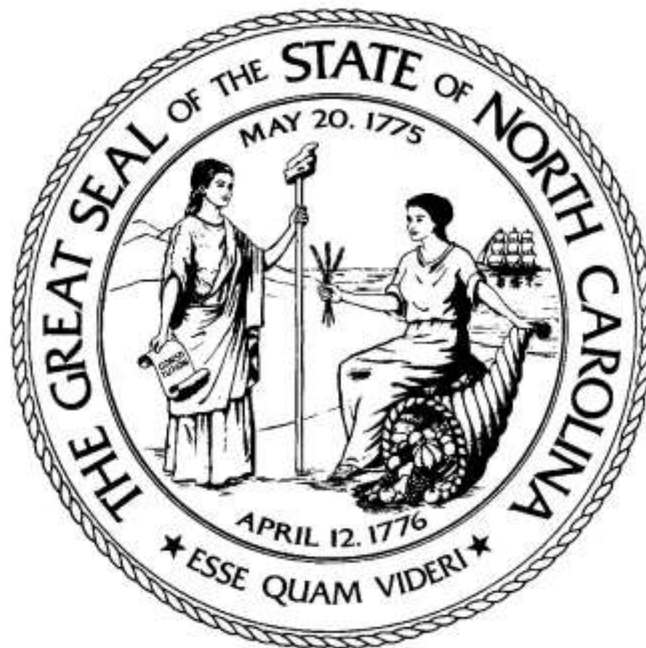
2013-2014
REVENUE LAWS STUDY COMMITTEE



REPORT TO THE 2013-2014
GENERAL ASSEMBLY OF NORTH CAROLINA
2014 SESSION

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TABLE OF CONTENTS

Letter of Transmittal i

Revenue Laws Study Committee Membership ii

Preface 1

Committee Proceedings 2

Committee Recommendations and Legislative Proposals 29

1. AN ACT TO AMEND THE REVENUE LAWS AS RECOMMENDED BY THE REVENUE LAWS STUDY COMMITTEE 30

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Appendices[*]

A. . Authorizing Legislation, Article 12L of Chapter 120 of the General Statutes
B. Disposition of Revenue Laws Study Committee Recommendations
C. Meeting Agendas

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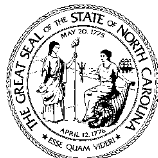
[*]All of the meeting handouts, including Power Point presentations, may be accessed online in PDF format at the Revenue Laws Study Committee website: http://www.ncleg.net/committees/revenuelaws



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

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

May 13, 2014

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:

[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

The 2013 General Assembly enacted both of the Revenue Laws Study Committee legislative proposals: S.L. 2013-2, Unemployment Fund Solvency and Program Changes and S.L. 2013-414, Revenue Laws Technical, Clarifying, and Administrative Changes. The 2013 General Assembly also made substantial changes to the State's income and sales tax structure this past session in S.L. 2013-316, Tax Simplification and Reduction Act. The Committee spent time at each of its meetings this past interim looking at the policy changes made in the Tax Simplification and Reduction Act and discussing technical and administrative changes that needed to be made to improve the efficiency, simplicity, and clarity of the Act.

The Revenue Laws Study Committee met eight times after the adjournment of the Regular Session of the 2013-2014 biennium of the North Carolina General Assembly on July 26, 2013. 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.[3] In addition to studying the tax changes in the Tax Simplification and Reduction Act, 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. The Committee considered 12 legislative proposals at its meeting on April 9, 2014. Those proposals have been incorporated into one recommendation for this report.

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

TAX SIMPLIFICATION AND REDUCTION

The General Assembly made substantial changes to the State's income and sales tax structure in S.L. 2013-316. The Tax Simplification and Reduction legislation broadened the income tax base and reduced the income tax rates. It expanded the sales tax base by eliminating some preferential sales tax exemptions and tax rates, adding service contracts and entertainment activity to the sales tax base, and moving the taxation of electricity and piped natural gas to the sales tax structure. The Act also eliminated the estate tax, effective January 1, 2013, and capped the excise tax on motor fuel at 37.5 cents per gallon from October 1, 2013, until June 30, 2015. The Committee discussed these changes at its October meeting.

The Tax Simplification and Reduction Act eliminated the estate tax, effective January 1, 2013. During the Committee's meeting on February 11, 2014, Mike Godwin on behalf of the NC Bar Association's Estate Planning and Fiduciary Law Section informed the Committee of a technical error in the statute imposing income tax on estates and trusts,[4] which is contained in Section 2.3 of the Legislative Proposal. Mr. Godwin also requested the Committee consider limiting or repealing the State's income tax on estates and trusts. North Carolina imposes income tax on a trust if a beneficiary of the trust is a resident of the State. Mr. Godwin told the Committee that North Carolina was among only five states that impose income tax based solely on the residency of a trust beneficiary and that the tax was under constitutional challenge in the NC Business Court (The Kimberly Rice Kaestner Trust v. NC Dep't of Revenue, 12 CVS 8740). The Committee did not pursue repealing or modifying the taxation of estates and trusts.

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[4] G.S. 105-160.2.

