



North Carolina Department of Revenue

www.dor.state.nc.us

Michael F. Easley
Governor

E. Norris Tolson
Secretary

February 24, 2003

MEMORANDUM

TO: Secretary E. Norris Tolson

FROM: Sabra J. Faires
Assistant Secretary for Tax Administration

SUBJECT: Response to Governor's Commission to Modernize State Finances

This memo sets out the recommended response of Tax Administration to the Governor's Commission to Modernize State Finances. It was prepared in response to the request you received from the Governor's Office to analyze the Commission's Final Report and suggest ways to accomplish the goals of the Commission's recommendations.

The Final Report of the Commission makes an overall recommendation that State and local taxes have broader bases and lower rates and then makes recommendations in the following four tax categories – sales tax, individual income tax, corporate income and franchise tax, and other nontax finance issues. This response addresses each category and its recommendations separately in the order in which they appear in the report.

The responses to the recommendations in the tax categories set out ways to implement the Commission's recommendations and give the earliest recommended effective date for any proposed change. An attachment to this memo indicates the estimated fiscal effect of the sales tax recommendations made in the memo. The memo sets out the fiscal impact of some of the recommendations for the individual income tax.

This response does not separately address the Commission's overall recommendation of a broader base and lower rate. The recommendations in each category are made with this broad recommendation in mind. If the recommendations in the categories are adopted, the base for all taxes addressed in the recommendations will be broader and, consequently, the rates could be lowered.

I. Sales Tax

The Commission's Report contains five sales tax recommendations. This memo numbers each of the recommendations and discusses them in the order in which they appear in the report.

Report Recommendation One: Eliminate the differential rates of taxation of goods and services and remove the caps on the sales and use taxes.

Response: The State sales tax is imposed at a general rate plus seven rates that differ from the general rate and has three caps as explained in the following table.

Sales Tax Rate	G.S. 105-	Application
4.5%	164.4(a)	General rate in effect until 7/1/03; general rate is 4% after that date
2%, \$300 cap	164.4(a)(1a)	Manufactured homes
3%, \$1,500 cap	164.4(a)(1b)	Aircraft, boat, railway car, or locomotive
1%	164.4(a)(1c)	Horses, mules, animal semen, various items sold to freezer locker plants, and fuel, other than electricity, sold to farmers, manufacturers, laundries, and dry cleaners
1%, \$80 cap	164.4(a)(1d) and 164.4A	Farm machinery, mill machinery, telephone company property, laundry machinery, freezer plant machinery, broadcasting machinery, tobacco equipment, farm storage facilities, farm containers, recycling facility equipment, air courier equipment, and flight crew training equipment
3%, \$1,500 cap	164.4(a)(1e)	Mobile classroom or mobile office
2.83%	164.4(a)(1f)	Electricity sold to farmers and dry cleaners
2.83%	164.4(a)(1g)	Electricity sold to manufacturers that use 900,000 or fewer megawatt hours a year
0.17%	164.4(a)(1g)	Electricity sold to manufacturers that use over 900,000 megawatt hours a year
3%	164.4(a)(4a)	Electricity not taxed at a lower rate
6%	164.4(a)(4c)	Telecommunications service
5%	164.4(a)(6)	Direct-to-home satellite service
6%	164.4(a)(7)	Spirituous liquor

For all the items taxed at a rate other than the general State rate, the State could obviously eliminate the different rate and cap, if any, by taxing the items at the full rate or exempting them. The Department recommends the following actions with respect to each preferential rate and cap. The actions are a combination of taxation at the general State rate and exemption, plus retention of a few of the rates with modifications.

Except for the changes suggested concerning the taxation of fuel, the earliest practical effective date for implementing the recommended changes is October 1, 2003, assuming legislation is enacted in July. The start of any calendar quarter after that is a practical implementation date. The establishment of equal taxes on fuel requires more study to develop a proposal. Assuming a proposal is developed within the next year, the earliest practical effective date for implementing the proposal is likely January 1, 2005.

2%, \$300 Cap on Manufactured Homes

Eliminate this rate and cap by taxing all manufactured homes and modular homes as if they were constructed pursuant to a performance contract. Under this approach, sales or use tax at the general State rate and applicable local rate would be due on the materials and no tax would be due on the sale. The tax treatment varies now depending on whether the home is considered the product of a performance contract or the subject of a retail sale. The effect would be a tax increase with respect to manufactured homes and a tax decrease with respect to modular. The 2%, \$300 cap has its genesis with the former 1%, \$80 cap on motor vehicles. Under property tax, manufactured homes are taxed as real property. Collecting sales tax on a manufactured home in accordance with the same basis as a stick-built home would align the taxation of these items.

3%, \$1,500 Cap on Aircraft, Boats, Railway Cars, and Locomotives

Eliminate this rate and cap by:

- Exempting aircraft, locomotives, and railway cars used by a common carrier from tax.
- Retaining the exemption in G.S. 105-164.13(9) for boats used in commercial fishing.
- Taxing all other airplanes, boats, railway cars, and locomotives at the general State rate and applicable local rate.

Under the Streamlined sourcing principles, the sale or lease of aircraft, locomotives, and railway cars used in interstate commerce is sourced at the point of delivery. The practical effect will be that common carriers will take delivery in a State that exempts the item from tax. In this respect, this proposed exemption will not decrease revenue from common carriers and will avoid taxing business inputs.

This proposal will increase revenue with respect to other boats, airplanes, railway cars, and locomotives. Compliance for boats can be monitored through registrations with the Wildlife Resources Commission and the Coast Guard. Compliance for airplanes can be monitored through registrations with the Federal Aviation Administration. Occasional, isolated sales of a boat, airplane, or another item remain exempt from tax under G.S. 105-164.3(1).

1% Rate on Various Items

The specific items subject to this rate and the Department's recommended actions are set out below. The recommended actions simplify the tax, preserve the State's traditional preferences for agriculture and manufacturing, and equalize the tax treatment of various forms of energy.

- a. Horses and Mules. – Eliminate the preferential rate on this item by exempting horses and mules sold to a farmer for agricultural purposes and taxing all other sales of horses and mules at the general State rate and the applicable local rate. This proposal will decrease revenue from sales to farmers and increase revenue from sales to all others. A breeder of horses and mules is considered a livestock farmer.
- b. Semen for Artificial Insemination of Animals. – Eliminate the preferential rate on this item by adding it to the list of items in G.S. 105-164.13(2a) that are exempt when purchased for commercial purposes.
- c. Fuel, Except Electricity, Sold to Farmers. – Eliminate this preferential rate by replacing the sales tax on fuel with a tax that equalizes the rates on all energy sources used by farmers and others. The replacement tax would tax all fuel, whether it's fuel oil, electricity, piped natural gas, or another fuel at equivalent rates.
- d. Fuel, Except Electricity, Sold to Manufacturers. – Eliminate this preferential rate by replacing the sales tax on fuel with a tax that equalizes the rates on all energy sources used by manufacturers and others. The replacement tax would tax all fuel, whether it's fuel oil, electricity, piped natural gas, or another fuel at equivalent rates. Manufacturing energy is exempt in many states. To address competitive issues, the rates should decline with volume so that large users of energy have low rates. The taxation of fuel now varies by type. Fuels that are or have been subject to special franchise taxes, such as electricity and piped natural gas, are subject to higher taxes than those, such as fuel oil, that have not been subject to these taxes.
- e. Fuel, Except Electricity, Sold to Laundries and Dry Cleaners. - Eliminate this preferential rate by replacing the sales tax on fuel with a tax that equalizes the rates on all energy sources used by laundries, cleaners, and others. The replacement tax would tax all fuel, whether it's fuel oil, electricity, piped natural gas, or another fuel at equivalent rates.

