Recommendations of the State and Local Fiscal Modernization Study Commission to the General Assembly:

The following recommendations have been identified as high priority items by the State and Local Fiscal Modernization Study Commission. In summary, the recommendations:

- make the sales tax more progressive by broadening the sales tax base to include many services that are currently exempt from the sales tax (warranty and repair services, entertainment services, etc.) and by broadening the sales tax base to include currently exempt food items;

- broaden the individual income tax base, take low-income taxpayers off the tax rolls and reduce income tax rates across all income levels;

- reduce the top corporate tax rate and adopt combined reporting;

- provide relief to local government through the State's assumption of a portion of Medicaid costs;

- provide greater flexibility to city and county governments with respect to how they raise revenue by allowing a menu of options including real estate transfer fees or deed stamp taxes, impact fees, motor vehicle license fees and other vehicle use fees, taxes on prepared food and drink, and occupancy taxes;

- provide funding for water and sewer infrastructure;

- eliminate differential sales tax rates; and

- modernize the local ad valorem tax on real property and provide local governments flexibility in providing tax relief for elderly and fixed income residents.

The Commission believes that these recommendations should be approved by the General Assembly and signed into law by the Governor during this legislative session. As the General Assembly considers options to modernize the state and local system of taxation, the Commission respectfully urges its members not to make changes unless they are consistent with these recommendations. Members of the General Assembly should also be aware that the Commission has made other recommendations which while not as high a priority are nonetheless important and should be considered by the legislature in the future.

Each of the recommendations can stand alone with the exception of the first and second recommendations. Significant income tax rate reductions can only be accomplished in a revenue-neutral manner by offsetting the revenue loss with additional revenue from broadening the sales tax base.

Detailed revenue estimates of each recommendation are not available at this time. Accordingly, it may be necessary to adjust tax rates in order for the recommendations to be revenue neutral. In addition, a detailed incidence analysis of the recommendations is not available at this time. To the extent that low-income taxpayers are adversely affected by the recommendations, the proposed standard deduction and or exemption amounts should be modified.

Specific Recommendations:

1. Broaden the sales tax base and lower the sales tax rate.

(A). Effective January 1, 2008, the following services which are commonly taxed by other states should be included in the sales tax base and taxed at the combined general rate:

- pet grooming services;
- landscaping;
- typesetting;
- storage (automotive, fur, household goods, marina services, and so on);
- carpet and upholstery cleaning;
- garment repair and altering;
- gift and package wrapping;
- services provided by health clubs and tanning parlors;
- shoe repair;
- swimming pool cleaning and maintenance;
- janitorial services;
- exterminating services;
- telephone answering services;
- tire recapping and repairing;
- window cleaning;
- automotive services;
- entertainment services (some of which are currently taxed at 3%);
- warranty services; and
- currently exempt installation and repair services.

The Commission recommends that the sales tax should be expanded to include a broad range of additional services but has identified significant issues which must be addressed before final recommendations can be made.

(B). Effective January 1, 2008, currently exempt food items should be taxed at the combined general rate. The Commission recommends that low-income taxpayers receive targeted income tax relief to offset the additional sales tax burden caused by taxing food at the combined general sales tax rate.

Increases in sales tax revenue from the base broadening described above should be used to offset revenue losses from changes in the income tax. To the extent that additional sales tax revenue exceeds reductions in income tax revenue, both state and local sales tax rates should be lowered in a revenue neutral fashion.

2. Reduce the top marginal individual income tax rate, broaden the individual income tax base and reduce the number of individual income tax filers.

(A). Effective January 1, 2008, the base for calculating North Carolina taxable income should be federal adjusted gross income (AGI) with minimal exclusions and deductions as required by law (retirement income exempted from North Carolina income tax under the *Bailey* decision, interest on federal obligations, interest on in-state municipal bonds) or equity considerations (North Carolina income tax refunds included in federal AGI and a deduction for higher education tuition payments when a credit is claimed on the federal return).