The Tax Simplification and Reduction Act made the following changes to the individual tax laws, effective January 1, 2014:

- Eliminated the three-tier rate bracket and substituted a flat rate of 5.8% in 2014 and 5.75% thereafter.
- Increased the standard deduction amount from $6,000 to $15,000 for a married couple filing jointly.
- Retained the itemized deduction amount claimed on federal income tax return for charitable contributions.
- Limited the itemized deduction amount claimed on federal income tax return for mortgage interest and property taxes paid on real estate to $20,000.
- Enhanced child credit for AGI under $40,000 (MFJ) from $100 per child to $125 per child.
- Eliminated all other deductions, exemptions, and credits except as follows:
    - Income not allowed to be included in tax base by federal law or court action.
    - Social security income.
    - Interest on certain bond obligations.

The State requires income tax withholding from an individual's wage and salary. The amount of taxes withheld should approximate the individual's tax liability. To help taxpayers prepare for the individual tax law changes, the Department of Revenue required all employees to complete a new tax withholding Form NC-4. The purpose of Form NC-4 is to allow for a more accurate withholding amount. If too much income is withheld, a taxpayer will receive a refund of the excess tax paid when a tax return is filed at the end of the taxable year; this additional withholding is comparable to an interest-free loan to the State. If too little income is withheld, a taxpayer will owe taxes when a return is filed at the end of the taxable year. The Revenue Laws Committee discussed these tax changes and the Form NC-4 at its December meeting.

The Tax Simplification and Reduction Act made the following changes to the corporate income tax laws, effective January 1, 2014:

- Reduced the tax rate from 6.9% to 6% for 2014 and 5% for 2015. The legislation provided a trigger for possible rate reduction in 2016 to 4% and in 2017 to 3%.
- Eliminated all credits except the one for investing in major recycling facilities.
- Allowed existing tax credits that have a sunset date to sunset as scheduled, with the exception of the tax credit for research and development; the sunset for that credit was extended from January 1, 2014, to January 1, 2016.

The Tax Simplification and Reduction Act made many changes to the sales tax laws, effective January 1, 2014:

- Increased the rate on modular homes and manufactured homes from 2.5% and 2%/$300 cap respectively to 4.75%.
- Repealed the sales tax exemption for nutritional supplements sold by chiropractors, meals served in higher educational institution facilities, and newspapers.
- Repealed the gross receipts franchise tax on live entertainment and movies and included admission charges to a live event, a movie, and an attraction in the sales tax base.
- Expanded the sales tax base to include service contracts.

The Tax Simplification and Reduction Act made the following changes to the sales tax laws, effective July 1, 2014:

- Repeals the sales tax exemption for certain bakery items sold in a bakery thrift store.
- Repeals sales tax holiday for school items and Energy Star products.
- Requires farmers to meet an annual income threshold of $10,000 from farming activities to qualify for farm-related sales tax exemptions.
- Caps the State and local sales tax refund allowed to nonprofit entities at $45 million.

- Repeals the gross receipts franchise tax on electricity and the excise tax on piped natural gas and include the gross receipts derived from the sale of these two utilities in the sales tax base.

The Committee began discussing these tax law changes at its October meeting and continued to review them throughout the course of the interim. The Department of Revenue and the legislative staff worked closely with the taxpayers impacted by these changes to resolve questions and administrative concerns.

Modular Homes and Manufactured Homes

Retailers of modular and manufactured homes noted the substantial difference in the amount of tax liability incurred on the purchase of a modular or manufactured home. The Committee considered how stick-built homes are taxed: contractors pay State and local sales tax on the materials used to build the home and the person who purchases the home pays the contractor. The amount paid the contractor is based upon the cost of the materials used, the labor used to construct the home, and the profit recognized by the contractor. The manufacturer and modular home industry argued that the sales tax on these homes is imposed not only on the materials used to construct it, but also upon the labor involved and any profit realized by the retailer. The industry reports that the average material cost of a factory-built home is approximately 50% of the invoice price. The industry also noted that the typical factory-built home sale today involves more site work and the administration of the tax as it applies to site work and the home itself is confusing and difficult. The imposition of the tax did not concern the industry when it was low and capped, but the higher rate magnifies the concerns cited. In deference to these concerns, the Committee recommends that 50% of the sales price of a manufactured home and a modular home be exempt from sales tax. This change is contained in Part VIII of the Legislative Proposal.

Prepaid Meal Plans

The removal of the sales tax exemption for meals sold in a higher educational institutional facility subjected the meals to sales tax. The Committee learned that most colleges and universities offer prepaid meal plans and that the cost of those plans is bundled with tuition payments. Imposition of sales tax on these purchases raised questions about what the taxable transaction is and who is the responsible retailer is. The Committee worked with the schools, outside vendors, and the Department of Revenue to address these issues. The Committee's recommendation on the taxation of prepaid meals plans is found in Part IV of the Legislative Proposal.

Newspapers

Prior to the tax law change this session, sales tax applied differently to newspapers depending upon how they were sold. If a person purchased a newspaper over the counter, digitally, or by subscription, the sales tax applied; if a person purchased a newspaper through an independent carrier, a street vendor, or a vending machine, no tax applied because of the sales tax exemption. One purpose of the repeal of the sales tax exemption for newspapers was to treat the purchase of a similar product similarly. The Committee learned at its October meeting that although the General Assembly repealed the sales tax exemption for newspapers, newspapers sold through a vending machine were exempt in an amount equal to 50% of the sales price because of the vending machine exemption. The Committee recommends that the 50% sales tax exemption applicable to items purchased through a vending machine should not apply to newspapers. Section 8.3.(b) of Part VIII of the Legislative Proposal makes this change.