- f. Freezer Locker Plant Supplies. – Eliminate this preferential rate by making these items subject to tax at the general State rate plus the applicable local rate. The rationale for this special interest exemption is not clear.

1% Rate on Various Items, With \$80 Cap

The specific items subject to the rate and cap and the Department's recommended actions are set out below. The recommended actions simplify the tax, preserve the traditional preferences for farming and manufacturing, avoid taxing machinery and equipment used to produce tangible goods or services that are subject to tax, and treat structures in the same manner as real property. Tangible property, which is the product of manufacturers and farmers, and telecommunications service, laundry service, and dry cleaning service share a significant feature – the goods and services are subject to sales tax.

- (1) Farm Machinery and Accessories. – Eliminate this preferential rate and cap by:

- Exempting items within this category that are depreciable property.
- Taxing all other items in this category at the general State rate plus the applicable local rate.

The exempt items would be purchased under an exemption certificate. Depreciable property is property that is capitalized under the Internal Revenue Code. The treatment here would parallel the refund in G.S. 105-164.14(h) for machinery and equipment placed in service in a low enterprise tier area.

- (2) Manufacturing Machinery and Accessories. - Eliminate this preferential rate and cap by:

- Exempting items within this category that are depreciable property.
- Taxing all other items in this category at the general State rate plus the applicable local rate.

The exempt items would be purchased under an exemption certificate. Depreciable property is property that is capitalized under the Internal Revenue Code. The treatment here would parallel the refund in G.S. 105-164.14(h) for machinery and equipment placed in service in a low enterprise tier area.

- (3) Telephone Company Property. – Eliminate this preferential rate and cap by:

- Exempting equipment within this category that is depreciable property.
- Removing the exemption for prewritten computer software. Custom computer software would remain exempt under G.S. 105-164.13(43).

The exempt items would be purchased under an exemption certificate. Depreciable property is property that is capitalized under the Internal Revenue Code. The treatment here would parallel the refund in G.S. 105-164.14(h) for machinery and equipment placed in service in a low enterprise tier area.

- (4) Laundry and Dry Cleaning Machinery and Accessories. - Eliminate this preferential rate and cap by:
- Exempting items within this category that are depreciable property.
 - Taxing all other items in this category at the general State rate plus the applicable local rate.

The exempt items would be purchased under an exemption certificate. Depreciable property is property that is capitalized under the Internal Revenue Code. The treatment here would parallel the refund in G.S. 105-164.14(h) for machinery and equipment placed in service in a low enterprise tier area.

- (5) Freezer Plant Machinery and Accessories. - Eliminate this preferential rate and cap by taxing all items in this category at the general State rate plus the applicable local rate.
- (6) Broadcasting Equipment and Accessories. - Eliminate this preferential rate and cap by taxing all items in this category at the general State rate plus the applicable local rate. If companies whose services are subject to tax, such as those who provide direct-to-home satellite broadcasts, are in this category, the Department recommends that the equipment they have that falls within the current preferential rate be treated the same as manufacturing equipment and be exempt if it is depreciable property.
- (7) Bulk Tobacco Barns and Accessories. - Eliminate this preferential rate and cap by taxing all items in this category at the general State rate plus the applicable local rate. If a farmer builds a barn, either the farmer or the contractor who builds the barn will pay sales or use tax on the cost of the materials used to construct the barn. Eliminating this preference will treat a "pre-constructed" barn the same as one that is constructed on site. Depreciable farm equipment would remain eligible for either the existing preferential rate and cap in G.S. 105-164.4A(1) or, if these recommendations are adopted, the exemption for those items.
- (8) Farm Storage Facilities and Accessories. - Eliminate this preferential rate and cap by taxing all items in this category at the general State rate plus the applicable local rate. If a farmer builds a storage facility, either the farmer or the contractor who builds the facility will pay sales or use tax on the cost of the materials used to construct the facility. Eliminating

this preference will treat a “pre-constructed” facility the same as one that is constructed on site. Depreciable farm equipment would remain eligible for either the existing preferential rate and cap in G.S. 105-164.4A(1) or, if these recommendations are adopted, the exemption for those items.

- (9) Farm Containers. – Eliminate this preferential rate and cap by exempting all items in this category from tax. G.S. 105-164.13(23) exempts various packaging materials from tax and this category of packaging materials can be added to that exemption.
- (10) Recycling Facility Equipment. – This preferential rate and cap was enacted as part of the tax package for Nucor. By enacting that package, the State made a commitment to that company. The company should therefore receive the benefit intended. The Department recommends that the same result be achieved in a different manner. The Department recommends exempting the recycling facility equipment from tax and reducing either of the following by the amount of tax that would have been paid under this section at the rate of 1%, with an \$80 cap:
 - The refund allowed Nucor in G.S. 105-164.14(g) for sales tax paid on building materials.
 - The credit for transportation expenses allowed Nucor in G.S. 105-129.8.
- (11) Air Courier Equipment. – This preferential rate and cap was enacted as part of the tax package for FedEx. By enacting that package, the State made a commitment to that company. The company should therefore receive the benefit intended. The Department recommends that the same result be achieved in a different manner. The Department recommends exempting the air courier equipment from tax and reducing the amount of a credit taken under Article 3A for a year by the amount of tax that would have been paid under this section at the rate of 1%, with an \$80 cap.
- (12) Flight Crew Training Equipment. – This preferential rate and cap is one of the tax preferences enacted for U.S. Airways as an incentive to establish flight crew training facilities in this State. It applies to air couriers, such as FedEx, as well. The Department recommends that the same result be achieved in a different manner. The Department recommends exempting the flight crew training equipment from tax and reducing the amount of a credit taken under Article 3A for a year by the amount of tax that would have been paid under this section at the rate of 1%, with an \$80 cap.

3%, \$1,500 Cap on Mobile Classrooms and Mobile Offices

Eliminate this rate and cap by:

- Retaining the exemption in G.S. 105-164.13(41) for mobile classrooms sold to local boards of education or local boards of trustees of community colleges.
- Making other mobile classrooms subject to tax at the general State rate and applicable local rate.
- Taxing mobile offices at the same rate as special mobile equipment, which is subject to the general State rate and applicable local rate.

