2009-2010

JOINT FINANCE – INTERIM

MINUTES

Finance

House Standing Committee

Details

- Meets Tuesdays, Wednesdays, Thursdays at 8:30 am in 544 LOB
- Meeting notices via email
- Web Site: http://www.ncleg.net/documentsites/committees/jhsfctr/Homepage/index.html

Members

Senior Chairman	Rep. Luebke
Chairman	Rep. Gibson
Chairman	Rep. Wainwright
Chairman	Rep. Weiss
Vice Chairman	Rep. Hill
Vice Chairman	Rep. Holliman
Vice Chairman	Rep. Howard
Vice Chairman	Rep. McComas
Vice Chairman	Rep. Womble
Members	Rep. K. Alexander, Rep. Blackwood, Rep. Blust, Rep. Braxton, Rep. Carney, Rep. Cotham, Rep. Faison, Rep. Folwell, Rep. Hall, Rep. Hughes, Rep. Jones, Rep. Lewis, Rep. McCormick, Rep. McGee, Rep. Owens, Rep. Rhyne, Rep. Ross, Rep. Setzer, Rep. Stam, Rep. Starnes, Rep. Tillis

Finance

Senate Standing Committee

Details

- Meets Tuesdays, Wednesdays at 1:00 PM in 544 LOB LB
- Meeting notices via email
- Web Site: http://www.ncleg.net/documentsites/committees/jhsfctr/Homepage/index.html

Members

Co-Chairman	Sen. David W. Hoyle
Co-Chairman	Sen. Daniel G. Clodfelter
Co-Chairman	Sen. Clark Jenkins
Vice Chairman	Sen. Larry Shaw
Vice Chairman	Sen. Fletcher L. Hartsell, Jr.
Members	Sen. Charles W. Albertson, Sen. Austin M. Allran, Sen. Tom Apodaca, Sen. Bob Atwater, Sen. Philip E. Berger, Sen. Dan Blue, Sen. Charlie S. Dannelly, Sen. Tony Foriest, Sen. Eleanor Kinnaird, Sen. Floyd B. McKissick, Jr., Sen. Joe Sam Queen, Sen. David Rouzer, Sen. R. C. Soles, Jr., Sen. Harris Blake, Sen. Julia Boseman, Sen. Andrew C. Brock, Sen. Harry Brown, Sen. Don East, Sen. Linda Garrou, Sen. W. Edward (Eddie) Goodall, Sen. Steve Goss, Sen. Neal Hunt, Sen. Martin L. Nesbitt, Jr., Sen. Jean Preston, Sen. William R. Purcell, Sen. Tony Rand, Sen. Bob Rucho, Sen. Josh Stein, Sen. Richard Stevens, Sen. A. B Swindell, Sen. Jerry W. Tillman

Interim Joint House and Senate Finance Committee
Tuesday, November 3, 2009
Room 643, Legislative Office Building
10:00 a.m.

MINUTES

The Interim Joint House and Senate Finance Committee met at 10:00 a.m. on Tuesday, November 3, 2009, in room 643 of the Legislative Office Building. Sixty-one members of the committee were present. Representative Luebke presided as chair.

Opening Remarks by Finance Chairs

Representative Luebke and Senator Hoyle welcomed members and outlined the charge to the Committee (study of the North Carolina's tax structure).

Overview of Sales Taxation

Bill Fox, Professor, Department of Economics, Director, Center for Business & Economic Research, University of Tennessee, was recognized. He outlined the importance of sales tax, defining the tax base, problems with taxing businesses and where sales taxes are headed. He stated that there is pressure for rate increases, that the base needs updating to tax business purchases, services and interstate transactions. A copy of his presentation and his vita is attached.

At 11:40 a.m., the Committee recessed for lunch to reconvene at 1:00 p.m.

Overview of North Carolina Sales Tax

Cindy Avrette, a staff attorney with the Research Division, was recognized. She gave a historical overview and background of the State's sales tax. Trina Griffin, a staff attorney with the Research Division, was recognized to explain rates other than the State general rates, such as the preferential rate and the combined general rate. Sabra Faires, the Senate Tax Counsel, was recognized to explain the goals of the Streamlined Sales Tax Project. A copy of their presentation is attached.

North Carolina Sales Tax Exemptions

Sandra Johnson, a fiscal analyst with the Fiscal Research Division, was recognized. She explained medical and food related exemptions. Martha Walston, a staff attorney with the Fiscal Research Division, was recognized to outline agricultural, industrial, and business related exemptions. Canaan Huie, the House Tax Counsel, was recognized. He discussed incentive related exemptions. Dan Ettefagh, a staff attorney with the Bill Drafting Division, was recognized to outline and explain the reasons behind the remaining sales tax exemptions such as, entity and transaction-based exemptions, media exemptions and streamlined-based exemptions. A copy of their presentations is attached.

North Carolina Sales Tax Refunds

Due to limited time, this item was moved to the November 17, 2009 agenda.

The Department of Revenue's 2007 Biennial Tax Expenditure Report was distributed to each Committee member. A copy is attached.

The meeting adjourned at 3:11 p.m.

Representative Paul Luebke, Presiding Chair

DeAnne Mangum, Committee Clerk

VISITOR REGISTRATION SHEET

Interim Joint House and Senate Finance Committee — Nov. 3, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
[signature]	Hunton & Williams
Jon Carr	Jordan Price Law Firm
[signature]	Bass & Assoc.
Joe McClees	McClees Consulting
Dick Colton	Law Offices of Richard Colton
Andy Hall	Elon Law School
Melanie Soles	DCR
Karen Wells	Arts North Carolina

VISITOR REGISTRATION SHEET

Interim Joint House and Senate Finance Committee — Nov. 3, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
CHUCK MCGRADY	FALLING CREEK CAMP 195 FERNBROOK WAY HENDERSONVILLE, NC 28791
TOM CORS	THE NATURE CONSERVANCY
Reid Wilson	Conservation Trust for North Carolina
Lori Andrews	[illegible]
Cam Cowie	BPMHC
Catherine DUPRE	Carolinas Healthcare System
Martha McConnell	Carolinas HealthCare
DANIEL BAUM	K+L GATES
Wendy Ickley	Nelson Mullins
Mike Krzyzewski	DU
Kim Crouch	NCBA

VISITOR REGISTRATION SHEET

Interim Joint House and Senate Finance Committee — Nov. 3, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Amy McConkey	Smith Anderson
Paul Matthews	Progress Energy
Sammy Roberson	TWC
Marcus Tatum	Brooks, Pierce
Jamie Fennick	TWC
Brad Phillips	TWC
Rose Williams	NCDOI
Sarah Smith	WCSR
Tommy Doyle	NCPAPA
Doug Heron	Williams Mullen
David Barnes	Poyner Spruill

VISITOR REGISTRATION SHEET

Interim Joint House and Senate Finance Committee — Nov. 3, 2009
Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
CHARLES COLLINS	ADP
Beth Cooley	Council On State Taxation (COST)
[signature]	Pricewaterhouse Coopers LLP
Ran Coble	N.C Center for Public Policy Research
Mitch Leonard	SEANC
Susan Beaupied	LA for Rep Rhyne
Kelli Kukuna	NC League of Municipalities
Jay Stem	NCAA
Sam Taylor	NCBIO
[signature]	JD, AL, PA
L. Andrews	NCFB
P. Page	NCFB

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Interim Joint House and Senate Finance Committee — Nov. 3, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Laura Blair	NC State Ports Authority
Marge Freeman	NCAE
Ann McMillin	Moore & Van Allen, Charlotte
Damien Graham	Triangle Transit
DREW MALETZ	GREATER RALEIGH CHAMBER OF COMMERCE
Jake Cashion	Greater Winston-Salem Chamber of Commerce
Allison Waller	Charlotte Chamber
Brian Francis	Mecklenburg County Mayor Office
Pam Melton	CountyLink

VISITOR REGISTRATION SHEET

Interim Joint House and Senate Finance Committee — Nov. 3, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
W. Gardner Culpepper	Chowan County
K. Massey	self
Johanna Reese	DOT
John White	Durham Chamber
Mike Pate	NCACPA
Edgar Miller	Conservation Trust for NC
Steve Brewer	CenturyLink
Herb Crenshaw	AT&T
Bill Haigh	alltel

VISITOR REGISTRATION SHEET

Interim Joint House and Senate Finance Committee — Nov. 3, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
[illegible]	NMRS
Andy Ellen	NCLMA
[illegible]	
Ed [illegible]	BP
Dennis Patterson	OSA
Harrison Gilbert	Governor's Office
Nathan Kauffman	OSBM
Rebecca Tuck	NCACC
David Johnson	NCACC
DAVID THOMPSON	NCACC
Tommy Clark	NCWRC

VISITOR REGISTRATION SHEET

Interim Joint House and Senate Finance Committee — Nov. 3, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Molly Diggins	Siena Ale
Tenisha Jacobs	NCDOJ
Ed Strickland	NC DOR
Michael Haven	NC DOR
Bo Heath	MWC
Henry Lapp	"
Michelle Frazier	MFS
Don McCorquodale	SAS
Chris Fitzsimon	NC Policy Watch
Mark Rose	BB&T

VISITOR REGISTRATION SHEET

Interim Joint House and Senate Finance Committee — Nov. 3, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
[signature]	NC Vote
Amy Hobbs	McGuireWoods
Julia Leggett	The Arc of NC
Leslie B Conan	Capstrat
[signature]	NC Justice Ctr.
Meg Gray	NC Justice Ctr
[signature]	Covenant w/ NC's Children
Cecil Banks	NCAE
Elizabeth Taylor	Kochanek Law Group
Keli Coleman	Eisai, Inc.
Beatrice Williams	@UCA

VISITOR REGISTRATION SHEET

Interim Joint House and Senate Finance Committee — Nov. 3, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Hugh Tilson	NCHA
Ann Lake	DVLE
[illegible]	CAA
[illegible]	NCLM
[illegible]	NCPSS
Lawless Bean	City of Wilmington
Elizabeth Robinson	NCRMA
Kathy Hawkins	Progress Energy

VISITOR REGISTRATION SHEET

Interim Joint House and Senate Finance Committee — Nov. 3, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
JOHN GOODMAN	NC CHAMBER
John McAlister	NC Chamber
Richard Thompson	Dominion
Luis Willamizar	NCANAHA
SCOTT GRAHAM	DUKE ENERGY
Tom Mann	Multi Chanks
Thomas Moore	Ed Winston & Walsh
Rick Zechini	NC Assoc. of Realtors
Rita HARRIS	NC commerce Dept
Butch Gunnells	NC Beverage Assoc
Doug Lassiter	NCSTA

VISITOR REGISTRATION SHEET

Interim Joint House and Senate Finance Committee — Nov. 3, 2009
Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Jessi Hayes	NC Home Builders
Lisa Martin	NC Home Builders
Bill Rowe	NC Justice Center
Tony Solari	DST
R. Rogers	NCCCMTF
Katherine Joyce	NCASA
Leanne Winner	NCSBA
Lucius Fuller	Attorney NCMA & NCCA
Charlie Diehl	NC Trucking Association
John Palumbo	NCADA
Doug Miskew	Capstrat

AGENDA

Joint Meeting of the Senate and House Finance Committees

November 3, 2009
10:00 a.m. – 4:00 p.m.

Meeting called by Senate Finance Cochairs: Senators Clodfelter, Hoyle, and Jenkins
and House Finance Cochairs: Representatives Luebke, Gibson, Wainwright, and Weiss

10:00 a.m. – 10:15 a.m.	**Opening Remarks by Finance Chairs**
10:15 a.m. – Noon	**Overview of Sales Taxation** *Bill Fox, Professor, Department of Economics; Director, Center for Business & Economic Research, University of Tennessee*
Noon – 1:30 p.m.	**Lunch**
1:30 p.m. – 2:30 p.m.	**Overview of North Carolina Sales Tax** Historical overview, *Cindy Avrette, Research Division, NCGA* Rates other than the State general rate, *Trina Griffin, Research Division, NCGA* Streamlined Sales Tax Project, *Sabra Faires, Senate Tax Counsel, NCGA*
2:30 p.m. – 3:30 p.m.	**North Carolina Sales Tax Exemptions** Medical and food related exemptions, *Sandra Johnson, Fiscal Research Division, NCGA* Agricultural, industrial, and business related exemptions, *Martha Walston, Fiscal Research Division, NCGA* Incentive related exemptions, *Canaan Huie, House Tax Counsel, NCGA* Remaining exemptions, *Dan Ettefagh, Bill Drafting Division, NCGA*
3:30 p.m. – 4:00 p.m.	**North Carolina Sales Tax Refunds** Nonprofit refunds, *Rodney Bizzell, Fiscal Research Division, NCGA* Incentive related refunds, *Canaan Huie, House Tax Counsel, NCGA*

Next Meeting Date: November 17, 2009



Vita (MS Word format)

William F. Fox

Professor, Department of Economics
Director, Center for Business & Economic Research
The University of Tennessee
715 Stokely Management Center
Knoxville, Tennessee 37996-0570
phone: (865) 974-6112
fax: (865) 974-3100
BillFox@utk.edu

- Ph.D., Economics, Ohio State University
- M.A., Economics, Ohio State University
- B.S., Business, Miami University, Oxford, Ohio

RESEARCH AND ADMINISTRATIVE WORK

Dr. Fox has held appointments as a visiting scholar for the Federal Reserve Bank of Kansas City, as a visiting professor at the University of Hawaii, and as Distinguished Fulbright Chair for American Studies at the University of Frankfurt, Germany.

In addition, Dr. Fox has served as a consultant on finance, taxation, and economic development in a number of states and developing countries.

Dr. Fox is a member of the American Economics Association and a past president of the National Tax Association.

SELECTED PUBLICATIONS

"Tax Policy Changes Continued Even as the Economy Grew," *The Book of the States*, Council of State Governments, 2008.

"The Federal Role in State Taxation: A Normative Approach," (with John Swain), *National Tax Journal*, September 2007.

"On The Extent, Growth, and Consequences of State Business Tax Planning," (with Donald Bruce and John Deskins) in *Corporate Income Taxation in the 21st Century*, edited by Alan Auerbach, James Hines and Joel Slemrod, Cambridge University Press, 2007.

"The United States of America," in *The Practice of Fiscal Federalism, Comparative Perspectives* edited by Anwar Shah, Montreal & Kingston: McGill-Queen's University Press, 2007, pp 344-369.

"How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?" (with

LeAnn Luna and Matthew Murray) *National Tax Journal*, March 2005.

"Has Internet Access Taxation Affected Internet Use? A Panel Data Analysis," (with Donald Bruce and John Deskins) *Public Finance Review*, March 2004. Reprinted in *State Tax Notes*, May 17, 2004.

"Total State and Local Business Taxes: Fiscal 2003 Update," (with Robert Cline, Tom Neubig, and Andrew Phillips) *State Tax Notes*, October 20, 2003.

"Do Economic Effects Justify the Use of Tax Incentives?" (with Matthew N. Murray) *Southern Economic Journal*, July 2004.

"Fiscal Federalism in Bosnia-Herzegovina: Subsidiarity and Solidarity in a Three-Nation State" (with Christine Wallich) *Public Budgeting and Management*, Fall 2003. Also published in Subsidiarity and Solidarity: Asymmetrical Fiscal Decentralization, edited by Robert Ebel and Richard Bird, Edward Elgar Publishing Ltd., forthcoming.

"Destination-Based Indirect Taxation: The Case of Bosnia and Herzegovina," *European Journal of Law and Economics*, Vol. 16, 2003.

"Prospects and Challenges for State and Local Government in a Digital World," (with Kelly Edmiston) in *State and Local Government Finances at the Beginning of the 21st Century* edited by David Sjoquist, Edward Elgar, 2003.

"History and Economic Impact of the Sales Tax," in *Sales Taxation*, edited by Jerry Janata, Institute for Professionals in Taxation, September 2003.

"To Tax or Not to Tax: The Case of Electronic Commerce," (with Donald Bruce and Matthew Murray), *Contemporary Economic Policy*, October 2002.

"State Corporate Tax Revenue Trends: Causes and Possible Solutions" (with LeAnn Luna), *National Tax Journal*, September 2002.

"Investing in Rural Infrastructure" (with Sanela Porca), in *Beyond Agriculture: New Policies for Rural America*, edited by Mark Drabenstott, Federal Reserve Bank of Kansas City: 2000. Also published in *International Regional Science Review*, January 2001.

"Should E-Commerce Transactions be Exempt from the Sales Tax?" (with LeAnn Luna) *Quarterly Journal of Electronic Commerce*, Vol. 1, Number 2, 2000.

"E-Commerce in the Context of Declining State Sales Tax Bases," (with Donald Bruce), *National Tax Journal*, December 2000.

"Sub-National VAT or Retail Sales Tax: What is Tax Policy's Panacea?" (with LeAnn Luna) Proceedings of the Ninety-First Annual Conference of the National Tax Association, 2000.

"Can the Sales Tax Survive a Future Like its Past?" in *The Future of State Tax Policy Tax*, edited by David Brunori, Urban Institute Press, 1998.

"Fiscal Federalism in Bosnia and Herzegovina: The Dayton Challenge" (with Christine Wallich), in *Fiscal Federalism in Developing Countries*, edited by Richard Bird and Francois Vaillencourt, Cambridge University Press, 1998.

'Fiscal Incentives and Local Economic and Fiscal Performance" (with Matthew Murray), in *Local Government Tax and Land Use Policy in the United States*, edited by Helen Ladd, Edward Elgar press, Northampton, MA, 1998.

'Intergovernmental Aspects of Growth and Stabilization Policy" (with Matthew Murray), in *Intergovernmental Fiscal Relations: Perspectives and Prospects*, edited by Ron Fisher, Kluwer Press, 1997.

'The Sales Tax and Electronic Commerce: So What's New?" (with Matthew Murray), *National Tax Journal*, September 1997.

March 05, 2009

INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES
State Legislative Building
Raleigh, North Carolina 27603

House Finance Committee *Senate Finance Committee*

October 20, 2009

Dr. William F. Fox, Director
Center for Business & Economic Research
The University of Tennessee
804 Volunteer Blvd.
Temple Court, Room 101
Knoxville, TN 37996-4334

RE: Presentation to the Interim Joint House and Senate Finance Committees

Dear Dr. Fox:

This letter confirms your invitation to appear before the interim Joint House and Senate Finance Committee (Committee) at its meeting on Tuesday, November 3, 2009. The meeting is scheduled to begin at 10:00 a.m. and will be held in Room 643 of the Legislative Office Building in Raleigh, North Carolina.

Your role at the meeting is to provide an overview of the state of sales taxation and answer any questions from members of the Committee.

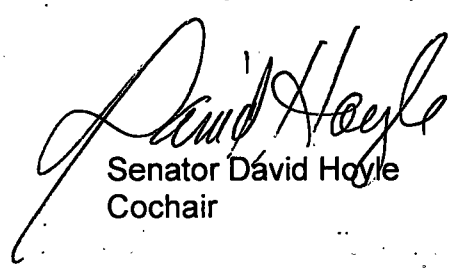
The Committee will reimburse your travel expenses for surface transportation to your airport of departure and from that airport to your home or office upon your return; round trip coach class airfare to Raleigh, North Carolina; surface transportation from Raleigh-Durham International Airport to your hotel and return; and one round trip between your hotel and the Legislative Office Building in downtown Raleigh. The Committee will reimburse you for up to two nights of overnight lodging if required and for meals at the rate allowed for employees of the State of North Carolina while in out-of-state status. We will need documentation in the form of original receipts for airfare, lodging expenses, and surface transportation, so please save your receipts. Receipts are not required for meals because the reimbursement amount is fixed. DeAnne Mangum, Committee Clerk, will assist you with your reimbursement.

Please bring at least **100** copies of any written materials that you wish to distribute to the Committee. As an alternative, we will be happy to make copies here if you will provide us with an electronic copy of the written materials by noon on Monday, November 2. A PowerPoint projector, laptop computer and screen will be available in

the meeting room. PowerPoint presentations are not expected, but are welcome. Your presentation can be preloaded if you send it electronically or you may bring your presentation on a jump drive or on a CD. Please contact DeAnne Mangum (**DeAnne.Mangum@ncleg.net**) by Monday, November 2 if you plan on using PowerPoint during your discussion.

We appreciate your willingness to attend this meeting and look forward to your presentation to the Committee. Please let us know if we may be of any assistance in connection with your appearance before the Committee.

Sincerely,



Senator David Hoyle
Cochair

cc: The Honorable Paul Luebke, Cochair
The Honorable Pryor Gibson, Cochair
The Honorable William Wainwright, Cochair
The Honorable Jennifer Weiss, Cochair
The Honorable Dan Clodfelter, Cochair
The Honorable Clark Jenkins, Cochair
Cindy Avrette, Committee Counsel
Sabra Faires, Senate Tax Counsel
Canaan Huie, House Tax Counsel
Rodney Bass, General Accounting Supervisor

US States and the Sales Taxes

Presented to
Joint House and Senate Finance Committees
North Carolina Legislature

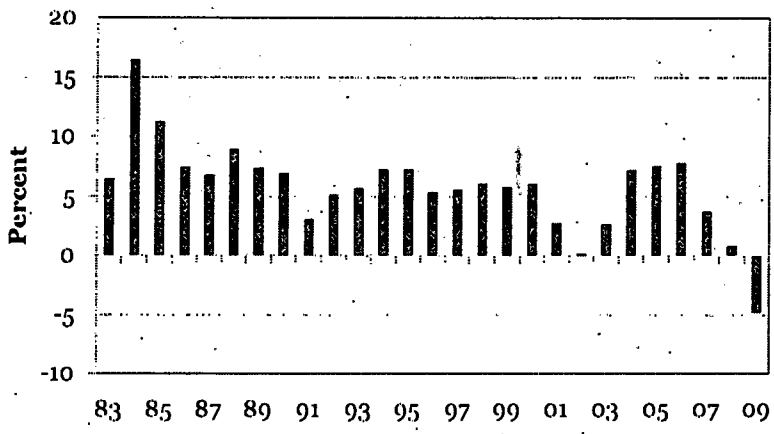
William F. Fox, Director
Center for Business and Economic Research
The University of Tennessee, Knoxville
November 2, 2009

Topics

- I. Importance of General Sales Tax
- II. Why Tax Sales?
- III. Defining the Sales Tax Base
- IV. Problems of Taxing Business
- V. Where is the Sales Tax Headed?

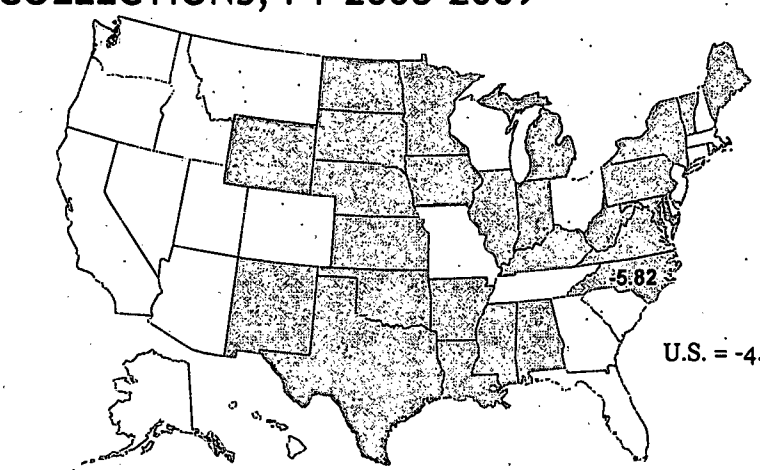
11/2/2009

GROWTH IN U.S. STATE GENERAL SALES TAX COLLECTIONS



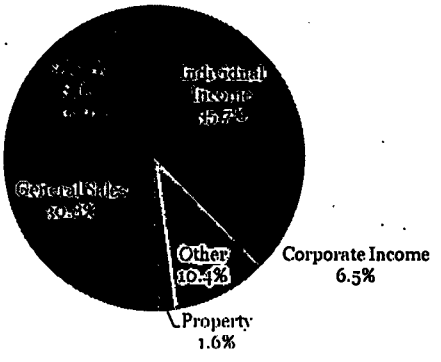
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PERCENT GROWTH IN STATE SALES TAX COLLECTIONS, FY 2008-2009

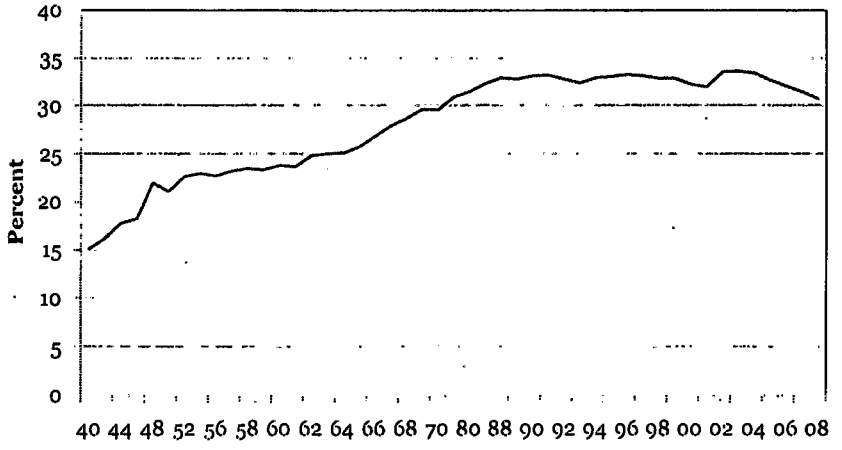


Less than -6.0% --18--
-6.0% to 0.0% --17--
Greater than 0.0% --10--
Not Levied --5--

PERCENTAGE DISTRIBUTION OF U.S. TAX COLLECTIONS, 2008

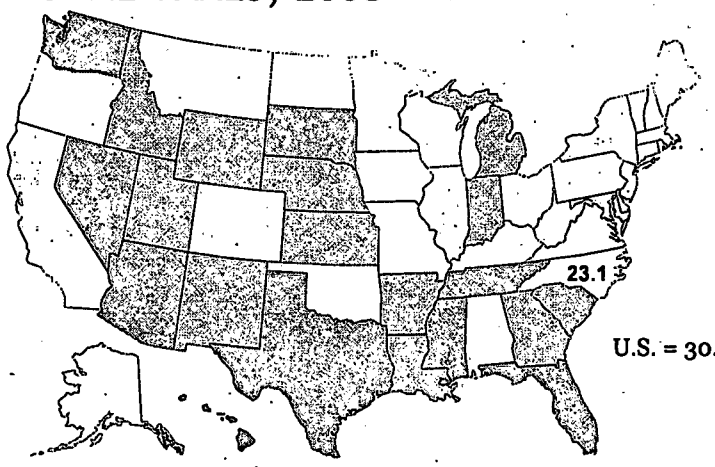


GENERAL SALES TAX AS A PERCENT OF TOTAL TAXES, Selected Years



11/2/2009

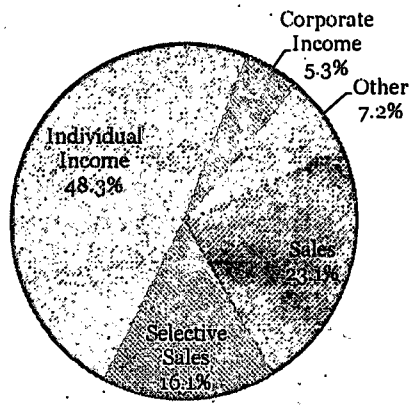
STATE GENERAL SALES TAXES AS A PERCENT OF TOTAL TAXES, 2008



Less than 30.8% --24--
30.8% to 40.0% --12--
Greater than 40% --9--
Not Levied --5--

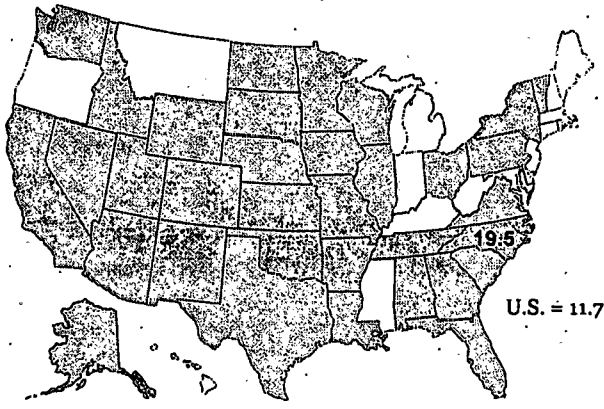
11/2/2009

Percentage Distribution of North Carolina Tax Collections, 2008



11/2/2009

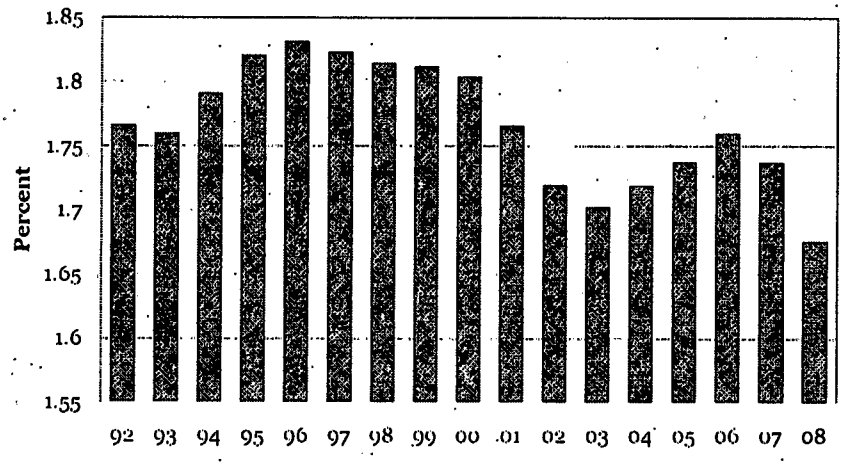
LOCAL GENERAL SALES TAXES AS A PERCENT OF TOTAL LOCAL TAXES, 2007



Not Applicable --16--
0.0% to 11.7% --14--
Greater than 11.7% --20--

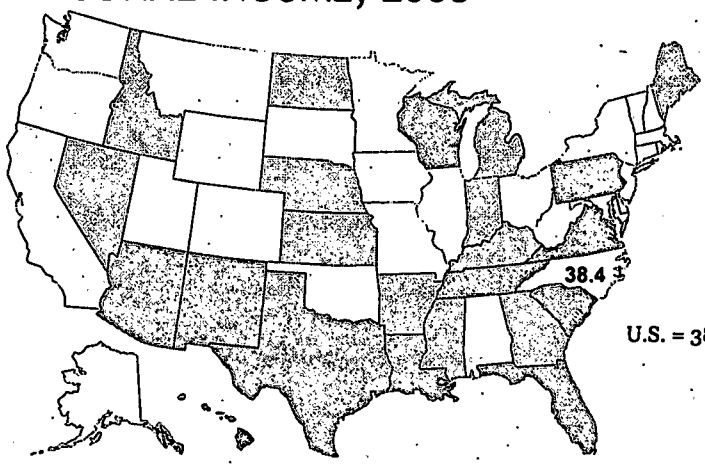
11/2/2009

STATE GENERAL SALES TAX COLLECTIONS AS A PERCENT OF GDP



11/2/2009

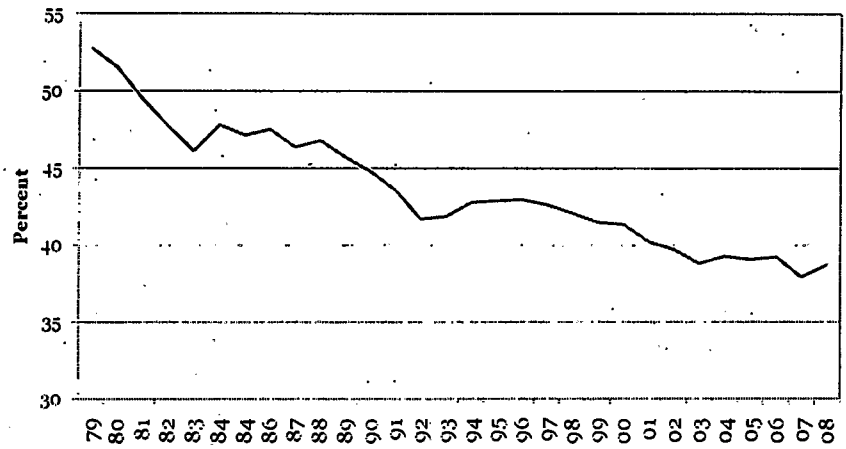
STATE SALES TAX BASE AS A PERCENT OF PERSONAL INCOME, 2008



Less than 39% --22--
39% to 51% --12--
Greater than 51% --11--
No sales tax --5--

11/2/2009

U.S. SALES TAX BASE AS A PERCENT OF PERSONAL INCOME, 1979-2008



CAUSES OF CHANGE IN THE SALES TAX

- Legislated Exemptions
  - Fairness - Food, Clothing
  - Economic Development - Holidays, Location
- Changes in Consumption Patterns

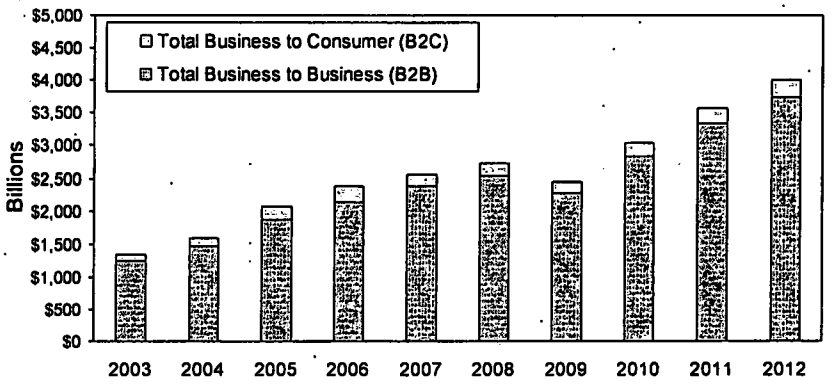
PERSONAL CONSUMPTION EXPENDITURES 1979 and 2007

	1979 Percent	2007 Percent
Total Expenditure	100.0	100.0
Durable Goods	13.4	11.2
Autos	5.9	4.5
Furn & Household	5.2	4.3
Other Durables	2.4	2.3
Nondurable Goods	39.1	29.2
Food and Beverage	20.3	13.7
Other Nondurables	18.8	15.2
Services	47.4	59.7

CAUSES OF CHANGE IN THE SALES TAX

- Legislated Exemptions
  - Fairness - Food, Clothing
  - Economic Development - Holidays, Location
- Changes in Consumption Patterns
- Cross Border Shopping
  - Mail Order
  - Driving Next Door
  - E-Commerce

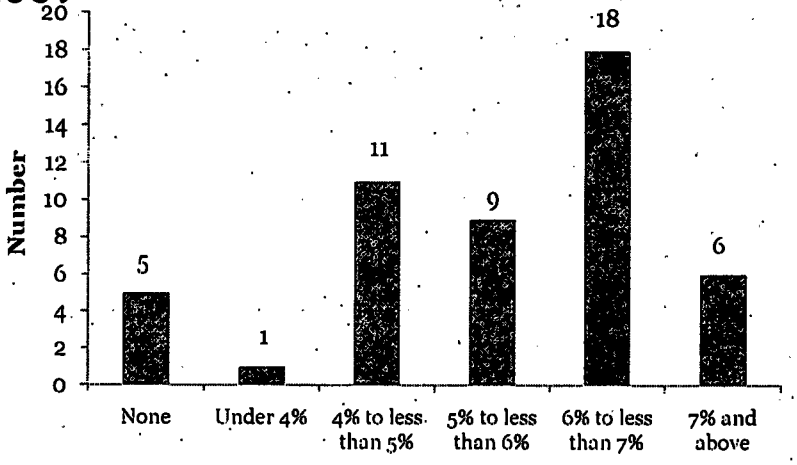
ESTIMATED TOTAL E-COMMERCE SALES



*Sales-taxing states only.

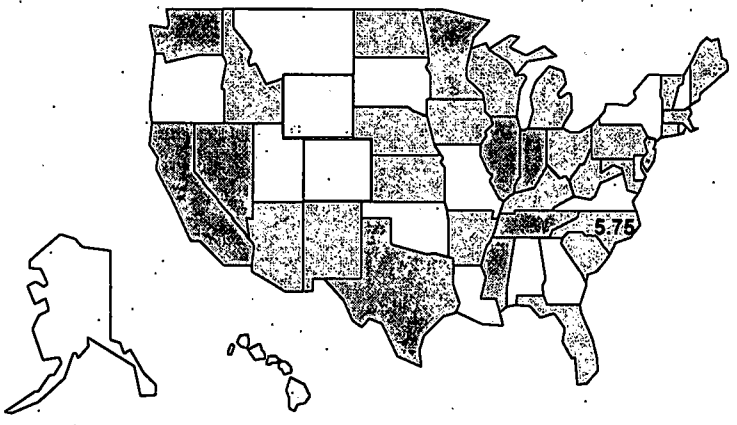
11/2/2009

STATE GENERAL SALES TAX RATES, 2009



11/2/2009

STATE SALES TAX RATES, 2009



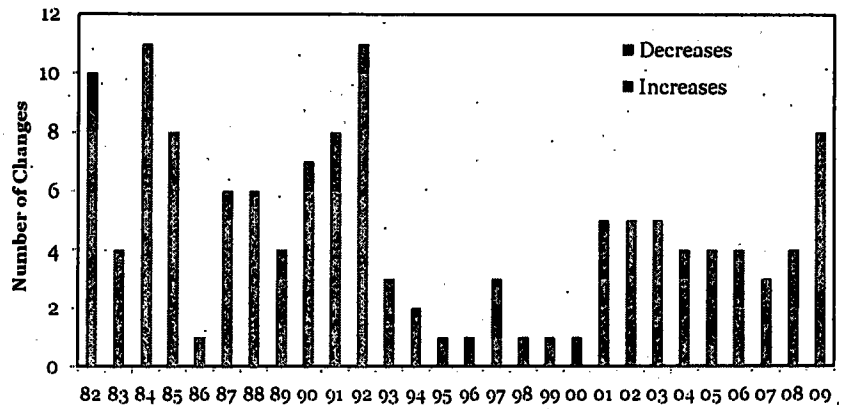
Less than 5% --12--

5% to 6% --21--

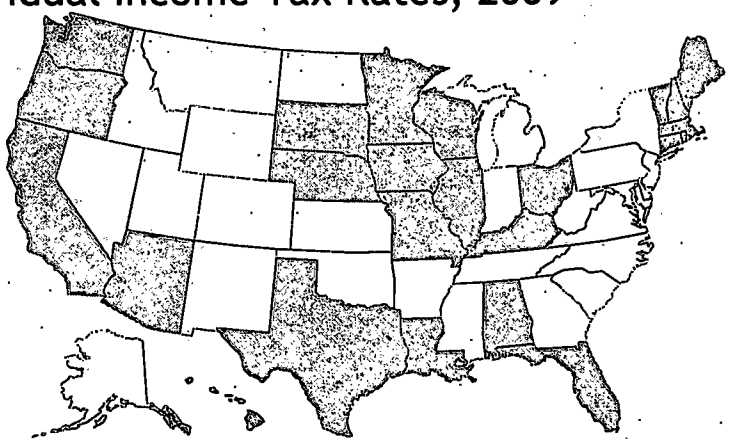
Greater than 6% --12--

None --5--

NUMBER OF SALES TAX RATE CHANGES



States with Significant Changes in Individual Income Tax Rates, 2009



States with No Significant Change (26)

States with Significant Changes (24 + Washington, D.C.)

WHY TAX SALES?

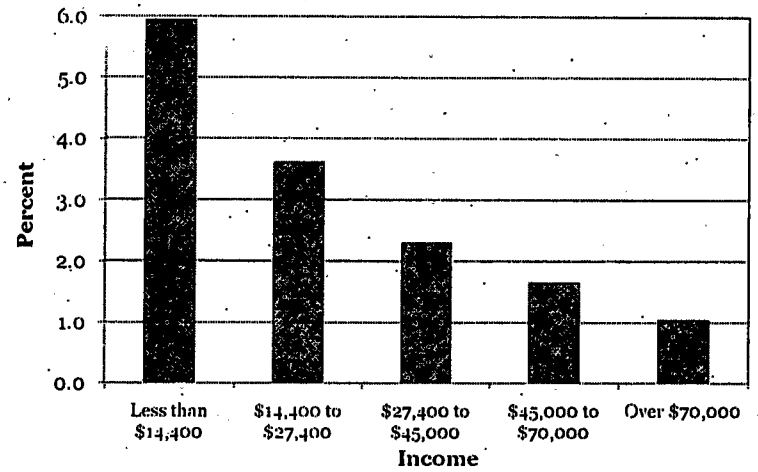
- Conceptual Basis Lies in Taxing Consumption
- Is the Sales Tax a Consumption Tax?
- Alternative Ways to Tax Consumption
  - Value added
  - Consumable income

DEFINING THE SALES TAX BASE

- Tax on Consumption
- Other Goals

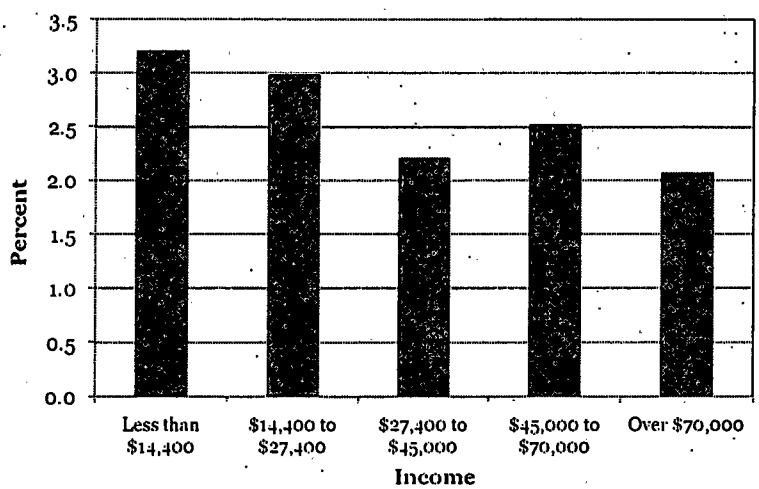
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HAWAII STATE SALES TAX COLLECTIONS AS PERCENT OF CURRENT INCOME



11/2/2009

HAWAII STATE SALES TAX COLLECTIONS PERCENT OF LIFETIME INCOME



11/2/2009

TAX ON CONSUMPTION

- All household purchases
- All purchases regardless of how obtained
- All purchases regardless of the income used
- All purchases regardless of the vendor
- No business purchases

11/2/2009

PROBLEMS OF TAXING BUSINESS

- Not a consumption tax
- Vertical integration
- Hurts equity
- Economic Development

WHERE IS THE SALES TAX HEADED

- Pressure for Rate Increases
- Base Changes
  - Business purchases
  - Services
  - Consumer goods
  - Interstate transactions
- Federal Efforts to Tax Sales

Overview of North Carolina Sales Tax

- Historical Overview, Cindy Avrette
- State Sales Tax Rates, Trina Griffin
- Streamlined Sales Tax Agreement, Sabra Faires

November 3, 2009



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Historical Overview

Cindy Avrette,
Research Division,
NCGA



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Historical Timeline ...

1777	1839
Property Tax	**State financed free public education**

- ✓Second law enacted was new tax system
- ✓License taxes; income tax in 1849
- ✓Public interest to extend school term from 4 to 6 months sparked talk of tax reform in 1913



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Historical Timeline ...

1921
Major Tax Reform

- ✓State programs funded with local taxes
- ✓Segregated State and local taxes
- ✓State relinquished property tax to locals
- ✓Relied on income, inheritance, franchise, license taxes



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Historical Timeline ...

1931	1933
Schools, roads, prisons	**Sales tax**

- ✓1931 General Assembly deadlocked and reverted to Statewide property tax; tax increases
- ✓1933 General Assembly enacted temporary 3% retail sales tax, tax on alcohol, and other rates

Emergency Revenue Act of 1933

An Emergency Revenue Act passed to levy "*additional and extraordinary*" taxes *to meet a supreme emergency in the shrinkage of the ordinary revenues of the State and as a further relief from property taxes to provide another form of revenue for the support of the public schools of the State in substitution for the taxes levied on property for this purpose.*"

Sales Tax of 1933

- 3% sales tax on all tangible personal property except meat, bread, and flour
- Nationally
  - Mississippi enacted first sales tax in 1930
  - 23 states enacted sales tax by beginning of WWII
  - 45 states enacted sales and use tax today

Historical Timeline ...

1935	1937
Wholesale tax rate	**Single article cap**

✓Sales tax rate and a 1% wholesale tax rate on WS sales and certain consumer sales, mill machinery

✓Single article cap of $10; increased to $15 in 1937

Historical Timeline ...

1939

Sales tax permanent and use tax article enacted

Exempt horses, mules, coffins

✓Sales tax generally accepted by most citizens as a convenient means of paying small installments toward the support of State government

Historical Timeline ...

1941	1945	1947
Exempt food	**Exempt prescription drugs**	**Exempt fuel sold to farmers**

✓Exemptions based on identity of consumer

✓Exemptions based on type of transaction or property.

The Sales Tax Study of 1951

- Eugene Shaw, Commissioner of Revenue
- Problems and Solutions
  - Single article cap; Eliminate it
  - Exemptions; Eliminate all exemptions except ...
    - Sales in interstate commerce
    - Sales to governmental units
    - Sales of productive equipment to farmers & manufacturers
    - Sales of raw materials that become component part

The Sales Tax Study of 1951

- Extend sales tax to ...
  - All forms of amusements and entertainment
  - Lodging accommodations
  - Automotive service and repairs
  - All services and repairs to tpp
  - Repair services to plumbing, electrical, heating, and air conditioning equipment

Historical Timeline ...

1955	1957
Single article cap repealed	Combined sales and use tax article enacted
Lodging taxed	WS tax rate extended
WS tax rate extended	Exemptions expanded
1%, $80 cap on vehicles, planes	Tax on funeral expenses



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Historical Timeline ...

1961	1961-1983
WS tax repealed; 1%, $80 tax rate enacted; 1% rate added	Tax on vehicles, planes, railway cars, and boats
Food exemption repealed	



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Historical Timeline ...

1971

- 1¢ local sales tax authorization
- Distributed point of sale

1983 1985

- Two ½¢ local sales tax authorizations
- Distributed per capita with use restricted
- Exempt food purchased with food stamps



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Historical Timeline ...

1987

- Merchants discount repealed

1989

- Sales tax on vehicles replaced with highway use tax

1998

- Exempt food
- Use of exemptions and refunds as economic development incentives



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Historical Timeline ...

2000	2001	2007	2009
SSTP	Third ½¢ local sales tax authorization	Medicaid swap	Digital products

✓Changing world: technology; goods v. services

✓Integration of State and local revenue sources and funding responsibilities

Sales Tax Revenues

Fiscal Year	Sales Tax Revenue
1933-34	$6,011,700
1940-41	14,256,941
1949-50	41,869,874
1970-71	285,893,056
1980-81	737,098,123
1990-91	1,682,340,881
2000-01	3,435,558,577
2008-09	4,677,961,056

State General Sales Tax Rate Changes

- 1933: 3% sales tax rate
- 1991: 4% sales tax rate
- 2001: 4.5% sales tax rate, temporary
- 2005: 4.25% sales tax rate, temporary
- 2007: 4.25% sales tax rate, permanent
- 2009: 5.25% sales tax rate, temporary
- 2009: 5.75% sales tax rate, Medicaid Swap

State Sales Tax Rates

Trina Griffin, Research Division, NCGA

Overview

- **General Rate**
- **Preferential rates**
  - Manufactured homes
  - Modular homes
  - Aircraft and boats
  - Electricity to Commercial Laundries and Dry Cleaners
  - Electricity to Manufacturers and Farmers
  - Electricity to Commercial Businesses and Residences
- **Combined general rate**
  - Spirituous Liquor
  - Telecommunications
  - Video Programming



General Rate

- The general **State rate** of tax is 5.75%. The 1% increase enacted this year is scheduled to expire July 1, 2011.
- The **local rate** of tax varies:
  - In 91 counties, the rate is 2%, for a combined State and local rate of **7.75%.**
  - In Alexander, Catawba, Cumberland, Haywood, Martin, Pitt, Sampson, and Surry, the rate is 2.25%, for a combined State and local rate of **8%.**
  - In Mecklenburg, the rate is 2.5%, for a combined State and local rate of **8.25%**
- Items that are subject to state sales tax are also subject to the local sales and use tax.



Preferential Rates

- Manufactured homes
- Modular homes
- Aircraft and boats
- Electricity
  - Commercial Laundries and Dry Cleaners
  - Manufacturers and Farmers
  - Other Commercial Businesses and Residences

Manufactured Homes: Current Law

- Current Rate – 2%/$300 cap.
- Revenue: $15.9 million.

Manufactured Homes: History

- Prior to 1989, manufactured homes were considered motor vehicles.
- At that time, motor vehicles were subject to a sales tax of 2% with a cap of $300.
- In 1989, the General Assembly created the Highway Trust Fund, which was funded, in part, by a highway use tax imposed on motor vehicles in lieu of the sales tax and at the rate of 3% with a $1,500 cap (S.L. 1989-692).
- The same legislation established a separate sales tax on manufactured homes to distinguish them from motor vehicles and so they would continue to be taxed at the same rate of 2%/$300 cap.
- There have been no rate changes since 1989.

Modular Homes: Current Law

- Current rate – 2.5%/no cap; 20% of taxes collected are distributed to counties.
- Revenue = $4.6 million.

Modular Homes: History

- Prior to 2004, different rates applied depending on the type of frame. "On-frame," or steel frame homes, were taxed the same as manufactured homes (2%/$300). "Off-frame," or wood frame homes, were taxed at the general rate.
- S.L. 2003-400 - Modular homes were distinguished from manufactured homes, and the rate was set at 2.5% with no cap.
- This change was proposed by the North Carolina Manufactured Housing Institute to simplify the administration of the tax.

Airplanes and Boats: Current Law

- Current rate – 3%/$1,500 cap.
- Revenue = $13.2 million.

Airplanes and Boats: History

- 1955 – $15 maximum single article cap was repealed and 1%/$80 cap was imposed on motor vehicles and airplanes.
- 1961 – Rate increased to 1½% and cap was increased from $80 to $120 for motor vehicles and airplanes.
- 1967 – Rate on boats increased to 1½% with a $120 cap to match tax on motor vehicles and airplanes.
- 1969 – Beginning in 1969, aircraft, boats, motor vehicles, and railway cars were taxed at the same rate of 2%.
- 1983 – Cap raised to $300.
- 1989 – Sales tax on motor vehicles converted to a highway use tax at rate of 3%, $1,500 cap to fund the Highway Trust Fund. The cap for aircraft, boats, and railway cars was also increased to $1,500, but rate was not changed.
- 1991 – Rate on aircraft, boats, and railway cars raised to 3% (cap remained the same).
- 2005 - Railway cars subject to general rate of tax to conform with Streamlined.
- No change on aircraft and boats since 1991.

Electricity: Current Law

- Current rate – There are 3 different rates depending on the purchaser of electricity and the purpose for which it is used.
- Sold to:
  - Commercial laundry or dry cleaners 2.83%
    - Revenue = $0.5 million
  - Manufacturers and farmers .8%
    - Fully exempt 7/1/2010
    - Revenue @ 1.8% = $22 million
  - Commercial businesses and residences 3%
    - Revenue = $105 million

Electricity: History

- Pre-1985 – 6% franchise tax on gross receipts.
- 1985 – The 1983 General Assembly changed the rate structure to enable individuals to deduct the taxes from their federal income (S.L. 1983-1097). Effective January 1, 1985, the franchise tax was reduced to 3.22% and a State sales tax of 3% was imposed.

Electricity: History

- 1996 – Sales tax rate on electricity and piped natural gas used by farmers, manufacturers, laundries, and dry cleaners reduced from 3% to 2.83%, effective Aug. 1, 1996; part of Bill Lee enactment (S.L. 1996-13).
- 1998 - Electricity used by a major recycling facility exempted from sales tax (S.L. 1998-55).

Electricity: History

- 2001– Sales tax rate on electricity sold to manufacturers that use more than 900,000 megawatt-hours of electricity annually was reduced to .17%, eff. 1/1/02.
- A rate schedule was also established reducing sales tax on electricity sold to manufacturers that use more than 5,000 megawatt hours annually but less than 900,000, eff. 7/1/05 (S.L. 2001-476, as amended by S.L. 2001-487) .

Megawatt hours used annually	Rate
5,000 or less	2.83%
Between 5,000 and 250,000	2.25%
Between 250,000 and 900,000	2.0%
Over 900,000	.17%



Electricity: History

- 2004 – Graduated sales tax rate was repealed and rate of 2.83% imposed. At the time of this act, no manufacturers qualified for the .17% rate.
- A lower rate of .17% is enacted for electricity used in an aluminum smelting facility, with an October 1, 2007 sunset.



Electricity: History

- In 2006, the rate on electricity sold to manufacturers and farmers was reduced from 2.83% to 2.6% and an exemption was created for electricity sold to an eligible Internet data center (S.L. 2006-66).
- In 2007, a four-year phase-out of the sales tax on electricity sold to manufacturers and farmers was enacted as part of SB 3 *Promote Renewable Energy/Baseload Generation* (S.L. 2007-397):
  - Oct. 1, 2007 = 1.8%
  - July 1, 2008 = 1.4%
  - July 1, 2009 = .8%
  - July 1, 2010 = exempt

Combined General Rate

- What is it?
  - Defined term established in S.L. 2005-276.
  - State's **general rate** (5.75%) + sum of rates of local sales tax authorized for every county (2.25%).
  - Increased from 7% to **8%,** effective September 1, 2009.
- What is subject to the combined general rate?
  - Spirituous Liquor
  - Telecommunications
  - Video Programming

Spirituous Liquor: History

- Prior to 2001, mixed beverages were subject to sales tax but spirituous liquor was not. Spirituous liquor was subject to 28% excise tax, which was in lieu of sales tax.
- 2001– Spirituous liquor became subject to 6% State sales tax with a corresponding excise tax reduction from 28% to 25%, eff. 2/1/02 (S.L. 2001-424). Mixed beverages continued to be taxed at combined State and local rate, which was 6.5% at the time.
- There is no local sales tax on spirituous liquor.
- 2005 – Spirituous liquor became subject to combined general rate, which was 7% at the time.

Telecommunications: History

- Prior to 1985, the gross receipts of regulated power, natural gas, and telephone companies were subject to a 6% franchise tax.
- 1984 – Franchise tax recodified as a 3% State sales tax (no local tax) and a 3.22% franchise tax for a total rate of 6.22%.
- 1987 – Eff. 1/1/89, 6½% sales tax imposed on intrastate long-distance calls with a corresponding exemption from franchise tax; 3% sales tax on local calls; sales tax did not apply to long-distance interstate calls, telephone membership corporations, or coin-operated pay phone calls (SL 1987-557).

Telecommunications: History

2001 – Taxes on telecommunications were simplified by applying one tax at one rate; all telecommunications became taxed equally.

- Initially, the rate was set at 4.5% in order to achieve a revenue-neutral result (SL 2001-430).
- However, before the 4.5% rate ever went into effect, the rate was increased to 6% to generate revenue during the 2001 recession (SL 2001-424).

Telecommunications: History

- 2005 – Combined general rate was applied to telecommunications, resulting in a 7% rate, eff. 10/1/05 (S.L. 2005-276).
- 2007 – The term "ancillary service" was adopted to conform to the SSTA (S.L. 2006-33). No change in tax treatment.

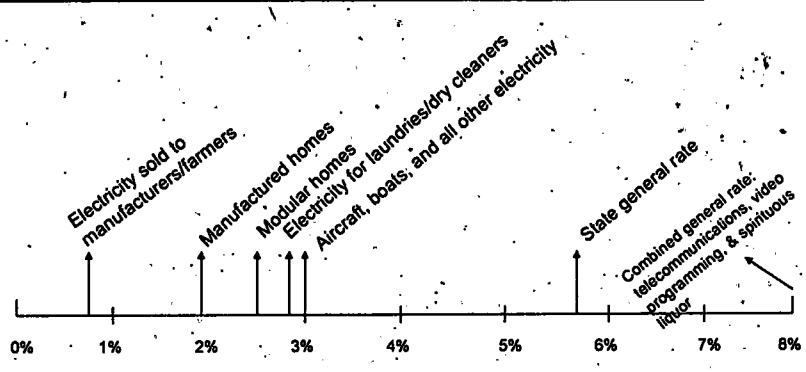
Video Programming: History

- Prior to 2005, cable and satellite television services were taxed differently depending upon the provider of the service. Satellite service was not subject to sales tax, but cable providers were subject to a 5% local franchise tax.
- 2001 – Tax treatment of these services was equalized by imposing a 5% sales tax on direct-to-home satellite service, which was intended to be comparable to the 5% local franchise tax on cable providers. This was a recommendation of the Governor's Loophole Closing Commission (S.L. 2001-424, as amended).

Video Programming: History

- 2005 – Video programming became subject to the combined general rate, which was 7%.
- 2006 - *Video Service Competition Act* enacted. It did not change the amount of tax on video programming services, but it altered the calculation of and created a new distribution method for the local share of shared sales tax collections (S.L. 2006-151).

Sales Tax Rates in NC



Streamlined Sales Tax Agreement

Sabra Faires, Senate Tax Counsel, NCGA

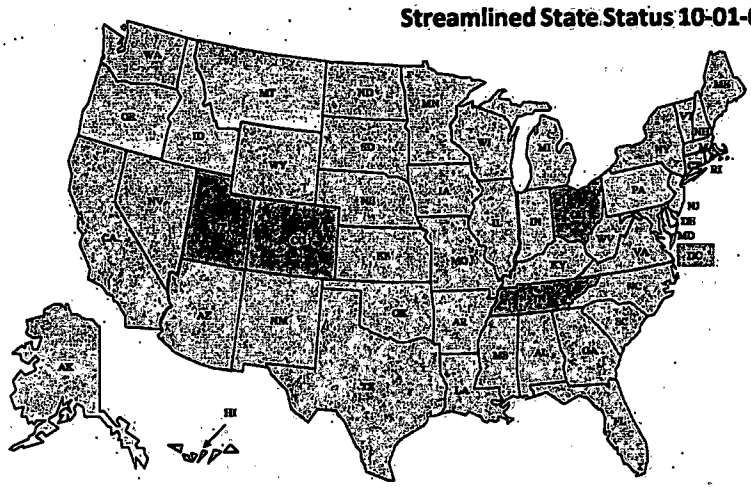
Nature of Agreement

- Voluntary written agreement developed by states
- Adopted November 12, 2002, by states participating in the Streamlined Sales Tax Project and amended frequently since then
- 41 states and the District of Columbia have approved the Agreement
- 23 states have implemented the Agreement by changing their laws to conform to the requirements of the Agreement
- NC became a member of the Agreement October 1, 2005

Becoming a Member of the Agreement

- State changes its laws, administrative rules, and policies to conform to the Agreement
- State submits:
  - Petition for membership
  - Certificate of compliance
  - Taxability matrix
- Other states review, ¾ vote required
- Recertify compliance each year

Streamlined State Status 10-01-09



Full Member States
Associate Member States – flex to full
Advisory States – Not Conforming
Non-sales tax states
Project states – Not Advisory
Non-participating state

Goals of Agreement

Simplify and modernize sales and use tax laws in order to:

- Reduce complexity for all retailers
- Promote equity between local, brick and mortar retailers and remote sellers by establishing a system that:
  - Lessens the administrative burden recognized in the 1992 U.S. Supreme Court case of Quill Corporation v. North Dakota
  - Encourages voluntary compliance by remote sellers
  - Encourages Congress to require remote sellers to collect for the member states
- Relieve consumers of the obligation to report use tax on purchases from remote sellers

Governance of Agreement

- Governing Board administers Agreement
  - Includes representatives of each member state
  - DOR Secretary represents NC
- Executive Committee and Executive Director
- State and Local Advisory Council
  - NC League of Municipalities represented
- Business Advisory Council

NC's Experience

- Collection of over $46.5 million through voluntary compliance since joining
- Numerous legislative changes since 2000 to conform to the Agreement
- Numerous administrative changes at DOR since 2000 to conform to the Agreement

Simplicity Among States

- Uniform definitions
- Uniform sourcing
- Uniform rounding method
- Uniform treatment of bad debts
- Uniform sales tax holiday provisions
- Uniform returns and remittance processes

Uniform Definitions

- Library of Definitions
  - Administrative definitions for core terms, such as tangible personal property and sales price
  - Product definitions used in tax imposition or exemptions
  - Sales tax holiday definitions
- If Agreement defines a term, a state must use a definition that is substantially the same
- Exemptions for products cannot split product definition unless Agreement authorizes the "carve-out"
  - Food, clothing, and drugs and other health-care items

Uniform Sourcing

- Sourcing determines the jurisdiction to which tax is attributable
- Destination sourcing, as opposed to origin sourcing, is the general rule – where a good or service is received
- Special rules for leases and rentals, telecommunications service, ancillary service, direct mail, and florist wire sales
- Effective January 1, 2010, states have origin-based sourcing option for intrastate sales the purchaser does not receive at the seller's business location

Uniform Sales Tax Holiday Provisions

- Exempt items must be defined by Agreement
- Exemptions apply to both State and local tax
- Can use price thresholds and exempt items priced below the threshold
- Must follow procedures for layaways, rain checks, exchanges, back orders, and determining time of holiday

Exceptions to Agreement

- Vending machine sales
- Motor vehicles, aircraft, watercraft
- Modular homes, manufactured homes, mobile homes
- Electricity, piped natural or artificial gas, or other heating fuels delivered by the seller

Simplicity Within Each State

- Uniform State and local base
- One State rate, with two general exceptions
- One rate per local jurisdiction
- No caps and thresholds

Uniform State and Local Base

- Items in State Base must be in local base
- Food
  - Not in every local sales tax
  - Administered as if it were a State tax
  - Distributed among local jurisdictions based on a formula
- Exception when federal law prohibits local tax – such as Direct TV

One Rate Per Jurisdiction



- NC has 103 jurisdictions that can impose a tax
  - The State,100 counties, and two transportation authorities
- One State rate unless:
  - Second rate is on food or drugs and is the same if on both
  - Federal law prohibits imposition of local tax and additional rate achieves tax parity for similar products
- Single local sales and use tax rate

Simplicity in Filing Return and Paying Tax

- State level administration of tax
- State responsible for electronic, downloadable databases of jurisdiction boundaries and tax rates
- Central, electronic registration for all states
- Simple electronic return and electronic payment

Simplicity Through Use of Technology

- Certified service provider – agent for the seller
- Certified automated system - software used by seller

Federal Legislation

- Main Street Fairness Act expected to be introduced this session
- Senator Mike Enzi (R-WY) and Congressman Bill Delahunt (D) Maine
- Compensation issue under review

Resources

- http://www.streamlinedsalestax.org/
- http://www.dornc.com/taxes/sales/streamlined.html

State Sales and Use Tax Exemptions

Medical & Food, Sandra Johnson

Agricultural & Business, Martha Walston

Economic Development, Canaan Huie

Remaining Exemptions, Dan Ettefagh

November 3, 2009



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Medical and Food Related Exemptions

Sandra Johnson, Fiscal Research Division, NCGA



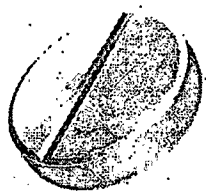
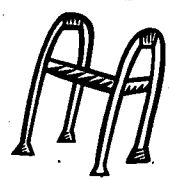
STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Overview

- Three Major Sales and Use Tax Exemptions
- History
- Revenue and Recent Challenges
- Options



Three Major Sales and Use Tax Exemptions, FY 07-08/FY 08-09

Food	Prescription Drugs	Durable Medical Equip
		
$582.2 Million	$387.8 Million	$25.5 Million
G.S. 164.13B	G.S. 164.13(12)	G.S. 164.13B

History of the Sales and Use Tax and Food

1933 → Exempts food for human consumption

1961 → Repeals food exemption



History of the Sales and Use Tax and Food

1998 → Eliminates the State sales and use tax rate on food

2000 → Enters Streamlined Sales Tax Project

2001 → Redefines food into two types

2003 → Determines prepared food is taxable by the state

Food for Home Consumption

- Definition—G.S. 105-164.13B
- Exempt unless it is defined as:
  - Dietary supplements
  - Vending machine items
  - Prepared food
  - Soft drinks
  - Candy



Food for Home Consumption

Fiscal Year 08-09

- Sales and use tax rate
  - State rate 0%
  - Local rate 2%
- State exemption $582.2 M
- Local revenue $262.4 M

Prepared Food

- Definition—G.S. 105-164.3(28)
- Subject to the State and local sales tax if:
  - It is sold in a heated state
  - It consists of two or more foods
  - Foods mixed or combined by retailer
  - It is sold with eating utensils

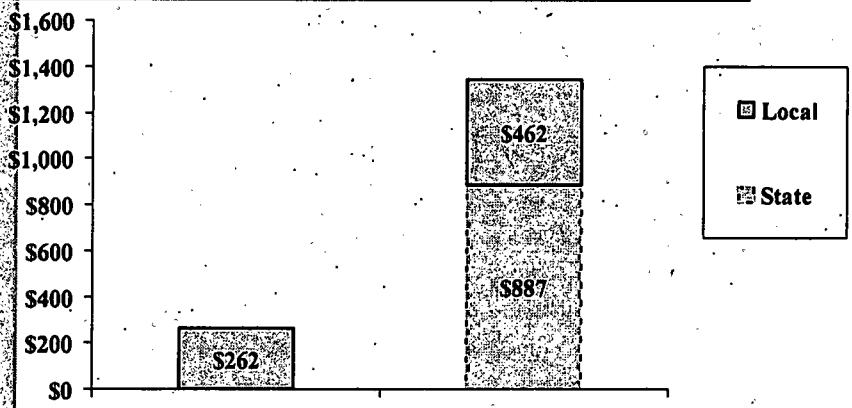


Prepared Food

Fiscal Year 08-09

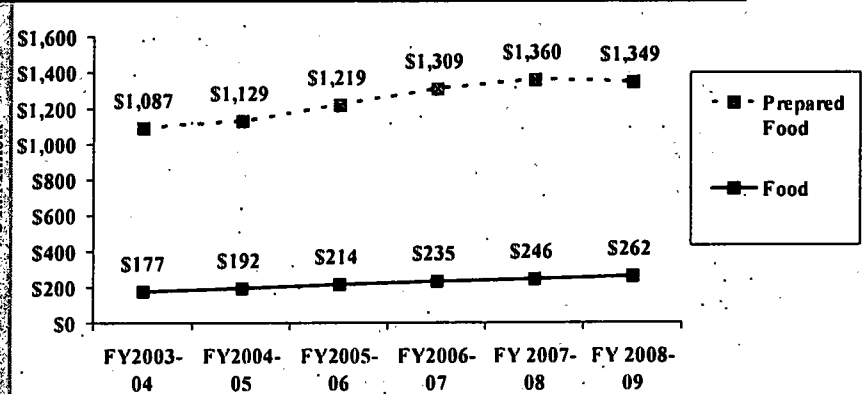
• Sales and use tax rate	6.75%
– State	4.44%
– Local	2.31%
• Revenue	$1.4 Bill.
– State	$886.6 Mill.
– Local	$462.0 Mill.

Tax Collections on Food and Prepared Food, FY08-09



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Sales Tax Collections on Food and Prepared Food ($ In Millions)



Source: 2004-2009 Statistical Abstract, North Carolina Department of Revenue, Tables 32, 56 and 57 in most publications

STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Recent Challenges

- Blurred line between food and prepared food
- Difficulty in administering different rates



Options?

- Past recommendations
- How other states tax food
  - U.S.
  - Streamlined Sales and Use Tax Project
- Revising tax treatment

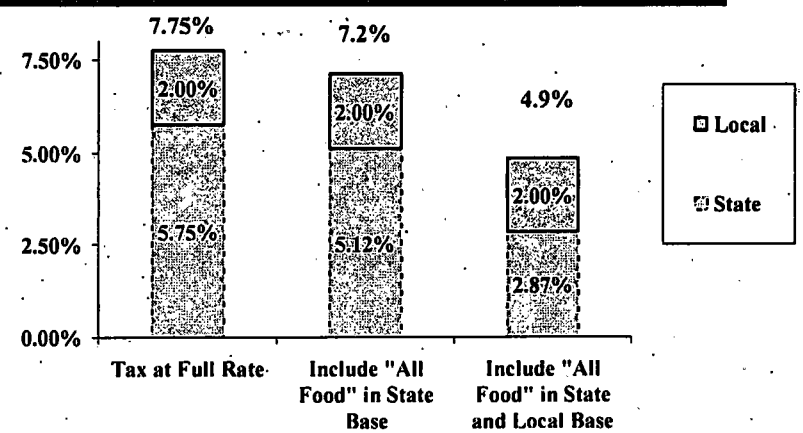


Past Recommendations on the Taxation of Food

1951	Eliminate food exemption
1984	Provide tax credit to low-income families
1991	Maintain tax on food
2008	Eliminate food exemption

STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Options for Taxing Food and Prepared Food, FY 2010-11

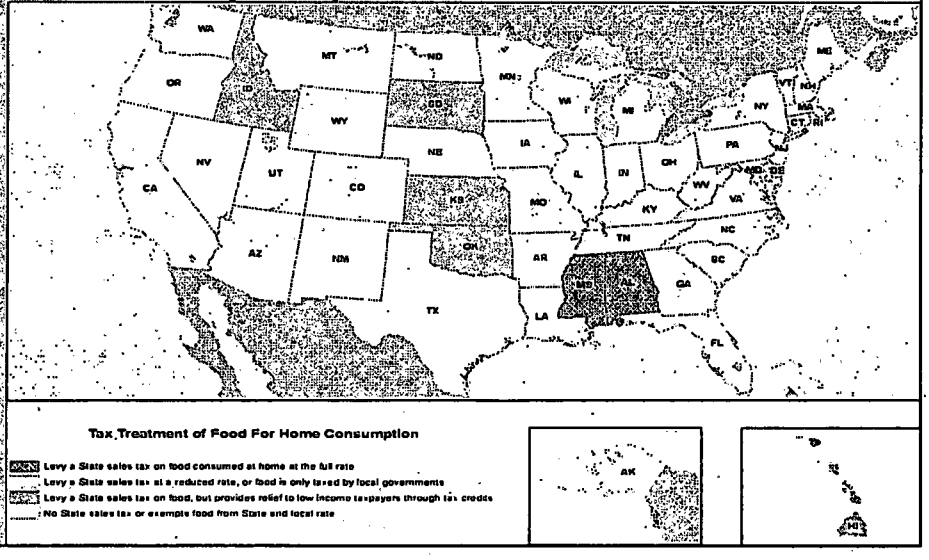


STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Tax Treatment of Food, U.S.