Admission Charges for an Entertainment Activity

Over the past two decades, the General Assembly authorized numerous committees to study the State's tax code and to recommend changes that would modernize it. Most reports recommended expanding the sales tax base to entertainment activities. Many other states already impose sales tax on these activities. S.L. 2013-316 expanded the sales tax base to include the gross receipts derived from admission charges to entertainment events. The Act exempted the following events from the tax: events at elementary and secondary schools, agricultural fairs, youth sporting events, State attractions, and limited nonprofit events. The Committee learned that the latter three exemptions appear to be causing confusion and will result in similar entertainments being taxed differently.

The Committee chairs appointed a subcommittee to consider the exemptions from the sales tax on admission charges. The subcommittee members were Senator Rucho, Chair, and Representatives Carney and Moffitt. The subcommittee considered the exemptions from the sales tax on admissions in other states and discussed the administrative difficulties of interpreting the current exemptions. It expressed concern that the exemptions create situations where similar entertainment events are taxed differently. The subcommittee stated a desire that similar entertainment events should be taxed similarly and recommended that the exemption for events sponsored and held at elementary and secondary schools be retained but that the other four exemptions be repealed. The subcommittee also expressed a concern about the administrative burdens of collecting and remitting the tax for very small nonprofit entities that do not have permanent staff and recommended that an event sponsored by a nonprofit entity be exempt if the entity does not have any paid staff and the entity does not compensate any person participating in the event.

In addition to the exemptions from the tax, taxpayers asked the Committee to address other implementation issues, such as the definition of an admission charge, the applicability of the tax to amenities, the consequence of a cancelled attraction, and the party responsible for collecting and remitting the tax. The Committee recommends legislative changes to address these issues in Part V of the Legislative Proposal.

Service Contracts

The Tax Simplification and Reduction Act expanded the sales tax to include the gross receipts derived from a service contract, including a service contract on a motor vehicle. At least 30 other states impose sales tax on service contracts. The Committee began its discussions of the implementation issues surrounding the expansion of the tax to this service at its October meeting. The Committee considered questions such as: Must the service contract be sold in conjunction with the property covered in the contract? Must the service be provided by the same person selling the property covered in the contract? Are charges for the renewal of a service contract subject to tax? Are periodic payments for a service contract subject to tax?

The Committee's stated that similar transactions should be taxed the same, and that clarity of understanding and ease of administration should be considered. The Department of Revenue and the legislative staff worked closely with taxpayers to resolve issues under the parameters given by the Committee. The Committee's recommendations related to the sales tax applicable to service contracts can be found in Part VI of the Legislative Proposal.

Farm Exemption Certificate

The Tax Simplification and Reduction Act imposed an income threshold a person must meet to qualify for a sales tax agricultural exemption certificate. Effective July 1,

2014, a person does not qualify for an agricultural exemption certificate unless the person has an annual gross income for the preceding taxable year[5] of at least $10,000 from farming operations. The farming community posed some questions about the implementation of the income threshold. The Committee looked at the following issues at its March meeting: How should the agricultural exemption certificate administrative process be revised? How are retailers expected to administer the new threshold requirements? How can the threshold accommodate fluctuations in farming income? The Committee's recommendation related to the imposition of the income threshold for an agricultural exemption certificate is in Part III of the Legislative Proposal.

Utility Taxes

At its February meeting the Committee heard presentations on changes to the taxation of utilities as part of the Tax Simplification and Reduction Act. Effective July 1, 2014, the Act repealed the gross receipts franchise tax on electricity and the excise tax on piped natural gas and included both items in the State sales tax base to tax them at the combined general rate of 7%. The Act also replaced the current tax-sharing of the franchise and excise tax revenues with cities with a distribution of part of the sales tax collected on these items. The Committee considered two issues related to these changes, the actions required of the Utilities Commission under the Act, and the effect of amended returns on the new distributions to the cities of the sales tax on electricity and piped natural gas.

Public utilities recover costs of their service from customers through rates approved by the Utilities Commission. Taxes are generally recovered through these rates. The franchise tax on electricity is one of the taxes recovered through rates. The

[5] The statute currently says "calendar year." The Department has requested that the term be changed to "taxable year." The bill draft makes this change

Act required the Utilities Commission to change rates charged by these utilities to reflect the tax changes in the Act. The Commission initiated a proceeding to examine all of the changes in the Act, and how these changes would impact utilities and ratepayers.

The new distributions to cities of the sales tax on electricity and piped natural gas are based on the distribution under the repealed franchise and excise taxes the last year those taxes were in effect. Utilities are allowed to file amended returns on the repealed taxes for up to three years. Amended returns filed on the repealed taxes can change both distributions under the repealed taxes and the amount to be distributed to cities under the new sales tax on electricity and piped natural gas.

Section 14.13(a) in Part XIV of the Legislative Proposal provides guidance to the Department on how to treat amended returns that change past and future distributions. First, it provides that any additional funds needed for increases to past distributions under the repealed taxes can be drawn from the sales tax revenue. Second, it creates a date certain for future distributions to be determined. The Department of Revenue will set the distributions for each fiscal year by September 15 using amended returns processed by the Department prior to July 31 of that year.