If a mobile classroom is sold to a nonprofit educational institution, the institution can obtain a refund of the tax paid. Sales to the State will be exempt if the Revenue Laws Study Committee recommendation on exempting State agencies from tax is adopted and will otherwise be subject to a refund of local tax.

This proposal will increase revenue from the sale of mobile classrooms to the extent that they are purchased by an entity other than a nonprofit educational institution. It will increase revenue from the sale of mobile offices.

This preferential rate has its genesis in the former 1%, \$80 cap on motor vehicles. Both mobile classrooms and mobile offices were formerly considered motor vehicles.

2.83% on Electricity for Farmers, Laundries, and Dry Cleaners

Eliminate this preferential rate by replacing the sales tax on electricity with a tax that equalizes the rates on all energy sources used by farmers, laundries, dry cleaners, and others. The replacement tax would tax all fuel, whether it's fuel oil, electricity, piped natural gas, or another fuel at equivalent rates. Manufacturing energy is exempt in many states. To address competitive issues, the rates should decline with volume so that large users of energy have low rates. The taxation of fuel now varies by type. Fuels that are or have been subject to special franchise taxes, such as electricity and piped natural gas, are subject to higher taxes than those, such as fuel oil, that have not been subject to these taxes.

2.83% and 0.17% on Electricity for Manufacturers

Eliminate this preferential rate by replacing the sales tax on electricity with a tax that equalizes the rates on all energy sources used by manufacturers and others. The replacement tax would tax all fuel, whether it's fuel oil, electricity, piped natural gas, or another fuel at equivalent rates. Manufacturing energy is exempt in many states. To address competitive issues, the rates should decline with volume so that large users of energy have low rates. The taxation of fuel now varies by type. Fuels that are or have been subject to special franchise taxes, such as electricity and piped natural gas, are subject to higher taxes than those, such as fuel oil, that have not been subject to these taxes.

3% on Residential Electricity and Other Electricity Not Subject to a Lower Rate

Eliminate this preferential rate by replacing the sales tax on electricity with a tax that equalizes the rates on all energy sources. The replacement tax would tax all fuel, whether it's fuel oil, electricity, piped natural gas, or another fuel at equivalent rates. Manufacturing energy is exempt in many states. To address competitive issues, the rates should decline with volume so that large users of energy have low rates. The taxation of fuel now varies by type. Fuels that are or have been subject to special franchise taxes, such as electricity and piped natural gas, are subject to higher taxes than those, such as fuel oil, that have not been subject to these taxes.

6% on Telecommunications Service

Keep the tax on telecommunications service as a State-only tax and continue to share the revenue from this tax with local governments as specified in G.S. 105-164.44F. Change the rate so that it is not a fixed rate, but is the equivalent of the State general rate plus the authorized rate for all counties. When telecommunications taxes were reformed in 2001, the combined State and local rate was 6%. The State general rate has since increased temporarily from 4% to 4.5% and the authorized local rate has increased from 2% to 2.5%. An ultimate goal of these proposals is to decrease the State and local sales tax rates. If the telecommunications tax rate were tied to the combination of the State and local rates, the tax rate would decrease when those rates decreased. The goal of the telecommunications reform was to tax all telecommunications service equally, not to tax it at a rate different from the prevailing rates.

5% on Direct-to-Home Satellite Service

Keep the tax on direct-to-home satellite service as a State-only tax and change the rate so that it is not a fixed rate, but is the equivalent of the State general rate plus the authorized rate for all counties. The tax rate is set at 5% to equalize the tax treatment of cable television and direct-to-home satellite service. Cable companies typically pay a 5% local franchise tax. The Department recommends that cable service be taxed at the same rate as direct-to-home, if direct-to-home is taxed at a rate higher than 5%, and that the cable provider be allowed a credit for the amount of tax paid to a local unit for service provided in cities.

6% on Liquor

Keep the tax on liquor as a State-only tax and change the rate so that it is not a fixed rate, but is the equivalent of the State general rate plus the authorized rate for all counties. When this tax was enacted in 2001, the combined State and local rate was 6%. The State general rate has since increased temporarily from 4% to 4.5% and the authorized local rate has increased from 2% to 2.5%. An ultimate goal of these proposals is to decrease the State and local sales tax rates. If the rate on alcohol were tied to the combination of the State and local rates, the tax rate would decrease when those rates decreased.

Report Recommendation Two: Eliminate sales tax exemptions.

Response: Several different statutes exempt items from sales tax. The exemptions and the Department's recommendations on the exemptions are set out in two different tables. One table addresses the exemptions in statutes other than G.S. 105-164.13 and the other addresses the exemptions in G.S. 105-164.13. The recommendations attempt to establish consistency among the exemptions, to eliminate anachronistic exemptions, and to eliminate exemptions that serve special interests rather than the principles set out in the Final Report.

The earliest practical effective date for the changes recommended in Table 1 varies. For the changes concerning software and digital equivalents, the earliest practical date is January 1, 2004. The effective dates for services are set out under Recommendation Three. The repeal of the exemptions for golf cart batteries and food could become effective October 1, 2003, assuming legislation is enacted in July. If the sales tax holiday is repealed for 2003, the repeal should be enacted by July 1, so that merchants will not begin advertising campaigns and programming changes that are not needed.

The earliest practical effective date for the changes recommended in Table 2 is October 1, 2003, assuming legislation is enacted in July. The first day of any calendar quarter after that is also a practical effective date.

Table 1: Exemptions Outside G.S. 105-164.13		
Cite in 105	Current Sales Tax Exemption	Recommendation
164.3 (46)	Prewritten computer software that is not delivered by means of a storage medium	Adopt the Streamlined Sales tax definition of tangible personal property so that prewritten computer software is taxable regardless of the method of delivery. Taxation of the same product, such as TurboTax, varies now depending on the whether it is downloaded or purchased in a box at a store.
164.3 (46)	Digital equivalents of tangible property	Adopt the Streamlined Sales Tax definition of digital equivalents and apply sales tax to these items. Taxation now depends on the method of delivery. For example, a year's subscription to the multi-volume "Federal Tax Reporter" is taxable if hard copies are sent but is not if it is received online.
164.4	Most services	See the recommendations under the proposal on services.