- Two levy the full rate
- Seven levy reduced rates
- Six apply local tax
- 26 states exempt food
- Four levy full rate but w/ caveats
- Five no sales tax

Tax Treatment of Food for Home Consumption, U.S.



Sales and Use Tax History, Rx Drugs & Medical Equipment

1933	Prescription drugs taxed
1939	Prescription drugs tax exempt
1943	Prosthetics tax exempt
1961	Medicine sold on prescription by physicians and dentist



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Sales and Use Tax History, Rx Drugs & Medical Equipment

1988	Exempts insulin prescribed by physicians and veterinarians
1999	Repeals tax for prescription drugs sold to hospitals
1999	All durable medical equipment becomes tax exempt

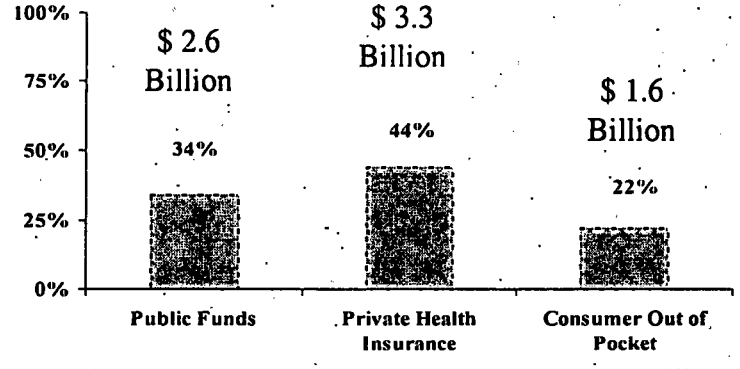


STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Other States Tax Treatment, Rx Drugs

- Two states tax Rx drugs
  - IL—1% sales tax
  - LA—Local sales tax
- 43 states exempt Rx Drugs
- Five states no sales tax

Percent of Drug Expenditures, by Type of Payer, 2006



Source: Kaiser Family Foundation. "Prescription Drug Trends." Published September 2008.

Agricultural and Industrial Related Exemptions

Martha Walston, Fiscal Research Division, NCGA

Categories

- Items sold to or produced by farmers
- Manufacturing items
- Packaging items
- Items sold to commercial laundries
- Computer software

STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Items Sold to Farmers

- Items used in planting, cultivating harvesting, or curing of crops or in production of dairy products, eggs, or animals.
- Commercial fertilizer, lime, land plaster, plastic mulch, plant bed covers, potting soil, baler twine, and seeds
- Farm machinery, attachment and repair parts and lubricants for machinery
- Horses and mules
- Containers
- Grain, feed, or soybean storage facilities.
- Fuel other than electricity used for farm purposes
- ($54.3M)

Items Sold to Farmers

- Facilities, equipment, and supplies used for commercial purposes for housing, raising, or feeding animals ($10.8M)
- Tobacco items ($0.1M)
- Logging machinery, attachments, repair parts, lubricants and fuel for machinery used in commercial logging business ($7.0M)
- Substances used on animals or plants ($94.1M)

Items Produced by Farmers

- Products of forests and mines in their original state
- Products of a farm sold in their original state by the producer if the producer is not primarily a retail merchant
- Farm products sold to manufacturer for further manufacturing or processing

Manufacturing Items

- Manufactured products produced and sold to other manufacturers, producers, or retailers for resale
- Personal products sold to manufacturer that become part of manufactured products
- Machinery and equipment used by certain manufacturers and on which a 1% privilege tax with $80 cap is imposed
- Effective July 1, 2010, fuel and electricity sold to manufacturer for use in connection with operation of manufacturing facility

Manufacturing Items

- Sales of the following:
  - Broadcasting equipment to cable providers ($12M)
  - Towers and broadcasting equipment to FCC licensed radio or television companies ($1.5M)
  - Central office equipment, switchboard equipment, private branch exchange equipment to telephone company providing telecommunications service to subscribers on a commercial basis ($31M)

Manufacturing Items

- Sales of products of waters in their unmanufactured or original state.
- Sales of boats, fuel, machinery, equipment, and supplies used by one of the following in a commercial operation:
  - Holder of commercial fishing license
  - Holder of shellfish license
  - Operator of for-hire boat ($1.6M)

Packaging Items

- Items used for packaging, shipment, or delivery of personal property sold at wholesale or retail and
  - Considered part of sale
  - Delivered with the personal property to the customer
- Container used as packaging by the owner of the container to deliver personal property to a purchaser and required to be returned
- ($61.7M)

Commercial Laundries, Pressing and Dry Cleaning Establishments

- Materials used for identification of garments
- Wrapping paper, bags, hangers
- Detergents and cleaning fluids
- Machinery, parts and accessories, and lubricants
- Fuel, other than electricity, used in the service
- ($1.7M)

Computer Software

- Custom computer software
- Computer software that becomes a component part of other computer software offered for sale
- Computer software that meets any of the following:
  - Designed to run on an enterprise server operating system
  - Sold to a person who operates a datacenter and is used within the datacenter.
  - Sold to person who provides cable service, telecommunications service, or video programming and is used to provide ancillary service, cable service, Internet access service, telecommunications service or video programming
- ($9.6M)

Incentive Related Exemptions

Canaan Huie, House Finance Counsel, NCGA

Sales Tax Exemptions
Economic Development

- Major Recycling Facilities
- Interstate Air Couriers
- Interstate Air Passenger Carriers
- Interstate Air Businesses
- Datacenters
- Railroad Intermodal Facilities

Exemptions
Major Recycling Facilities

- Enacted in 1998, effective July 1, 1998
- Anticipated beneficiary was Nucor
- Exemption of the following items sold for use at the facility
  - Lubricants and other additives for motor vehicles and other equipment
  - Non-capitalized materials, supplies, and parts
  - Electricity
- Fiscal information unavailable from DOR due to taxpayer secrecy laws
- Original estimates from Fiscal Research put the cost at $270,000

Interstate Air Couriers

- Enacted in 1998, effective January 1, 2001
- Anticipated beneficiary was Fed Ex
- Exemption of the following items sold for use at the hub:
  - Aircraft lubricants, repair parts and accessories
  - Materials handling equipment and racking systems
- Fiscal information unavailable from DOR due to taxpayer secrecy laws
- Original estimates from Fiscal Research put the cost at $160,000

Interstate Air Passenger Carriers

- Enacted in 1999, effective May 1, 1999
- Anticipated beneficiaries were US Air (now US Airways) at CLT and, later, Midway Airlines at RDU
- Exemption of the following items sold for use at the hub:
  - Aircraft lubricants, repair parts, and accessories
  - Aircraft simulators for flight crew training (subject to 1%/$80 rate in 1999, complete exemption in 2005, added for other taxpayers in 2009)
- Fiscal information unavailable from DOR due to taxpayer secrecy laws
- Original estimates from Fiscal Research put the cost at $1.2 million

Interstate Air Businesses

- Enacted in 2004, effective October 1, 2004
- Anticipated beneficiary was Timco
- Exemption of the following items sold to an interstate air business
  - Component parts or lubricants for commercial aircraft used during maintenance, repair, or overhaul
- Fiscal information unavailable from DOR due to taxpayer secrecy laws
- Original estimates from Fiscal Research put the cost at $4 million

Eligible Internet Data Centers

- Definition
  - Internet service providers and Web search portals
  - Facilities all located on one parcel of land or commonly owned contiguous parcels
  - Located in a lower-tiered area
  - Commerce certifies that the taxpayer will make an investment of at least $250 million within 5 years
- Note
  - Certain types of data centers that don't meet these requirements are still eligible to have some items subject to the 1%/$80 excise tax rather than the sales and use tax

Eligible Internet Data Centers

- Enacted in 2006, effective October 1, 2006
- Anticipated beneficiary was Google
- Exempts the following items sold to an eligible Internet data center
  - Electricity
  - Eligible business property
    - Capitalized under the Code and
    - Used for one of the following
      - Provision of Internet service or Web search portal services, including heating and cooling equipment for the property
      - Generation, transformation, transmission, distribution, or management of electricity
      - Related computer engineering or computer science research
- DOR estimates this exemption cost $1.8 million in FY 07-08

Railroad Intermodal Facilities

- Enacted in 2007, effective January 1, 2007
- Anticipated beneficiary was Norfolk Southern
- Exempts the following items sold to the owner or lessee of an intermodal railroad facility that reside at the facility
  - Intermodal cranes
  - Intermodal hostler trucks
  - Railroad locomotives
- Fiscal information unavailable from DOR – impact of less than $200,000 expected from all incentives (income/franchise taxes, sales tax exemptions, sales tax refunds) for railroad intermodal facilities

Remaining Sales Tax Exemptions

Dan Ettefagh, Legislative Drafting Division, NCGA

Broad Rationales for Remaining Sales Tax Exemptions

- Prohibitions
- Alternative tax-based exemptions
- Exemptions for products used outside of the State
- Entity- and transaction-based exemptions
- Media exemptions
- Streamlined- and final sale-based exemptions
- Miscellaneous reasons

Exemptions Stemming from Prohibitions

- Constitutional or federal law
- Sales on the Cherokee Indian Reservation ($10M)
- Disaster relief debit card purchases



Alternative Tax-based Exemptions

- Piped natural gas taxed under Article 5E ($110.2M)
- Motor vehicles subject to the highway use tax ($301M)
- Motor fuel and alternative fuels (for which a refund is not allowed) subject to the motor fuels tax ($723.5M)



Exemptions for Products Used Outside of the State

- Articles purchased for resale
- Purchases delivered outside of the State
- Sales of fuel and articles for use on ocean-going vessels



Entity- and Transaction-based Exemptions

- Entity-based exemptions
  - Purchases by the Department of Transportation
  - Purchases by State agency pursuant to valid purchase order
  - Purchases of mobile classrooms by boards of education or community colleges ($0.5M)
  - Sales by non-profits conducted annually for fund raising ($1.1M)
  - Sales by non-profits whose proceeds go to the State
- Transaction-based exemptions
  - Accounts of sales charged off for income purposes
  - Articles repossessed by vendors



Media Exemptions

- Lease or rental of films, transcriptions, and recordings to broadcasters ($5M)
- Lease or rental of films for exhibition ($2.8M)
- Audiovisual masters ($2.2M)
- Non-subscriber sales of newspapers, door-to-door magazine sales ($7.4M)
- Advertising supplements & printed matter distributed with newspapers ($4.3M)
- Components of free distribution periodicals ($5.5M)

Final Sale- & Streamlined-based Exemptions

- Sales of motor vehicle bodies
- Deposit on returnable beverage container
- Deposit on returnable replacement parts
- Separately stated installation charges ($10.4M)
- Separately stated delivery charges for delivery of direct mail ($0.5M)
- Certain telecommunications services ($6.1M+)

Miscellaneous Exemptions

- Public school books ($3M)
- Sales by blind merchants ($0.5M)
- Water delivered by mains/pipes ($42.5M)
- Municipal sales of electricity supplied by federal agency ($0.3M)
- Sales of diesel used for RR cars and locomotives ($17M)
- Articles donated by retailer or wholesaler
- Goods (other than tobacco) sold through vending machines ($5.5M)
- Certain sales of articles to professional land surveyors (> $0.1M)
- Interior design services "sold" with articles
- Penny vending machines (> $0.1M)

Conclusion

- Questions?
- Comments?
- Concerns?

North Carolina Sales Tax Refunds

Nonprofit and Government refunds, *Rodney Bizzell*

Incentive related refunds, *Canaan Huie*

November 3, 2009



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Nonprofit and Government Refunds

Rodney Bizzell, Fiscal Research Division, NCGA



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Which Nonprofits Receive Refunds?

- Nonprofit Hospitals
- Continuing Care Retirement Facilities
  - Must be excluded from property tax under 105-278.6A
- University affiliated nonprofits involved in design or construction of university facilities
- Most 501(c)(3) organizations
  - Educational Institutions
  - Churches and other Religious Institutions
  - Charitable

Eligible 501(c)(3)s

- S.L. 2008-107, Sec. 28.22 provides a definitive category of the type of nonprofit entity entitled to a sales and use tax refund.
- Includes all but three 501(c)(3) organizations in the National Taxonomy of Exempt Entities. Includes categories that were already exempt:
  - Religious Organizations
  - Educational Institutions
  - Charitable Organizations
  - Volunteer Fire and EMS Departments (some are structured as 501(c)(4)) (SL 2009-233)

Ineligible 501(c)(3)s

- Community Improvement and Capacity Building (Economic Development, Community Improvement/Development)
- Public and Societal Benefit (Public Utilities, Financial Institutions, Telecommunications Services)
- Mutual and Membership Benefit (Insurance Providers, Retirement/Pension Funds)

Nonprofit Sales Tax Refunds – FY 2008-09

Exemption / Exclusion		Refunds Issued		Percentage
Hospitals		231,285,709		80%
Educational		40,744,808		14%
Religious		2,615,262		1%
Charitable		10,235,823		4%
Retirement Facilities		4,323,835		1%
	Total	$ 289,205,437		100%

Source: Statistical Abstract of North Carolina Taxes, NC DOR

Governmental Entities

- Counties
- Municipalities
- Special Districts
- LEAs (local portion only)

2005 Changes to LEA Refund Eligibility

- Repealed both the state and local sales and use tax refund for LEAs
  - Effective for all purchases made after July 1, 2005
  - Local refund was reinstated in S.L. 2006-66 to reflect original legislative intent to repeal only the state tax refund
- Instituted transfer from Department of Revenue to the State Public School Fund (SPSF) in its place
  - Transfer started in Fiscal Year 2006-07
  - Transfers made quarterly in the amount of:
    - ¼ the prior year total adjusted by the percentage change in total state tax collections

Government Sales Tax Refunds – FY 2008-09

Exemption / Exclusion		Refunds Issued		Percentage
Counties	$	56,983,541		30%
Municipalities	$	64,154,598		34%
Public Schools	$	20,658,916		11%
Special Districts/Authorities	$	7,458,198		4%
U.S. Government	$	4,049,026		2%
University System	$	11,262,406		6%
Other	$	22,769,630		12%
Total	$	187,336,314		100%

Source: Statistical Abstract of North Carolina Taxes, NC DOR

Incentive Related Refunds

Canaan Huie, House Finance Counsel, NCGA

Economic Development

- Interstate Carriers/Utility Companies
- Passenger Air Carriers
- Major Recycling Facilities
- Low Tier Machinery
- Nonprofit Insurance Companies
- Certain Industrial Facilities
- Motorsports
- Analytical Services
- Railroad Intermodal Facilities

Interstate Carriers/Utility Companies

- Long standing refund for interstate carriers, utility companies added in 2006 effective for purchases made on or after July 1, 2006
- Does not appear to have been any particular beneficiary anticipated
- Provides for a periodic apportioned refund for sales and use taxes paid on locomotives and railway cars and fuel, lubricants, repair parts, and accessories for motor vehicles, railroad cars, locomotives, or airplanes
- DOR estimates the refund cost $5.1 million in FY 07-08

Major Recycling Facilities

- Enacted in 1998, effective for purchases made on or after July 1, 1998
- Anticipated beneficiary was Nucor
- Provides an annual refund for taxes paid directly or indirectly on building materials, building supplies, fixtures, and equipment
- Due within 6 months after the end of the facility's fiscal year
- DOR estimates this refund cost less than $100,00 in FY 07-08

Lower-Tier Machinery

- Enacted in 1999, effective for purchases made on or after January 1, 2000
- No particular anticipated beneficiary
- Provides a refund of sales and use taxes paid at the general rate for machinery and equipment used in an industry eligible for credits under the Bill Lee Act or Article 3J
  - Most mill machinery is not eligible for this refund because it is subject to an excise tax at the rate of 1%/$80 rather than a sales tax at the general rate
- Due within 6 months after the end of the calendar year.
- DOR estimates this refund cost $200,000 in FY 07-08

Nonprofit Insurance Companies

- Enacted in 1999, effective for purchases made on or after May 1, 1999
- REPEALED effective January 1, 2008
- Anticipated beneficiary was TIAA-CREF
- Provides an annual refund for taxes paid directly or indirectly on building materials, building supplies, fixtures, and equipment
- Due within 6 months after the end of the taxpayer's fiscal year.
- DOR estimates this refund cost less than $100,00 in FY 07-08

Certain Industrial Facilities

- Originally enacted in 2003 2nd Extra Session, effective for purchases made on or after January 1, 2004
- Expires for purchases made on or after January 1, 2013
- Significantly expanded over the years to include more industry group
- Provides an annual refund for taxes paid directly or indirectly on building materials, building supplies, fixtures, and equipment
- Investment thresholds must be met – additional requirements for particular industries
- Due within 6 months after the end of the taxpayer's fiscal year

Certain Industrial Facilities

- Eligible Industries
  - Air courier services
  - Aircraft manufacturing
  - Bioprocessing
  - Computer manufacturing
  - Financial services
  - Motor vehicle manufacturing
  - Pharmaceuticals and medicine
  - Semiconductor manufacturing
  - Solar electricity generating materials manufacturing
- Anticipated beneficiaries
  - Fed Ex
  - Merck
  - Dell
  - Fidelity Investments
- DOR estimates
  - $677,000 claimed in calendar year 2007
  - $1.1 million claimed by 2 taxpayers in 2008

Passenger Air Carriers

- Enacted in 2005, effective for purchases made on or after July 1, 2005
- Expires for purchases made on or after January 1, 2011
- Anticipated beneficiary was US Airways
- Provides an annual refund of the net amount of sales and use taxes paid on fuel in excess of $2.5 million annually
- In addition to refund allowed for interstate carriers in general
- Due within 6 months after the end of the calendar year.
- DOR estimates this refund cost $3 million in FY 07-08

Motorsports – Aviation Fuel

- Enacted in 2005, effective for purchases made on or after July 1, 2005
- Expires for purchases made on or after January 1, 2011
- It was anticipated that this would have the greatest impact on several NASCAR teams based in North Carolina
- Allows an annual refund for sales taxes paid on aviation fuel used to travel to and from a motorsports event.
- Due within 6 months of the end of the State's fiscal year.
- DOR estimates $173,000 claimed in 2007 calendar year, $101,001 claimed in 2008 calendar year

Motorsports – Vehicle Parts

- Enacted in 2006, effective for purchases made on or after July 1, 2007
- It was anticipated that this would have the greatest impact on several NASCAR teams based in North Carolina
- Allows an annual refund of 50% of sales taxes paid on property other than tires or accessories that comprises any part of a profession motor racing vehicle
- Due within 6 months of the end of the State's fiscal year.
- DOR does not have a specific estimate on this provision, but it is expected to be minimal

Analytical Services

- Enacted in 2007, for purchases made on or after July 1, 2007
- Anticipated beneficiary was Labcorp
- Allows an annual refund equal to 50% of the greater of
  - Eligible taxes paid on tangible personal property that are consumed in analytical service activities – eligible taxes are those that exceed the amount paid in FY 06-07
  - Sales and use taxes paid on medical reagents
- Due within 6 months of the end of the State's fiscal year
- DOR does not have a specific estimate on this provision
- Original estimates from Fiscal Research put the cost at $5.5 million to $6 million annually

Railroad Intermodal Facilities

- Enacted in 2007, effective January 1, 2007
- Anticipated beneficiary was Norfolk Southern
- Provides an annual refund for taxes paid directly or indirectly on building materials, building supplies, fixtures, and equipment
- Due within 6 months of the end of the State's fiscal year
- Fiscal information unavailable from DOR – impact of less than $200,000 expected from all incentives (income/franchise taxes, sales tax exemptions, sales tax refunds) for railroad intermodal facilities

North Carolina

Biennial Tax Expenditure Report

2007





Policy Analysis and
Statistics Division

Interim Joint House and Senate Finance Committee
Tuesday, November 17, 2009
Room 643, Legislative Office Building
10:00 a.m.

MINUTES

The Interim Joint House and Senate Finance Committee met at 10:00 a.m. on Tuesday, November 17, 2009, in room 643 of the Legislative Office Building. Fifty-four members of the committee were present. Representative Gibson presided as chair.

Principles of Sound Tax Policy: How does the North Carolina Sales Tax Measure Up?

Roby Sawyer, CPA, PhD, Department of Accounting, College of Management, NCSU, was recognized.. He explained ten sales tax principles from equity and fairness to simplicity to sufficient and predictable government revenues. He discussed what make an ideal of a sales tax. A copy of his power point is attached.

Properties of the North Carolina Sales Tax

Karl Smith, PhD, Assistant Professor of Public Economics and Government, School of Government, UNC-Chapel Hill, was recognized to outline the properties of North Carolina's sales tax. He discussed taxing tangible goods, volatility of revenues, and declining revenue. He stated that outdated revenue laws coupled with the changing economy and technology are making it harder to generate revenue. A copy of his presentation is attached.

North Carolina Sales Tax Refunds

Rodney Bizzell, a fiscal analyst from the Fiscal Research Division, was recognized. He explained the facts and histories of nonprofit and government refunds. Canaan Huie, the House Tax Counsel, was recognized to explain economic development refunds. He explained who qualified for the refunds, how the refunds differ, and the reporting requirements. A copy of their presentation is attached.

Sales Tax Revenues

Barry Boardman, an economist with the Fiscal Research Division, was recognized for a historical perspective in terms of stability and volatility in collections. He gave an overview of the State's tax structure, sales tax growth and stability, and the tax base. A copy of his power point is attached.

Relationship between State and Local Sales Tax

Heather Fennell, a staff attorney with the Research Division, was recognized. She discussed the general sales tax, a brief history which included the Medicaid swap. She also explained transit, occupancy and meals taxes, and their rates and locales. Ms. Fennell reminded members that expanding the State base expands the local base and the rate varies among counties. A copy of her power point is attached.

Related Taxes

Ryan Blackledge, a staff attorney with the Bill Drafting Division, was recognized. He explained a variety of taxes administered like sales tax and similar to sales tax. These include certain machinery and equipment taxes, the highway use tax, the motor fuels tax, events and amusements taxes, privilege license taxes, and disposal taxes. A copy of his power point is attached.

The meeting adjourned at 2:52 p.m.

Representative Pryor Gibson, Presiding Chair

DeAnne Mangum, Committee Clerk

INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES
State Legislative Building
Raleigh, North Carolina 27603

House Finance Committee *Senate Finance Committee*

November 18, 2009

NOTICE

TO: Members, House Finance Committee
Members, Senate Finance Committee

FROM: Representative Paul Luebke, Co-Chair
Representative Pryor Gibson, Co-Chair
Representative William Wainwright, Co-Chair
Representative Jennifer Weiss, Co-Chair
Senator Dan Clodfelter, Co-Chair
Senator David Hoyle, Co-Chair
Senator Clark Jenkins, Co-Chair

SUBJECT: Interim Joint Finance Committee Meetings on Tax Reform

There will be a joint meeting of the House and Senate Finance Committees as follows:

DAY:	**Tuesday**
DATE:	**December 1, 2009**
TIME:	**10:00 a.m.**
LOCATION:	**Room 643, Legislative Office Building**

Meeting dates and meeting materials will be posted on the Committees' website, (http://www.ncleg.net/documentsites/committees/jhsfctr/Homepage/index.html). Printed meeting materials will be provided to other legislators upon request.

Please advise DeAnne Mangum, Committee Clerk, at (919) 733-2405 or e-mail deanne.mangum@ncleg.net if you will be unable to attend.

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Nov. 17, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
HUGH TILSON	NCHA
Martha McNeill	CHS
John Palumbo	NCAHA
BILL SCOGGIN	PLG
ANN LOVE	DUKE
CHARLES COLLINS	ADP
DAVID BARNES	Pogun Spruill
Brad Phillips	TWC
Jack Stanley	TWC
Sammy Roberson	TWC

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Nov. 17, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Meg Gray	NC Budget & Tax Center
David Heinen	NC Center for Nonprofits
Morgan Kershner	PriceWaterhouseCoopers
Joseph D. M	McClees Consultn
Dick Carlton	Law Office of R. Carlton
Doug Howey	NC Petroleum & Convenience Mkters
Jon Card	Jordan Price Law firm.
Roz Savitt	NC Child Care Coalition
Connie Wilson	CWC, Inc.

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Nov. 17, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
L. Andrews	NCFB
	Public School Forum
Emily Doyle	NCPAPA
JOHN SHAW	PCS
	WCPSS
	NCICU
	Hunton & Williams
	CAS
Joel Maynard	GWW; Kenan
Charlie Dietz	NC Trucking Assoc.
Thomas Moore	Fidelis - Wolfe

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Nov. 17, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Shanna Smith	NCGA
Drew Moretz	Raleigh Chamber
Joe Lanier	Nelson Mullins
Wendy Kelly	Nelson Mullins
Cady Thomas	NCAR
Daniel Baum	K&L Gates
Catherine DuPre	Cardinal Healthcare System
Chuck Allen	US-Airways
Allison Waller	Charlotte Chamber
Cam Cover	BPMI&L
Lin Zimmer	Candidate HR 103

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Nov. 17, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
[signature]	NCBIO
Jessi Hayes	NC Home Builders
Lisa Martin	NC Home Builders
Doug Heron	Williams Mullen
Doug Lassiter	NCSTA
Melanie Soles	DCR
Rita Harris	NC Commerce
[signature]	Nelson Mullins
Emily Wilbourne	The Policy Group
Leigh Williamson	NCANGHA

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Nov. 17, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Mary Wilding	Novant Health
David Thompson	NCACC
Ed Regan	NCRGEA
Roland Stoffer	IEI
Mary Klenz	League of Women Voters
Jane Kimmel	" " "
Bill Rowe	NC Justice Center
Julia White	NCMMC
Susan Beaujean	Rep Rhyne L.A.
Eric Wayne	Dept. of Revenue

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Nov. 17, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Amy McConkey	Smith Anderson
Bo Heath	McGuire Woods
Kim Crouch	NC Bar Association
Elizabeth Robinson	NCRMA
Karl Knapp	
Matt Farrell	TPG
Cecil Bass	NCAE
Tenisha Jacobs	NCDOJ
David Rice	MFS
Michelle Frazier	MFS
Butch Gunnells	NC Bev. A

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Nov. 17, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Nathan Batts	NCBA
Mac Boxley	NC Aggregates
Damien Graham	Triangle Transit
Matt Gentile	E&Y
Morgan Beam	Civitas
Pam Motton	CenturyLink
Tommy Clark	NCWRC
Sarah Clapp	NCWRC
Beatrice Williams	CLCA
Will Culpepper	Moore + Van Allen
Amy Hobbs	MWC

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Nov. 17, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Ed Strickland	NC DOR
Nathan Kruthaupt	OSBM
[signature]	NFIB

AGENDA

Joint Meeting of the Senate and House Finance Committees

November 17, 2009
9:30 a.m. – 3:30 p.m.

Meeting called by Senate Finance Cochairs: Senators Clodfelter, Hoyle, and Jenkins
and House Finance Cochairs: Representatives Luebke, Gibson, Wainwright, and Weiss

9:30 a.m. – 9:45 a.m.	**Opening Remarks by Finance Chairs**
9:45 a.m. – 11:30 a.m.	**Principles of Sound Tax Policy: How does the North Carolina Sales Tax Measure Up?** *Roby Sawyers, CPA, PhD, Department of Accounting, College of Management, NCSU* **Properties of the North Carolina Sales Tax** *Karl Smith, PhD, Assistant Professor of Public Economics and Government, School of Government, UNC-Chapel Hill*
11:30 a.m. – 1:00 p.m.	**Lunch**
1:00 p.m. – 1:30 p.m.	**North Carolina Sales Tax Refunds** Nonprofit refunds, *Rodney Bizzell, Fiscal Research Division, NCGA* Incentive related refunds, *Canaan Huie, House Tax Counsel, NCGA*
1:30 p.m. – 2:30 p.m.	**Sales Tax Revenues** Trends in collections: A historical perspective in terms of stability and volatility, *Barry Boardman, Economist, Fiscal Research Division, NCGA*
2:30 p.m. – 3:00 p.m.	**Relationship between State and Local Sales Tax** Historical overview of local sales tax authorizations, base, and rates *Heather Fennell, Research Division, NCGA*
3:00 p.m. – 3:30 p.m.	**Related Taxes** Other taxes administered like sales tax and similar to sales tax *Ryan Blackledge, Bill Drafting Division, NCGA*

Next Meeting Date: December 1, 2009

Principles of Sound Tax Policy – How Does the NC Sales Tax Measure Up?

Roby B. Sawyers, CPA, Ph.D.
College of Management
November 17, 2009

NC STATE UNIVERSITY

A Framework for Evaluating Tax Proposals

- A framework based on guiding principles helps lawmakers:
  - evaluate the current tax structure
  - evaluate and compare proposals to modify the current state tax revenue system

NC STATE UNIVERSITY

Ten Guiding Tax Principles

- These principles are widely recognized and accepted
- No ranking of the principles is implied
- While the principles may be applied to one type of tax (such as the sales tax) many of the principles are better applied broadly to the tax system as a whole.

#1 Equity and Fairness

- Similarly situated taxpayers should face the same tax and similar transactions should be taxed in the same manner
- Encompasses concepts of both horizontal equity and vertical equity
  - Horizontal equity provides that two taxpayers with the same ability to pay should pay the same amount of tax
  - Vertical equity means that the person with the greater ability to pay should pay more tax

#1 Equity and Fairness

- In practice, equity is a difficult concept to apply.
  - What is a taxpayer? Is a married couple one or two taxpayers? Should two single taxpayers pay less tax than a married couple with the same income?
  - Flat taxes like sales taxes may be considered "fair" in that those with higher incomes pay more tax than taxpayers with lower income
  - Progressive taxes such as the individual income tax may be considered "fair" in that taxpayers with higher incomes pay tax at higher rates than lower income taxpayers

#1 Equity and Fairness

- Fairness and equity are often discussed in terms of whether a tax system is proportional (flat), progressive or regressive
- Sales taxes are often considered regressive when total income is used as the base due to the fact that lower income taxpayers are likely to consume a greater percent of their income purchasing items subject to the sales tax
- North Carolina's policy of exempting food from the sales tax reduces progressivity

Tax Rate Structures and Equity

- Expanding the sales tax to services will impact the progressivity of the sales tax
- Some services (legal and professional) are more likely to be consumed by wealthy taxpayers while others (certain repair services) are more likely to be consumed by lower income taxpayers
- While a regressive tax system would not be "fair", it is important to look at the system as a whole, not just one type of tax

Transactional Equity

- Similar transactions should be subject to the same tax
- In theory, purchasing a pair of shoes via the Internet should be taxed the same as purchasing shoes at the shoe store
- Sales tax holidays violate this principle

#2 Certainty

- Tax rules should clearly specify when the tax is to be paid, how it is to be paid and how the amount is to be determined
  - Certainty is reduced when a tax system is complex
  - Certainty helps increase compliance
  - Are transactions subject to tax easy to identify?
  - If a taxpayer can not determine if a particular transaction should be subject to tax, certainty does not exist

#2 Certainty

- The sales tax fails our certainty test when sellers (and buyers) don't know if a transaction is subject to tax
  - Food is not subject to sales tax but candy is
    - Is a Twix bar candy or food?
  - Food is not subject to sales tax but soft drinks are
    - Is bottled ice tea a soft drink?

#3 Convenience of Payment

- A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer
  - This is accomplished through assessing a sales tax on the purchase of goods at the time of the purchase

#4 Economy in Collection

- The costs to collect a tax should be kept to a minimum for both the government and taxpayers
  - Compliance costs are high when it is uncertain whether a particular transaction is subject to sales tax
  - If the sales tax base is broadened to include more services, compliance costs for small, less sophisticated service providers could be high
  - However, many of these service providers already collect sales tax on sales of tangible goods
  - Service providers often provide services in multiple taxing jurisdictions

#5 Simplicity

- The tax law should be as simple as possible so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner
  - Complexity leads to errors and can reduce compliance
  - Complexity leads to higher administration and enforcement costs on the part of government
  - In general, a sales tax that has exemptions, multiple definitions and different rates is not simple!
  - One of the goals of the SSTP is simplification, but has it accomplished its goal?

#6 Neutrality

- The tax law should not impact a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction
  - Incentive related sales tax exemptions such as that for recycling facilities and interstate air couriers violate this principle
  - The different tax results from buying online vs. buying from a brick and mortar seller violate this principle
  - Broad bases and low rates help promote neutrality

#7 Economic Growth and Efficiency

- The tax system should be efficient and not impede or reduce the productive capacity of the economy
  - Tax rules should not result in competitive disadvantages for North Carolina firms relative to firms in other states
  - Tax rules should not favor a particular industry or sector
  - Economists generally agree that consumption taxes that reward saving (as opposed to taxes on income) are more efficient and result in greater economic growth

#8 Transparency and Visibility

- Taxpayers should know that a tax exists and how and when it is imposed on them and others
- Sales taxes that are levied on purchases made by the final consumer meet this criterion
- However, when business inputs are taxed (services or tangible goods), the principle of transparency is violated
  - The additional tax is effectively hidden from the ultimate consumer
- Determining when services are delivered may also prove difficult

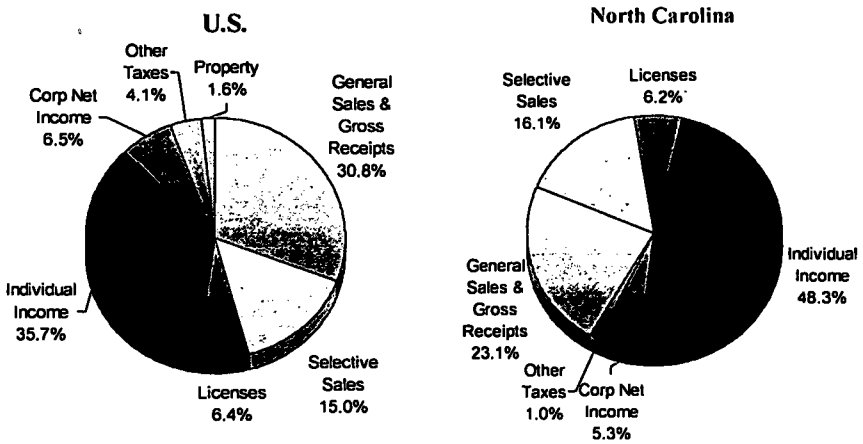
#9 Minimum Tax Gap

- A tax should be structured to minimize noncompliance
- Compliance with the existing sales tax is generally very high (with the exception of the use tax)
- To the extent transactions are conducted in cash, there is more likelihood of noncompliance with both the income tax and sales tax
- This may be a problem with broadening the sales tax to include certain types of services

#10 Sufficient and Predictable Government Revenues

- The tax system should provide the government with a sufficient and predictable source of revenue without having to resort to rate increases
- A mix of taxes provides a more stable tax base because different types of taxes are affected differently by the economy
- North Carolina relies more on the individual income tax (and less on the sales tax) than most states

STATE TAX COLLECTIONS (2008)



Here's Why

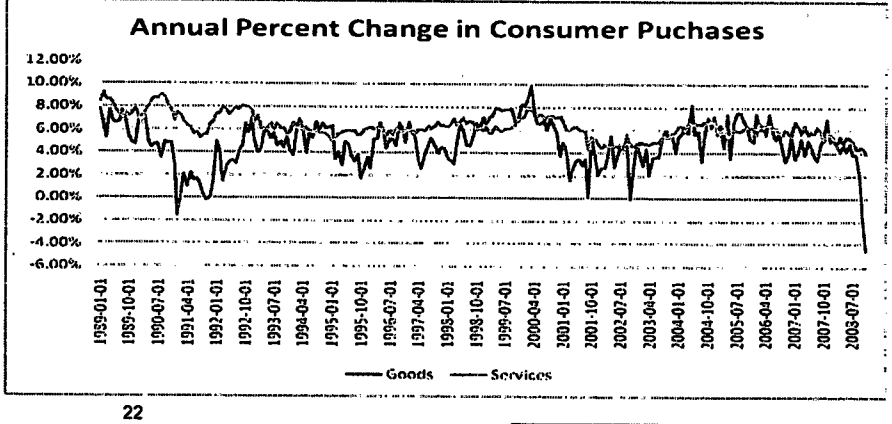
- FTA catalogs 168 separate services
- NC taxes 30 services
- Average services taxed by a state = 56
- 18 states tax fewer services than NC
- 4 states tax over 140 services

Personal Consumption Expenditures 1979 and 2007

	1979 Percent	2007 Percent
Total Expenditures	100.0	100.0
Durable Goods	13.4	11.1
Nondurable Goods	39.1	29.2
Services	47.4	59.7

Sales Tax

The NC sales tax base rests on the more volatile component.



#10 Sufficient and Predictable Government Revenues

- Broadening the sales tax to include services and getting rid of special rates and exemptions should result in a more stable source of revenue for the state

Sales Tax on Tangible Goods

Karl Smith

July 28, 2009

UNC School of Government www.sog.unc.edu

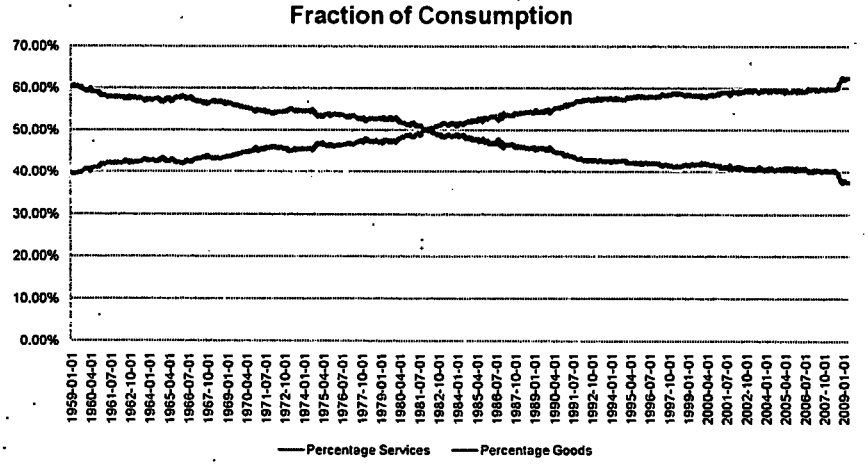
Overview

1. Sales Tax Ideal
2. Unrepresentative of Consumption
3. Increasing Volatility
4. Declining Base
5. Regressive Incidence
6. Permanently Lower Revenue

The Ideal

- The sales tax in principle is a tax on consumption
- Best features of a consumption tax
  - Taxes what citizens take out
  - Smoother than Income
  - Grows with the economy
  - Tracks ability to pay

Less Representative of Consumption



Less Representation of Consumption

- Distorts the market
- Accelerates the shift away from manufacturing
- Creates Deadweight loss and Base Erosion

Less Representation of Consumption

- Deadweight loss
  - When the consideration of taxes causes less efficient economic choices.
  - Ex. Buying an item on Ebay because shipping is less than tax
  - Ex. Waiting for a tax holiday when an item is needed today
  - Ex. Driving just across state lines to pay cheaper tax

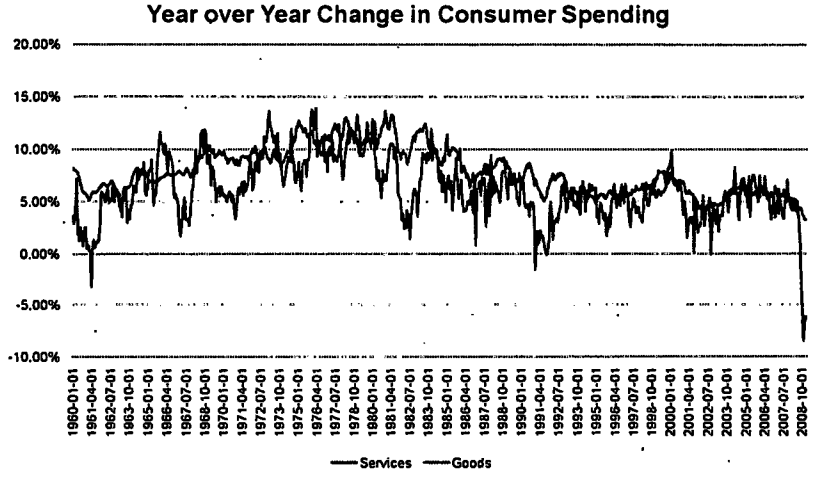
Less Representation of Consumption

- As the tax rate increases deadweight loss increases exponentially
  - Greater numbers of inefficient choices are made
  - Greater severity of inefficiency
  - Ex. More people will drive further to avoid an 9% tax than a 1%.
  - More people driving times further average distance drove imply exponential increase in inefficiency

Less Representation of Consumption

- Erosion of the Base
  - Goes hand in hand with Deadweight Loss
  - As consumer change behavior to avoid the tax, the tax base itself shrinks
- Corollary
  - An increase in taxes never raises quite as much as a simple forecast would show.
  - The base itself is altered by the tax

Increasing Volatility



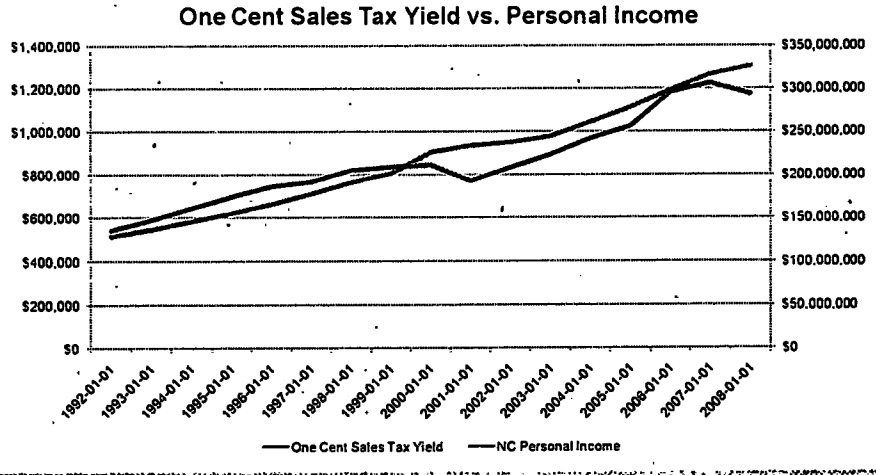
Volatility

- Sales of services are less volatile than income
- Sales of durable goods are more volatile than income
  - Especially, without food, durable goods make up a large fraction of sales tax base

Volatility

- Volatility can be just as dangerous on the way up as done
- Cyclically high revenues expose governments to pressure to increase services or reduce tax rates

Declining Base



Declining Base

- Leads to raising tax rates just to keep up
- Increases deadweight loss
- Erodes the base even faster!!

- History is an overly optimistic guide

Declining Base

- Two accelerating harmful factors
  - As manufacturing declines each additional percentage point loss will be a larger percentage of your base

  - As tax rates rise each additional one cent will cause more base erosion than the cent before it

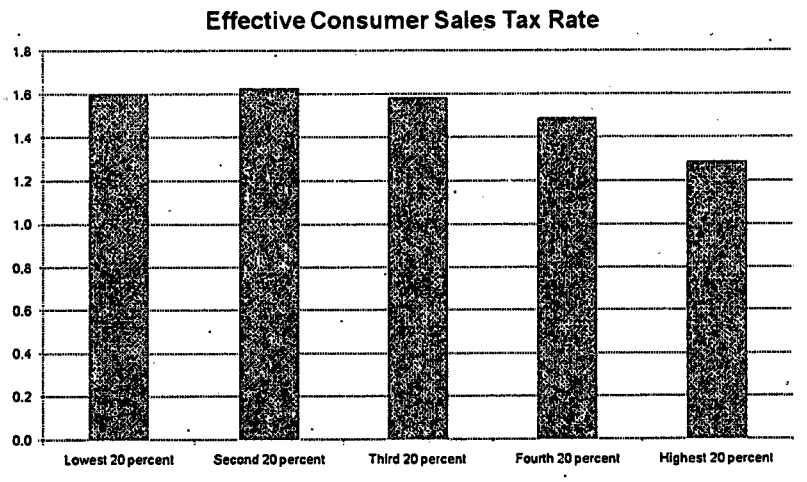
Declining Base

- Two accelerating harmful factors
  - As manufacturing declines each additional percentage point loss will be a larger percentage of your base
  - As tax rates rise each additional one cent will cause more base erosion than the cent before it

Regressive Incidence

- As consumers become wealthier they consume more services.
- A sales tax on goods is therefore more regressive than an consumption tax generally

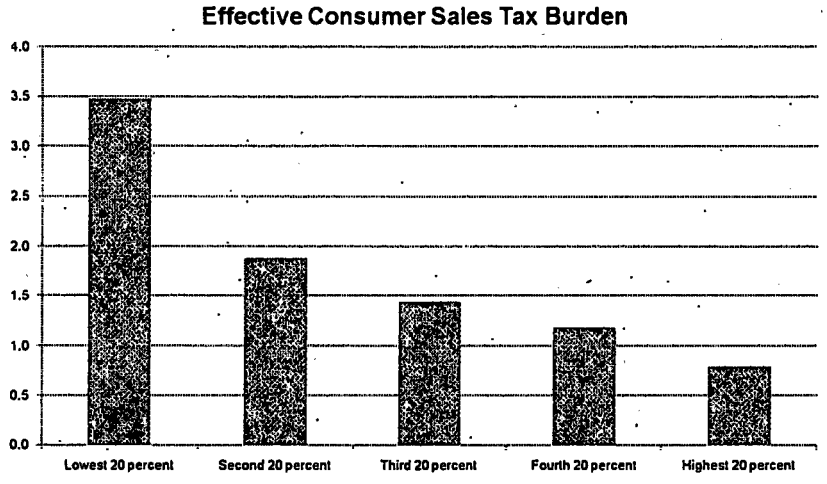
Regressive Incidence



Regressive Incidence

- In a given year a consumption tax is already regressive.
- Low income households spend more than their income. Upper income households less
- Some of this is consumption smoothing
- Some may be bequest motive

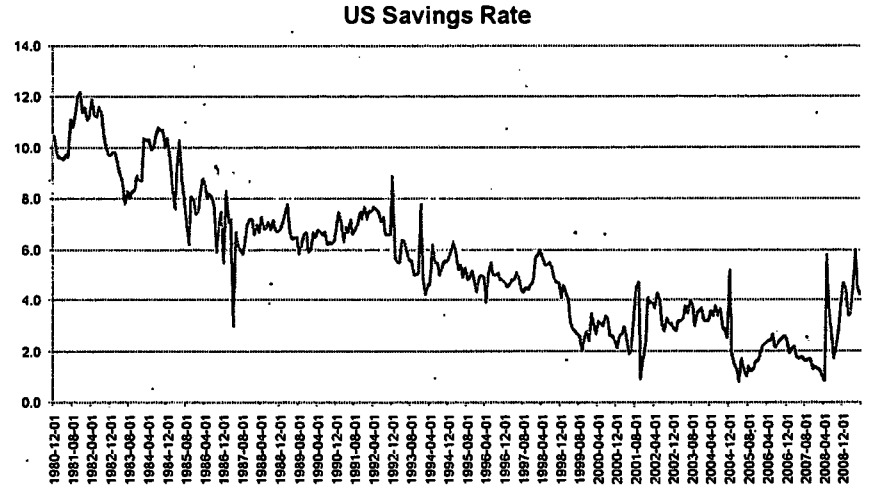
Regressive Incidence



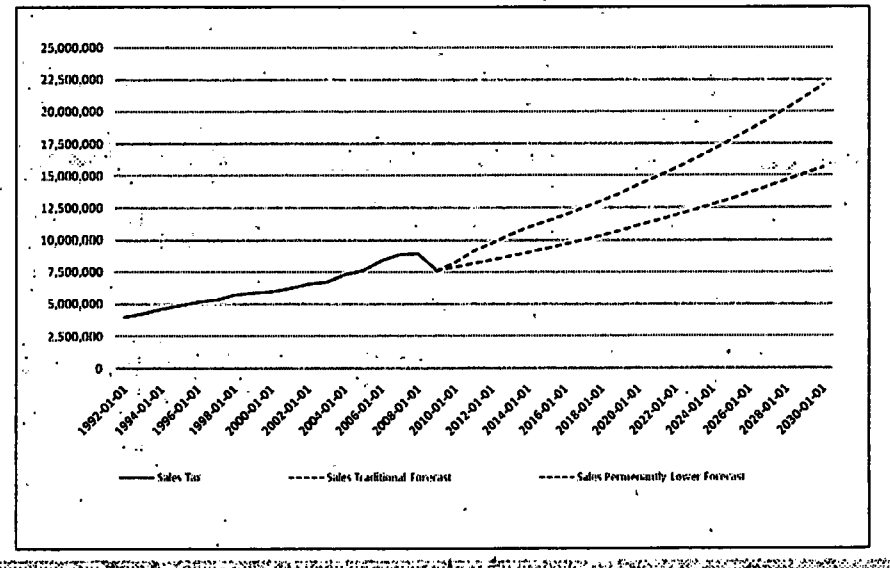
Permanently Lower Revenue

- Sales Tax was goosed by easy credit binge
- End of the binge means lower sales tax and lower growth rate
- We have to accept a "new normal"

US Savings Rate



Permanently Lower Sales



How Does the Current Sales Tax Add Up

- Relative to theoretical ideal
  - Less representative of true consumption
  - More distortion in the private market
  - Does not keep up with economic growth
  - More volatile
  - More regressive



North Carolina Sales Tax Refunds

Nonprofit and Government refunds, *Rodney Bizzell*

Economic Development refunds, *Y. Canaan Huie*

November 17, 2009



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Nonprofit and Government Refunds

Rodney Bizzell, Fiscal Research Division, NCGA



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Key Facts About Nonprofits

- A nonprofit is a private corporation that works for the public benefit, but is separate and independent from government.
- The most common type of nonprofit falls under section 501(c)3 of the Internal Revenue Code.
- Their purposes are religious, charitable, scientific and literary. Any excess funds must be used to fulfill public purpose.
- 501(c)3s are exempt from federal taxation, and donations are tax deductible. They are also exempt from income and sales taxes in most states.



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Key Facts About North Carolina Nonprofits

- There are over 10,000 501(c)3 nonprofits filing Form 990s (required for budgets over $25,000).
- 501(c)3 organizations range in size from multi-million dollar operations (Duke or Wake Forest University) to soup kitchens, shelters and PTAs.
- Revenues come from a variety of sources:
  - Governments
  - Private individuals
  - Corporations and foundations
  - Fees



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

History – Nonprofit Tax Treatment

- 1933 – NC Sales Tax Implemented
- 1941 – General Assembly added the first exemption relating to sales to religious or charitable institutions.
  - Strictly confined to sales of equipment, furniture and furnishings sold to trustees of churches and Sunday Schools for use in Church and Sunday School buildings..

History – Nonprofit Tax Treatment

- 1943 – General Assembly added a new provision exempting sales of tangible personal property to nonprofit religious and charitable institutions, nonprofit hospitals and State education institutions (property must be used in carrying on the work of the institution).
- 1947 – General Assembly expanded nonprofit exemptions to include educational institutions not operated for profit.
- 1949 – Exemptions expanded to include sales of building materials sold to contractors to be used in construction and repair work for religious, charitable and nonprofit organizations not subject to sales tax.

History – Nonprofit Tax Treatment

- 1961 – Several exemptions repealed
  - Nonprofit exemptions repealed
  - Replaced with a sales tax refund
- 1995 – Nonprofit sales tax refunds expanded to include "homes for the aged, sick or infirm whose property is excluded from property tax under G.S. 105-278.6A"

Types of Nonprofits Eligible for Sales Tax Refunds

- Religious
- Charitable
- Nonprofit Hospitals
- Nonprofit Educational Institutions
- Qualifying CCRCs

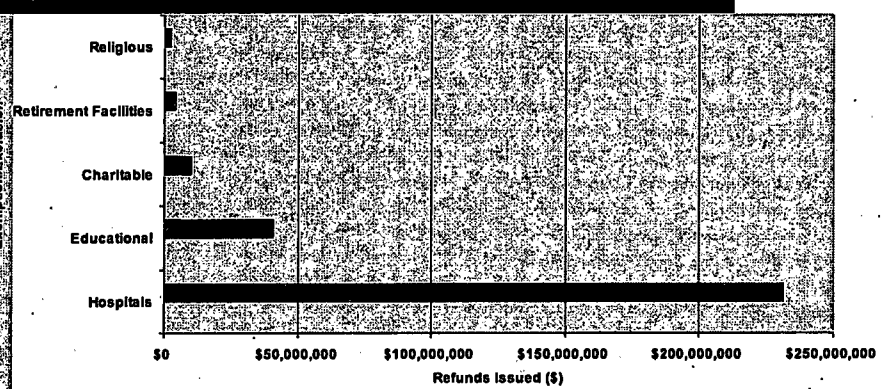
Recent Developments

- Lynnwood Foundation v. NC Dept of Revenue (2008)
  - Charitable status of institutions were subject to interpretation
  - The Lynnwood Foundation successfully challenged the Department's ruling
  - Revealed a need for clarification on what organizations qualify as charitable

Recent Developments

- S.L. 2008-107 links nonprofit refund status to classification in the National Taxonomy of Exempt Entities (NTEE)
- Does not significantly change which organizations are eligible, but it removes uncertainty.
- Changes in the law may be necessary as NTEE is modified.

Nonprofit Sales Tax Refunds – FY 2008-09



Source: Statistical Abstract of North Carolina Taxes, NC DOR

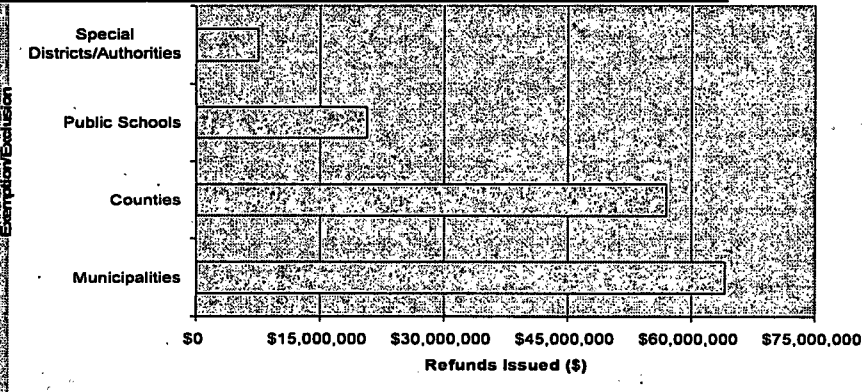
Government Refunds

- Sub-state Governments.
  - Counties
  - Municipalities
  - Special Districts
  - Public Schools

History – Government Tax Treatment

- 1933 – Sales of merchandise sold to governmental units were exempted from sales tax.
- 1961 – Sales tax exemptions replaced with refunds.
- 2005 – General Assembly repealed refunds for public schools.
  - In lieu of refunds, a quarterly transfer is made to the Public School Fund.
  - Initially, the state and local portion of the sales tax refund was repealed. The local portion was restored in 2006.

Government Sales Tax Refunds – FY 2008-09



Source: Statistical Abstract of North Carolina Taxes, NC DOR

Economic Development Refunds

Y. Canaan Huie
House Finance Counsel
NCGA

Economic Development

- Interstate Carriers/Utility Companies
- Passenger Air Carriers
- Major Recycling Facilities
- Low Tier Machinery
- Nonprofit Insurance Companies
- Certain Industrial Facilities
- Motorsports
- Analytical Services
- Railroad Intermodal Facilities

Economic Development Refunds

- Three main variables on which these refunds differ
  - Period covered
    - Calendar quarter
    - Semiannual
    - Calendar year
    - Taxpayer's fiscal year
    - State's fiscal year
  - Amount of refund
    - Full
    - Partial
    - Above a threshold
  - Reporting requirements



Reporting Requirements

- In 2005, the General Assembly enacted requirements directing the Department of Revenue to report, by taxpayer, on most economic development related sales tax refunds
- Refund provisions enacted since 2005 have generally not included this requirement



Interstate Carriers

- Long standing provision, railway cars and locomotives added in 2006 effective for purchases made on or after July 1, 2006
- Provides for a periodic (by rule, these are quarterly) apportioned refund for sales and use taxes paid on locomotives and railway cars and fuel, lubricants, repair parts, and accessories for motor vehicles, railroad cars, locomotives, or airplanes
- No specific anticipated beneficiary – more of a "tax fairness" issue
- DOR estimates the refund cost $5.1 million in FY 07-08
- No specific reporting requirement



Utility Companies

- Enacted in 2006 effective for purchases made on or after July 1, 2006
- Provides for a periodic (by rule, these are semiannually) apportioned refund for sales and use taxes paid on locomotives and railway cars and accessories for railway cars and locomotives and railway cars
- No specific anticipated beneficiary – more of a "tax fairness" issue
- Original estimates from Fiscal Research put the cost of this refund at $370,000 annually
- No reporting requirement



Passenger Air Carriers

- Enacted in 2005, effective for purchases made on or after July 1, 2005
- Expires for purchases made on or after January 1, 2011
- Anticipated beneficiary was US Airways
- Provides an annual refund of the net amount of sales and use taxes paid on fuel in excess of $2.5 million annually
- Due within 6 months after the end of the calendar year.
- DOR reports this refund cost $3.8 million for claims received in calendar year 2007, no claims in the initial report for calendar year 2008

Major Recycling Facilities

- Enacted in 1998, effective for purchases made on or after July 1, 1998
- Anticipated beneficiary was Nucor
- Provides an annual refund for taxes paid directly or indirectly on building materials, building supplies, fixtures, and equipment
- Due within 6 months after the end of the facility's fiscal year
- No claims were reported for calendar year 2007 calendar year or in the initial report for calendar year 2008

Lower-Tier Machinery

- Enacted in 1999, effective for purchases made on or after January 1, 2000
- No specific anticipated beneficiary
- Provides an annual refund of the sales and use taxes paid on machinery and equipment by a taxpayer in a lower-tiered county in a Bill Lee- or Article 3J-eligible industry
- Due within 6 months after the end of the State's fiscal year.
- DOR reports this refund cost $50,000 for calendar year 2007, no claims in the initial report for calendar year 2008

Nonprofit Insurance Companies

- Enacted in 1999, effective for purchases made on or after May 1, 1999
- REPEALED effective January 1, 2008
- Anticipated beneficiary was TIAA-CREF
- Provides an annual refund for taxes paid directly or indirectly on building materials, building supplies, fixtures, and equipment
- Due within 6 months after the end of the taxpayer's fiscal year.
- DOR reports this refund cost less than $10,000 for calendar year 2007, no claims in the initial report for 2008

Certain Industrial Facilities

- Originally enacted in 2003 2nd Extra Session, effective for purchases made on or after January 1, 2004
- Significantly expanded over the years
- Provides an annual refund for taxes paid directly or indirectly on building materials, building supplies, fixtures, and equipment
- Due within 6 months after the end of the taxpayer's fiscal year



Certain Industrial Facilities

- Eligible Industries
  - Air courier services
  - Aircraft manufacturing
  - Bioprocessing
  - Computer manufacturing
  - Financial services
  - Motor vehicle manufacturing
  - Pharmaceuticals and medicine
  - Semiconductor manufacturing
  - Solar electricity generating materials manufacturing
- Anticipated beneficiaries
  - Fed Ex
  - Merck
  - Dell
  - Fidelity Investments
- DOR reports
  - $677,000 claimed in 2007 calendar year
  - $1.1 million claimed in the initial report for the 2008 calendar year



Motorsports – Aviation Fuel

- Enacted in 2005, effective for purchases made on or after July 1, 2005
- Expires for purchases made on or after January 1, 2011
- It was anticipated that this would affect several NASCAR teams based in North Carolina
- Allows an annual refund for sales taxes paid on aviation fuel used to travel to and from a motorsports event.
- Due within 6 months of the end of the State's fiscal year.
- DOR reports $174,000 claimed in calendar year 2007, $101,001 claimed in initial report for calendar year 2008

Motorsports – Vehicle Parts

- Enacted in 2006, effective for purchases made on or after July 1, 2007
- It was anticipated that this would affect several NASCAR teams based in North Carolina
- Allows an annual refund of 50% of sales taxes paid on property other than tires or accessories that comprises any part of a profession motor racing vehicle
- Due within 6 months of the end of the State's fiscal year.
- DOR does not have a specific estimate on this provision, but it is expected to be minimal
- No reporting requirement

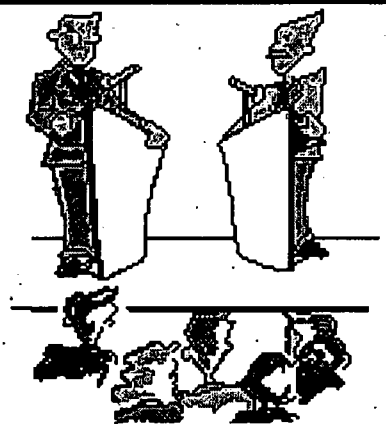
Analytical Services

- Enacted in 2007, for purchases made on or after July 1, 2007
- Anticipated beneficiary was Labcorp
- Allows an annual refund equal to 50% of the greater of
  - Eligible taxes paid on tangible personal property that are consumed in analytical service activities – eligible taxes are those that exceed the amount paid in FY 06-07
  - Sales and use taxes paid on medical reagents
- Due within 6 months of the end of the State's fiscal year
- DOR does not have a specific estimate on this provision
- Original estimates from Fiscal Research put the cost at $5.5 million to $6 million annually
- No reporting requirement

Railroad Intermodal Facilities

- Enacted in 2007, effective January 1, 2007
- Anticipated beneficiary was Norfolk Southern
- Provides an annual refund for taxes paid directly or indirectly on building materials, building supplies, fixtures, and equipment
- Due within 6 months of the end of the State's fiscal year
- Fiscal information unavailable from DOR – impact of less than $200,000 expected from all incentives (income/franchise taxes, sales tax exemptions, sales tax refunds) for railroad intermodal facilities
- No reporting requirement

Questions



Sales Tax Collections

November, 17 2009

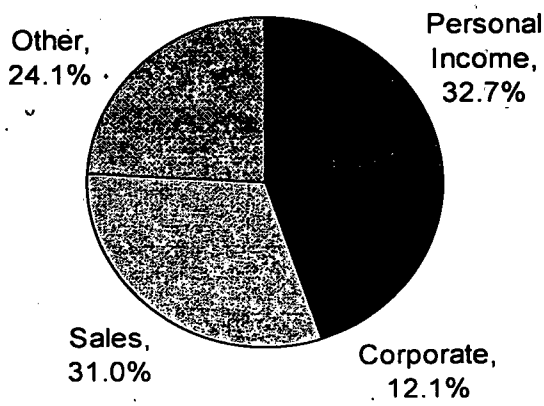
Barry Boardman, Ph.D.
Fiscal Research Division
North Carolina General Assembly

STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

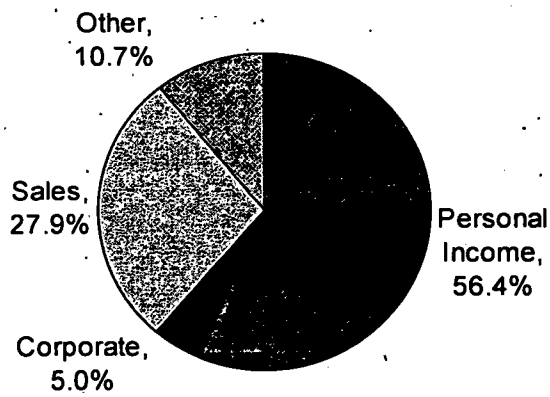
Overview

- State's tax structure
- Sales tax growth
- Sales tax stability
- The tax base

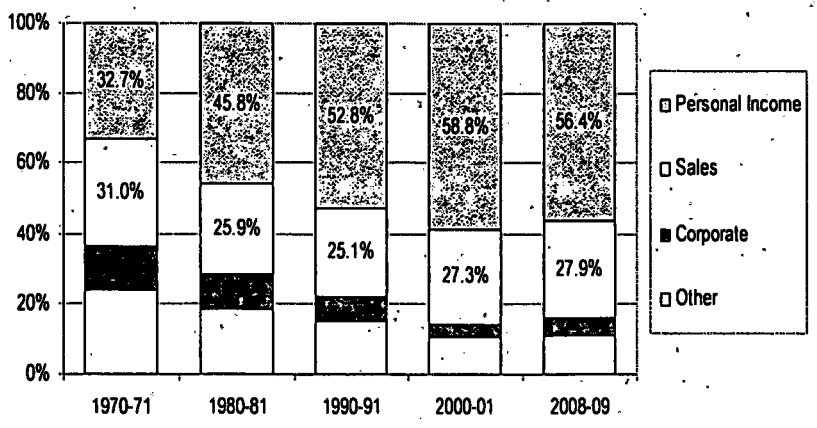
State Tax Structure, FY 1970-71



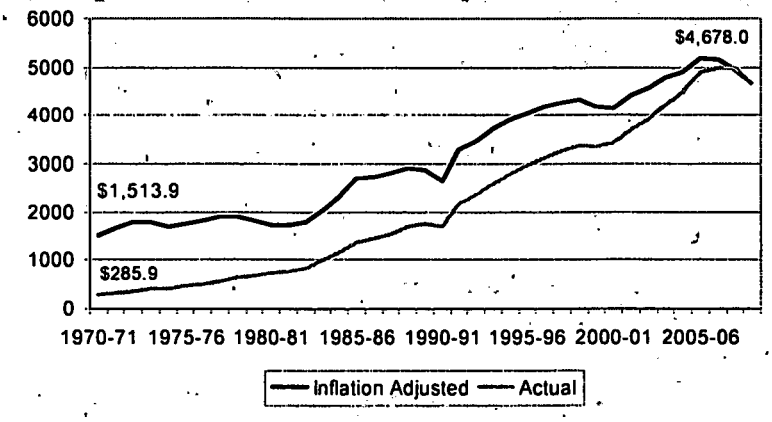
State Tax Structure, FY 2008-09



State Tax Structure



Baseline Collections



Stability and Growth

- Personal income related to
  - changes in the business cycle
  - demand for government services (Wagner's Law)
- Per capita income (adjusted for inflation, 2005 $)
  - $13,800 in 1970
  - $32,417 in 2008
- To measure growth and stability compare sales tax collections with personal income

Stability and Growth

- **Measuring Growth** – long-run responsiveness (elasticity)*:
  - $G = \frac{\%\text{ change sales tax revenue}}{\%\text{ change in income}}$
  - if G > 1 sales tax grows faster than income
  - if G < 1 sales tax slower than income

*regression equation: $\ln(\text{sales tax}) = \alpha + G^{*}\ln(\text{income}) + \gamma^{*}(\text{tax rate})$

Growth and Stability

- North Carolina long-term responsiveness of the sales tax:
  - is **.87**
  - compares with .92 average for the U.S. (1965 - 2007)

Stability and Growth

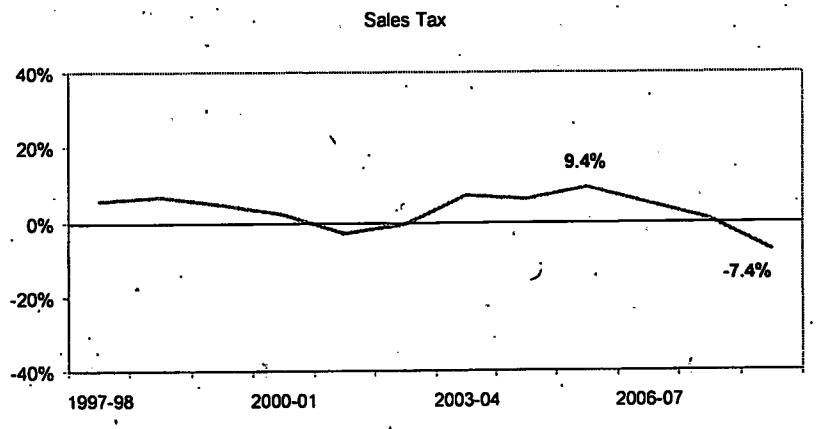
- **Measuring Stability** – short-term changes from economic variability*:
  - $S = \frac{\text{change in growth of sales tax}}{\text{change in growth of income}}$
  - if S > 1 sales tax more volatile than income
  - if S < 1 sales tax less volatile than income

*regression equation: $\Delta \ln(\text{sales tax}) = \alpha + S^* \Delta \ln(\text{income}) + \gamma^* (\text{tax rate})$

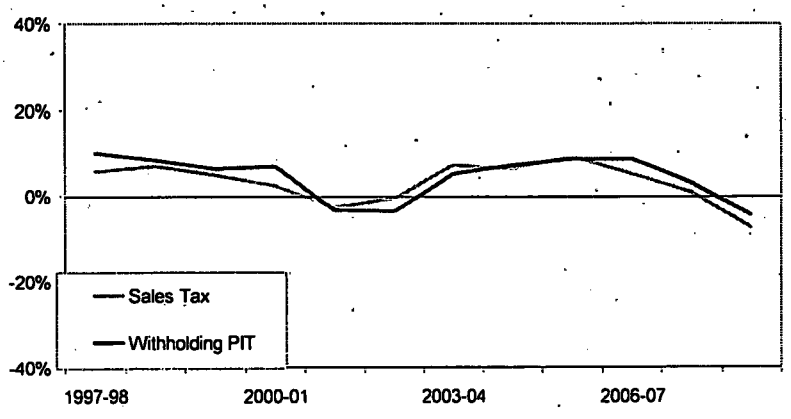
Growth and Stability

- North Carolina short-term volatility to income changes:
  - is **1.16**
  - compare with 1.24 average for the U.S. (1965 - 2007)
  - compare to personal income 2.58 (U.S., 1965 - 2007)
  - compare to corporate income 2.61 (U.S., 1965 - 2007)

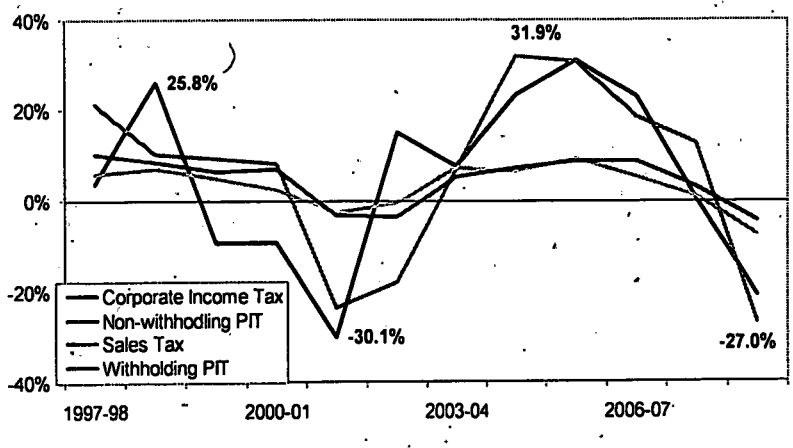
Growth and Stability



Growth and Stability



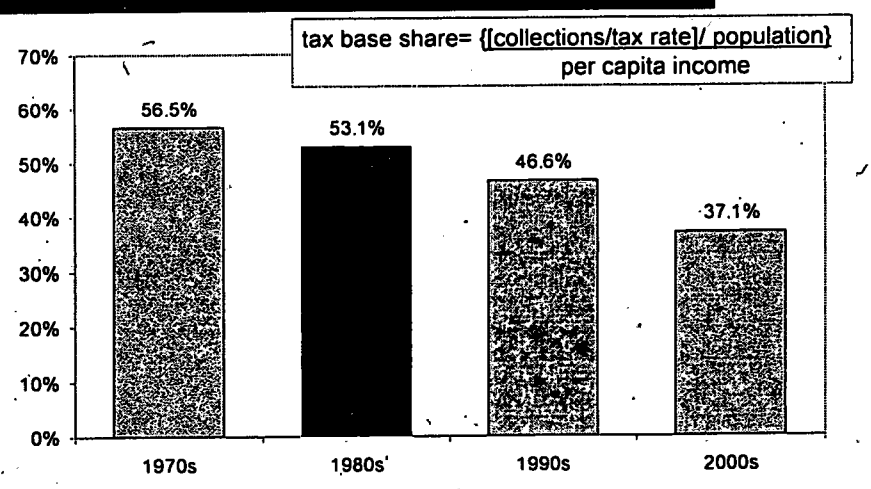
Growth and Stability



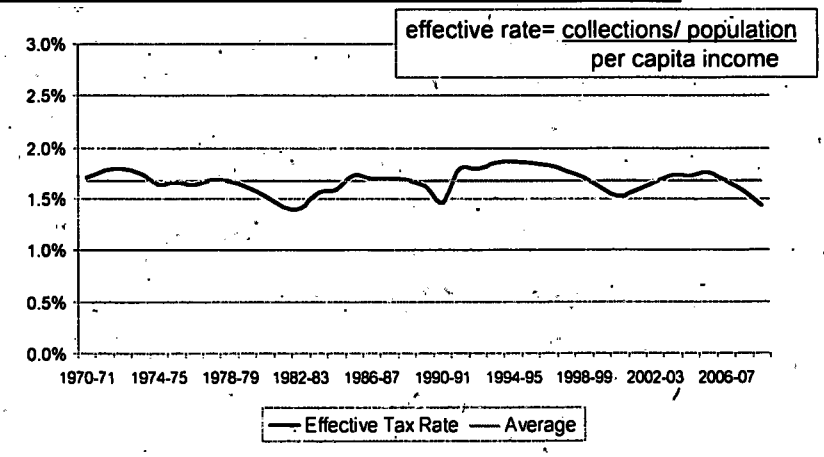
The Sales Tax Base

- Has the tax base narrowed?
  - Calculate tax base from annual collections & tax rate
  - To help measure changes in tax base you want to control for
    - Population growth
    - Personal Income growth

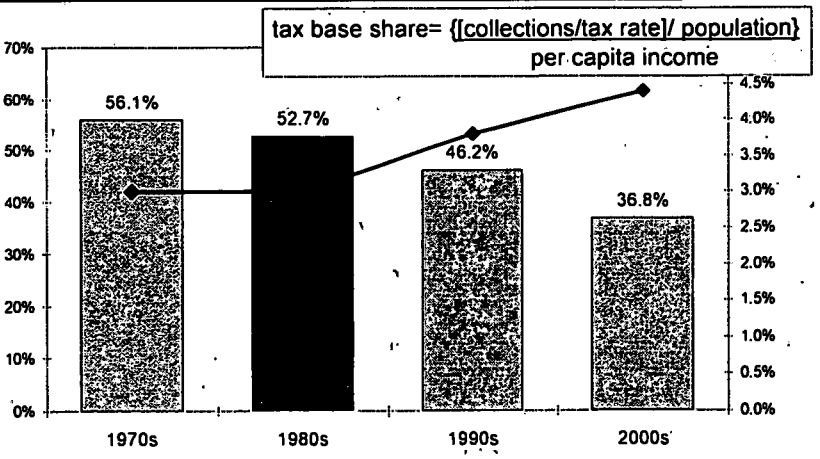
The Sales Tax Base



The Sales Tax Base



The Sales Tax Base



Conclusions

- State's reliance on sales tax stable over last 40 years
- Sales tax grows slower than personal income
- Sales tax more stable than income taxes
- Based on per capita income, the tax base has narrowed

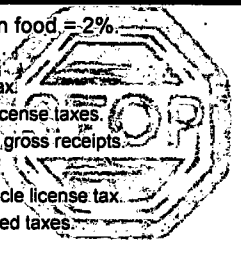
Overview of North Carolina Local Sales Tax

Heather Fennell,
Research Division,
NCGA

November 17, 2009

Other Local taxes...