CORPORATE INCOME TAX CHANGES

The Committee considered the State's corporate income tax apportionment formula. Multistate corporations must apportion their income among the states in which they do business. There is a standard three-factor apportionment formula based upon equal weighting of the percentage of property located in a state, payroll paid in a state, and sales made in a state. North Carolina uses a double weighted sales factor where property and payroll are weighted at 25% each while sales are weighted twice. The Committee learned the new trend in corporate tax apportionment is an ever increasing weight upon the sales factor. Some states are moving to a single sales factor

apportionment formula. A single sales factor apportionment favors businesses that locate and employ people in a state and sell a product outside the state. North Carolina currently allows single sales factor apportionment for excluded corporations, public utilities, and qualified capital intensive corporations.

The Committee also looked at the difference between North Carolina's net economic loss (NEL) deduction for corporations and the federal net operating loss (NOL) deduction. A net loss deduction provides relief to corporations that have incurred economic misfortune. It is allowed during a period in which a company's allowable tax deductions are greater than its taxable income, resulting in a negative taxable income. A loss generally occurs when a company has incurred more expenses than revenues during the period.

The Committee appointed a subcommittee to determine whether North Carolina should replace its NEL with some form of a NOL. The subcommittee members were Representative Lewis, Chair, Senator Hartsell and Representative Blust. The subcommittee met twice and worked closely with the Department of Revenue and the interested parties. The key differences between a NOL and a NEL is that a NOL occurs when tax deductible expenses are more than taxable revenues, while a NEL occurs when tax deductible expenses are more than all income, including any income that is not subject to North Carolina corporate income tax. Also, a federal NOL may be carried back two years and carried forward 20 years while a NEL may only be carried forward for 15 years.

The subcommittee recommended that the State replace the NEL deduction with a State net loss deduction that is determined in a similar manner to the federal NOL. North Carolina is the only state that has a NEL. Shifting to a State net loss calculation will simplify and ease the administration of the State's corporate income tax laws. The

move is supported by the Department of Revenue and the interested parties. Part I of the Legislative Proposal contains this recommendation.

SALES TAX AND RETAILER-CONTRACTORS

For the second year in a row, this Committee has grappled with the sales tax dilemma posed by performance contractors. In 2012, the Department of Revenue presented on this complex area of law and, although it did not make a specific recommendation, it identified various options for consideration. The Committee did not take any action in anticipation that the issue would be addressed as part of the comprehensive tax reform efforts slated for the 2013 Session. However, this issue was not included in the tax reform measure and was back before the Committee during the interim.

This issue centers on the gray area where retail sales and performance contracts intersect. Under current law, retailers are required to collect and remit sales tax on retail sales of tangible personal property. Under a performance contract, the contractor agrees to furnish the necessary materials, labor, and expertise to accomplish the job; it is not a contract for the sale of specific items. Contractors are deemed to be the consumers or end users of the tangible personal property they use in fulfilling performance contracts and, as such, are liable for payment of the applicable tax.[6] This tax treatment reflects the underlying premise of sales tax, which is that it is intended to be a consumption tax on final goods and services. That is, the end user of the item purchased is the person who should pay the tax. While these rules may seem straightforward, it is not always clear who the end user is when a customer purchases an item from a home improvement store and enters into a contract with the store for the installation of the item in their

[6] The tax may not be added to the agreed-upon contract price as a separate charge on the invoice, but it must be included in the computation of the cost of the materials necessary to perform the contract.

home. For example, a retailer that sells a refrigerator or a television and offers installation of that property is clearly engaged in a retail sale. The retailer must collect sales tax on the item, but the installation service is exempt from sales tax as long as it is separately stated on the invoice at the time of sale. Conversely, a customer who enters into a performance contract does not owe sales tax on the property used to fulfill that contract, but rather the contractor owes sales or use tax on those items. A clear example of a performance contract would be a contract for the painting of a house or for cleaning services. The customer would not pay sales tax on the paint or the cleaning products used to complete those services. The interpretation problems most often arise with "retailer-contractors," like the major home improvement stores, that perform the installation of major fixtures that are permanently incorporated into real property, such as cabinetry and carpeting. The sale of an item whose fabrication and installation are more custom and permanent in nature begins to look less like a retail sale and more like a real property improvement. The difficulty lies in determining when that line has been crossed.

Over time, the Department has developed guidance through its technical bulletins, and the tax treatment is ultimately determined by looking at a number of factors, such as whether an item is sold with an installation agreement, the tenor of the agreement, if there is one, whether an item is pre-fabricated, whether an item is built on-site, and whether a specific quantity is stated in the agreement. Determining the tax consequences involves a complex and fact-specific analysis. In fact, the sale and installation the same item, such as carpet or cabinets, can have different tax treatment depending on who the seller is and how the transaction is structured.

This issue drew particular attention in 2009 when newspaper reports revealed a long-running dispute between Lowe's and the Department of Revenue on the

application of the law in this area. The report indicated that Lowe's was not collecting sales tax when it sold and subsequently installed items such as cabinets, flooring, and countertops. The Department's position is that these transactions are retail sales plus installation and that Lowe's should be collecting sales tax on the purchases but not the installation charges as long as those charges are separately stated on the customer's invoice. Lowe's position is that these transactions are performance contracts and, therefore, they are only required to pay the use tax because they are the user or consumer of that property and that the cost is factored into the contract price ultimately paid by the customer, but it is not a separately stated cost.