164.12A	Electric golf cart battery chargers when sold at the same time as golf cart	Repeal. This is a special interest exemption.
164.13	Over 50 different categories and items	See the separate table for that statute.
164.13A	Tips for serving food	Retain.
164.13B	Food	Repeal. Inclusion of food in the base contributes significantly to a stable base, distinctions between prepared food (which is taxable) and nonprepared food are often difficult and lead to various inequities, taxpayers remain confused about the State exemption and the continued local tax on food, food purchased with food stamps will continue to be exempt, and concerns about regressive impacts can be addressed through the income tax.
164.13C	Various items sold during the Sales Tax Holiday	Repeal. The sales tax holiday is difficult to administer, is a major stumbling block to voluntary collection by retailers like Amazon, and, as indicated in studies, decreases tax revenue and shifts the timing of sales but not the overall volume of sales.
164.14	Refunds to interstate carriers, governmental agencies, various nonprofit entities, and businesses that place machinery and equipment in service in a low tier county	Retain the interstate carrier refund, exempt state and local governments from tax rather than allowing than a refund, take a hard look at the nonprofit exemptions to determine the continued rationale for these exemptions, and review the refund for machinery and equipment to determine its effectiveness. The category of nonprofit charitable organization in particular needs to be reviewed.

Table 2: Exemptions Listed in G.S. 105-164.13		
Cite in 164.13	Current Sales Tax Exemption	Recommendation
(1)	Commercial fertilizer, lime, land plaster, and seeds sold to farmers	Retain. Preserves traditional farm preference and farm products are subsequently sold.
(2a)	Various medicines, pesticides, and other items for use on animals or plants held or produced for commercial purposes	Retain. Preserves traditional farm preference, crops are grown for sale, and animals are for business purpose.
(3)	Products of forests and mines in their original state	Repeal. This exemption creates inequities among purchasers of the same item. For example, gravel bought from the quarry is exempt and gravel bought from another source at is subject to tax.
(4)	Cotton, other items sold to manufacturers for further processing	Repeal as a technical amendment. These items are exempt under G.S. 105-164.8 as an ingredient part of a manufactured product.
(4a)	Baby chicks and poults sold for commercial purposes	Retain. Preserves traditional farm preference and animals are for a business purpose to produce eggs and chickens.
(4b)	Products of the farm sold in their original state by the producer and ice used to preserve crops and fish for sale at retail	Repeal the product of the farm exemption and retain the ice exemption. The product exemption creates inequities among purchasers of the same item. For example, corn bought from the farmer is exempt and corn bought at the grocery store is subject to tax. The ice is similar to a packaging material and can be incorporated in that group of items.
(4c)a	Facilities for housing, raising, or feeding animals held for commercial purposes	Repeal. The preferential rates and exemptions for preconstructed buildings for various farm purposes are fairly recent additions to the sales tax laws and are special interest exemptions that are not matched even for manufacturers. A consistent principle in sales tax would be to uniformly tax building materials used to construct real property and "preconstructed" equivalents of real property.
(4c)b	Building materials and other	Repeal. See the explanation for

	items used to construct or improve structures for housing, raising, or feeding animals held for commercial purposes	(4c)a.
(4c)c	Any equipment used in a facility or structure exempt under (4c) a or b.	Repeal. Depreciable farm equipment would remain eligible for either the existing preferential rate and cap in G.S. 105-164.4A(1) or, if these recommendations are adopted, the exemption for those items.
(4d)	Tobacco sheets	Repeal. This was enacted to address a temporary shortage of tobacco sheets and may not be needed in any event due to the decline in tobacco warehouses. If the sheets accompany the tobacco, they are exempt as a packaging item.
(5)	Sales for resale	Retain. This is a basic feature of sales tax law that prevents cascading taxes.
(5a)	Manufacturing items subject to excise tax effective 1/1/06	Repeal. With the recommended changes to the 1%, \$80 category, the tax in Article 5F should be repealed.
(7)	Products of the water sold in their original state by the producer	Repeal. This exemption creates inequities among purchasers of the same item. For example, fish bought from the fisherman who caught it is exempt and fish bought at the grocery store is subject to tax.
(8)	Component parts of manufactured products	Retain. This is a basic feature of the sales tax law that prevents cascading taxes.
(8a)	Fuel sold to a small power production facility	Repeal and align this with a tax that replaces the sales tax on fuel with a tax that equalizes the rates on all energy sources used by power producers and others. See the discussion of the 1% rate recommendations.
(9)	Boats, fuel oil, machinery, and supplies for commercial fishing	Retain the exemption for items in this category that are depreciable property, tax fuel under a replacement tax that equalizes the tax treatment of all fuel, and tax other items at the general State rate and applicable local rate. This aligns fishing with the recommendation for farmers under G.S. 105-164.44A(1).
(10)	Various items sold to laundries and dry cleaners	Repeal the exemption for items used to identify garments for cleaning,

		retain the exemption for bags, wrapping paper, and hangars as a packaging exemption, and retain the exemption for cleaning fluids. Dry cleaning solvent is subject to a special tax under G.S. 105-187.31.
(10a)	Various items sold to a major recycling facility	Retain. This is part of the tax incentives enacted for Nucor.
(10b)	Electricity sold to a major recycling facility	Retain. This is part of the tax incentives enacted for Nucor.
(11)	Motor fuel and alternative fuel subject to the per gallon excise tax	Retain.
(11a)	Diesel fuel sold to railroads for use in rolling stock other than motor vehicles	Repeal. The refund allowed in G.S. 105-164.14(a) for this fuel would remain. When this exemption was enacted, fuel was not one of the items for which a refund was allowed under G.S. 105-164.14(a). The refund is based on mileage in this State.
(12a)	Various medical items	Retain and align with the Streamlined Sales Tax definitions. See the discussion of that proposal.
(13)	Drugs	Retain and align with the Streamlined Sales Tax Definitions. See the discussion of that proposal.
(13c)	Nutritional supplements sold by chiropractors	Repeal. This is a special interest exemption that favors items sold by chiropractors over the same item sold by anyone else.
(14)	Public school books	Repeal as a technical amendment if the Revenue Laws proposal to exempt State agencies from tax is enacted. Local boards are eligible for sales tax refunds.
(15)	Worthless accounts	Retain. This prevents payment of tax that is never received by a retailer.
(16)	Reposessed articles	Repeal. The sales tax is a transaction tax that applies each time an item is sold by a retailer. Used articles are subject to tax.
(17)	Sales the State cannot tax under federal law, the U.S. Constitution, or the State Constitution	Retain. This is the law whether or not it is set out in an exemption statute.
(18)	The first \$1,500 of funeral expenses	Repeal. Move the imposition of tax to G.S. 105-164.4 and apply to all services included in the category that are not otherwise subject to tax. This addresses expansion into services as

