

…

~~(4) The appraised valuation of the tangible personal property of a mobile telecommunications company (excluding towers) that is appraised in accordance with the provisions of G.S. 105-336(c) is allocated among the local taxing units in which the property of the company is situated on January 1 in the proportion that the original cost of the property in the taxing unit bears to the original cost of all such property in this State.~~"

SECTION 17.(b) G.S. 105-339, as amended by Section 11.1(f) of S.L. 2014-3, reads as rewritten:

"**§ 105-339. Certification of appraised valuations of nonsystem property and locally assigned rolling stock, tangible personal property of tower aggregator companies, and ~~certain~~ tangible personal property of mobile telecommunications companies.**

Having determined the appraised valuations of the nonsystem properties of public service companies in accordance with subdivisions (b)(2) and (b)(3) of G.S. 105-335 and the appraised valuations of locally assigned rolling stock in accordance with subdivision (c)(1) of G.S. 105-335, the appraised valuations of the tangible personal property of tower aggregator companies in accordance with G.S. 105-336(d) and the appraised valuations of ~~towers of~~ the tangible personal property of mobile telecommunications companies in accordance with ~~G.S. 105-336(d),~~G.S. 105-336(c) and (d), the Department of Revenue shall assign those appraised valuations to the taxing units in which such properties are situated by certifying the valuations to the appropriate counties and municipalities. Each local taxing unit receiving such certified valuations shall assess them at the figures certified and shall tax the assessed valuations at the rate of tax levied against other property subject to taxation therein."

SECTION 17.(c) Section 11.1(g) of S.L. 2014-3 is repealed.

SECTION 17.(d) Subsection (c) of this section is effective when it becomes law. The remainder of this section is effective for taxes imposed for taxable years beginning on or after July 1, 2015.

SECTION 18.(a) G.S. 160A-206 reads as rewritten:

"**§ 160A-206. General power to impose taxes.**

(a) Authority. – A city shall have power to impose taxes only as specifically authorized by act of the General Assembly. Except when the statute authorizing a tax provides for penalties and interest, the power to impose a tax shall include the power to impose reasonable penalties for failure to declare tax liability, if required, or to impose penalties or interest for failure to pay taxes lawfully due within the time prescribed by law or ordinance. In determining the liability of any taxpayer for a tax, a city may not employ an agent who is compensated in whole or in part by the city for services rendered on a contingent basis or any other basis related to the amount of tax, interest, or penalty assessed against or collected from the taxpayer. The power to impose a tax shall also include the power to provide for its administration in a manner not inconsistent with the statute authorizing the tax.

(b) Prohibition. – A city may not impose a license, franchise, or privilege tax on a person engaged in any of the businesses listed in this subsection. These businesses are subject to sales tax at the combined general rate for which the city receives a share of the tax revenue or they are subject to the local sales tax:

(1) Supplying piped natural gas.
(2) Providing telecommunications service taxed under G.S. 105-164.4(a)(4c).
(3) Providing video programming taxed under G.S. 105-164.4(a)(6).
(4) Providing electricity."

SECTION 18.(b) G.S. 153A-146 reads as rewritten:

"**§ 153A-146. General power to impose taxes.**

(a) Authority. – A county may impose taxes only as specifically authorized by act of the General Assembly. Except when the statute authorizing a tax provides for penalties and interest, the power to impose a tax includes the power to impose reasonable penalties for failure to declare tax liability, if required, and to impose penalties or interest for failure to pay taxes lawfully due within the time prescribed by law or ordinance. In determining the liability of any taxpayer for a tax, a county may not employ an agent who is compensated in whole or in part by the county for services rendered on a contingent basis or any other basis related to the amount of tax, interest, or penalty assessed against or collected from the taxpayer. The power to impose a tax also includes the power to provide for its administration in a manner not inconsistent with the statute authorizing the tax.

(b) Prohibition. – A county may not impose a license, franchise, or privilege tax on a person engaged in any of the businesses listed in this subsection:

(1) Supplying piped natural gas.
(2) Providing telecommunications service taxed under G.S. 105-164.4(a)(4c).
(3) Providing video programming taxed under G.S. 105-164.4(a)(6).
(4) Providing electricity."

SECTION 19. The Department of Revenue may draw the funds needed to make the following distributions from the sales and use tax collections under Article 5 of Chapter 105 of the General Statutes:

(1) The September 15, 2014, distribution of the franchise tax to cities under G.S. 105-116.1 for the calendar quarter than begins April 1, 2014.

(2) The September 15, 2014, distribution of the excise tax to cities under G.S. 105-187.44 for the calendar quarter than begins April 1, 2014.

SECTION 20.(a) G.S. 105-153.3 reads as rewritten:

"**§ 105-153.3. Definitions.**

The following definitions apply in this Part:

…

(18) Surviving spouse. – Defined in section 2(a) of the Code.

~~(18)~~(19) Taxable year. – Defined in section 441(b) of the Code.

~~(19)~~(20) Taxpayer. – An individual subject to the tax imposed by this Part.

~~(20)~~(21) This State. – The State of North Carolina."

SECTION 20.(b) G.S. 105-153.5(a)(1) reads as rewritten:

"(a) Deduction Amount. – In calculating North Carolina taxable income, a taxpayer may deduct from adjusted gross income either the standard deduction amount provided in subdivision (1) of this subsection or the itemized deduction amount provided in subdivision (2) of this subsection that the taxpayer claimed under the Code. In the case of a married couple filing separate returns, a taxpayer may not deduct the standard deduction amount if the taxpayer or the taxpayer's spouse claims the itemized deductions amount:

(1) Standard deduction amount. – An amount equal to the amount listed in the table below based on the taxpayer's filing status:

Filing Status	**Standard Deduction**
Married, filing ~~jointly~~jointly/surviving spouse	$15,000
Head of Household	12,000
Single	7,500
Married, filing separately	7,500."

SECTION 20.(c) G.S. 105-134.1 reads as rewritten:

"**§ 105-134.1. Definitions.**

The following definitions apply in this Part:

…

(15a) Surviving spouse. – Defined in section 2(a) of the Code.

…."

SECTION 20.(d) G.S. 105-134.6(a2) reads as rewritten:

"(a2) Deduction Amount. – In calculating North Carolina taxable income, a taxpayer may deduct either the North Carolina standard deduction amount for that taxpayer's filing status or the itemized deductions amount claimed under the Code. The North Carolina standard deduction amount is the lesser of the amount shown in the table below or the amount allowed under the Code. In the case of a married couple filing separate returns, a taxpayer may not deduct the standard deduction amount if the taxpayer or the taxpayer's spouse claims itemized deductions for State purposes.

A taxpayer that deducts the standard deduction amount under this subsection and is entitled to an additional deduction amount under section 63(f) of the Code for the aged or blind may deduct an additional amount under this subsection. The additional amount the taxpayer may deduct is six hundred dollars ($600.00) in the case of an individual who is married and seven hundred fifty dollars ($750.00) in the case of an individual who is not married and is not a surviving spouse. The taxpayer is allowed the same number of additional amounts that the taxpayer claimed under the Code for the taxable year.

Filing Status	Standard Deduction
Married, filing ~~jointly~~jointly/ surviving spouse	$6,000
Head of Household	4,400
Single	3,000
Married, filing separately	3,000."

SECTION 20.(e) Subsections (a) and (b) of this section are effective for taxable years beginning on or after January 1, 2014. Subsections (c) and (d) of this section are effective retroactively for taxable years beginning on or after January 1, 2012, and before January 1, 2014. The remainder of this section is effective when it becomes law.

SECTION 21. G.S. 105-164.13B(a)(4) reads as rewritten:

"(a) State Exemption. – Food is exempt from the taxes imposed by this Article unless the food is included in one of the subdivisions in this subsection. The following food items are subject to tax:

…

(4) Prepared food, other than bakery items sold without eating utensils by an artisan bakery. The term "bakery item" includes bread, rolls, buns, biscuits, bagels, croissants, pastries, donuts, danish, cakes, tortes, pies, tarts, muffins, bars, cookies, and tortillas. An artisan bakery is a bakery that meets all of the following requirements:

a. It derives over eighty percent (80%) of its gross receipts from bakery items.

b. Its annual gross receipts, combined with the gross receipts of all related ~~persons as defined in G.S. 105-163.010,~~ persons, do not exceed one million eight hundred thousand dollars ($1,800,000). For purposes of this subdivision, the term "related person" means a person described in one of the relationships set forth in section 267(b) or 707(b) of the Code."

SECTION 22.(a) G.S. 105-153.4 reads as rewritten:

"**§ 105-153.4. North Carolina taxable income defined.**

(a) Residents. – For an individual who is a resident of this State, the term "North Carolina taxable income" means the taxpayer's adjusted gross income as modified in G.S. 105-153.5 and ~~G.S. 105-153.6 and G.S. 105-134.6A.~~G.S. 105-153.6.

(b) Nonresidents. – For a nonresident individual, the term "North Carolina taxable income" means the taxpayer's adjusted gross income as modified in G.S. 105-153.5 and ~~G.S. 105-153.6 and G.S. 105-134.6A,~~ G.S. 105-153.6, multiplied by a fraction the denominator of which is the taxpayer's gross income as modified in G.S. 105-153.5 and ~~G.S. 105-153.6 and G.S. 105-134.6A,~~ G.S. 105-153.6, and the numerator of which is the amount of that gross income, as modified, that is derived from North Carolina sources and is attributable to the ownership of any interest in real or tangible personal property in this State, is derived from a business, trade, profession, or occupation carried on in this State, or is derived from gambling activities in this State.