- Sales tax on food = 2%.
- Other taxes:
  - Property tax.
  - Privilege license taxes.
  - Rental car gross receipts.
  - Animal tax.
  - Motor vehicle license tax.
  - State-shared taxes.



Overview

- General sales tax:
  - Tax rates.
  - Tax base.
  - History of local sales tax.
  - Medicaid swap.
- Other sales taxes:
  - Transit tax.
  - Occupancy tax.
  - Meals tax.

Sales Tax Rates

- The State general rate is 5.75%. The 1% increase enacted this year will expire in 2011.
- The local rate varies:
  - In 91 counties, the rate is 2%.
  - In Alexander, Catawba, Cumberland, Haywood, Martin, Pitt, Sampson, and Surry Counties the rate is 2.25%.
  - In Mecklenburg, the rate is 2.5%.
- The "combined general rate" is 8%.

The Base

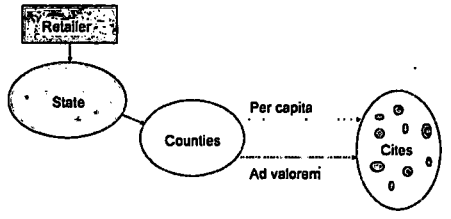
- The local rate applies to the same items the State general rate applies to.
  - Exemptions, refunds, and sales tax holidays that apply to the State rate also apply to local rate.
- 2001 pre-paid phone cards added to the sales tax base:

  Fiscal impact: State - $4 million
  Local - $1.8 million

First 1 cent – 1967-1971

First 1 cent		Any lawful purpose	Point of collection

Flow of revenues



Study of North Carolina's Tax Structure
Interim Joint House and Senate Finance Committee

First ½ cent - 1983

First 1 cent		Any lawful purpose	Point of collection
First ½ cent		Counties - 30% school capital	Per capita

Study of North Carolina's Tax Structure
Interim Joint House and Senate Finance Committee

Second ½ cent - 1986

First 1 cent		Any lawful purpose	Point of collection
First ½ cent		Counties - 30% school capital	Per capita
Second ½ cent		Counties - 60% school capital	Per capita

Study of North Carolina's Tax Structure
Interim Joint House and Senate Finance Committee

Third ½ cent - 2001

First 1 cent		Any lawful purpose	Point of collection
First ½ cent		Counties - 30% school capital	Per capita
Second ½ cent		Counties - 60% school capital	Per capita
Third ½ cent		Any lawful purpose	½ Point of collection ½ Per capita

2007- Medicaid Swap

- State assumes County share of Medicaid over 3 year period.
- Third ½ cent tax phased out, State rate correspondingly increases.
- Second ½ cent distribution changes from per capita to point of collection.
- Hold harmless provision – each County to benefit by at least $500,000.

After the Medicaid Swap

First 1 cent		Any lawful purpose	Point of collection
First ½ cent		Counties - 30% school capital	Per capita
Second ½ cent		Counties - 60% school capital	Per capita Point of collection
Third ½ cent		Repealed	
¼ cent		Any lawful purpose	Point of collection – *distributed to County only.*

Overview

- General sales tax
  - Tax rate
  - Tax base
  - History of local sales tax
  - Most recent swing
- Other sales taxes:
  - Transit tax.
  - Occupancy tax.
  - Meals tax.

Transit taxes

Mecklenburg ½ Cent	1997	Finance, construct, operate and maintain local public transportation.
Triangle and Triad ½ Cent	Authorized 2009	
94 other counties ¼ Cent	Authorized 2009	

Occupancy Taxes

- First allowed in 1983 for 5 counties and 3 cities.
- A tax on the gross receipts derived from the rental of any room, lodging, or accommodation furnished by a hotel, motel, inn, tourist camp, or similar place.
- 76 Counties.
- 87 Cities.
- Rate varies from 2% to 6%*.

Occupancy Taxes

- Trend towards uniformity.
- North Carolina Travel and Tourism Coalition policy statement:
  - **Rate** – The county tax rate cannot exceed 6% and the city tax rate, when combined with the county rate, cannot exceed 6%.
  - **Use** – At least two-thirds of the proceeds must be used to promote travel and tourism and the remainder must be used for tourism-related expenditures, which may include beach nourishment.
  - **Definitions** The terms "net proceeds," "promote travel and tourism," "tourism- related expenditures," and "beach nourishment" are defined terms.

Meals Tax

- Tax of 1% on the sales price of prepared food and beverages sold at retail for consumption on or off the premises by any retailer within the county that is also subject to sales tax imposed by the State.
- 4 Counties and 3 cities currently have a meals tax.

Key Points to Remember

- Expanding the State base expands the local base.
- The sales tax first became a local revenue source in 1967.
- The rate varies among the counties.

Related Taxes

Ryan Blackledge
Legislative Drafting

November 17, 2009

Related Taxes

- Sales tax substitutes
  - Certain machinery and equipment
  - Highway use tax
  - Motor fuels tax
- Events and amusement taxes
- Privilege license taxes
- Disposal taxes

Mill Machinery Tax

- Came from the wholesale tax (1% rate)
- Moved from sales tax to privilege tax (paid by the plant) to comply with SSTP
- Purchase of mill machinery (or parts) for use in manufacturing industry or plant
- 1% of sales price (max $80) on equipment or other tangible personal property
- Revenue = $36.56 million in 2006-07

Mill Machinery Tax Expanded

- Tax has been expanded to become an economic development tool
- Newer categories:
  - Major recycling facility
  - R&D company in physical, engineering, or life sciences
  - Software publishing company
  - Industrial machinery refurbishing company
  - Datacenter (includes forfeiture provision)

Tax on Manufacturing Fuel

- Part of mill machinery article
- Applies to fuel used by manufacturing plant
- Being phased out
- Rate currently at 0.3%
- Expires July 1, 2010

Highway Use Tax History

- Created in 1989
- Replaced 2% sales tax on motor vehicles
- Intended to provide the major source of revenue for the new Highway Trust Fund
  1. Build a system of intrastate highways and seven urban loops
  2. Provide assistance to cities
  3. Accelerate secondary road paving

Highway Use Tax

- 3% of the retail value of motor vehicle on most vehicle transfers
  - $1000 cap for Class A or B commercial vehicles
  - $1500 cap for non-commercial recreational vehicles
- Credited to Highway Trust Fund
- Alternative rate for leased vehicles
  - 8% / 3% of gross receipts on short- / long-term leases
  - Revenue credited to General Fund
- Revenue = $441 million in 2008-09

Motor Fuels Tax

- Rate per gallon varies
  - 17.5¢ + (greater of 12.4¢ OR 7% of average wholesale price of motor fuel)
- Current rate = 29.9¢ per gallon
- Distribution of majority of tax:
  - 75% to Highway Fund
  - 25% to Highway Trust Fund
- Revenue = $1.53 billion in 2008-09

Events and Amusements Tax

- Dances, athletic events, shows, exhibitions
  - 3% on gross receipts
  - Catch-all category
  - Revenue = $12.3 M in 2007-08
- Motion Picture Shows
  - 1% on gross receipts
  - Revenue = $2.1 M in 2007-08

Events and Amusements Exemptions

- Local talent performing in a religious or charitable event
- North Carolina Symphony Society, Inc.
- Agricultural exhibit (with approval of the Secretary of Revenue)
- Recognized "outdoor historical dramas"
- Elementary and secondary school athletic contests, dances, other amusements
- First $1000 of civic organizations' dances
- Youth athletic competition put on by a non-profit with ticket price of $10 or less
- All events promoted and managed by "a non-profit arts organization"
- Teen center
- Entertainment on a Cherokee Indian reservation
- Arts and community festivals on public property not longer than seven consecutive days
- Farm-related events held on farmland

Privilege License Taxes

- Paid to state or local government for "privilege" of doing business
- Rate
  - Flat annual payment
  - Percentage of gross receipts
  - Other calculation
- Studied (and criticized) by
  - 1956 Tax Study Commission
  - 1966 Tax Study Commission
  - 1968 Tax Study Commission
  - 1991 Revenue Laws
  - 1992 Revenue Laws
  - 1996 Revenue Laws
  - 2003 Revenue Laws
  - 2008 Revenue Laws

State Privilege License Taxes

	Rate	2007-08 Revenue
Installment paper dealers	0.277% of face value of obligations	$27.1 million
Loan agencies	$250 per location	$0.5 million
Banks	$30 per $1M of assets	$8.5 million
Newspapers	$15 per ton of non-recycled content short of 40%	< $100,000
Professionals	$50 per year	$2.1 million

Local Privilege License Taxes

- Counties (G.S. 153A-152)
  - No general taxing power
  - Repealed Schedule B lists taxable activities
- Cities (G.S. 160A-211)
  - General taxing power
  - Repealed Scheduled B provides limits on activities cities may tax
- Sometimes gross receipts, sometimes flat amount



Study Committees' Criticisms of Privilege License Tax System

- Inconsistencies
- Outdated language
- Seemingly arbitrary distinctions
- Compliance issues
- Not necessarily tied to proper principles of taxation such as:
  - Fairness
  - Ability to pay
  - Responsiveness to growth
  - Administrative costs



Disposal Taxes

- Provide additional disposal funds for activities that create greater disposal costs

	Rate	2006-07 Revenue
Scrap Tires	2% on small tires, 1% on large	$13.9 million
White Goods	$3 per white good	$5.23 million
Dry Cleaning Solvent	$10/gal (halogenated hydrocarbon-based), $1.35/gal (hydrocarbon-based)	$754 thousand
Solid Waste Disposal	$2 per ton of waste	?

Quick Review

- Sales tax substitutes
  - Certain machinery and equipment (1%/$80)
  - Highway use & motor fuels taxes
- Events and amusements taxes
- Privilege license taxes
  - State and local
  - Criticisms by study committees
- Disposal Taxes
  - Scrap tires, white goods, dry cleaning, solid waste

Interim Joint House and Senate Finance Committee
Tuesday, December 1, 2009
Room 643, Legislative Office Building
10:00 a.m.

MINUTES

The Interim Joint House and Senate Finance Committee met at 10:00 a.m. on Tuesday, December 1, 2009, in room 643 of the Legislative Office Building. Fifty-one members of the committee were present. Senator Hoyle presided as chair.

Expanding Sales Taxation of Services: Options and Issues

Michael Mazerov, Center on Budget and Policy Priorities, Senior Fellow, Center's State Fiscal Project, was introduced. He explained the history of service taxes on sales, the benefits of expanding the service tax and some of the possible drawbacks. He stated that the benefits of taxing services outweigh the drawbacks. A copy of his power point presentation and a handout is attached.

Taxation of Services: A Case Study of Other States

Cindy Avrette, a staff attorney with the Research Division, and Sandra Johnson, a fiscal analyst with the Fiscal Research Division, were recognized. They gave an overview of commonly taxed services, other states' experiences with expanding the services sales tax, and other states' sales tax revenues as a percentage of total revenues. They explained how the inclusion of services in the sales tax base affects sales tax volatility. They provided a list of services by type taxed by states (attached). A copy of their power point is attached.

Representative Stam was recognized. He requested a reduction in personal and sales taxes, spending reform, a widening of the tax base, a reduction of the rate and overall spending reform. A copy of his press release is attached.

Sales Tax Administration

Eric Wayne, Director, Sales Tax Division, Department of Revenue, was recognized. He outlined the responsibilities of the Division which include taxpayer education, forms redesign, and Streamlined Sales Tax. He explained the costs of the Division, the Division's resources, and a request for additional resources. He also explained how the Division had updated forms to make them easier to complete. A copy of his presentation and an example of a form is attached.

The meeting adjourned at 3:07 p.m.

Senator David Hoyle, Presiding Chair

DeAnne Mangum, Committee Clerk

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Dec. 1, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
[signature]	JP Assoc
[signature]	NCAMPHA
[signature]	MCR
[signature]	MCIC
[signature]	NCSTA
Lisa Martin	NC Home Builders
[signature]	Edwards Wild
[signature]	K&L Gates
[signature]	K+L GATES
[signature]	JD, AL, PA
[signature]	Poyner Spruill

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Dec. 1, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
[signature]	N.C. Council of Churches
Jon Carr	Jordan Price Law Firm
Sara Kusan	NC Society of Surveyors
Sam Crew	Brooks Pierce
ANN LOCE	DUKE U
Martha McCreen	Carolinas HealthCare Sys.
Paul Stam	NCBA
Allison Waller	Charlotte Chamber
Edna Dosh	UNC Charlotte
Nathan Batts	NCBA
Tony Solari	DST

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Dec. 1, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Kerry Swearingen	SAS
John Goodman	NC Chamber

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Dec. 1, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
[signature]	NCICU
[signature]	Hunton & Williams
[signature]	NC State Bd of Ed
[signature]	WCPSS
Emily Doyle	NCPAPA
John Shaw	PCS
[signature]	NCASA
Amy Whited	NC Medical Society
[signature]	NCAA
Patrick Oglesby	1830 N Lakeshore Dr Chapel Hill 27514
Chuck Allen	US Airways

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Dec. 1, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Chuck Stone	SEANC / NCAHC
Ben Hartt	McGuire Woods
Lauren Whaley	NC Credit Union League
Amy McConkey	Smith Anderson
Elizabeth Robinson	NCRMA
Ken Crouch	NCBA
Shannon Smith	NCGA
Susan Lattis	Womble Carlyle
Sammy Roberson	TWC
Charles Collins	ADP
Dirk Carlton	Law office of Dirk Carlton

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Dec. 1, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Rob Thompson	Covenant w/ NC's Children
MEG GRAY	NC BUDGET & TAX CENTER
W. Gardner Culpepper	Personal Interest
Keli Coleman	EISAI, Inc.
Will Culpepper	Moore + Van Allen
Ashley Jones	Biotech Ctr NC
Amy Hobbs	MUSC
BRIAN LEWIS	NCAE
Chris Fitzsimon	NC Policy Watch
Mitch Kokai	John Locke Foundation

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Dec. 1, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Jarry Bewley	LBA
DOUG CHAPMAN	NC GVC
Mark Peters	NC Green Industry Council
Bill Wright	alltel
Pam Melton	CenturyLink
Ron Coble	NC Center for Public Policy Research
Doug Howey	NC Petroleum & Convenience Marketers
Butch Gunnells	NC Beverage A
Allison Fowler	NC State Grange
Tommy Clark	NCWRC
Darrel Herron	NC Center for Nonprofits

VISITOR REGISTRATION SHEET

Interim Joint House & Senate Finance — Dec. 1, 2009

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Nathan Kauffman	OSBM
ROLAND STEPHEN	IEI
LISA NOLEN	NCACC
Rebecca Troutman	NCACC
Michelle Frazier	MFS
Michael Hunser	NCDOR
ERIC WAYNE	NCDOR
Tenisha Jacobs	NCDOJ
A. Hanik	EDUN
Matt Benedetti	Home Depot
DREW MORITZ	RALEIGH CHAMBER

AGENDA

Joint Meeting of the Senate and House Finance Committees

December 1, 2009
10:00 a.m. – 3:30 p.m.

Meeting called by Senate Finance Cochairs: Senators Clodfelter, Hoyle, and Jenkins
and House Finance Cochairs: Representatives Luebke, Gibson, Wainwright, and Weiss

10:00 a.m. – 10:15 a.m.	**Opening Remarks by Finance Chairs**
10:15 a.m. – Noon	**Expanding Sales Taxation of Services: Options and Issues** *Michael Mazerov, Center on Budget and Policy Priorities, Senior Fellow, Center's State Fiscal Project*
Noon – 1:30 p.m.	**Lunch**
1:30 p.m. – 2:30 p.m.	**Taxation of Services: A Case Study of Other States** *Presented by Cindy Avrette, Research Division, and Sandra Johnson, Fiscal Research Division* *Prepared by the Finance Team*
2:30 p.m. – 3:30 p.m.	**Sales Tax Administration** *Eric Wayne, Director, Sales Tax Division, Department of Revenue*

Next Meeting Date: December 15, 2009

Sales Taxation of Services: Options and Issues

Presentation to the
Interim Joint House and Senate Finance Committees
North Carolina General Assembly
December 1, 2009

Michael Mazerov, Senior Fellow
Center on Budget & Policy Priorities
Washington, DC
mazerov@cbpp.org

NC not alone in taxing few services: A product of history

- 24 of 45 states enacted sales taxes 1930-40 to offset plunging property taxes in Depression
- Most states didn't include services because
  - Services much smaller share of economy
  - Priority was getting enforceable tax up & generating $$ ASAP (goods more traceable)
  - Tax on services viewed as tax on labor/jobs
- Two sales taxes enacted at that time did include generalized taxation of services – HI & NM

Why should states expand their taxation of services?

- **To improve "horizontal equity" – equal tax treatment of similarly-situated people**
  - Sales tax supposed to be general tax on consumption, tax equally people who consume same $ amount; failure to tax services unfair to those who prefer goods over services

Why should states expand their taxation of services?

- **To improve "horizontal equity"**
  - Goods and services often substitutes (e.g., in some states, person who rents DVDs pays sales tax, while person who spends same amount on HBO pays no tax)
  - Eliminate inequities caused by partial taxation of services (e.g., in some states HBO not taxed while pay-per-view is)

Why should states expand their taxation of services?

- **To raise additional revenue**
  - Substantial untapped revenue potential
  - Fairer to get it from someone avoiding tax on her consumption than to tax existing taxpayer more heavily
  - Preferable to rate increases, which tend to stimulate tax avoidance (e.g., more cross-border and Internet shopping)

Revenue potential of expanded taxation of household services (NC)

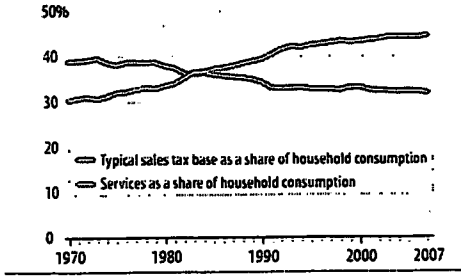
FY10-11 (estimates done for Senate budget plan)

- Installation/repair of tangible personal property: $253 million
- Convert existing amusement tax to sales tax: $28 million
- Other recreation/entertainment: $106 million
- Building repair/alteration: $75 million
- Storage and moving: $20 million

Why should states expand their taxation of services?

- **To mitigate long-term erosion of sales tax**
  - Economy is shifting from consumption of goods to consumption of services
  - Result: failure of sales tax revenue to grow as rapidly as cost of services sales tax is supposed to pay for
  - This is probably the most important reason to expand sales tax to include more services

Services are growing as share of consumption



Why should states expand their taxation of services?

- **To reduce sales tax revenue volatility**
  - Greater taxation of services appears to mitigate fall-off in sales tax revenue during recessions
  - People often postpone purchases of big-ticket items when they fear/experience job loss, but they still get their hair cut and cars repaired

Why should states expand their taxation of services?

- **To eliminate some thorny administrative problems**
  - E.g.: No need to require business to separately report taxable parts and tax-exempt labor if labor is also taxable
  - Can reduce compliance costs for business and enforcement costs for states

Why should states expand their taxation of services?

- **To improve economic efficiency**
  - Unnecessarily-high sales tax rate from too narrow base creates some adverse economic incentives
  - E.g., artificially stimulates Internet and cross-border shopping
  - E.g., compounds adverse effects of sales taxation of business inputs

Sales taxation of services and regressivity (1)

- What little research there is suggests that conventional wisdom — that broad taxation of services reduces regressivity of sales tax — is wrong
- Why: low-income people have to get their cars and plumbing fixed just like more affluent do
- Extension of sales tax to services purchased mostly by affluent can reduce sales tax regressivity (but little revenue yield)

Sales taxation of services and regressivity (2)

- Broad expansion to services coupled with completely offsetting rate cut will neither increase nor decrease regressivity of sales tax significantly
- But generating net additional revenue from sales tax will increase regressivity of overall tax system because of greater reliance on an inherently regressive tax
- Any net increase in sales tax revenue from expansion to services should be offset with some low-income relief, e.g., expanded EITC

What are some possible drawbacks of expanding the sales tax to services?

- **Brings many new retailers into system**
  - Have to be registered, educated, have returns processed, be audited
  - In contrast, rate increase on existing tax base has almost no additional costs
  - Problem sometimes exaggerated; many service sellers also sell taxable goods or self-remit use tax on things they buy

What are some possible drawbacks of expanding the sales tax to services?

- **Likely substantial noncompliance by individual sellers of some services**
  - Some services often provided "off-the-books" by individuals (e.g., child care, house cleaning, home repair)
  - Income tax reporting already poor; unlikely to collect sales tax
  - Legitimate businesses could be dis-advantaged

Benefits of taxing services outweigh the drawbacks

- Sales tax will fall farther and farther behind growing cost of providing public services if services aren't taxed
- Potential to raise sales tax rates much further is constrained by Internet sales
- Need for horizontal equity; people shouldn't have different sales tax burdens because of how they like to spend their money
- Significant short-term revenue-raising potential

What services could states tax?

- Services sold mostly from one business to another (b2b)
  - E.g., payroll processing
- Services sold mostly to households
  - E.g., personal trainers
- Services frequently sold to both
  - E.g., auto repair

States should generally avoid taxing B2B sales of services

- Violates principle of what sales tax is supposed to be – tax on consumption
- Often leads to "pyramiding" – with possible negative economic, political, and distributional effects
  - Definition: imposing sales tax on inputs into production, passing cost of those inputs into cost of final product, then subjecting full price of product to sales tax all over again

The case against pyramiding and taxing business inputs (1)

- **Lack of transparency**
  - Citizens don't see what they're paying for public services because part of sales tax is buried in price of what they buy

The case against pyramiding and taxing business inputs (2)

- **Adverse distributional impacts**
  - Governments rely on regressive sales tax more than they otherwise might because part of sales tax burden buried in prices
  - Some evidence that hidden portion of sales tax is more regressive than visible portion that appears at cash register

The case against pyramiding and taxing business inputs (3)

- **Possible adverse economic development impacts**
  - Possible disadvantage in competing for customers with out-of-state companies not subject to input taxes
  - If substantial taxation of inputs, can be disincentive to be located in state

The case against pyramiding and taxing business inputs (4)

- **Adverse effects on economic efficiency**
  - Taxation of b2b sales creates incentive for "vertical integration," i.e. bringing service in-house (e.g. hire accountant employee rather than accounting firm)
  - Tax-induced vertical integration hurts economic efficiency (existence of independent service providers suggests they are more efficient than employees)
  - Competitive disadvantage for small businesses (can't afford to avoid tax by hiring their own janitors, accountants, etc.) Also, small service businesses lose large corporate customers.

What are the arguments <u>in favor</u> of taxing b2b sales of services? (1)

- **May be less economically distorting than higher sales tax rate.**
  - There's already substantial taxation of b2b sales of goods; if alternative is sales tax rate increase, may be less economically distorting to put new tax on b2b sales of services than to tax b2b sales of goods at even higher rate

What are the arguments <u>in favor</u> of taxing b2b sales of services? (2)

- **Can be a "second best," pyramiding-free approach to taxing household purchases of <u>exempt</u> services and goods**
  - Example: may be distributionally undesirable to tax sale of hospital services, but may be acceptable to tax hospital's purchases of accounting, electricity, etc. even if passed into price of hospital services

What are the arguments in favor of taxing b2b sales of services? (3)

- **Some business purchases of services are really disguised form of providing compensation to employees/customers in form of consumption**
  - Company country club memberships
  - Skybox rentals
  - Luxury hotels on business trips
  - "Company" cars

What are the arguments in favor of taxing b2b sales of services? (4)

- **Reducing sales tax evasion**
  - Given large and growing number of self-employed workers, significant potential to claim personal consumption of some services as business-related to evade tax (e.g., telephone, car repair, hotels)
  - Would place unreasonable burden on seller/government to police eligibility for b2b exemption.

A practical, real-world approach to taxation of b2b services

- States generally should avoid expanded sales taxation of services that are exclusively or primarily sold from one business to another.
- Should focus efforts on expanding sales taxation of household services
- Taxation of services widely purchased by both households and businesses (e.g. car repair) is acceptable
- States should tax business purchases that are disguised forms of personal consumption

What household services could states tax? (see author's paper for detailed list)

Lawn and garden	Pet-related
Personal transportation	Storage and moving
Residential utility	Telecommunications
Financial and insurance	Personal care
Misc. personal (childcare)	Home cleaning/maintenance
Clothing-related	Education-related
Other professional (legal)	Admissions/recreation/travel
Personal property rentals	Medical
Vehicle repair/maintenance	Residence construction/repair
Housing and real-estate	Misc. repair/installation

What services does North Carolina tax now?

Custom fabrication/printing	Commercial art/graphic design
Dry cleaning and laundry service	Photocopying
Electricity (reduced rate)	Photo finishing
Landline and cellular telephone service	Some entertainment admissions (reduced rate)
Cable and satellite TV (including pay-per-view) and radio	Diaper service

Q: How does North Carolina compare to other states in taxation of services?

- Below average
- In 2007, NC taxed 30 out of 168 services in Federation of [State] Tax Administrators study
- 27 of 46 states (incl DC) with sales taxes taxed more services
- SC and GA comparable; VA taxes even fewer; TN taxes twice as many

Taxation of household services

- Taxation of household services more extensive than conventional wisdom might suggest.
- But only half the states tax more than 20 of 40 household services in FTA list; only 5 tax more than 30.
- HI, NM, and SD tax virtually all
- Virtually all states tax restaurant meals, rentals of tangible personal property (e.g. videos) and transient accommodations.

Are there reasons states might not want to tax certain services?

- Taxation administratively impractical/ costly and/or substantial evasion likely
- Service is a necessity that absorbs a large share of income of low-income families
- Other social policy concerns
- Sales taxation barred by federal law

Approaches to expanding sales taxation of services

- Comprehensive (HI, NM, SD only)
  - All services defined as taxable unless explicitly exempted
  - Mirrors taxation of sales of tangible personal property (goods)
- Incremental
  - State enumerates additional services it wishes to tax
  - Enumeration often occurs in definition of retail sale; "sale at retail includes [list of services]."

Comprehensive extension of sales tax base to services

Pros:

- Major revenue gain
- Eliminates need to continually revisit sales tax as new services are invented
- Reduces enforcement/administrative issues in defining services and drawing lines between taxable and exempt services – and litigation

Comprehensive extension of sales tax base to services

Cons:

- Immediately brings 000s of new vendors into sales tax system
- Likely to encompass many services that shouldn't be taxed for distributional or economic reasons; therefore likely to have to deal with lots of special pleading for
  - Exemptions from tax
  - Input exemptions to avoid excessive pyramiding

Incremental approach to extending sales tax base to services

Pros:

- Inherently requires deliberate consideration of which services state wishes to tax, permitting balancing of distributional, administrative, and other issues

Incremental approach to extending sales tax base to services

Cons:

- Political – selected services will claim they're being unfairly targeted, with no underlying principle of taxation
- Revenue gains may be modest

Incremental approach to extending sales tax base to services

More cons:

- Problem of newly-invented services
  - Sales tax has to be constantly revisited because new services constantly being invented
  - Many newly-invented services will get a free ride until legislators get around to extending tax to them (if ever)

Incremental approach to extending sales tax base to services

Still more cons:

- Can be difficult to write clear, water-tight definition of a specific service
  - So, have to devote resources to writing public education materials, regs, and "private letter rulings" for specific sellers
  - Sellers will litigate if they think definition vague enough to allow them to avoid charging tax

Incremental approach to extending sales tax base to services

Likely to prevail despite significant drawbacks; states not willing to expand sales tax to all services at once

Mechanics:

- Will depend somewhat on specific written structure of each state's law
- Enumeration often occurs as: " a 'retail sale' includes [list of services]"

Broad or specific definitions of services under enumeration approach?

- Err on side of being as specific and detailed as possible
  - E.g. "Retail sale includes admission, equipment rental, and other fees for participant sports, which include but are not limited to bowling, batting cages, skiing, . . ."
- Consider using standard definitions of services developed by fed. govt. for other purposes
  - North American Industry Classification System
  - North American Product Classification System

Conclusions:

- No time like the present to seek inclusion of more services in North Carolina sales tax base
  - Can help address current fiscal gap
  - Base expansion preferable to rate increase on equity grounds
  - Essential to avoid long-term erosion

Expanding Sales Taxation of Services: Options and Issues

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Center on Budget and Policy Priorities

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Summary

Sales of tangible goods dominate most states' sales tax bases; only a few states impose their sales taxes on a broad array of services. Sales of "non-durable goods" like clothing and light bulbs and "durable goods" like cars and computers generate the vast majority of state sales tax receipts. According to the Federation of Tax Administrators, a majority of states apply their sales tax to less than one-third of 168 potentially-taxable services. Five of the 45 states with sales taxes impose them on fewer than 20 services.[1]

Most states could improve their sales taxes and their tax systems in general with some expansion of the tax base to include services. Levying sales taxes on services makes state tax systems fairer, more stable, more economically neutral, and easier to administer. Moreover, because state sales taxes are a major source of funding for schools, universities, health care, public safety, and other functions of state and local government, adding services to state sales tax bases can help states maintain their support for those functions, for instance during an economic downturn when state revenues are declining. Broadening the sales tax base can also avert other, less sound tax increases that otherwise might be enacted when a state needs new revenue. There are significant economic, administrative, and legal issues that must be addressed in expanding the sales taxation of services. The barriers are not insurmountable, however, and the benefits from a broader sales tax base outweigh the challenges.

Why Tax Services?

Public finance economists and other tax experts have been urging states for decades to include more services in the sales tax base.[2] Levying a sales tax on services satisfies all the criteria by which state tax policy options are normally evaluated.

- **Taxing additional services can generate substantial new sales tax revenue.** Table 1 (see page 5 in the body of the report) indicates that the annual, nationwide revenue yield from taxing all services purchased by households except health care, education, housing, and a few others would be on the order of $87 billion. The new revenue from taxing household services would be less than this, since most states do tax services to some extent. Table 1 suggests, however, that states that do not tax services to any significant degree at present — such as California, Illinois, Massachusetts, and Virginia — probably could increase their sales tax revenue by more than one-third if they taxed services purchased by households comprehensively.

  Some states have prepared their own estimates of the revenue gained by expanding the sales taxation of services. In June 2009, Maine became the most recent state to broaden its sales tax base significantly; it expects to generate $41 million in annual revenue by levying its sales tax on

[1] Federation of Tax Administrators, *Sales Taxation of Services: 2007 Update*, October 2008; www.taxadmin.org/fta/pub/services/services.html. See report for extensive footnotes that affect classification as taxable or exempt.

[2] In a majority of states with sales taxes, some local governments are also authorized to impose them. In most instances, the local sales tax base — the group of items subject to tax — is substantially similar or identical to the state sales tax base. In the interest of readability, this report will refer to "state" sales taxes, but nearly all of the discussion applies to local sales taxes as well (including the sales tax of the District of Columbia).

Sales and Use Taxes: An Introduction

Most people are familiar with the sales tax, the charge that is added to the cost of goods and some services purchased in retail stores. The tax is calculated as a percentage of the sales price, collected from the purchaser at the time of sale, and remitted weekly or monthly by the retailer to the state tax agency. Forty-five states and thousands of local governments use sales tax revenue to pay for K-12 education, higher education, public health, public safety, transportation, parks, and a range of other services.

How much revenue is generated by the sales tax depends on both the percentage tax rate and the "tax base" — the goods and services that are subject to taxation. Besides omitting most services from the tax base, many states exempt from taxation categories of goods viewed as necessities of life, such as food and medicine.

In addition to taxing goods and a few services purchased by households at retail stores, sales taxes often apply to purchases by businesses from other businesses. A retailer's purchases from a manufacturer or wholesaler of items for resale usually are not subject to sales taxation, nor are a manufacturer's purchases of items that are directly incorporated into its output. Nonetheless, goods and services purchased by businesses that do not fall into either of these categories — such as manufacturing equipment, electricity, and office furniture — are often subject to sales taxation. The policy issues raised by the taxation of such "business-to-business" sales will be discussed at length in the body of this report.

Sales taxes are charged when the seller and buyer are in the same state. States levy "compensating use taxes" on purchases of goods when the seller and buyer are in different states. The use tax is almost always identical to the sales tax with respect to both rate and base. The purpose of the use tax is to eliminate the possibility of avoiding sales tax by purchasing from an out-of-state vendor — and thereby eliminate the incentive to do so. In some cases, the out-of-state seller charges the use tax to the buyer just as if the tax were a sales tax, and the buyer is unaware of the distinction. Even if the seller does not charge the use tax, the buyer is legally obligated to pay the use tax directly to the state in which the purchase will be used. (This obligation is largely ignored by individual consumers but frequently fulfilled by businesses that buy from out-of-state vendors.) Use taxes are imposed only rarely on interstate purchases of services; as will be discussed elsewhere in this report, one consequence of expanding sales taxation of services may be a need to reconsider that policy.

Some states levy special taxes on particular services in lieu of or in addition to the sales tax. For example, some states impose special taxes on car and hotel rentals, admission charges for entertainment and cultural events, and utility services like telephone and electricity. Where such taxes are not imposed in lieu of some other business tax (such as the corporate income tax), and where they legally may be passed on to purchasers like the sales tax through itemization on the bill or invoice, these special taxes may be thought of as sales taxes for purposes of much of the analysis contained in this report.

The District of Columbia and forty-five states — all except Alaska, Delaware, Montana, New Hampshire, and Oregon — levy sales taxes. They are a critical revenue source for state governments, supplying $236 billion in state tax revenue in 2007 — 31 percent of total state taxes. In many states, local governments also levy sales taxes.

entertainment admissions, auto and equipment repairs, and such other services as laundry and car washes. This $41 million represents a 4.4 percent boost in its sales tax collections. In 2006, New Jersey added roughly one dozen services to its sales tax base. The state said this would yield more than $400 million in new revenue each year, a 5 percent increase in sales tax receipts. Note that the Maine and New Jersey expansions covered some but not all potentially taxable services. Other states have estimated the revenue that could be gained by expanding the taxation of services much more extensively than did Maine or New Jersey; these estimates (a sampling of which is shown in Table 4 of this report) confirm that states are losing billions of dollars a year due to the tax-exempt status of most services.

- **Taxing services broadly is essential if the long-run revenue adequacy of the sales tax is to be maintained.** Household spending has been shifting from goods to services for decades. The traditional sales tax base, purchases of durable goods plus non-durable goods except groceries (which the majority of states exempt), fell from 39 percent of household consumption in 1970 to 32 percent in 2007. Over the same interval, consumption of services rose from 31 percent to 45 percent of total household purchases.[3] (See Figure 1, p. 12.) Largely to compensate for this trend, states have increased sales tax rates sharply over this period. The ability of states to continue raising rates is constrained, however, by such factors as the ease with which consumers can shift their purchases to the Internet — where sales taxes often are not charged. If consumption continues to shift toward services, including services in the tax base will be essential to maintaining sales tax revenues over the long term.

- **Bringing services into the sales tax base may reduce the year-to-year volatility of sales tax collections.** Sales tax bases are dominated by purchases of "big-ticket" durable goods (such as cars, appliances, and furniture), which often decline sharply during economic downturns. Limited research finds that purchases of some services do not fall as precipitously as durable goods purchases do when the economy slows nor rise as rapidly when the economy is booming. The research suggests that including more services in the sales tax base could moderate slightly the volatility of sales tax revenues over the course of the business cycle.

- **Expanding the taxation of services will make the sales tax fairer.** The sales tax is intended to be a general tax on consumption. There is little reason to distinguish between consumption of goods and consumption of services, which in fact can be substitutes for one another. For example, it is not equitable — it violates the principle of "horizontal equity" — to tax the person who rents a videotape but not the person who watches a pay-per-view movie on cable TV.

  Moreover, sales taxes are regressive; that is, they absorb a greater share of the income of lower-income taxpayers than of higher-income taxpayers. This is largely because higher-income persons do not consume their entire incomes; the portion of their incomes that they save is not subject to sales or other consumption taxes. Ideally, states could consider reducing the regressivity of sales taxes by expanding the sales tax to services purchased primarily by the affluent. While worth doing, the revenue gain would not be substantial. To broadly tax services, states must include services purchased by low-, moderate- and middle-income

[3] The remaining household consumption not accounted for in these figures is composed of housing and food for use at home. The source of the data is the personal consumption expenditures component of the Gross Domestic Product Accounts published by the Commerce Department.

households as well as those purchased by high-income people. In general, a broad expansion of the sales tax to services will not change relative tax burdens.[4]

There is one circumstance, however, in which expansion of the sales tax to services could make a state's overall tax system somewhat less equitable. That can occur if taxing services raises the proportion of total state revenue that is derived from the sales tax and thereby lowers the proportion that is derived from more progressive sources such as personal and corporate income taxes. There are a number of ways this potential to increase the regressivity of the tax system as a whole can be avoided. The sales tax base expansion can be balanced with other changes in the tax code, such as a reduction in the sales tax rate or an increase in the personal income tax. Alternatively, targeted credits administered through the income tax or rebates of sales taxes paid can be used to mitigate the increased sales tax burden low-income families could experience when a sales tax is broadly expanded to include services.

- **Imposing a sales tax on services can improve the allocation of economic resources.** The failure to tax services while most goods are taxed subtly distorts resource allocation throughout the economy by creating an artificial incentive to purchase services rather than goods. For example, some consumers may be encouraged to repair older cars and appliances rather than replace them with more energy-efficient and less polluting alternatives — although the effect is probably modest. The failure to tax services has also contributed to steady increases in sales tax rates, which create their own economic distortions. Unnecessarily high tax rates on goods resulting from under-taxation of services stimulate such wasteful activities as tax-motivated interstate shopping.

- **Expanding the taxation of services can simplify the process of administering and complying with the sales tax.** Expanding the taxation of services can reduce the effort and costs entailed in enforcing and complying with the sales tax. When retailers sell taxable goods as well as tax-exempt services, it can be difficult and costly for tax administrators and merchants alike to ensure that the proper amount of tax has been collected and remitted. If all of a retailer's sales are subject to tax, many accounting burdens and disputes diminish or disappear.

Expanded sales taxation of services can contribute to the realization of all of these arguably desirable tax policy objectives. There are tradeoffs involved, however. For example, moving toward very comprehensive taxation of services with less than 12-18 months of lead-time could strain the administrative capabilities of state tax departments since many businesses that previously did not collect sales tax would need to be brought into the sales tax system. Thus, achieving an optimal balancing of these goals requires an understanding of all of the potential effects of expanding taxation of services and careful choices about which services to tax.

Which Services Could States Tax? Which Services Should They Tax?

As policymakers contemplate which currently-exempt services they might bring into the sales tax base, it can be useful to think of services as falling into three categories:

[4] Such generalized taxation of services would have to exempt health care services for this statement to be fully accurate, however. Research suggests that imposing sales taxes on health care services in addition to most other household services would increase the regressivity of the sales tax.

- services primarily purchased by businesses, such as payroll processing and television advertising;
- services primarily purchased by households, such as diaper service and cable TV; and
- services frequently purchased by both households and businesses, such as landscaping and pest control.

Economists generally counsel states to forgo taxing the first category of services, so-called "business-to-business" sales. They point out that taxing the goods and services businesses buy to use as inputs into the production of other goods and services often leads to "tax pyramiding." Tax pyramiding refers to the situation in which an input is taxed when purchased and then effectively taxed again when its cost is passed through into the price of a taxable good or service into which it has been incorporated. Tax pyramiding results in the actual sales tax imposed on a particular good or service bought by a household being higher than what is added at the cash register. Because the sales taxes imposed on inputs are hidden in the selling price of the item, states may tend to rely on this revenue source more than they otherwise would. Moreover, some research suggests that the hidden sales taxes are even more burdensome for low-income families than the visible sales tax that is imposed on the final sale, because necessities like food and utilities that often are tax-exempt nonetheless can have substantial sales taxes hidden in their prices.

Taxation of business inputs also tends to complicate sales tax administration. For example, rules need to be developed for taxing services like accounting that are purchased by businesses for company-wide use in multiple states.

The greatest concern of economists regarding sales taxation of services purchased by businesses is that it can distort the allocation of economic resources. Since services provided to an employer by an employee are rarely subject to sales tax, taxation of business-to-business sales of services can encourage businesses to provide services using their own employees even if they could be produced more efficiently by an independent firm. In addition, if purchases of services subject to sales tax are major cost items for a business (for example, data processing services for a financial institution), a more efficient business that tries to pass those taxes into its prices could lose business to a less efficient competitor located in another state that exempts those inputs from sales taxation. Alternatively, a business that makes substantial purchases of taxable services might choose to expand in a state that is sub-optimal from an economic efficiency standpoint but that exempts those services from sales tax.

While these arguments against taxing business purchases of services have merit, there are at least two countervailing considerations:

- State sales taxes already apply to numerous purchases of goods by businesses. Assuming that the concerns of economists about the distorting effect on resource allocation of taxing business inputs are valid, economic theory implies that the distortion grows as the tax rate increases. If the choice is between increasing the tax rate at which business-to-business sales of goods are taxed and taxing some business-to-business sales of services in order to hold down the tax rate, the latter could actually have a less adverse impact on the efficient allocation of resources.
- In an economy in which a growing number of people run their own businesses, exempting all

purchases of goods and services by businesses would open the door to substantial tax evasion. Business owners could claim that purchases of many services — such as telecommunications, hotel rentals, and auto and computer repair — were for business use when they were actually for personal use. Preventing this abuse would require that substantial additional resources for tax enforcement be provided to state tax departments. The costs of preventing tax evasion could exceed the economic benefits of exempting business inputs from taxation.

In broadening their states' taxation of services, policymakers generally have struck what arguably is a reasonable balance among the resource allocation issues raised by economists, their states' revenue needs, and practical tax enforcement considerations. States largely have avoided taxing services purchased almost exclusively by businesses (like advertising and accounting); instead, to the extent they have taxed services, states have targeted household services (like haircuts) or mixed household/business services (like landscaping). Where a particular industry has made a credible case that taxation of a service in the latter category has an adverse economic impact (for example, telecommunications purchased by a bank's "call center"), elected officials also have been willing to enact industry-specific exemptions. Such an approach may make more sense than an across-the-board exemption for all services that happen to be purchased by both businesses and households.

Even if states forgo taxing services that are predominantly purchased by businesses, there is a wide array of services to which the sales tax can be applied. Appendix I of this report lists over 200 types of services purchased by households or by both households and businesses, organized into 20 broad categories including personal care, home cleaning and maintenance, recreation and travel, and lawn and garden. As entrepreneurs perceive new profit-making opportunities, new services will continue to be invented. States can either implement taxation of services in a way that will incorporate newly emerging services or can monitor the evolution of the service sector and update their tax policies accordingly.

The Legal Mechanics of Imposing a Sales Tax on Services

Legislators can expand the taxation of services in two different ways. The comprehensive approach is to apply to services the typical language used to tax goods. Under most state sales tax laws, all sales of goods are taxable unless they are explicitly identified as exempt. Hawaii, New Mexico, and South Dakota apply this same treatment to sales of services. Hawaii and New Mexico adopted this approach from the inception of their sales taxes; South Dakota did so to expand the taxation of services well after the sales tax had been enacted.

The remaining states that tax services do so by specifically enumerating taxable services. The enumeration often can be found in the definition of a taxable "retail sale."

Each approach to taxing services has its own advantages and disadvantages. A key advantage of the comprehensive approach, for example, is that newly-developed services are immediately taxable without legislative action. This is appropriate given the role of the sales tax as a general tax on consumption. It also ensures that the revenue yield of the sales tax is maintained as new services displace old goods and services (for example, as downloading an update for a GPS device substitutes for buying a new road atlas).

The major disadvantage of the comprehensive approach to expanding the sales taxation of services is that it is likely to bring a large number of services into the sales tax base in one fell swoop. The services subjected to taxation are likely to include many business-to-business services that policymakers might not wish to tax because of the potentially adverse economic effects discussed previously. Moreover, state revenue departments may not be equipped to integrate numerous new services and the merchants selling them into their sales tax administration systems in a short period of time. These factors likely explain why all the states that have expanded their taxation of services in recent years did so incrementally, a few services at a time.

The greatest challenge facing legislators who choose to extend their state's sales tax to specifically-enumerated services is defining unambiguously the services they intend to tax. Many services are technologically complex and industry-specific, and legislators and their staffs cannot be expected to be business experts. Clear definitions are essential, however, because providers of a newly-taxed service often will look for every legal opportunity to avoid having to add a 4-10 percent sales tax to their prices. In a 2009 case, for example, a bank disputed New York's claim that an online credit scoring service to which it subscribed constituted a taxable information service rather than a tax-exempt consulting service. An explicit reference to credit-scoring services as taxable would have made it less likely that the bank would have brought the case.

A question often arises as to whether it is preferable to write the law to identify taxable services in broad terms (such as "fees for participant sports") or specifically (such as "admissions, equipment rental, and other fees for bowling, batting cages, skiing . . ."). The answer is that states would be well-advised to do both. ("Taxable sales include admission, equipment rental, and other fees for participant sports, which include but are not limited to bowling, batting cages, skiing. . . .") Broad definitions can serve as a good "backstop" for more specific listings that may inadvertently omit a particular service. A broad definition can also provide a basis for taxing a newly-invented service until such time as the legislature has an opportunity to identify it explicitly. Nonetheless, broad definitions are not sufficient to ensure taxability in the face of a taxpayer determined not to charge sales tax.

One promising approach to enumerating taxable services is to piggyback on standardized lists and definitions developed for other purposes. The North American Industry Classification System (successor to the well-known SIC system) and the North American Product Classification System (under development) could be referenced for sales taxation purposes.[5] South Dakota's sales tax statute already references SIC definitions, for example. In addition to taking advantage of careful definitional work, using NAICs or NAPCS to establish the state sales tax base could make it easier to gauge the revenue impact of taxing services; state-by-state data on the dollar volume of sales of services are already categorized by NAICS and will be further categorized by NAPCS beginning with the upcoming release of data from the 2007 economic census.

[5] Information about NAICS is available at www.census.gov/eos/www/naics/. Information about NAPCS is available at www.census.gov/eos/www/napcs/napcs.htm.

APPENDIX 1: POTENTIALLY - TAXABLE SERVICES

H = services primarily purchased by households
H/B = services commonly purchased by households and businesses

Lawn and garden-related services

H/B Landscaping and gardening
H/B Lawn care (chemical/fertilizer treatment)
H/B Lawn mowing
H/B Lawn installation (soil prep, seeding, sod)
H/B Tree and shrub care (incl. trimming and removal)
H/B Landscape architect services

Pet-related services

H/B Veterinary services (doctors, hospitals)
H Horse boarding and training
H Kennels
H Pet grooming
H Pet sitting/walking services
H Pet training (incl. classes)

Personal transportation and related services and rentals

H/B Charter bus/limo/plane/boat - short-term rentals and long-term leases (with or without driver/pilot/crew)
H/B Car/truck/van/motorcycle/RV/ATV/trailer - short-term rentals and long-term leases (incl. misc. charges)
H/B Bus/train/limo/subway tickets and fares (local, inter-, and intra-state)
H/B Airline tickets (for info. only; sales taxation barred by federal law)
H/B Taxi fares
H/B Personal chauffer services (separate from vehicle rental)
H/B Personal pilot services (separate from plane rental)
H Vehicle security monitoring services

Storage and moving services

H/B Auto storage (including fees for long-term garage and parking spaces)
H/B Parking garage fees (short-term)
H/B Personal plane hangaring/parking fees
H Marina services (docking/storage/seasonal removal, etc.)
H Household goods storage (including self-storage fees)
H Fur/clothing storage
H Household goods moving services
H Vehicle transport services (including drive-away)
H/B Delivery/shipping/handling charges (purchased goods)
H/B Packing/crating/shipping charges (outgoing shipping, e.g., gifts)
H Gift wrapping services
H/B Messenger/courier services (personal use)
H/B Private shipping/mailing charges (e.g., FedEx, UPS)
H House/mobile home moving services

Residential utility services

H Electricity
H Natural gas
H Water/Sewer

H Refuse removal/hauling/dumping

Telecommunications and related services (incl. monthly fees and one-time charges)

H/B Local telephone service
H/B Interstate/international telephone service (including calling plan fees)
H/B Mobile telephone service (incl. monthly fees, airtime charges, roaming charges, long-distance charges)
H/B Paging service
H/B Caller ID, call forwarding, voice mail, 3-way/conference calling, and similar enhanced phone services
H/B Internet access service
H/B Faxing services
H/B DSL/ISDN service
H Prepaid telephone calling cards
H/B Voice over Internet protocol (VOIP) telephone service

Financial and insurance services

H/B Service charges of banking institutions (miscellaneous)
H/B Safe deposit box rental charges
H Bill paying services (fee and commission)
H Investment counseling/financial planning/portfolio management
H/B Mutual fund management fees
H/B Credit and debit card fees (incl. annual membership and usage fees)
H/B Stock brokerage fees/commissions
H/B Insurance services (life, real property, auto, etc.)
H/B Imputed brokerage service value of loans and deposits in depository institutions
H Fees/commissions for check cashing, money orders, traveler's checks, money wiring

Personal care services

H Hair care
H Hair removal
H Nail care
H Day spa services (facials, makeovers, etc.)
H Massage services
H Tanning parlors
H Weight loss salons and counseling
H Tattoo and piercing services

Miscellaneous personal services

H Dating services
H Personals advertising
H Miscellaneous advertising for personal purposes (e.g., items for sale, positions wanted)
H Household errand/"personal shopper"/gift consulting/management consulting services
H Child day care services
H Adult day care services
H Baby-sitting services (casual)
H/B Photocopying/printing services
H Taxidermy services
H Custom butchering services
H/B Bodyguard services
H Escort services

Home cleaning and maintenance services

H General house cleaning services

H/B	Carpet cleaning services
H/B	Window cleaning services
H/B	Floor cleaning services
H/B	Upholstery/furniture cleaning services
H	Swimming pool/hot tub cleaning and maintenance services
H	Septic maintenance services
	Ductwork cleaning services
H	Gutter cleaning services
H/B	Snow removal services
H	Chimney cleaning services
H/B	HVAC maintenance services
H	Radon and other home environmental testing services
H/B	Pest control services
H	Condominium/co-op maintenance fees
H	Water softening/conditioning services
H/B	Interior decorating and design services
H	Home security system consulting, installation, and monitoring
H	Closet/storage design consulting services

Clothing-related services

H	Diaper service
H	Laundry and dry cleaning and pressing services, coin-operated
H	Laundry and dry cleaning and pressing services, non-coin-operated
H	Shoe repair
H	Shoe shining and dyeing
H	Alterations, repairs, dyeing, and imprinting of clothing and accessories
H	Original tailoring of clothing
H	Jewelry repair/cleaning/custom design and fabrication

Education-related services

H	Personal instruction (formal classes and one-on-one; see separate list for examples)
H	School and university tuition, room and board charges, student fees
H	College and private school admission and financial aid counseling
H	Test preparation classes
H	Private tutoring services
H	Private testing services
H	Summer camp tuition and fees

Miscellaneous professional services

H	Funeral and related services
H/B	Accounting/tax preparation
H/B	Legal services (wills, estate planning, accident defense, etc.)
H/B	Notary services
H/B	Private investigator services
H/B	Computer consulting/trouble-shooting/data restoration services
H	Personal property appraisal services
H	Art conservation/restoration services to individuals
H	Art/antique collecting advisory and brokerage services
H	Commissions on auction purchases/sales (brokerage service)
H	Career counseling and resume preparation services
H	Debt counseling services
H/B	Commercial art, graphic design, calligraphy, printing services (e.g., resume and invitations)

H	Personal/professional coaching services
	Admissions/amusements/recreation/travel-related services
H	Pari-mutuel racing events
H	Amusement parks and fairs — admissions, rides, and games
H	Admission charges/fees for participant sporting/game facilities (see separate list)
H	Coin-operated mechanical amusements (video games, pinball, karaoke, etc.)
H	Admissions to school and college sports events (incl. season tickets, "skybox" rentals, etc.)
H	Admissions to professional sports events (incl. season tickets, "skybox" rentals, etc.)
H	Admissions to movies
H	Admissions to cultural events/venues (see separate list)
H	Admissions to boat, car, computer, craft, etc. shows
H	Lottery tickets
H	Other gambling admission and misc. charges
H	Health club memberships and fees
H	Recreational/scenic transportation (see separate list)
H	Memberships (dues, initiation fees, etc.) in sporting clubs and teams (tennis, golf, swimming, baseball, etc.)
H	Memberships (dues, initiation fees, etc.) in book and music clubs
H	Misc. memberships (dues, initiation fees, etc.) in sororities, neighborhood assns., social clubs, AARP, etc.
H	Memberships in buying clubs and coops (e.g., Costco)
H	Cable/satellite/Internet TV and radio (monthly, pay-per-view, installation, and misc. fees)
H	Ticket broker services
H	Fees for online gaming, entertain. and info. services and downloadable "digital goods"(see separate list)
H	900 number telephone information and entertainment services
H	Services of DJs, musical performers/bands, dancers, other performers for adults
H	Services of children's performers (clowns, magicians, entertainers, puppeteers, storytellers, etc.)
H	Psychic/fortune teller/astrologer services
H	Admission fees/cover charges for nightclubs and bars
H/B	Services of photographer/videographers (studios and traveling)
H/B	Photo finishing
H	Media conversion services (e.g., videotape to DVD)
H/B	Wedding/party/event planning services
H/B	Catering services
H/B	Services of private party waiters, bartenders, etc.
H/B	Hotel/motel/inn/cabin room rentals
H	Complimentary meals and hotel rooms at gambling casinos
H	Campground and RV park rental charges
H/B	Services of travel agents (fees and commissions)
H	Services of tour operators (fees and commissions)
H/B	Reservation services
H	Services of waiters compensated through tips
H	Served meals/prepared foods (restaurants, takeout, street vendors, etc.)
	Personal property leases and rentals (other than vehicles)
H	Musical instruments
H	Sporting goods (skis, bicycles, camping equipment, etc.)
H/B	Hand and power tools
H/B	Gardening tools and equipment
H	Tables/chairs/dishes/party-related equipment and appliances
H	Dance floors, party tents, "moon bounces," etc.
H	Furniture, appliances, home electronics
H/B	Computers and peripherals

H Miscellaneous personal property rentals
H Luggage cart rentals at public transit facilities
H Tuxedo/clothing/uniform/costume rentals
H Video tape/DVD/video game rentals
H VCR/DVD/video game equipment rentals

Misc. repair/installation/fabrication services (other than residences, vehicles, & clothing)

H Furniture and upholstery repair and refinishing
H Appliance repair (kitchen, laundry, vacuum, etc.)
H Home entertainment equipment repair
H Sporting goods repair (e.g., racket re-stringing, bike, gun repair)
H/B Computer repair, hardware upgrading, maintenance
H Camera and video equipment repair
H Musical instrument repair
H Piano tuning
H Sharpening services
H Watch/clock repair
H Picture/artwork framing
H Product assembly/installation services (e.g., furniture, jungle gyms, gas grills, computers, stereo systems)
H Service/extended warranty contracts on personal property
H Custom fabrication services (furniture, cabinets, shelving, window treatments, pillows, sporting goods, etc.)

Medical and related services

H Services of doctors and dentists
H Home nursing services
H Medical testing services
H Psychologist/social work/counseling services
H Optometrists
H Nutritionists/dieticians
H Occupational/physical/massage/speech therapy
H Alternative medicine practitioners (e.g., acupuncture, chiropractors)
H Hospital services
H Nursing home services
H Specialized facilities (substance abuse, hospice, dialysis, etc.)
H Nursing home/elder care consultants
H Rent/fees for assisted living facilities
H Rental of medical equipment for home use

Vehicle repair and maintenance services

H/B Auto/motorcycle/RV/ATV repair and maintenance services (engine, transmission, body, tire, etc.)
H/B Boat repair and maintenance services
H/B Airplane repair and maintenance services
H/B Auto/boat/plane cleaning and waxing services
H/B Auto washing and waxing (coin op)
H/B Auto and boat road service, towing, and removal and disposal of wrecked vehicles
H/B Auto/boat/plane rust-proofing, painting, other exterior maintenance and customization
H Car audio installation and repair
H/B Auto locksmith services

Residential construction/renovation/repair services

H Locksmith services
H Architectural services

H Consulting engineer services
H Gross charges of a general contractor for labor or for total job
H Skilled trades services (original construction, renovation, and repair; see separate list)
H Basement waterproofing services
H Floor refinishing
H Site excavation and grading
H Well drilling and maintenance
H Rental of construction equipment

Housing and real estate-related services

H Real estate agent fees/commissions (buyers' and sellers' agents)
H Real estate title search services
H Real estate appraisal services
H Real estate surveying services
H Real estate inspection services
H Real estate advertising
H Escrow agent services
H Apartment search and roommate matching services
H Loan "points," lock-in fees, other loan-origination fees
H Residential rentals
H Trailer park site rentals

Examples of personal instruction (formal classes and one-on-one)

- Musical instruments/voice
- Dance
- Yoga, aerobics, etc.
- Personal trainers
- Ceramics/painting/sculpture/crafts
- Cooking
- Woodworking
- Auto repair
- Driving
- Sailing
- Flying
- Sports (e.g., golf, tennis, fencing, martial arts)
- Computer and computer software use
- Misc. adult-education-type courses (investing, retirement planning, public speaking, travel, etc.)

Examples of cultural events/venues for which admission might be charged

- Theater, music, dance, ice show, circus, etc. performances
- Museums (public and private)
- Historic houses and gardens
- Natural sites and parks
- Guided tours/walks

Examples of participant sports/game facilities/services for which admission fees may be charged

- Golf (courses, driving ranges, miniature)
- Batting cages
- Climbing walls
- Skating rinks
- Shooting ranges
- Horse stables/pony rides
- River rafting
- Tennis courts
- Squash and raquetball courts
- Bungee-jumping
- Ski lifts
- Swimming pools
- Sky diving
- Parasailing
- Fishing charter boats
- Services of hunting/fishing/climbing guides
- Bowling alleys
- Billiard parlors

- Laser tag
- Paintball
- Go-carts

Examples of recreational/sight-seeing transportation

- Train rides
- Boat rides
- Chair lifts/gondolas
- Bus/limo/van/jeep rides
- Dinner cruises
- Helicopter, balloon, plane, glider rides

Examples of online entertainment and information services

- Online gaming services
- Online music access services
- Downloadable music and video
- Adult content sites
- Gambling sites
- Online newspaper and magazine subscriptions and archives
- Online databases and information (financial, current stock prices, genealogy, etc.)
- Downloadable software
- Downloadable articles (pay-per-view)

Examples of skilled residential construction/renovation/repair services

- Carpentry
- Painting/staining/deck treatment, etc.
- Wallpapering
- Plumbing
- Drywall/plaster
- Masonry/cement/stucco/driveway
- Roofing
- Electrical
- Heating and air conditioning
- Flooring installation
- Custom cabinetry making/installation
- Swimming pool
- Fencing
- Tile/marble/countertops

The Taxation of Services: A Case Study of Other States

Prepared by the Finance Team

Presented by:
Cindy Avrette, Research Division
Sandra Johnson, Fiscal Research Division

December 1, 2009

Overview

- Which services are most commonly taxed by other states?
- What are other states' experiences with expanding the sales tax base to services?
- What is the states' sales tax revenue as a percentage of their total revenues?
- How does inclusion of services in the sales tax base affect sales tax volatility?