		well as the \$1,500 exemption.
(20)	Sales by blind merchants supervised by DHHS	Repeal. This affects snack bars in State facilities. Sales at these facilities should be taxed the same as sales at other eating establishments.
(21)	Films leased for purpose of exhibition	Retain and tax all movie entertainment equally. Repeal the 1% privilege tax on movies and replace it with sales tax at the general State rate and applicable local rate.
(22)	Films and recordings leased to radio or television stations	Repeal. The rationale for this exemption is not clear.
(22a)	Audiovisual masters	Retain and tax all movie entertainment equally. Repeal the 1% privilege tax on movies and replace it with sales tax at the general State rate and applicable local rate.
(23)	Packaging items	Retain.
(24)	Fuel and other items sold to ocean-going vessels operated for hire	Retain.
(25)	Sales by Cherokee merchants	Retain.
(26)	Food sold at school cafeterias	Retain.
(26a)	Food sold by a school cafeteria to a child care center	Retain.
(27)	Food sold dining rooms of educational institutions	Retain.
(28)	Newspapers sold by street vendors, by carriers making door-to-door deliveries, and by vending machines and magazines sold by vendors making door-to-door sales	Repeal. This exemption is an anachronism of the 1960s when papers were delivered by youths. Most subscribers now pay directly to the paper, either online or by check.
(29)	Sales to N.C. Art Museum	Repeal if the Revenue Laws recommendation to exempt State agencies from tax is enacted.
(30)	Vending machine sales at a price of 1 cent	Repeal as obsolete.
(31)	Meals sold and delivered by nonprofit agencies to elderly and incapacitated persons	Retain.
(31a)	Food sold by a nonprofit religious organization when the proceeds are used for religious activities	Retain.
(32)	Motor vehicles, motor vehicle bodies to be mounted on an untitled chassis, and motor vehicle bodies temporarily in the State to be mounted on a	Retain. Motor vehicles are subject to the highway use tax.

	chassis	
(33)	Property purchased for export	Retain.
(33a)	Property delivered by common carrier or U.S. Postal Service to purchasers outside the State	Retain.
(34)	Sales by nonprofit organizations when the proceeds are given to the State	Retain.
(35)	Sales in an annual fundraiser by a nonprofit organization when the proceeds are used by the organization	Retain.
(36)	Advertising supplements and other printed matter delivered with a newspaper	Repeal. The General Assembly repealed the exemption for free circulation publications. Repeal of this would equalize the treatment between the advertising supplements and free circulation publications.
(38)	Food purchased with food stamps	Retain. This exemption is a condition of receiving federal funds.
(40)	Department of Transportation	Repeal as unnecessary if the Revenue Laws recommendation to exempt State agencies from tax is enacted. Revenue is transferred each year from the Highway Fund to the General Fund to compensate the General Fund for this loss of revenue.
(41)	Mobile classrooms sold to local boards or community colleges	Retain.
(42)	Donated items	Retain.
(43)	Custom computer software	Retain.
(44)	Piped natural gas	Retain. Piped natural gas is subject to a separate tax under G.S. 105-187.41.
(45)	Sales of various items to an interstate air courier or an air passenger carrier for use at a hub	Retain. This is part of the incentives enacted for U.S. Airways and FedEx.
(46)	Electricity sold by a municipality that buys power from the Tennessee Valley Authority and makes payments in lieu of taxes	Retain. This was enacted when the former 6% franchise tax on electricity was split between a sales tax and the franchise tax. If a new tax is designed to equalize the tax on all energy sources, this item will likely need to be modified.
(47)	Bottle deposits	Retain.
(48)	Deposits on batteries and other rebuilt or remanufactured parts	Retain.
(49)	Installation charges	Repeal as part of expansion of sales tax into services.

(50)	Fifty percent of sales price of vending machine items	Repeal for the reasons set out in the report of the prior Loophole Closing and Efficiency Commission.
------	---	---

Report Recommendation Three: Consider the expansion of the sales tax base to include more services.

Response: The Department is mindful of the Commission's note of caution in this area. The Department suggests that the expansion into services begin with services that are associated with tangible personal property or are predominantly end-user services that do not have cascading effects on businesses. The Department has identified the following services that meet these criteria. If these, or some number of these is implemented, and a further expansion of the base is desired, the Department recommends adding more services in the professional areas, such as accounting services.

The services below are listed in the order in which the Department recommends their implementation. The earliest practical effective date for implementing any of the recommendations listed below is January 1, 2004. If more than three of the categories are to be implemented, six months' time is needed between the effective date of the first three and the others to give the Department time to notify and register those affected.

1. Entertainment services. This category consists of the following. Many states in the southeast impose sales tax on some entertainment.
 - a. Live entertainment, including spectator sports, for which an admission is charged. This entertainment is currently taxed at the rate of 3% under the State privilege license tax in G.S. 105-37.1. The tax in G.S. 105-37.1 would be repealed.
 - b. Motion picture shows. This entertainment is currently taxed at the rate of 1% under the State privilege license tax in G.S. 105-38.1. The tax in G.S. 105-38.1 would be repealed.
 - c. Amusement parks and arcades. This entertainment is currently not subject to the privilege license tax.
 - d. Participant sports and activities, such as bowling, golf, skiing, pool, and boating. This entertainment is currently not subject to the privilege license tax.
 - e. Historic sites, museums, and similar institutions.
2. Services to repair, clean, maintain, or install tangible personal property. This category is closely associated with the sale of tangible personal property. It includes labor charges for automobile service and repair and maintenance contracts. Application of tax in this area would end confusion over when tax is due on a warranty or maintenance contract and when it is not. Currently, tax is due if the contract is required and is not due if the contract is optional. Several states tax these services. Many of the southeast states tax all warranty and service contracts.

3. Charges for parking vehicles in lots and garages. Tennessee, Florida, Texas, and South Dakota currently tax these.
4. Real property support services. This consists of:
 - a. Services to clean or maintain real property, such as janitorial services, trash disposal services, and carpet, swimming pool, gutter, and window cleaning services.
 - b. Landscaping services. The Commission noted that a lawn mower is subject to tax but a lawn service is not.
 - c. Extermination and pest control services.
5. Personal beauty and grooming services. This consists of:
 - a. Hair and nail care services, including hair removal.
 - b. Cosmetic and makeup services.
 - c. Body piercing and tattoo services.
 - d. Tanning services.
 - e. Facials, massages, wraps, and similar spa services.
6. Services for which a license as a real estate broker, real estate salesperson, or real estate appraiser is required.
7. Financial services to:
 - a. Effect a transaction in securities.
 - b. Open or maintain an account at a financial institution or a mutual fund.
 - c. Withdraw funds from an account or transfer funds from one account to another.
8. Investigation and security services. This consists of services for:
 - a. Investigation.
 - b. Security guards and patrols.
 - c. Armored cars.
 - d. Security systems.
 - e. Locksmiths.
9. Employment service. This consists of:
 - a. Services for providing temporary workers.
 - b. Services provided to individuals to assist them in finding employment.
 - c. Services provided to employers to assist the employers in finding suitable individuals to fill vacancies.

Report Recommendation Four: Adopt changes required to comply with the Streamlined Sales Tax Agreement.

Response: The Department strongly supports the Streamlined Sales Tax Project. The following changes are needed for North Carolina to enter the Agreement.