(c) Part-year Residents. – If an individual was a resident of this State for only part of the taxable year, having moved into or removed from the State during the year, the term "North Carolina taxable income" has the same meaning as in subsection (b) of this section except that the numerator includes gross income, as modified under G.S. 105-153.5 and ~~G.S. 105-153.6 and G.S. 105-134.6A,~~ G.S. 105-153.6, derived from all sources during the period the individual was a resident.

(d) S Corporations and Partnerships. – In order to calculate the numerator of the fraction provided in subsection (b) of this section, the amount of a shareholder's pro rata share of S Corporation ~~income~~ income, as modified in G.S. 105-153.5 and G.S. 105-153.6, that is includable in the numerator is the shareholder's pro rata share of the S Corporation's income attributable to the State, as defined in G.S. 105-131(b)(4). In order to calculate the numerator of the fraction provided in subsection (b) of this section for a member of a partnership or other unincorporated business that has one or more nonresident members and operates in one or more other states, the amount of the member's distributive share of the total net income of the ~~business~~ business, as modified in G.S. 105-153.5 and G.S. 105-153.6, that is includable in the numerator is determined ~~by multiplying the total net income of the business by the ratio ascertained under the~~ in accordance with the provisions of G.S. 105-130.4. As used in this subsection, total net income means the entire gross income of the business less all expenses, taxes, interest, and other deductions allowable under the Code that were incurred in the operation of the business.

(e) Tax Year. – A taxpayer must compute North Carolina taxable income on the basis of the taxable year used in computing the taxpayer's income tax liability under the Code."

SECTION 22.(b) G.S. 105-153.5 is amended by adding a new subsection to read:

"(c1) Other Additions. – S Corporations subject to the provisions of Part 1A of this Article, partnerships subject to the provisions of this Part, and estates and trusts subject to the provisions of Part 3 of this Article must add any amount deducted under section 164 of the Code as state, local, or foreign income tax."

SECTION 22.(c) This section is effective for taxable years beginning on or after January 1, 2015.

SECTION 23.(a) G.S. 105-164.13, as amended by Section 6.1(f) of S.L. 2014-3, reads as rewritten:

"**§ 105-164.13. Retail sales and use tax.**

The sale at retail and the use, storage, or consumption in this State of the following tangible personal property, digital property, and services are specifically exempted from the tax imposed by this Article:

…

(62) An item used to maintain or repair tangible personal property or a motor vehicle pursuant to a service contract taxable under this Article if the purchaser of the contract is not charged for the item. ~~This exemption does not apply to an item used to maintain or repair tangible personal property pursuant to a service contract exempt from tax under G.S. 105-164.4I(b).~~ For purposes of this exemption, the term "item" does not include a tool, equipment, supply, or similar tangible

personal property used to complete the maintenance or repair and that is not deemed to be a component or repair part of the tangible personal property or motor vehicle for which a service contract is sold to a purchaser."

SECTION 23.(b) G.S. 105-187.52(c) reads as rewritten:

"(c) Exemption. – State agencies are exempted from the privilege taxes imposed by this Article. <u>The exemption in G.S. 105-164.13(62) does not apply to an item used to maintain or repair tangible personal property pursuant to a service contract exempt from tax under G.S. 105-164.4I(b)(4).</u>"

SECTION 23.(c) Notwithstanding G.S. 105-164.13(62), as amended by S.L. 2014-3 and by subsection (a) of this section, the sales and use tax exemption in G.S. 105-164.13(62) applies to an item used pursuant to a service contract that meets the definition of a "service contract" as defined in G.S. 105-164.3(38b), notwithstanding that the service contract was sold before January 1, 2014, and effective on, before, or after January 1, 2014.

SECTION 23.(d) Subsections (a) and (b) of this section become effective October 1, 2014. The remainder of this section is effective when it becomes law.

SECTION 24. Except as otherwise provided, this act is effective when it becomes law.

Bill Draft 2015-TDxz-5: Revenue Laws Technical Changes.

2013-2014 General Assembly

Committee:		**Date:**	January 8, 2015
Introduced by:		**Prepared by:**	Finance Team
Analysis of:	2015-TDxz-5		Committee Counsel

SUMMARY: This draft incorporates the Revenue Laws technical changes that were circulated during the 2014 Session in Senate Bill 763, House Bill 1224, and House Bill 189, or some combination thereof. These provisions make technical corrections and clarifying changes to the tax statutes largely based on recommendations of the Department of Revenue.

BACKGROUND: After passage of House Bill 1050 early in the 2014 Session, the companion bill, Senate Bill 763, became the primary vehicle for additional revenue laws technical changes and passed the Senate in late July. However, a number of substantive provisions were added to the bill on the House floor, in which the Senate did not concur. The non-roll call changes were then put into House Bill 1224 and the roll call technical changes were put into House Bill 189. Neither of those bills passed.

EFFECTIVE DATE: Except as otherwise provide, this bill would become effective when the act becomes law.

BILL ANALYSIS:

Section	Explanation and Effective Date
1	This section does two things. First, it clarifies that the changes related to retailer-contractors, which become effective January 1, 2015, are not to be construed to affect the interpretation of any statute that is the subject of a State tax audit for taxable years beginning prior to the effective date of the changes. The prior language referred to "audit pending," which the Department indicated was unclear. The changes made by Part VII of S.L. 2014-3 are not intended to be retroactive, and therefore any audit or litigation resulting derived from an audit for taxable years prior to January 1, 2015 is subject to the statutes and interpretations of the Department for those years. Second, it clarifies the effective date by providing that the changes apply to withdrawals from inventory on or after that date as well as sales since retailer-contractors do both; they make retail sales of items and they withdraw items from inventory that are used in the performance of a real property contract.
2	This section clarifies the conditions under which a retailer is or is not liable for the collection of tax on the rental of private residences rented for fewer than 15 days and listed with a real estate broker during the period in which the Department's Important Notice was in effect and during the 30-day period following the effective date of S.L. 2014-3. The original provision was not specific to the private residence changes but generically referred to the entire

	section, which could have been interpreted to affect the liability of retailers required to collect tax on the rental of accommodations generally. This section becomes effective June 1, 2014.
3	This section repeals an unnecessary provision; Section 14.1 of S.L. 2014-3 made the same change.
4	The Tax Reduction Act, S.L. 2013-316, included electricity and piped natural gas in the State sales tax base while repealing the utility franchise tax on electricity and the excise tax on piped natural gas. Section 4.2(a) of the Act directed the Utilities Commission to adjust the rates of electricity and piped natural gas to reflect the repeal of the utility franchise tax and the excise tax on piped natural gas. The Act also reduced the corporate income tax rate. However, the Act did not direct the Utilities Commission to take any action on utility rates related to the reduction in corporate income tax rates. In May of 2014 the Commission took its first action related to the Act. The Commission issued an order directing utilities to adjust rates to reflect the repeal of the utility franchise tax, the repeal of the excise tax on piped natural gas, and the reduction in the corporate income tax rate. Dominion Power and PSNC Energy both appealed this order, on the grounds that the Act did not direct the Commission to take action related to the reduction in the corporate income tax rate. In October of 2014 the Commission reversed its first order. The Commission authorized the utilities not to reduce their rates related to the changes in the corporate income tax rate, and allowed any utility that had reduced rates for this reason to recover those funds from customers. No utility has taken this step of seeking to recover these funds from customers. Except for Dominion Power, all of the retail electric and piped natural gas utilities are passing on the savings from the reduction in the corporate income tax rates to their customers. This section would clarify the intent of the General Assembly regarding the impact of the Act on utility rates. This draft would direct the Commission to adjust utility rates to reflect the reduction in the corporate income tax rate and would also direct the Commission to impose interest on any refunds issued to utility customers as a result of reduction in the corporate income tax rate.
5	S.L. 2014-3 enacted a new tax on vapor products as part of the current tax on other tobacco products (OTP). This section makes a technical change that allows North Carolina manufacturers of vapor products to collect the new vapor tax on internet retail sales, while allowing the manufacturers to continue to the current practice of applying to the Secretary of Revenue to be relieved of the tax for vapor products shipped to wholesale and retail dealers. The Secretary allows manufacturers to be relieved of paying the tax on OTP when the tax is paid by the wholesale or retail dealer. This section becomes effective June 1, 2015.
6	This section clarifies that the credit may be taken when the property is placed into service in this State. When a renewable energy project is put together,

	there are usually two sets of investors, those that want the federal credit and those that want the State credit. If the lessee is to get the federal credit, it must "place it into service". However, if the lessor wants the State credit, it must "place it into service". As clarified by this section, the lessor may claim the State credit as long as somebody (the lessee) places the property into service.
7	This section incorporates a revision made to G.S. 15-130.5(b)(4) made by Section 14.3 of S.L. 2014-3 so that the changes engross correctly in the codification process.
8	This section clarifies that the phrase "subject to tax under Part 2 or 3 of Article 4" applies to a beneficiary of a transferor. Subsection (a) becomes effective for the 2013 taxable year; subsection (b) becomes effective for the 2014 taxable year.
9	This section provides that neither an individual nor a withholding agent may be penalized for underpayment of income tax for the 2014 taxable year if the reason for the underpayment is the clarification of the law in S.L. 2014-3. S.L. 2014-3 clarified that a person who is not eligible for a federal standard deduction is not eligible for a State standard deduction. A nonresident alien individual is not allowed a standard deduction. This section does not change the effective date of the substantive law change or the amount of tax due and payable.
10	This section clarifies that the term "retailer" is any person required to collect sales tax imposed under G.S. 105-164.4, other than a facilitator. The current definition does not reflect the expansion of the sales tax base to prepaid meal plans, admission charges, piped natural gas, and service contracts.
11	This section makes technical and conforming changes.
12	This section clarifies that the exemption provisions applicable to fuel also include piped natural gas. PNG is considered fuel, but since the imposition of the combined rate of tax for PNG is separate from the general tax imposed on fuel, the Department of Revenue requested this clarifying change.
13	This section does four things. First, it would clarify that a farmer is allowed a sales and use tax exemption for farm-related purchases if the farmer's sales plus other amounts used to determine farm income under the Code exceeds $10,000. Under current law, the farmer's gross income may be reduced by the farmer's basis of livestock. Under this section, gross sales of livestock would not be reduced by the cost or basis of the livestock sold. Second, it would clarify that the exemption expires ***upon the earlier of*** the following: when a person fails to meet the income requirement for three consecutive years or ceases to engage in farming operations. And a new farmer may obtain a conditional exemption provided the person submits applicable income tax returns to the Department ***and provided*** the person is engaged in farming operations. Third, it would make a similar clarifying change as made in Section 11 of this bill for the farm exemption for fuel and piped natural gas. It also makes other technical changes suggested by the Department of Revenue.