Services Taxed by Other States

- Federation of Tax Administrators
  - Lists over 100 services
  - Divided into 16 categories
  - 1996, 2004, and 2007
- Michael Mazerov Study
  - Lists over 200 services
  - Divided into 20 categories
- Caveats
  - Lists meant as examples of possible services to tax
  - No model legislation
  - Similar services listed under two or more categories, eg, repair services
  - Services listed that taxed in ways other than through sales tax

Federation of Tax Administrators Types of Services, 2007

Service Group	Number of Taxable Services
• Agricultural	5
• Industrial and mining	4
• Construction	4
• Utilities	16
• Transportation	9
• Storage	6
• Finance, insurance, and real estate	8

Federation of Tax Administrators Types of Services, 2007

Service Group	Number of Taxable Services
• Personal	20
• Business	34
• Computer	8
• Automotive	5
• Admissions and amusements	15
• Professional	9



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

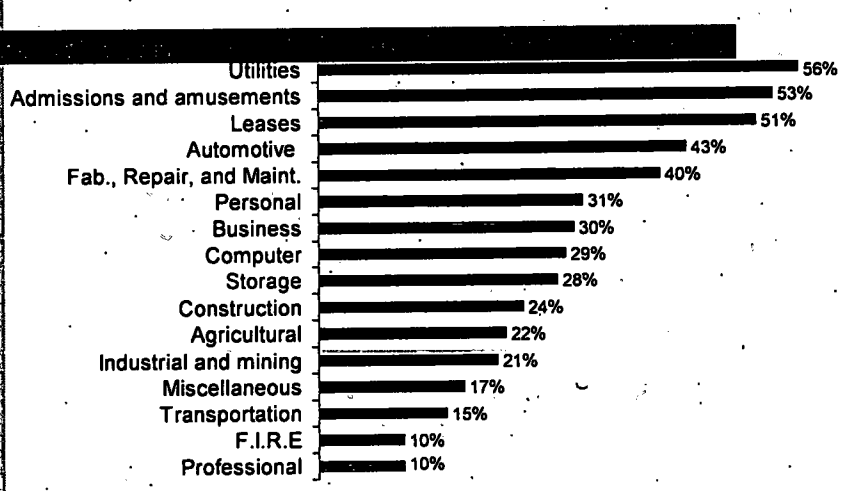
Federation of Tax Administrators Types of Services, 2007

Service Group	Number of Taxable Services
• Leases	4
• Fabrication, installation and repair	19
• Miscellaneous	2
Total Number of Taxable Services	168



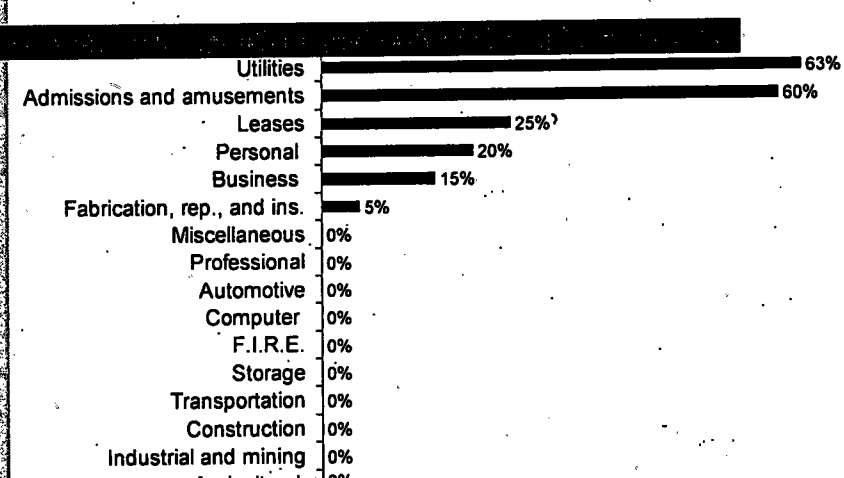
STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Taxation of Services, by State, 2007



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

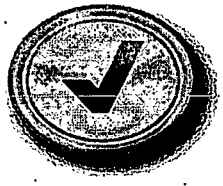
Taxation of Services, NC, 2007



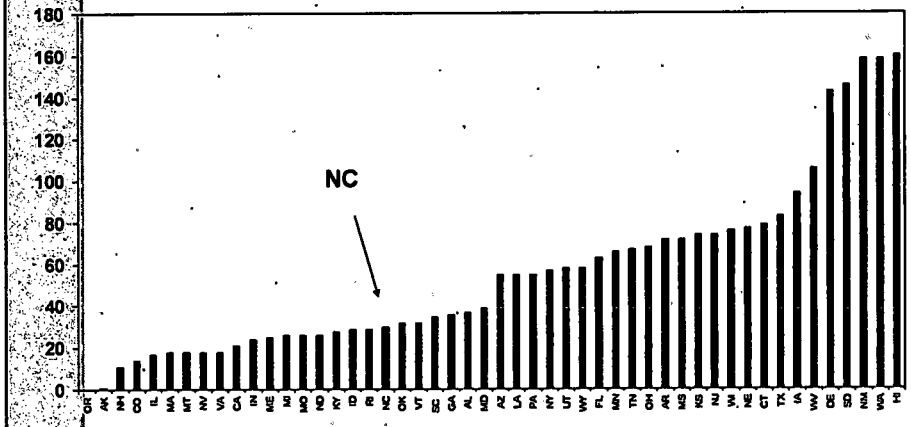
STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Case Studies of Selected States

- States taxing 100+ services
- States taxing 60-100 services
- States w/ recent action
- Neighboring states



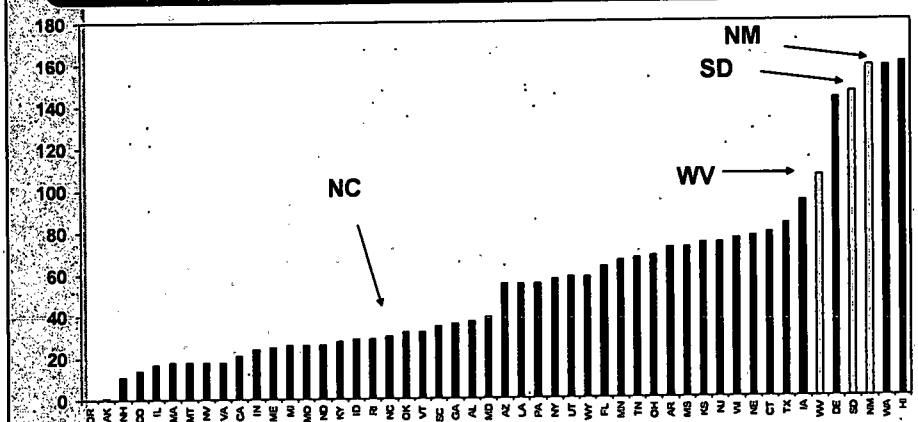
Taxation of Services, by State 2007



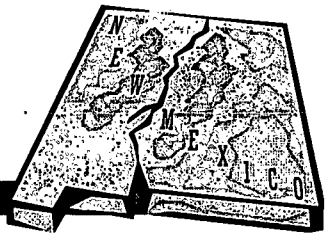
North Carolina

- State rate 5.75%
- Highest combined rate 8.25%
- FTA services in base 35
- FTA services taxed
  - Utilities
  - Leases and rentals
  - Admissions and amusements
  - Digital downloads (enacted 2009, effective 2010)

Taxation of Services, States w/ 100+ Services, 2007

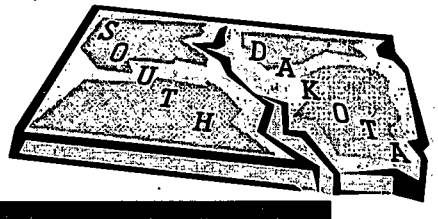


New Mexico



- State rate 5.0%
- Highest combined rate 7.925%
- FTA services in base 158
- Sales tax enacted in 1935 included services unless specifically exempt
- Comprehensive approach

South Dakota



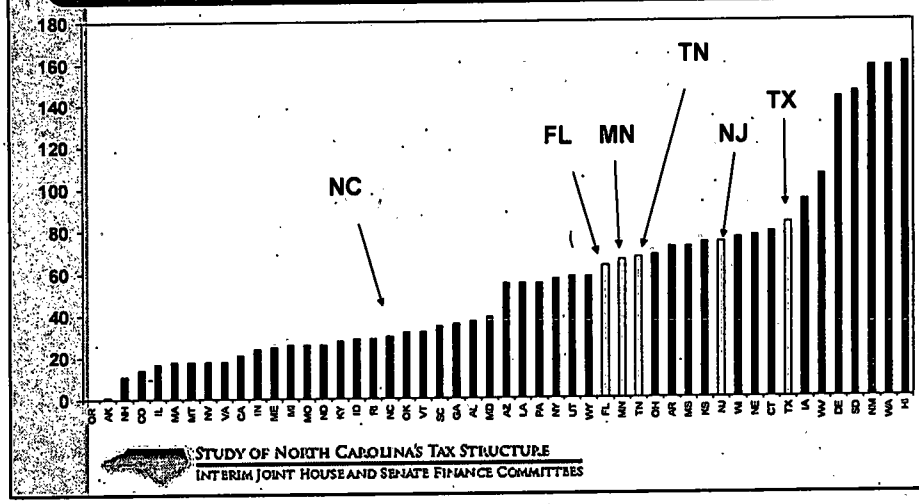
- State tax rate 4.0%
- Highest combined rate 6.0%
- FTA services in base 146
- Services added to base in 1979
- Rate reduced when services added? No

West Virginia

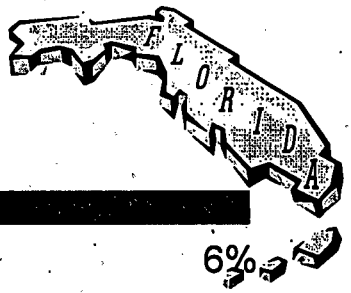


- State tax rate 6.0%
- No local rate
- FTA services in base 105
- Tax all services except professional and personal services
- 2006 Tax Modernization Project and 2009 Tax Modernization Project
  - Reduce sales tax on food to 3%
  - Emphasis on business taxes, PIT, and property tax

Taxation of Services, States w/ 60-100 Services, 2007

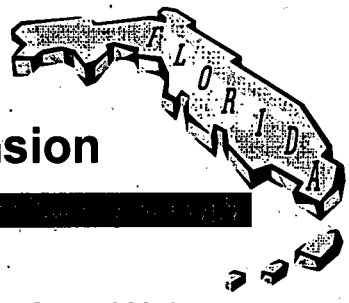


Florida



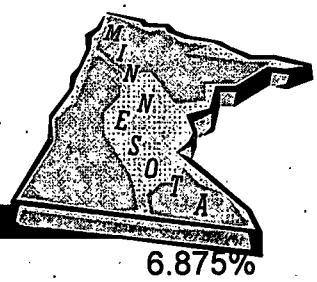
- State rate 6%
- Highest combined tax rate 7.5%
- FTA services in base 63
- Rate reduced when services added? No
- Main differences from NC in services
  - Installation, repairs, and warranties
  - Admissions, including some membership fees
  - Storage, nonresidential cleaning, pest control

Florida – 1987 Expansion



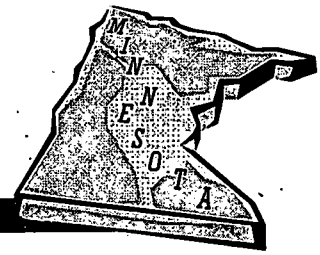
- Broad-based effort
- Based on recommendation from Walter Hellerstein
- Enacted, then repealed 6 months later and replaced with 1 cent tax increase
- Advertisers were vocal opponents and ran TV and other ads opposed to the tax

Minnesota



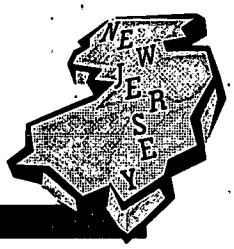
- State tax rate 6.875%
- Highest combined tax rate 7.875%
- FTA services in base 66
- Rate reduced when services added? No
- Main differences from NC in services
  - Installation
  - Admissions, including some membership fees
  - Pet grooming & landscaping services
  - Nonresidential maintenance, janitorial services, pest control
  - Automotive cleaning and maintenance, parking
  - Security, alarm services, detective services

Minnesota



- Sales tax enacted in 1967
- Most of the services added in 1987
- Installation and delivery charges added in 2001
- Proposed expansion to professional services in 2001 failed
- Proposed expansion to professional services, sewer services, and repair services in 2007 failed

New Jersey



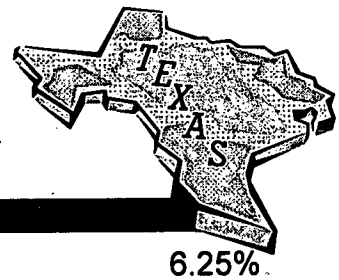
- State Rate 6%
- No local rate
- FTA Services in Base 74
- Rate reduced when services added? No
- Main differences from NC in services
  - Installation, repairs, and warranties
  - Admissions, including some membership fees
  - Automotive cleaning and maintenance, parking
  - Landscaping, pet grooming, storage, security services

Tennessee



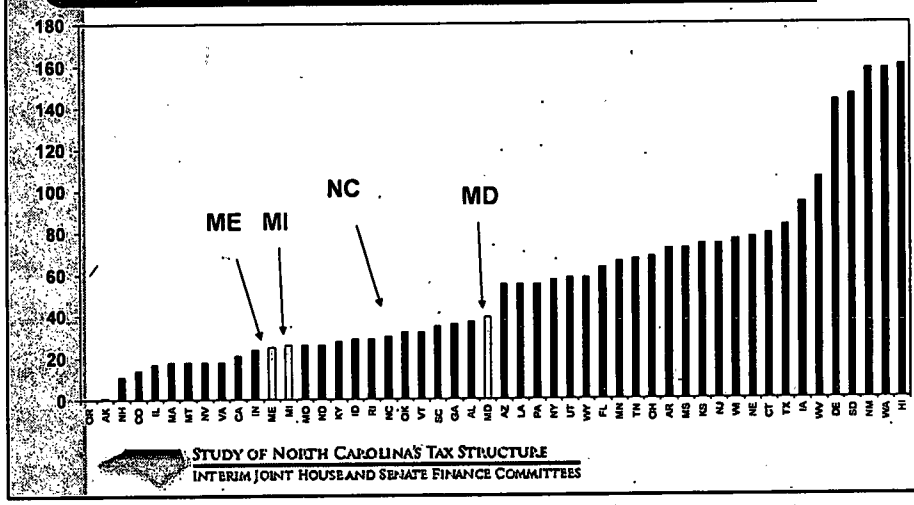
- State Rate 7%
- Highest combined rate 9.75%
- FTA Services in Base 67
- Rate reduced when services added? No
- Main differences from NC in services
  - Installation, repairs, and warranties
  - Admissions, including some membership fees
  - Automotive cleaning and maintenance, parking

Texas



- State tax rate 6.25%
- Highest combined tax rate 8.25%
- FTA services in base 83
- Rate reduced when services added? No
- Main differences from NC in services
  - Installation, repairs, and warranties
  - Admission, including some membership fees
  - Construction services, including contractors & trades
  - Information services, security services
  - Maintenance and janitorial services, landscaping

Taxation of Services, States w/ Recent Action, 2007

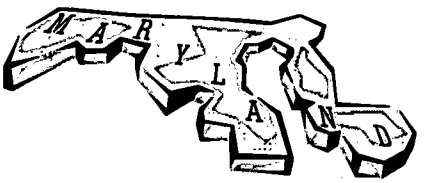


Maine



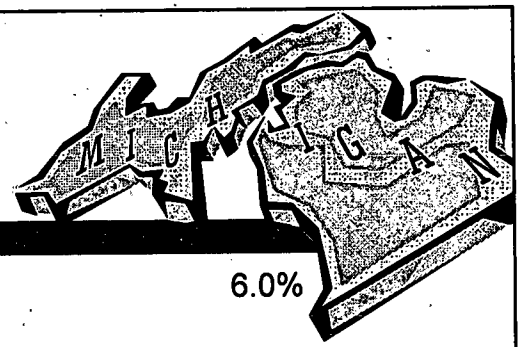
- State tax rate 5.0%
- No local rate
- FTA services in base
- Rate reduced when services added? No
- Main differences from NC in services
  - Installation, repairs, and warranties
  - Pet grooming; storage; admissions; auto repairs
- Limited nonprofit sales tax exemption

Maryland



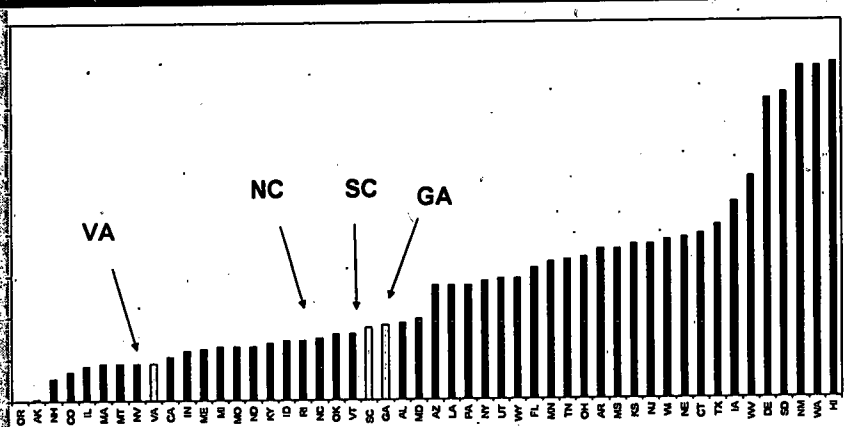
- State tax rate 6.0%
- No local rate
- FTA services included in base 37
- Rate reduced when services added? No
- Expanded sales tax base to some services in 1990s
- Main differences from NC in services
  - Maintenance and janitorial services
  - Security services, detective services
- Reform efforts in 2007 failed

Michigan

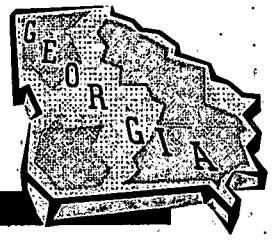


- State tax rate 6.0%
- No local rate
- FTA services in base 26
- Tax rate reduced when services added? No
- Expanded base to include 23 services in 2007
- Tax repealed within 2 hours of becoming law
  - Enacted a permanent 22% surtax on new MI business tax

Taxation of Services, Surrounding States, 2007

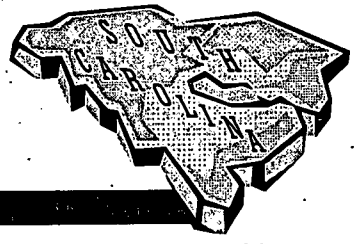


Georgia



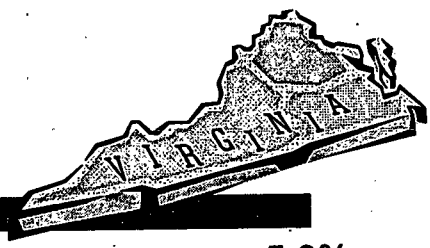
- State tax rate 4.0%
- Highest combined tax rate 7.0%
- FTA services in base 36
- Main differences from NC in services
  - Transportation services
- 2007 G.R.E.A.T. Plan failed
  - Eliminate all state and local property taxes
  - $980 million from taxing all services taxed by more than 10 states OR $1.3 billion from eliminating sales tax exemptions

South Carolina



- State tax rate 6.0%
- Highest combined tax rate 8.0%
- FTA services in base 34
- Main differences from NC in services
  - Warranties
  - Admissions, some membership fees
  - Health clubs, tanning parlors
- SC Tax Realignment Commission (TRAC)

Virginia

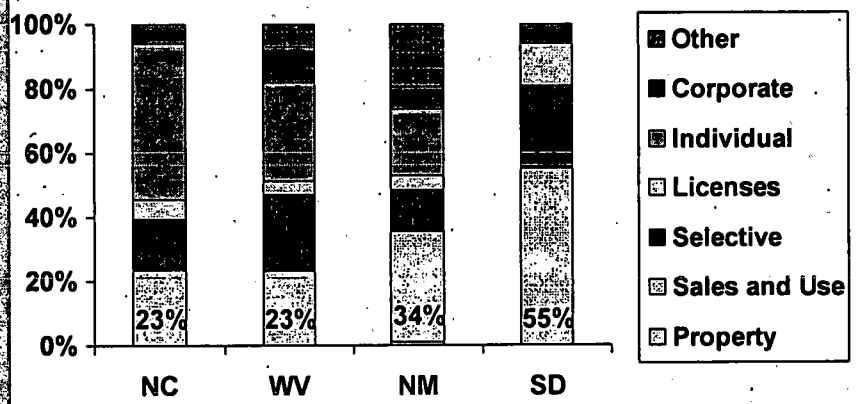


- State rate 5.0%
- Highest combined tax rate 7.0%
- FTA services in base 18
- Main differences from NC in services
  - Warranties
- No significant expansion of base in years
- No attempts to expand sales tax base to services; loosely discussed as an option

Sales Tax as a Percentage of GF Revenues

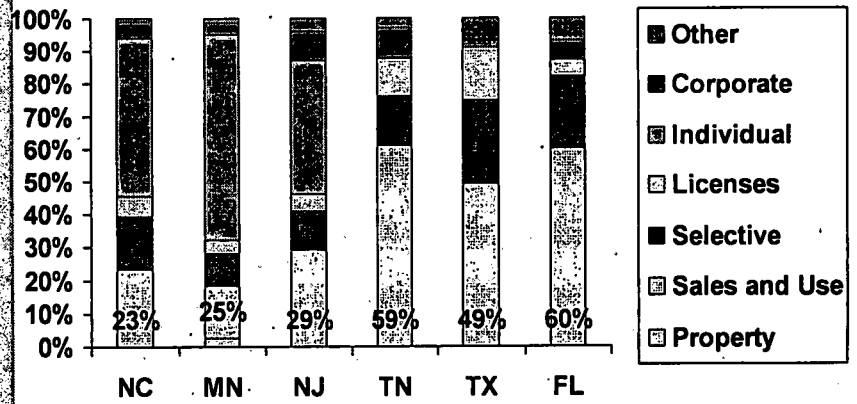
- Most Eastern seaboard states have tax structures similar to NC
- Southern states gradually adding services to tax base, lack personal income taxes

Tax Structure, States w/ 100+ Services, FY 2007-08



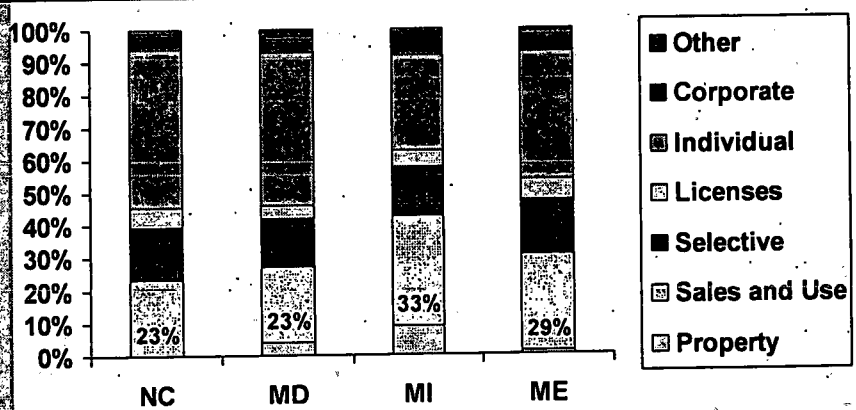
STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Tax Structure, States w/ 60-100 Services, FY 2007-08



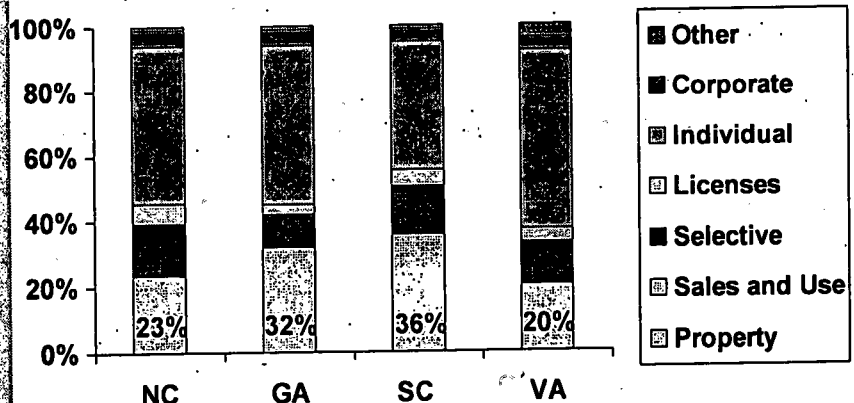
STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Tax Structure, States w/ Recent Action, FY 2007-08



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Tax Structures, Surrounding States, FY 2007-08



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Sales Tax Stability and Growth

- Sales tax bases dominated by purchases of 'big-ticket' durable goods
- Limited research finds that purchases of some services less volatile
- Empirical research on this question has produced mixed results, but on balance suggests that expansion of base to services may moderate slightly sales tax volatility

Stability and Growth of Sales Tax

- **Stability measures year to year changes**
- **Growth measures long term changes**
- **More information on methodology:**
  - Felix, Alison. "The Growth and Volatility of State Tax Revenue Sources in the Tenth District." Federal Reserve Bank of Kansas City Economic Review. 3rd Quarter 2008.

Stability and Growth of Sales Tax

- **Measuring Stability** – short-term changes from economic variability*:

$$S = \frac{\text{change in growth of sales tax}}{\text{change in growth of income}}$$

if S > 1 sales tax more volatile than income

if S < 1 sales tax less volatile than income

*regression equation: $\Delta \ln(\text{sales tax}) = \alpha + S^* \Delta \ln(\text{income}) + \gamma^* \Delta(\text{tax rate}) + c^* \text{food}$



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Stability and Growth of Sales Tax

- **Measuring Growth** – long-run responsiveness (elasticity)*:

$$G = \frac{\%\text{ change sales tax revenue}}{\%\text{ change in income}}$$

if G > 1 sales tax grows faster than income

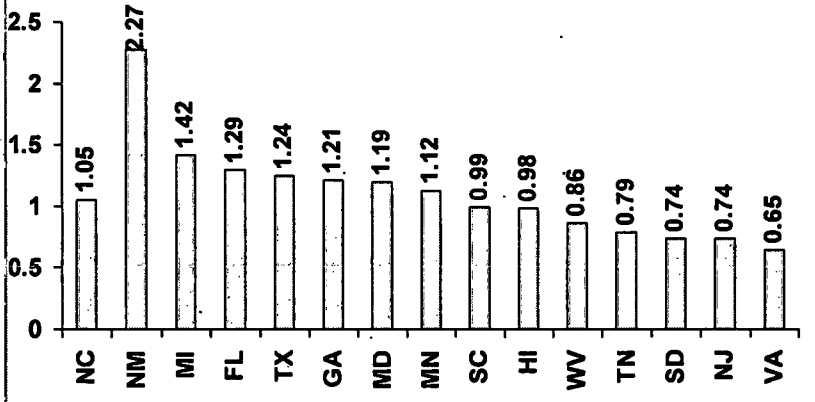
if G < 1 sales tax slower than income

*reg. equation: d [ln (salestx)]=a+S*d [ln (personal income)]+ b*d [tax rate] +c*food



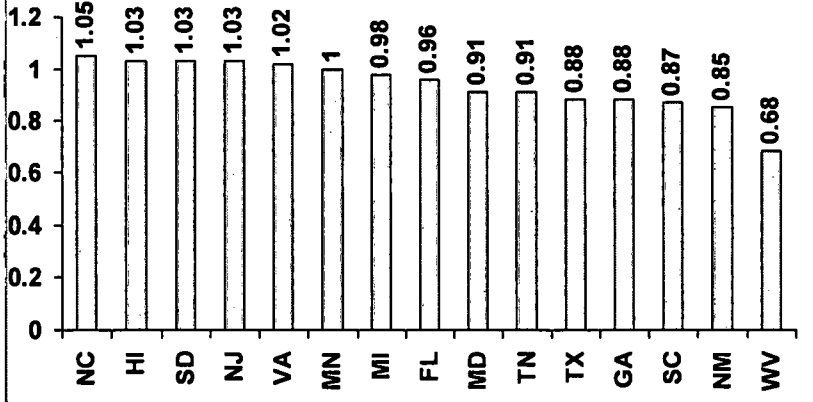
STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Stability of Sales Tax, 1977-2006



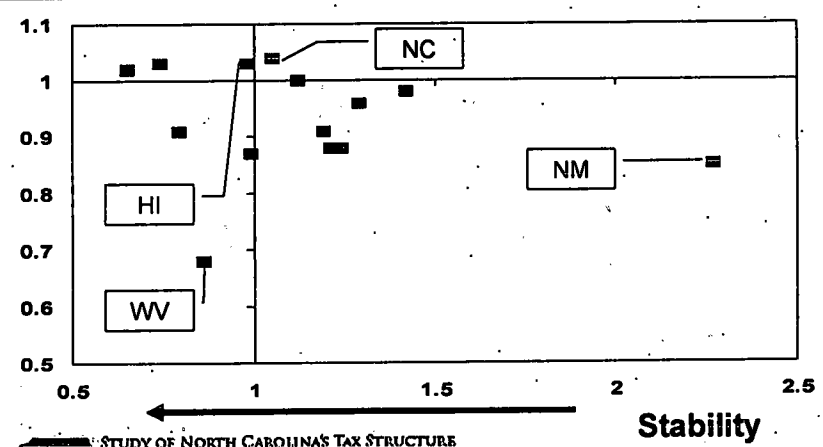
STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Growth of Sales Tax, 1977-2006



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Stability and Growth of Sales Tax



Conclusion

- Many states tax more services than NC
- Most commonly taxed services that are not currently taxed by NC
  - Repairs, installation, warranties
  - Amusements and entertainment
  - Automotive cleaning & maintenance services, storage
- States that tax more services tend to have more sales tax stability
- NC's combined tax rate high for a state that also taxes income

Federation of Tax Administrators
Survey of Services

		Current NC law	Other States
	Agricultural Services		
1	Soil prep., custom baling, other ag. services	E	4
2	Veterinary services (both large and small animal)	E	5
3	Horse boarding and training (not race horses)	E	9
4	Pet grooming	E	18
5	Landscaping services (including lawn care)	E	21
	Industrial and Mining Services		
6	Metal, non-metal and coal mining services	E	5
7	Seismograph & Geophysical Services	E	6
8	Oil Field Services	E	11
9	Typesetting service; platemaking for the print trade	E	21
	Construction		
10	Gross Income of Construction Contractors	E	12
11	Carpentry, painting, plumbing and similar trades.	E	13
12	Construction service (grading, excavating, etc.)	E	12
13	Water well drilling	E	10
	Transportation Services		
14	Income from intrastate transportation of persons	E	11
15	Local transit (intra-city) buses	E	5
16	Income from taxi operations	E	8
17	Intrastate courier service	E	8
18	Interstate air courier (billed in-state)	E	1
	Storage		
19	Automotive storage	E	18
20	Food storage	E	9
21	Fur storage	E	15
22	Household goods storage	E	12
23	Mini -storage	E	13
24	Cold storage	E	12
25	Marina Service (docking, storage, cleaning, repair)	E	17
26	Marine towing service (incl. tugboats)	E	8
27	Travel agent services	E	4
28	Packing and crating	E	10
	Utility Service - Industrial Use		
29	Intrastate telephone & telegraph	T	42
30	Interstate telephone & telegraph	T	27
31	Cellular telephone services	T	42
32	Electricity	T	36
33	Water	E	18
34	Natural gas	E	37
35	Other fuel (including heating oil)	T	38
36	Sewer and refuse, industrial	E	14

	Utility Service - Residential Use		
37	Intrastate telephone & telegraph	T	40
38	Interstate telephone & telegraph	T	27
39	Cellular telephone services	T	43
40	Electricity	T	22
41	Water	E	12
42	Natural gas	E	22
43	Other fuel (including heating oil)	T	23
44	Sewer and refuse, residential	E	10
	Finance, Insurance and Real Estate		
45	Service charges of banking institutions	E	3
46	Insurance services	E	6
47	Investment counseling	E	6
48	Loan broker fees	E	3
49	Property sales agents (real estate or personal)	E	5
50	Real estate management fees (rental agents)	E	5
51	Real estate title abstract services	E	5
52	Tickertape reporting (financial reporting)	E	8
	Services		
	Personal Services		
53	Barber shops and beauty parlors	E	7
54	Carpet and upholstery cleaning	E	19
55	Dating services	E	8
56	Debt counseling	E	7
57	Diaper service	T	23
58	Income from funeral services	E	14
59	Fishing and hunting guide services	E	11
60	Garment services (altering & repairing)	E	20
61	Gift and package wrapping service	E	21
62	Health clubs, tanning parlors, reducing salons	E	22
63	Laundry and dry cleaning services, coin-op	E	6
64	Laundry and dry cleaning services, non-coin op	T	22
65	Massage services	E	11
66	900 Number services	T	29
67	Personal instruction (dance, golf, tennis, etc.)	E	6
68	Shoe repair	E	20
69	Swimming pool cleaning & maintenance	E	17
70	Tax return preparation	E	6
71	Tuxedo rental	T	38
72	Water softening and conditioning	E	13
	Business Services		
	Sales of advertising time or space:		
73	Billboards	E	4
74	Radio & television, national advertising	E	2
75	Radio & television, local advertising	E	4
76	Newspaper	E	4
77	Magazine	E	4
78	Advertising agency fees (not ad placement)	E	11

	Business Services (continued)		
79	Armored car services	E	16
80	Bail bond fees	E	4
81	Check & debt collection	E	8
82	Commercial art and graphic design.	TT	23
83	Commercial linen supply	T	32
84	Credit information, credit bureaus	E	13
85	Employment agencies	E	11
86	Interior design and decorating	E	10
87	Maintenance and janitorial services	E	19
88	Lobbying and consulting	E	7
89	Marketing	E	6
90	Packing and crating	E	11
91	Exterminating (includes termite services)	E	20
92	Photocopying services	T	43
93	Photo finishing	T	43
94	Printing	T	44
95	Private investigation (detective) services	E	16
96	Process server fees	E	6
97	Public relations, management consulting	E	7
98	Secretarial and court reporting services	E	8
99	Security services	E	18
100	Sign construction and installation	E	32
101	Telemarketing services on contract	E	6
102	Telephone answering service	E	20
103	Temporary help agencies	E	9
104	Test laboratories (excluding medical)	E	8
105	Tire recapping and repairing	E	28
106	Window cleaning	E	19
	Computer:		
107	Software - package or canned program	T	46
108	Software - modifications to canned program	E	28
109	Software - custom programs - material	E	24
110	Software - custom programs - professional serv.	E	14
111	Internet Service Providers-Dialup	E	9
112	Internet Service Providers-DSL or other broadband	E	11
113	Information services	E	14
114	Data processing services	E	10
115	Mainframe computer access and processing serv.	E	11
	Computer Online Services:		
116	Online Data processing services	E	7
117	Software - Downloaded	T	28
118	Books - Downloaded	T	15
119	Music - Downloaded	T	15
120	Movies/Digital Video - Downloaded	T	16
121	Other Electronic Goods - Downloaded	T	14

	Automotive Services		
122	Automotive washing and waxing.	E	21
123	Automotive road service and towing services	E	19
124	Auto service. except repairs, incl. painting & lube	E	25
125	Parking lots & garages	E	21
126	Automotive rustproofing & undercoating.	E	25
	Admissions & Amusements		
127	Pari-mutuel racing events.	T	28
128	Amusement park admission & rides	T	36
129	Billiard parlors	T	27
130	Bowling alleys	E	27
131	Cable TV services	T	26
132	Direct Satellite TV	T	24
133	Circuses and fairs -- admission and games	T	34
134	Coin operated video games	E	17
135	Admission to school and college sports events	T	23
136	Membership fees in private clubs.	E	23
137	Admission to cultural events	T	31
138	Pinball and other mechanical amusements	E	19
139	Admission to professional sports events	T	37
140	Rental of films and tapes by theaters	E	7
141	Rental of video tapes for home viewing	T	44
	Professional Services		
142	Accounting and bookkeeping	E	5
143	Architects	E	5
144	Attorneys	E	5
145	Dentists	E	4
146	Engineers	E	5
147	Land surveying	E	7
148	Medical test laboratories	E	4
149	Nursing services out-of-hospital	E	4
150	Physicians	E	4
	Leases and Rentals		
151	Personal property, short term (generally)	T	44
152	Personal property, long term (generally)	T	44
153	Bulldozers, draglines and const. mach., short term	T	44
154	Bulldozers, draglines and const. mach., long term	T	44
155	Rental of hand tools to licensed contractors.	T	44
156	Short term automobile rental	T	47
157	Long term automobile lease	T	39
158	Limousine service (with driver)	E	16
159	Aircraft rental to individual pilots, short term	T	39
160	Aircraft rental to individual pilots, long term	T	38
161	Chartered flights (with pilot)	E	9
162	Hotels, motels, lodging houses	T	46
163	Trailer parks - overnight	E	26

	Fabrication, Installation and Repair Services		
164	Custom fabrication labor	T	38
165	Repair material, generally	T	46
166	Repair labor, generally	E	24
167	Labor charges on repair of aircraft	E	16
168	Labor charges - repairs to interstate vessels	E	11
169	Labor charges - repairs to intrastate vessels	E	20
170	Labor - repairs to commercial fishing vessels	E	15
171	Labor charges on repairs to railroad rolling stock	E	11
172	Labor charges on repairs to motor vehicles	E	21
173	Labor on radio/TV repairs; other electronic equip.	E	24
174	Labor charges - repairs other tangible property	E	24
175	Labor - repairs or remodeling of real property	E	15
176	Labor charges on repairs delivered under warranty	E	5
177	Service contracts sold at the time of sale of TPP.	E	31
178	Installation charges by persons selling property	E	22
179	Installation charges - other than seller of goods	E	18
180	Custom processing (on customer's property)	E	26
181	Custom meat slaughtering, cutting and wrapping	E	14
182	Taxidermy	E	26
183	Welding labor (fabrication and repair)	E	30
184	Other	E	

	Totals	
5	Agricultural Services	0
4	Industrial and mining services	0
4	Construction	0
16	Utilities	10
9	Transportation	0
6	Storage	0
8	F.I.R.E.	0
20	Personal services	4
34	Business services	5
8	Computer services	5
5	Automotive services	0
15	Admissions and amusements	9
9	Professional services	0
4	Leases	1
19	Fabrication, repair and installation	1
0	Miscellaneous	0
166	**Non-exempt entries**	35

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JOINT CAUCUS PRESS RELEASE

FOR IMMEDIATE RELEASE -- December 1, 2009 --

Proposed Principles for Job Creation through Tax and Spending Reform

Raleigh – The Interim Joint Finance Committee convenes today to continue its consideration of proposals to reform North Carolina's tax structure. Republican members of the House and Senate Finance Committees released their outline for tax reform proposals to provide renewed vitality to job creation.

1. The concept of substantially reducing personal and corporate income tax rates and sales tax rates is good. If that reduction is accomplished by broadening the base in a revenue neutral way, that is the right way to go. But it raises four major issues.

2. Neither the public nor Republicans trust Democrats to keep the rates low. There must be a mechanism to ensure this. Two possibilities:
   a) A Constitutional amendment limiting the state sales tax rate at 3% ± and the county sales tax rate to an equivalent. The Constitution currently specifies a 10% limit on tax on net income.
   b) A Statute that sets out as a Rule of Order, applicable to each House, that an increase in the rate must be separately passed by both Houses and signed by the Governor, and cannot be combined with any other matter unless by a 2/3 vote of each House.

3. The base widening must delete the exemptions and refunds which are in current law for political reasons/not because of true economic considerations.

4. Tax Reform must include spending reform that has passed the House in the past – zero based budgeting, and must include:
   a) Procedural reforms must allow "off budget" sources of revenue to be considered as part of the budget process.

b) The minority party is entitled to proportionate representation on the Budget Conference Committee.
c) The Governor's proposed budget must only include the amount of revenue collected in the prior year (with a recession exception).

5. In determining what is "revenue neutral" the temporary taxes imposed in 2009 shall be treated as if they had expired.

6. We should also look at other reforms that take advantage on behalf of our citizens as federal taxpayers of federal deductibility issues. This could save our citizens $1 billion a year in federal income taxes.

###

Joint House and Senate Finance Committees December 1, 2009

ERIC K. WAYNE, DIRECTOR

SALES AND USE TAX DIVISION

NORTH CAROLINA DEPARTMENT OF REVENUE

Tax Rate Increase or Taxable Base Expansion

- Taxpayer Education
- Employee Education
- Technology System Changes
- Forms Redesign
- Worksheets
- Affidavits
- Streamlined Sales Tax
- Internal Costs (Budget Concerns)
- Departmental Resources

Taxpayer Education

- Notices
  - Mailings
  - Website Only
- Internet, e-Alerts
- E-505 Notice – General Issues
- Law Change Document
- Administrative Rules, Technical Bulletins, Directives
- Interactive Voice Response (IVR) – Frequently Asked Questions

Employee Education

- Training
  - Headquarters
  - Satellite Locations
  - TACC
- Intranet

Technology System Changes

- Integrated Tax Administration System (ITAS)
  - Rate Changes
  - Distribution Changes
  - Testing
  - Other Programming
  - System Training
- Online Filing and Payment
- EDI Changes

Forms Redesign – Rate Increase

- E-500 (Sales and Use Tax Return)
- E-500E (Utility and Liquor Sales and Use Tax Return)
- E-588 and 8 Other Refund Claim Forms
- Tax Charts
- E-505AC (New Registrations)

Worksheets



- Worksheets – 4 required (09/09 increase)
- Example Monthly 09/09
- Cross Over Dates

North Carolina Department of Revenue

Affidavits



- Savings Clause
- Contractor/Subcontractor
- Necessary at Time of Crossover?

North Carolina Department of Revenue

Streamlined Sales Tax

- Compliance
  - Definitions, Rules, Adopted Interpretations
- Permitted Effective Dates
  - State
  - County
- Rate and Boundary Tables
- Streamlined Electronic Return Mapping

Internal Costs (Budget Concerns)

- Printing and Mailing
  - $60k - 9/1/09 increase (Rate Only)
- Information Technology Changes
  - $25K
  - 391 hours
- Note: Full system changes could not be implemented due to the time frame and pending October changes.

Departmental Resources

- Temporary Reassignments
  - Correcting Return Errors
  - Forms Team
  - Administrative Services Employees
- Phone calls
- Correspondence
- Written Educational Documents

North Carolina Department of Revenue

Base Expansion Items to Consider

- Changing Midstream
- Resources
- Lead Time for Implementation
- Imposition Statutes Clearly Identify Intent
- Channels of Communication
- Noncompliance
- State/Local Governments

North Carolina Department of Revenue

Changing Midstream

- Drywall/Plaster Service
  - Historically a Performance Contractor
  - Use Tax on Materials
- Taxable Service
  - Will Purchases of Material be Exempt?
  - Enact Savings Clause?

Resources

- Current Staffing:
  - Director
  - Assistant Director (vacant)
  - 6 Administration Officers
  - 2 Administrative Assistants
- Additional Needs

Lead Time for Implementation

- Proper Administration
- Technical Material Rewrites
- Education

Imposition Statutes Clearly Identify Intent

- Comprehensive versus Incremental (Services)
  - All?
  - Some?
- Avoid Ambiguity
- Point to Other References?
  - North American Industry Classification System (NAICS)
  - North American Product Classification System (NAPCS)

Channels of Communication

- Public Affairs Division
- Partner with Other Agencies, Boards, Associations
- Internet
- CCH

Noncompliance Concerns – Some Services Areas

- Small Businesses (Cash)
- Economy
- Delinquent Notices
- Collection Cases
- Registrations

State/Local Governments

- General State and Applicable Local Taxes
  - (7.75%, 8%, 8.25%)
- Locals
  - Distribution

Currently Subject to Combined General Rate

- Video Programming (Shared with Locals)
- Spirituous Liquor (State Only)
- Telecommunications (Shared with Locals)
- Current Rate 8%

Base Expansion Possibilities

- Optional Maintenance Contracts
- Gift Wrapping Receipts
- Carpentry, Painting, Plumbing, etc.
- Golf Course Fees
- Labor Charges In Conjunction with Tangible Property Repairs

Optional Maintenance Contracts

- Current Treatment – Computer Software
  - Upgrades/Support Services
  - Receipts – Exempt (use tax)
- Possibilities – Streamlined Grants Options
  - All Taxable
  - All Exempt
  - Tax a Percentage
- Custom Software Versus Prewritten Software Issues
- Non-Software Transactions

Gift Wrapping Receipts

- Current Treatment
  - Receipts Exempt
  - No Use Tax on Materials
- Possibility
  - Tax Due on Receipts

Carpentry, Painting, Plumbing, etc.

- Current Treatment
  - Use Tax on Purchases
  - Receipts Exempt from Tax
- Possibilities
  - Impose Tax on Total Receipts
  - Exempt Purchases
- Other Thoughts
  - New Property Exclusions?
  - Saving Clause Language?
  - Cross Over Issues

Golf Course Fees

- Current Treatment
  - Separately Stated Green Fees – Exempt
  - Separately Stated Cart Rental Receipts – Taxable
  - Carts Provided in Conjunction With Green Fees – Taxable at time of purchase or rental
- Possibility
  - Total Fees Subject to Tax
- Advantages
  - Specific Industry
  - Easier to Identify Affected Businesses
  - Sophisticated Point of Sale Systems

Labor Charges in Conjunction with Repairs of Tangible Personal Property

- Current Treatment
  - Exempt if Separately Stated
- Possibilities
  - Continue to Exempt
  - Repeal Exemption
  - Tax Total Repair Charges
- Advantages
  - Many Businesses Currently Registered
  - Partial Education Needed

Haircuts

- Current Treatment
  - Exempt
- Possibilities
  - Impose Tax at Time of Service
- Questions:
  - Impose on the Operator of the Shop
  - Impose on Each Barber/Beautician
- Items to Consider:
  - Cash Basis
  - Burden on Small Businesses

•Questions ?

8-09

Do NOT Mail with Return

Worksheet for Completing Form E-500, Sales and Use Tax Return, for Month Ending September 30, 2009

North Carolina Department of Revenue

This worksheet can be used by monthly and monthly with prepayment filers to calculate the tax due on their receipts and purchases for the month of September 2009.

	Purchases for Use September		Tax
1. Purchases for Use for September 2009	0.00	x (5.5%) =	0.00 *

	Receipts September		
2. Receipts for September 2009	0.00	x (5.5%) =	0.00 *

3. Transfer Adjusted Purchases for Use to Line 4 of Form E-500 0.00 *
Tax on Line 1 divided by 4.5% (0.045)

4. Transfer Adjusted Receipts to Line 4 of Form E-500 0.00 *
Tax on Line 2 divided by 4.5% (0.045)

Line Instructions

Line 1. Enter the amount of "Purchases for Use" subject to the 5.5% State rate of tax.
Line 2. Enter the amount of "Receipts" subject to the 5.5% State rate of tax.
Line 3. Transfer the Adjusted Purchases for Use amount to Form E-500, Sales and Use Tax Return, Line 4 in the "Purchases for Use" column.
Line 4. Transfer the Adjusted Receipts amount to Form E-500, Sales and Use Tax Return, Line 4 in the "Receipts" column.

Add the amounts in the columns "Purchase for Use" and "Receipts" on Line 4 of Form E-500, Sales and Use Tax Return. Compute the tax due on the combined amount at the 4.5% State rate and enter the amount under the column "Tax."

This worksheet is for your personal use in computing the tax on your Sales and Use Tax Return for the month ending September 30, 2009. **Do not mail this worksheet with your return.** Questions can be directed to the Taxpayer Assistance and Collection Center at 1-877-252-3052 (toll-free).

* Automatically calculated.

Do NOT Mail with Return

Do NOT Mail with Return

Do NOT Mail with Return

E-500
Web-Fill
10-09

Sales and Use Tax Return

North Carolina Department of Revenue

Legal Name *(First 24 Characters)*

Period Beginning *(MM-DD-YY)*

Street Address

Period Ending *(MM-DD-YY)*

City | State | Zip Code *(5 Digit)*

Account ID



1.	**North Carolina Gross Receipts** *(Do not include tax collected)*				0.00
2.	**Sales for Resale** *(Do not include on Line 3 below)*				0.00
3.	**Receipts Exempt From State Tax**				0.00

Tax Type	Purchases for Use		Receipts	Rate		Tax
4. Gen. State Rate	0.00	+	0.00	x 5.75%	=	0.00
5. 3% State Rate	0.00	+	0.00	x 3%	=	0.00
6. 2.5% State Rate Modular Homes	0.00	+	0.00	x 2.5%	=	0.00
7. 2% State Rate	0.00	+	0.00	x 2%	=	0.00
8. 2% Food Rate	0.00	+	0.00	x 2%	=	0.00
9. 2% County Rate *See Instructions*	0.00	+	0.00	x 2%	=	0.00
10. 2.25% County Rate	0.00	+	0.00	x 2.25%	=	0.00
11. 0.5% Transit County Rate	0.00	+	0.00	x 0.5%	=	0.00
12. 0.25% Transit County Rate	0.00	+	0.00	x 0.25%	=	0.00

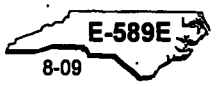
13.	**Total State and County Tax** *(Add Tax From Lines 4 through 12)*		0.00
14.	**Excess Collections**		0.00
15.	**Total Tax** *(Add Lines 13 and 14)*		0.00
16.	**Penalty - State and County**		0.00
17.	**Interest - State and County**		0.00
18.	**Less Prepayment for This Period**		0.00
19.	**Prepayment for Next Period**		0.00
20.	**Less any Credit** *(Attach explanation)*		0.00
21.	**Total Due** *(Add Lines 15 - 17 and 19, Minus Lines 18 and 20)*	$	0.00

Signature: **Date:**

I certify that, to the best of my knowledge, this return is accurate and complete.

Title: **Phone:**

MAIL TO: P.O. Box 25000, Raleigh, NC 27640-0700



North Carolina Department of Revenue
Post Office Box 25000
Raleigh, North Carolina 27640-0001

Affidavit To Exempt Contractors From the Additional 1% State Sales and Use Tax

To be used in connection with sales or purchases of building materials for use in the performance of lump sum or unit price contracts entered into or awarded prior to September 1, 2009, or entered into or awarded pursuant to bids made prior to September 1, 2009. This affidavit is to be executed by the contractors to their suppliers of building materials and is valid only when used in connection with the Additional 1% State sales and use tax.

This is to certify that _____, a contractor, entered into a lump sum or unit price contract with _____ on _____ or pursuant to a firm bid made on _____ whereby said contractor agreed to furnish the materials and labor for the erection, alteration, or repair of a building or structure at _____.

This affidavit is submitted to _____, a supplier of building materials, for the completion of such lump sum or unit price contract without charging the Additional 1% State sales or use tax.

It is understood and agreed that the contractor will retain on file the original or duplicate original of said lump sum or unit price contract for a period of not less than three years from the date this affidavit was executed for examination by an authorized agent of the Secretary of Revenue of North Carolina with respect to the sales and use tax liability of the aforesaid building contractor or supplier.

_____
Contractor/Subcontractor

By: _____ _____ _____ _____
Authorized Agent | Title | Telephone Number | Date

Instructions

1. This affidavit must be fully completed in all respects by a general contractor or a subcontractor who has entered into a lump sum or unit price contract, or was awarded such contract pursuant to a bid made prior to September 1, 2009, for the erecting, altering, or repairing of a building or structure. It must be submitted by such contractor to a supplier of building materials as evidence of the holding of such lump sum or unit price contract.
2. The building materials supplier and the contractor should retain the affidavit on file for a period of not less than three years.
3. The contractor must retain on file the original or duplicate original of the lump sum or unit price contract.
4. Purchase orders, invoices, shipping orders, delivery tickets, or any other pertinent records of the supplier and contractor must be subject to examination as evidence of such facts.

Under the provisions of G.S. 105-236(7), any person who willfully attempts, or who aids or abets any person to attempt, in any manner to evade or defeat any tax imposed by law, or the payment of the tax, is guilty of a Class H felony. For each misuse of an exemption certificate, the Secretary must assess against the purchaser a penalty of $250.

Interim Joint House and Senate Finance Committee
Thursday, January 14, 2010
Room 643, Legislative Office Building
10:00 a.m.

MINUTES

The Interim Joint House and Senate Finance Committee met at 10:00 a.m. on Thursday, January 14, 2010, in room 643 of the Legislative Office Building. Forty-nine members of the committee were present. Representative Weiss presided as chair.

Review of FTA Sales Tax Service Catagories

Cindy Avrette, a staff attorney with the Research Division was recognized. She provided an overview of prior meetings' materials. She explained that the current meeting's presentation was to look at ways to consider expanding the State's tax base, by looking at services, by category, that North Carolina might tax. Sabra Faires, the Senate Tax Counsel, was recognized to explain the admissions and amusements category, the installation category, the alteration, repair, and maintenance of tangible personal property category and the storage category. Cindy Avrette explained the property support category, the personal and pet care category, the repair, maintenance, and remodeling of real property category, and the professional services category. Sandra Johnson, a fiscal analyst with the Fiscal Research Division, was recognized to answer questions. The presentations also included what other states were doing by category. A copy of the power point is attached. A copy of the Federation of Tax Administrators' survey of services is also attached.

The meeting adjourned at 12:51 p.m.

Jennifer Weiss
Representative Jennifer Weiss, Presiding Chair

DeAnne Mangum
DeAnne Mangum, Committee Clerk

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Jan. 14, 2010
Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Gaylor Payne	MWC
Will Culpepper	Moore + Van Allen
W. Gardner Culpepper	Personal Interest
Rebecca Troutman	NCACC
Nathan Batts	NCBA
Andy Hall	ELON
Herb Crenshaw	AT&T
Roby Sawyers	NC State
Joel Levy	City of Charlotte
Deatrice Williams	CLCA
Tommy Clark	NCWRC
Courtney Denning	NCBA

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Jan. 14, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Rob Thompson	Covenant with NC's Children
Meg Gray	NC Budget & Tax
Elaine Mejia	NC Budget & Tax
Mary Foreman	NCAE
Cecil Bass	NCAE
Michelle Frazier	MFS
Chris Fitzsimon	NC Policy Watch
Mary Trotter	Budget Office
Jim Newman	DOI

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Jan. 14, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Doug Heron	Williams Mullen
Preston Howard	MCIC
[signature]	MSC
Jodi Hays	NC Home Builders Assoc.
Ann Lore	DUKE
Drew Saunders	Electricities
Ken Melton	K.M.A.
[signature]	Bgm & Asso.
Thomas Moore	E.L.t. Ltd.
Bo Heath	McGuire Woods
[signature]	Smith Moore Leatherwood

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Jan. 14, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Elizabeth Robinson	NCRMA
Andy Ellen	NCRMA
Jennifer Fullmer	K&W
Linda Andrews	NCFB
Dana Simpson	Smith Anderson
Hugh Tilson	NCHA
Tim Maxwell	NCICU
Mac Boxley	NC Aggregates Assoc.
Allison Walter	Charlotte Chamber
David Heinen	NC Center for Nonprofits
Chris Nida	NCLM

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Jan. 14, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Betsy Bailey	NC Engineers
Wendy Kelly	NMES
Amy McConkey	Smith Anderson
Amy Hobbs	MWC
Daniel Baum	Troutman Sanders
Brian Balfour	Civitas
Ran Coble	NC Center for Public Policy Research
Thomas C. Caves, Jr.	NC Dept. of Crime Control & Public Safety
Shannon Smith	NC GA

AGENDA

Joint Meeting of the Senate and House Finance Committees

January 14, 2010
10:00 a.m. – Noon
Room 643, Legislative Office Building

Meeting called by Senate Finance Cochairs: Senators Clodfelter, Hoyle, and Jenkins
and House Finance Cochairs: Representatives Luebke, Gibson, Wainwright, and Weiss

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10:00 a.m. – 10:15 a.m. **Opening Remarks by Finance Chairs**

10:15 a.m. – Noon

Review of FTA Sales Tax Service Categories

The Federation of Tax Administrators conducted a survey of service taxation in 1990. The survey had been updated periodically, last in 2007. The FTA survey lists 168 different services, divided into 16 categories.

Cindy Avrette, Research Division; Sabra Faires, Senate Tax Counsel; and Sandra Johnson, Fiscal Research Division

- Overview of Prior Meeting Materials
  Cindy Avrette
- FTA Service Category: Admissions and Amusements
  Sabra Faires
- FTA Service Category: Installation
  Sabra Faires
- FTA Service Category: Alteration, Repair, and Maintenance of Tangible Personal Property
  Sabra Faires
- FTA Service Category: Storage
  Sabra Faires
- FTA Service Category: Property Support
  Cindy Avrette
- FTA Service Category: Personal and Pet Care
  Cindy Avrette
- FTA Service Category: Repair, Maintenance, and Remodeling of Real Property
  Cindy Avrette
- FTA Service Category: Professional Services
  Cindy Avrette

Next Meeting: February 3rd
Topic: Personal Income Tax

Federation of Tax Administrators
Survey of Services

		Current NC law	Other States
	Agricultural Services		
1	Soil prep., custom baling, other ag. services	E	4
2	Veterinary services (both large and small animal)	E	5
3	Horse boarding and training (not race horses)	E	9
4	Pet grooming	E	18
5	Landscaping services (including lawn care)	E	21
	Industrial and Mining Services		
6	Metal, non-metal and coal mining services	E	5
7	Seismograph & Geophysical Services	E	6
8	Oil Field Services	E	11
9	Typesetting service; platemaking for the print trade	E	21
	Construction		
10	Gross Income of Construction Contractors	E	12
11	Carpentry, painting, plumbing and similar trades.	E	13
12	Construction service (grading, excavating, etc.)	E	12
13	Water well drilling	E	10
	Transportation Services		
14	Income from intrastate transportation of persons	E	11
15	Local transit (intra-city) buses	E	5
16	Income from taxi operations	E	8
17	Intrastate courier service	E	8
18	Interstate air courier (billed in-state)	E	1
	Storage		
19	Automotive storage	E	18
20	Food storage	E	9
21	Fur storage	E	15
22	Household goods storage	E	12
23	Mini -storage	E	13
24	Cold storage	E	12
25	Marina Service (docking, storage, cleaning, repair)	E	17
26	Marine towing service (incl. tugboats)	E	8
27	Travel agent services	E	4
28	Packing and crating	E	10
	Utility Service - Industrial Use		
29	Intrastate telephone & telegraph	T	42
30	Interstate telephone & telegraph	T	27
31	Cellular telephone services	T	42
32	Electricity	T	36
33	Water	E	18
34	Natural gas	E	37
35	Other fuel (including heating oil)	T	38
36	Sewer and refuse, industrial	E	14

	Utility Service - Residential Use		
37	Intrastate telephone & telegraph	T	40
38	Interstate telephone & telegraph	T	27
39	Cellular telephone services	T	43
40	Electricity	T	22
41	Water	E	12
42	Natural gas	E	22
43	Other fuel (including heating oil)	T	23
44	Sewer and refuse, residential	E	10
	Finance, Insurance and Real Estate		
45	Service charges of banking institutions	E	3
46	Insurance services	E	6
47	Investment counseling	E	6
48	Loan broker fees	E	3
49	Property sales agents (real estate or personal)	E	5
50	Real estate management fees (rental agents)	E	5
51	Real estate title abstract services	E	5
52	Tickertape reporting (financial reporting)	E	8
	Services		
	Personal Services		
53	Barber shops and beauty parlors	E	7
54	Carpet and upholstery cleaning	E	19
55	Dating services	E	8
56	Debt counseling	E	7
57	Diaper service	T	23
58	Income from funeral services	E	14
59	Fishing and hunting guide services	E	11
60	Garment services (altering & repairing)	E	20
61	Gift and package wrapping service	E	21
62	Health clubs, tanning parlors, reducing salons	E	22
63	Laundry and dry cleaning services, coin-op	E	6
64	Laundry and dry cleaning services, non-coin op	T	22
65	Massage services	E	11
66	900 Number services	T	29
67	Personal instruction (dance, golf, tennis, etc.)	E	6
68	Shoe repair	E	20
69	Swimming pool cleaning & maintenance	E	17
70	Tax return preparation	E	6
71	Tuxedo rental	T	38
72	Water softening and conditioning	E	13
	Business Services		
	Sales of advertising time or space:		
73	Billboards	E	4
74	Radio & television, national advertising	E	2
75	Radio & television, local advertising	E	4
76	Newspaper	E	4
77	Magazine	E	4
78	Advertising agency fees (not ad placement)	E	11

	Business Services (continued)		
79	Armored car services	E	16
80	Bail bond fees	E	4
81	Check & debt collection	E	8
82	Commercial art and graphic design.	TT	23
83	Commercial linen supply	T	32
84	Credit information, credit bureaus	E	13
85	Employment agencies	E	11
86	Interior design and decorating	E	10
87	Maintenance and janitorial services	E	19
88	Lobbying and consulting	E	7
89	Marketing	E	6
90	Packing and crating	E	11
91	Exterminating (includes termite services)	E	20
92	Photocopying services	T	43
93	Photo finishing	T	43
94	Printing	T	44
95	Private investigation (detective) services	E	16
96	Process server fees	E	6
97	Public relations, management consulting	E	7
98	Secretarial and court reporting services	E	8
99	Security services	E	18
100	Sign construction and installation	E	32
101	Telemarketing services on contract	E	6
102	Telephone answering service	E	20
103	Temporary help agencies	E	9
104	Test laboratories (excluding medical)	E	8
105	Tire recapping and repairing	E	28
106	Window cleaning	E	19
	Computer:		
107	Software - package or canned program	T	46
108	Software - modifications to canned program	E	28
109	Software - custom programs - material	E	24
110	Software - custom programs - professional serv.	E	14
111	Internet Service Providers-Dialup	E	9
112	Internet Service Providers-DSL or other broadband	E	11
113	Information services	E	14
114	Data processing services	E	10
115	Mainframe computer access and processing serv.	E	11
	Computer Online Services:		
116	Online Data processing services	E	7
117	Software - Downloaded	T	28
118	Books - Downloaded	T	15
119	Music - Downloaded	T	15
120	Movies/Digital Video - Downloaded	T	16
121	Other Electronic Goods - Downloaded	T	14

	Automotive Services		
122	Automotive washing and waxing.	E	21
123	Automotive road service and towing services	E	19
124	Auto service. except repairs, incl. painting & lube	E	25
125	Parking lots & garages	E	21
126	Automotive rustproofing & undercoating.	E	25
	Admissions & Amusements		
127	Pari-mutuel racing events.	T	28
128	Amusement park admission & rides	T	36
129	Billiard parlors	T	27
130	Bowling alleys	E	27
131	Cable TV services	T	26
132	Direct Satellite TV	T	24
133	Circuses and fairs -- admission and games	T	34
134	Coin operated video games	E	17
135	Admission to school and college sports events	T	23
136	Membership fees in private clubs.	E	23
137	Admission to cultural events	T	31
138	Pinball and other mechanical amusements	E	19
139	Admission to professional sports events	T	37
140	Rental of films and tapes by theaters	E	7
141	Rental of video tapes for home viewing	T	44
	Professional Services		
142	Accounting and bookkeeping	E	5
143	Architects	E	5
144	Attorneys	E	5
145	Dentists	E	4
146	Engineers	E	5
147	Land surveying	E	7
148	Medical test laboratories	E	4
149	Nursing services out-of-hospital	E	4
150	Physicians	E	4
	Leases and Rentals		
151	Personal property, short term (generally)	T	44
152	Personal property, long term (generally)	T	44
153	Bulldozers, draglines and const. mach., short term	T	44
154	Bulldozers, draglines and const. mach., long term	T	44
155	Rental of hand tools to licensed contractors.	T	44
156	Short term automobile rental	T	47
157	Long term automobile lease	T	39
158	Limousine service (with driver)	E	16
159	Aircraft rental to individual pilots, short term	T	39
160	Aircraft rental to individual pilots, long term	T	38
161	Chartered flights (with pilot)	E	9
162	Hotels, motels, lodging houses	T	46
163	Trailer parks - overnight	E	26

	Fabrication, Installation and Repair Services		
164	Custom fabrication labor	T	38
165	Repair material, generally	T	46
166	Repair labor, generally	E	24
167	Labor charges on repair of aircraft	E	16
168	Labor charges - repairs to interstate vessels	E	11
169	Labor charges - repairs to intrastate vessels	E	20
170	Labor - repairs to commercial fishing vessels	E	15
171	Labor charges on repairs to railroad rolling stock	E	11
172	Labor charges on repairs to motor vehicles	E	21
173	Labor on radio/TV repairs; other electronic equip.	E	24
174	Labor charges - repairs other tangible property	E	24
175	Labor - repairs or remodeling of real property	E	15
176	Labor charges on repairs delivered under warranty	E	5
177	Service contracts sold at the time of sale of TPP.	E	31
178	Installation charges by persons selling property	E	22
179	Installation charges - other than seller of goods	E	18
180	Custom processing (on customer's property)	E	26
181	Custom meat slaughtering, cutting and wrapping	E	14
182	Taxidermy	E	26
183	Welding labor (fabrication and repair)	E	30
184	Other	E	

	Totals	
5	Agricultural Services	0
4	Industrial and mining services	0
4	Construction	0
16	Utilities	10
9	Transportation	0
6	Storage	0
8	F.I.R.E.	0
20	Personal services	4
34	Business services	5
8	Computer services	5
5	Automotive services	0
15	Admissions and amusements	9
9	Professional services	0
4	Leases	1
19	Fabrication, repair and installation	1
0	Miscellaneous	0
166	**Non-exempt entries**	35

Review of FTA Sales Tax Service Categories

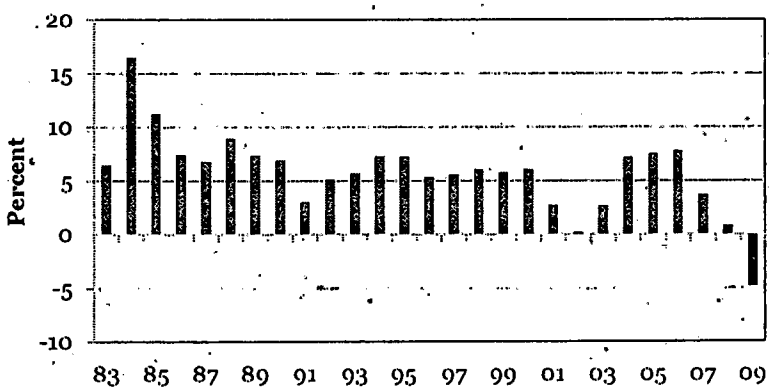
Prepared by:
Cindy Avrette, Research Division
Sabra Faires, Senate Tax Counsel
Sandra Johnson, Fiscal Research Division

January 14, 2010

Sales Tax Overview

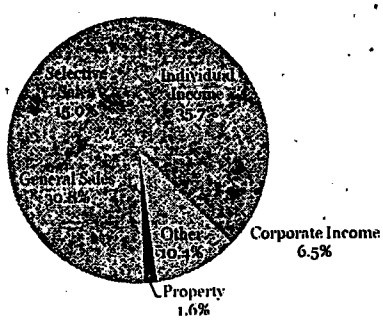
- Mainstay of state tax collections
  - North Carolina enacted 3% sales tax on tangible personal property in 1933
  - 23 states enacted sales tax by beginning on WWII
  - 45 states have a sales and use tax today

Growth in State Sales Tax Collections

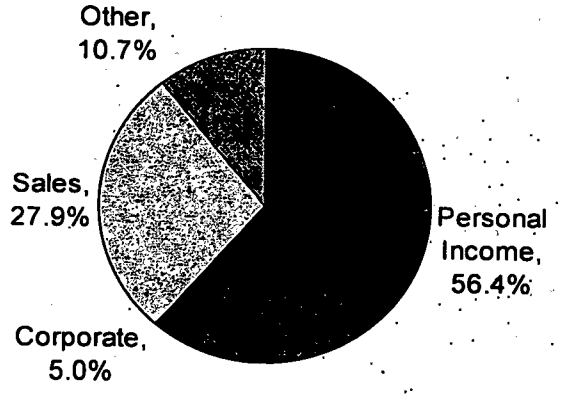


States' Tax Structure, 2008

PERCENTAGE DISTRIBUTION OF U.S. TAX COLLECTIONS, 2008

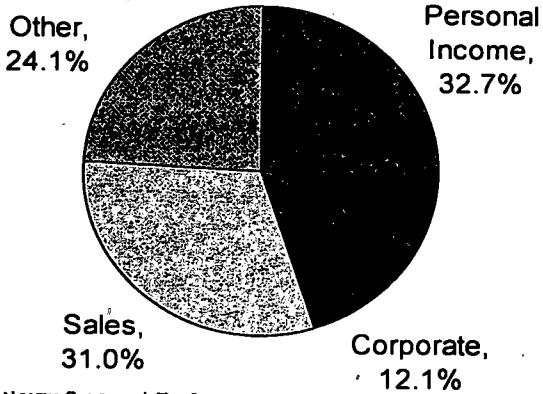


NC's Tax Structure, FY 2008-09



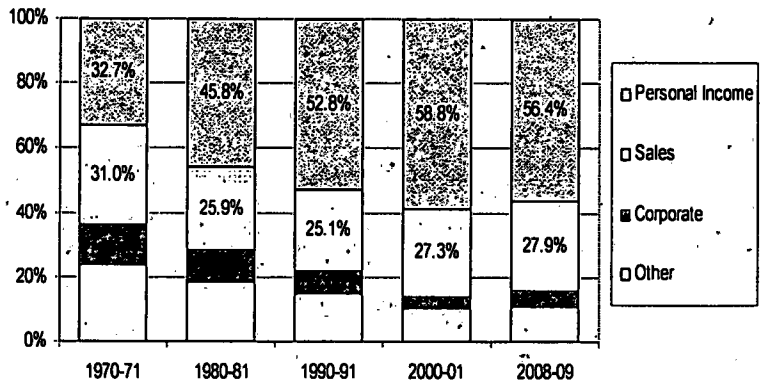
STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

NC's Tax Structure, FY 1970-71



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

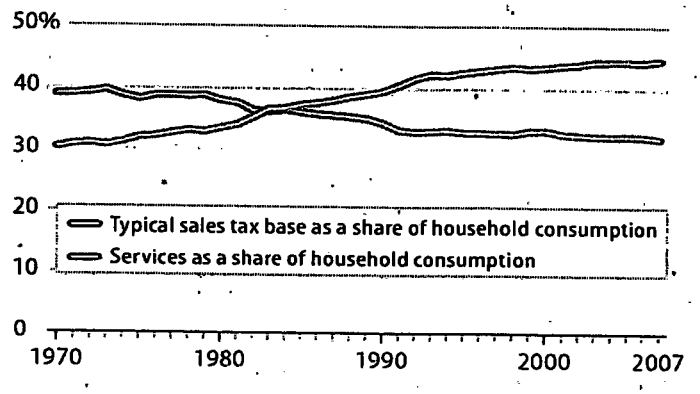
NC's Tax Structure



Sales Tax Overview

- Mainstay of state tax revenues
- Tax on consumption
  - Tax less representative of consumption today than 1933

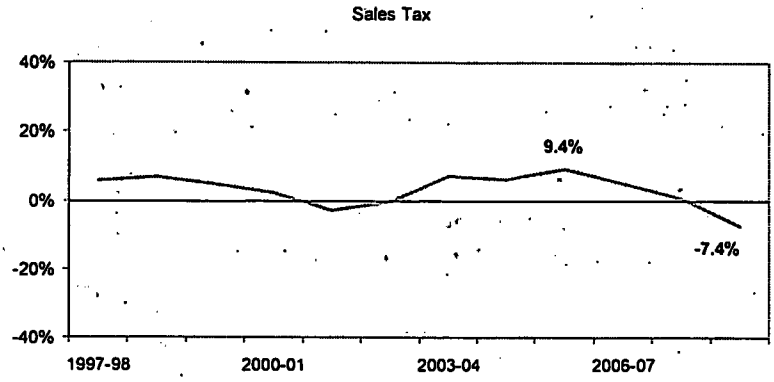
Change in Consumption Patterns



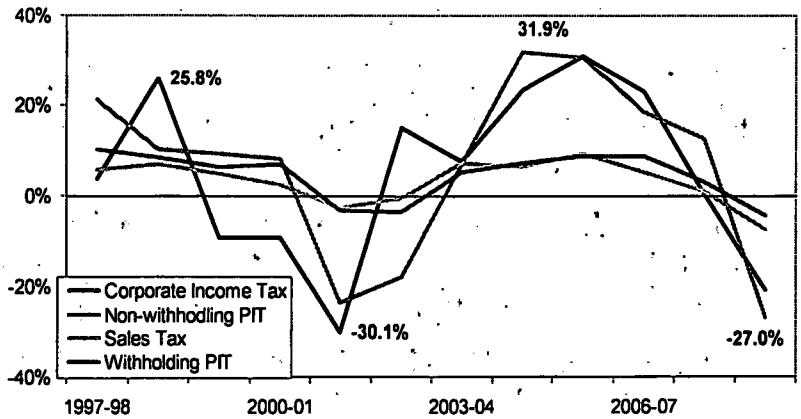
Sales Tax Overview

- Mainstay of state tax revenues
- Tax on consumption
- More stable source of revenue than income tax, but growing more volatile
  - Durable goods make up a large fraction of sales tax base
  - Sales of durable goods more volatile than income
  - Sales of services less volatile than income

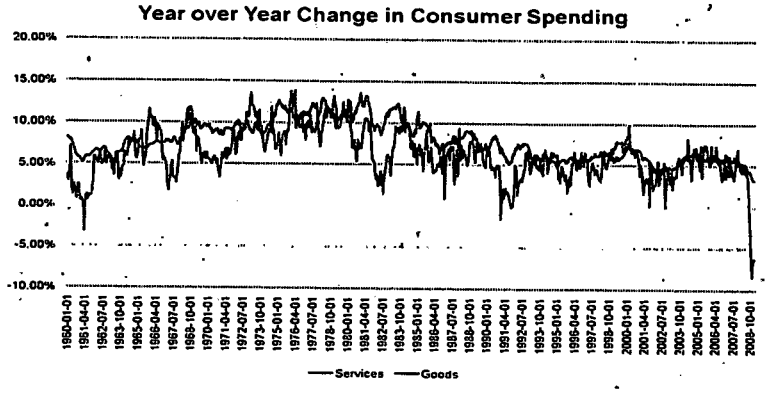
Growth & Stability of Sales Tax Revenue



Growth & Stability of Tax Revenue



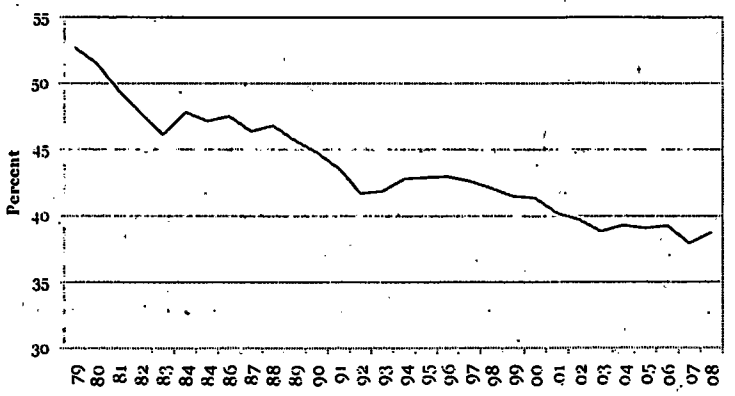
Increasing Sales Tax Volatility



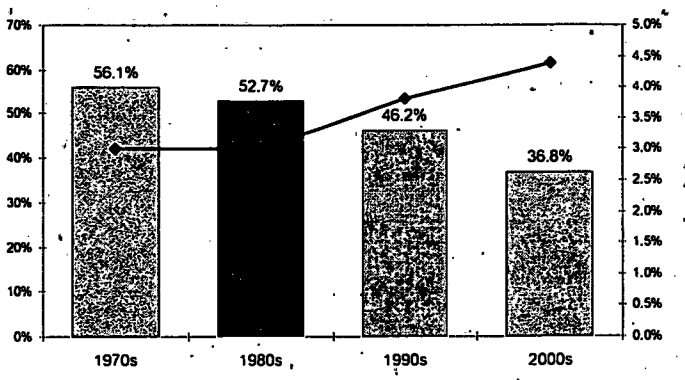
Sales Tax Overview

- Mainstay of state tax revenues
- Tax on consumption
- More stable source of revenue than income tax, but growing more volatile
- Tax collections shrinking due to narrower tax base
  - Legislated exemptions
  - Changes in consumption patterns
  - Cross border shopping

Sales Tax Collections as % of PI



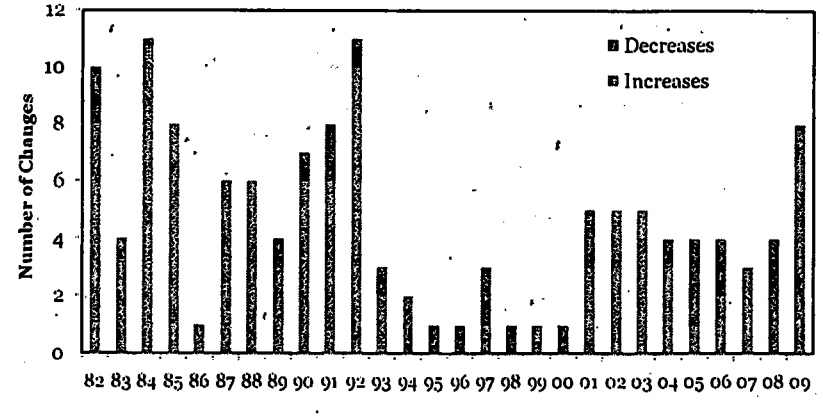
NC Sales Tax Base



Sales Tax Overview

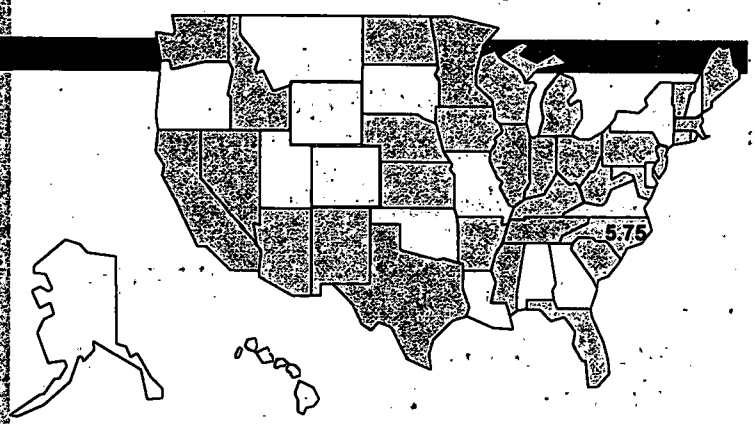
- Mainstay of state tax revenues
- Tax on consumption
- More stable source of revenue than income tax, but growing more volatile
- Tax collections shrinking due to narrower tax base
- To maintain adequacy of tax revenue source:
  - Increase the general tax rate
  - Expand the tax base

of Sales Tax Rate Changes



11/2/2009

STATE SALES TAX RATES, 2009



Less than 5% --12--
5% to 6% --21--
Greater than 6% --12--
None --5--

Ways to Expand NC's Sales Tax Base

- Eliminate current sales tax exemptions
  - Food, prescription drugs, and durable medical equipment < $1 billion
  - Agricultural and industrial related exemptions = approximately $286 million
  - Economic development related exemptions < $8 million
  - All other exemptions < $100 million

Ways to Expand NC's Sales Tax Base

- Eliminate current sales tax exemptions
- Eliminate current sales tax refunds
  - Refunds to nonprofit entities > $289 million
  - Refunds to governmental entities > $187 million
  - Refunds related to economic development incentives < $20 million

Ways to Expand NC's Sales Tax Base

- Eliminate current sales tax exemptions
- Eliminate current sales tax refunds
- Eliminate current preferential tax rates > $161 million
  - 5.75% (General State rate).
  - 3% (Aircraft, boats, electricity for commercial business and residents)
  - 2.83% (Commercial laundry, dry cleaners)
  - 2.5% (Modular homes)
  - 2% (Manufactured homes)
  - 0.8% (Electricity for manufacturers and farmers)

Ways to Expand NC's Sales Tax Base

- Eliminate current sales tax exemptions
- Eliminate current sales tax refunds
- Eliminate current preferential tax rates
- **Include additional services in the sales tax base**
  - Should services be included in the tax base?
  - Which services should be included in the tax base?