(B). Effective January 1, 2008, individual income tax rates should be reduced as shown in the following table:

Marginal Rate on Taxable Income*	Single/MFS	MFJ/QW	HOH
3 – 4%	Up to $10,000	Up to $20,000	Up to $15,000
4 – 5%	$10,001 - $60,000	$20,001 - $120,000	$15,001 - $90,000
5 – 6%	$60,001 - $120,000	$120,001 - $240,000	$90,001 - $180,000
6 – 7%	$120,001 +	$240,000 +	$180,000+

* The proposed rates assume that additional revenues from broadening the sales tax will be used to offset revenue losses resulting from reductions in individual income tax rates. To the extent that increased revenues from the sales tax are used to reduce sales tax rates and not income tax rates, the rate reductions proposed above will not be possible.

(C). Effective January 1, 2008, a standard deduction from federal AGI should be allowed. For low income taxpayers, this standard deduction is intended to remove significant numbers of taxpayers from tax filing and payment obligations and to offset the impact of increasing sales taxes. A smaller standard deduction should be allowed for taxpayers with moderate and higher amounts of income.

The standard deduction should range from $0 to $16,000 as shown in the following table:

Standard Deduction**	Single/MFS	MFJ/QW	HOH
$8,000/$16,000/$12,000	$0 - $60,000	$0 - $120,000	$0 - $90,000
$4,000/$8,000/$6,000	$60,001 - $120,000	$120,001 - $240,000	$90,001 - $180,000
None	$120,001 +	$240,000 +	$180,000+

* These amounts should be modified as necessary in order to ensure that low income taxpayers are not adversely impacted by the recommended changes.

(D). Effective January 1, 2008, deductions from federal AGI should be allowed for personal and dependency exemptions. The allowable exemption amount should vary depending on filing status and North Carolina taxable income as shown below:

Exemption Amount	Single/MFS	MFJ/QW	HOH
$2,000	$0 - $60,000	$0 - $120,000	$0 - $90,000
$1,200	$60,001 - $120,000	$120,001 -$240,000	$90,001 - $180,000
None	$120,001 +	$240,000 +	$180,000+

Comparison of Tax Payment Thresholds Under Current Law with Recommended Changes

Under current law, the first $5,500 of income of a single taxpayer with no dependents would be exempt from North Carolina income tax. Under the Commission's recommendations, this taxpayer could earn up to $10,000 without owing any North Carolina income tax.

Under current law, a taxpayer that files as head of household with two dependents would pay no income tax on $15,224 of income (after taking into account the current child credit of $100 per child). Under the Commission's recommendations, this taxpayer could earn up to $18,000 without owing any North Carolina income tax (before any allowable child tax credit).

Under current law, $11,000 of income of a married couple with no children would be exempt from North Carolina income tax. Under the Commission's recommendations, this taxpayer could earn up to $20,000 without owing any North Carolina income tax.

Under current law, a married couple with two children would pay no income tax on the first $19,334 of income (after taking into account the current child credit of $100 per child). Under the Commission's recommendations, this family could earn up to $24,000 without owing any North Carolina income tax (before any allowable child tax credit).

(E). Under current law, a variety of income tax credits are allowed including credits for child and dependent care expenses, credits for children, credits for charitable contributions for non-itemizers, credits for qualified business investments, business incentives and energy tax credits, credits for disabled taxpayers, dependents and spouses, credits for real property land donations, credits for rehabilitating historic structures and mill facilities, credits for property taxes on farm machinery, credits for handicapped dwelling units, credits for conservation tillage equipment, credits for gleaned crops, credits for poultry composting, and credit for recycling oyster shells.

The Commission recommends that the Revenue Laws Study Committee should review the current individual income tax credits to determine the extent to which the current credits should be continued, recommend any phase-outs of the current credits and determine the extent to which the tax rates above would need to be adjusted in order to maintain revenue neutrality if any or all credits are retained. The Revenue Laws Study Committee should also consider whether an education deduction should be allowed for higher education tuition payments when an education credit is taken instead of a deduction for federal tax purposes.