	Fourth, it would provide that certain tangible personal property purchased to fulfill a contract with a person who holds a farmer exemption certificate or a conditional farmer exemption certificate is exempt to the same extent as if purchased directly by the person who holds the exemption certificate. This section becomes effective July 1, 2014. A contractor who paid sales and use tax on an item exempt from sales and use tax, as enacted by this section, may request a refund from the retailer and the retailer may, upon issuance of the refund or credit, request a refund for overpayment of tax under G.S. 105-153.3.
14	This section does two things: • It provides that a retailer who has an agreement with a food service contractor to collect and remit the sales tax on gross receipts derived from a prepaid meal plan is not liable for the tax that the retailer remits to the food service contractor. • It requires a retailer to report gross receipts derived from a prepaid meal plan on an accrual basis of accounting for purposes of reporting sales tax.
15	This section makes a change as to who may apply for a certificate of registration for legal entity so that it is consistent with the changes made in Section 14.18 of S.L. 2014-3 as to who may be liable for unpaid sales tax for a legal entity.
16	This section changes a statute that was not codified as it was intended to be amended by Section 47 of S.L. 2013-414. The section does not change the substance of the subdivision. The change made last session codified the Department's administrative practice of allowing protective refund claims to be filed when an event prevented a taxpayer from having the information necessary to file a request for refund, such as pending litigation or an ongoing income tax audit in another state that may affect the taxpayer's NC tax liability.[*]
17	Part XI of S.L. 2014-3 established a procedure for the central assessment of mobile telecommunications property. The intent of this Part was to shift the responsibility for conducting the valuations of this particular kind of property from the individual counties to the Department of Revenue without creating any "winners" or "losers" in terms of the values allocated to the counties. This section makes minor modifications to that Part to ensure that there is no shifting of value among counties as a result of the change. The Department appraises this property at its "true value," which includes consideration of its original cost but with deductions made for all forms of depreciation to arrive at the property's fair market value. However, under S.L. 2014-3, the allocation of the value among the counties in which the property is located would have been based only on original cost. Using original cost would have had the effect of overinflating the value allocated to

[*] Generally speaking, there is a time limit within which a taxpayer may file a claim for refund. If the claim for refund is not timely filed, it will be barred. The Department has administratively allowed for a taxpayer in these circumstances to file a timely but incomplete claim for refund, known as a "protective refund claim," and then later perfect the claim when the essential information becomes available.

	a particular county and decreasing the value allocated to other counties. This section provides that once the Department determines the value of the property, it will be allocated among the counties based on where the property is located.
18	Cities have historically been prohibited from imposing a license, franchise, or privilege tax on certain utility-related businesses, such as telecommunications, video programming, and electricity. With the repeal of G.S. 160A-211, effective July 1, 2015, the specific prohibition language would also be repealed. While cities only have the power to tax or charge a fee to the extent the legislature has granted them the authority to do so, and the repeal of this prohibition is not necessarily a grant of authority otherwise, the utilities industry has concerns about the deletion of the prohibition as it relates to rights-of way and has requested that the language be kept in the statutes. This section recodifies the language in a more appropriate place in the statutes.
19	S.L. 2013-316, included electricity and piped natural gas in the State sales tax base while repealing the utility franchise tax on electricity and the excise tax on piped natural gas. A portion of both of the repealed taxes was shared with the cities. The tax-sharing revenue under the repealed taxes was replaced with a distribution of part of the sales tax on electricity and piped natural gas. This section clarifies that funds from the sales tax may be used for the final distribution of the repealed franchise tax on electricity and repealed excise tax on piped natural gas.
20	This section conforms to federal law, and codifies the current practice, of providing the same standard deduction amount for a surviving spouse as for a married couple filing jointly. Subsections (a) and (b) make the necessary changes to the tax statutes effective for taxable years beginning on or after January 1, 2014. Subsections (c) and (d) make the same change for taxable years 2012 and 2013. When North Carolina used federal taxable income as its starting point, a specific reference to "surviving spouse" was not necessary because the amount of the standard deduction was automatically a part of that calculation. However, with the change in the 2012 taxable year to federal adjusted gross income, this conforming provision was inadvertently omitted.
21	This section removes a reference to a repealed statute, and incorporates the definition that was referenced in the repealed statute.
22	Subsection (a) of this section would remove reference to a repealed statute and clarify in the personal income tax statutes that income of a partnership that is apportionable to multiple states is allocated and apportioned in accordance with G.S. 105-130.4. Income that is not apportionable should be allocated to the appropriate state. The current statute refers to a ratio rather than to the rules of allocation and apportionment. For State income tax purposes, subsection (b) of this section would require S Corps, partnerships, estates and trusts to add back State income tax that was deducted from federal income. Prior to S.L. 2013-316, the statutory requirement for the add-back for S Corporations, partnerships, estates and

	trusts was a cross reference to the individual requirement. When the individual requirement was repealed, add-back for S Corporations, partnerships, estates and trusts requirement was erroneously repealed as well.[†] This section becomes effective for taxable years beginning on or after January 1, 2015.
23	Subsection (a) of this section would clarify that the exemption for items used to maintain or repair tangible personal property applies to those items used pursuant to a service contract subject to sales tax. If the service contract is not subject to tax, then the item used to maintain or repair the property is subject to tax. Subsection (b) of this section would make a conforming change in Article 5F regarding the treatment of items used in a service contract. These subsections would become effective when the act becomes law. Subsection (c) of this section would provide that the exemption applies, regardless of when the service contract was purchased. It would be difficult for a person to know, when a service is performed pursuant to a service contract, whether the service contract was purchased before or after January 1, 2014.

[†] This requirement was repealed for individual filers in S.L. 2013-316, when the itemized and standard deduction was changed for individual filers.

LEGISLATIVE PROPOSAL #2

AN ACT TO UPDATE THE REFERENCE TO THE INTERNAL REVENUE CODE AND TO DECOUPLE FROM CERTAIN PROVISIONS OF THE FEDERAL TAX INCREASE PREVENTION ACT OF 2014.

LEGISLATIVE PROPOSAL #2

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2015 REGULAR SESSION OF THE 2015 GENERAL ASSEMBLY

AN ACT TO UPDATE THE REFERENCE TO THE INTERNAL REVENUE CODE AND TO DECOUPLE FROM CERTAIN PROVISIONS OF THE FEDERAL TAX INCREASE PREVENTION ACT OF 2014.

SHORT TITLE: IRC Update.

PRIMARY SPONSORS:

BRIEF OVERVIEW: This legislative proposal updates from December 31, 2013, to January 1, 2015, the reference to the Internal Revenue Code used in determining certain State tax provisions.

FISCAL IMPACT: See Estimated NC Tax Effects of Revenue Law Proposal for IRC Update $(Millions), on page 57 of this report.

EFFECTIVE DATE: Except as otherwise provided, this proposal would become effective when it becomes law.

A copy of the proposed legislation and a bill analysis begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2015

H **D**

HOUSE DRH10012-SVxz-2D (01/08)

Short Title:	IRC Update.	(Public)
Sponsors:	Representative.	
Referred to:		

A BILL TO BE ENTITLED

AN ACT TO UPDATE THE REFERENCE TO THE INTERNAL REVENUE CODE AND TO DECOUPLE FROM CERTAIN PROVISIONS OF THE FEDERAL TAX INCREASE PREVENTION ACT OF 2014.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-228.90(b)(1b) reads as rewritten:

"(1b) Code. – The Internal Revenue Code as enacted as of ~~December 31, 2013,~~ January 1, 2015, including any provisions enacted as of that date that become effective either before or after that date."

SECTION 2.(a) G.S. 130.5B(c) reads as rewritten:

"**§ 105-130.5B. Adjustments when State decouples from federal accelerated depreciation and expensing.**

…

(c) Section 179 Expense. – For purposes of this subdivision, the definition of section 179 property has the same meaning as under section 179 of the Code as of January 2, 2013. A taxpayer who places section 179 property in service during a taxable year listed in the table below must add to the taxpayer's federal taxable income eighty-five percent (85%) of the amount by which the taxpayer's expense deduction under section 179 of the Code exceeds the dollar and investment limitation listed in the table below for the taxable year.