Expand Sales Tax to Services?

- ✓ Preserve principle of sales tax being a tax on consumption
- ✓ Mitigate erosion of sales tax
- ✓ Reduce sales tax revenue volatility
- ✓ Does not change relative tax burdens
- ✓ Preferable to rate increases
- ✓ Cut sales tax rate
- ✓ Improve economic efficiency
- ✓ Eliminate administrative issues

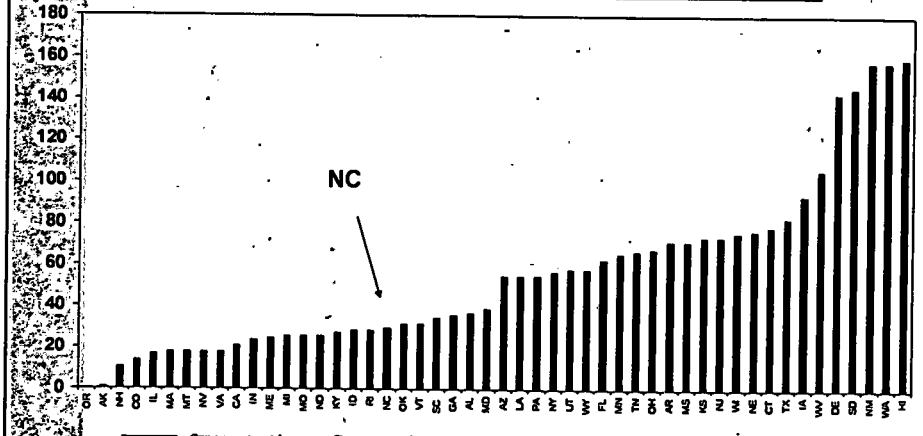
- × Brings new retailers into system
- × Likely substantial noncompliance by individual sellers of some services

Which Services?

- × Primarily business services
- ✓ Primarily household services
- ✓ Services frequently purchased by both businesses and households

- FTA "Survey of Services" includes 168 services
- NC currently taxes 35 services
  - Utilities
  - Lease & rentals
  - Computer online services

Taxation of Services by State, 2007



Federation of Tax Administrators Types of Services, 2007

Service Group	Number of Taxable Services
• Agricultural	5
• Industrial and mining	4
• Construction	4
• Utilities	16
• Transportation	9
• Storage	6
• Finance, insurance, and real estate	8

Federation of Tax Administrators Types of Services, 2007

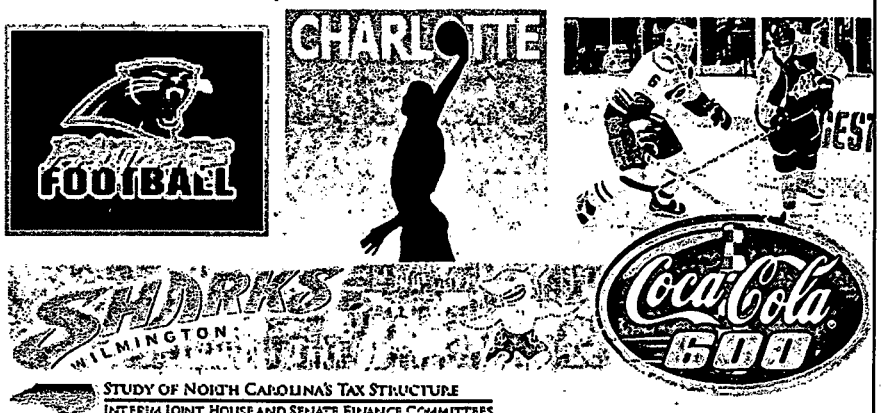
Service Group	Number of Taxable Services
• Personal	20
• Business	34
• Computer	8
• Automotive	5
• Admissions and amusements	15
• Professional	9

Federation of Tax Administrators Types of Services, 2007

Service Group	Number of Taxable Services
• Leases	4
• Fabrication, installation and repair	19
• Miscellaneous	2
Total Number of Taxable Services	168

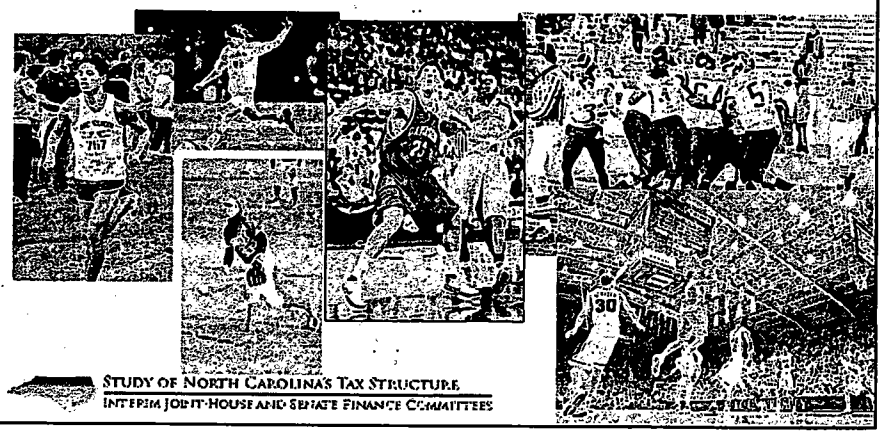
FTA: Admissions and Amusements

Professional Sports Events



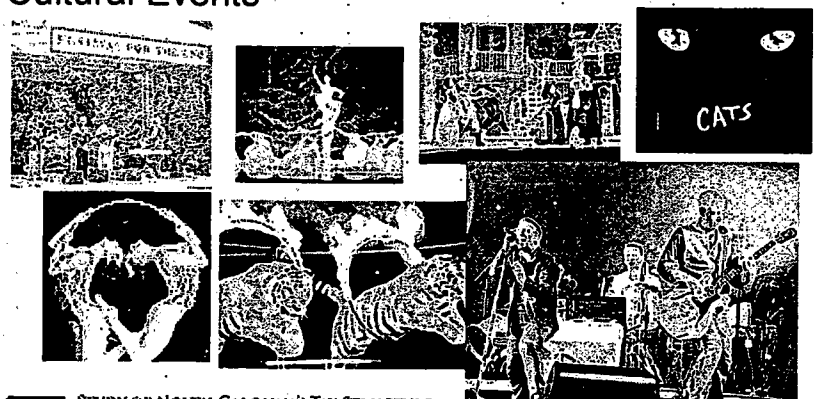
FTA: Admissions and Amusements

School and College Sports Events



FTA: Admissions and Amusements

Cultural Events



FTA: Admissions and Amusements

Spectator Sports & Events	Other States	NC Sales Tax	NC Privilege Tax
Professional sports events	37	No	3%
School and college sports events	23	No	3%
Cultural events	31	No	3%
Pari-mutuel racing events	28	No	3%

NC Amusement Privilege Tax

- **Pre 1900:** State privilege tax imposed on various exhibitions and performances at flat rates
- **1933:** State 3% sales tax enacted and gross receipts tax at the rate "levied in Article V … upon retail sales of merchandise" imposed on various amusements
- **1990:** Gross receipts amusement privilege tax rate set at "rate of three percent"
- **1991:** State sales tax rate increased from 3% to 4%

Scope of Amusement Privilege Tax

- Gross receipts tax on person who offers or manages a taxable amusement
- 3% on:
  - A dance or an athletic contest for which an admission fee of 50 cents or more is charged
  - Amusement or entertainment for which an admission fee is charged
  - A performance, show, or exhibition, such as a circus or dog show
- 1% on motion picture show

Exemptions to Amusement Privilege Tax

- Local talent performing in event to benefit nonprofits
- North Carolina Symphony Society, Inc.
- State and county fairs
- NC outdoor historical dramas
- Elementary and secondary school events
- First $1000 of civic organizations' dances that benefit nonprofits
- Nonprofit youth athletic event with ticket price of $10 or less
- Events of nonprofit choral and theatrical group
- Events of nonprofit center for performing and visual arts
- Nonprofit teen center
- Events on Cherokee reservation
- Nonprofit arts and community festivals held no longer than seven consecutive days
- Farm-related events held on farmland

Amusement Sales Tax Category

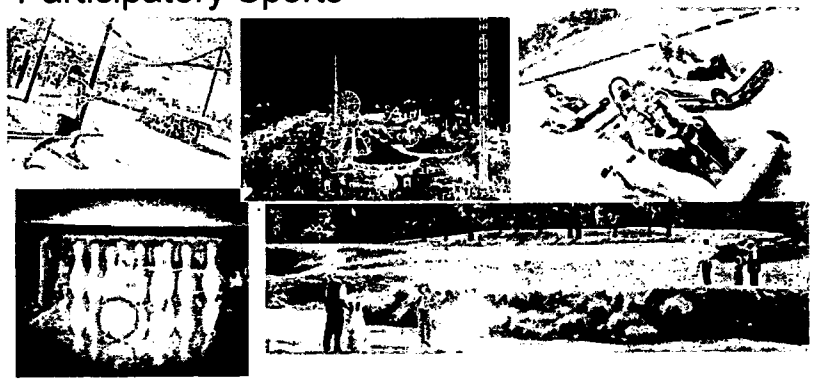
- An amusement sales tax category could include:
  - Conversion of privilege license tax on amusements to a sales tax
  - Admission to a live performance or another live event of any kind
  - Admission to a movie or another audiovisual work

Considerations

- Exemptions
  - Rationale of privilege license tax exemptions applied to sales tax
- Administrative issues
  - Effect on number of taxpayers
  - Local sales tax reporting
  - Effectiveness of collection
- Details to clarify
  - Permanent seat licenses
  - Club level and luxury suite packages

FTA: Admissions and Amusements

Participatory Sports



FTA: Admissions and Amusements

Participatory Activities



FTA: Admissions and Amusements

Participatory Sports & Events	Other States	NC Sales Tax	NC Privilege Tax
Amusement park: admission, rides	36	No	No
Circus & fair: admission, games	34	No	No
Billiard parlor	27	No	No
Bowling alley	27	No	No
Private club membership fee	23	No	No
Pinball, other mechanical games	19	No	No
Coin operated video games	17	No	No

Participatory Events and Tax

- Amusement park
  - Frequently have live shows subject to privilege tax
  - Food taxable
  - Merchandise sales taxable
- Fair
  - Frequently have live shows (exempt from privilege tax)
  - Food taxable
  - Merchandise sales taxable
- Bowling alley
  - Shoe rental taxable
  - Food and merchandise sales taxable
- Golf course and club
  - Golf cart rental taxable
  - Food and merchandise sales taxable

Private Club Membership Fee

- Fitness and health clubs and gyms
- Tennis and golf clubs
- Country clubs with swimming, golf, or tennis
- Considerations concerning membership fees
  - Allocation of fees when fees for access to activities mixed with other fees
  - Initiation fees, social membership fees

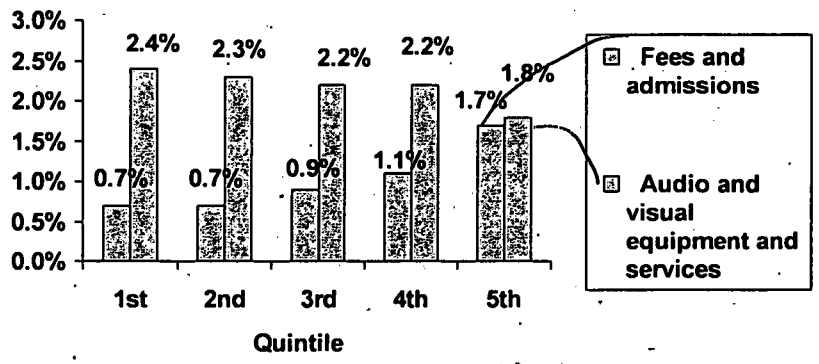
Amusement Sales Tax Category

- An amusement sales tax category could include participatory sports and activities:
  - Admission to a museum, cultural site, garden, amusement park, exhibit, show, or another similar attraction or event
  - Access to or use of property that enables the consumer to participate in a sport, game, or recreational or fitness activity
- Considerations
  - Exemptions, administrative issues
  - Membership fee details

FTA: Admissions and Amusements

Other Amusements	Other States	NC Sales Tax	NC Privilege Tax
Cable TV services	26	8	No
Direct Satellite TV	24	8	No
Rental of film, tape by theater	7	No	No
Rental of video tape for home	44	5.75	No

Share of Income Expended on Entertainment, 2008



Source: U.S. Bureau of Labor Statistics, Consumer Expenditure Survey, 2008

Revenue Impact: Amusements

Service	State Revenue	Local Revenue
Converting PLT for Amusements and Movies	$14.4 M	$12.4 M
Other Entertainment	$40.8 M	$17.2 M
Total	**$55.3 M**	**$29.5 M**

Assumes 4.75% rate and full fiscal year

FTA: Installation





FTA: Installation

Installation	Other States	NC Sales Tax
Installation charges by seller	22	No
Installation charges - other than seller of goods	18	No
Sign construction and installation	32	No

Installation

- Sales tax law, G.S. 105-164.3(37), defines "sales price" to include installation charges
- Sales tax law, G.S. 105-164.13(49), exempts installation charges that are separately stated
- Exemption could be repealed

FTA: Alteration, Repair, Maintenance



FTA: Alteration, Repair, Maintenance

Alteration, Repair, Maintenance	Other States	NC Sales Tax
Service contracts sold at the time of sale of TPP	31	No
Labor charges on warranty repairs	5	No
Repair labor, generally	24	No
Automotive washing and waxing	21	No
Auto service except repairs, incl. painting & lube	25	No
Automotive rustproofing & undercoating	25	No
Taxidermy	26	No

Recent Legislative Proposals

- 2009 House Budget, Section 27C.3 applied sales tax to:
  - Service contracts
  - Repair, maintenance, and installation services
- 2005 House and Senate Budgets applied sales tax to service contracts, but not final budget

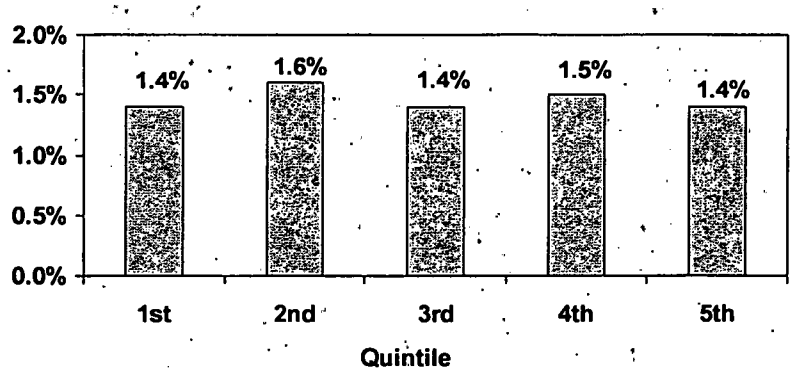
Service Contracts

- A warranty agreement, a maintenance agreement, a repair contract, or a similar agreement or contract by which the seller agrees to maintain or repair tangible personal property
- Considerations if taxable
  - Application to exempt property
  - Taxation of property used to make contract repairs

Alteration, Repair, and Maintenance

- This sales tax category could include:
- Altering tangible personal property by tailoring, monogramming, engraving, or making similar changes to the property
- Repairing tangible personal property to restore it to proper working order
- Maintaining tangible personal property to keep the property in working order, to avoid breakdown, or to prevent unnecessary repairs
- Cleaning tangible personal property

Share of Income Expended on Vehicle Maintenance and Repairs, 2008

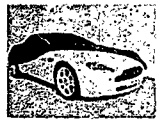


Source: U.S. Bureau of Labor Statistics, Consumer Expenditure Survey, 2008

FTA: Storage









FTA: Storage

Tangible Personal Property	Other States	NC Sales Tax
Automotive storage	18	No
Food storage	9	No
Fur storage	15	No
Household goods storage	12	No
Mini -storage	13	No
Cold storage	12	No
Marina Service (docking, storage, cleaning, repair)	17	No

FTA: Storage

Storage-related Services	Other States	NC Sales Tax
Marine towing service	8	No
Travel agent services	4	No
Packing and crating	10	No

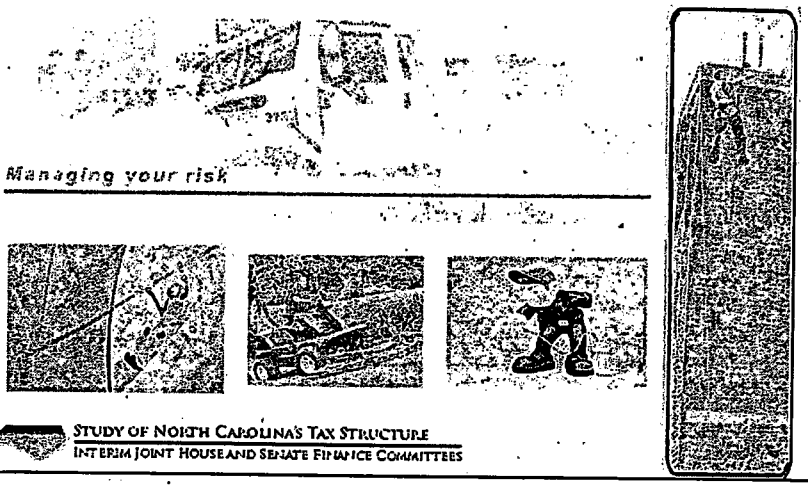
Storage

- Sales tax law, G.S. 105-164.3(44), defines storage as the keeping or retention of property in this State for any purpose except sale in the regular course of business
- This sales tax category could include rental or lease of the following for the storage of tangible personal property:
  - A mini-warehouse
  - A safe deposit box
  - Another secure self-storage space or another secure self-storage space

Revenue Impact: Alterations and Repairs

Service	State Revenue	Local Revenue
Warranty, Service Contracts	$24.1 M	$10.2 M
Installation	$12.0 M	$5.0 M
Repair/ Maintenance	$227.6 M	$95.8 M
Storage/Moving	$22.4 M	$9.4 M
Total	**$286.0 M**	**$120.4 M**

Property Support Services



FTA: Property Support Services

Property Support Services	Other States	NC Sales Tax
Landscaping services	21	NO
Exterminating services	20	NO
Janitorial services (carpet cleaning, window cleaning)	19	NO
Security Services	18	NO
Swimming pool cleaning & maint.	17	NO
Armored car services	16	NO

Landscaping Services

- This category could include the following:
  - Installing or maintaining a tree, shrub, plant, lawn, or garden, either indoors or outdoors, or providing other similar landscape care and maintenance service
  - Installing or maintaining a walkway, retaining wall, deck, fence, pond, or other similar structure to enhance the landscape of an area
- Detail: Exempt landscaping services provided to maintain a right-of-way or a utility easement

Exterminating Services

- This category could include services that exterminate and control birds, mosquitoes, rodents, termites, and other insects and pests, including termite services
- Detail: Exempt exterminating services provided to a farmer to control pests in crops grown for commercial purposes

Janitorial Services

- This category could include cleaning any of the following:
  - Interior or exterior of a building or other structure
  - An item attached to a structure, such as carpet or gutter
  - A driveway, a parking lot, a swimming pool, the grounds at a building or other structure, or another outdoor area

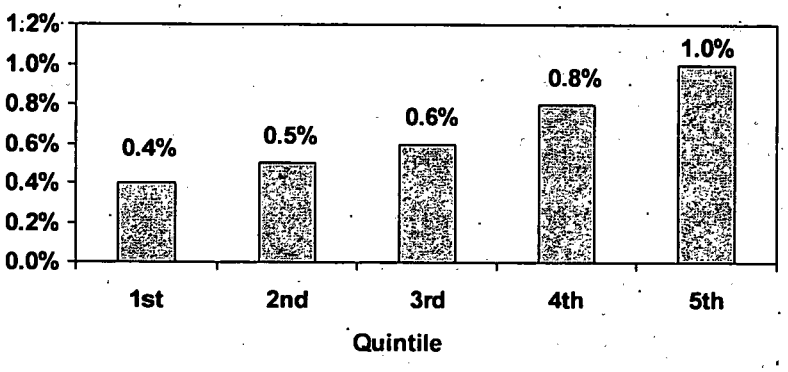
Security Services

- This category could include any of the following:
  - Guard or security patrol services
  - Armored car services
  - Remote monitoring of security alarm systems
  - Locksmith services
  - Telematic service that provides communication, tracking, and emergency response services to car owners

Revenue Impact: Property Support

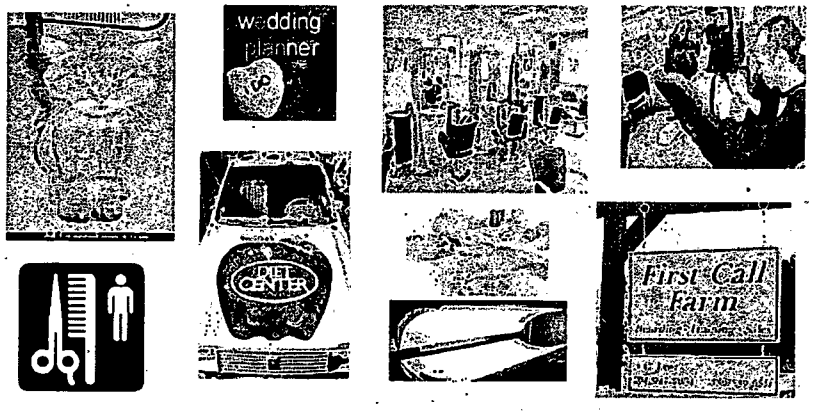
Service	State Revenue	Local Revenue
Landscaping	$62.3 M	$26.2 M
Exterminating	$16.1 M	$6.8 M
Janitorial/Other	$51.2 M	$21.6 M
Security	$44.6 M	$18.8 M
Total	$178.8 M	$75.3 M

Share of Income Expended on Household Services, 2008



Source: U.S. Bureau of Labor Statistics, Consumer Expenditure Survey, 2008

Personal and Pet Care Services



FTA: Personal & Pet Care Services

Personal Services	Other States	NC Sales Tax
Tanning parlors, reducing salons	22	NO
Pet grooming	18	NO
Massage services	11	NO
Fishing and guide services	11	NO
Horse boarding and training	9	NO
Barber shops and beauty parlors	7	NO

Personal Services

- This category could include any of the following:
  - Hair care
  - Nail care
  - Nonmedical skin care (facials, hair removal or replacement; non-therapeutic massage)
  - Nonmedical body modification (tatooing, tanning, piercing)
  - Nonmedical services to assist customers in attaining and maintaining a desired weight
  - Cosmetic surgery that is not deductible as a medical expense under the IRC

Personal Services, continued

- This category could include any of the following:
  - Dating, social escort, and other social introduction services
  - Discount buying, house sitting, fashion consulting, and personal shopping services
  - Party planning, wedding planning, and message delivery services
  - Fishing and guide services
  - Astrology, fortune-telling, palm reading, psychic, and other services that may provide useful information about a person's personality or may aid in the interpretation of past and present events

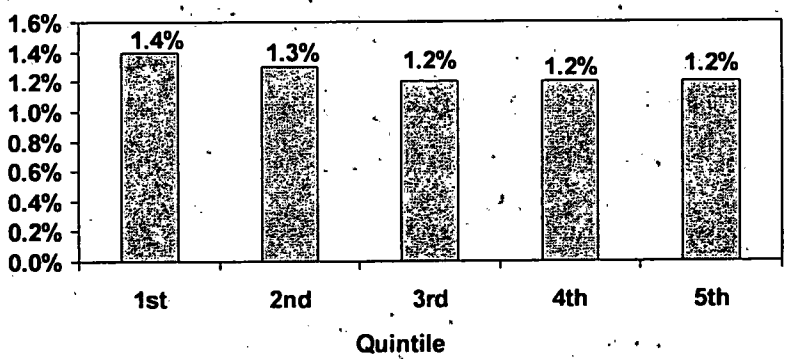
Pet Care Services

- This category could include grooming, training, boarding, or providing other care for an animal that is not held for a commercial purpose
- Detail: Exempt veterinary services

Revenue Impact: Personal and Pet Care

Service	State Revenue	Local Revenue
Pet (non- veterinary)	$2.4 M	$1.0 M
Personal	$22.8 M	$9.6 M
Total	$ 25.1 M	$ 10.6 M

Share of Income Expended on Personal Care Services, 2008



Source: U.S. Bureau of Labor Statistics, Consumer Expenditure Survey, 2008

Real Property Repair & Remodeling



FTA: Real Property Repair & Remodeling Services

Real Property Repair and Remodeling Services	Other States	NC Sales Tax
Real property repair or remodeling	15	NO
Carpentry, painting, plumbing, and similar trades	13	NO

Real Property Repair & Remodeling

- This category could include labor charges for any of the following:
  - Carpentry
  - Plumbing
  - Heating, cooling
  - Electrical
  - Painting
  - Flooring
- Detail: Exempt new construction
- Consideration: Difference between remodeling and new construction
  - Expands dimensions of existing structure
  - Increases the heated square space in an existing structure

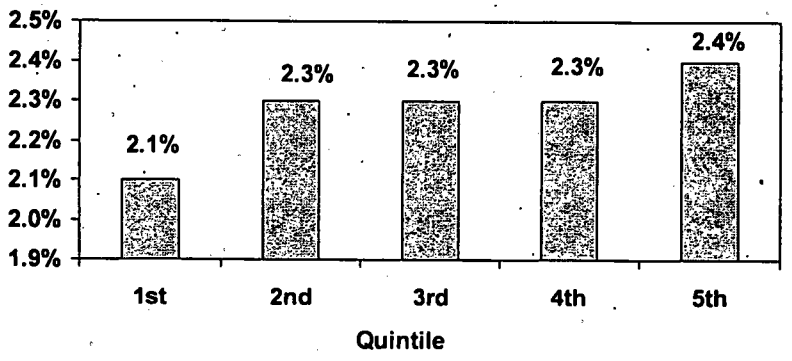


Revenue Impact: Building Repairs

Service	State Revenue	Local Revenue
Building repairs & alterations, not including new construction	$ 74.6 M	$ 23.7 M



Share of Income Expended on Household Maint. and Repair, 2008



Source: U.S. Bureau of Labor Statistics, Consumer Expenditure Survey, 2008

Professional Services



FTA: Professional Services

Professional Services	Other States	NC Sales Tax
Land surveying	7	NO
Accounting, bookkeeping, attorneys	5	NO
Architects, engineers	5	NO
Dentists, doctors, medical test labs, out-of-hospital nursing services	4	NO

Professional Services Primarily Purchased by Businesses

- Inconsistent with the purpose of the sales tax
  - Sales tax is a tax on consumption
  - Tax on inputs leads to tax pyramiding
- Artificial incentive for vertical integration
  - May create unlevel playing field for small businesses
  - Small businesses often supplier of these services

Professional Services Primarily Purchased by Businesses

- Multiple points of use
  - Services purchased for company-wide use
  - Sourcing issues
- More interstate transactions
  - Corporation more likely to have an out-of-state architect design a new HQ building than a homeowner is to design an addition to her home
  - Creates competitive disadvantage for in-state business

Revenue Impact: Professionals

Service	State Revenue	Local Revenue
Architectural and Engineering	$62.3 M	$26.2 M
Computer	$326.9 M	$137.6M
Legal	$359.6 M	$151.4 M
Accounting	$173.4 M	$73.0 M
Medical/Dentist	$700.7 M	$295.0 M

Revenue Neutrality

- Entertainment, Repair of TPP, Personal Services, and Real Property Support represents expanding the sales tax base by 9.7%
  - Repair, maintenance, and remodeling of real property
  - Professional services
  - Elimination of current exemption or credits
  - Elimination of current preferential tax rates
- The State sales tax rate could be cut from 4.75% to 4.3%

Summation

- Long-term viability of the sales tax base as a key source of revenue depends on modernization of the sales tax base
- Preservation of the sales tax as a tax on consumption depends on modernization of the sales tax base

Interim Joint House and Senate Finance Committee
Wednesday, February 3, 2010
Room 643, Legislative Office Building
1:00 p.m.

MINUTES

The Interim Joint House and Senate Finance Committee met at 1:00 p.m. on Wednesday, February, 2010, in room 643 of the Legislative Office Building. Fifty members of the committee were present. Senator Jenkins presided as chair.

Revenue and Budget Outlook

Barry Board, an economist with the Fiscal Research Division, was recognized. He discussed the current general fund revenue collections. He explained the Department of Revenue's resolution initiative, the fact that economy-based taxes continue to decline and that recent national and state forecasts indicate recovery may take a long time. A copy of Barry's power point is attached.

Actions Taken by States in Response to Fiscal Conditions

Rodney Bizzell, a fiscal analyst with the Fiscal Research Division, was recognized to give an overview of state tax actions around the country in 2009. He explained enacted revenue changes for the 2009-2010 fiscal year, national trends and specific taxes. A copy of his presentation is attached.

Personal Income Tax

Roby Sawyers, CPA, PhD, Department of Accounting, College of Management, NCSU, was recognized. He gave an overview of the personal income tax; a look at how the person income tax contributes to a sound tax structure; identified the ways states determine state taxable income; and explained the differences between federal adjusted gross income and federal taxable income. A copy of his power point and his handouts is attached.

Personal Income Tax Structure in North Carolina

Cindy Avrette, a staff attorney with the Research Division, was recognized to explain North Carolina's personal income tax laws including its history and development. She discussed how it is calculated, and the variety of exemptions and credits. A copy of her power point is attached.

Fiscal Trends in North Carolina's Personal Income Tax Collections and Tax Incidence Analysis

Barry Boardman was reintroduced. He presented an analysis of personal income tax revenues in relationship to General Fund revenues; he gave a historical perspective of personal income tax collections/growth; the tax's distribution; and discussed the stability of the personal income tax. A copy of his power point presentation is attached.

The meeting adjourned at 2:30 p.m.

Senator Clark Jenkins, Presiding Chair

DeAnne Mangum, Committee Clerk

HOUSE PAGES

NAME OF COMMITTEE Joint Finance DATE Feb 3, 2010

1. Name: _____

   County: _____

   Sponsor: _____

2. Name: _____

   County: _____

   Sponsor: _____

3. Name: _____

   County: _____

   Sponsor: _____

4. Name: _____

   County: _____

   Sponsor: _____

5. Name: _____

   County: _____

   Sponsor: _____

	House	SGT-AT-ARM	Senate
1.	Name: Dusty Rhodes		Ronald Spann
2.	Name: Fred Hyres		Ernie Sherrell
3.	Name: John Brandon		
4.	Name: Marvin Lee		

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Feb. 3, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Jay Taylor	NCBIO
	TANC - Ty Ann
Lori Ann Harris	AATA
LC Bengman	ITW
	NMRS
Patrick Sutton	NMRS
W. Gardner Culpepper	Personal Interest
Will Culpepper	Moore & Van Allen
Chip Bigelow	NCMS
	JD, AL, PA
	NMRS

VISITOR REGISTRATION SHEET

Revenue Laws — Name of Committee

Feb. 3, 2010 — Date

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Jeff Allen	NMRS
Herb Crenshaw	AT+T
Melanie Soler	DCR
Rita Harris	Commerce
L C Penegar	ITW
DAVID BARNES	Poyner Spruill
L Andrews	NCFB
Paul Meyer	NCLM
Martha Jo McConnell	Carolinas HealthCare System
DANIEL BAUM	TROUTMAN SANDERS
Fred Baron	Baron & Assoc.

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Feb. 3, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Amy Hobbs	MWC
Tim Milam	NCICU
Sam Harris	NCPST
Katherine Joyce	NCASD
John Shaw	PCS
Cam Over	BPMHL
Gregg Thomas	NFIB
D Stone	NCB
Z-DVBATS	Smith Moore Leatherwood
Sam Bode	WCSP
Lauren Whaley	NCCUL

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Feb. 3, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Doug Heron	Williams Mullen
Brian Balfour	Civitas
Damien Graham	Triangle Transit
Wes Kelly	NMRS
Amy McConkey	NC Beverage Assoc.
Amy Whited	NC Medical Society
KMacc Goff	Smith Anderson
Mike Krzyzewski	DM
Paul Stam	NCBA
Allison Waller	Charlotte Chamber
Bubba Barnhardt	NC Beverage Assoc

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Feb. 3, 2010

Name of Committee — **Date**

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NAME	FIRM OR AGENCY AND ADDRESS
DAVID RICE	MANNING FULTON

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Feb. 3, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Nac Boxley	NC Aggregates
Rob Thompson	Covenant w/ NC's Children + Assoc
[illegible]	N.C. H. Comm
Meg Gray	NC Budget & Tax Center
Michael Houser	NC Dept of Revenue
Mary Klenz	League of Women Voters
Cecil S Bat	NCAE
Bill [illegible]	CATS
Sarah King	City of Charlotte
Joel Levy	City of Charlotte
Patricia Yancey	APPCNC / LLPP

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Feb. 3, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Sharon Miller	CUCA
Tommy Clark	WRC
David Heman	NC Center for Nonprofits
Keli Coleman	Eisai, Inc.
Emily Wilbanks	TPG
Chris Collins	TSS
Jack Betts	Charlotte Observer
Scott Mooney	The Insider

AGENDA

Joint Meeting of the Senate and House Finance Committees

February 3, 2010
1:00 p.m. – 3:00 p.m.
Room 643, Legislative Office Building

Meeting called by Senate Finance Cochairs: Senators Clodfelter, Hoyle, and Jenkins
and House Finance Cochairs: Representatives Luebke, Gibson, Wainwright, and Weiss

1:00 p.m. – 1:15 p.m.	**Opening Remarks by Finance Chairs**
1:15 p.m. – 1:25 p.m.	**Revenue and Budget Outlook** A look at the State's revenue and budget outlook. *Barry Boardman, PhD, Economist, Fiscal Research Division, NCGA*
1:25 p.m. – 1:40 p.m.	**Actions Taken by States in Response to Fiscal Conditions** An overview of state tax actions around the country in 2009. *Rodney Bizzell, Senior Fiscal Analyst, Fiscal Research, NCGA*
1:40 p.m. – 2:10 p.m.	**Personal Income Tax** An overview of the personal income tax; a look at how the personal income tax contributes to a sound tax structure; identify the ways states determine state taxable income; and explore the differences between federal AGI and federal taxable income. *Roby Sawyers, CPA, PhD, Department of Accounting, College of Management, NCSU*
2:10 p.m. – 2: 40 p.m.	**Personal Income Tax Structure in North Carolina** An overview of North Carolina's personal income tax laws: its history and development. *Cindy Avrette, Principal Legislative Analyst, Research Division, NCGA*
2:40 p.m. – 3:00 p.m.	**Fiscal Trends in North Carolina's Personal Income Tax Collections and Tax Incidence Analysis** An analysis of personal income tax revenues in relationship to General Fund revenues, a historical perspective of personal income tax collections, and an analysis of the tax incidence of the personal income tax. *Barry Boardman, PhD, Economist, Fiscal Research Division, NCGA*

Next Meeting: February 24th
Topic: Personal Income Tax

General Fund Revenue Collections

February 3, 2010

Barry Boardman, Ph.D.
Fiscal Research Division
North Carolina General Assembly

Overview

- Resolution initiative by Department of Revenue eliminates shortfall
- Economy-based taxes continue to decline
- Recent national and state forecasts indicate recovery may take a long time to unwind

How Do Revenues Look So Far?

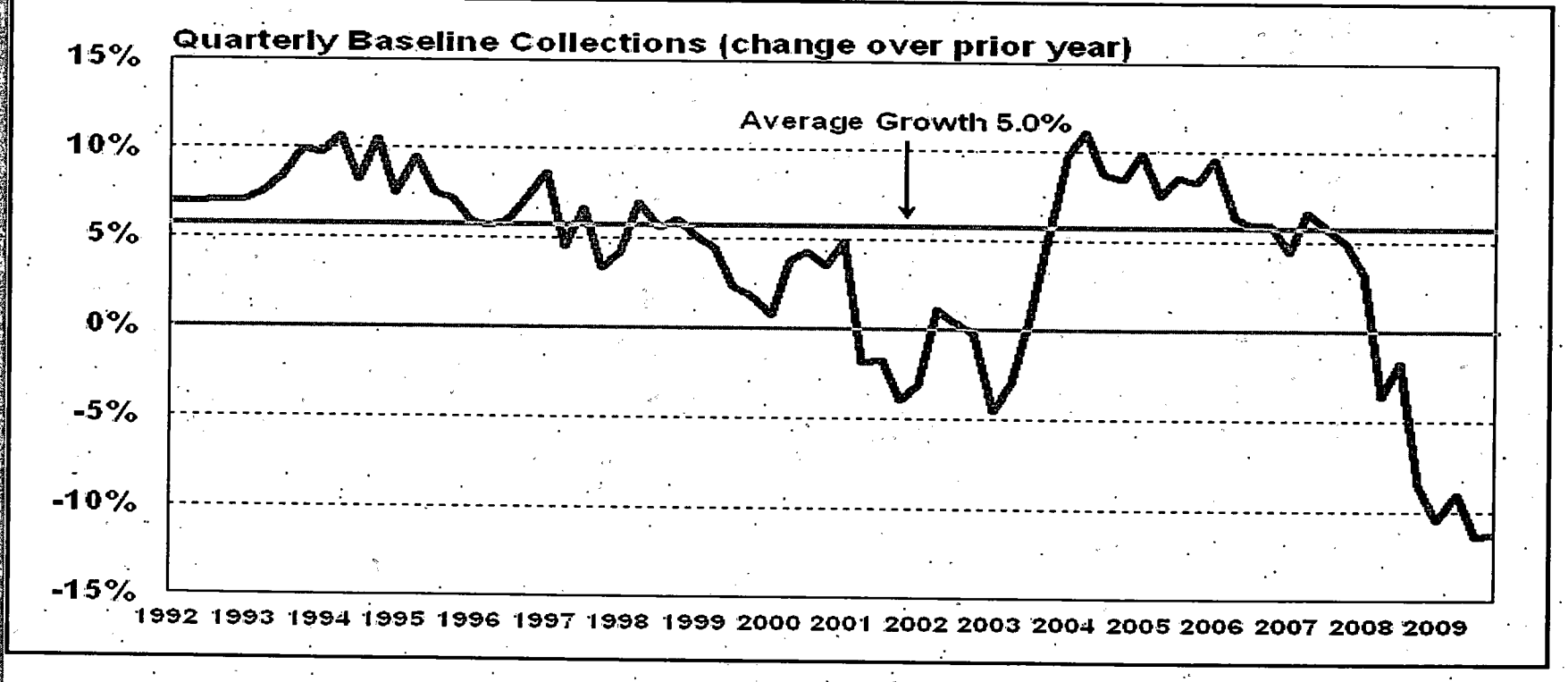
- State's collections are $30 million **above** $9.4 billion target through December
  - DOR's resolution payment initiative collected $422 million from over 200 corporate taxpayers
  - The budget included $150 million from this initiative
  - Without the $272 million the revenue shortfall would be $240 million or 2.6% below target

How Do Revenues Look So Far?

- Net income tax withholding are down 4.1% through December.
  - That compares with 3.8% through November.
- Sales tax collections continue to disappoint
  - Baseline (tax-adjusted) for the second quarter is down 11.3%
  - Net collections, including tax law changes are up 6.5%; however, budget targets projected a 11.5% increase.

Tracking Economy-Based Collections

Sales & Use Tax Collections
(adjusted for tax law changes)

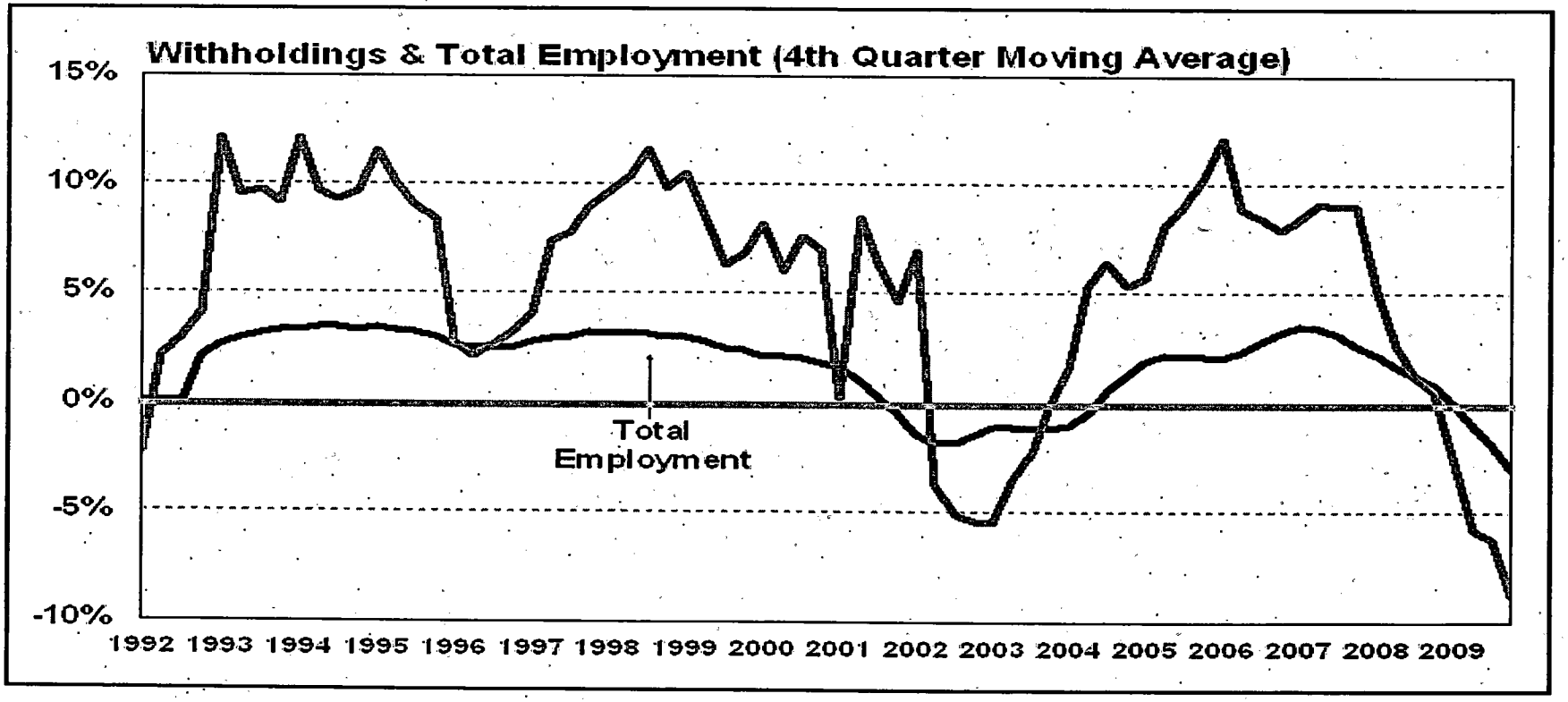


Why are Sales Collections Down?

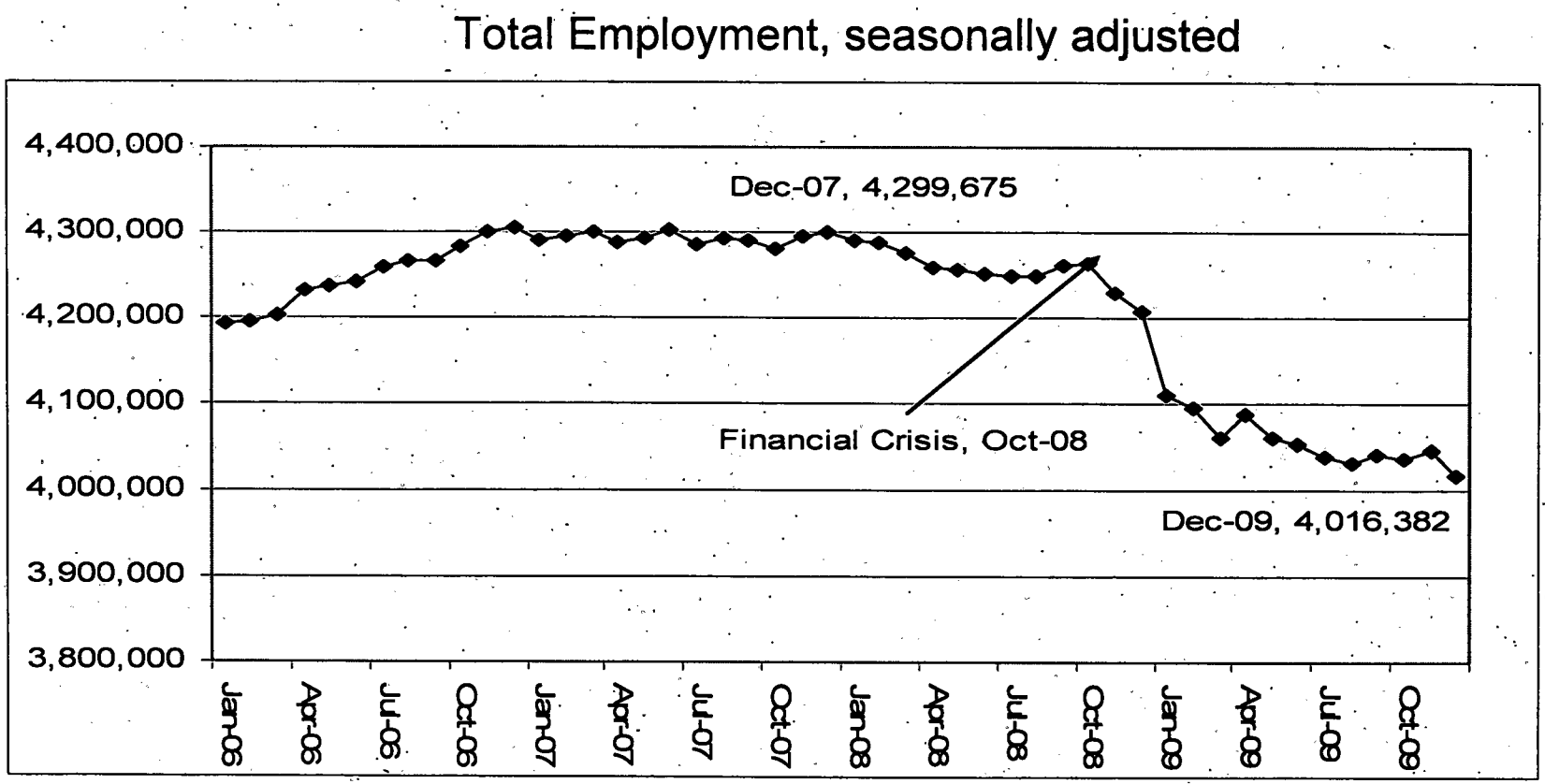
- Weak employment outlook
- Lower inflation-adjusted salary & wages
- Loss of household wealth from housing equity market losses
- Tight credit conditions persist
- Rather than increase debt during the recession, consumers are doing the opposite

Tracking Economy-Based Collections

Withholding Taxes



Tracking Economy-Based Collections



Source: NC Employment Security Commission

State's Economic Outlook

- Employment expected to improve second-half of 2010
- Personal income growth slow to materialize
- Wage & Salary income fell 4.4%(e) in 2009
- Growth in 2010 expected to be near 2.0%
- National and State forecasts have grown somewhat more pessimistic in the near term
  - expectations for a robust economy are being pushed out into 2011 and 2012.

Revenue: Things to Watch

- To meet budget forecast here is what has to happen
  - Employment picture brightens and consumer confidence improves
    - Wage & salary incomes will need to show improvements by last quarter
    - And consumer spending will have to rebound in early 2010

FY 2009-10
Fiscal Actions in Other States

February 3, 2010

Rodney Bizzell
Fiscal Research Division
North Carolina General Assembly

Study of North Carolina's Tax Structure
Interim Joint House and Senate Finance Committees

Overview

- Enacted FY 2009-10 Revenue Changes
  - NCSL and NASBO Surveys
- National Trends
- Specific Taxes

Overview

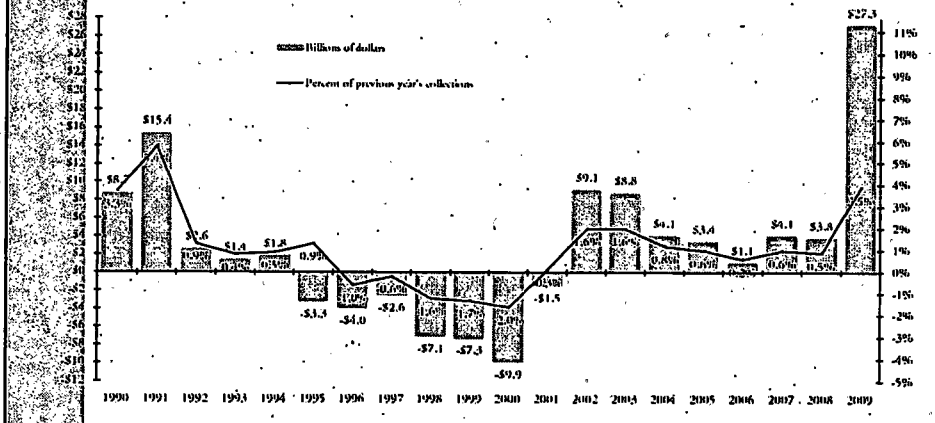
- The severe national recession resulted in the worst fiscal period for states since the Great Depression
- Thirty-six states reduced their FY 2009-10 budgeted expenditures.
- Twenty-nine states enacted net tax increases while nine states enacted net decreases.
- A wide variety of taxes were increased, but personal income and sales taxes were biggest revenue generators.

2009 Net State Tax Changes
by Type of Tax

Type of Tax	Dollars (in millions)	Percent of Total
Personal Income	$10,739.6	41.5%
Sales & Use	$6,129.0	23.7%
Fees	$5,273.6	20.4%
Miscellaneous	$967.8	3.7%
Cigarette & Tobacco	$908.1	3.5%
Alcoholic Beverage	$54.1	0.8%
Motor Fuel	$42.3	0.2%
Corporate Income	($202.2)	-0.8%
Net Change	**$23,912.3**	**100%**

Source: Fiscal Survey of States, National Association of State Budget Officers

Net State Tax Changes by Year of Enactment



Source: NCSL survey of legislative fiscal offices, various years. 2009 figures represent 47 reporting states. States not included are: MI, PA, and RI.

Personal Income Tax

- Net change: $10.7 billion
- Trend toward increasing rates for upper income brackets
- 12 states enacted personal income tax increases; 6 enacted decreases. Most decreases were in the form of additional exemptions.
- Maine lowered its upper income tax brackets ($32.8 million); off-set by expanding sales tax to more services.
- North Dakota lowered the personal income tax rate ($45 million); largely off-set by oil revenues.
- New York and California account for over half of the total additional revenue.

Source: Fiscal Survey of States, National Association of State Budget Officers

Sales Tax

- Net change: $6.1 billion.
- Twelve state enacted sales tax increases; five enacted decreases.
- Most decreases were in the form of additional exemptions; several increases were due to repealed exemptions.
- Connecticut reduced the sales tax rate by ½%; offset by personal and corporate income tax increases.

Source: Fiscal Survey of States, National Association of State Budget Officers

Fees

- Net change: $5.3 billion
- Nineteen states enacted fee increases. New York accounts for $2 billion.
- Wide variety
- $805 million for FY 2008-09

Source: Fiscal Survey of States, National Association of State Budget Officers

Corporate Income Tax

- Net change: ($202.2 million)
- Six states enacted corporate income tax increases; twelve enacted decreases.
- Several changes were related to IRC conformity.
- California accounts for ($330) million in film/jobs credits.

Source: Fiscal Survey of States, National Association of State Budget Officers

Cigarettes, Tobacco and Alcohol



- Net change: $962.2 million
- Seventeen states enacted cigarette tax increases. Continues a trend of increasing tobacco taxes.
- Four states enacted alcohol tax increases.

Source: Fiscal Survey of States, National Association of State Budget Officers

Questions?

Fiscal Survey of State is available at:
http://www.nga.org/Files/pdf/FSS0912.PDF

Broadening the Individual Income Tax Base -Starting with Federal AGI

Roby B. Sawyers, CPA, Ph.D.
College of Management
February 3, 2010

NC STATE UNIVERSITY

State Revenue Facts

- In the most recent fiscal year, over 56% of NC state tax revenue is generated from the personal income tax
- North Carolina relies more heavily on the personal income tax than most states with an income tax
- North Carolina relies more heavily on the personal income tax today than we used to
- North Carolina's top tax rate of 7.75% (before the surtax) is high compared to other states

NC STATE UNIVERSITY

Taxable Income vs. AGI as the Starting Point

- 29 states use federal adjusted gross income as the starting point in determining state taxable income
- 6 states including North Carolina use federal taxable income as the starting point
- 7 states don't have a state income tax
- Federal taxable income is a narrow base representing income after all federally allowed deductions – both deductions "for AGI" and deductions "from AGI"

Taxable Income vs. AGI

- Primary differences:
  - Federal taxable income is income after the standard deduction or sum of your itemized deductions (medical expenses, state and local taxes, mortgage interest, charitable contributions, etc.)
  - Federal taxable income is income after personal and dependency exemptions

Taxable Income vs. AGI

- Note that regardless of the base used, the items of income subject to tax are the same.
  - For example, capital gains are included in income under either approach
  - A portion of social security benefits are included in income under either approach

Current Law vs. AGI

- Our current system of additions and subtractions is confusing to taxpayers and complex
- Moving to AGI as the starting point broadens the income tax base and provides a less complex tax form for taxpayers (you could eliminate many of the additions and subtractions)
- AGI is also a less volatile base than taxable income
- Broadening the base allows for tax rates to be reduced without a loss of tax revenue

What would it mean?

- A few adjustments would still be required:
  - Legally obligated to exempt interest from federal obligations
  - Legally obligated to exempt certain retirement benefits under the *Bailey* decision
  - To avoid double-tax, would allow deduction for state and local tax refunds included in federal AGI

What would it mean?

- Social security benefits would be subject to North Carolina income tax to the same extent that they are subject to Federal tax
- Taxpayers would not receive deductions for mortgage interest, charitable contributions and other itemized deductions

Taxing Social Security Benefits

- The federal government began taxing a portion of social security benefits in 1984.
- Depending on the taxpayer's other income, up to 50% of social security benefits was originally subject to tax
- In 1993, the maximum amount subject to tax was increased to 85% for higher-income beneficiaries
  - Why 85%? About 85% of the average social security benefit represents an amount in excess of that contributed by the average worker

Taxing Social Security Benefits

- Only 25% of social security beneficiaries pay any tax liability on their benefits
- Over 80% of taxable social security benefits are reported by taxpayers with over $50,000 of adjusted gross income
- If you tax social security benefits to the same extent as the federal government, you are only taxing a small percent of beneficiaries receiving social security benefits

Itemized Deductions

- Only 37% of taxpayers in the U.S. itemize their deductions (Most take the standard deduction)
- High-income taxpayers are more likely to itemize than low-income taxpayers
- The largest itemized deductions claimed are for mortgage interest, state and local taxes and charitable contributions

What do other states do?