1. Adopt and apply the Streamlined uniform definitions for the terms listed below. None of these terms requires any significant change in the application of the tax.
 - Computer
 - Computer software
 - Delivered electronically
 - Direct mail
 - Drug
 - Durable medical equipment
 - Electronic
 - Mobility enhancing equipment
 - Prescription
 - Prosthetic device
 - Prewritten computer software
 - Tangible personal property
2. Modify the State exemption for food in G.S. 105-164.13B to comply with the Streamlined principle that a State cannot carve out a subset of a product definition and give that subset different treatment unless the Streamlined Agreement authorizes that modification. The Streamlined Agreement establishes various categories of food that states can tax or exempt. Three categories are candy, prepared food, and soft drinks. States can therefore exempt or tax any of these categories. States cannot, however, tax some candy, prepared food, or soft drinks that fall within these categories and exempt other items in the same categories from tax. G.S. 105-164.13B(2) creates impermissible subsets of candy, prepared food, and soft drinks. Under that statute, items in those three categories are exempt from tax if purchased for home consumption.

The Department recommends that all food be subject to tax, as explained in the discussion of the recommendation to eliminate exemptions. If this recommendation is not adopted, the Department recommends that all candy, soft drinks, and prepared foods be subject to tax. The requirements of the Streamlined Agreement on this subject can also be met by exempting all candy, prepared food, and soft drinks from tax.
3. Establish a uniform local sales tax base. This requires food to be exempt from the local tax or to be included in the taxable base for each

tax. The recent additional ½ cent local tax does not apply to food. The additional Mecklenburg ½ cent Public Transportation Tax also does not apply to food. The Department recommends that all food be subject to tax, as explained in the discussion of the recommendation to eliminate exemptions.

4. Change the due date of a monthly return from the 15th of a month to the 20th.
5. Adopt the Streamlined sourcing rules for leases and rentals. This conforms for the most part to current North Carolina law.
6. Allow voluntary collectors to file on an annual basis if their collections in a year do not exceed \$1,000.
7. Require 120 days' notice to mail order companies of local rate changes.
8. By the August 2004, sales tax holiday, delete items from the holiday if there is not a uniform Streamlined definition for the item. For example, school supplies and education software are not currently defined in the Agreement.
9. By 1/1/06, eliminate the varying State rates and caps. The Department's response to Recommendation A of the Sales Tax proposals explains how these rates and caps can be eliminated.

Report Recommendation Five: Simplify the administration of the local sales taxes.

Response: The administration of the local sales tax is complex because of the sourcing and distribution requirements that are an unavoidable aspect of a local tax. Transactions are taxable in a local jurisdiction only if the transaction is sourced to that jurisdiction. Local sales tax revenue belongs to the locality that imposed the tax. State law modifies the distribution back to the source county for some of the local taxes.

The complexities that arise from the sourcing and distribution of a local tax are unlikely to be solved without eliminating the local levy of the tax. The State now follows a destination sourcing rule for local sales taxes. The destination sourcing rule is the most commonly followed sourcing rule in the country and is not the cause of the complexity. The cause is the fact that transactions must be assigned to small geographic areas.

The Department recommends that the local taxes be eliminated and replaced with a State-imposed sales tax or other tax that is distributed back to the counties and cities based on formulas. The formulas could reflect the current distributions or take other factors into consideration, as determined by the

General Assembly and the local governments. Other changes in the State/local financial relationship can be adjusted at the same time. Medicaid costs, for example, are appropriate for the State alone to bear. The excise tax on real estate transfers can be restored to a local tax and the maximum rate increased, as in seven counties now.

The Department recognizes that local governments may not embrace this proposal out of concern over the security of their sources of revenue. The security issue is a practical issue that can be resolved through legislation or, if need be, by a constitutional amendment.

II. Individual Income Tax

Report Recommendation One: The State income tax should tie more closely to the federal tax Code.

Response: The State individual income tax now uses federal taxable income as the starting point and differs from federal law in several respects. The main differences are:

- A higher federal personal exemption than the State personal exemption. The federal personal exemption is indexed for inflation and the State personal exemption is not. For tax year 2002, the federal personal exemption is \$3000 and the State personal exemption is either \$2500 or \$2000, depending on adjusted gross income.
- A higher federal standard deduction than the State standard deduction. The federal standard deduction is indexed for inflation and the State standard deduction is not. For tax year 2002, the federal standard deduction is \$7850 for married filing joint and \$4700 for single. The State standard deduction for 2002 is \$5000 for married filing joint and \$3000 for single.
- Federal tax applies to some extent to social security benefits and State tax does not.
- Federal tax applies to public and private retirement benefits and State tax excludes part or all of these benefits. State law excludes \$2,000 of private retirement benefits, \$4,000 of public North Carolina state or local retirement benefits received by an employee who was not vested in the retirement system as of August 1989, and all of the public North Carolina state or local retirement benefits received by an employee who was vested in the retirement system as of August 1989.
- State law contains numerous tax credits that differ from or have no counterpart in federal law. The federal child credit, for example, applies only to children under the age of 17 and the State credit applies to college-age dependents.

A variety of approaches can be taken to align the State individual income tax more closely to the federal. Either the State personal exemption, the State standard deduction, or both of these could be set at the same amount as the federal. State law could track the federal on the taxation of social security benefits and other retirement benefits as much as possible.

The starting point for computing State tax liability could be changed so that it is aligned more closely to the federal tax base. Under current law, federal taxable income is the starting point for computing the amount of State tax due. This

starting point could be changed to either federal tax liability before federal tax credits or federal adjusted gross income.

Use of federal tax liability before federal tax credits has two primary advantages. First, it enables the tax to be reported on a much simpler return for those taxpayers who are residents and have no adjustments to federal tax liability that are required under the federal or State constitution or under a court decision. Second, it results in a more progressive application of tax due to the progressivity of the federal tax rates.

Use of federal tax liability as the starting point has several significant disadvantages, however. They are:

- The increased reliance on the federal government for the State's individual income tax.
- The constant need to adjust the State rate due to the frequent and significant changes in federal tax.
- The appearance of a high rate. The State rate would need to be at least 30% of federal tax liability.
- A potential State constitutional issue concerning a rate of at least 30%. Article V, Section 2(6) of the N.C. Constitution states that the "rate of tax on incomes shall not in any case exceed ten percent."
- The fact that all the other states that have ever used federal tax liability as a starting point have abandoned this approach.
- The loss of information that can be used for audit unless taxpayers are required to complete a schedule, which would defeat the purpose of the simpler return.

The other option to use as a starting point in computing State tax liability is federal adjusted gross income. The Department recommends the option of starting with federal adjusted gross income. Use of federal adjusted gross income, rather than federal tax liability, as the starting point allows the law to be simpler and avoids the pitfalls associated with a starting point of federal tax liability.