A taxpayer is allowed to deduct twenty percent (20%) of the add-back in each of the first five taxable years following the year the taxpayer is required to include the add-back in income.

Taxable Year of 85% Add-Back	**Dollar Limitation**	**Investment Limitation**
2010	$250,000	$800,000
2011	$250,000	$800,000
2012	$250,000	$800,000
2013	$25,000	$200,000
2014	$25,000	$200,000"

SECTION 2.(b) G.S. 105-153.6(c) reads as rewritten:

"**§ 105-153.6. Adjustments when State decouples from federal accelerated depreciation and expensing.**

…

(c) Section 179 Expense. – For purposes of this subdivision, the definition of section 179 property has the same meaning as under section 179 of the Code as of January 2, 2013. A taxpayer who places section 179 property in service during a taxable year listed in the table below must add to the taxpayer's federal taxable income or adjusted gross income, as appropriate, eighty-five percent (85%) of the amount by which the taxpayer's expense deduction under section 179 of the Code exceeds the dollar and investment limitation listed in the table below for that taxable year. For taxable years before 2012, the taxpayer must add the amount to the taxpayer's federal taxable income. For taxable year 2012 and after, the taxpayer must add the amount to the taxpayer's adjusted gross income.

A taxpayer is allowed to deduct twenty percent (20%) of the add-back in each of the first five taxable years following the year the taxpayer is required to include the add-back in income.

Taxable Year of 85% Add-Back	**Dollar Limitation**	**Investment Limitation**
2010	$250,000	$800,000
2011	$250,000	$800,000
2012	$250,000	$800,000
2013	$25,000	$200,000
2014	$25,000	$200,000"

SECTION 3.(a) G.S. 105-153.5 reads as rewritten:

"**§ 105-153.5. Modifications to adjusted gross income.**

…

(d) Decoupling Adjustments. – In calculating North Carolina taxable income, a taxpayer must add to the taxpayer's adjusted gross income any of the following items that are not included in the taxpayer's adjusted gross income:

(1) For taxable year 2014, the amount excluded from the taxpayer's gross income for the discharge of qualified principal residence indebtedness under section 108 of the Code. The purpose of this subdivision is to decouple from the extension of the income exclusion under section 102 of the Tax Increase Prevention Act of 2014.

(2) For taxable year 2014, the amount of the taxpayer's deduction for mortgage insurance premiums as qualified residence interest under section 163 of the Code. The purpose of this subdivision is to decouple from the extension of the deduction under section 104 of the Tax Increase Prevention Act of 2014.

(3) For taxable year 2014, the amount of the taxpayer's deduction for qualified tuition and related expenses under section 222 of the Code. The purpose of this subdivision is to decouple from the extension of the federal above-the-line deduction under section 107 of the Tax Increase Prevention Act of 2014.

(4) For taxable year 2014, the amount excluded from the taxpayer's gross income for a qualified charitable distribution from an individual retirement plan by a person who has attained age 70 1/2 under section 408(d)(8) of the Code. The purpose of this subdivision is to decouple

from the extension of the income exclusion under section 108 of the Tax Increase Prevention Act of 2014.

~~(d)~~(e) S Corporations. – Each shareholder's pro rata share of an S Corporation's income is subject to the adjustments provided in this section and in G.S. 105-153.6."

SECTION 3.(b) G.S. 105-153.5(d) is amended by adding a new subdivision to read:

"(10) For taxable year 2014, the taxpayer may deduct the amount that would have been allowed as a charitable deduction under section 170 of the Code had the taxpayer not elected to take the income exclusion under section 408(d)(8) of the Code."

S**ECTION 4.** This act is effective when it becomes law. Notwithstanding Section 1 of this act, any amendments to the Internal Revenue Code enacted after December 31, 2013, that increase North Carolina taxable income for the 2014 taxable year are effective for taxable years beginning on or after January 1, 2015.

Bill Draft 2015-SVxz-2D: IRC Update.

2015-2016 General Assembly

Committee:	Revenue Laws Study Committee	**Date:**	January 13, 2015
Introduced by:		**Prepared by:**	Trina Griffin Committee Counsel
Analysis of:	2015-SVxz-2D		

SUMMARY: Updates from December 31, 2013, to January 1, 2015, the reference to the Internal Revenue Code used in determining certain State tax provisions. The bill decouples from the following extensions under the federal Tax Increase Prevention Act of 2014 for the 2014 tax year, but it would conform to the $250 teacher expense deduction:

- ***Bonus depreciation***
- ***Enhanced Section 179 expensing***
- ***Exclusion from income for forgiveness of debt on principal residence***
- ***Deduction for mortgage insurance premiums***
- ***Deduction for higher education tuition expenses***
- ***Tax-free distribution from IRAs to public charities***

CURRENT LAW: North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.[*] The General Assembly determines each year whether to update its reference to the Code.[†] Updating the reference makes recent amendments to the Code applicable to the State to the extent that State law previously tracked federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. 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. The current reference to the Code is December 31, 2013.

BACKGROUND: On December 19, 2014, the Tax Increase Prevention Act of 2014 (TIPA) was signed into law[‡] and extended several provisions that were enacted last year in the American Taxpayer Relief Act (ATRA). ATRA was intended to avert the anticipated "fiscal cliff" due to the sunset provisions scheduled to take effect in 2013 that would have ended the Bush-era tax cuts contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA),

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[*] 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.

[†] 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."

[‡] P.L. 113-295.

which were temporarily extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act).

ANALYSIS:

UPDATE IRC REFERENCE DATE

Section 1 of the bill would update the reference to the Code from December 31, 2013, to January 1, 2015.

COUPLED PROVISION

By updating the reference to the Code, North Carolina would conform to various provisions, including the following:

Teachers' Classroom Expense Deduction

This bill would result in conformity with the extension of the federal teachers' classroom expense deduction for tax year 2014.

Explained. – This deduction allows primary and secondary education professionals to take an above-the-line deduction for qualified expenses up to $250 paid out-of-pocket during the year.

Federal Background. – This deduction was established under EGTRRA in 2001 (beginning with tax year 2002) and was scheduled to expire in 2006. It was subsequently extended through 2013. TIPA extended the deduction for one more year.

North Carolina Background. – Prior to 2012, teachers in North Carolina were allowed the deduction at the State level because North Carolina began its calculation of taxable income with federal AGI. In 2012, North Carolina enacted a stand-alone individual income tax deduction for this purpose. The stand-alone provision was enacted because, at the time, the federal deduction was set to expire and Congress had not yet acted to extend it. However, this deduction was repealed as part of the Tax Simplification and Reduction Act of 2013 (HB 998), effective for tax years beginning on or after January 1, 2014. Because Congress has extended the deduction for tax year 2014, the update of the IRC reference in this bill would mean that teachers will continue to be able to take advantage of this deduction.

DECOUPLED PROVISIONS

Bonus Depreciation[§]

Explained. – Businesses may depreciate the cost of a new asset[**] over a period of time, usually five to 15 years. Bonus depreciation allows a business to claim more of a deduction up front and spread the remainder out over the normal depreciation schedule.

Federal Background. – Since 2002, businesses have been authorized to take an additional depreciation deduction on depreciable property ranging from 30% to 100%, known as bonus depreciation. The 2010 Tax Relief Act provided 50% bonus depreciation for qualified property placed in service after December 31, 2012, and before January 1, 2013.

[§] Because North Carolina has already permanently decoupled from bonus depreciation, this bill has no impact in that regard. It is mentioned in the summary because it is the first tax year that the permanent provision is in effect (See. G.S. 105-153.6(a)).

[**] One important difference between bonus depreciation and section 179 expensing is that bonus depreciation applies only to new equipment, while section 179 expensing may apply to new and used equipment.

The American Taxpayer Relief Act of 2013 extended the 50% bonus depreciation provision for one year, and TIPA extended it for an additional year.

North Carolina Background. – Since 2002, North Carolina has decoupled from the federal bonus depreciation provisions. Under the Tax Simplification and Reduction Act[††], North Carolina permanently decoupled from this provision, which means that the General Assembly does not have to take any action to decouple from this provision to the extent Congress continues to extend it. For taxable years beginning on or after January 1, 2014, a taxpayer is required to add back 85% of the accelerated depreciation amount in the year it is claimed for federal purposes with a corresponding 20% deduction over the next five years. The taxpayer will be deducting the same amount of an asset's basis under State law as under federal law, it is just that the timing of the deduction differs.

Section 179 Expensing

Section 2 of the act does not conform to the one-year extension of the enhanced section 179 expensing provision. For tax year 2014, the deduction and investment limits are $25,000 and $200,000, which are what the limits would have been at the federal level if TIPA had not been enacted.

The act further provides that the property's basis will be the same for federal and State purposes and treats the difference in the same manner as State tax law has historically treated the bonus depreciation: A taxpayer must add back 85% of the additional expensing taken under federal law in 2014 and then deduct 20% of this amount over the succeeding five years. Full conformity to the section 179 expense deduction would have been $52 million.

Explained. – Section 179 of the Code allows taxpayers to immediately deduct, rather than gradually depreciate, the cost of qualified assets, subject to certain limitations.[‡‡] Use of the allowance has two components: a dollar limitation and an investment limitation. The dollar limitation is the maximum amount of the deduction that the taxpayer may elect to take. The investment limitation is the maximum amount that can be spent on equipment before the deduction begins to be reduced. The deduction is reduced, dollar for dollar, by the amount that exceeds the investment limitation. Prior to 2010, section 179 was commonly thought to apply to small businesses because of its maximum deduction and investment limits.[§§] However, the enhancements made by the Small Business Jobs Act of 2010 (2010 Jobs Act) were the most expansive ever enacted and those limits were extended under ATRA and TIPA.