- A little bit of everything!
  - 29 states exempt all social security income from tax while 15 tax some portion of social security benefits
  - 34 states allow some type of standard deduction
  - All states allow either a personal exemption or credit to adjust tax liability for family size
  - 34 states allow itemized deductions – sometimes following federal rules and sometimes with their own limitations
  - Seven states have a flat tax rate

	Arizona	*California*	*Connecticutt*	*Delaw*
Adjustme				
Social Security Benefits	Exempt	Exempt	Depends on Income	Exempt
Capital Gains	Same as Federal	Same as Federal	Some Exempt	Same as Federal
Retirement/Pension Income Exclusions:				
Private	None	None	None	$2,000/$12,500*
Public	$ 2,500	None	None	$2,000/$12,500
US Civil Service	$ 2,500	None	None	$2,000/$12,500
Military	$ 2,500	None	None	$2,000/$12,500
Standard Deductions:				
% of AGI				
Single	$ 4,373	$ 3,516	$ 12,750*	$ 3,250
Married-Joint	$ 8,745	$ 7,032	$ 24,000	$ 6,500
Married-Single	$ 4,373	$ 3,516	$ 12,000	$ 3,250
Head of Household	$ 8,745	$ 7,032	$ 19,000	$ 3,250
Itemized Deductions:				
State Income Taxes and Sales Tax	Federal	None	None	State (Sales Tax)
Other Taxes	State Calc	State Calc	None	State Calc
Interest	Federal	Federal	None	Federal
Medical Expenses	State Calc	Federal	None	Federal
Charitable Contributions	State Calc	State Calc	None	State Calc
Misc and Other	State Calc	State Calc	None	Federal
Personal Exemptions:				
Single	$ 2,100	Credit $94*	Credit 0 - 75%*	Credit $110**
Married-Joint	$ 4,200	Credit $188	Credit 0 - 75%	Credit $220
Head of Household	$ 3,150	Credit $94	Credit 0 - 75%	Credit $110
Dependent	$ 2,300	Credit $294	None	Credit $110
Tax Rate Structures:				
Flat Rate (Seven States)				
Progressive (Range)	2.59 % - 4.54%	1% - 9.3%	3% - 5%	0% - 5.95%
Number of Brackets	5	6	2	7
Notes:		*Credits limited at higher incomes	*Standard deductions and tax credits are subject to phase out	*The lower exclusion if under age 60, the higher exlusion if above age 60
				**Additional credit of $110 if age 60 or over

	Georgia	Hawaii	Idaho	Il
Adjustme				
Social Security Benefits	Exempt	Exempt	Exempt	Exempt
Capital Gains	Same as Federal	Subject to lower tax rate	Some Exempt	Same as Federal
Retirement/Pension Income Exclusions:				
Private	$ 30,000	State Calc	None	State Calc
Public	$ 30,000	Exempt	State Calc	Exempt
US Civil Service	$ 30,000	Exempt	State Calc	Exempt
Military	$ 30,000	Exempt	State Calc	Exempt
Standard Deductions:				
% of AGI				
Single	$ 2,300	$ 2,000	Federal	None
Married-Joint	$ 3,000	$ 4,000	Federal	None
Married-Single	$ 1,500	$ 2,000	Federal	None
Head of Household	$ 2,300	$ 2,920	Federal	None
Itemized Deductions:				
State Income Taxes and Sales Tax	State Calc	Federal	None	None
Other Taxes	Federal	Federal	Federal	None
Interest	State Calc	Federal	Federal	None
Medical Expenses	Federal	Federal	Federal	None
Charitable Contributions	Federal	Federal	Federal	None
Misc and Other	Federal	State Calc	Federal	None
Personal Exemptions:				
Single	$ 2,700	$ 1,040	Federal	$ 2,000
Married-Joint	$ 5,400	$ 2,080	Federal	$ 4,000
Head of Household	$ 2,700	$ 1,040	Federal	$ 2,000
Dependent	$ 3,000	$ 1,040	Federal	$ 2,000
Tax Rate Structures:				
Flat Rate				3%
Progressive (Range)	1% - 6%	1.4% - 8.25 %	1.6% - 7.8%	
Number of Brackets	6	9	8	
Notes:				

	Indianc	Kansas	Kentucky
Adjustme			
Social Security Benefits	Exempt	Depends on Income	Exempt
Capital Gains	Same as Federal	Some exempt	Some exempt
Retirement/Pension Income Exclusions:			
Private	State Calc	None	$ 41,110
Public	State Calc	Some exempt	State Calc
US Civil Service	State Calc	Exempt	State Calc
Military	State Calc	Exempt	State Calc
Standard Deductions:			
% of AGI			
Single	None	$ 3,000	$ 2,050
Married-Joint	None	$ 6,000	$ 4,100
Married-Single	None	$ 3,000	$ 2,050
Head of Household	None	$ 4,500	$ 2,050
Itemized Deductions:			
State Income Taxes and Sales Tax	None	State (Sales Tax)	None
Other Taxes	None	Federal	Federal
Interest	None	Federal	Federal
Medical Expenses	None	Federal	State Calc
Charitable Contributions	None	Federal	Federal
Misc and Other	None	Federal	Federal
Personal Exemptions:			
Single	$ 1,000	$ 2,250	Credit $20
Married-Joint	$ 2,000	$ 4,500	Credit $40
Head of Household	$ 1,000	$ 2,250	Credit $20
Dependent	$ 1,500	$ 2,250	Credit $20
Tax Rate Structures:			
Flat Rate	3.40%		
Progressive (Range)		3.5% - 6.45%	2% - 6%
Number of Brackets		3	6
Notes:			

	Lo	Maine	Maryland	:husetts
Adjustmer				
Social Security Benefits	Exempt	Exempt	Exempt	Exempt
Capital Gains	Same as Federal	Some exempt	Same as Federal	Special Rates
Retirement/Pension Income Exclusions:				
Private	$ 6,000	$ 6,000	$ 23,600	None
Public	Some Exempt	$ 6,000	$ 23,600	Exempt*
US Civil Service	Exempt	$ 6,000	$ 23,600	Exempt*
Military	Exempt	$ 6,000	$ 23,600	Exempt
Standard Deductions:				
% of AGI			15%	
Single	$ 4,500*	$ 5,350	$1,500 - $2,000*	None
Married-Joint	$ 9,000	$ 8,900	$3,000 - $4,000	None
Married-Single	$ 4,500	$ 4,450	$1,500 - $2,000	None
Head of Household	$ 9,000	$ 7,850	$3,000 - $4,000	None
Itemized Deductions:				
State Income Taxes and Sales Tax	State Calc	None	State (Sales Tax)	None
Other Taxes	State Calc	Federal	Federal	None
Interest	State Calc	Federal	Federal	None
Medical Expenses	State Calc	Federal	Federal	State
Charitable Contributions	State Calc	Federal	Federal	None
Misc and Other	State Calc	State Calc	Federal	State
Personal Exemptions:				
Single	$ 1,000**	$ 2,850	$ 2,400	$ 4,125
Married-Joint	$ 2,000	$ 5,700	$ 4,800	$ 8,250
Head of Household	$ 1,000	$ 2,850	$ 2,400	$ 6,375
Dependent	$ 1,000	$ 2,850	$ 2,400	$ 1,000
Tax Rate Structures:				
Flat Rate				
Progressive (Range)	2% - 6%	2% - 8.5%	2% - 4.75%	5.3% - 12%
Number of Brackets	3	4	4	Flat Rates**
Notes:	*Deduction amounts represent combined standard deduction and personal exemptions		*Standard deduction equals 15% of AGI with minimums and maximums shown above	*only contributory pension income is exempt
	**These amounts are included in the combined deduction/personal exemptions shown above			**Flat rates vary depending on type of income

	Michigan	Missouri	Montana	ska
Adjustme				
Social Security Benefits	Exempt	Depends on Income	Depends on Income	Same as Federal
Capital Gains	Some exempt	Some Exempt	Some Exempt	Some Exempt
Retirement/Pension Income Exclusions:				
Private	$ 42,240	$ 6,000	$ 3,600	None
Public	Exempt	$ 6,000	$ 3,600	None
US Civil Service	Exempt	$ 6,000	$ 3,600	None
Military	Exempt	$ 6,000	$ 3,600	None
Standard Deductions:				
% of AGI			20%	
Single	None	Federal	$1,690 - $3,810*	Federal
Married-Joint	None	Federal	$3,380 - $7,620	Federal
Married-Single	None	Federal	$1,690 - $3,810	Federal
Head of Household	None	Federal	$3,380 - $7,620	Federal
Itemized Deductions:				
State Income Taxes and Sales Tax	None	State (Sales Tax)	State (Sales Tax)	State (Sales Tax)
Other Taxes	None	State Calc	State Calc	Federal
Interest	None	Federal	Federal	Federal
Medical Expenses	None	Federal	State Calc	Federal
Charitable Contributions	None	State Calc	Federal	Federal
Misc and Other	None	Federal	State Calc	Federal
Personal Exemptions:				
Single	$ 3,400	$ 2,100	$ 2,040	Credit $ 111
Married-Joint	$ 6,800	$ 4,200	$ 4,080	Credit $ 222
Head of Household	$ 3,400	$ 3,500	$ 2,040	Credit $ 111
Dependent	$ 3,400	$ 1,200	$ 2,040	Credit $111
Tax Rate Structures:				
Flat Rate	4.01%			
Progressive (Range)		1.5% - 6%	1% - 6.9%	2.56% - 6.84%
Number of Brackets		10	7	4
Notes:			*Standard deduction equals 20% of AGI with minimums and maximums as shown above	

	New Mexic	New York	Ohio	Okla
Adjustme				
Social Security Benefits	Same as Federal	Exempt	Exempt	Exempt
Capital Gains	Some Exempt	Same as Federal	Same as Federal	Some Exempt
Retirement/Pension Income Exclusions:				
Private	None	$ 20,000	$ 200 Credit	$ 10,000
Public	None	Exempt	$ 200 Credit	$ 10,000
US Civil Service	None	Exempt	$ 200 Credit	$ 10,000
Military	None	Exempt	$ 200 Credit	$ 10,000
Standard Deductions:				
% of AGI				
Single	Federal	$7,500	None	$ 2,750
Married-Joint	Federal	$ 15,000	None	$ 5,500
Married-Single	Federal	$ 7,500	None	$ 2,750
Head of Household	Federal	$ 10,500	None	$ 4,125
Itemized Deductions:				
State Income Taxes and Sales Tax	Federal	State (Sales Tax)	None	Federal
Other Taxes	Federal	State Calc	None	Federal
Interest	Federal	Federal	None	Federal
Medical Expenses	Federal	State Calc	None	Federal
Charitable Contributions	Federal	Federal	None	Federal
Misc and Other	Federal	State Calc	None	Federal
Personal Exemptions:				
Single	Federal	None	$1,450 & $20 Cr	$ 1,000
Married-Joint	Federal	None	$2,900 & $40 Cr	$ 2,000
Head of Household	Federal	None	$1,450 & $20 Cr	$ 1,000
Dependent	Federal	$ 1,000	$1,450 & $20 Cr	$ 1,000
Tax Rate Structures:				
Flat Rate				
Progressive (Range)	1.7% - 5.3%	4% - 6.85%	0.649% - 6.555%	0.5% - 6.65%
Number of Brackets	4	5	9	7
Notes:	*Low and middle income taxpayers may claim up to an additional exemption of $2,500; subject to phase outs			

	O	Rhode Island	U
Adjustme			
Social Security Benefits	Exempt	Same as Federal	Depends on Income and Age
Capital Gains	Some Exempt/Special Rates	Same as Federal	Some Exempt
Retirement/Pension Income Exclusions:			
Private	9% Credit	None	$4,800/$7,500*
Public	9% Credit	None	$4,800/$7,500
US Civil Service	9% Credit/pre-1991 Exempt	None	$4,800/$7,500
Military	9% Credit/pre-1991 Exempt	None	$4,800/$7,500
Standard Deductions:			
% of AGI			
Single	$ 1,825	$ 5,350	Federal
Married-Joint	$ 3,650	$ 8,900	Federal
Married-Single	$ 1,825	$ 4,450	Federal
Head of Household	$ 2,940	$ 7,850	Federal
Itemized Deductions:			
State Income Taxes and Sales Tax	None	Federal	State (Sales Tax)
Other Taxes	Federal	Federal	Federal
Interest	Federal	Federal	Federal
Medical Expenses	State Calc	Federal	Federal
Charitable Contributions	Federal	Federal	Federal
Misc and Other	State Calc	Federal	Federal
Personal Exemptions:			
Single	$165 Cr. phased to $55	Federal	$ 2,550
Married-Joint	$330 Cr. phased to $110	Federal	$ 5,100
Head of Household	$165 Cr. phased to $55	Federal	$ 2,550
Dependent	$165 Cr. phased to $55	Federal	$ 2,550
Tax Rate Structures:			
Flat Rate			
Progressive (Range)	5% - 9%	3.75% - 9.9%	2.3% - 7%**
Number of Brackets	3	5	6
Notes:			*First amount subject to ages less than 65, the second amount if over 65
			**Also an alternative flat tax rate of 5.35%

	Virginia	West Virginia	Wisconsin
Adjustmer			
Social Security Benefits	Exempt	Same as Federal	Up to 50% taxable
Capital Gains	Some Exempt	Same as Federal	Some exempt
Retirement/Pension Income Exclusions:			
Private	None	None	None
Public	None	$ 2,000	Pre-1964 Exempt
US Civil Service	None	$ 2,000	Pre-1964 Exempt
Military	Most Taxable	$ 22,000	Exempt
Standard Deductions:			
% of AGI			
Single	$ 3,000	None	$ 8,790*
Married-Joint	$ 6,000	None	$ 15,830
Married-Single	$ 3,000	None	$ 7,520
Head of Household	$ 3,000	None	$ 11,350
Itemized Deductions:			
State Income Taxes and Sales Tax	State (Sales Tax)	None	None
Other Taxes	Federal	None	None
Interest	Federal	None	State Calc
Medical Expenses	Federal	None	Federal
Charitable Contributions	Federal	None	Federal
Misc and Other	Federal	None	None
Personal Exemptions:			
Single	$ 900	$ 2,000	$ 700
Married-Joint	$ 1,800	$ 4,000	$ 1,400
Head of Household	$ 900	$ 2,000	$ 700
Dependent	$ 900	$ 2,000	$ 700
Tax Rate Structures:			
Flat Rate			
Progressive (Range)	2% - 5.75%	3% - 6.5%	4.6% - 6.75%
Number of Brackets	4	5	4
Notes:			
			*Deductions subject to phase out

Overview of North Carolina's Personal Income Tax

Cindy Avrette
Research Division, NCGA

February 3, 2010

NC's Personal Income Tax

- NC Constitutional Amendment of 1920
  - Permitted the taxation of incomes
  - Rate of tax on incomes could not exceed 6%
  - Exemptions so only net incomes taxed
- Amendment of 1935
  - 6% limitation increased to 10%



Issues re: NC's Personal Income Tax

- Grown to become the largest single source of state revenues
  - Volatility of non-withholding portion of the tax
  - High marginal rate
- Reliance on federal tax code changes
- Primary vehicle for ensuring tax equity in the tax system as a whole



NC Personal Income Tax Prior to 1989

- NC did not employ a federal starting point for calculating State taxable income
- Numerous exemptions
- Numerous credits
- Five tax brackets
- Rates ranging from 3% to 7%



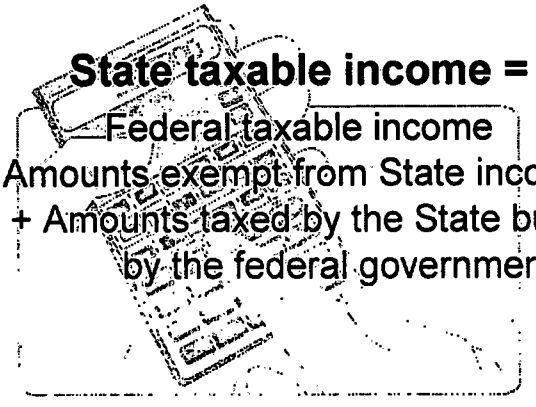
Tax Fairness Act of 1989

- Modernized the personal income tax
- Simplified calculation of the tax
- Provided relief to low income taxpayers
  - Reduced taxes for approximately 65% of the taxpayers
  - Increased personal exemption and standard deduction
  - Two tax brackets with rates of 6% and 7%

Calculating State Taxable Income

State taxable income =

Federal taxable income
- Amounts exempt from State income tax
+ Amounts taxed by the State but not by the federal government



Federal Taxable Income

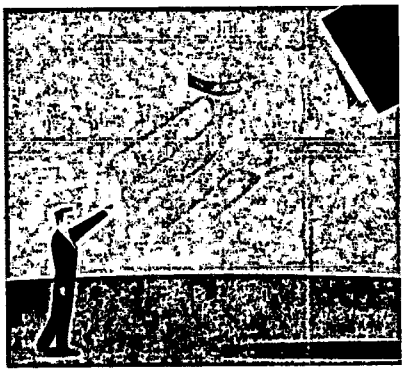
- Constitutional limitation on delegation of taxing authority
  - IRC Update
- Subjects NC tax revenues to federal tax policies
  - Bonus depreciation
- NC does not index personal exemptions or standard deduction

State Tax Exemptions: Federal Law

- Interest on US obligations
- Income from an Indian tribe
- Amounts paid under the Railroad Retirement Act of 1937



State Tax Exemptions: Contractual



- Gain from obligations issued before 1995 to the extent allowed by State law
- Bailey retirement income ($401.7 m)

State Tax Exemptions: Practice

- Interest on NC and local government obligations and obligations of a nonprofit educational institution charted in NC
- The deductible amount for interest on US, NC, and nonprofit educational institutions = $20.9 m
  - Deductible amount for NC obligations > $ 1 m

State Tax Exemptions: Accounting



- Refunds of state, local, and foreign taxes
- Amount by which basis of property under State law differs from the basis of the property under federal law

State Tax Exemptions: Social Security

- Federal practice
  - About 1/3 of people who receive SSI pay federal income tax on some portion of these benefits
- 5 states follow federal practice
- SSI benefits in excess of federal limit = $375.4 m

State Tax Exemption: Retirement

- Retirement income
  - $4,000 for governmental retirement income
  - $2,000 for private retirement income
- $80.9 million



State Tax Exemption: Unemployment



- *Severance wages* not to exceed $35,000 ($15.5 m)
- *Unemployment benefits* up to $2,400 received in 2009 ($47.8 m)

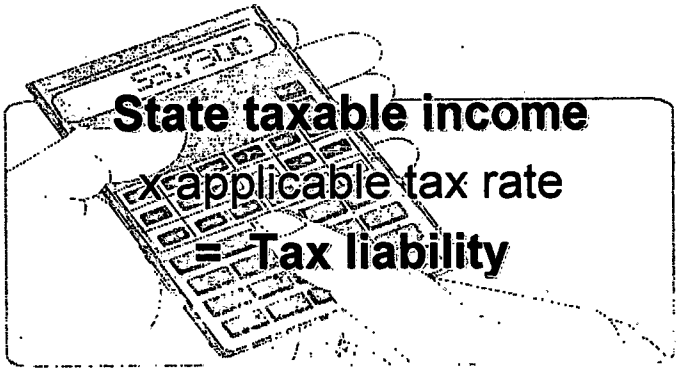
Misc. State Tax Exemptions

- *Erroneous Conviction*
- *Disaster Relief Reserve Fund*
- *Sale of Mfg'd Home Community to Mfg'd Home Owners*
- *NC 529 Plan*
  - AGI limits in 2012
  - $5 million
- *Volunteer Fire and Rescue*
  - $1 million

Add Backs: IRC Decoupling

- Standard deduction
  - Federal = $5,700 (single; MFS) $8,350 (H/H)
  - State = $3,000 (single; MFS); $$4,400 (H/H)
  - **Add back $2,700**
- Personal exemption
  - Federal = $3,650
  - State = $2,500 if AGI < $100,000 (MFJ)
  - State = $2,000 if AGI = or > $100,000 (MFJ)
  - **Add back *at least* $1,150 for each PE claimed**

Calculating State Tax Liability



State taxable income

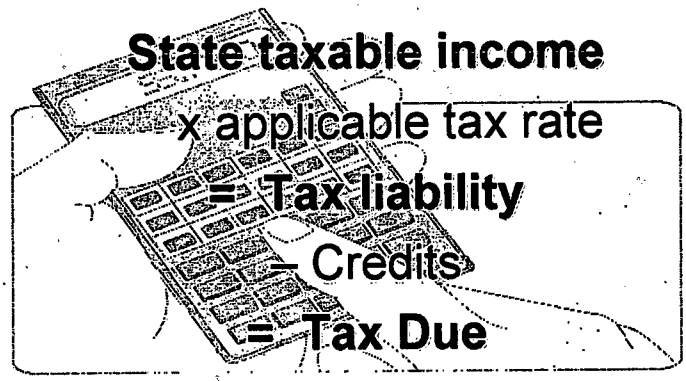
x applicable tax rate

= Tax liability

Tax Brackets and Rates

- Prior to 1989
  - 6 brackets
  - Rates ranging from 3% to 7%
- 1989
  - Two brackets
  - Rates of 6% and 7%
- 1991
  - Three brackets
  - 6%, 7%, and 7.75%
- 2001
  - Temporary 4th bracket of 8.25%
  - Extended twice
- 2009
  - Temporary surtax
  - 2% surtax, taxable income exceeds $100K (MFJ)
  - 3% surtax, taxable income exceeds $250K (MFJ)

Calculating State Tax Due



State taxable income

x applicable tax rate

= Tax liability

– Credits

= Tax Due

Tax Credits: Children

- *Children < 17*
  - AGI limitation
  - $147.3 million
- Childcare
  - $53.6 million
- *Adoption*
  - $5.9 million
  - Sunsets 2013

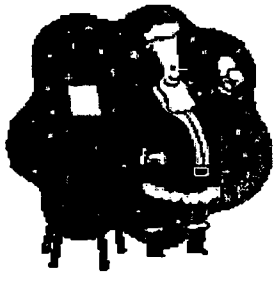


Tax Credit: *Earned Income*



- Refundable tax credit
- 5% of the federal credit amount
- $81.2 million
- Sunsets 2013

Tax Credits: *Non-itemizers*



- Charitable contributions by non-itemizers
  - $26.5 million
  - Sunsets 2011

Tax Credits: Health

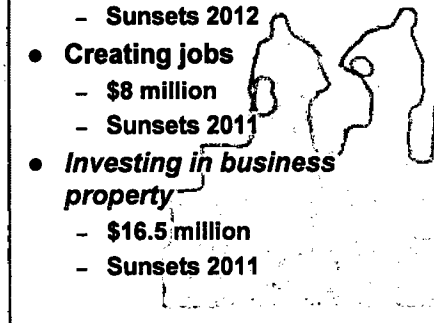
- *Long-term care premiums*
  - AGI limitation
  - $4.7 million
  - Sunsets 2013
- Disabled persons
  - $1.5 million
- Construction of dwellings for handicapped persons
- *Small business health insurance*
  - $5 million
  - Sunsets 2010

Tax Credits: Energy

- Investing in renewable energy property
  - $4 million
  - Sunsets 2016
- *Donations to acquire renewable energy property*
- Refund motor fuel excise tax for biodiesel
  - $1.2 million
  - Sunsets 2010
- Tax Credits for renewable fuels
  - Fuel dispensing facilities
  - Constructing fuel processing facilities
  - Alternative credit for constructing fuel processing facilities
  - Sunset 2011
- *Recycling facility*
  - $7.0 million

Tax Credits: Business

- *Work opportunity*
  - $0.4 million
  - Sunsets 2012
- Creating jobs
  - $8 million
  - Sunsets 2011
- *Investing in business property*
  - $16.5 million
  - Sunsets 2011
- *Investing in real property*
  - $0.4 million
  - Sunsets 2011
- *Research & development*
  - Business ($19 million)
  - UNC ($2.5 million)
  - Sunsets 2014
- *Low-income housing*
  - $34 million, refundable
  - Sunsets 2015
- *Film production*
  - $22.5 million, refundable
  - Sunsets 2014



Tax Credit: Real Property

- Real property donations
  - $25.7 million
- Conservation tillage equipment
- Gleaned crops
- Poultry composting facility
- Property taxes paid on farm machinery
  - $1.6 million
- *Recycling oyster shells*
  - Sunsets 2011

Tax Credits: Historic Rehabilitation

- *Income producing historic structure*
  - $3.0 million
- *Non-income producing historic structure*
  - $5 million
- *Income producing mill property*
  - $1 million
  - Sunsets 2011
- *Non-income producing mill property*
  - $5 million
  - Sunsets 2011



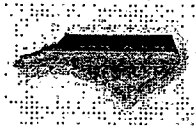
Prior Study Committee Recommendations: Next Meeting

- Broaden the base, lower the rates
- Use AGI as the starting point
- Eliminate exemptions, deductions, and credits
- Lessen the State's exposure to the volatility of the current PIT structure
- Ensure tax equity in tax structure as a whole

Personal Income Tax Collections

February 3, 2010

Barry Boardman, Ph.D.
Fiscal Research Division
North Carolina General Assembly

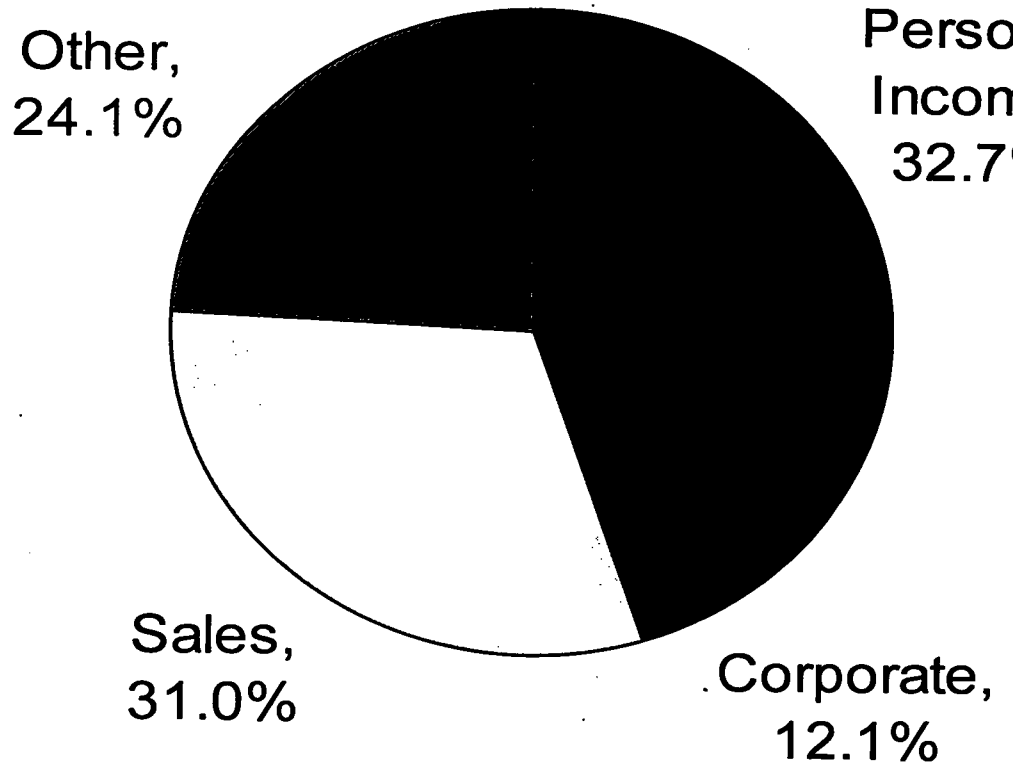


STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

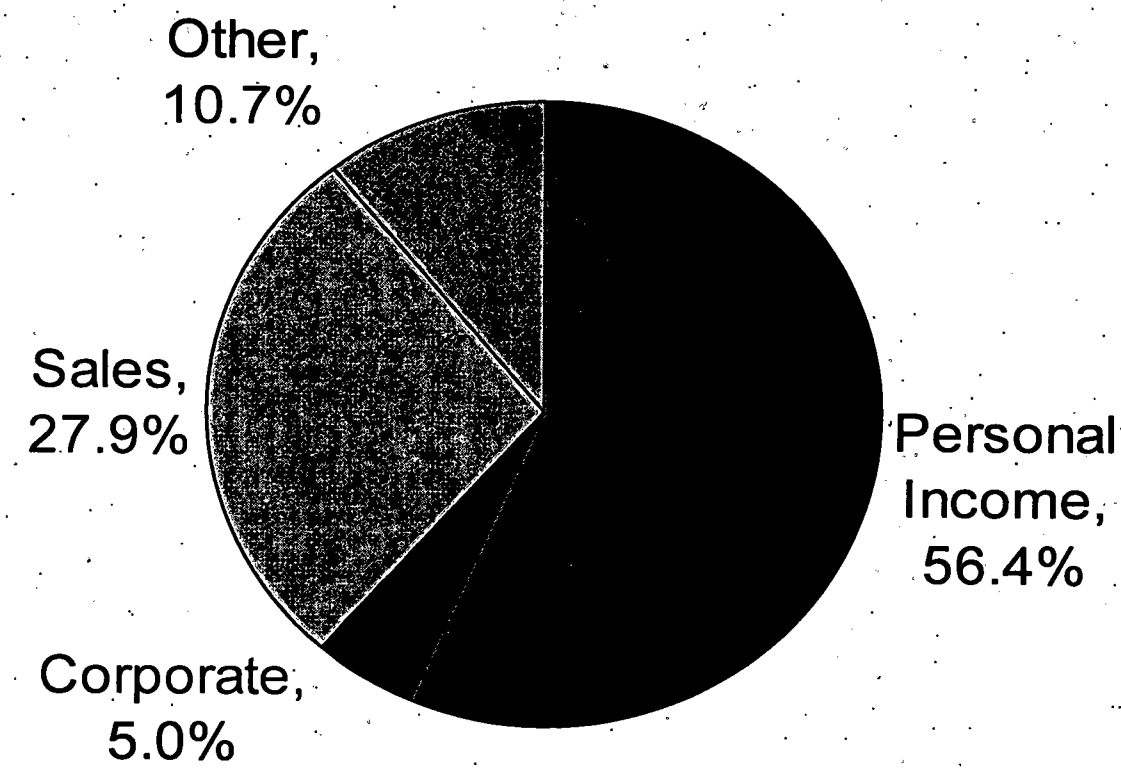
Overview

- State's tax structure
- PIT growth
- Distribution
- PIT stability

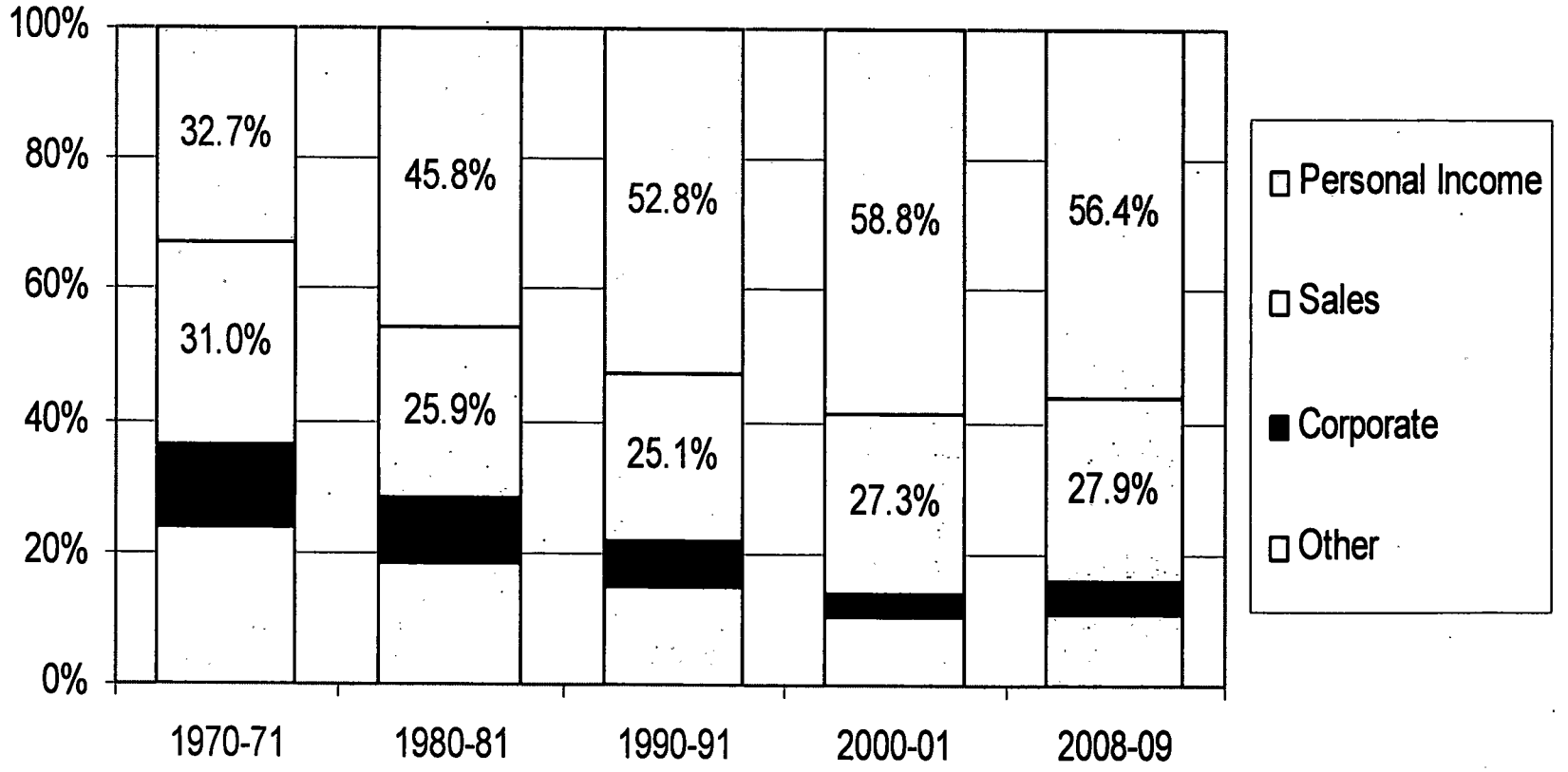
State Tax Structure, FY 1970-71



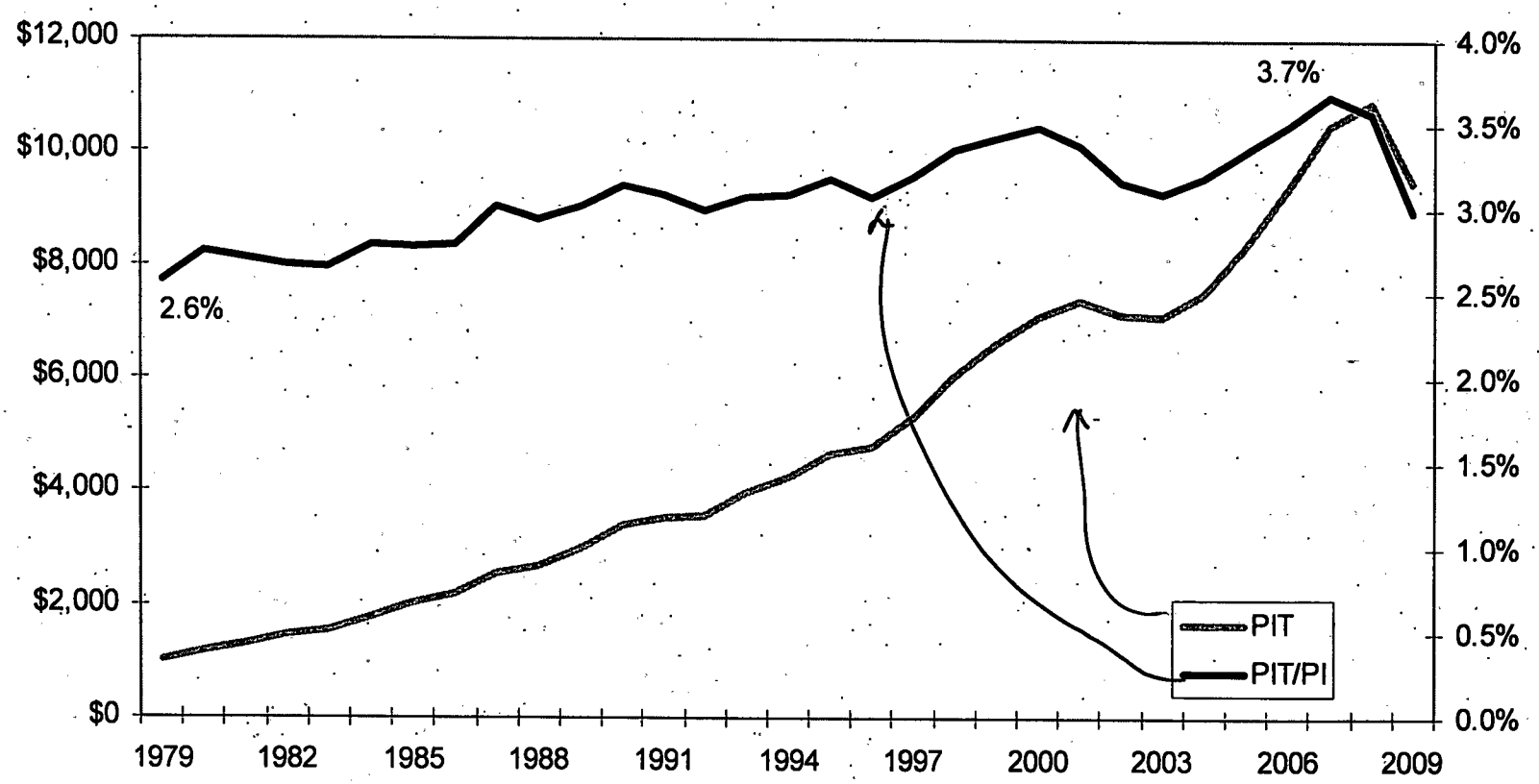
State Tax Structure, FY 2008-09



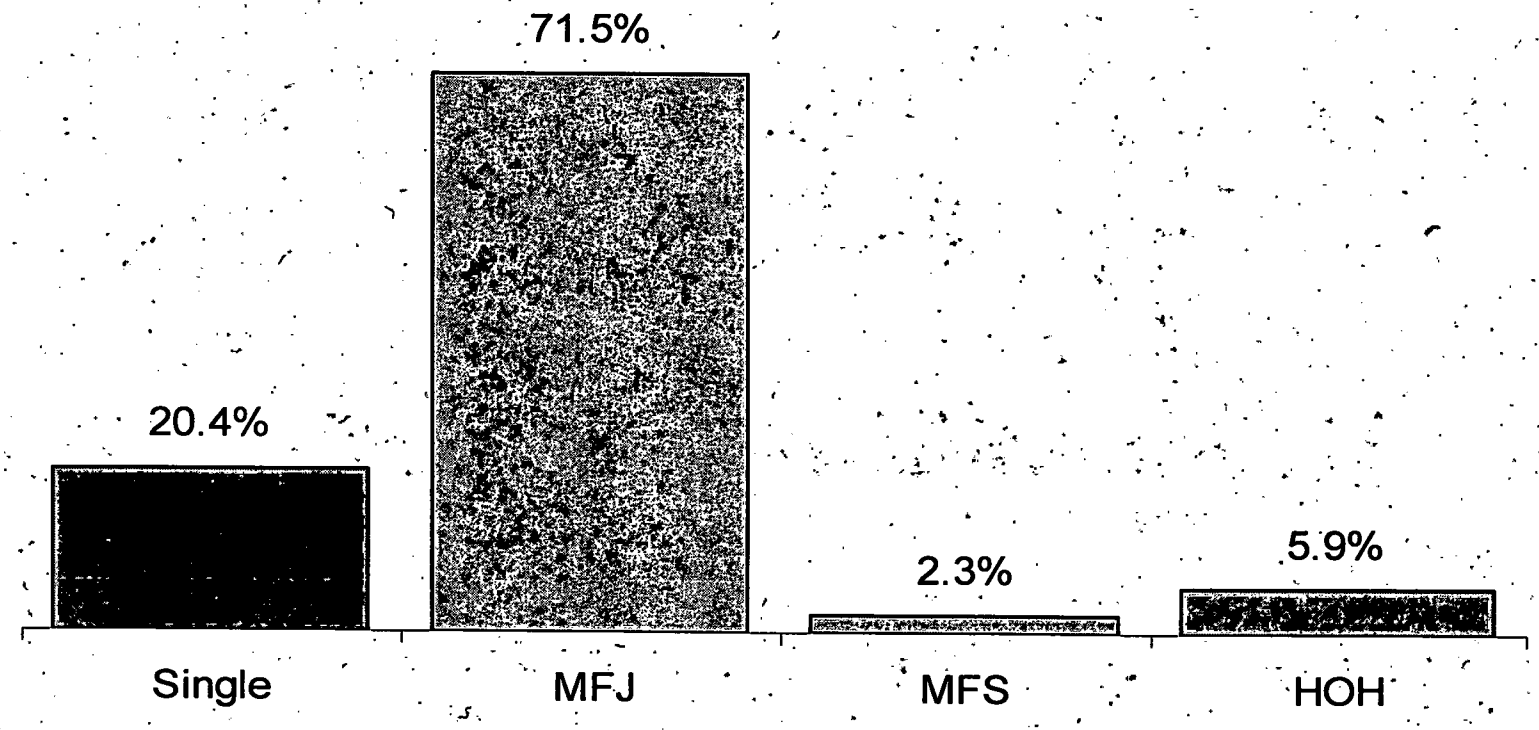
State Tax Structure



Personal Income Collections



PIT Paid by Filing Status



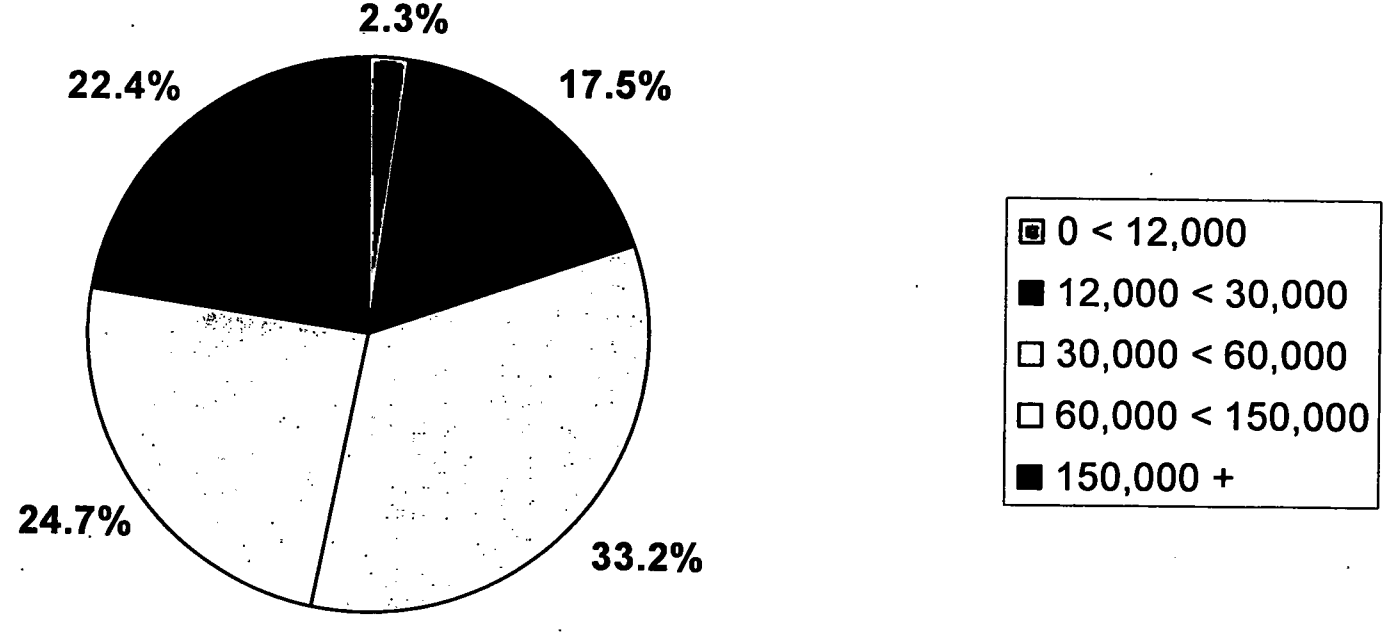
Source: Estimated using the Bearing Point tax model

Tax Distribution

- 3 million + returns
  - representing approximately 4.5 million taxpayers
- 3% or about 150,000 taxpayers pay 33% of total PIT
- 22% or about 1 million taxpayers pay 63% of total PIT

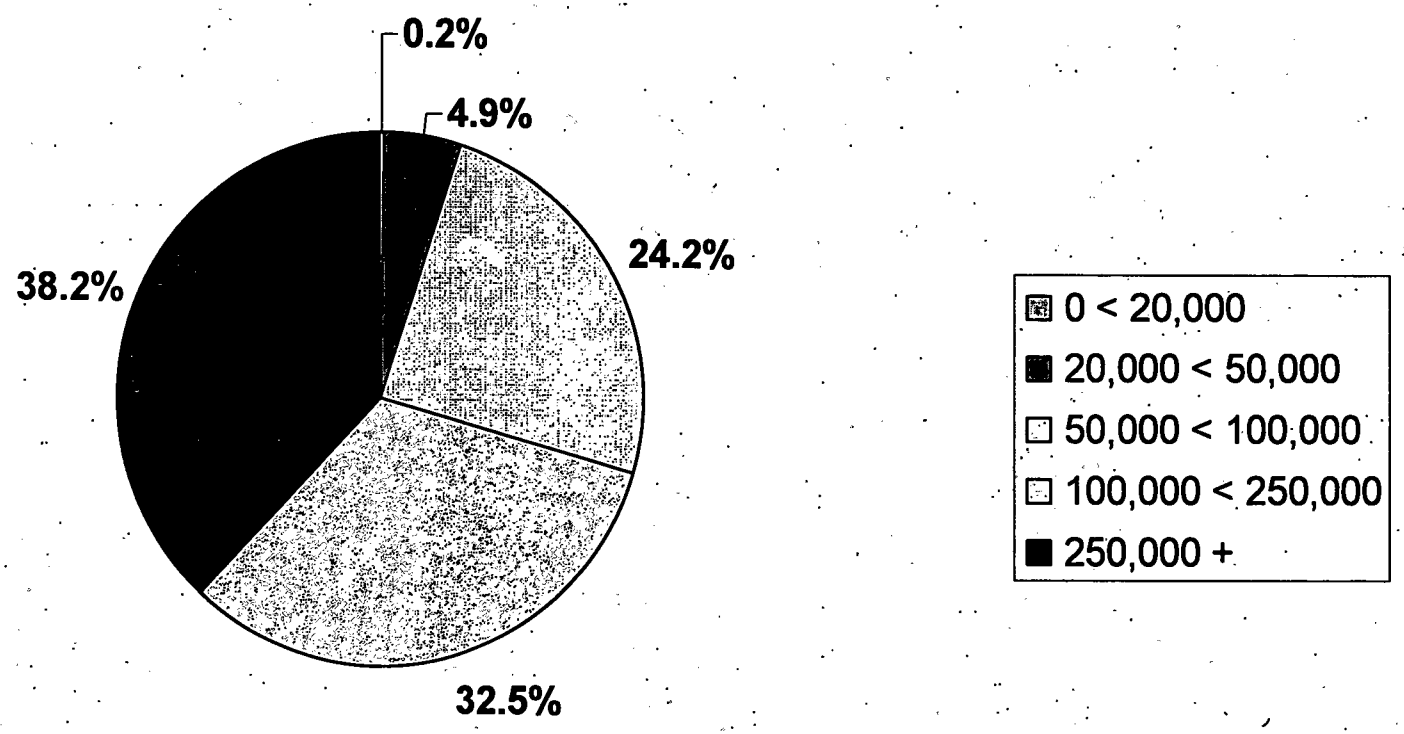
Source: Estimated using the Bearing Point tax model

Percent of Total Taxes Paid by Income: Single



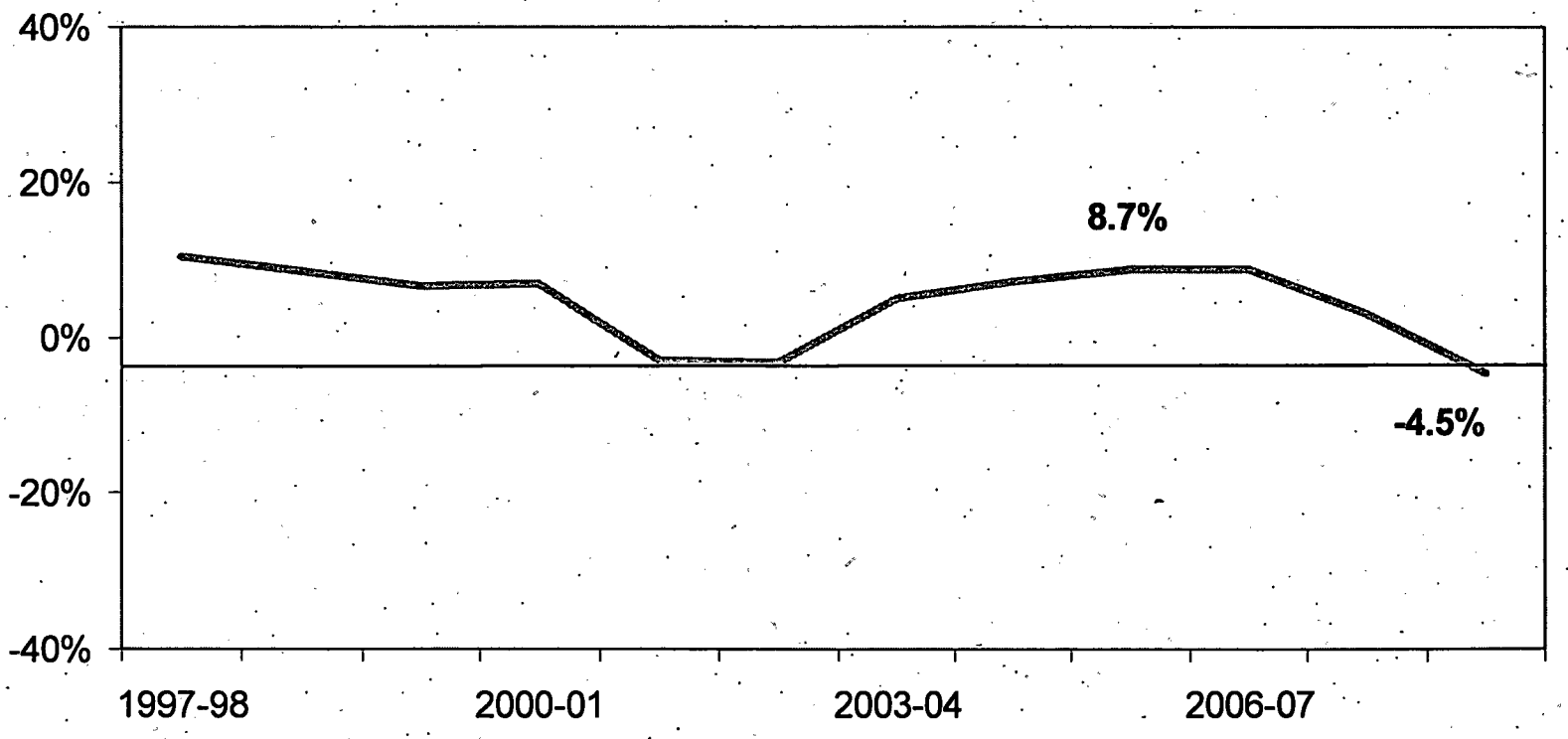
Source: Estimated using the Bearing Point tax model

Percent of Total Taxes Paid by Income: Married Filing Jointly

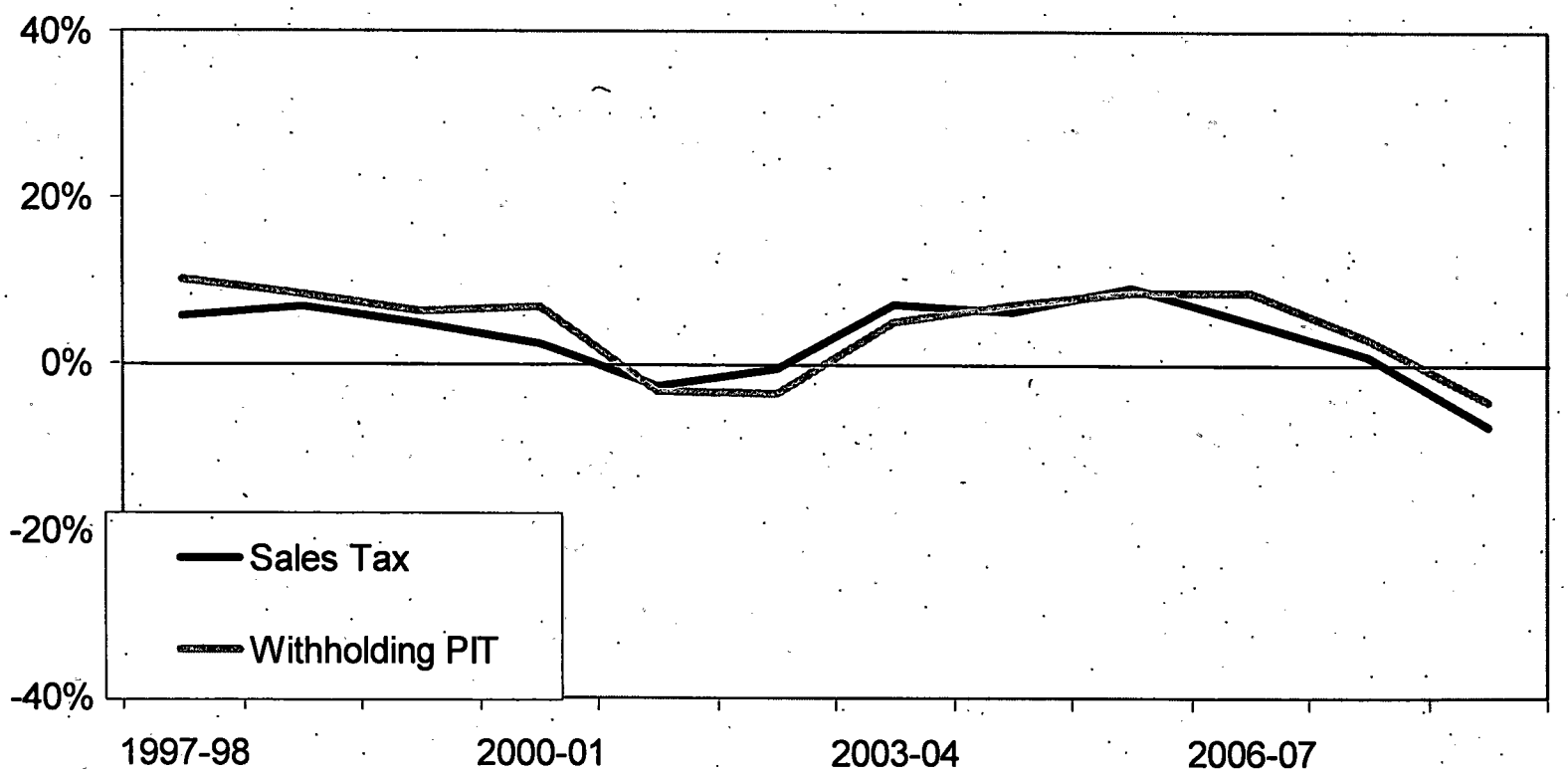


Source: Estimated using the Bearing Point tax model

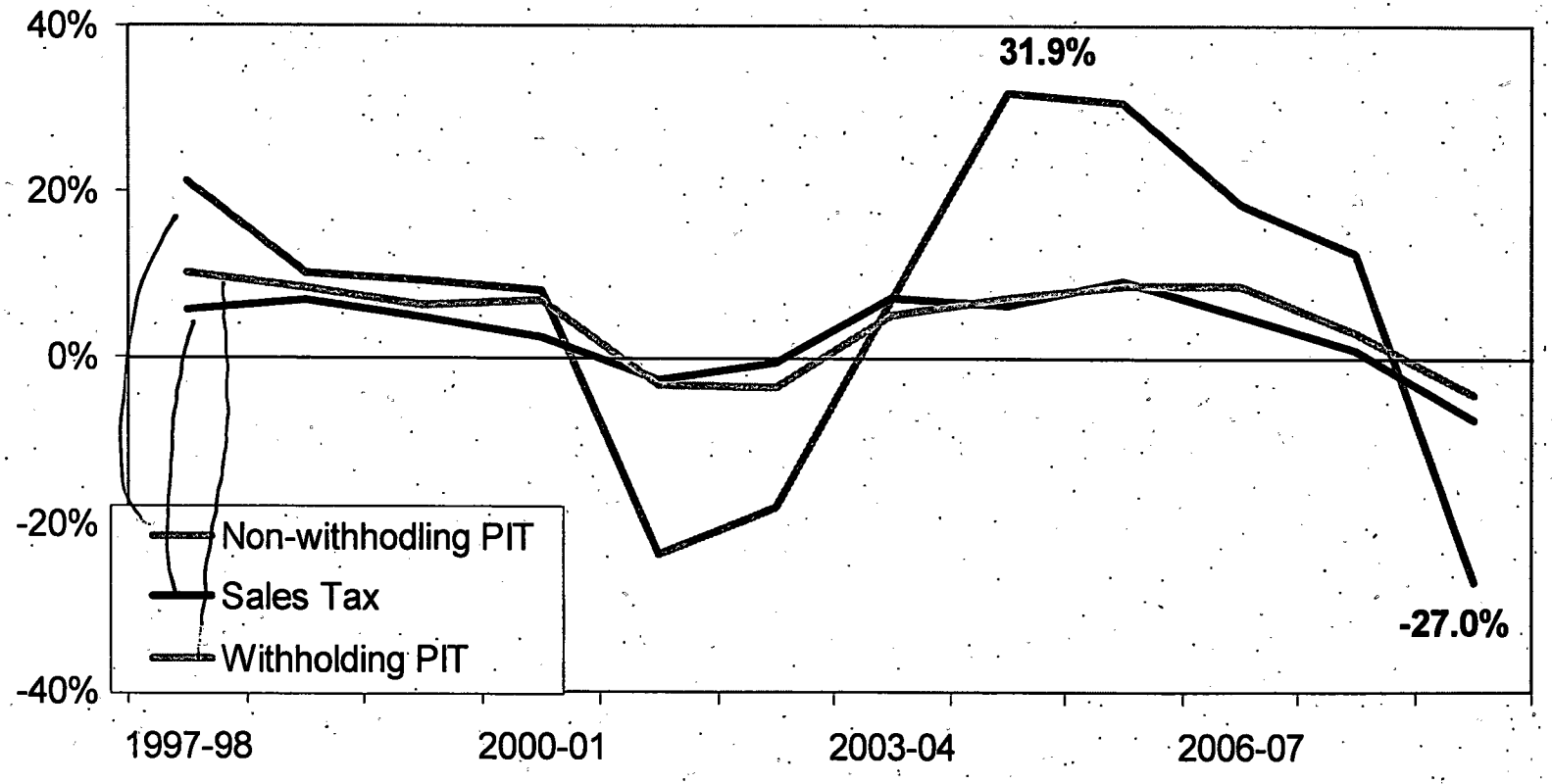
Stability: PIT Withholding



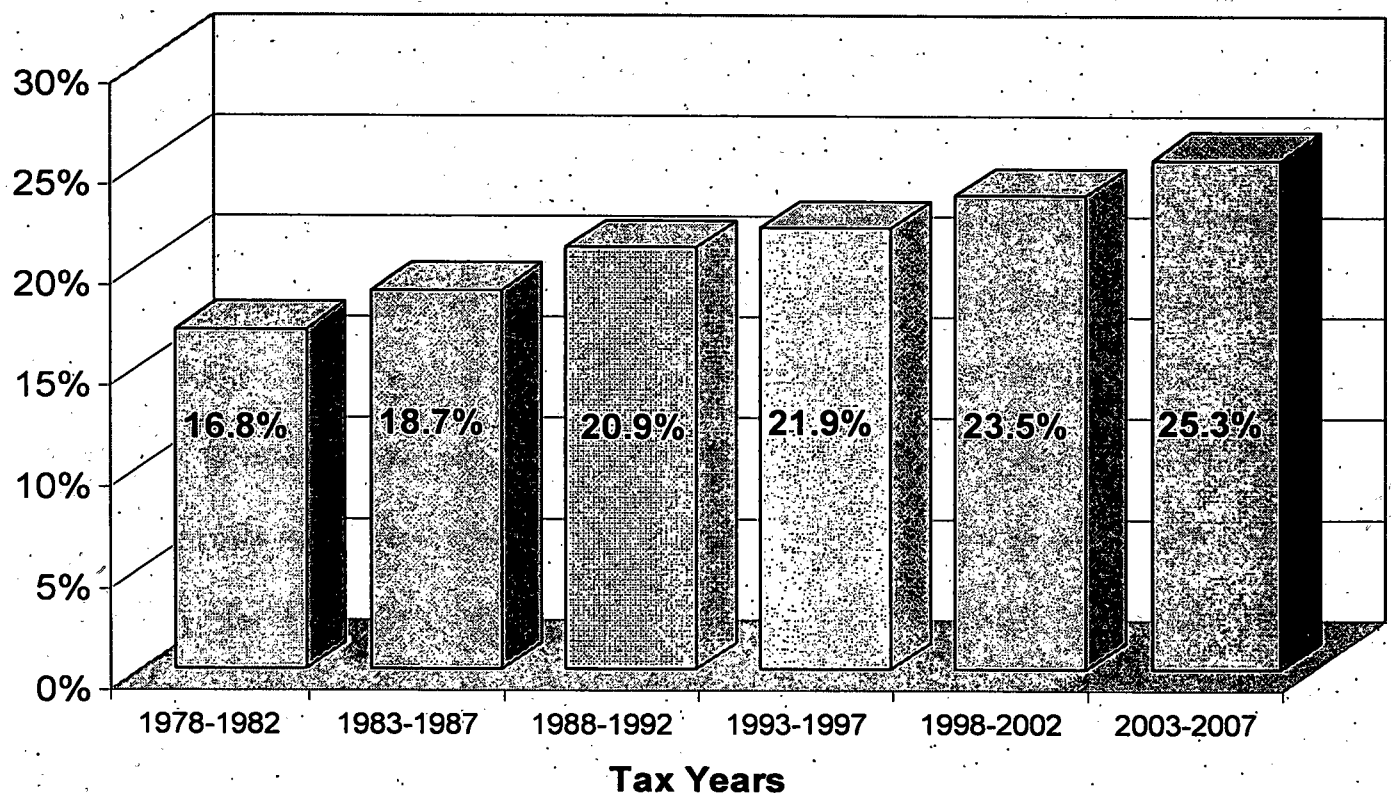
Stability


40%
20%
0%
-20%
-40%
Sales Tax
Withholding PIT
1997-98
2000-01
2003-04
2006-07

Stability


40%
20%
0%
-20%
-40%
31.9%
-27.0%
Non-withhodling PIT
Sales Tax
Withholding PIT
1997-98
2000-01
2003-04
2006-07

Average Share of Total PIT: Non-Withholding



Conclusions

- State's reliance on the personal income tax has increased significantly
- Over 70% of the tax paid by MFJ
- Non-withholding is highly volatile source of revenue
- Reliance on non-withholding has been increasing

Interim Joint House and Senate Finance Committee
Wednesday, February 24, 2010
Room 643, Legislative Office Building
10:00 a.m.

MINUTES

The Interim Joint House and Senate Finance Committee met at 10:00 a.m. on Wednesday, February 24, 2010, in room 643 of the Legislative Office Building. Fifty-one members of the committee were present. Representative Luebke presided as chair.

North Carolina Personal Income Tax

Cindy Avrette, a staff attorney with the Research Division, was recognized to review North Carolina's personal income tax laws including its history and development. She also explained prior study committee and legislative proposals related to personal income tax reform.

Rodney Bizzell, a fiscal analyst with the Fiscal Research Division, was recognized. He gave an overview of the current structure of the personal income tax. He outlined who are the taxpayers; what are the filing requirements; and add-backs. A copy of his power point presentation is attached.

Federal Taxation of Social Security and Federal Income Tax Deductions

Walter Nunnallee, Tax Professor, NCCU Law School, was recognized. He explained the itemized deductions allowable under the Internal Revenue Code and the federal taxation of social security income. A copy of his power point and handout is attached.

Personal Income Tax Reform: Issues with Respect to Base Broadening

Barry Boardman, an economist with the Fiscal Research Division, was recognized. He explained the current personal income tax base; gave an overview of deductions and credits; discussed State tax deductions and credits; and discussed federal itemized deductions. A copy of his power point is attached.

The meeting adjourned at 12:13 p.m.

Paul Luebke
Representative Paul Luebke, Presiding Chair

DeAnne Mangum
DeAnne Mangum, Committee Clerk

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Feb. 24, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Thom Moore	Eckerd Wilde
Matt Farrell	TPG
PRESCOTT EDWARDS	MCIC
Barbara Carsley	BSBC
John Bourdieu	Astra Zeneca
[illegible]	MCC
Melanie Soles	DCR
Rita Harris	NC Commerce
Lacy Cates	Speaker Office
Andy Ellen	NCRMP
Elizabeth Robertson	NCAM
John McAlister	NC Chamber

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Feb. 24, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Allison Waller	Charlotte Chamber
Emily Wilbourne	TPG
Amy Hobbs	MUC
Elizabeth Roman	NCRMA
Brian Balfour	Civitas
Shannon Smith	NCGA
Ken Crouch	NCBA
Doug Heron	Williams Mullen
Michelle Frazier	MFS
Christie Barbee	CAPA
[illegible]	NCICU

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Feb. 24, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
JOHN SHAW	PCS
Michael Hunsucker	NCDOR
[signature]	WCPSS
JOHN GOODMAN	NC CHAMBER
DANIEL BLUM	TROUTMAN SANDERS
[signature]	WCSR
[signature]	JD ALPA
[signature]	NFIB
[signature]	Bonding Asso
CS466	TSS
Jessi Hayes	NC Home Builders Assn.

VISITOR REGISTRATION SHEET

FINANCE — 2/24/10

Name of Committee — Date

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Marlowe Foster	Pfizer
Bill Scoggin	TSS
Joel Maynard	GPM & Assoc
Wendy Kelly	NMRS
Doug Lassiter	QSC STA
L. Andrews	NCFB
Patrick Bryan	NMRS
Lina Langston	

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — Feb. 24, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Andrew Foster	Guest of Prof. Walter Nunnellee
Vicky T. Young	NCDOT
Will Culpepper	Moore Van Allen
Ken Melton	K.M.A.
W. Gardner Culpepper	Personal Interest
Tommy Clark	WRC
David Heinen	NC Center For Nonprofits
David McGowan	NC Realtors
Nathan Batts	NCBA
Mason Goff	(Smith) Anderson)
Elaine Mejia	NC Justice Center

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — **Name of Committee**

Feb. 24, 2010 — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Meg Gray	NCBTC
Rob Thompson	Lobbyist w/ NC's Children
Mac Boxley	NC Aggregates Assn.
Erin Schwettpelz	UNC-GA
Matt Curgan	UMRS
Rebecca Troxler	NCACC

AGENDA

Joint Meeting of the Senate and House Finance Committees

February 24, 2010
10:00 a.m. – Noon
Room 643, Legislative Office Building

Meeting called by Senate Finance Cochairs: Senators Clodfelter, Hoyle, and Jenkins
and House Finance Cochairs: Representatives Luebke, Gibson, Wainwright, and Weiss

10:00 a.m. – 10:10 a.m.	**Opening Remarks by Finance Chairs**
10:10 a.m. – 10:30 a.m.	**North Carolina Personal Income Tax** A synopsis of the February 3, 2010, meeting and an overview of prior study committee and legislative proposals related to personal income tax reform. *Cindy Avrette, Principal Legislative Analyst, Research Division, NCGA* A descriptive analysis of the current personal income tax structure. *Rodney Bizzell, Senior Fiscal Analyst, Fiscal Research Division, NCGA*
10:30 a.m. – 11:00 a.m.	**Federal Taxation of Social Security and Federal Income Tax Deductions** A discussion of the itemized deductions allowable under the Internal Revenue Code and the federal taxation of social security income. *Walter Nunnallee, Tax Professor, NCCU Law School*
11:00 a.m. – Noon	**Personal Income Tax Reform: Issues with Respect to Base Broadening** A discussion of revenue stability, base broadening, tax incidence, and fiscal impacts. *Barry Boardman, PhD, Economist, Fiscal Research Division, NCGA*

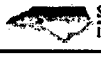
Next Meeting: March 17th
Topic: Business Taxes

North Carolina Personal Income Tax

Current Structure Overview

February 24, 2010

Rodney Bizzell
Fiscal Research Division
North Carolina General Assembly



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

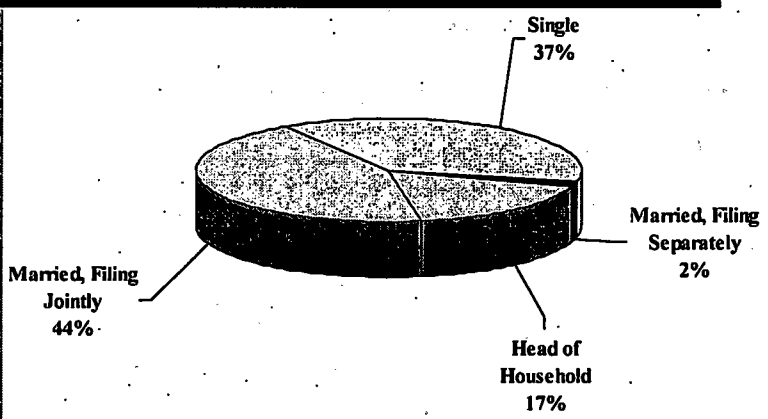
Overview

- Taxpayers at a Glance
- Filing Requirements
- Add-backs
- PIT Structure

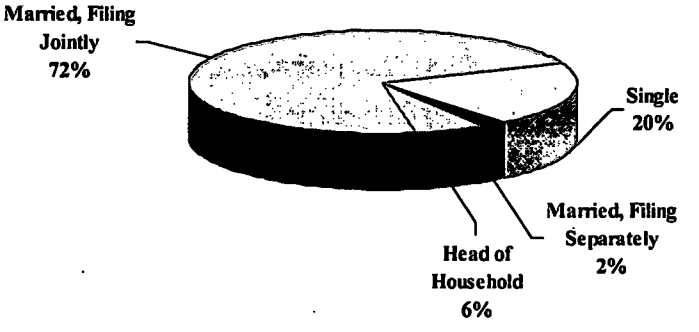
NC Taxpayers at a Glance

- Total Returns: 3.9 million
  - 3.1 million returns with tax liability
  - Approximately 800,000 returns with no tax liability
- Standard Deduction vs. Itemize
  - 66% Standard Deduction
  - 34% Itemize
- Returns with Taxable Social Security
  - 440,000 returns
  - $375 million State revenue impact

Percentage of Returns by Filing Status



Percentage of Personal Income Tax Paid by Filing Status



Who Files a North Carolina Return?

- No return is required for most taxpayers if gross income is below:
  - $5,500 Single
  - $11,000 Married, Filing Jointly
  - $2,500 Married, Filing Separately
  - $6,900 Head of Household
- Filing requirements differ from the federal requirements because the standard deduction and personal exemptions are different.
- Federal amounts are indexed; NC amounts are not.

Add-backs

- Add-backs are necessary to account for different standard deduction/exemption amounts.
  - Standard Deduction Adjustment
    - Adjustment for larger federal deduction
    - If you itemize, you must add back deductions for state and local taxes, motor vehicle taxes.
  - Personal Exemption Adjustment
    - Accounts for larger federal personal exemption amounts

Personal Income Tax Structure

Tax Rates Range from 6% - 7.75%

Example: MFJ couple with $120,000 NC taxable income

NC Taxable Income	Rate	Tax Liability
$0 - $21,250	6%	$1,275
$21,250 - $100,000	7%	$5,512
Over $100,000	7.75%	$1,550
NC Income Tax		$8,338

FEDERAL SYSTEM: GROSS INCOME →"AGI"→"TAXABLE INCOME"

TALKING POINTS

February 24, 2010

Gross Income (Broadly Construed W/ Statutory Exclusions)

- Examples of Exclusions:
  - Life insurance
  - Physical Personal Injury Awards
  - Employer Tax-Free Fringe Benefits
  - Like-Kind Exchanges
  - Home-Sale Exclusion
  - Social Security Benefits

§62 "Above-The-Line Deductions" (Generally Business-Related)

- Examples of Business Related Expenses: Business Interest, Travel, Wages, Rent, Depreciation
- Examples of Non-Business Related Expenses : Alimony, Qualified Education Expenses, Qualified Student Loan Interest, IRA Contributions

§63 "Below-The-Line" (Itemized) Deductions (Generally Non-Business-Related)

- Examples: Home Interest, Charitable Contributions, State & Local Taxes, MedicalExpenses, Unreimbursed Employee Business Expenses

Itemized Deduction Phase-Outs

- §67 (Miscellaneous Itemized 2% Rule)
- § 68 (3 % Rule)

FEDERAL SYSTEM: GROSS INCOME →"AGI"→"TAXABLE INCOME"

TALKING POINTS

A. Gross Income (Broadly Construed W/ Statutory Exclusions)

1. Examples of Exclusions:
   a) Life insurance
   b) Physical Personal Injury Awards
   c) Employer Tax-Free Fringe Benefits
   d) Like-Kind Exchanges
   e) Home-Sale Exclusion
   f) Social Security Benefits

B. §62 "Above-The-Line Deductions" (Generally Business-Related)

1. Examples of Business Related Expenses: Business Interest, Travel, Wages, Rent, Depreciation
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D. Itemized Deduction Phase-Outs

1. §67 (Miscellaneous Itemized 2% Rule)
2. § 68 (3 % Rule)

The Personal Income Tax Base

February 24, 2010

Barry Boardman, Ph.D.
Fiscal Research Division
North Carolina General Assembly

STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Overview

- The current tax base
- Overview of deductions and credits
- State tax deductions and credits
- Federal itemized deductions

Overview

- FRD estimates based on:
  - DOR Tax Expenditure Report, 2009
  - IRS Statistics of Income, 2007
  - BearingPoint Tax Model

Adjusted Gross Income

Adjusted Gross Income (2007, $ billions)		
Wages & Salaries	$154.5	72.7%
Capital Gains	16.1	7.6%
Pensions	14.4	6.8%
Business Income	6.3	3.0%
Interest	5.6	2.6%
Dividends	5.3	2.5%
Social Security	5.0	2.4%
IRA Distributions	4.4	2.1%
Unemployment Benefits	0.8	0.4%
AGI	**$212.4**	

Adjusted Gross Income

- Note: Using AGI as a starting point instead of Federal Taxable Income **does not** broaden the base
  - **It would eliminate the add-backs**
  - Example

Single: Fed deduction from AGI	$5,700
State deduction	3,000
Add-back amount	$2,700

Narrowing the Tax Base

• Personal Income (2007, $ billions)	$316
– Social Insurance Contributions	27
– Federal Itemized Deductions	26*
– State Tax Credits	5*
– State Deductions	20*
– Standard Deduction & Exemptions	11
– Misc. Federal exclusions	15
State Taxable Income	$212

*Focus for remainder of presentation

Credits and Deductions

- Federal and State deductions and credits reduce State revenue by $2.5 billion
- Federal itemized deductions
  - Reduce revenue by $1.3 billion
- 38 state credits and deductions
  - Reduce revenue by $1.2 billion

State Tax Credits

Credit for Children ($100 per)	$147.3
Earned Income Tax Credit (5% refundable)	$82.1
Child Care Expenses	$53.6
Charitable Contributions by Non-itemizers	$26.5
Certain Real Property Donations	$25.7
Qualified Business Investments	$7.0
Adoption Expenses	$5.9
Long-Term Care	$4.7
Historic Structures and Mills	$4.2

State Tax Credits

Property Taxes paid on Farm Machinery		$1.6
Disabled		$1.5
Conservation Tillage Equipment		$0.1
Recycling Oyster Shells		< $0.1
Gleaned Crops		< $0.1
Use of NC Ports		< $0.1
Handicapped Dwelling Units		< $0.1
Poultry Composting		< $0.1
Estimated Sub-Total		**$361.0**
Plus, $22 million in carry forwards	**Total**	**$383.0**

State Tax Deductions

Social Security	$375.0
Private Retirement and State Pensions	$80.9
Severance Wages	$15.5
Higher Personal Exemption Low and Middle Income	$215.9
Parental Savings and Trust (529 Plan)	$5.0
Volunteer Fire and Rescue	$1.0
14 other small or unavailable estimates	--
Total	$693.3

State Tax Deductions

Deductions Required by Court Order or Federal Law

U.S. and N.C. Obligation Interest	$20.9
Retirement Income under Bailey	$401.7
Total	**$422.6**

Itemized Deductions

Deduction	Estimated Impact
Medical and Dental Exemptions	$44
Real Estate Taxes	$162
Home Mortgage Interest	$675
Gifts to Charity	$320
Unreimbursed Employee Expenses	$95
Total	~$1.3 billion

Itemized Deductions

- Two federal deductions added back
  - State and local taxes
  - Personal property taxes (motor value tax)

Itemized Deductions

- Medical and Dental Expenses
  - Expenses greater than 7.5% of AGI
  - 400,000 tax returns
  - $1.5 billion in NC deductions
  - Reduces state tax liability $40 million

Itemized Deductions

- Real Estate Taxes
  - Non-business property taxes paid on assessed value
  - 1.6 million tax returns
  - $3.1 billion in NC deductions
  - Reduces state tax liability $155 million

Itemized Deductions

- Home Mortgage Interest
  - Includes interest on first and second mortgages
  - 1.4 million tax returns
  - $13.5 billion in NC deductions
  - Reduces state tax liability $675 million
  - Estimated $120 to $150 million reduction from second home mortgages

Itemized Deductions

- Gifts to Charity
  - Include cash and non-monetary gifts
  - 1.4 million tax returns
  - $6 billion in NC deductions
  - Reduces state tax liability $320 million

Itemized Deductions

- Employment and other expenses
  - Includes unreimbursed employee expenses
  - 475,000 tax returns
  - $1.7 billion in NC deductions
  - Reduces state tax liability $90 million

Itemized Deductions

Size of adjusted gross income	Under $50,000	$50,000 under $75,000	$75,000 under $100,000	$100,000 under $200,000	$200,000 or more
	Percent of Itemized Deductions, by Deduction				
Medical and Dental Exemptions	51.1%	19.9%	11.9%	13.1%	4.0%
Real Estate Taxes	21.6%	16.3%	15.1%	26.9%	20.0%
Home Mortgage Interest	23.8%	17.9%	15.8%	24.9%	17.7%
Gifts to Charity	16.1%	14.4%	13.5%	23.3%	32.7%
Unreimbursed Employee Expenses	27.4%	20.8%	14.5%	20.1%	17.2%
Total	20.0%	16.6%	14.9%	24.9%	23.6%

Itemized Deductions

Size of adjusted gross income	Under $50,000	$50,000 under $75,000	$75,000 under $100,000	$100,000 under $200,000	$200,000 or more
	Average Deduction				
Medical and Dental Exemptions	$1,805.8	$702.1	$419.9	$462.3	$142.0
Real Estate Taxes	$1,531.9	$1,642.6	$1,911.3	$2,705.5	$5,888.7
Home Mortgage Interest	$7,924.1	$8,375.8	$9,403.8	$12,016.8	$26,375.6
Gifts to Charity	$2,404.5	$3,022.0	$3,513.9	$4,652.3	$18,607.6
Unreimbursed Employee Expenses	$950.4	$721.4	$503.8	$696.4	$597.9

Conclusions

- Starting with AGI simplifies tax form
- Tax base narrowed 33% by Federal and State credits, deductions and exemptions
- $2.5 billion in revenue reduced through tax credits and deductions

Interim Joint House and Senate Finance Committee
Wednesday, April 7, 2010
Room 643, Legislative Office Building
10:00 a.m.