The current law provides little guidance as to what the correct interpretation is. The statutes do not define "contractor" or "performance contract" or speak to when the installation of tangible personal property constitutes a real property improvement. Sales tax applies to retail sales of tangible personal property but not to real estate improvements. A sale occurs when title or possession is transferred. When a contractor permanently affixes an item of tangible personal property to real estate, title and possession typically transfer upon installation. However, once the item is permanently affixed to real property, general principles of real estate law provide that the item is no longer tangible personal property but has transformed into a real property fixture. Therefore, when a homeowner obtains title or possession to the property, the property is real estate and, therefore, one could argue no retail sale of tangible personal property has occurred. Adding further confusion to the mix, North Carolina's definition of "retailer" includes the business of installing tangible personal property *regardless of whether it is permanently affixed to real property*. This definition suggests that all contractors are also retailers, which seems to conflict with other principles at play. Moreover, the Department's interpretation of whether a transaction is a retail sale or

performance contract varies depending on a number of different factors and does not necessarily hinge on whether an item is permanently affixed to real property.

After a staff presentation to the full Committee, the Co-Chairs appointed a subcommittee to continue work on the issue. The subcommittee members were Senator Tamara Barringer, Chair, Senator Rick Gunn, and Representative Bill Brawley. The subcommittee had one meeting at which interested parties were represented and had an opportunity to voice their concerns; the attendees included the Retail Merchants Association, representatives from Lowe's, Home Depot, and the Plumbing, Heating, and Cooling Contractors of NC, and the Department of Revenue. Andy Ellen, representing the Retail Merchants Association, gave a presentation highlighting the three-part test that is commonly used to determine when tangible personal property that is affixed to real property loses its identity as such and becomes a real property improvement. The three factors are: intent, expectation, and method. First is the intent of the property owner to have the item permanently and substantially improve the land. Second, would a purchaser of the property expect that the seller will leave the item behind? Third, would removal of the item cause significant damage to the property? Mr. Ellen advocated incorporating this test either into the statute directly or into its application.

During the Committee's examination of this issue, the consistent message from the retailers was that they do not have a preference as to how the items are taxed; rather, they just want clarity in the law so that retailers engaged in similar businesses are on a level playing field and so that similar transactions are taxed similarly, whether they are performed by a contractor or a retailer acting as a contractor. In developing the proposal, the subcommittee recognized that this issue is much broader than only that aspect of it affecting Lowe's and Home Depot and similar retailers, but given the lack of

statutory guidance and the inconsistent interpretations of the Department, the subcommittee opted for a proposal more limited in scope that represents a first step in bringing much-needed clarity and consistency to the law while acknowledging that additional legislation may be required in the future. Also, while consideration was given to recommending a proposal where the tax treatment would depend on whether a transaction involved a standard installation or a true performance contract where the price and details of the job are more custom in nature, the subcommittee, in consultation with the Co-Chairs, ultimately recommended a proposal that incorporates the real property improvement concept. In other words, if an item, once installed, loses its identity as tangible personal property and would likely be treated as a permanent part of the real estate under the principles of real estate law, then the contractor who installs that item is the consumer or final user of the item and is liable for payment of the tax. There was also considerable discussion about whether the proposal should contain a list of items to be treated as retail sales regardless of the nature of the installation. The Department supported the idea of a list because it would provide the clearest guidance to both the Department and the retailers. However, codifying a list of specific items in statute is generally disfavored because it presents a risk of unintentionally excluding items that were not contemplated that the time it was drafted, potentially raises interpretational questions about whether the list is exclusive or illustrative, and becomes outdated as new technology enters the marketplace. Ultimately, the Co-Chairs concluded that the best approach would be for the Department to develop, in consultation with the stakeholders, administrative guidance that identifies the types of items that become real property once installed in accordance with well-established principles of real estate law.

The thrust of this proposal is that it specifically provides that the general rate of tax applies to the sales price of tangible personal property sold to a real property contractor for use in improving or altering real property. This statement makes clear that a contractor is the end user of tangible personal property that ultimately becomes part of real property. The imposition would apply to all real property contractors, including retailers when they act as contractors. It defines a "real property contractor" as a person who contracts to furnish tangible personal property and the labor to install or apply that tangible personal property to real property. It defines a "retailer-contractor" as a person that acts as a real property contractor when it performs real property contracts and as a retailer when it sells tangible personal property. It further provides that a retailer-contractor may purchase materials exempt from tax and then accrue and remit tax when the materials are withdrawn from the inventory to use in fulfilling a real property contract. If the retailer-contractor subcontracts the installation, then the subcontractor would pay the tax on the items the subcontractor purchases to fulfill the contract. The second part of the proposal holds harmless retailers that have been following the law as interpreted by the Department, such as Home Depot, as well as retailers who have asserted that the Department's interpretation is inconsistent with existing statutes, such as Lowe's. The proposal would become effective January 1, 2015.