Tax year 2004 is the earliest practical effective date for legislation that changes the starting point in computing State tax liability. These returns would be filed in 2005. Significant computer and form changes are required for the Department to implement this type of change. Taxpayers and tax practitioners need time to become educated about the changes. Changes of a lesser magnitude, such as retaining the current starting point and conforming to federal law on the treatment of retirement benefits, can become effective for the 2003 tax year, assuming the legislation is enacted by September 1, 2003.

The Department has used its income tax model to explore numerous proposals to use federal tax liability as the starting point and achieve the Commission's goals of broadening the base and lowering the rate. The current rate structure

leaves few options to lower the rate that do not result in significant revenue losses even when the base is broadened to include social security and other retirement benefits. Three options and their features are set out below. One option does not increase the total amount of revenue generated from the individual income tax. Two options increase the total amount of revenue generated but decrease the amount of tax paid by most taxpayers. The options show the dollar impact on each group of taxpayers at various taxable income thresholds. It does not show the percentage by which any particular individual's liability would increase or decrease.

All the options share the following features:

- Use of projected revenue for tax year 2004 as the baseline against which the fiscal impact is calculated. The 2004 baseline revenue assumes that the standard deduction for married filing joint is \$6,000 and that the child credit is \$100.
- Use of federal adjusted gross income as the starting point.
- Elimination of the standard deduction and personal exemption add-backs by allowing a personal exemption and standard deduction amount that is not tied to the federal. The personal exemption amount in the options is \$2,500.
- Elimination of the marriage penalty in both the standard deduction amounts and the rates.
- No additions to federal adjusted gross income except interest on bonds and other obligations issued by municipalities in other states.
- No deductions from federal adjusted gross income except for:
 - *Bailey* deductions.
 - Railroad retirement.
 - Interest on U.S. government obligations.
 - Income earned by Indians.
 - Bonus depreciation recovery, as enacted in the 2002 session.
- Ability of all spouses to file a joint return, even if one is a non-resident and has no North Carolina taxable income.
- No credits other than those in Article 3A, 3B, 3D, or 3E or the following credits:
 - Taxes paid to another state.
 - The child credit. The Department recommends that the eligibility requirements for the State credit be aligned with those for the federal credit.
 - The credit for child care expenses.
 - The credit for real property donations for conservation property.
- An increase in the child credit to \$140 below certain adjusted gross income levels (\$20,000 for single and married filing single; \$32,000 for head of household, and \$40,000 for married filing joint).

The three options differ in the following respects. Option 1 creates a 7.5% bracket within the current 7% bracket at the following taxable income levels: \$20,000 for single, \$30,000 for head of household, and \$40,000 for married filing joint. Option 2 creates the same 7.5% bracket as Option 1 and also lowers the current 6% rate to 5.75%. Option 3 lowers the current 6% rate to 5.8% and does not create a 7.5% bracket.

AGI	# of Returns (000's)	TY 2004 Revenue Change (\$millions)		
		Option 1	Option 2	Option 3
< 0	79.6	\$0.0	-\$0.1	-\$0.1
0 < 10,000	560.7	-\$2.3	-\$6.0	-\$5.2
10,000 < 20,000	717.6	-\$0.6	-\$12.9	-\$10.5
20,000 < 30,000	558.4	\$7.4	-\$9.0	-\$6.6
30,000 < 50,000	783.2	\$35.6	\$5.1	-\$4.7
50,000 < 75,000	529.6	\$49.5	\$23.3	\$0.1
75,000 < 100,000	320.0	\$57.9	\$39.9	\$3.0
100,000 < 200,000	337.8	\$80.3	\$61.0	-\$20.4
200,000+	114.7	<u>\$49.6</u>	<u>\$43.7</u>	<u>\$11.7</u>
Subtotal, Model	4,001.6	\$277.4	\$145.0	-\$32.7
Credit Eliminations		34.0	34.0	34.0
Total		\$311.4	\$179.0	\$1.3

Report Recommendation Two: Adopt strategies to help low-income taxpayers.

Response. Several options are available to achieve this goal. The option that best fits the goal depends to a large extent on what is considered a low-income taxpayer. If a low-income taxpayer is an individual who has a State income tax liability, the Department recommends the first three options in the order listed. If a low-income taxpayer is an individual who does not have a State income tax liability, the last option is the only one that would benefit that individual. The Department recommends that the pros and cons of the fourth option be compiled and considered before that option is adopted.

The earliest practical effective date of the options varies. The earliest practical date for the first two options is tax year 2003. The earliest practical date for the third option depends on the extent of the changes made to achieve a closer tie to federal law. The earliest practical date for the fourth option is tax year 2003, assuming legislation is enacted by July 1.

Four options are:

- An increase in the standard deduction.
- A decrease in the rates.

- Closer tie to federal so that taxpayers who are not required to file federal returns are also not required to file State returns. Because of the add-backs now for the personal exemption and the standard deduction, some taxpayers who are not required to file federal returns are required to file State returns.
- Adoption of an earned income tax credit.

III. Corporate Income and Franchise Taxes

Report Recommendation One: Elimination or simplification in the use of credits.

Response. The tax laws contain numerous credits, many of which are complicated to understand and administer. The Department recommends the following actions with respect to the credits. Credits that are slated to expire need no legislation to implement the expiration. The earliest practical effective date for credits recommended for repeal is tax year 2004. This date avoids an issue of detrimental reliance on a credit that was on the books when activity occurred in a taxable year but was repealed later in that tax year.

- Allow the Article 3A credits to expire. If it is determined that incentive credits are needed, replace these credits with much simpler credits such as credits for any business that creates a job that pays above a set amount. The Article 3A credits are set to expire for business activities that occur on or after January 1, 2006.
- Allow the credit for use of the State ports to expire and consider others way to increase use of the ports. This credit is set to expire effective with the 2004 tax year.
- Allow the credit for manufacturing cigarettes for export to expire. This credit is set to expire effective with the 2005 tax year.
- Allow the credit for construction of a renewable energy equipment facility to expire. This credit is set to expire effective with the 2006 tax year.
- Repeal the following credits:
 - Constructing dwelling units for the handicapped (G.S. 105-130.22.) This credit was enacted in 1973. Its effectiveness in achieving the goal of increasing the number of handicapped dwelling units in the State has not been evaluated.
 - Constructing a cogenerating power plant (G.S. 105-130.25).
 - Conservation tillage equipment (G.S. 105-130.36).
 - Gleaned crop (G.S. 105-130.37).
 - Savings and loan supervisory fees (G.S. 105-130.43).
 - Constructing a poultry composting facility (G.S. 105-130.44).

Report Recommendation Two: Simplify taxation by moving to combined reporting by related entities, as required at the federal level.

Response: Combined reporting by related entities can take many forms. Possible options are:

- Starting with the federal consolidated return, with or without adding corporations domiciled in tax-haven countries.
- Worldwide combination.
- Water's edge combination, with or without tax-haven countries.
- Unitary business.
- Nexus -- each corporation has to be doing business in N.C.