MINUTES

The Interim Joint House and Senate Finance Committee met at 10:00 a.m. on Wednesday, April 7, 2010, in room 643 of the Legislative Office Building. Forty-seven members of the committee were present. Representative Gibson presided as chair.

Corporate Income Tax and Franchise Tax Collections

Barry Boardman, an economist with the Fiscal Research Division, was recognized. He examined the growth and stability of North Carolina's corporate income and franchise taxes. He provided an overview of collection trends, volatility and distribution. A copy of his power point is attached.

Corporate Income Tax

Cindy Avrette, a staff attorney with the Research Division, was recognized. She explained corporate tax laws in North Carolina discussing the history and types of taxes. She also examined the taxpayer, the tax base and the tax rate. A copy of her power point presentation is attached.

Franchise Tax

Sabra Faires, the Senate Tax Counsel, was recognized. She gave an overview of the franchise tax in North Carolina, She explained the history, the nature, the businesses subject to the tax, the rates and calculations, and how other states apply the franchise tax. She also discussed possible tax reform options. A copy of her power point is attached.

Business Taxes and Economic Development

Rodney Bizzell, a fiscal analyst with the Fiscal Research Division, was recognized. He discussed major corporate income and franchise tax credits. He explained corporate tax credits and economic development and how Article 3 credits have a large fiscal impact and these credits are generally related to economic development. He also explained economic development grants and the overall costs. A copy of his presentation is attached.

An Evaluation of North Carolina's Economic Development Incentives Programs

Jason Jolley, Senior Research Director, UNC Center for Competitive Economies, was recognized. He explained the findings of a UNC Study on economic incentives outcomes and recommended changes. He also explained which incentives achieved the greatest return in regards to job creation, distressed area benefits, and North Carolina's competitiveness. A copy of his power point presentation is attached. Also attached is a summary of the UNC report and the complete UNC report.

The meeting adjourned at 12:49 p.m.

Representative Pryor Gibson, Presiding Chair

DeAnne Mangum, Committee Clerk

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 7, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
[signature]	NWC
Maeve Goff	Smith Anderson
[signature]	JD, AL, PA
Karen Mehl	CFSH - NC
Jennifer Mahan	MHANC
Michael Houser	NC DOR
Matt Gentile	EY
Breanna Tanville	Office of Larry Shaw
Courtney Denning	NC Bar Association
Kevin Holman	NCACC
Wendy Cotten	NCACC

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 7, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Lennie Collins	NC DOR
Rob Thompson	Covenant w/ NC's Children
Meg Gray	NC BTC
Deatrice Williams	CLCA
Tommy Clark	WRC
David Farrell	VanNoLLe
Johanna Reese	DOT
Matt Harcher	Hunton & Williams
Savanna Farris	NCSU
Roby Sawyers	NC State
David McCoy	State Controller

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 7, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Kevin Leonard	NCACC
Ela Mejia	NCJC
Michelle Frazier	MFS
Anthony Allison	NCACC
Butch Gunnells	NC Beverage Assoc
Doug Howey	NC Petro & Convenience
Amy Hobbs	MWC
Ken Melton	K.M.A.
John White	Durham Chamber

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 7, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Matt Harrell	TPG
Lisa Martin	NC Home Builders
[illegible]	NBS
Brooke Mueller	Walmart
Josi Hayes	NC Home Builders Assn
Peter Harris	NC Commerce
John McMillan	MFHS
Barbara Canales	BSCGA
ANN WARE	DUKE
Henry Jones	Attorney Raleigh
MIKE MANN	NCBAA

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 7, 2010

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VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Amy Whited	NC Med Society
Chip Baggott	NCMS
W. Gardner Pelly	Personal Interest
BJ Miller	Moses Cone Health System
Hugh Tilson	NCHA
John McAlister	NC Chamber
Will Culpepper	Moore + Van Allen
Sue Harrison	UNC PSS
Alice Garland	NCEA
Julia Leggett	The Arc of NC
Joel Levy	City of Charlotte

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 7, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Shannon Smith	NCGA
Drew Morris	Raleigh Chamber
Joe Lanier	Nelson Mullins
Thom Iles	John Deere
Brad Phillips	TWC
Tammy Roberson	TWC
Brian Balfour	CWA
Lauren Whaley	NC Credit Union League
Sarah Blalock	Hunton and Williams
Kelli Kinney	NCLM
Cam Cree	BPM HL

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 7, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Deb Deckoff	NAMI NC
Paul Stark	NCBA
Daniel Blum	Troutman Sanders
Connie Wilson	CWC
Kathryn Westcott	ACEC/NC

AGENDA

Joint Meeting of the Senate and House Finance Committees

April 7, 2010
10:00 a.m. – Noon
Room 643, Legislative Office Building

Meeting called by Senate Finance Cochairs: Senators Clodfelter, Hoyle, and Jenkins
and House Finance Cochairs: Representatives Luebke, Gibson, Wainwright, and Weiss

10:00 a.m. – 10:15 a.m.	**Opening Remarks by Finance Chairs**
10:15 a.m. – 10:25 a.m.	**Corporate Income Tax and Franchise Tax Collections** A look at the growth and stability of North Carolina's corporate income and franchise taxes. *Barry Boardman, Economist, Fiscal Research Division, NCGA*
10:25 a.m. – 10:45 a.m.	**Corporate Income Tax** An overview of the corporate income tax laws in North Carolina: the taxpayer, the tax base, and the tax rate. *Cindy Avrette, Research Division, NCGA*
10:45 a.m. – 11:05	**Franchise Tax** An overview of the franchise tax in North Carolina: the taxpayer, the tax base, and the tax rate. *Sabra Faires, Senate Tax Counsel, NCGA*
11:05 a.m. – 11:20 a.m.	**Business Taxes and Economic Development** A look at the business tax credits and programs designed to promote economic development. *Rodney Bizzell, Fiscal Research Division, NCGA*
11:20 a.m. – Noon	**An Evaluation of North Carolina's Economic Development Incentive Programs** Synopsis of the research conducted by the UNC Center for Competitive Economies for the Joint Select Committee on Economic Development Incentives, NCGA. The Center issued its final report, July 2009. *Jason Jolley, Senior Research Director, UNC Center for Competitive Economies*

Next Meeting: April 28th
Conclusion of Business Taxes

Corporate Income and Franchise Tax Collections

April 7, 2010

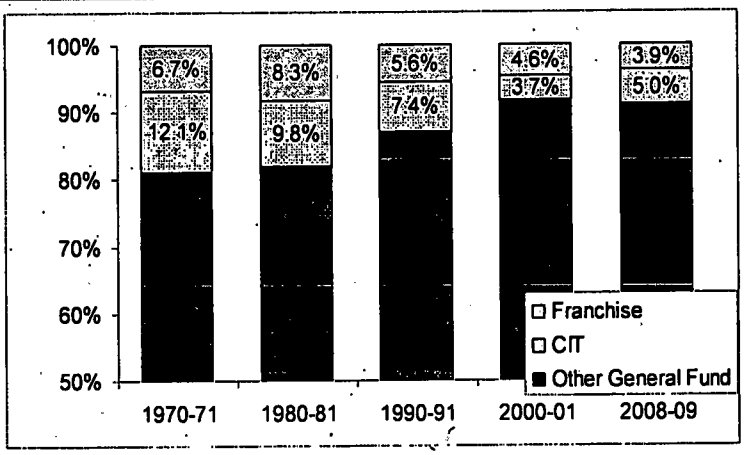
Barry Boardman, Ph.D.
Fiscal Research Division
North Carolina General Assembly

Study of North Carolina's Tax Structure
Interim Joint House and Senate Finance Committees

Overview

- Collection Trends
- Volatility
- Distribution

Corporate and Franchise Tax Trends



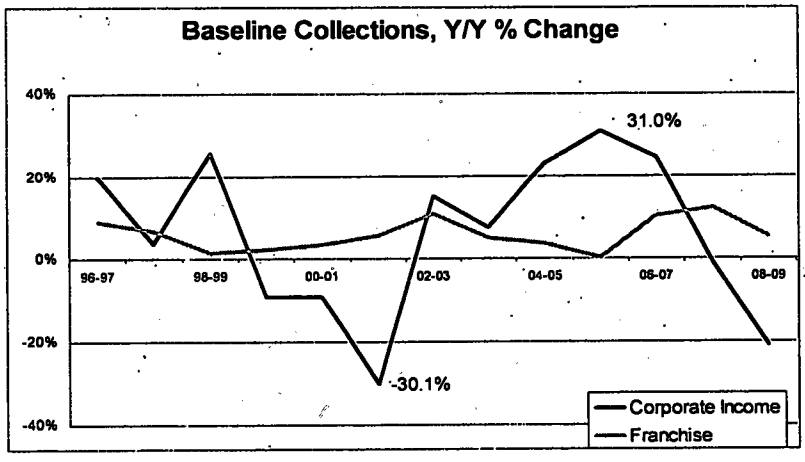
Corporate and Franchise Tax Trends

Business Type	Number
C-Corporation*	80,167
S-Corporation	126,151
Limited Liability Company**	208,839
Limited Liability Partnership**	1,513
Limited Partnerships**	12,933

*Based on 2005 Tax Returns

**Based on data from the Secretary of State

Volatility



Corporate Taxpayers, 2005

Net Taxable Income: 2005 Tax Year	# Returns	Income Tax (Millions)	Tax Credits (Millions)	Average Income Tax
$0	52,140			
$1-$100,000	21,837	29.19	0.77	$1,301
$100,001-$500,000	3,608	56.84	0.98	$15,483
$500,001-$1,000,000	908	44.41	0.82	$47,997
$1,000,001-$5,000,000	1,210	182.65	5.63	$146,299
$5,000,001-$10,000,000	247	120.06	8.02	$453,602
$10,000,001+	217	623.15	81.59	$2,495,672
TOTALS	80,167	1,056.29	97.81	$34,199

Tax Distribution

- 65% of returns had no net taxable income
- Less than 8% of all C-corporations have net taxable income over $100,000
- 217 corporations paid 56.5% of net corporate income tax revenue (after credits)
- 464 paid nearly 70% of net corporate income tax revenue (after credits)

Conclusions

- Reliance on Corporate Income is diminishing
  - Key reason is change in types of incorporation
- Corporate income tax is volatile revenue source
  - With more businesses paying through PIT, these collections are growing more volatile
- Franchise is a stable source of income, only 4% of GF
- Most corporate income tax comes from fewer than 1,000 corporations
  - Just over 200 of them produce over half the revenue

Overview of North Carolina's Corporate Income Tax

Cindy Avrette
Research Division, NCGA

April 7, 2010

Business Taxes in North Carolina

- Corporate Income Tax
- Franchise Tax
- Annual Reporting Fees
- Privilege and License Taxes
- Excise Tax on Certain Machinery & Equipment
- Sales Tax
- Property Tax

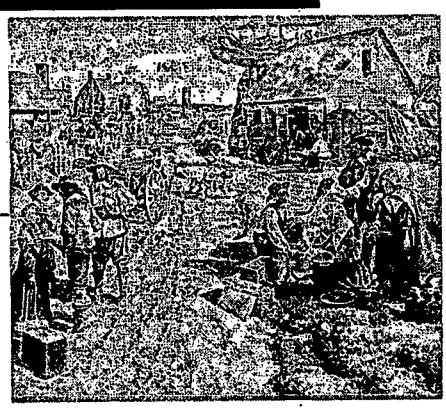
Business Taxes in North Carolina

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- Excise Tax on Certain Machinery & Equipment
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- Property Tax

Evolution of NC's Tax System

1777 — Created Tax System

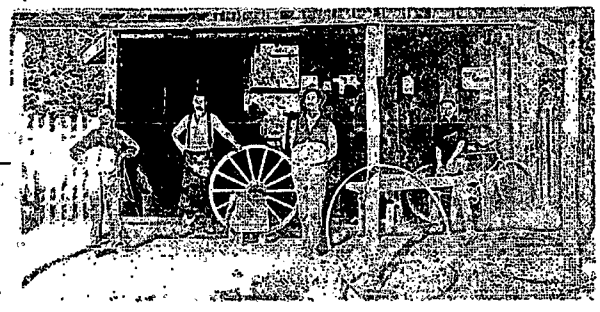
2nd act of General Assembly



Evolution of NC's Tax System

1782

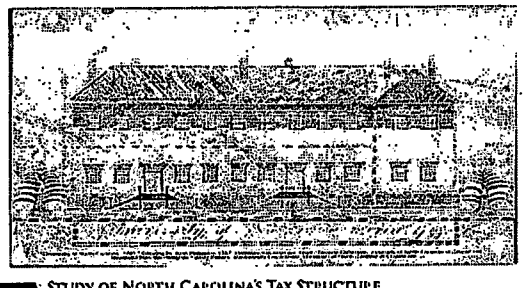
License taxes first enacted



Evolution of NC's Tax System

1849

Corporations taxed on capital stock – forerunner of franchise tax



Free public schools in 1839

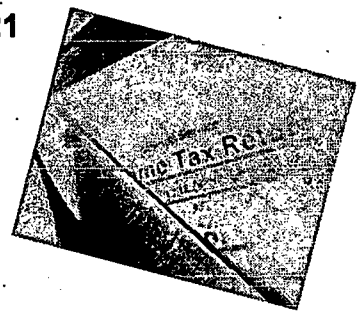
Evolution of NC's Tax System

Revenue Act of 1921

1921

No State tax on property

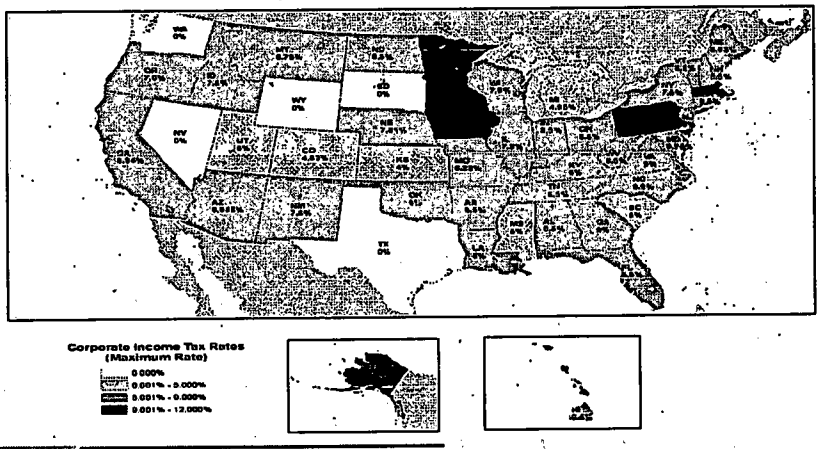
Two new taxes:
- **State administered PIT**
- **Corporate IT**



NC Corporate Income Tax Rates

- 1921: 3% of net income
- 1939: 6% of net income
- 1987: 7% of net income
  - Public School Building Fund
- 1991: 7.75% of net income, plus surtax
- 1996: phased down rate to 6.9%, effective after 1999
- 2009: 3% surtax for 2009 and 2010

Corporate Tax Rates



Corporate Income Tax Decline

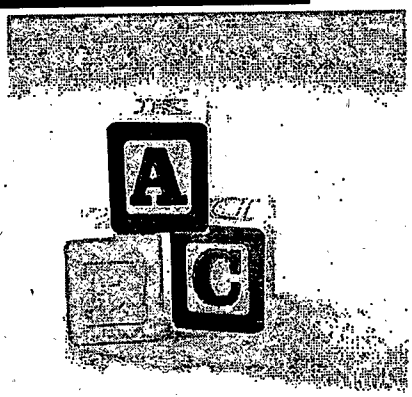
- Since 1950s, the federal corporate income tax has been declining as a percentage of government revenues
- NC corporate income tax base has been following the same trend

Reasons for Decline of CIT

- Tax Policy Decisions
  - Federal tax policy decisions
  - NC tax policy decisions
  - State tax credits
- Tax Shifting Strategies
  - Made possible to a large degree by single entity reporting

Basic CIT Building Blocks

- Tax rate applied to net taxable income
  - All corporations chartered in NC
  - All corporations doing business in NC
- Tax credits applied



Taxable Income

- NC taxable income = Federal taxable income, as adjusted
  - Accelerated depreciation
- Key differences
  - Net operating loss v Net economic loss
  - Bonus depreciation
- State deduction adjustments

Taxable Income

- Federal taxable income, as adjusted
- Key differences
  - Net operating loss v Net economic loss
  - Accelerated depreciation
  - Bonus depreciation
- State deduction adjustments

Tax Policy Decisions that Reduce CIT Collections

State Tax Credits

- Dwelling units for handicapped
- Real property donations
- Conservation tillage equipment
- Gleaned crop
- Manufacturing cigarettes
- State ports
- Renewable energy
- Film production
- Small business health insurance
- WOTC
- Rehabilitation
- Low income housing
- R&D
- Article 3J

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Tax Policy Decisions that Reduce CIT Collections $164.5 million for FY 09-10

Apportionment Formula

- Multistate corporations apply NC apportionment formula to determine NC taxable income
- Apportionment formulas
  - Three factors: Sales, Property, and Payroll
  - Double-weighted sales (1988)
  - Single sales (2009 for a 'qualified capital intensive corporation')

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Tax Policy Decisions that Reduce CIT Collections

STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Business & Non-Business Income

Multi-state corporation required to:

- Allocate its non-business income to a state based on its connection with that state
- Apportion its business income between the states in which it conducts business based upon each state's apportionment formula

Business & Non-Business Income

- State law defines 'business income'
- *Strategy:* Characterize income as non-business income
- Pre-2002, NC definition narrow
- 2002, NC changed its definition of business income to include all income that is apportionable under the US Constitution

Single Entity Reporting

State filing options

- Mandatory separate entity returns
- Elective consolidated returns
- Mandatory combined unitary returns
- Discretionary combined unitary returns
- A hybrid system
  - Require single entity reporting
  - Unless directed otherwise by Secretary of DOR

Single Entity Reporting

- NC requires a separate return
- Must determine State net income as if a separate return had been filed for federal tax purposes
- *Strategy:* Create legal structures to shift income from one state to another, lower tax, state
  - IHC
  - *Limited* case

Single Entity Reporting

Legislative efforts to address income shifting

- 2001: Royalty add-back
- 2002: Broad definition of business income
- 2005: Consideration of "throwout" rule
- 2006: Patent and copyright add-back
- 2007: Captive REITs

Single Entity Reporting

- "Forced combinations" by Secretary of DOR
  - Uncertainty as to when to combine
  - Uncertainty as to who is included in the combination
- *Walmart v. Hinton* upheld Secretary's authority to require combined reporting
- Millions collected through forced combinations – RECENT PROJECT

Tax Reform Options

- Mandatory combined reporting
  - Comprehensive way to nullify tax shifting strategies
  - Broadens the corporate tax base
  - Reduces uncertainty re: combinations
- Reduce tax credits and deductions
- Reduce corporate tax rate
- Equal weighted apportionment formula, with throw-out or throw-back rule

Overview of North Carolina's Franchise Tax

Sabra Faires
Senate Tax Counsel

April 7, 2010

History of Tax

- One of NC's oldest taxes
- Originated in 1849 as a tax on the capital stock of a corporation
- 1901- 1913, rate was graduated and ranged from $5 to $500.
- 1913 – rate set at percentage (.001)
- 1933- rate set at $1.50 per $1,000 (.0015)

Nature of Tax

- Privilege tax for:
  - Privilege of engaging in business
  - The "enjoyment, under the protection of the laws of this State, of the powers, rights, privileges and immunities derived from the State by the form of" the existence of the business structure
  - The benefit and protection received from the government and laws of NC in doing business
  - Privileges not possessed by individuals or partnerships

Businesses Subject to the Tax

- C corporation
- S corporation
- Electric membership corporation
- Limited liability company (LLC) that elects to be taxed as a corporation under the IRC

Businesses Not Subject to the Tax

- Limited liability company (other than ones electing to be taxed as a corporation)
- Limited liability partnership
- Limited partnership
- Partnership
- Sole proprietor
- Insurance companies

Rate of Tax

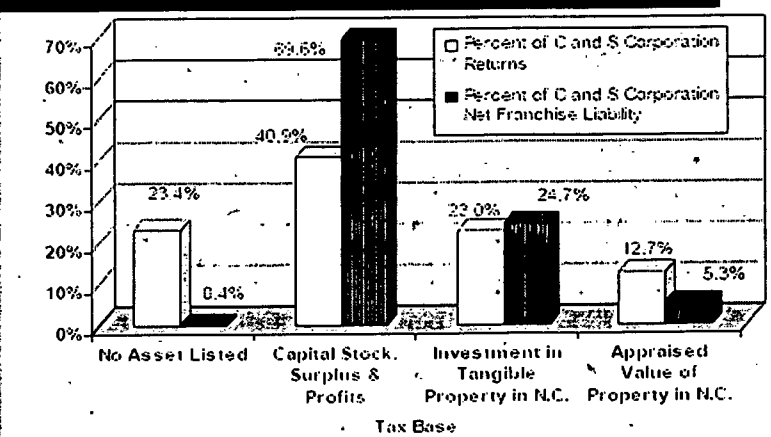
- $1.50 per $1,000 of taxable assets (.0015)
- $35 minimum tax
- $75,000 maximum tax for holding companies – those that receive at least 80% of income from subsidiaries

Calculation of Tax

Tax rate applied to highest of three asset bases:

- Capital stock, surplus, and undivided profits apportioned to NC using the apportionment percentage determined for income tax
- Book value of NC real and tangible personal property, less outstanding debt created to acquire or improve the real property
- 55% of the appraised value of NC real and tangible personal property

Franchise Filers By Base



Utility Franchise Tax

- Applies instead of the general franchise tax
- Calculated on gross receipts
- Applies to:
  - Electric power company – 3.22% rate
  - Water utility company - 4% rate
  - Sewer utility company – 6%
- Tax on electric power companies is shared with cities

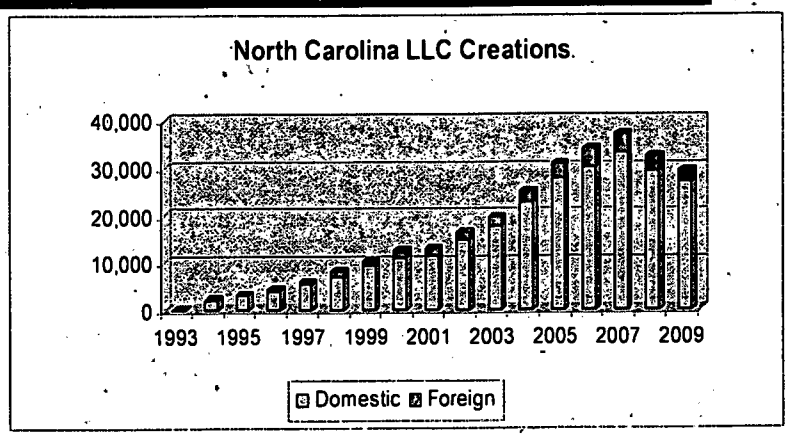
Other States

State	Franchise Tax
NC	Yes: .0015 of asset base
FLA	No
GA	Yes: ranges from $10 to $5,000
KY	Yes: .0021 of capital employed
SC	Yes
TENN	Yes: .0025 of asset base

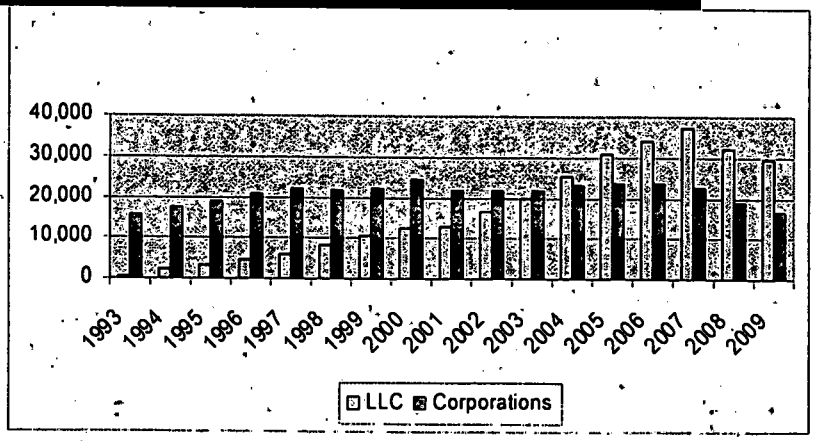
Limited Liability Companies in NC

1989	LLCs authorized; higher annual report fee imposed on LLCs in recognition of their exclusion from franchise tax
1997	Single member LLCs authorized
2001	Corp required to include assets of controlled LLC
2002	Controlled LLC requirement tweaked
2006	LLC subject to franchise tax if it elects to be taxed as C corp
2009	LLC subject to franchise tax if it elects to be taxed as S corp

Limited Liability Companies



Growth in LLCs and Corporations



S Corps and LLCs

	S Corp	LLC
Pass-through	Yes	Yes
Ownership	Typically by individuals – in closely held, family owned business	Individuals, corporations, partnerships, or other LLCs
Owners' liability limited	Yes	Yes
Subject to franchise tax	Yes	No

Current Business Entities

Business Corporation	272,836
Limited Liability Company	231,273
Limited Liability Partnership	1,590
Limited Partnerships	12,946
Professional Corporation	14,585
Professional Limited Liability Company	5,891
Total	539,121

Annual Report Requirements

Entity	Report	Fee
Corp	Yes	$25 paper; $18 online
Professional Corp	No	N/A
LLC	Yes	$200
Professional LLC	No	N/A
Limited Partnership	No	N/A
Limited Liability Partnership	Yes	$200

Tax Reform Options

- Broaden base, lower rate by:
  - Treating LLCs the same as S corps
  - Treating all business entities whose owners have limited liability the same
- 2009 House Budget , Sec. 27B.2, SB 202, 6th Ed., expanded franchise tax to all limited liability businesses

Tax Reform Options

- 21st Century Tax Rate Reduction and Modernization Plan
  - Expands franchise tax to all limited liability businesses
  - Repeals all other State and local privilege license taxes
  - Repeals the annual corporate report fee

Business Taxes and Economic Development

April 7, 2010

Rodney Bizzell
Fiscal Research Division
North Carolina General Assembly

Study of North Carolina's Tax Structure
Interim Joint House and Senate Finance Committees

Overview

- Overview of major corporate income and franchise tax credits
- Corporate tax credits and economic development
  - Article 3 credits have large fiscal impact
  - Are generally related to economic development
  - Economic development grants
  - Overall Costs

Overview

- FRD estimates based on:
  - DOR Tax Expenditure Report, 2009
  - FRD Economic Development Inventory
  - Fiscal Impacts are for FY 2009-10

CIT and Franchise Tax Credits

- In general, major incentive credits (Article 3B -3J) share certain attributes
  - Can be taken against the corporate income or franchise tax
  - Credits are limited to 50% of taxable income (exceptions include low-income housing credits and major computing facility credits)
  - In some cases, credits generated in a given year must be taken in installments over several succeeding years.

CIT and Franchise Tax Credits

- Article 3B – Business and Energy
  - Credit for Investing in Renewable Energy Property
  - Credit for Renewable Fuel Dispensing Facilities
  - Credit for Constructing Renewable Fuel Processing Facilities
  - Alternative Credit for Constructing Renewable Fuel Processing Facilities
  - Work Opportunity Tax Credit
  - Credit for Donations to a Nonprofit to Acquire Renewable Energy Property

Article 3B - Business and Energy Tax Credits – Credit for Investing in Renewable Energy Property

- Enacted in 1999
  - Credit = 35% of the cost of renewable energy property constructed, purchased, or leased
  - Includes solar energy equipment, residential space heating, geothermal heat pumps/equipment.
  - Residential property: take credit in year property placed in service and credit capped at varying amounts for different types of property
  - Installments/caps: Credit taken over 5 years; caps vary according to type of property.
- Cost = $4.0 million

Article 3B - Business and Energy Tax Credits - Renewable Fuel Facilities

- **Enacted in 2004**
- **Dispensing credit**
  - Credit = 15% of cost of constructing and installing the part of the dispensing facility directly and exclusively used for dispensing or storing renewable fuel
  - Credit taken in 3 equal installments
- **Production credit (Option 1)**
  - Credit = 25% of cost of constructing and equipping a facility for processing renewable fuel
  - Credit taken in 7 equal installments
- **Production credit (Option 2 – requires minimum investment)**
  - Credit = 35% of cost of constructing and equipping a facility for processing renewable fuel
  - Credit must be taken in 7 equal installments
- **Cost = $0.2 million**

Article 3B - Business and Energy Tax Credits – Other credits

- Work Opportunity Tax Credit
  - Enacted in 2007
  - Credit is equal to 6% of federal credit for hiring disadvantaged workers.
  - Cost = $0.4 million
- Credit for Donations to a Nonprofit to Acquire Renewable Energy Property
  - Enacted in 2007
  - Credit same as Credit for Investing in Renewable Energy Property
  - Cost = $0.5

Article 3C – Tax Incentives for Recycling Facilities

- Enacted in 1998
  - Provides a credit for an owner who purchases or leases machinery and equipment for a major or large recycling facility
- Credit for purchasing or leasing machinery and equipment
  - 50% for Major Facilities ($300 million investment and 250 jobs)
  - 20% for Large Facilities ($150 million investment and 155 jobs)
- Credit may not exceed 100% of tax liability
- Cost = $7 million

Article 3D – Historic Rehabilitation Tax Credits

- Enacted in 1998
- Provides a credit of 20% and 30% respectively for qualified rehabilitation expenditures for income-producing and nonincome-producing certified historic structures.
- 40% credit available if the structure at one time served as a State training school for juveniles.
- Cost = $8.0 million

Article 3E – Low-income Housing Tax Credits

- Enacted in 1999
- A taxpayer allowed a federal credit is allowed a credit equal to a percentage (10% - 30%) of the development's qualified basis.
- Percentage credit depends on the percentage of units affordable to low-income groups and the income of the area where the housing is located.
- Refundable if it exceeds tax liability.
- Cost = $41.6 million

Article 3F – Research and Development Tax Credits

- Created as a stand-alone credit in 2004
- Prior to 2004, a credit was available for R&D expenditures as part of the Bill Lee Act.
- Credit varies depending on several factors
  - 20% for North Carolina university research expenses
  - 3.25% for research conducted by a small business or in a development tier one area
  - If not covered above
    - 1.25% for expenses up to $50M
    - 2.25% for expenses between $50M and $200M
    - 3.25% for expenses above $200M
- Cost = $22 million

Article 3G – Tax Incentives for Major Computer Manufacturing Facilities

- Enacted in 2004 during the one-day Special Session
- Credit amount was determined based on production factors and varied by year and employment levels.
- Dell facility opened in September 2005. The plant closed earlier this year.
- Cost = $106,000 claimed on returns processed in 2007. No clawback applies.

Article 3H - Mill Rehabilitation Credit

- Originally enacted in 2006
- Provides a tax credit of 30% to 40% of the cost of the project depending on tier location.
- Available for income and non-income producing projects. Federal credit is also available for income producing properties.
- Cost = $6 million per year

Article 3J - Tax Credits for Growing Businesses

- Replaced William S. Lee Act Incentives in 2007
- Credit for Creating Jobs - $750 - $12,500/job
- Credit for Investing in Business Property - 3.5% - 7% of eligible investment
- Credit for Investing in Real Property (Tier 1 counties only – 30% of eligible investment)
- Cost = $25 million
- Lee Act Credits = $70 - $80 million

Film Industry Production Credit

- Enacted in 2005
- Provides a credit of 25% of qualifying expenses for production companies that spend at least $250,000 in NC.
- Refundable if it exceeds tax liability
- Maximum credit per production is $7.5 million
- Cost = $22.5

Appropriations Incentive Programs

- Department of Commerce
  - $54.8 million appropriated for economic development programs and support
  - Commerce administer 9 direct incentive programs
  - 3 *direct incentive* programs received an appropriation, totaling $20 million
  - JDIG received 95% of *direct incentive* appropriations
  - $34.5 million for *support programs*, 72% is pass-through funding to non-State entities

FY 2009-10 Cost Summary

- Article 3B – J = $120 million
- Article 3A (Lee Act) credits = $70 - $80 million
- Film Credit = $22.5 million
- Appropriations = $55 million
- TOTAL = $277 million

How Effective Are North Carolina's Economic Development Tax Credits?

UNC Economic Incentives Analysis Findings

April 7, 2010

Jason Jolley, Senior Research Director

UNC Center for Competitive Economies (C^3E)

1

Background

Joint Select Committee On Economic Development Incentives

- Hired C^3E in January 2008 to examine incentives outcomes and recommend changes
- Which incentives achieve the greatest return?
  - Quality Job Creation
  - Distressed Areas Benefit
  - NC Competitiveness

NC Economic Incentive Types

Statutory Incentives

- **Tax credits** to qualifying businesses for job creation, training and investment
- Lee Act and Article 3J

Discretionary Incentives

- **Cash grants** to new and expanding businesses for job creation and/or retention
- Job Development Investment Grant (JDIG)
- One North Carolina Fund

3

Major Findings

- Tax Credits
  - Comprise most economic development spending
  - Ineffective at job creation
  - Little benefit to distress communities as most credits go to wealthier counties
- Corporate Tax Rate
  - Highest in Southeast
  - Competitive neutral rate of 6.5% could be achieved with elimination of tax credits
  - Survey of executives found most preferred lower tax rates to select tax incentives

NC Incentives Portfolio

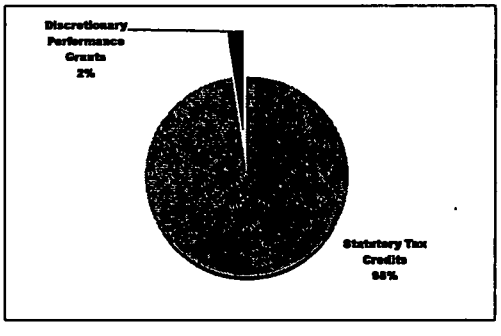
1996 - 2006: $2 billion in economic incentives

5,000+ incented companies form a "portfolio" of investment strategies

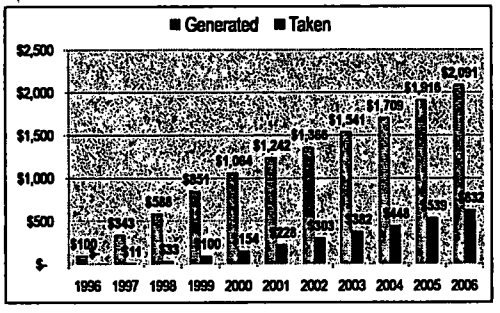
- Pre/post incentive quarterly employment and wage history for each incented firm (250,000 data points)
- Surveys/Case studies of incented firms

Which incentives /companies best achieve NC's economic development priorities?

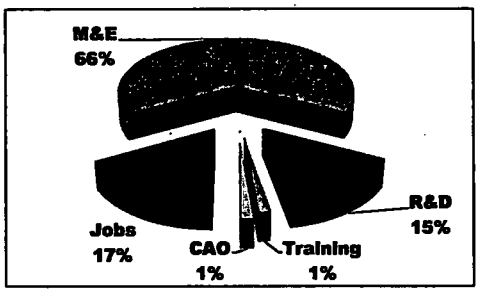
Incentive Portfolio Allocation



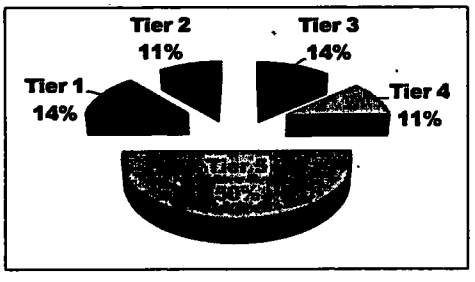
Lee Act "Costs" Have Exceeded $2 Billion



Lee Credits 1996-06 = $2.1 Billion



All Lee Credits - 2002-06 $875 Million



Incentives Have Limited Effect on Corporate Locations

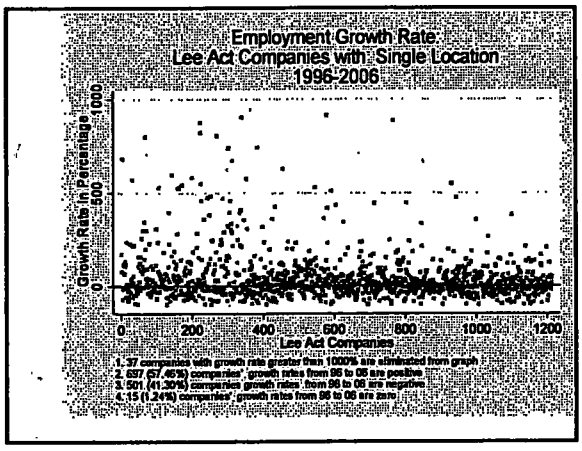
- National surveys indicate incentives are relatively low in importance in location decisions
- **Site Selection** magazine (2008) survey of corporate executives ranked incentives eighth
- UNC survey of NC incented and non-incented ranked incentives 12th and 13th respectively
- Incentives do not compensate for inadequate workforce or infrastructure

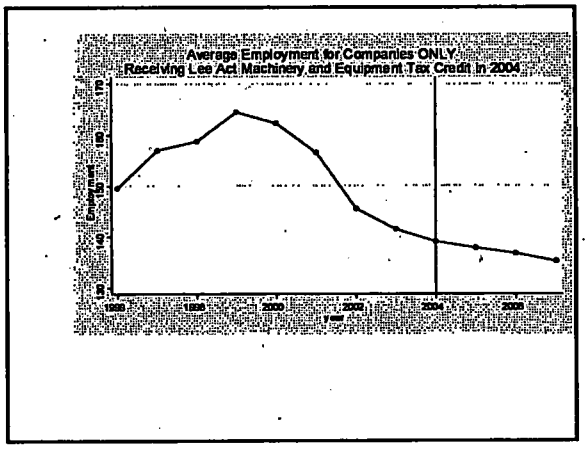
Updating NC's Incentive Portfolio

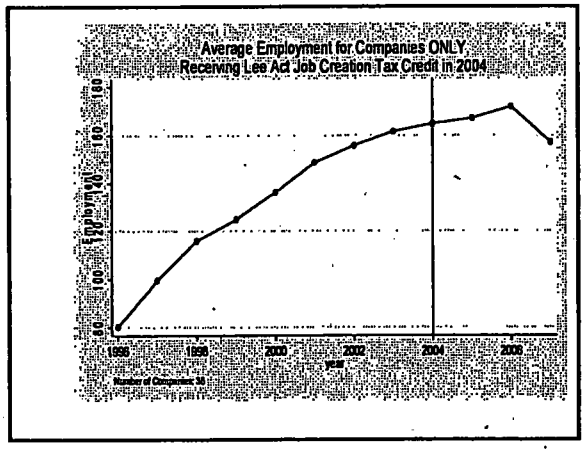
- Current incentive portfolio relies too much on tax credits that are less effective than in 1990s
- Few tax credit incented firms show job growth – <u>most have same or fewer jobs after tax credits</u>
- Most tax credits are for investment - strongly associated with job loss
- Even job creation tax credits show weak effect
- R&D credits best correlated with later job growth

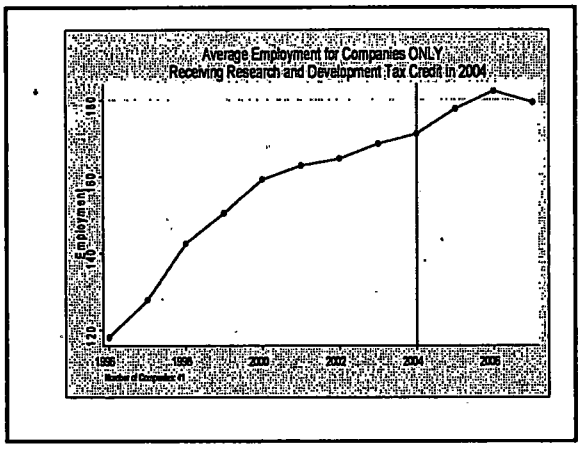
The Carolina Center for Competitive Economies (C3E) *Kenan Institute for Private Enterprise*











NC Corporate Tax Rate

- UNC survey found executives preferred lower tax rate to selective tax incentives
- Rate reduction positive effect on more firms
- Reallocating incentives portfolio can support corporate tax rate reduction
- Reducing current 6.9% rate to competitive neutral rate of 6.5%

NC Corporate Tax Rate

North Carolina	6.9%
Alabama	6.5%
Tennessee	6.5%
Georgia	6.0%
Virginia	6.0%
Florida	5.5%
South Carolina	5.0%

Summary of Recommendations

- Most tax credits ineffective as job creation tool and offer limited benefit to distressed areas
- Competitive neutral corporate tax rate reduction would benefit more companies
- Retain R&D tax credit which benefits smaller companies that are adding jobs
- Discretionary incentives have potential for job creation, especially if revised and targeted for smaller projects in distressed areas

An Evaluation of North Carolina's Economic Development Incentive Programs

Final Report

July 2009

Prepared for

North Carolina General Assembly
Joint Select Committee on Economic Development Incentives

University of North Carolina Center for Competitive Economies

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The UNC Center for Competitive Economies (C^3E) is part of the Frank Hawkins Kenan Institute of Private Enterprise and UNC's Kenan-Flagler Business School of the University of North Carolina at Chapel Hill. The Center brings the considerable resources of the University to help communities in North Carolina, the United States and beyond address critical challenges of competitiveness and economic development. In that role, C^3E conducts economic policy studies for local, state and national governments across the spectrum of economic development issues.

Executive Summary

In March 2007, the President Pro Tempore of the North Carolina State Senate and the Speaker of the North Carolina House of Representatives established a Joint Select Committee on Economic Development Incentives to examine the state's economic incentive programs. In January 2008, the North Carolina General Assembly contracted with the University of North Carolina's Center for Competitive Economies (C^3E) to assist the Joint Select Committee on Economic Development Incentives in evaluating the performance North Carolina's economic development incentive programs.

C^3E undertook this 18-month research program with the goal of addressing a set of questions deemed key to the committee's efforts:

1. What is an economic incentive and which ones are most appropriate for the committee to assess?

2. How is the success of economic incentives to be judged and which outcomes are the highest economic development priorities for North Carolina?

3. What companies have received economic incentives, how much have they gotten, and how much more will be granted under current policies?

4. What have been the benefits from economic incentives and how do programs and types of recipients differ in their economic impact?

5. To what extent do North Carolina's economic incentives affect the state's economy?

6. How would the economic impact of reducing the state's corporate tax rate compare to that of current economic incentives?

This summary of findings discusses the importance of each critical research question under examination, reviews the research approaches utilized to examine these questions, and highlights key findings from the research. More detailed analysis and secondary research findings can be found in the complete report and appendices.

Executive Summary: Research Methodology

Study Period: 1996-2006

At the time of the committee's formation, North Carolina had recently completed its first decade of experience between 1996 and 2006 in the use of financial incentives in economic development. This span of time encompassed a dynamic period in the state's economic history. Much of the state's economic foundation in "traditional industries" – textiles, furniture, and agriculture – came under tremendous global competitive pressure, resulting in numerous plant closures and workforce reductions. Meanwhile, more technology-intensive industries such as pharmaceuticals, telecommunications, and computer hardware and software experienced both rapid growth and retrenchment in the "dot com" boom and bust of the late 1990s.

Data Sources

This economic dynamism, combined with the expanded use of incentives during the 1996 to 2006 study period, provided an abundance of both quantitative and qualitative information. Much of the required relevant information resided at the North Carolina Departments of Commerce and Revenue:

- The North Carolina Department of Commerce provided information on Job Development Investment Grant (JDIG) and One North Carolina Fund (One NC) incentive recipients.
- The General Assembly passed legislation authorizing the Department of Revenue to release tax filings for William S. Lee tax credit recipients to C^3E to complete the study. Electronic tax filings were available for companies receiving Lee tax credits from 1996 to 2006; and hard copies of tax returns, which included additional information on type of credit claimed, were released for 2002 to 2006 returns.
- The North Carolina Employment Security Commission provided quarterly employment history from 1990 to 2006 for incented firms based on information provided by the North Carolina Department of Revenue and Department of Commerce. In total, this database exceeds 250,000 observations used to track the pre- and post-employment performance of incented companies.

Executive Summary: Case Studies and Surveys

Quantitative employment and incentive data was then augmented by qualitative data from company case studies and surveys. Executives from 36 companies receiving Lee Act incentives participated in confidential interviews to discuss the impact of the Lee Act on their companies' business expansion and location decisions. Sixteen detailed case studies were conducted on JDIG/One NC companies, including documentation of local and state incentives received. Another four case studies (two in South Carolina and two in Virginia) were performed to examine companies North Carolina had unsuccessfully competed to attract into the state.

Additionally, a survey was utilized to determine the perspective of incented and non-incented companies on the importance of economic development incentives to their business expansion and location decisions and on the state's business climate.

Research Analysis

The majority of the research was completed between February and December 2008, although additional analysis will be performed to assist the legislature in its deliberations. C^3E researchers provided research results to the committee and its staff frequently in the course of the committee's meetings throughout 2008. Those findings addressed the initial key questions and are summarized below:

1) What Is An Economic Incentive And Which Ones Are Most Appropriate For The Committee To Assess?

C^3E worked with the Joint Select Committee and the legislative staff to define the relevant population of economic development incentives to be addressed in the study. As anticipated, this apparently simple question was complicated by differing understandings as to the definition of incentives and the state's history of experience in their use.

North Carolina offers a wide range of economic development assistance that could be included in an expansive definition of economic incentives. Types of assistance range from highly specialized services, such university-based technology transfer programs, to broadly available small business training programs offered through the community college system. Historically, the state has also offered direct industrial development assistance such as industrial revenue bond financing, customized job training programs and industrial development.

Studied Incentives

However, in the early 1990s the state undertook a specific effort to develop a program of economic development incentives in response to its perceived weakening competitive position with economic development rival states. This program of statutory tax credits, which came to be known as the William S. Lee Act incentives program, was later expanded through the addition of the discretionary incentive programs of the Job Development Investment Grant (JDIG) and One North Carolina Fund.

The implementation of these incentive programs marked a significant strategic shift in North Carolina's economic development efforts. Accordingly, the committee chose to limit the analysis to these programs and the state's Research and Development tax credits. The study did not measure or examine the effectiveness of local economic development incentive packages, although some data were collected on the types and amounts of local incentives in the JDIG/One NC case studies and surveys of incented companies.

2) How Can The Success Of Economic Incentives Be Judged And Which Measures Are The Highest Priorities For North Carolina?

North Carolina was a late entrant in establishing an economic development incentive program, relative to many other southern states. The William S. Lee Act was created in 1996 and has undergone multiple revisions to expand eligibility, refine criteria, and modify thresholds since the original legislation. The One North Carolina Fund and Job Development Investment Grants are also economic development incentive tools utilized by the state for economic development purposes. As North Carolina's palette of economic incentives has expanded, often in response to unanticipated circumstances, the core goals of the economic incentives may have been perceived as muddled, inconsistent, or even contradictory. Therefore, to assess the performance of North Carolina's economic incentives, it was first necessary to freshly define the standards by which such performance was to be measured.

Performance Criteria

The justification for economic incentives in the public arena is typically and simplistically presented as "job creation". But there are a wide range of other legitimate desired outcomes to consider in judging performance. The relevance and priority of these outcomes is a function of public policy as articulated by the General Assembly. Working with the Joint Select Committee and supported by legislative staff, C^3E defined three parameters to utilize in measuring the effectiveness of the state's economic development incentive programs:

Quality Job Creation

- Job creation measures included the number of new jobs created and/or existing jobs maintained after receiving an incentive, the wage level of created jobs, whether or not the job was in a targeted industry sector/cluster, the location of the job, and whether incented companies were hiring existing residents for new jobs and creating upward employment opportunities.

Distressed Areas Benefit

- Benefit measures in distressed areas included examining the share of new job creation in distressed areas (classified as Tier One counties) and the wage levels associated with those jobs. Additional prospective measures included reemployment of displaced workers and replacement of declining industries.

North Carolina's Economic Competitiveness

- Economic competitiveness was examined through the lens of economic diversification and insulation from any negative effects of globalization. Focusing on the location of headquarters, entrepreneurship, and high-value industry clusters were also prospective measures. These key measures were examined

through a portfolio approach designed to determine which economic incentive programs were offering the best return on investment.

3) What Companies Have Received Economic Incentives, How Much Have They Gotten, And How Much More Will Be Granted Under Current Policies?

The examination of the statutory and discretionary incentive programs activity between 1996 and 2006 revealed that, in many ways, North Carolina's economic incentives were being used differently than how the public widely perceived them. The study found that the focus by the media – and therefore the public – on a few "high profile" examples (such as Dell, Google, Goodyear, etc.) tended to distort the public's understanding of both the participation in and the costs of the state's incentive programs.

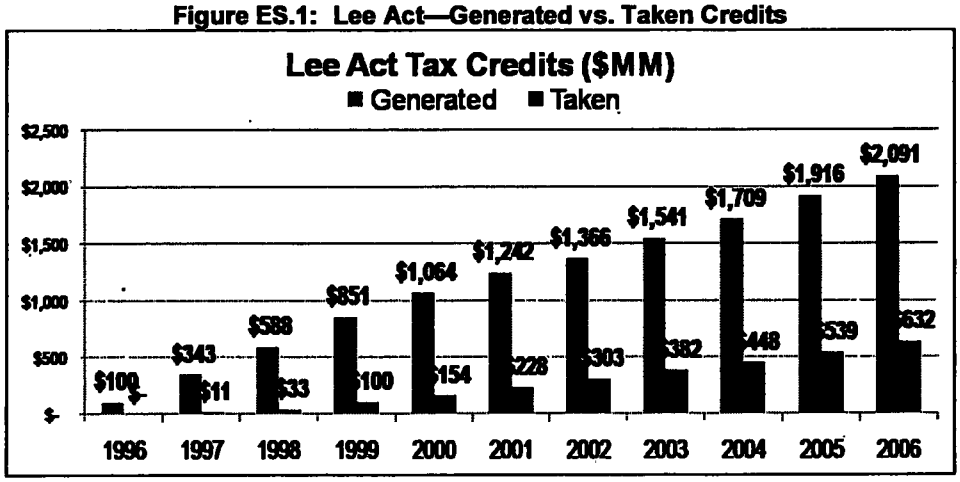
Incentive Use Differs from Assumptions

Between 1996 and 2006, approximately 5,000 companies participated in one or more of the North Carolina economic incentive programs covered in this research. Analysis of this population found the following disparities between public and legislative expectations and actual participation:

Costs are High but Typically Overstated

- By 2006 the total maximum amount of incentives "generated" or awarded by the state since 1996 exceeded $2 billion, but the eventual actual cost will be less.
- Media accounts typically cite maximum possible incentive amounts, whereas the eventual actual cost will be significantly less because most incentives are in the form of tax credits that historically are not fully utilized.
- The amount of tax credits used or "taken" in the period totaled $632 million (Figure ES.1); an estimated 35% of the $2.1 billion generated credits will never be used.

Figure ES.1: Lee Act—Generated vs. Taken Credits

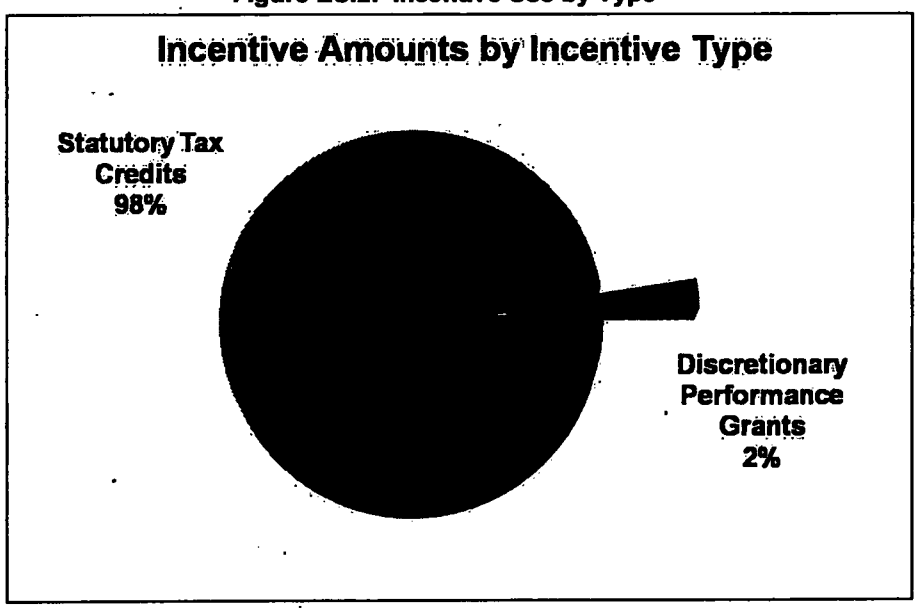


High-Profile Discretionary Incentives are Atypical

- Media studies found that discretionary incentive (JDIG, One NC) deals receive a disproportionate level of coverage compared to Lee Act tax credit recipients, thus creating a distorted perception of incentive use.

- Lee Act tax credits consume the majority of North Carolina's incentive "portfolio" allocation (Figure ES.2), representing 98% of the allocation, while discretionary incentives only comprise 2%.

Figure ES.2: Incentive Use by Type



Most Firms Get Small Incentives, Only a Few Get Large Amounts

- Media attention focused on the large incentive deals also distorts perceptions of the typical incentive amount received by a company.

- Between 2002 and 2006, 1,967 companies received $875 million in Lee Act tax credit incentives. But of these, 860 companies (44%) received less than $25,000 each, calling into question the effectiveness of such small amounts on business behavior.

- By contrast, for the same period just 46 companies (2%) received an average of more than $11 million each, for a total of $523 million or nearly 40% of the total tax credits generated.

4) What Have Been The Benefits From Economic Incentives And How Do Programs And Types Of Recipients Differ In Their Economic Impact?

The economic and job creation impact of economic incentives is an issue of much debate for policymakers. Most academic studies have demonstrated that economic development incentives, particularly statutory tax credits, yield limited effectiveness in job creation and usually succeed only under competitive scenarios where other factors are deemed equal among competing areas. Dr. Michael Luger, Dean of the Manchester Business School (UK) and former UNC professor, conducted several prior assessments of the William S. Lee Act and created a simulation model to examine the possible job creation impacts of the Lee Act. Dr. Luger's simulations found that the Lee Act had a modest impact on job creation in North Carolina.

Incentives Usage Inconsistent with Performance Criteria

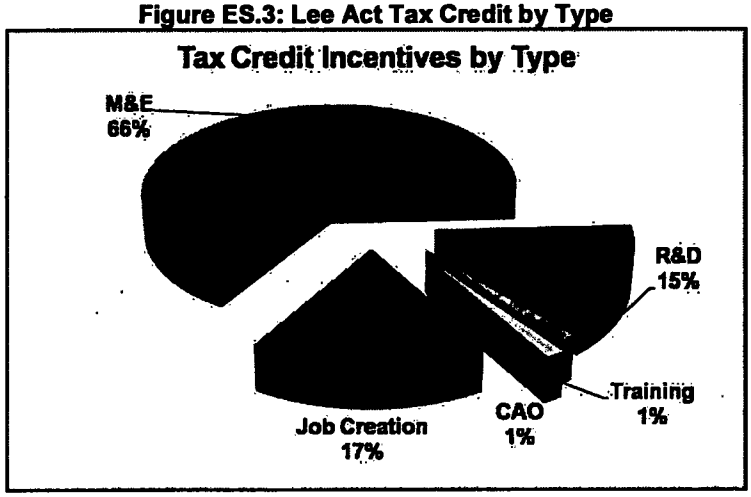
While there may be many objectives for the use of incentives in economic development, the criteria established by the Select Committee for evaluating the performance of North Carolina economic incentives specifically emphasized their contribution to job creation in the state's distressed counties. By those measures, the use of economic incentives between 1996 and 2006 failed to achieve those goals.

Most Incentives Went to Investments, Not Job Creation

- The popular perception is that job creation is the major focus on economic development incentives, yet only a small amount of Lee Act tax credits are directly attributed to job creation activities.

- Only 18% of Lee Act tax credits generated from 1996 to 2006 were used specifically for job creation or employee training, whereas two-thirds (66%) were used for machinery and equipment (M&E) investment (Figure ES.3).

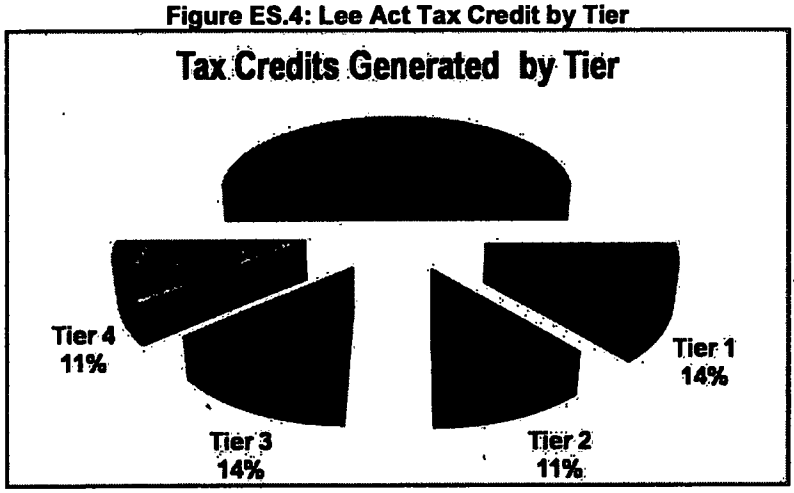
Figure ES.3: Lee Act Tax Credit by Type



Few Incentives Benefitted Distressed Areas

- While the Lee Act provided favorable incentives in the state's poorest counties (Tier 1), most tax credits went to the least distressed counties (Tier 5) (Figure ES.4).

Figure ES.4: Lee Act Tax Credit by Tier



- During the most recent period of 2002 to 2006, companies receiving Lee Act incentives generated $875 million in tax credits. Of that amount, half of the incentives went to companies in the least distressed counties (Tier 5) while only 14% went to companies in the most distressed counties (Tier 1) (Figure ES.4).

Job Creation by Incented Firms is Generally Lacking

This study was enhanced when the General Assembly legislatively empowered C^3E to obtain and analyze confidential data unavailable to previous analysts. C^3E obtained

quarterly employment history for all firms that receive a Lee Act tax credit and report employment levels to the NC Employment Security Commission. These data were analyzed to examine the pre- and post-tax-credit employment trends of incented companies. Data analysis required that C^3E hold counties' tier status constant across the analysis, using 2006 tier designations, and limit some of the analysis to companies with single locations and/or companies existing throughout the study period. Additionally, data on the type of credit claimed by companies under the Lee Act was only available from 2002 to 2006. These methodological procedures are not expected to significantly alter the findings or trends.

Single location companies in the study period were examined to determine the growth rate and levels of employment change of companies receiving one or more Lee Act tax credits from 1996 to 2006. Surprisingly, the examination revealed that only 57.46% of companies receiving a Lee Act tax credit had a positive growth rate (i.e., more employees) in 2006 than they did in 1996 (Figures ES.5 and ES.6). Over 41% of the companies had a declining growth rate, leading to fewer employees at these businesses in 2006 than in 1996. These trends were also analyzed for each tier (see subsequent sections of the full report for charts/tables).

Figure ES.5: Employment Growth Rate for Lee Act Companies

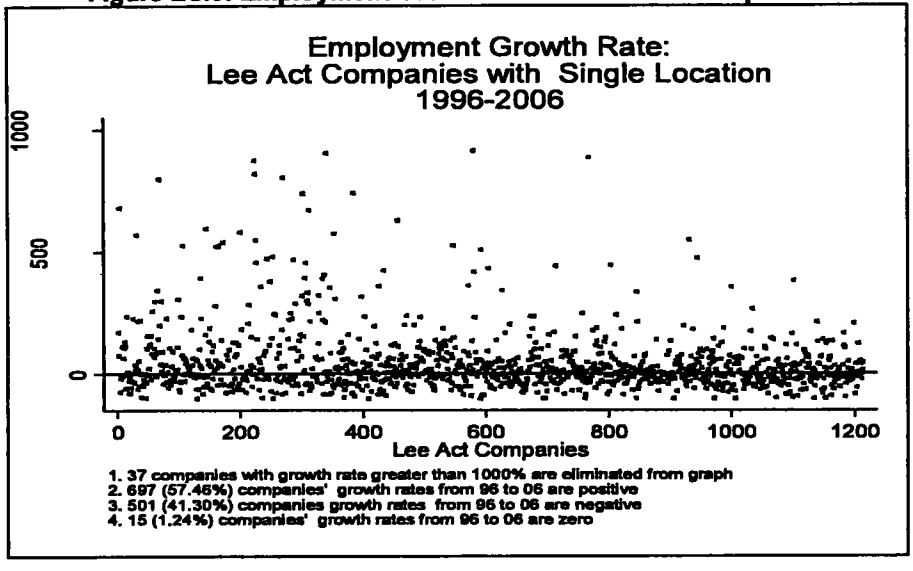
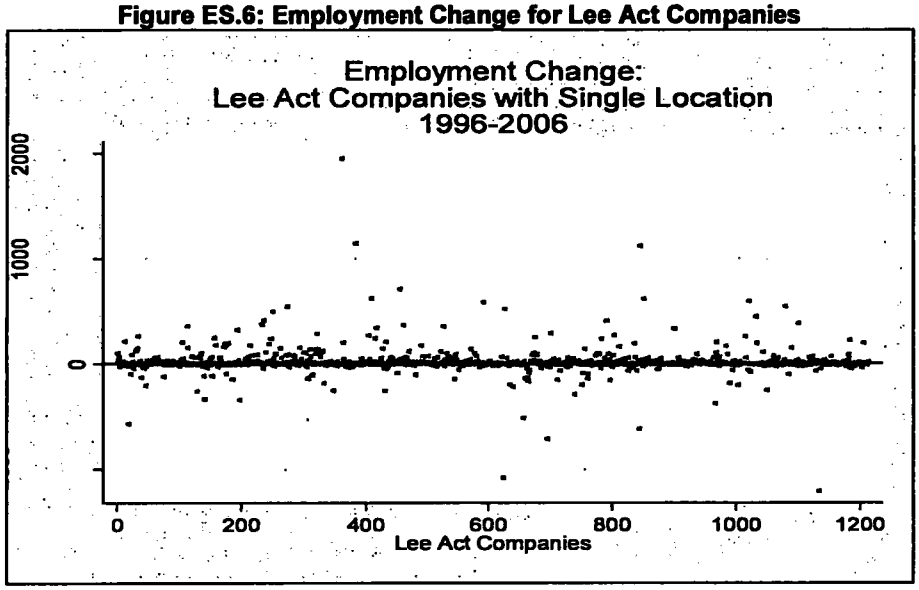


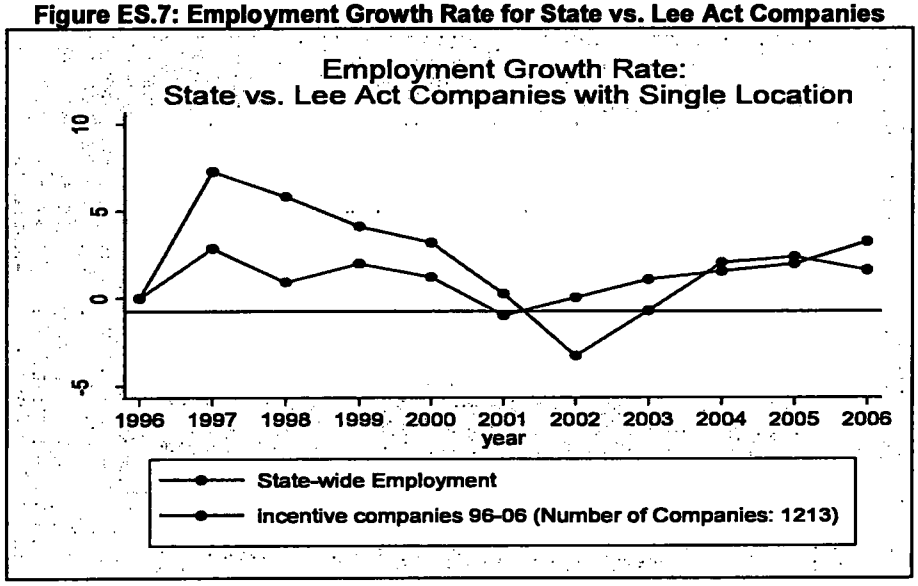
Figure ES.6: Employment Change for Lee Act Companies



Job Creation by Incented Firms Lagging State Economy in Recent Years

Next, the employment growth rates of incented firms existing from 1996 to 2006 and existing from 2002 to 2006 were examined against the overall employment growth for the state. Data on the growth rate comparison for each tier is available in the full report. Incented companies did demonstrate a slightly higher employment growth rate in the 1990s, yet the gap between incented companies and the state average closed over time and is nearly negligible now (Figure ES.7).

Figure ES.7: Employment Growth Rate for State vs. Lee Act Companies



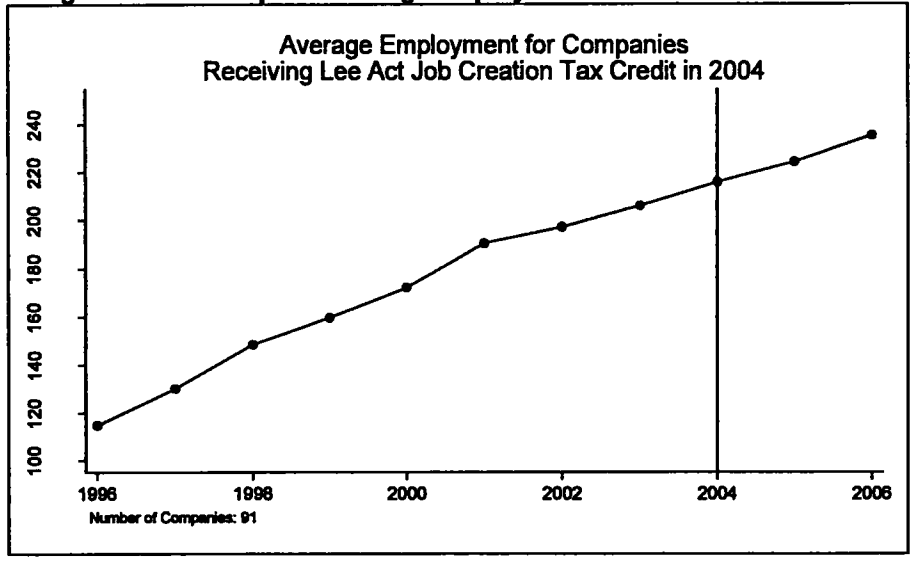
Pre- and Post-Tax-Credit Incentive Analysis Shows Lack of Job Creation

To fully assess the Lee Act's impact on employment levels, it was important to contrast the pre- and post-incentive employment levels of incented firms. An analysis was conducted to examine the difference in pre- and post-incentive employment by both tier and credit type.