Federal Background. – Since 2010, the deduction limitation has been $500,000 and the investment limitation has been $2 million. Without the recent extensions, the limits would have reverted to the prior levels of $25,000 and $200,000.

North Carolina Background. – Prior to 2010, North Carolina typically conformed to the enhanced section 179 expense deduction provisions. However, given the expansive nature of the enhancements made by the 2010 Jobs Act, which have been extended over the last several years, North Carolina has decoupled and adopted lower limits since 2010.[***]

[††] HB 998; S.L. 2013-316.

[‡‡] Generally, taxpayers take the Section 179 expensing deduction first and claim bonus depreciation on any remaining basis.

[§§] Prior to the Emergency Economic Stabilization Act of 2008 (EESA), deduction limit was $125,000 with a phase-out beginning at $500,000.

[***] North Carolina's dollar and investment limitations were $250,000 and $800,000, respectively, for taxable years 2010 through 2012. The dollar and investment limitations for 2013 were $25,000 and $200,000, respectively.

Income Exclusion for Discharge of Qualified Principal Residence Indebtedness

Section 3 of the act does not conform to the extension of the income exclusion for the discharge of qualified principal residence indebtedness. It requires a taxpayer to add back the amount excluded at the federal level for purposes of determining North Carolina taxable income. The cost to conform to this provision would be approximately $14 million.

Explained. – Taxpayers are generally required to recognize income from the discharge of indebtedness. An exception from this rule is for the discharge of qualified principal residence indebtedness, which has been excludible from gross income on a temporary basis since 2007.[†††] The exclusion is limited to $2 million, and applies to indebtedness incurred in the acquisition, construction, or substantial improvement of a principal residence and secured by the residence.

Federal Background. – This exclusion was scheduled to expire for debt discharged after December 31, 2013, but was extended for one year under TIPA.

North Carolina Background. – North Carolina conformed to this provision from 2007 through 2012, but decoupled for the first time for tax year 2013.

Deduction for Mortgage Insurance Premiums as Interest

Section 3 of the act does not conform to the extension of the deduction for mortgage insurance premiums as interest for tax year 2014. Therefore, taxpayers are required to add back the amount they took as a deduction at the federal level for purposes of determining North Carolina taxable income. The cost to conform to this provision would be approximately $4 million.

Explained. – Generally, taxpayers may not deduct any interest paid or accrued during the tax year that is considered personal interest. This restriction does not apply to certain types of interest, including qualified residence interest. Qualified residence interest includes interest on home acquisition indebtedness of up to $1 million and interest on home equity indebtedness of up to $100,000. In the case of a home acquisition loan, an individual who cannot pay the entire down payment amount may be required to purchase mortgage insurance.

Federal Background. –Since 2006, premiums paid for qualified mortgage insurance in connection with acquisition indebtedness for a qualified residence are treated as qualified residence interest and are deductible.[‡‡‡] The treatment of qualified mortgage insurance as qualified residence interest was set to expire for amounts paid or accrued after December 31, 2013. TIPA extends the availability of the deduction for one year.

North Carolina Background. – North Carolina conformed to this provision from 2006 through 2012, but decoupled for the first time for tax year 2013.

[†††] This exclusion was originally authorized in the Mortgage Debt Relief Act of 2007.

[‡‡‡] The deduction is subject to a phaseout. For every $1,000, or fraction thereof, by which the taxpayer's AGI exceeds $100,000, the amount of mortgage insurance premiums treated as interest is reduced by 10%.

Higher Education Deduction

Section 3 of the act does not conform with the extension of the federal qualified tuition and expenses deduction for tax year 2014. The cost to conform to this provision would be approximately $1 million.

Explained. – Subject to income limitations, a taxpayer may take an above-the-line deduction for qualified education expenses paid during the year for the taxpayer or the taxpayer's spouse or dependents. Generally, any accredited public, nonprofit, or proprietary post-secondary institution is an eligible educational institution. The maximum deduction is $4,000 for an individual whose adjusted gross income for the tax year does not exceed $65,000 ($130,000 for MFJ filers), or $2,000 for other individuals whose adjusted gross income does not exceed $80,000 ($160,000 for MFJ filers).

Federal Background. – This deduction was established under EGTRRA and was scheduled to expire in 2006. It was subsequently extended through 2013. TIPA extended the deduction for one more year.

North Carolina Background. – North Carolina had conformed to this provision until last year when it decoupled for the 2013 taxable year.

Income Exclusion for Distributions from IRAs to Charity

This bill would not conform with the extension of the income exclusion for a qualified charitable distribution from an individual retirement plan by a person who has attained the age of 70½ for tax year 2014. The treatment is capped at a maximum of $100,000 per taxpayer.

Explained. – Generally, a taxpayer must include in gross income distributions made from a traditional or Roth IRA account except to the extent they represent a return of nondeductible contributions or are rolled over into another qualified retirement plan.

Federal Background. – Since 2006,[§§§] taxpayers age 70½ or older may contribute up to $100,000 from their IRA account to a charity tax-free. This income exclusion was set to expire for distributions made in tax years beginning after December 31, 2013. TIPA extends the availability of this exclusion for one year.

North Carolina Background. – North Carolina conformed to this provision for 2006 through 2012, but decoupled for 2013.

[§§§] This exclusion was originally authorized by the Pension Protection Act of 2006. The law was extended through 2009 by the Emergency Economic Stabilization Act of 2008, and through 2011, by the 2010 Tax Relief Act.

Estimated NC Tax Effects of Conforming to Federal Tax Legislation (HR 5771)
$(Millions)

Provision	FY 14-15 Fiscal Impact
Increased Section 179 expensing limits	-52
Deduction of up to $250 for teacher classroom expenses	-1
Deduction for tuition expenses	-1
Exclusion from income for cancellation of debt on principal residence	-14
Deduction for mortgage insurance premiums	-4
Tax free distribution from IRAs to public charities	-1
Total	-73

Estimated NC Tax Effects of Revenue Laws Proposal for IRC Update
$(Millions)

	FY 14-15 Fiscal Impact
Deduction of up to $250 for teacher classroom expenses	-1
Total	-1

Fiscal Research
01/13/2015

LEGISLATIVE PROPOSAL #3

AN ACT TO LIMIT THE TAX EXEMPTION FOR RETIREMENT PLAN DISTRIBUTIONS ROLLED OVER INTO A QUALIFYING TAX-EXEMPT BAILEY RETIREMENT TO ROLLOVER DISTRIBUTIONS FROM ANOTHER QUALIFYING TAX-EXEMPT BAILEY RETIREMENT ACCOUNT, AS RECOMMENDED BY THE REVENUE LAWS STUDY COMMITTEE.

LEGISLATIVE PROPOSAL #3

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2015 REGULAR SESSION OF THE 2015 GENERAL ASSEMBLY

AN ACT TO LIMIT THE TAX EXEMPTION FOR RETIREMENT PLAN DISTRIBUTIONS ROLLED OVER INTO A QUALIFYING TAX-EXEMPT BAILEY RETIREMENT TO ROLLOVER DISTRIBUTIONS FROM ANOTHER QUALIFYING TAX-EXEMPT BAILEY RETIREMENT ACCOUNT, AS RECOMMENDED BY THE REVENUE LAWS STUDY COMMITTEE.

SHORT TITLE: Rollovers into Qualifying Bailey Plans.

PRIMARY SPONSORS:

BRIEF OVERVIEW: This legislative proposal would limit the exemption for retirement plan distributions from a qualifying Bailey account to the portion of the distribution attributable to a State, local, or federal government retirement plan.

FISCAL IMPACT:

EFFECTIVE DATE: Except as otherwise provided, this proposal would become effective when it becomes law.

A copy of the proposed legislation and a bill analysis begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2015

S **D**

SENATE DRS15012-RBxz-4 (11/20)

Short Title:	Rollovers into Qualifying Bailey Plans.	(Public)
Sponsors:	Senator (Primary Sponsor).	
Referred to:		

A BILL TO BE ENTITLED

AN ACT TO LIMIT THE TAX EXEMPTION FOR RETIREMENT PLAN DISTRIBUTIONS ROLLED OVER INTO A QUALIFYING TAX-EXEMPT BAILEY RETIREMENT TO ROLLOVER DISTRIBUTIONS FROM ANOTHER QUALIFYING TAX-EXEMPT BAILEY RETIREMENT ACCOUNT, AS RECOMMENDED BY THE REVENUE LAWS STUDY COMMITTEE.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-153.5(b)(5) reads as rewritten:

"(b) Other Deductions. – In calculating North Carolina taxable income, a taxpayer may deduct from the taxpayer's adjusted gross income any of the following items that are included in the taxpayer's adjusted gross income:

…

(5) The amount received during the taxable year from one or more State, local, or federal government retirement plans to the extent the amount is exempt from tax under this Part pursuant to a court order in settlement of <u>one or more of the cases listed in this subdivision. The deduction provided by this subdivision does not apply to distributions from a retirement plan exempt from tax under this subdivision to the extent attributable to a rollover from a retirement account that is not exempt under this subdivision. The portion of a distribution that is attributable to a rollover from a retirement account that is not exempt under this subdivision is taxable in accordance with the methodology used by Superior Court Judge Jack A. Thompson in his Order Regarding the Optional Retirement Program for State Institutions for Higher Education, signed on November 19, 1999. This subdivision applies to a court order in settlement of </u>any of the following cases:

a. Bailey v. State, 92 CVS 10221, 94 CVS 6904, 95 CVS 6625, 95 CVS 8230.

b. Emory v. State, 98 CVS 0738.

c. Patton v. State, 95 CVS 04346."