TAX LAW COMPLIANCE CHANGES

During the Committee's meeting on January 14, 2014, Charlie Helms, Director of the Collections Division, Department of Revenue, presented the Committee the following three legislative requests to aid tax collection:

- Allow out-sourcing of in-state cases to private collection agencies.
- Increase budget for locator service contracts.
- Subject ABC retail permits to tax compliance checks.

The Collections Division requested the authority to use private debt collection agencies to locate and contact delinquent taxpayers. The private debt collectors would not have any authority to use the forced collection procedures of the Department such as garnishment. After Committee discussion, the Committee did not move forward with the use of private debt collectors.

The Collections Division requested that ABC retail permittees be tax compliant as a prerequisite to renew a permit. The ABC Commission did not object to the request. The Committee approved a requirement a person file all State tax returns and pay all State taxes to receive and hold an ABC permit. State taxes must be collectable and finally determined to be due for the tax to block an ABC application. The requirement would closely follow the statute[7] requiring lottery retailers to file and pay all State taxes. Section 10.1 of the Legislative Proposal incorporates this proposal.

The Collections Division requested the Committee increase the funding for locator services by authorizing increased expenditures from the collection assistance fee. G.S. 105-243.1 imposes a 20% collection assistance fee on overdue tax debts after 90 days. The collection assistance fee is credited to a special account and must be applied to the costs of collecting overdue tax debts. The Department of Revenue uses locator services through contracts with private data services to identify current addresses for taxpayers. The Committee voted in favor of increasing the authorization from $150,000 to $500,000 annually on taxpayer locater services to be paid from the collection assistance fee account. Section 10.1 of the Legislative Proposal authorizes the use of $500,000 for locator services.

[7] G.S. 18C-141.

PRIVILEGE LICENSE TAX CHANGES

The privilege license tax may be one of the most studied systems of taxation by this Committee, which has reached the same conclusion every time—that it is also one of the most problematic. In 1996, after four previous studies,[8] this Committee recommended repealing virtually all of the State-level privilege license taxes. The following quote made during a 1996 briefing on this issue is as apt today as it was then and reflects the collective conclusion of the current Committee members:

> *Privilege license taxes do not conform to any generally accepted principles or philosophies of taxation…There is no generally accepted principle of taxation that calls for professionals and businesses to be taxed in compensation for the 'privilege' of doing business in the state...The best approach for achieving equity among businesses is to limit taxes to a reasonable, nominal amount applied uniformly rather than trying to achieve equity according to size or profitability.*[9]

At the time, the Committee addressed only the State privilege taxes, anticipating that the local privilege tax system would be addressed in a second stage of reform. Eighteen years and four additional studies[10] later, this Committee is recommending a substantial overhaul to the local privilege license tax system.

Over 300 cities levy a privilege license tax generating a cumulative total of $62 million; 20 cities collect more than $500,000 from the levy. At the January 14, 2014, meeting, Christopher McLaughlin, Assistant Professor of Public Law and Government at the UNC School of Government, provided the Committee with an overview of the local privilege license tax system and an analysis of its deficiencies. Historically, this system of taxation has been considered an outmoded, inefficient, and arbitrary method of raising revenue largely because it places a tax burden on a limited number of

[8] 1956 Tax Study Commission, 1966 Tax Study Commission, 1968 Tax Study Commission, and 1992 Revenue Laws Study Committee.
[9] Comments by Charles D. Liner at the October 16, 1992 Revenue Laws Study Committee meeting.
[10] 2004, 2008, 2012, and 2014.

businesses. Through Mr. McLaughlin's presentation, the Committee heard once again how the system is archaic, inconsistent, and arbitrary. The system is archaic because it is based on references to repealed statutes, which are essentially "trapped in time" and cannot be changed. Specifically, the repealed statutes refer to monetary caps that have never been adjusted for inflation and to businesses that sell items like record players, tape cartridges, and bagatelle tables. The Committee heard that the law is often applied inconsistently because local business license officers have different, yet valid, interpretations of how to apply the repealed statutes. The system is arbitrary because there is no rationale for exempting some businesses altogether, subjecting some to caps, and subjecting others to an unlimited amount of tax. Some cities, like Durham and Charlotte, base privilege tax on gross receipts resulting in tax bills of thousands of dollars. Given these characteristics, the administration of privilege license taxes frequently proves to be a source of confusion and frustration for local governments and taxpayers alike.

Following Mr. McLaughlin's presentation, the Committee heard from Paul Meyer, Director of Governmental Affairs with the North Carolina League of Municipalities, and Robin Rose, Deputy Chief Financial Officer for the City of Raleigh. Mr. Meyer acknowledged the problems with this tax. Specifically, he referenced the lack of uniformity, the absence of definitions, the fact that out-of-town businesses are often treated differently or are potentially subject to double taxation, and the use of a gross receipts schedule with no cap. He also pointed out that there are only two taxes that a city has authority to levy: the property tax and the privilege tax. As such, a number of cities have become reliant on the tax as a source of revenue. Mr. Meyer mentioned that this issue is among the League's legislative priorities and that it is willing to work with the Retail Merchants' Association to help craft a fairer, simpler, and more

comprehensible system while recognizing the revenue needs of cities which provide many services necessitated by the businesses taxed.