3. Reduce the corporate income tax rate and require combined reporting.

Effective January 1, 2009, affiliated groups of corporations that are engaged in a unitary business should be required to file combined returns. An affiliated group is defined as a group of two or more corporations in which more than 50% of the voting stock of each member corporation is directly or indirectly owned by a common owner or owners, either corporate or non-corporate, or by one or more of the member corporations. A unitary business is defined as one or more related business organizations engaged in business activity both within and without the State among which one or more of the following exist: a unity of ownership, operation or use or an interdependence in their functions. A unitary business should be defined as broadly as allowed under current judicial authority.

Members of a combined group should be allowed to make a “water’s edge” election and thereby elect to disregard the income and apportionment factors of a member of the combined group that is a foreign corporation that conducts eighty percent or more of its business activity outside the United States and outside a tax haven country.

The corporate tax rate should be reduced in a revenue neutral fashion. Based on conservative assumptions of the impact of combined reporting, the corporate rate should be reduced to 6% or lower.

4. The State should assume responsibility for the nonfederal share of Medicaid Assistance Program costs, excluding administrative costs.

   Alternatives include:

   (A). An immediate takeover at a cost to the State of approximately $500 to $600 million, or

   (B). A takeover accomplished over 3 to 4 years. Alternatives include:

      (1). assuming responsibility for a portion of Medicaid in excess of a percentage of property values in each county. Complete Medicaid relief would be phased-in over 3 to 4 years by reducing the threshold required for relief. For example, the State could immediately assume responsibility for Medicaid expenditures in excess of the revenue received by a $.10 tax on real property within each county. The one-year cost to the state would be approximately $51 million. Phasing in the takeover in this manner would provide immediate relief for about one-third of the counties in the State.

      (2). cutting the county share of Medicaid across the board in order to provide relief to all counties.

   The shift in responsibility from the counties to the State should be accompanied by a shift in funding sources or by the State identifying new sources of revenue. A shift in funding sources could be accomplished through the counties giving up the 2% local sales tax on food or other sources of revenue currently shared among the State and the counties such as the 2.5% local sales tax, lottery proceeds, corporate income tax, etc.

5. The State should provide greater flexibility to city and county governments with respect to how they raise revenue by providing a menu of options including real estate transfer fees or deed stamp taxes, impact fees, motor vehicle license fees and other vehicle use fees, taxes on prepared food and drink, and occupancy taxes.

   Each city and county government should have the same authority and the ability to pick and choose which revenue sources are appropriate.

   The Revenue Laws Study Committee should study and set maximum rates for each tax.

6. Provide funding for water and sewer infrastructure.

The State of North Carolina should issue bonds, the proceeds of which should be used to provide funding for water and sewer infrastructure. Funds should be allocated to local utilities with the greatest need and should be used to provide incentives to regionalize or otherwise provide more cost effective services.

7. Eliminate differential rates in the sales tax.

The following transactions that are currently subject to sales or excise tax at special rates should be taxed at the combined general sales tax rate.

(A). All sales of motor vehicles taxed under the highway use tax. The tax is to be assessed on the retail value of the motor vehicle with no reduction for an allowance given by the seller for trade-ins. Taxes collected on motor vehicles at the combined general tax rate should be credited to the North Carolina Highway Trust Fund.

(B). Admissions and amusements currently taxed at 3%.

(C). Long-term leases and rentals of motor vehicles.

8. Modernize the local ad valorem tax on real property and provide local governments flexibility in providing tax relief for elderly and fixed income residents.

   (A). Effective January 1, 2008, local governments should be given the option to provide property tax deferrals for elderly and fixed income residents. Requirements for deferral and events that result in the payment of deferred tax should be uniform across the state and determined by the Property Tax Subcommittee of the Revenue Laws Study Committee.

   (B). Effective January 1, 2008, the State should require each county of the State to:

      (1). reappraise all real property in any year following a year in which the median sales assessment ratio (as conducted by the Department of Revenue) does not exceed .90, or

      (2). revalue property on an annual basis using annual indexing with an index to be determined for each county by the Department of Revenue.