SECTION 2. This act is effective for taxable years beginning on or after January 1, 2016.

This Bill Analysis reflects the contents of the bill as it was presented in committee.

Bill Draft 2015-RBxz-4: Rollovers into Qualifying Bailey Plans.

2015-2016 General Assembly

Committee:	Revenue Laws Study Committee	**Date:**	January 12, 2015
Introduced by:		**Prepared by:**	Cindy Avrette Committee Counsel
Analysis of:	2015-RBxz-4		

SUMMARY: The bill draft would limit the tax exemption for retirement plan distributions from a qualifying Bailey account to the portion of the distribution attributable to a State, local, or federal government retirement plan.

CURRENT LAW: G.S. 105-153.5 exempts from State income tax the amount received during the taxable year from one or more State, local, or federal government retirement plans to the extent the amount is exempt from tax pursuant to a court order in settlement of one or more of three cited cases. The most well-known of these cases was the *Bailey* case, and for purposes of this summary the three cases are collectively referred to as the *Bailey* case. A person is a member of the *Bailey* class if the person vested in one or more of the governmental retirement plans on or before August 12, 1989. The exemption applies to not only any defined benefits the retiree receives but also to any income distributed to the retiree from a supplemental retirement income plan, such as a 401(k) or a 457 plan.[1]

In 2002, the federal laws with respect to pension portability became much more flexible. The changes provided that contributions into most types of retirement plans could be rolled over into another retirement plan or IRA. The Department of Revenue issued a directive, PD-04-1, to address the tax consequences of rolling over amounts from non-qualifying *Bailey* retirement accounts into a qualifying *Bailey* retirement account. Under that directive, all distributions from a qualifying *Bailey* retirement account are tax-exempt, regardless of the source of funds.

BILL ANALYSIS: The bill draft would limit the tax exemption for distributions from a qualifying *Bailey* supplemental retirement plan to those distributions attributable to contributions to a qualifying plan. The limitation would mean that distributions in a qualifying *Bailey* supplemental retirement plan attributable to a rollover contribution from a non-qualifying retirement plan would be taxable to the same extent those distributions would be taxable if the contribution had remained in the non-qualifying plan. The draft provides that the portion of a distribution that is taxable would be determined in accordance with the methodology used by Superior Court Judge Jack A. Thompson in his Order Regarding the Optional Retirement Program (ORP) for State institutions for Higher Education, signed on November 19, 1999.

After the 2002 federal pension portability changes, the Department issued Directive PD-03-1 on June 30, 2003. Under that directive, the Department advised that if a *Bailey* retirement account included rollover contributions from a non-qualifying *Bailey* retirement account that only a portion of the

[1] The Court issued several subsequent orders resolving questions about eligibility. One of the orders, issued in November 1998, held that participants in the State's Supplement Retirement Income Plan or the State's Deferred Compensation Plan are vested in the plan as of August 12, 1989, if they contributed to the plan by that date. If a person is vested in the plan, then all future withdrawals from the plan are exempt from tax.

distributions received would be exempt from State income tax. The Department based its directive on the rationale used by Judge Thompson in his Order Regarding the ORP. This Order addressed when a participant in the ORP is vested and how to determine the portion of the retirement benefits in the ORP that are subject to future income tax exemption under the *Bailey* settlement. This position was also consistent with the treatment of distributions from the Thrift Savings Plan when a participant in the Plan was "vested" in the employee component but not in the employer fixed percentage component as of August 12, 1989.

The Department rescinded this directive and replaced it with PD-04-1, in accordance with an Advisory Opinion issued by the Attorney General's Office. The Opinion advised that all benefits from state-created and state-administered plans should be treated as exempt from State income taxes if paid to persons vested in those plans as of August 12, 1989, regardless of the source of the funds. This draft essentially codifies the Department's first directive on this issue, PD-03-1.

EFFECTIVE DATE: The bill draft would become effective for taxable years beginning on or after January 1, 2016.

BACKGROUND: A question appeared in the newspaper column Money Matters in the summer of 2014 asking whether it was true a person could avoid paying as much as $116,000 in State income tax by transferring an IRA rollover valued at more than $2 million into a *Bailey* vested State retirement plan. The answer was yes. The Revenue Laws Study Committee found that this tax planning strategy allows a person to exempt from State income tax distributions from a private retirement plan that would otherwise be taxable except for the fact the person rolled the funds over into a State government *Bailey* plan.

The *Bailey* tax exemption originates from a U.S. Supreme Court case decided in 1989, *Michigan v. Davis*. Prior to 1989, many states, including North Carolina, provided state employees a retirement benefit in the form of an exemption from state income tax on their retirement income received from a state retirement plan. The U.S. Supreme Court ruled those tax exemptions violated the principle of intergovernmental immunity because the states did not provide a similar exemption for federal retirement income. States had to choose between exempting all governmental retirement income and taxing it. North Carolina chose to grant a $4,000 income tax exemption for government retirement benefits.[2]

Vested State employees sued the State arguing the change in the law was an unconstitutional impairment of contract. The N.C. Supreme Court ruled in favor of the State employees in *Bailey v. North Carolina*. Based on a trial court Order Approving Class Action Settlement on October 7, 1998, any governmental employee who vested prior to August 12, 1989, does not pay State income tax on retirement benefits received from a government retirement plan.

After the federal changes with respect to pension portability in 2002, the Department issued PD-03-1. The Department received several questions about its decision to tax a portion of a distribution from a qualifying tax-exempt *Bailey* retirement account that included rollover contributions from IRAs or other retirement plans. In response to those questions, the Department sought an opinion from the North Carolina Attorney General. The AG's opinion noted that the heart of the *Bailey* decision is the principle that the State entered into a contract with members and retirees of various State-created retirement plans, and part of that contract was that the benefits paid from those plans would be exempt from tax. Nothing in *Bailey* suggested that the contract for a tax exemption is limited to

[2] In 2013, the General Assembly repealed this income tax exemption for government retirement benefits, effective for the 2014 taxable year. It also repealed the $2,000 tax exemption allowed for private retirement benefits.

specific benefits contained in statutes or plan documents as of August 12, 1989. The opinion acknowledged that federal laws have enhanced the benefits available through *Bailey* accounts, including their investment options and portability; however, it advised that a plan's particular source of funding does not prevent the nature of its distribution from qualifying as benefits that are tax exempt under the *Bailey* decision.

The Department issued a new Directive in accordance with the AG's opinion, PD-04-1. Upon the issuance of the new Directive, the number of *Bailey* eligible participants choosing to make rollover contributions into their *Bailey* eligible plan increased from less than 200 in the beginning of 2004 to more than 1,400 in 2006. The number of *Bailey* eligible participants making rollover contributions into a *Bailey* eligible plan has plateaued to a range of 200 to 400 a year since 2007.

APPENDIX A

AUTHORIZING LEGISLATION
ARTICLE 12L OF CHAPTER 120
OF THE
GENERAL STATUTES

ALL MATERIALS DISTRIBUTED AT MEETINGS MAY BE VIEWED ON THE COMMITTEE'S WEBSITE:
http://www.ncleg.net/committees/revenuelaws

ARTICLE 12L

Revenue Laws Study Committee

§ 120-70.105. Creation and membership of the Revenue Laws Study Committee.

(a) Membership. – The Revenue Laws Study Committee is established. The Committee consists of 20 members as follows:

(1) Ten members appointed by the President Pro Tempore of the Senate; the persons appointed may be members of the Senate or public members.

(2) Ten members appointed by the Speaker of the House of Representatives; the persons appointed may be members of the House of Representatives or public members.

(b) Terms. – Terms on the Committee are for two years and begin on January 15 of each odd-numbered year, except the terms of the initial members, which begin on appointment. Legislative members may complete a term of service on the Committee even if they do not seek reelection or are not reelected to the General Assembly, but resignation or removal from service in the General Assembly constitutes resignation or removal from service on the Committee.

A member continues to serve until a successor is appointed. A vacancy shall be filled within 30 days by the officer who made the original appointment. (1997-483, s. 14.1; 1998-98, s. 39; 2009-574, s. 51.1.)

§ 120-70.106. Purpose and powers of Committee.

(a) The Revenue Laws Study Committee may:

(1) Study the revenue laws of North Carolina and the administration of those laws.

(2) 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.

(3) Call upon the Department of Revenue to cooperate with it in the study of the revenue laws.

(4) Report to the General Assembly at the beginning of each regular session concerning its determinations of needed changes in the State's revenue laws.

These powers, which are enumerated by way of illustration, shall be liberally construed to provide for the maximum review by the Committee of all revenue law matters in this State.

(b) The Committee may make interim reports to the General Assembly on matters for which it may report to a regular session of the General Assembly. A report to the General Assembly may contain any legislation needed to implement a recommendation of the Committee. When a recommendation of the Committee, if enacted, would result in an increase or decrease in State revenues, the report of the Committee must include an estimate of the amount of the increase or decrease.

(c) The Revenue Laws Study Committee must review the effect Article 42 of Chapter 66 of the General Statutes, as enacted by S.L. 2006-151, has on the issues listed in this section to determine if any changes to the law are needed:

(1) Competition in video programming services.