There are questions to determine within each option, such as will the combination be elective or required and will the combination occur before or after apportionment. Some options can be combined, such as requiring all related corporations with nexus in North Carolina to combine while allowing other related corporations that share a unitary business with one or more of the combined members to also be part of the combined return. Each option has advantages and disadvantages and will have different fiscal results.

The Department recommends focusing further study on requiring a corporate family to file a combined return if it files a federal consolidated return and limiting the participants in the combined return to those entities that make up the federal consolidated return. This is the simplest approach because the income before apportionment would come directly from the federal return. The Department further recommends that the corporate family for a federal consolidated return be supplemented by related members domiciled in a tax-haven country.

The Department cannot determine the fiscal impact of this proposal until it receives more data on the extent of a corporate family and the apportionment of income among the states by the family members. The Department recommends that a corporation that files in North Carolina and is a member of a federal consolidated return be required to provide the information listed below with its 2003 tax return. The Department can then use this information to determine the impact. If North Carolina changes from a single-entity to a combined reporting state, tax year 2006 is the earliest practical effective date.

The information needed to determine the fiscal impact of requiring combined returns for corporations that are members of a federal consolidated return is as follows:

- A list of all other corporations that are part of the federal consolidated return.
- Each corporation's FEIN.
- Whether the corporations that are part of the federal consolidated return also file North Carolina returns.

- The federal taxable income before net operating loss reported on the consolidated return.
- The federal taxable income before net operating loss for each member of the consolidated return based on the separate entity pro-forma.
- Each corporation's North Carolina and everywhere property, payroll, and sales.

If related corporations that are domiciled in tax-haven countries are included, as recommended, the following additional information is needed to determine the fiscal impact:

- A list of corporations that are related to the corporation, are not part of the consolidated return, and are domiciled in a tax-haven country.
- Those corporations' FEIN, if they have one.
- Those corporations' federal taxable income before net operating loss, if they have filed federal income tax returns, or, if they have not filed federal returns, information on their gross receipts and allowable deductions so the Department can determine what their federal taxable income would have been if they had filed federal returns.
- Each corporation's North Carolina and everywhere property, payroll, and sales.

Report Recommendation Three: Modernize the franchise tax.

Response. The franchise tax is one of the oldest types of taxes. It functions as an alternative corporate income tax in many instances. It applies only to corporations. It does not apply to the more modern forms of business structures, such as limited liability companies. The effect is that the scope of a tax that was enacted to apply to businesses in general has narrowed significantly.

The following changes can be made to achieve the Commission's goal. The earliest practical effective date for the first two proposed changes is payments made in 2005. The earliest date for the other changes is payments made in 2004:

- Expand the tax to include all business enterprises that have assets of at least \$500,000 (or some other threshold so that the tax does not apply to the small businesses).
- Reduce the LLC annual report fee to \$20 and have LLCs file their annual report with the franchise return.
- Eliminate the deduction for debt equity.
- Allow depreciation based on book depreciation rather than accelerated tax depreciation.
- Modify the affiliated debt deduction.

Report Recommendation Four: Consider the effect of establishing a throwout provision.

Response. The Department supports consideration of this type of provision. The purpose of the provision is to ensure that the income of a corporation is allocated among the states in which the corporation has a business nexus. The earliest practical effective date of adopting a throwout provision is tax year 2003, assuming legislation is enacted by August.

Report Recommendation Five: Conform more closely to the federal definition of corporate income.

Response. Repealing the following provisions will conform North Carolina law more closely to the federal on the topics listed. The Department recommends repealing all these provisions except those concerning net economic losses. State law requires nontaxable income to be considered in determining whether a company has a loss and federal law does not. The Department finds that inclusion of all income better reflects whether a loss has occurred. The earliest practical effective date for repealing any of these provisions is tax year 2003.

- Treatment of dividends. Repeal G.S. 105-130.5(b)(3) and 105-130.7.
- Charitable contribution deductions. Repeal G.S. 105-130.5(b)(5), G.S. 105-130.9, and G.S. 105-130.5(a)(3).
- Depreciation of recycling or resource recovery facilities and equipment. Repeal G.S. 105-130.5(b)(6) and 105-130.10.
- Deductions for expenses for reforestation and cultivation of commercially grown trees. Repeal G.S. 105-130.5(b)(12).
- International banking facility income. Repeal G.S. 105-130.5(b)(13).
- Marketing assessments. Repeal G.S. 105-130.5(b)(15).
- Amortization of bond premiums. Repeal G.S. 105-130.5(c)(1).
- Interest expense deduction. Repeal the proviso in G.S. 105-130.5(c)(3).
- Interest earned by savings and loan associations. Repeal G.S. 105-130.5(c)(5).
- Net operating losses. Repeal G.S. 105-130.8, G.S. 105-130.5(b)(4), and G.S. 105-130.5(a)(6).
- Amortization of OSHA mandated equipment. Repeal G.S. 105-130.10A.
- Organizations exempt from tax. Rewrite G.S. 105-130.11 so that an organization is not exempt from State tax unless it is exempt from federal tax.
- RICs and REITs. Repeal G.S. 105-130.12 as a technical change.

Report Recommendation Six: Consider the effects of a move back to the equal weighting of payroll, property and sales in determining the share of income taxed by North Carolina.

Response. The Department recommends reverting to traditional equal-weighted formula set out in the Uniform Division of Income for Tax Purposes Act (UDITPA). The earliest practical effective date of changing the apportionment formula is tax year 2003, assuming the legislation is enacted by August.

IV. Other Nontax Finance Issues

Report Recommendations One through Three: These recommendations are unrelated to taxes administered by the Department of Revenue and are not addressed here.

Report Recommendation Four: *Tax Procedure Reforms as follows:*

- a. *Clarify the Secretary of Revenue's authority to address inappropriate tax planning strategies by taxpayers.*

Response. Two statutes currently give the Department of Revenue some ability to address tax planning strategies. G.S. 105-130.6 gives the Secretary the authority to require a corporation and its parent or affiliates to file a consolidated return if the return of the corporation does not reflect the true earnings of the corporation in this State. G.S. 105-130.16 gives the Secretary the authority to determine the net income of a corporation when the corporation conducts its business so as to distort its true net income. The Department does not have much experience in the application of this authority and supports efforts to improve the Department's authority.

- b. *Review tax hearing and appeals processes.*

Response. The Department concurs in this goal. This is a complex issue that will require considerable study. The Department plans to review the process internally with the goal of making a recommendation and welcomes input from taxpayers and tax practitioners on this topic.

cc: Karl Knapp, Tax Research Division Director
Andy Sabol, Sales and Use Tax Division Director
Nancy Pomeranz, Personal Taxes Division Director
Greg Radford, Corporate Taxes Division Director
Johnny Bailey, Property Tax Division Director