Based on her experience with the administration of Raleigh's privilege license tax, Ms. Rose offered some practical insight for the Committee's consideration. She stated that many small towns do not levy the tax because the revenue is not worth the cost of administration in light of the complexity of the current law. She also pointed out that, in Raleigh, 80% of licensed businesses pay $500 or less; among those, 50% pay $50 or less. One of the main complaints that she hears from businesses are the inequities among businesses because of the arbitrary exemptions and caps.

Next, the Committee heard from Andy Ellen, President and General Counsel, NC Retail Merchants' Association, and three business owners, Lynn Ford of Ford's Produce, Dick Harlow of Dick Broadcasting, and Mack McLamb of Carlie C's grocery store. The comments centered on the inequities and the substantial increase in tax faced by many businesses because of cities that have transitioned to a gross receipts schedule or increased their existing cap. Many businesses went from having a $50 privilege tax bill in one year to having one for thousands of dollars the next. For example, Mr. McLamb shared that his annual privilege license tax represents 6% of his business' income. Mr. McLamb has on previous occasions expressed concern that a gross receipts system punishes those businesses that have high receipts but a low profit margin.

In at least two of the Committee's meetings, the members engaged in prolonged discussion of this topic consistently raising concerns about the inequities of the tax and expressing displeasure at the abuses committed by some cities with unlimited or exorbitant gross receipts' schedules. A number of members expressed support for an outright repeal of the tax. Supporters of the proposal view it as the next step in the tax reform process creating a simpler and fairer tax. On the other side of the issue, some

members expressed concern that cities would have to raise property taxes if it passes without a way to make up for lost revenue. There was also discussion that cities would not be able to collect from all businesses.

Part XII of the Legislative Proposal would repeal the cities' current broad authority[11] and substitute authority to levy a flat tax capped at $100 per business location. Under existing law, a business is subject to the tax if it "carries on" business within a city. Under the proposal, a business must have a physical location, whether temporary or permanent, within a city's limits in order to be subject to the tax. A single business may have multiple locations and multiple businesses may operate from a single location.

This proposal also eliminates the multitude of restrictions and caps on various types of trades, businesses, and professions that exist either by virtue of the repealed Schedule B or existing State privilege license tax statutes. Currently, cities are prohibited from levying a privilege license tax on certain professionals who are taxed at the State level, such as attorneys, physicians, engineers, real estate brokers, and home inspectors. This proposal removes the restriction but limits the local tax to the business entity that employs the individual or with whom the individual is otherwise affiliated. Other businesses that cities are currently prohibited from taxing include banks, private protective services, burglar alarm dealers, household appliance dealers, and office equipment dealers. These restrictions are removed. However, cities would still be prohibited from levying any license, franchise, privilege, or business taxes on the following businesses because cities receive a share of sales tax revenue levied on these

[11] G.S. 160A-211(a), the subsection that authorizes cities to levy a privilege license tax, was inadvertently repealed in Section 58(b) of S.L. 2013-414. The repeal was a drafting error as evidence by the fact that Section 58(d) of that same act amends the same subsection and leaves the remainder of the statute intact. Section 12.1 of this proposal reenacts the provision to correct the error.

businesses: piped natural gas, telecommunications, video programming, and electricity. 501(c)(3)s are also excluded from the definition of business and would not be subject to the tax.

Approximately 64 types of businesses are subject to a cap on the amount of tax that a city may impose. Examples of businesses whose rate is capped at less than $100 include: amusements, $25; collection agencies, $50; peddlers of farm products, $25; contractors, $10; restaurants, $42.50; barbershops & beauty parlors, $2.50 per person employed; firearms dealers, $50; auto dealers, $25. These caps are removed. The proposal also repeals county authority to levy a privilege tax. County authority is much more limited. Only 37 counties currently levy the tax generating less than $500,000 cumulatively. The proposal would have an estimated fiscal impact of $11.4 to $24.6 million. The specific impact would depend upon whether each city opts to levy the maximum tax and whether they would be able to collect from all eligible businesses. The proposal would become effective July 1, 2015.

TAX & TAG TOGETHER AND LICENSE PLATE AGENTS

At its meeting on December 10, 2013, the Committee heard a presentation on the Tax & Tag Together program. In September, the State began implantation the Tax & Tag Together program, a combined system for motor vehicle registration renewal and property tax collection. Under the new program, the motor vehicle owner will receive one bill, and make one payment for both property taxes and vehicle registration renewal.

In order to provide that vehicle registration and renewal may be issued throughout the State, the Division of Motor Vehicles (DMV) enters into commission contracts with license plate agents (LPAs). The LPAs are compensated on a per transaction basis. Under the Tax & Tag Together program, the LPAs are now collecting

the property tax on motor vehicles at the time of vehicle registration. S.L. 2013-372 provided increased compensation for the new duties required of LPAs under the Tax & Tag Together program.

At the December meeting, the Chairs of the Committee appointed a subcommittee to study the changes in S.L. 2013-372, and determine the appropriate compensation for LPAs to collect the property tax on motor vehicles. S.L. 2013-372 provided that per compensation rate for the collection of property tax would be set at a transitional rate of $1.06 per transaction for the first six months of the program. The subcommittee met twice, and recommended the full Committee adopt a legislative proposal to further increase the compensation of LPAs.