(2) The number of cable service subscribers, the price of cable service by service tier, and the technology used to deliver the service.

(3) The deployment of broadband in the State.

The Committee must review the impact of this Article on these issues every two years and report its findings to the North Carolina General Assembly. The Committee must make its first report to the 2008 Session of the North Carolina General Assembly. (1997-483, s. 14.1; 2006-151, s. 21.)

§ 120-70.107. Organization of Committee.

(a) The President Pro Tempore of the Senate and the Speaker of the House of Representatives shall each designate a cochair of the Revenue Laws Study Committee. The Committee shall meet upon the joint call of the cochairs.

(b) A quorum of the Committee is nine members. No action may be taken except by a majority vote at a meeting at which a quorum is present. While in the discharge of its official duties, the Committee has the powers of a joint committee under G.S. 120-19 and G.S. 120-19.1 through G.S. 120-19.4.

(c) The Committee shall be funded by the Legislative Services Commission from appropriations made to the General Assembly for that purpose. Members of the Committee receive subsistence and travel expenses as provided in G.S. 120-3.1 and G.S. 138-5. The Committee may contract for consultants or hire employees in accordance with G.S. 120-32.02. Upon approval of the Legislative Services Commission, the Legislative Services Officer shall assign professional staff to assist the Committee in its work. Upon the direction of the Legislative Services Commission, the Supervisors of Clerks of the Senate and of the House of Representatives shall assign clerical staff to the Committee. The expenses for clerical employees shall be borne by the Committee. (1997-483, s. 14.1.)

APPENDIX B

DISPOSITION OF COMMITTEE'S RECOMMENDATIONS TO THE 2014 REGULAR SESSION OF THE 2013 GENERAL ASSEMBLY

ALL MATERIALS DISTRIBUTED AT MEETINGS MAY BE VIEWED ON THE COMMITTEE'S WEBSITE:
http://www.ncleg.net/committees/revenuelaws

DISPOSITION OF REVENUE LAWS STUDY COMMITTEE RECOMMENDATIONS TO THE 2014 REGULAR SESSION OF THE 2013 GENERAL ASSEMBLY

SHORT TITLE	SENATE SPONSORS	HOUSE SPONSORS	BILL #	FINAL STATUS*
Omnibus Tax Law Changes		**Howard** **W Brawley** **Lewis** **Setzer**	**HB 1050**	**Enacted*** **SL 2014-3**

* Bills were modified prior to enactment.

APPENDIX C

MEETING AGENDAS

ALL MATERIALS DISTRIBUTED AT MEETINGS MAY BE VIEWED ON THE COMMITTEE'S WEBSITE:
http://www.ncleg.net/committees/revenuelaws

REVENUE LAWS STUDY COMMITTEE AGENDA

Rep. Julia Howard ***Sen. Bill Rabon***

Tuesday, October 14, 2014
Room 544, Legislative Office Building
9:30 a.m.

I. **Welcome and Approval of Minutes from the May 13, 2014, Meeting**

II. **2014 Finance Law Changes**
Cindy Avrette and Trina Griffin, Research Division

III. **Rollover of Private 401(k)s into Tax Exempt State 401(k)s**

- ***History of the NC Income Tax Exclusion for Governmental Pension Income***
  Cindy Avrette, Research Division, Finance
- ***Tax Planning Strategy: Roll Private 401(k) into State 401(k)***
  Steven Long, Attorney, Parker, Poe, Adams & Bernstein, LLP
- ***Pension Policy re: Rollovers and Financial Information on Tax-Exempt 401(k) Rollovers into the State 401(k) plan***
  David Vanderweide, Fiscal Research Division, Salaries and Benefits

IV. **Worker Misclassification**

- ***Overview of Worker Misclassification Issues***
  Rodney Bizzell, Fiscal Research Division
- ***Agency Efforts to Address Misclassification***
  - **Department of Revenue**
    Alan Woodard
  - **Division of Employment Security**
    Ted Brinn
  - **Industrial Commission**
    Bryan Strickland
  - **Government Data Analytics Center**
    John Correllus

V. **Bill Draft: Omnibus Revenue Laws Changes**

- **Provisions from Senate Bill 763, House Bill 189, and House Bill 1224**
  Trina Griffin, Research Division
- **Basis of Reporting Sales Tax Liability**
  Jonathan Tart, Fiscal Research Division

VI. **Adjournment**

Next Meeting Date: Tuesday, November 18, 2014
in Room 544, LOB, at 9:30 a.m.

REVENUE LAWS STUDY COMMITTEE AGENDA

Rep. Julia Howard ***Sen. Bill Rabon***

Tuesday, November 18, 2014
Room 544, Legislative Office Building
9:30 a.m.

I. **Welcome and Approval of Minutes from the October 14, 2014, Meeting**

II. **"The Sharing Economy"**

A. Introduction
Trina Griffin, Research Division, NCGA

B. Short-Term Rentals

- **Overview**
  Trina Griffin, Research Division, NCGA
- **NC Restaurant & Lodging Association**
  Lynn Minges, President & CEO
- **The Oakwood Inn Bed & Breakfast**
  Doris Jurkiewicz, Owner
- **Committee Discussion**

C. Digital Dispatch Services

- **Overview**
  Greg Roney, Research Division, NCGA
- **Transportation Network Companies**
  Uber, *Rachel Holt, Regional General Manager - East Coast*
  Lyft, *April Mims, Public Policy Manager*
  Taxi Taxi, *Michael Solomon, President*
- **Insurance Considerations**
  Oyango A. Snell, State Government Relations Counsel, Property Casualty Insurers Association of America (PCI)
- **Committee Discussion**

III. **Permanent License Plates**
John Turcotte, Director, PED
S.L. 2014-96 directed the Revenue Laws Study Committee to review the requirements and eligibility for permanent registration plates and to examine the costs incurred by the Division of Motor Vehicles to administer permanent registration plates. In 2012, the Program Evaluation Division issued three reports on this issue, and two follow-up reports.

IV. **Bill Draft re: Technical, Clarifying, and Administrative Changes (Part II)**
Heather Fennell, Research Division, NCGA

V. **Adjournment**

Next Meeting Date: Tuesday, December 9, 2014
in Room 544, LOB, at 9:30 a.m.

REVENUE LAWS STUDY COMMITTEE AGENDA

Rep. Julia Howard ***Sen. Bill Rabon***

Tuesday, December 9, 2014
Room 544, Legislative Office Building
9:30 a.m.

I. **Welcome and Approval of Minutes from the November 18, 2014, Meeting**

II. **State and Local Government Responsibilities and Revenues**
Kara Mallonzi, Associate Professor of Public Law and Government, School of Government, UNC-Chapel Hill

III. **Bill Draft re: Rollover of Private 401(k)s into Tax Exempt State 401(k)s**
Cindy Avrette, Research Division, NCGA

IV. **Expiration of the Internet Tax Freedom Act**
Heather Fennell, Research Division, NCGA

V. **Bill Draft re: Revenue Laws Technical, Clarifying, and Administrative Changes**
Cindy Avrette, Research Division, NCGA

VI. **IRC Update**
Jonathan Tart, Fiscal Research, NCGA

VII. **Adjournment**

Next Meeting Date: Tuesday, January 13, 2015
in Room 544, LOB, at 9:30 a.m.

Revenue Laws Study Committee Agenda

Rep. Julia Howard ***Sen. Bill Rabon***

Tuesday, January 13, 2015
Room 544, Legislative Office Building
9:30 a.m.

I. **Welcome and Approval of Minutes from the December 9, 2014, Meeting**

II. **Bill Draft: IRC Update**
Jonathan Tart, Fiscal Research Division, NCGA
Trina Griffin, Research Division, NCGA

III. **Bill Draft: Rollovers into Qualifying Bailey Plans**
Cindy Avrette, Research Division, NCGA
David Vanderweide, Fiscal Research Division, NCGA

IV. **Review and Approve Final Report**
Committee Staff

V. **Adjournment**

APPENDIX D

NORTH CAROLINA DEPARTMENT OF REVENUE
BAILEY DIRECTIVE PD-03-1
DATE: JUNE 30, 2003

(Important Note: this Directive has been replaced by Directive PD-04-1.)

ALL MATERIALS DISTRIBUTED AT MEETINGS MAY BE VIEWED ON THE COMMITTEE'S WEBSITE:
http://www.ncleg.net/committees/revenuelaws

North Carolina Department of Revenue

DIRECTIVE

Subject: *Bailey v. State of North Carolina; Emory v. State of North Carolina; Patton v. State of North Carolina*
Tax: Individual Income Tax
Law: G.S. 105-134.5 and G.S. 105-134.6
Issued By: Personal Taxes Division
Date: June 30, 2003
Number: PD-03-1 **(Important Note: this Directive has been replaced by Directive PD-04-1.)**

This Directive supplements previous Directives on this subject and addresses the consequences of rollover distributions from a qualifying tax-exempt *Bailey* retirement account. It also addresses the consequences of rolling over amounts from other retirement plans or IRAs into a qualifying tax-exempt *Bailey* retirement account. If you have any questions about this Directive, you may call the Personal Taxes Division of the North Carolina Department of Revenue at (919) 733-3565. You may also write to the Division at P.O. Box 871, Raleigh, North Carolina 27602-0871.

The information contained in this Directive is based on the rationale used by Superior Court Judge Jack A. Thompson in his Order Regarding the Optional Retirement Program for State Institutions of Higher Education, which he signed on November 19, 1999. This Order addressed when a participant in the Optional Retirement Program (ORP) is vested and how to determine the portion of the retirement benefits in the ORP that are subject to future income tax exemption under the *Bailey* settlement. Directive PD-00-1 explains Judge Thompson's Order in detail. The Department's position in this Directive is also consistent with the treatment of distributions from the Thrift Savings Plan when a participant in the Plan was "vested" in the employee component but not in the employer fixed percentage component as of August 12, 1989. Information regarding the treatment of distributions from the Thrift Savings Plan is contained in Directive PD-99-2.

The Economic Growth and Tax Relief Reconciliation Act of 2001

On June 7, 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). This Act made numerous changes with respect to pension portability. In general, beginning in 2002, distributions from most types of retirement plans may be rolled over into another retirement plan or into an IRA. Because of the increase in rollover flexibility, especially for governmental §457 plans, the Department has issued this Directive to address the impact rollovers have on the tax-exempt status of State, local, and federal governmental retirement plans that qualify under the *Bailey* settlement.

Rollover Distributions From a Qualifying Tax-Exempt *Bailey* Retirement Account

Under the *Bailey* settlement, State, local, and federal governmental employees and retirees who were "vested" in a qualifying retirement system as of August 12, 1989 do not pay North Carolina income tax on their retirement benefits in future years. This means that retirement benefits are exempt from North Carolina income tax if the benefits are distributed from a qualifying *Bailey* retirement account in which the employee/retiree was "vested" as of August 12, 1989. If the employee/retiree rolls over any of the qualifying tax-exempt benefits into another retirement plan, the benefits retain their tax-exempt status **only** if the retirement plan into which the benefits are rolled over is also a qualifying *Bailey* retirement account in which the employee/retiree was "vested" as of August 12, 1989. Rollovers to IRAs will always result in a loss of the tax-exempt status since IRAs do not qualify under the *Bailey* settlement.

> *Example:* *Taxpayer A was "vested" in both the State's Deferred Compensation Plan (§ 457 plan) and the State's Supplemental Retirement Income Plan (§ 401(k) plan) as of August 12, 1989. In 2002, Taxpayer A elected to roll over the balance in his Deferred Compensation account into his Supplemental Retirement Income account. Future distributions from Taxpayer A's Supplemental Retirement Income account will be exempt from North Carolina income tax.*

> *Example:* *Taxpayer B was "vested" in the State's Deferred Compensation Plan (§ 457 plan) as of August 12, 1989; however, he was not vested in the State's Supplemental Retirement Income Plan (§ 401(k) plan) as of that date. In 2002, Taxpayer B elected to roll over the balance in his Deferred Compensation account into his Supplemental Retirement Income account. Future distributions from Taxpayer B's Supplemental Retirement Income account will be subject to North Carolina income tax, except for the $4,000 deduction provided by G.S. 105-134.6(b)(6).*

> *Example:* *Taxpayer C was "vested" in the State's Deferred Compensation Plan (§ 457 plan) as of August 12, 1989. In 2002, Taxpayer C elected to roll over the balance in his Deferred Compensation account into an IRA. Future distributions from Taxpayer C's IRA will be subject to North Carolina income tax, except for the $2,000 deduction provided by G.S. 105-134.6(b)(6).*

Rollovers Into a Qualifying Tax-Exempt *Bailey* Retirement Account

Retirement plan distributions rolled over into a qualifying tax-exempt *Bailey* retirement account are tax-exempt only if they are rolled over from another qualifying tax-exempt *Bailey* retirement account.

If a qualifying tax-exempt *Bailey* retirement account includes rollover distributions from IRAs or other retirement plans (other than another qualifying tax-exempt *Bailey* retirement account), only a portion of the retirement benefits is exempt from North Carolina income tax. To determine the portion of each distribution that is exempt from State income tax, the employee/retiree must determine the portion of the account balance at the time of retirement that is attributable to any rollover distributions from IRAs and other retirement plans (other than another qualifying tax-exempt *Bailey* retirement account). For simplicity, the portion attributable to rollover distributions from IRAs and other retirement plans (other than another qualifying tax-exempt *Bailey* retirement account) does not include any amounts earned subsequent to rollover. The following formula is used to determine the percentage of the retirement benefits received each year that are exempt from State income tax:

$$\frac{(B - R)}{B} = E$$

"E" is the exempt percentage.
"B" is the account balance at the time of retirement.
"R" is the portion of account balance at the time of retirement attributable to any rollover distributions from IRAs or other retirement plans (other than another qualifying tax-exempt *Bailey* account).

> *<u>Example:</u> Taxpayer X was "vested" in both the State's Deferred Compensation Plan (§ 457 plan) and the State's Supplemental Retirement Income Plan (§ 401(k) plan) as of August 12, 1989. In 2002, Taxpayer X elected to roll over the balance in his Deferred Compensation account into his Supplemental Retirement Income account. Future distributions from Taxpayer X's Supplemental Retirement Income account will be 100% exempt from North Carolina income tax.*

> *<u>Example:</u> Taxpayer Y was "vested" in the State's Deferred Compensation Plan (§ 457 plan) as of August 12, 1989. In 2003, Taxpayer Y ceases his secondary employment with a private company and elects to roll over the $25,000 balance in his § 401(k) plan with the private company into his State Deferred Compensation account. When Taxpayer Y retires in 2010, his State Deferred Compensation account has a balance of $50,000. Future distributions from Taxpayer Y's State Deferred Compensation account will be 50% exempt from North Carolina income tax under the Bailey settlement. [($50,000 - $25,000) / $50,000 = 50%]. The portion of the distributions that are subject to tax (50%) will be eligible for the $4,000 deduction provided by G.S. 105-134.6(b)(6). Therefore, if Taxpayer Y*

receives distributions totaling $5,000 from his Deferred Compensation account during 2011, $2,500 would be exempt from State income tax under the Bailey settlement and the remaining $2,500 would be excludable from State income tax under G.S. 105-134.6(b)(6).

<u>Example:</u> Taxpayer Z was "vested" in the State's Supplemental Retirement Income Plan (§ 401(k) plan) as of August 12, 1989. In 2003, Taxpayer Z elects to roll over $20,000 from his IRA into his Supplemental Retirement Income account. When Taxpayer Z retires in 2020, his Supplemental Retirement Income account has a balance of $60,000. Future distributions from Taxpayer Z's Supplemental Retirement Income account will be 67% exempt from North Carolina income tax under the Bailey settlement. [($60,000 - $20,000) / $60,000 = 67%]. Therefore, if Taxpayer Z receives distributions totaling $25,000 from his Supplemental Retirement Income account during 2021, $16,750 would be exempt from State income tax under the Bailey settlement and $4,000 would be excludable from State income tax under G.S. 105-134.6(b)(6).

APPENDIX E

NORTH CAROLINA DEPARTMENT OF REVENUE
BAILEY DIRECTIVE PD-04-1
DATE: AUGUST 23, 2004
(Important Note: this Directive **replaces** *Directive PD-03-1.)*

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North Carolina Department of Revenue

DIRECTIVE

Subject: *Bailey v. State of North Carolina; Emory v. State of North Carolina; Patton v. State of North Carolina*
Tax: Individual Income Tax
Law: G.S. 105-134.5 and G.S. 105-134.6
Issued By: Personal Taxes Division
Date: August 23, 2004
Number: PD-04-1

This Directive amends and supersedes Directive PD-03-1, in which the Department advised that a proportionate ratio would be required to determine the tax exempt portion of a distribution from a qualifying tax-exempt *Bailey* retirement account when the account contained rollover distributions from IRAs or other retirement accounts (other than another qualifying tax-exempt *Bailey* retirement account). This position was based on the rationale used by Superior Court Judge Jack A. Thompson in his Order Regarding the Optional Retirement Program for State Institutions of Higher Education, signed on November 19, 1999. The North Carolina Attorney General's Office recently advised the Department that the rationale used in Judge Thompson's Order is limited to ORP benefits and should not be used in determining the taxability of benefits distributed from the other plans that qualify for exemption from State taxation under the *Bailey* settlement. Therefore, the Department has changed its position regarding the taxability of distributions from a qualifying tax-exempt *Bailey* retirement account that contains rollover distributions from IRAs or other retirement accounts. (Participants in the Optional Retirement Program for State Institutions of Higher Education (ORP) should refer to Directive PD-00-1 to determine the taxability of distributions from the ORP.)

On June 7, 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). This Act made numerous changes with respect to pension portability. In general, beginning in 2002, distributions from most types of retirement plans may be rolled over into another retirement plan or into an IRA. Because rollover distributions lose their character upon rollover, all distributions from a qualifying *Bailey* retirement account in which the employee/retiree was "vested" as of August 12, 1989, are exempt from State income tax regardless of the source of the funds contained in the account. Conversely, qualifying tax-exempt *Bailey* benefits rolled over into another retirement plan lose their character and would not be exempt upon distribution from the other plan unless that plan is a qualifying *Bailey* retirement account in which the employee was vested as of August 12, 1989. (Rollovers to IRAs will always result in a loss of tax-exempt status since IRAs do not qualify under the *Bailey* settlement.)

Taxpayers who may have paid North Carolina income tax on a portion of their benefits distributed from a qualifying tax-exempt *Bailey* retirement account based on the Department's previous position with respect to the proportionate ratio method described in Directive PD-03-1, should file an amended income tax return to exclude any qualifying benefits.

If you have questions about this Directive, you may call the Personal Taxes Division of the North Carolina Department of Revenue at (919) 733-3565. You may also write to the Division at P.O. Box 871, Raleigh, North Carolina 27602-0871.