Part XIII of the Legislative Proposal permanently sets the LPA transaction rate for the collection of property tax under the Tax & Tag Together program at the transitional rate of $1.06 per transaction. The proposal provides that the transitional rate will apply to the collection of property taxes with registration renewals for the entire 2013 fiscal year and clarifies that the $1.06 rate will apply to all transactions where an LPA collects property tax, effective July 1, 2014.

TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES

At the March 12 and April 9 meetings, the Committee considered technical and administrative changes to the excise tax statutes, recommended by the Department of Revenue and taxpayers. These changes may be found in Part XIV of the Legislative Proposal.

At the April 9 meeting, the Committee was presented with two bill drafts: one containing technical changes and one containing administrative and clarifying changes. Most of the changes in these two bill drafts were recommended by the Department of

Revenue and taxpayers. These changes may be found in Part XIV of the Legislative Proposal.

TAX ADMINISTRATION

During the Committee's meeting on February 11, 2014, Jeff Epstein, Chief Operating Officer, Department of Revenue presented the Committee an update on the computer modernization program, the Tax Information Management System (TIMS). The TIMS implementation was designed to replace the current Integrated Tax Administration System (ITAS) that has been operational since October, 1994. ITAS currently supports 12 tax schedules that account for at least 95% of all taxes collected by the Department of Revenue.

The Department of Revenue entered a series of contracts and amendments with CGI Technologies and Solutions Inc. (CGI) to implement TIMS. Effective January 10, 2014, the Department of Revenue and CGI signed an agreement terminating their relationship. The Department of Revenue told the Committee that the TIMS system was processing only non-ITAS tax schedules and could not process the largest tax schedules, including income tax. However, the TIMS system was successful in identifying over $300 million in unpaid taxes.

For TIMS, the Department of Revenue paid CGI $63,845,388 through December 31, 2013 plus an additional $22,287,081 was spent on internal costs. The final CGI payment for terminating the contract was estimated to be $5 million. The Department of Revenue plans to rely on the 20-year-old legacy system, ITAS, until a new replacement program can be implemented.

JOB DEVELOPMENT GRANT INCENTIVES

The Tax Simplification and Reduction Act eliminated most of the tax credits used to incent economic development in favor of a more attractive tax structure: lower tax

rates for all business taxpayers, a more simple tax structure, a State net loss deduction recommended by this Committee, and other general tax changes. Besides the tax code, North Carolina has grant programs to incent economic development. The Committee heard a presentation at its March 12, 2014 meeting on two of the key programs used in economic development: Job Development Investment Grants (JDIG) and One North Carolina Fund (One NC) awards.

The JDIG program is designed to stimulate economic activity and create new jobs by providing a discretionary incentive that offers sustained annual grants directly to new and expanding businesses statewide, measured against a percentage of withholding taxes (10% to 75%) paid by new employees. It was created in 2002 and the first grants were awarded in 2003. The program is scheduled to sunset on January 1, 2016.

Each JDIG project must meet eligibility criteria and be competitive with other states/countries. The grant must be necessary for the company to locate or expand in North Carolina. Each project must also pass an economic modeling test to demonstrate a positive net impact to the State. Finally, the grant must be provided to a business other than a sports team (except motor sports racing) and it must create a minimum number of jobs based on the tier location.

The total amount paid out for all JDIG grants in any one year cannot exceed $15 million.[12] The maximum length per project is 12 years, so the maximum payout for projects awarded in any given year is $180 million (12 years $15 million). If Commerce fully utilized the permissible liability caps and companies performed at maximum levels, the JDIG program would have cost $2.7 billion. The actual cost of the program

[12] S.L. 2013-360 modified liability to be $22.5 million for FY 2013-15 Biennium and $7.5 million for 7/1/15 to 12/31/15.

will be less since liability caps have not been maximized, which occurs for a number of reasons, including: Commerce underutilizing the liability cap during a given calendar year, JDIG projects being terminated, and companies not performing at maximum contract levels. In some cases, projects move or otherwise fail to maintain minimum eligibility criteria and are subject to clawback provisions to recoup grant payments.

The General Assembly provides the JDIG program with a recurring appropriation of $63 million (as of FY 2014-15), which the Office of State Budget and Management cash flows to Commerce for disbursement to companies. Appropriations are adjusted based on the Commerce Department's Annual Funding Study.

A second discretionary grant program is the One North Carolina Fund (One NC). This fund provides grants to local governments for assistance in the recruitment, expansion or retention of new and existing businesses. One NC awards require a matching grant from a unit of local government. The companies receiving grants must meet the local wage standard and be looking to move or expand to another region.

One NC grants can be used for the installation and purchase of equipment; structural repairs, improvements or renovations of existing buildings to be used for expansion; and construction or improvements to new or existing water, sewer, gas or electric utility distribution lines, or equipment for existing buildings (new buildings are eligible for manufacturing and industrial operations).

The total amount committed to One NC awards in a single biennium cannot exceed $28 million. This program is also cash flowed by the Office of State Budget and Management and receives a $9 million recurring appropriation, which is adjusted according to the Commerce Department's Annual Funding Study.

COMMITTEE RECOMMENDATIONS AND LEGISLATIVE PROPOSALS

The Revenue Laws Study Committee makes the following recommendation to the 2014 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. Omnibus Tax Law Changes