As an illustration, data on companies receiving a Lee Act tax credit in 2004 are provided (Figure ES.8). Yearly performance data by credit and tier are available in the full report.

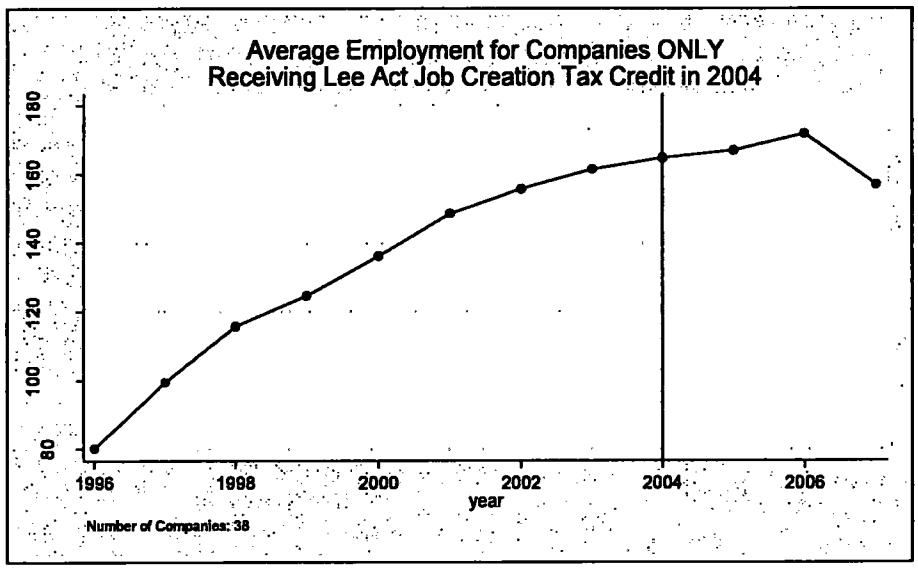
This graph illustrates the average employment for companies receiving a job creation tax credit in 2004 through the William S. Lee Act. Companies are not excluded if they also received another type of tax credit. On average, job creation after the tax credit is positive, yet the tax credit does not appear to cause an increase in the rate of job growth.

Figure ES.8: Example of Average Employment Job Creation Tax Credit



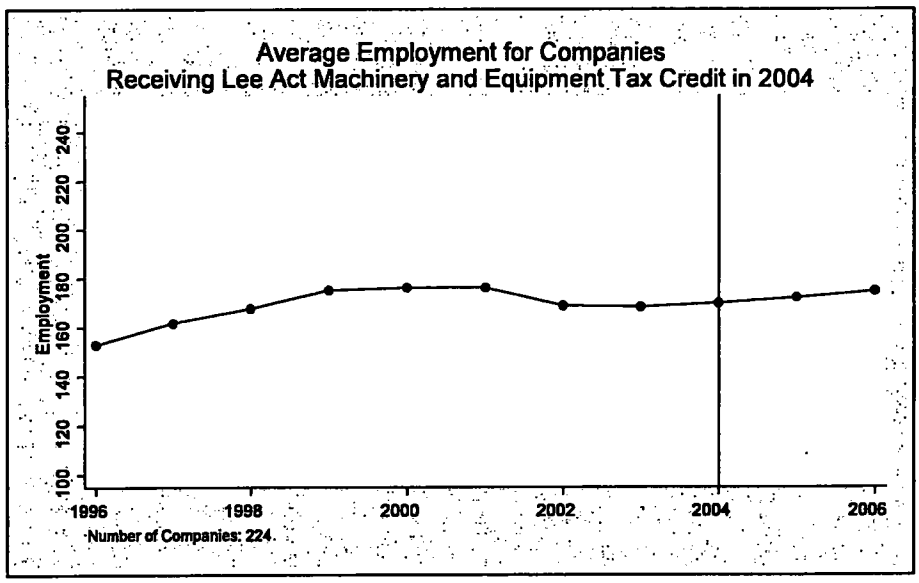
In an effort to isolate the impact of the job creation tax credit, firms only receiving a job creation tax credit and no other tax credits in 2004 were also examined (Figure ES.9). Again, the slope of average employment after the tax credit was generally positive, but the credit does not appear to influence the rate of job creation.

Figure ES.9: Example of Average Employment Job Creation Tax Credit ONLY



Similar analyses are presented for machinery and equipment and research and development tax credits for 2004. The first graph (Figure ES.10) demonstrates the average pre- and post-credit employment levels for businesses receiving a machinery and equipment tax credit in 2004, but does not exclude the company if it received other tax credits.

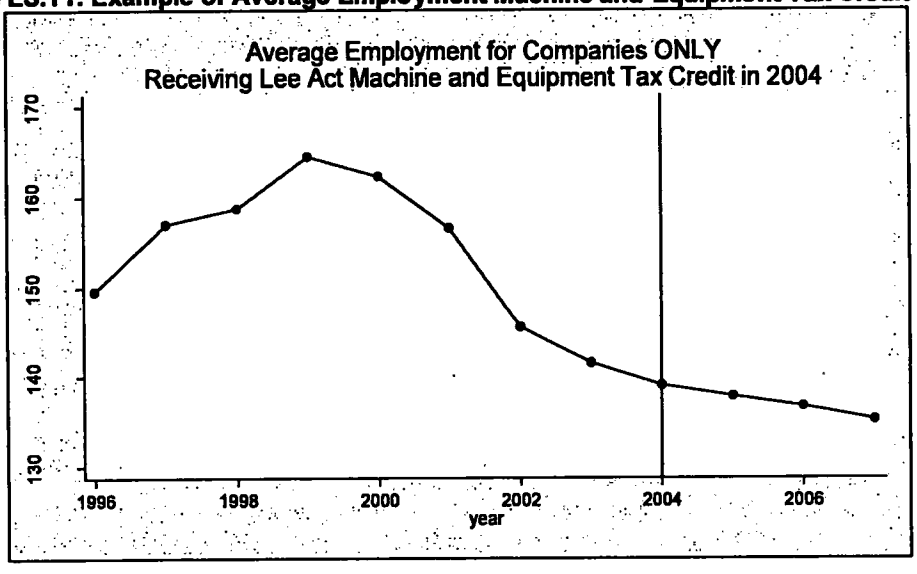
Figure ES.10: Example of Average Employment Machinery and Equipment Tax Credit



The second graph (Figure ES.11) focuses on companies only receiving a machinery and equipment tax credit in 2004. Taken in conjunction with other tax credits, the M&E credit does not appear to increase average employment levels at all. Companies only taking the M&E tax credit in 2004 demonstrate an employment loss in subsequent

years, which may illustrate that companies taking the M&E credit are more susceptible to economic downturns or that these companies are engaging in capitalization—the substitution of labor with capital (i.e., machinery and equipment).

Figure ES.11: Example of Average Employment Machine and Equipment Tax Credit ONLY



An examination of research and development tax credits for 2004 reveals positive employment growth for companies taking an R&D tax credit with other credits (Figure ES.12) and R&D tax credit only (Figure ES.13).

Figure ES.12: Example of Average Employment Research and Development Tax Credit

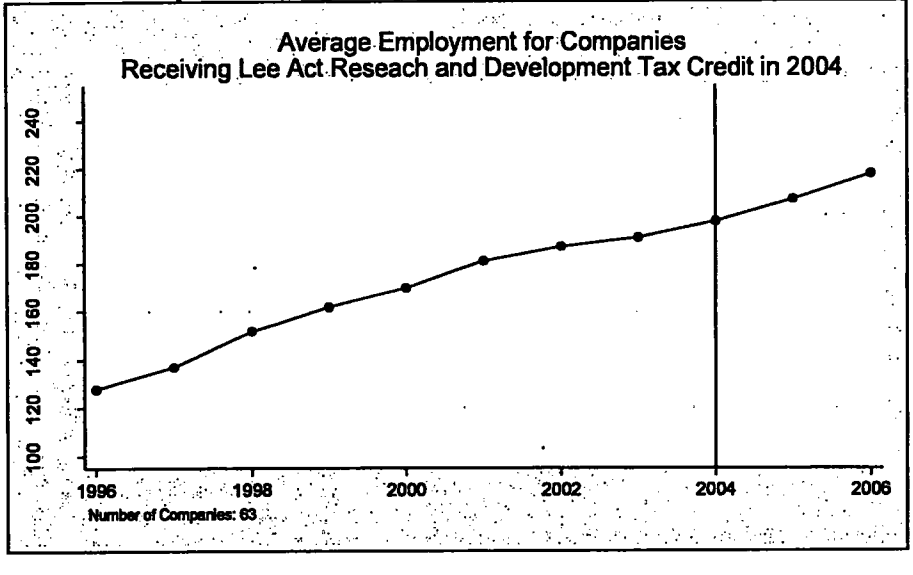
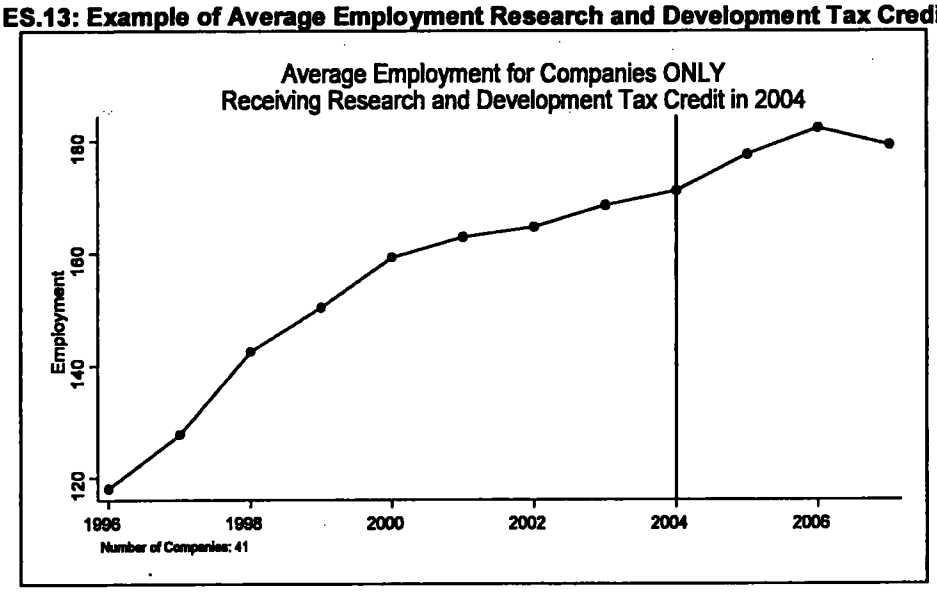


Figure ES.13: Example of Average Employment Research and Development Tax Credit ONLY



This illustrative snapshot of 2004 is indicative of the general findings on the performance of the William S. Lee Act. Statutory tax credits are having little to no effect on employment growth and a limited impact on company expansion/location decisions in North Carolina.

Discretionary Incentives Offer Advantages over Tax Credits

Unlike statutory tax credits, the state's discretionary programs are better directed toward the state's targeted industry clusters and are more likely to influence a company's location or expansion decision. In remarks to the Joint Select Committee on Economic Development Incentives, North Carolina Secretary of Commerce Jim Fain said that in the JDIG program, "81% of the jobs induced to date have been in our targeted sectors."

A panel of economic development scholars assembled by the C^3E for a Symposium on Economic Development Incentives also acknowledged that discretionary programs are more likely to allow for economic development targeting to key industry clusters, and these programs are more likely to assist in economic transformation of distressed regions. Like the statutory tax credits, the majority of discretionary economic development incentives are utilized in the state's less distressed counties.

Scholars also acknowledge that incented job creation in growing metropolitan areas must generate sufficiently large wages and investment levels to offset the fiscal costs incurred by local and state governments by the influx of new residents. Discretionary incentives leading to investment and job creation have a much larger economic impact when existing residents are employed, especially in distressed areas.

5) To What Extent Do North Carolina's Economic Incentives Affect the State's Economy?

North Carolina is a large state, ranking 10th in population (9,061,032). The state's workforce exceeds 4.6 million people and the gross state product (GSP) is $400 billion (9th largest), exceeding the GSPs of Georgia, Virginia, Michigan, and Massachusetts. If North Carolina were a country, it would have the 23rd largest national economy.

Economic Incentives Have Limited Potential

Currently, North Carolina has more than 500,000 businesses. The state is limited to providing direct assistance to only a few thousand companies per year through statutory tax credits, and to a few dozen firms annually through targeted discretionary incentives. To generate just a 1% gain in employment, the state would need to incent the creation of 90,000 new jobs.

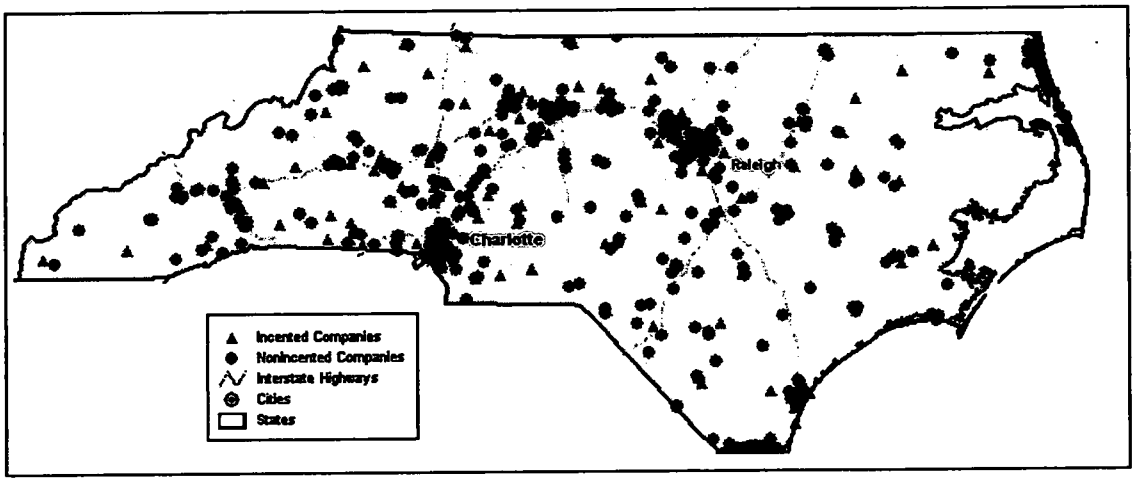
The large number of businesses claiming and generating small amounts of Lee Act tax credits suggests that the state's statutory tax credit programs are having a limited effect on the state's economy. The size of the state's economy makes it challenging for an incentive program to greatly stimulate statewide economic growth. However, discretionary programs provide an opportunity for a transformative effect on the state's most distressed regions by laying the groundwork for future growth and employment in areas struggling with economic adjustment and unemployment.

State Survey and Case Studies Indicate Incentives are Low Priority

Academic research suggests that economic development incentives play a limited role in influencing company location decisions and usually are effective only when other factors are equal among competing states. A survey of companies receiving the Lee Act tax credit indicated that incentives ranked low on the list of priorities for business executives. Similar surveys by national site selection magazines also demonstrate that incentives are generally less important than a skilled, well-educated workforce, adequate infrastructure, state tax rates, and regulatory climate.

C^3E surveyed North Carolina companies to determine their perception of the effectiveness and importance of economic development incentives. The survey included 150 Lee Act recipients and 465 non-incented companies (Figure ES.13).

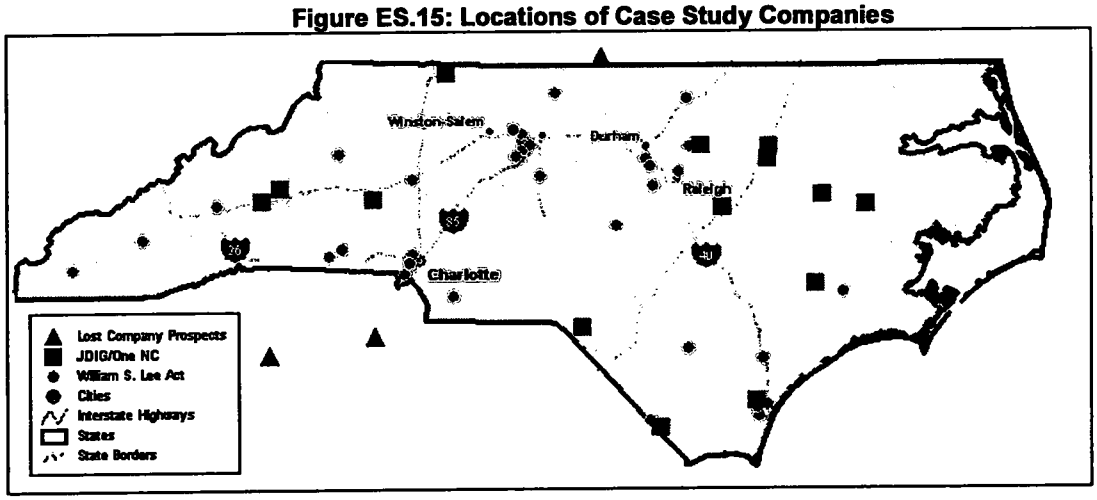
Figure ES.14: Lee Act Recipients and Non-Incented Companies



The survey revealed several interesting findings about the perception of incentives among North Carolina businesses. Incentives ranked well below other factors such as skilled labor availability, highway access, tax rates, and regulatory climate. Incented businesses ranked incentives 12th and non-incented ranked incentives 13th, respectively. Surprisingly, 62% of surveyed NC executives were unaware that their company received an incentive. This lack of awareness by a majority of executives indicates that incentives in the form of tax credits have little impact on business decisions.

Case studies were also conducted with 36 companies receiving a Lee Act tax credit, 16 companies receiving a JDIG or One NC grant, and four companies that North Carolina tried to recruit but lost to other states (Virginia and South Carolina). The map (Figure ES. 14) below identifies the general location of case study companies.

Figure ES.15: Locations of Case Study Companies



Brief highlights of case study findings are provided here. In general, interviews with executives whose company received a Lee Act credit revealed that the credit had little impact on the company's decision to engage in economic growth or expansion. Most

executives viewed the credit as an "after the fact" accounting function. Many executives interviewed were unaware that their company even received an incentive.

JDIG and One NC case studies tracked the investment levels of incented companies using publicly available data and interviews with relevant officials. These case studies documented the amount of local investment utilized to incent the company's expansion or location choice. In most instances, the case studies revealed that consultants played a much smaller role in incentive receipt than popularly perceived. Only one of the 36 Lee Act companies interviewed had been approached by a consultant regarding available incentives. Consultants continue to play a role in some high-profile incentive deals, but the case studies revealed that few are paid as a percentage of the incentive received.

When Incentives are Most Effective

To the extent incentives have been found to substantially influence company location decisions, they are most effective when:

- the targeted prospects are highly mobile and less resource constrained
- the incentives are tailored to the company's specific priorities
- used proactively to target growth companies with substantial job creation "upside," rather than reacting to an individual company's "auction" opportunities
- used to strengthen existing industrial clusters through buyer-supplier chain enhancements
- used to target firms with the best match for existing labor market availability, thus maximizing the net economic benefit of a location success

6) How would the economic impact of reducing the state's corporate tax rate compare to that of current economic incentives?

The last major task in the study examined the extent to which the corporate tax rate could be reduced if the state abolished economic incentives. An analysis by Dr. Roby Sawyers, Professor of Accounting at North Carolina State University, revealed that if the statutory tax credits had been abolished, the corporate tax rate could have been reduced from 6.9% to 6.19% in 2003, 6.24% in 2004, and 6.25% in 2005.

Currently, North Carolina has one of the highest corporate tax rates in the southeast (Figure ES.15) which is perceived to be a significant disadvantage for North Carolina to attract companies.

Table ES.1: Corporate Tax Rate

State	Corporate Tax Rate
North Carolina	6.90%
Alabama	6.50%
Tennessee	6.50%
Georgia	6.00%
Virginia	6.00%
Florida	5.50%
South Carolina	5.00%

NC Company Surveys Reveal Preference for Tax Reduction

The study's survey of incented and non-incented firms asked the following question: "Some people believe that it is better for North Carolina's economy to offer select incentives to certain businesses, while other people believe it is better to reduce taxes impacting business taxpayers and their owners. Which strategy do you think is better for NC's economy?" Approximately 14.5% of non-incented companies and 21.7% of incented companies stated it was better to offer select incentives to certain businesses, while 85.5% of non-incented companies and 78.3% of incented companies stated it was better to reduce taxes impacting businesses taxpayers and their owners. **A majority of companies in both groups favored reduced taxes over incentives.**

Executive Summary: Research Findings Summary

NC incentives are most effective in influencing business decisions when:

- Prospects are mobile
- Prospects are well matched to local resources
- Other location factors are competitive
- Incentives are tailored to companies' specific priorities
- Benefits are front-loaded and packaged with other assistance
- Incentives are used proactively early in a firm's location process

NC incentives have the greatest economic benefit when the:

- Company employs local residents, especially displaced workers
- Location has excess capacity in local infrastructure, minimizing public service outlays
- Company has a catalytic effect on local suppliers
- Company is in growth mode, dependent on local advantage
- Company is a headquarters in an export industry
- Incentives match NC economic development strategic priorities

NC Statutory Tax Credits Findings:

- Statutory tax credit spending vastly exceeds discretionary incentive spending.
- Statutory tax credits are not tied to NC's strategic economic development goals.
- The majority of tax credits are claimed by companies in less distressed areas.
- Large numbers of claimed tax credits are too small in amount to induce businesses to change their behavior.
- The majority of tax credits claimed are for machinery and equipment investment and are not directly related to job creation.
- Lee Act incentives are often viewed as an "after the fact" tax credit or accounting function.
- Company executives were unaware that their company received an incentive.
- Statutory tax credits are not significantly benefiting distressed counties.
- Tax credits have a positive marketing effect as a program to benefit existing businesses and are utilized as a marketing tool by economic developers.

Discretionary Incentive Programs Findings:

- Discretionary incentive programs provide a better opportunity for strategic economic development targeting.
- Discretionary incentives are likely more effective than tax credits at inducing companies to create jobs and investment.
- Unlike statutory tax credits, a set of defined metrics are utilized prior to approval and disbursements of discretionary grants.
- The absence of a wage standard can undermine discretionary incentive programs' economic benefit.
- The local match requirement is a significant burden on distressed counties.

- Legislative goal setting and independent oversight would enhance the program's administration and accountability.

Corporate Tax Rate Findings:

- Reducing North Carolina's corporate tax rate is a viable alternative to statutory tax credits.
- Reducing business taxes is preferred by both incented and non-incented companies as an alternative to selected tax credits.
- Corporate tax rate reduction would bring North Carolina "in line" with our competitor states.
- Eliminating the William S. Lee Act would have allowed for a revenue-neutral offset corporate tax rate reduction of approximately 6.25% (down from 6.9%) in 2005.
- Corporate tax rate reduction has lower transaction costs than statutory tax credits for tax filings and reporting..

Economic Incentives Utilization Findings:

- North Carolina's economic incentives can affect only a few businesses and therefore should be strategically targeted to maximize benefits.
- North Carolina can gain competitive advantages over rival states through proactive use of incentives to initiate location decisions by firms in strategic industrial clusters.
- Targeting efforts should incorporate emphasis on workforce availability and development capabilities to maximize incumbent worker employment.
- North Carolina state leaders lack objective data analysis on the state of North Carolina's economy and the performance of the state's economic development programs.
- While the data analysis is complex, North Carolina does have the available data to better track the performance of the state's economy and the state's economic development programs.

Executive Summary: Recommendations

1. Retain North Carolina's Research and Development Tax Credit.

North Carolina offers a Research and Development ("R&D") tax credit based on the percentage of qualified research expenses that a business pays or incurs during the year. This credit has been modified by the legislature several times. Recently the General Assembly extended the tax credit, which had been scheduled to expire on January 1, 2009, for five years.

The R&D tax credit was the only investment-based tax credit incentive examined that was correlated with companies adding new jobs both before and after receiving the incentive. Moreover, job quality goals are admirably intrinsic as the credit is premised on companies satisfying several "employment quality" eligibility criteria, including wage standards, health insurance, and occupational safety regulatory compliance.

The R&D credit is also distinct from other investment-based tax credits in that it is available to companies regardless of their industry, business type, or size. Therefore, corporations, partnerships, and limited liability companies are eligible. This flexibility enhances the prospect of its use by firms in distressed areas and incents (or rewards) innovative corporate strategies that undergird "growth companies" regardless of industry.

North Carolina firms generated $221 million in state R&D tax credits between 2003 and 2008. Retaining the R&D tax credit will cost an estimated $250 million in credits generated and $124 million taken during 2010 to 2015.

2. Eliminate North Carolina's Statutory Tax Credits (i.e. Article 3J Program).

North Carolina's current economic incentive portfolio is heavily allocated toward the statutory tax credits constituting the William S. Lee Act and the Article 3J program. Of the more than $2 billion in economic incentives committed between 1996 and 2006, 98% of the incentives were in the form of statutory tax credits.

Such tax credits were the basis of North Carolina's original foray into economic incentives. The process that devised what became the William S. Lee Act was a thorough and thoughtful one that drew on the best available information to devise appropriate incentives for the economy of the mid-1990s. In fact, the incentives appeared to have succeeded for several years as the companies receiving them outperformed the overall North Carolina economy throughout the 1990s.

Unfortunately, by the end of that decade companies receiving statutory tax credits no longer outperformed – or even matched – the state's economy. The explanation for this performance decline may be attributable to several factors, including legislative amendments that expanded the number of eligible firms and possibly diluted the net employment effect. But the economic circumstances and growth industries of the early 1990s had clearly changed by 2001, and they have changed even more dramatically in 2009. Thus it is reasonable that an incentive portfolio highly reliant on tax credits should be reconsidered based on updated information.

Research has shown that the most effective incentives are those that can be tailored to address company-specific location decision matrices. Statutory tax credits, while having the advantage of certainty based on stated eligibility criteria, lack the flexibility needed to develop customized incentive packages. Moreover, despite significant modifications over the years, statutory tax credits have consistently failed to significantly benefit distressed counties.

Tax credits can have a positive marketing effect as a program to benefit existing businesses, and they have been commonly utilized as a marketing tool by economic developers. While employment outcome research and even the company executives themselves have minimized the effectiveness of tax credits, undoubtedly among the more than 3,000 firms receiving such tax credits in North Carolina between 1996 and 2006, there were numerous instances where such credits were essential. Unfortunately, the rigidity of the credits' statutory nature makes North Carolina's current tax credits expensively inefficient for targeting such opportunities selectively.

We recommend eliminating the Article 3J program in advance of its scheduled "sunset" date. North Carolina's statutory tax credits accounted for an estimated $783 million in credits generated between 2003 and 2008. Forecasting tax credit generation and usage is complicated by the transition from the Lee Act to Article 3J credit programs, as well as the dampening effect of the current economic downturn. Nonetheless, eliminating the Article 3J program is predicted to result in total savings of $574 million in retained tax revenues during 2010 to 2015, with the great majority of savings being realized in the later years due to the lag effect of the carry-forward nature of current credits.

3. *Expand JDIG and One NC Programs in Number of Annual Projects and Annual Threshold with Increased Amounts Targeted to Distressed Counties.*

Many of the deficiencies of North Carolina's statutory tax credit incentives have been addressed in the development and implementation of the state's discretionary incentive programs, the Jobs Development Investment Grants and the One North Carolina Fund. While to date the discretionary incentives have shown limited success in targeting distressed counties, a strong potential for enhancing such outcomes nonetheless exists within the program.

Administration of the program through the Department of Commerce provides for the deliberate evaluation of potential net economic benefits. Such analysis provides a basis for calculating the appropriate scale of offered incentives and the capability to incorporate economic incentives within a broader package of assistance resources. The inclusion of specific performance outcomes as the prerequisite for incentive payments provides a powerful enforcement mechanism absent from the statutory tax credits.

We recommend that the JDIG and One NC programs be expanded, committing additional funding to distressed counties. To maximize the net economic benefit of discretionary incentive projects, the Department of Commerce's cost-benefit model should be modified to emphasize a stronger preference for incumbent workforce utilization, location of corporate headquarters, and consistency with Commerce's targeted industry clusters.

Achieving these objectives will require a more proactive effort to use incentives in targeting firms whose workforce and other location criteria provide better matches for the characteristics of North Carolina's distressed counties. We therefore also recommend increasing state and regional economic development research and marketing budgets for proactive targeting of growth-stage companies in targeted industry clusters.

Doubling the JDIG program with increased amounts targeted to distressed counties will require an estimated additional cost of $74 million total from 2010 to 2015. Enhancing economic development research and marketing will require an additional $1.5 million per year.

4. *Utilize Savings from Elimination of Statutory Tax Credits to Support Phased Reduction of Corporate Tax Rate to Competitive Neutral Rate of 6.5%.*

North Carolina's corporate tax rate is conspicuously higher than the next highest rates of its primary rival states. We recommend that a portion of the future saving achieved by the elimination of the Article 3J statutory tax credits be used in a multi-year reduction of the current rate of 6.9% to a competitive neutral rate of 6.5%.

Reducing North Carolina's corporate tax rate was found to be a viable alternative to continuing the existing statutory tax credits. Corporate tax rate reduction is economically preferable in that it has lower transaction costs for tax filings and reporting than statutory tax credits. Our surveys also found that reducing business taxes was preferred by both incented and non-incented companies as an alternative to selected tax credits.

Such corporate tax rate reduction would bring North Carolina "in line" with our competitor states. At 6.9%, North Carolina's corporate tax rate is 0.4% higher than Alabama and Tennessee (6.5%). A reduction to 6.5% would still leave the North

Interim Joint House and Senate Finance Committee
Wednesday, April 28, 2010
Room 643, Legislative Office Building
10:00 a.m.

MINUTES

The Interim Joint House and Senate Finance Committee met at 10:00 a.m. on Wednesday, April 28, 2010, in room 643 of the Legislative Office Building. Fifty-one members of the committee were present. Senator Clodfelter presided as chair.

Opening Remarks

Senator Clodfelter extended a welcome to the newest member of the committee, Senator Michael Walter. He wished "happy birthday" to Senator Jenkins and Representative Holliman. He also welcomed Jonathan Tart, a new staff member with the Fiscal Research Division.

Other Business Taxes: Excise Tax and Sales Tax

Cindy Avrette, a staff attorney with the Research Division, was recognized. She explained the excise tax and sales tax laws applicable to businesses. She also discussed the recommendations of previous study commissions on these taxes. A copy of her power point is attached.

Other Business Taxes: Local Privilege License

Chris McLaughlin, Assistant Professor of Public Law and Government, UNC School of Government, was recognized. He explained the local privilege license taxes (PLT) imposed on businesses by looking at collections, specifics on what constitutes a local privilege license and the variety of local entities that may collect the tax. He explained the "oddities" of the tax and questioned how to correctly collect the tax from big box retailers. He also examined internet sweepstakes and possible difficulties in collecting the privilege license tax for counties and municipalities. He finally pointed out constitutional concerns and sample PLT's by municipalities. A copy of his power point is attached.

Business Tax Reform: An Economic Development Opportunity

Brent Lane, Center Director with the UNC Center for Competitive Economies, was recognized to discuss the relationship between business taxes and economic development. He explained how large North Carolina's economy is and how economic development is limited. He discussed the NC labor force; wages by industry, NC versus US wages and NC per capita income in recent years. He summarized by explaining why tax reform will equal economic development. A copy of his power point is attached.

Financing the Future: Fiscal Modernization in North Carolina

Roby Sawyer, CPA, PhD, NCSU College of Management, was recognized. He explained the North Carolina's need for fiscal modernization. He explained that North Carolina's tax system is based primarily on laws created in the 1920's and 1930's, which was a model system then, but insufficient now. He looked at the series of

temporary sales tax and income tax rate increase along with surtaxes created to deal with budget shortfalls. He offered recommendations such as comprehensive tax reform; broadening income and sales tax bases while lowering the rates to create a revenue neutral change; and base broadening efforts should be done in a manner to provide relief for low-income taxpayers. A copy of his power point presentation is attached.

Legislative Session Updates

2010 Recommendations of the Debt Affordability Advisory Committee

Vance Holloman, Deputy State Treasurer, was recognized to present the 2010 recommendations of the Debt Affordability Advisory Committee. He provided the current outstanding debt by type; the authorized but unissued tax-support debt figures; and the new debt authorizations created by the 2009 General Assembly. He went on to explain the importance of being a "Triple-Triple A" bond rating state and offered comparisons to other states with that rating. He offered General Fund Debt Affordability Study results and other recommendations of the Committee. A copy of his power point presentation is attached. A copy of the 2010 Debt Affordability Study is attached.

Consensus Revenue Estimate

Rodney Bizzell, a fiscal analyst with the Fiscal Research Division, was recognized to provide a General Fund economic forecast and budget outlook. The May 2009 forecast showed a $391 million shortfall, the 2010-2011 fiscal year revenue has been adjusted down $703 million, and the expired estate tax has lead to an $85 million loss in revenue. He outlined the budget for the 2010-11 fiscal year and looked at the budget gap scenario. A copy of the power point is attached.

General Fund Availability

Evan Rodewald, a fiscal analyst with the Fiscal Research Division, was recognized. He gave a very brief presentation on the monies available in the General Fund.

Use of Fee Revenue in Recent Years

Rodney Bizzell was recognized. He provided an overview of fees; the General Assembly's oversight of agency fees, the use of fees in recent years to increase General Fund availability, and guidelines for future consideration. A copy of his presentation is attached.

Senator Clodfelter commended the staff for their assistance to the Committee and adjourned the meeting at 12:40 p.m.

Senator Dan Clodfelter, Presiding Chair

DeAnne Mangum, Committee Clerk

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 28, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Mitchell Kokai	John Locke Foundation
Emily Welborne	TPG
Amanda Arrington	HBUS
Kim Allison	HBUS
[illegible]	NCBIO
Shena Carraway	Alpha Kappa Alpha Sorority Inc
A. Galloway	AKA
Lori Ann Harris	LAHA
Marge Norman	NCHE
Michelle Frazier	MFS
Susan Valaun	NWI

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 28, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
John Goodman	NC Chamber
Kathy Hawkins	Progress Energy
Patrick Baffour	NC AEC
Zeb Alley	Nelson Mullins
W. Gardner Culpepper	Personal Interest
Will Culpepper	Moore & Van Allen
Amy Hobbs	McGuireWoods
[illegible]	Misc
Melanie Soden	DCR
Thomas Mace	Fedwire
Lucius W Pullen	NCMA & NCAA

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 28, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Gene Autry	OKa -
Roy Rogers	Cowboy Hall of Fame
Jon Carr	Jordan Price
[illegible]	NMRS
JOE LANIER	NMRS
L. Andrews	NCFB
DAVID BARNES	Payne Spruill
Bernie Madoff	Butner
Amy Whited	NC Medical Society
Chris Killian	Nelson Mullins
Elizabeth Robinson	NORMA

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 28, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
John Burdick	Astra Zeneca
Daniel Baum	Troutman Sanders
Bob Hunter	MWC
Joyce Peters	JD Assoc
Tom Bone	Bone & Assoc.
Snoopy	Barron Inc.
Michael Houser	N/C DOR
John Shaw	PCS
Jaime King	NCMS
D. Mowell	NCICU
Gene Causby	NCSCA

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 28, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Betsy Bailey	PENC
Cody Thomas	NCAR
Andy Ellen	NCPWA
Peggie Patton	NCPTA & NCDS
Rita Harris	NC Commerce

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — **Name of Committee**

April 28, 2010 — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Tommy Clark	NCWRC
April Wall	Alpha Kappa Alpha Sorority Inc.
Terry Anderson	"
Sharon Williams	"
Karen Clark	"
Kendra Davis	"
Vivian L. Bullock	"
Teresa Colreath	Alpha Kappa Alpha Sorority Inc.
Pris Allen	"
Jennie A. Johnson Franklin	Alpha Kappa Alpha Sorority, Inc.
Alisa E. Debnam	Alpha Kappa Alpha Sorority, Inc

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 28, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Sarah King	City of Charlotte
Bill Rowe	NC Justice Center
Rob Thompson	Covenant w/ NC's Children
Lennie Collins	NC DOR
Ginny Upchurch	NCDOR
Matt Hancher	Hunton + Williams
Clara Forrest	AKA Sorority
Brenda C Hampton	Alpha Kappa Alpha Sorority
[illegible]	AKA Sorority Inc.
Syvil Burke	AKA Sorority, Inc.

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — **Name of Committee**

April 28, 2010 — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Tiffany Smith	Alpha Kappa Alpha Sorority, Inc.
Wendy Cayolva	Alpha Kappa Alpha Sorority, Inc.
Jasna McElrath	Alpha Kappa Alpha Sorority Inc.
Pamela B. Williams	Gaston County Alpha Kappa Alpha Sorority, Inc.
Ina L. Hager	Gaston County Alpha Kappa Alpha Sorority Inc.
Hattie M. Hardin	AKA Sorority P.O. Box 492 Gastonia, NC 28053
Sandra Jeter	Gaston County Alpha Kappa Alpha Sorority
DeAndria Williams	Alpha Kappa Sorority, Inc.
Carmella D. Watkins	Gamma Gamma Omega Chapter Alpha Kappa Alpha Sorority, Inc.
Deatrice Williams	CUCA
Jamie Fenwick	Time Warner Cable
Ran Coble	NC Center for Public Policy Research

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 28, 2010
Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Margy Trathen	Brooks Pierce
Chuck Allen	US Airways
Doug Heron	Williams Mullen
CARRIE HILEMAN	WILLIAMS MULLEN
Shanna Smith	NCGA
Kristi Sitholé	NCLM
Vance Holloman	NCDST
Dona Fazzini	"
A Solari	NCDST
Cam Cover	BPMHL
Kelli Kuhlman	NCLM

VISITOR REGISTRATION SHEET

Joint House and Senate Finance — April 28, 2010

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO DeANNE MANGUM

NAME	FIRM OR AGENCY AND ADDRESS
Sherince Anderson	Alpha Kappa Alpha Sorority Inc. P.O. Box 53341 Fayetteville, NC 28305
Benita Powell	AKA / Fayetteville State U. Assist Attorney PO Box 15439 F'ville, NC 28301
[signature]	mmc

AGENDA

Joint Meeting of the Senate and House Finance Committees

April 28, 2010
10:00 a.m. – 12:30 p.m.
Room 643, Legislative Office Building

Meeting called by Senate Finance Cochairs: Senators Clodfelter, Hoyle, and Jenkins
and House Finance Cochairs: Representatives Luebke, Gibson, Wainwright, and Weiss

10:00 a.m. – 10:15 a.m.	**Opening Remarks by Finance Chairs**
10:15 a.m. – 10:25 a.m.	**Other Business Taxes: Excise Tax and Sales Tax** Cover the excise tax and sales tax laws applicable to businesses and recommendations of past study commissions on these taxes. *Cindy Avrette, Research Division, NCGA*
10:25 a.m. – 10:50 a.m.	**Other Business Taxes: Local Privilege License** Cover the local privilege license taxes imposed on businesses. *Chris McLaughlin, Assistant Professor of Public Law and Government, UNC School of Government*
10:50 a.m. – 11:10 a.m.	**Business Tax Reform: An Economic Development Opportunity** Discuss the relationship between business taxes and economic development. *Brent Lane, Director, Kenan Institute's Center for Competitive Economies*
11:10 a.m. – 11:20 a.m.	**Financing the Future: Fiscal Modernization in North Carolina** Provide a synopsis of the need for fiscal modernization in North Carolina and recommendations for comprehensive tax reform. *Roby Sawyers, CPA, PhD, College of Management, NCSU*
11:20 a.m. – 12:30 p.m.	**Legislative Session Updates** 2010 Recommendations of the Debt Affordability Advisory Committee *Vance Holloman, Deputy Treasurer, State and Local Government, State Treasurer's Office* Consensus Revenue Estimate *Barry Boardman, Economist, Fiscal Research Division, NCGA* General Fund Availability *Evan Rodewald, Budget Development, Fiscal Research, NCGA* Use of Fee Revenue in Recent Years *Rodney Bizzell, Fiscal Research, NCGA*

Other Business Taxes: Excise Tax and Sales Tax

Cindy Avrette
Research Division, NCGA

April 28, 2010

Business Taxes in North Carolina

- Corporate Income Tax
- Franchise Tax
- Annual Reporting Fees
- Sales Tax
- Excise Tax on Certain Machinery & Equipment
- Privilege and License Taxes
- Property Tax

Business Taxes in North Carolina

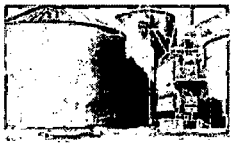
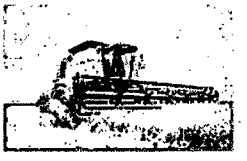
- Corporate Income Tax
- Franchise Tax
- Annual Reporting Fees
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- Property Tax

Business Taxes in North Carolina

- Corporate Income Tax
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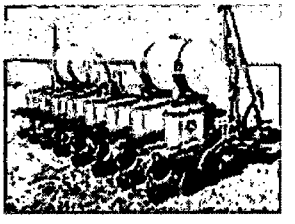
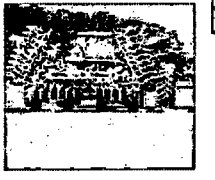
STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Sales Tax Exemptions: Agricultural Machinery



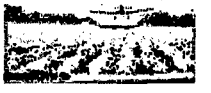
Machinery

Parts & accessories



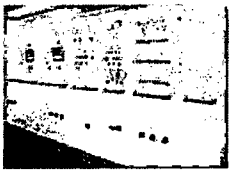
Insecticides



Sales Tax Exemptions: Machinery Equipment used by Media Groups



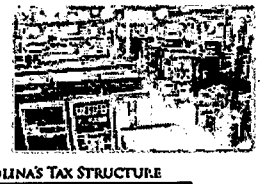
Television and cable service providers





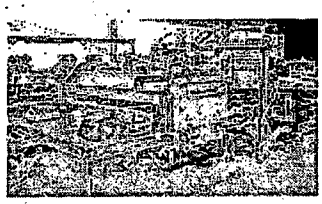
R a d i o

Telephone companies



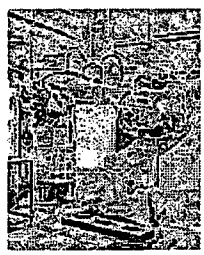

Excise Tax on Mill Machinery





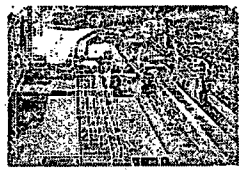
Motors, pulleys, belts, engines,

Gloves, boots, hair nets





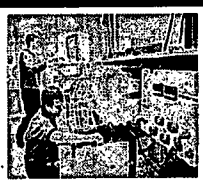
Hand tools, cables,





Repair parts

Excise Tax on Certain Machinery & Equipment



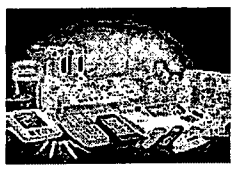
Industrial Machinery Refurbishing





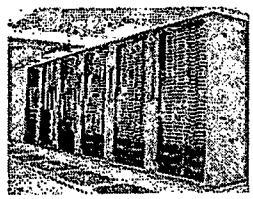


R&D in Life Sciences





Software publishing



Tax Reform Options

- Eliminate sales tax on tangible personal property purchased by business for use in providing good or service
- Eliminate the 1%, $80 tax on manufacturing machinery
- 21st Century Tax Rate Reduction & Modernization Plan: Replace the 1%, $80 excise tax with a a sales tax exemption for equipment capitalized for tax purposes, and attachments and repair parts for that equipment

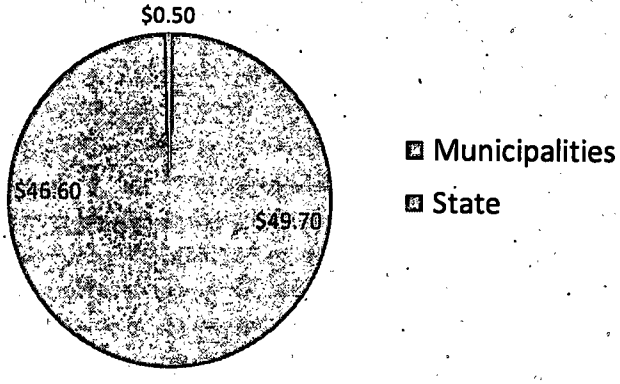
Local Privilege License Taxes

Chris McLaughlin
Assistant Professor, UNC School of Government
mclaughlin@sog.unc.edu
919.843.9167

April 2010

UNC School of Government www.sog.unc.edu

PLT Collections 2006-07

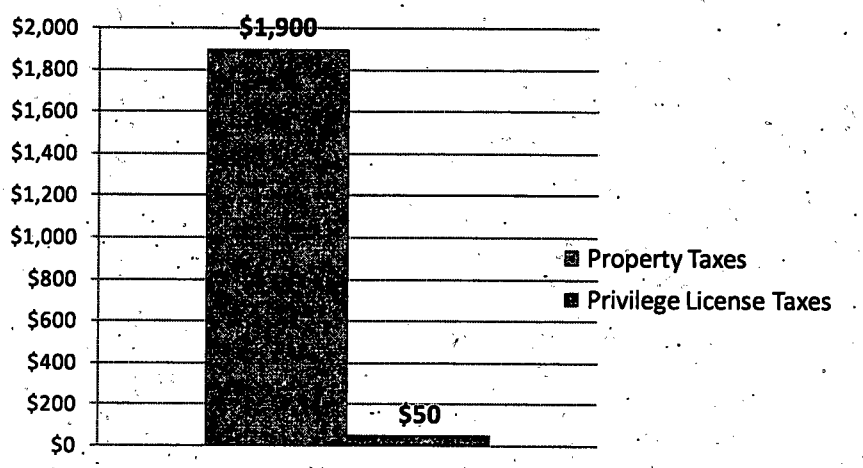


Total: $96,800,000

UNC SCHOOL OF GOVERNMENT

Municipal PLTs v. Property Taxes

($ millions, 2006-07)



Current State PLTs

(All but 7 state PLTs were repealed as of July 1997)

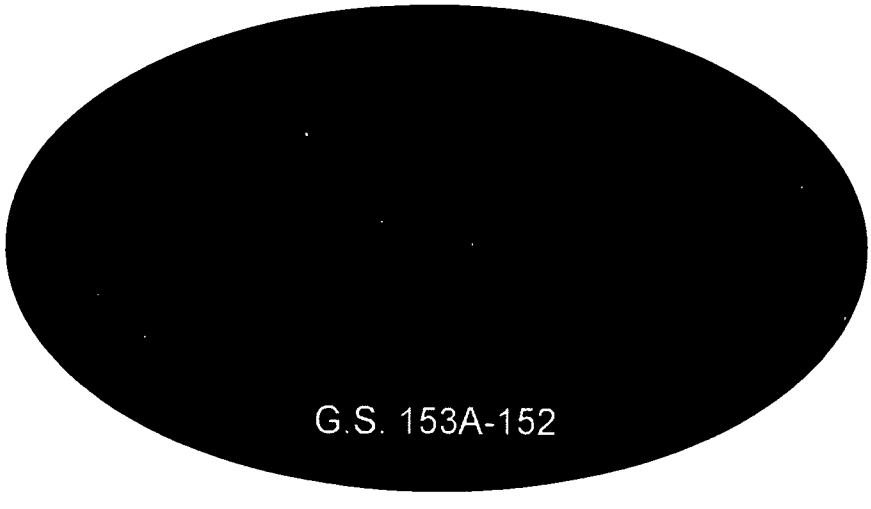
Amusements	3%
Motion Picture Shows	1%
Professionals	$50
Installment Paper Dealers	277% of face value of obligations/quarter
Loan agencies, check cashers, pawnbrokers	$250 per location
Banks	$30 for each $1 million in assets
Newsprint publishers	$15 on each ton that fails to meet the applicable content percentage

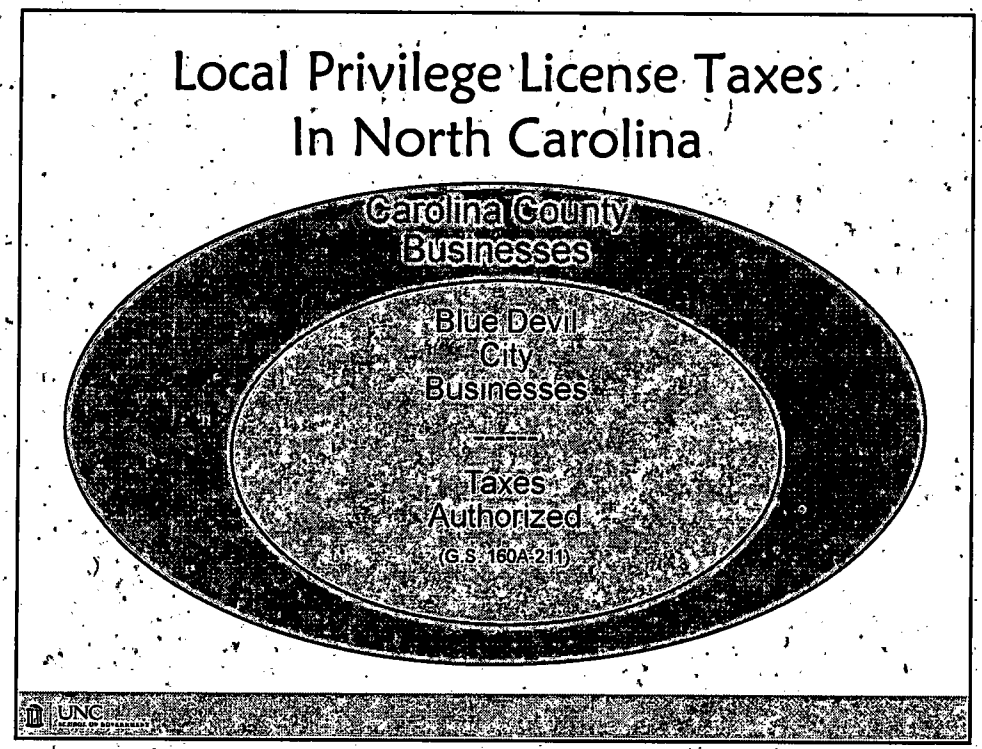
Local PLT's Since 1997

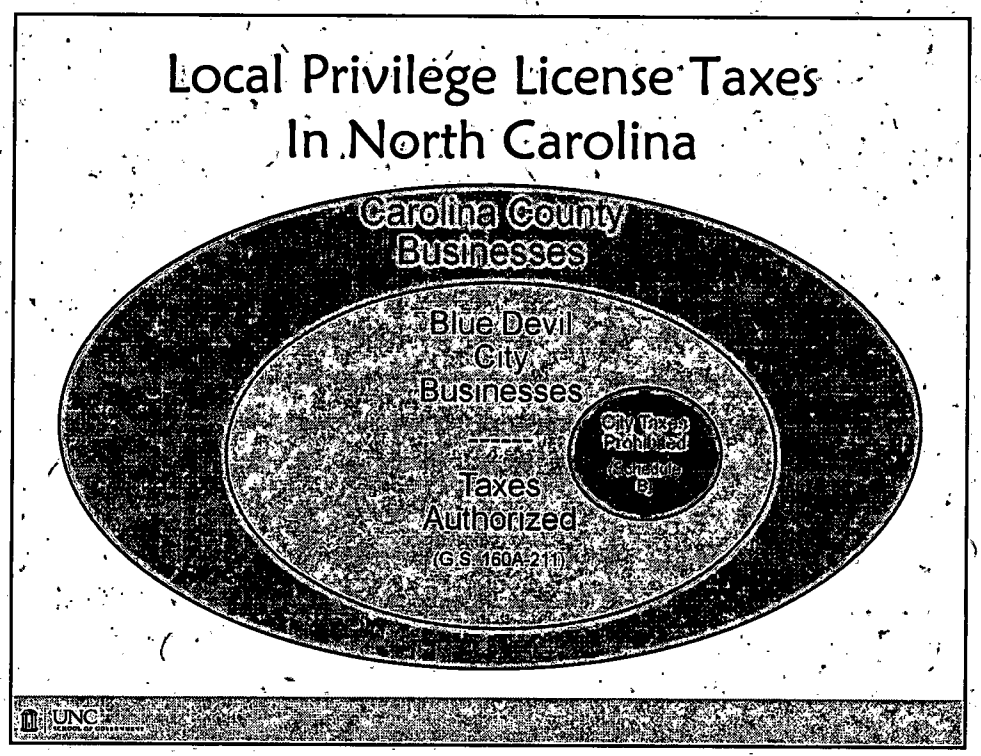
- **Municipalities** (§160A-211):
  - GENERAL authority to levy PLT's on <u>all</u> businesses EXCEPT as limited by 30 repealed Schedule B provisions
- **Counties**(§153A-152):
  - SPECIFIC authority to levy PLT'S on <u>certain</u> businesses ONLY as permitted by 11 repealed Schedule B provisions



Local Privilege License Taxes In North Carolina

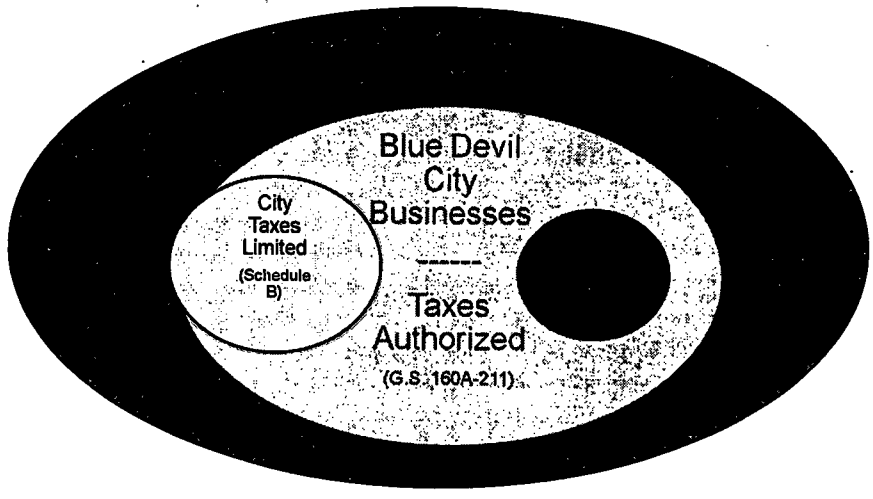






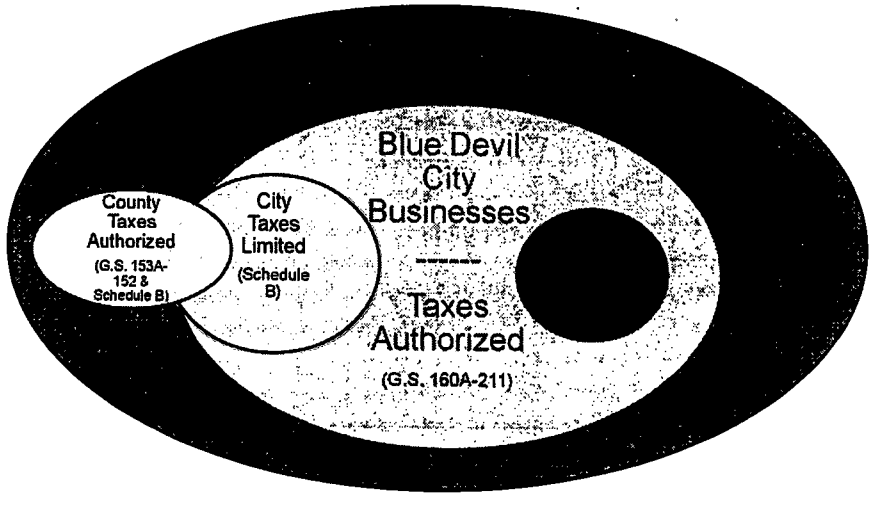
UNC SCHOOL OF GOVERNMENT

Local Privilege License Taxes In North Carolina



UNC SCHOOL OF GOVERNMENT

Local Privilege License Taxes In North Carolina



UNC SCHOOL OF GOVERNMENT

Oddities from Schedule B

- Seasonal Christmas tree sales: $100 max
- Seasonal Christmas tree sales by grower: unlimited
- Vending Machines (< 5): $5 max
- Vending Machines (>=5): NO city PLT
- Vending Machines (>=5 at one location): Unlimited
- Vending Machines (milk): Unlimited
- Vending Machines (juice, >=5): Unlimited
- Selling Computers: NO city PLT
- Repairing Computers: Unlimited
- Selling/Repairing Record Players: NO city PLT
- Selling/Repairing DVD/CD Players: Unlimited

How to Tax Target?

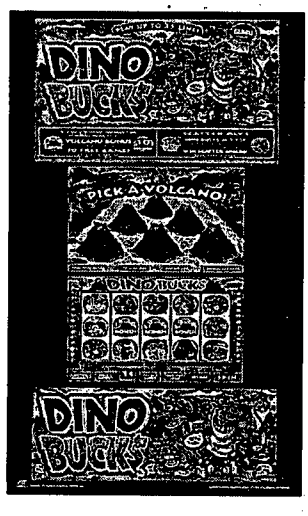
- **Gross Receipts on all sales . . . except**
  - Bicycles ($25 max)
  - DVDs ($25)
  - Computers, calculators (No tax)
  - Ice Cream ($2.50 max)
  - Motor Oil/Auto Accessories ($12.50 max)
- **Plus…**
  - Chain Store ($50)
  - Restaurant ($42.50)
  - Barber Shop/Beauty Salon ($2.50 per stylist)
  - Check Cashing ($100)
  - Vending Machines (????)



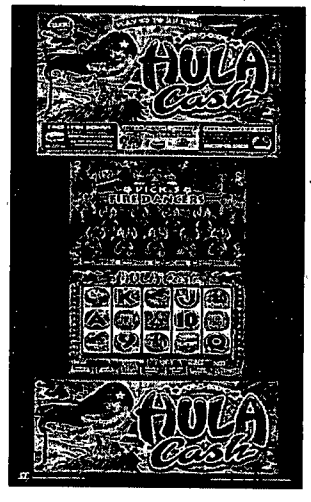
Sample City PLT Provisions For Retailers

- Gross Receipts
  - Durham: $50 up to $15,000, then 50¢ per $,1000; no max
  - Charlotte: 60¢ per $1,000; $10,000 max tax
- Flat Fee
  - Dunn: $30 per retailer, $35 per grocery store
- Example: SuperTarget store with $50M receipts
  - Durham: $25,000
  - Charlotte: $10,000
  - Dunn: $250

Internet Sweepstakes







Different Questions for Counties and Municipalities

- *Counties:*
  - Is there a statute that authorizes us to tax internet sweepstakes?
- *Municipalities:*
  - Is there a statute that prohibits or restricts our taxation of internet sweepstakes?

Electronic Video Games
(Repealed GS 105-66.1)

- "owning or operating machines that play electronic video games when a coin or other thing of value is deposited into the machine"
- Password = "thing of value"?
- $5 per machine for both counties/cities

Telecommunications Providers

- No privilege license taxes
  - GS 160A-211(d) (cities)
  - GS 153A-152(b) (counties)
- No PLTs on sale of cell phone minutes
- Excludes "internet access service"
  - GS 105-164.3(48)

Constitutional Concerns

- NC Constitution: taxes must be "*just and equitable*"
- Cannot use taxes to eliminate legal businesses
  - Flat Rate:
    - $1 million per machine? $10,000?
  - Gross Receipts:
    - 90%? 15%?

3 PLT Options for Cities

1. Existing "service" category
   (assuming telephones not involved)
2. Existing (or new) "internet service provider" category
3. New category aimed *only* at internet sweepstakes businesses

Lumberton "Cyber-Gambling Establishments"

- Any for-profit business . . . where persons utilize electronic machines, including but not limited to computers and gaming terminals, to conduct games of chance, including but not limited to sweepstakes, and where cash, merchandise or other items of value are redeemed or otherwise distributed, whether or not the value of such distribution is determined by electronic games played or by predetermined odds.
- Involving "payment, directly or as an intended addition to the purchase of a product, whereby the customer receives one or more electronic sweepstakes tickets, cards, tokens or similar items entitling or empowering the customer to enter a sweepstakes, and without which item the customer would be unable to enter the sweepstakes"

Sample City PLTs for Internet Sweepstakes

- *Hendersonville*:
  - **$2,600 flat fee**
- *Kannapolis & Oxford:*
  - **Gross receipts** plus **$500 per machine**
- *Laurinburg & Aberdeen:*
  - **$2,000 flat fee** plus **$2,500 per machine**
- *Lumberton:*
  - **$5,000 flat fee** plus **$2,500 per machine**

Business Tax Reform:

An Economic Development Opportunity

Brent Lane, Center Director
UNC Center for Competitive Economies (C^3E)

NC's Economy is Big

- Population of 9,061,032 (10th)
- Workforce of 4,600,000
- GSP of $400 Billion (9th) passing GA, VA, MI, MA since 2003
- NC would be 23rd largest national economy
- A big economy is hard to affect

NC Economic Development

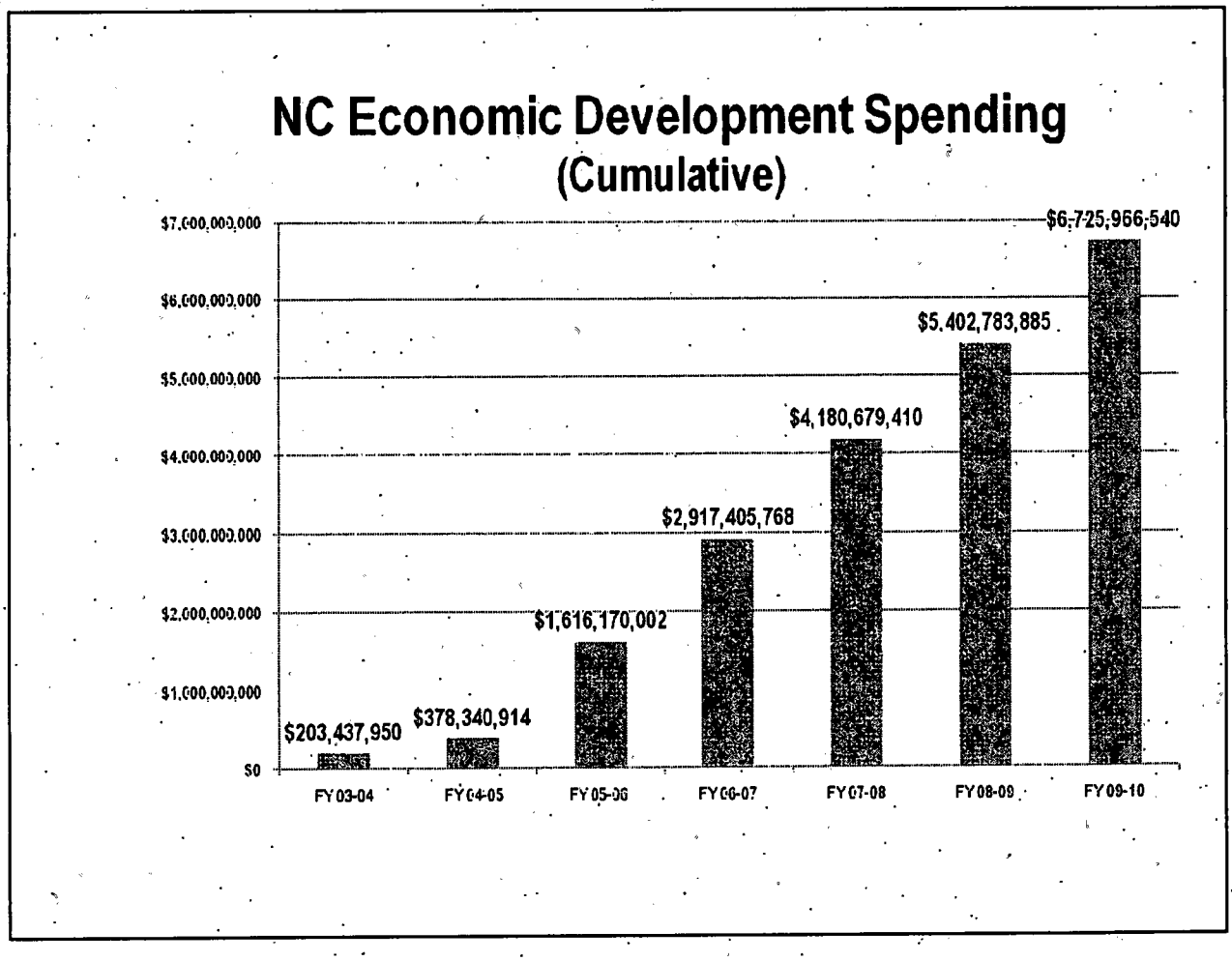
Our capacity to effect NC economy is limited

- NC has 500,000+ businesses
- Direct assistance possible to only a few thousand companies
- Targeted incentives to a few dozen firms
- Just 1% gain in employment requires creation of 40,000+ new jobs
- Even great success can be insufficient

NC Economic Development by Fund Source, FY 2008-09

Bill Lee Act Credits Taken:	$ 93,060,434
Other Tax Expenditures:	$993,800,000
General Fund Appropriations:	$121,392,275
Transportation	$ 13,851,766
Total	**$1,222,104,475**

FRD Economic Development Inventory February 2010

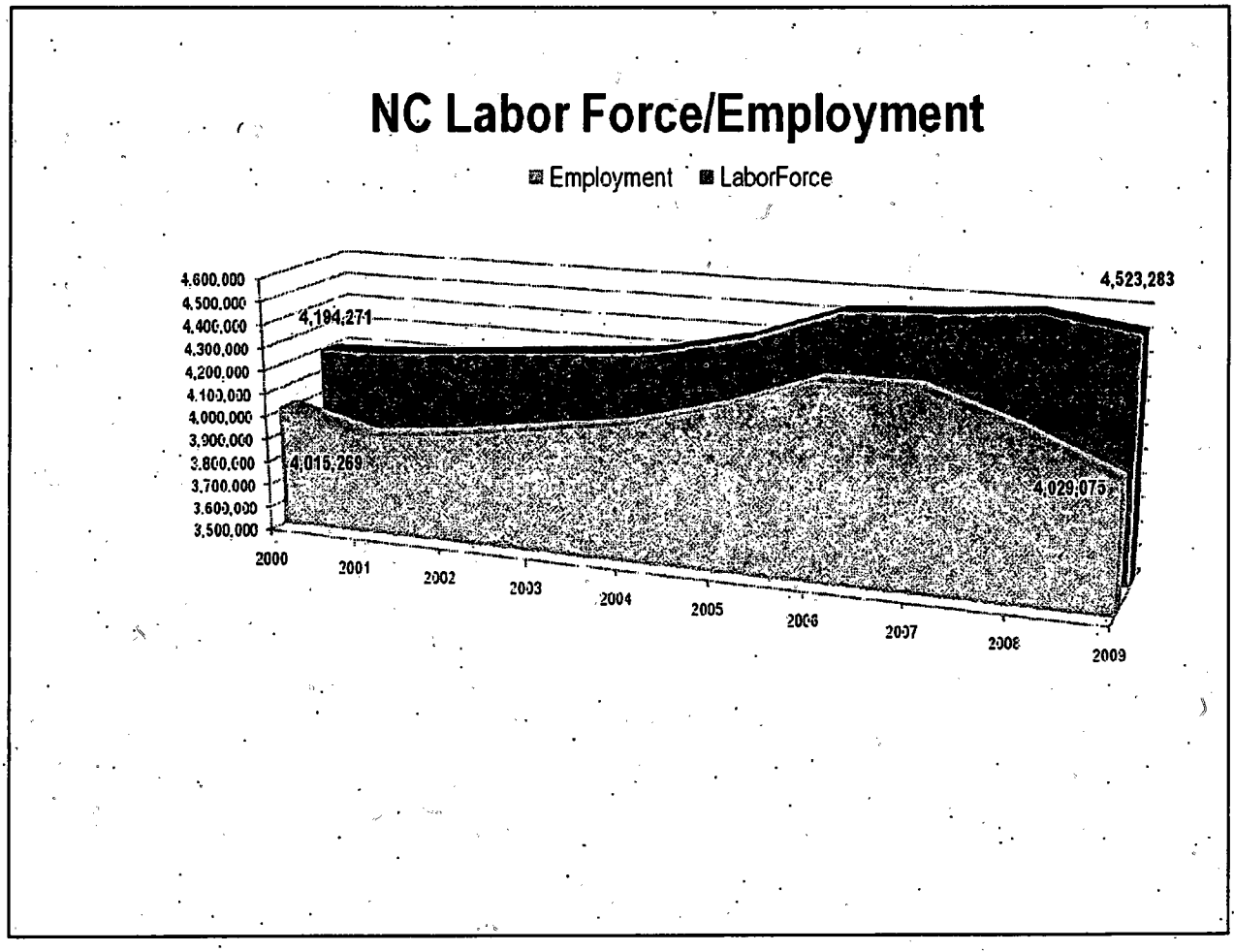

NC Economic Development Spending
(Cumulative)
$7,000,000,000
$6,000,000,000
$5,000,000,000
$4,000,000,000
$3,000,000,000
$2,000,000,000
$1,000,000,000
$0
$203,437,950
$378,340,914
$1,616,170,002
$2,917,405,768
$4,180,679,410
$5,402,783,885
$6,725,966,540
FY03-04
FY04-05
FY05-06
FY06-07
FY07-08
FY08-09
FY09-10

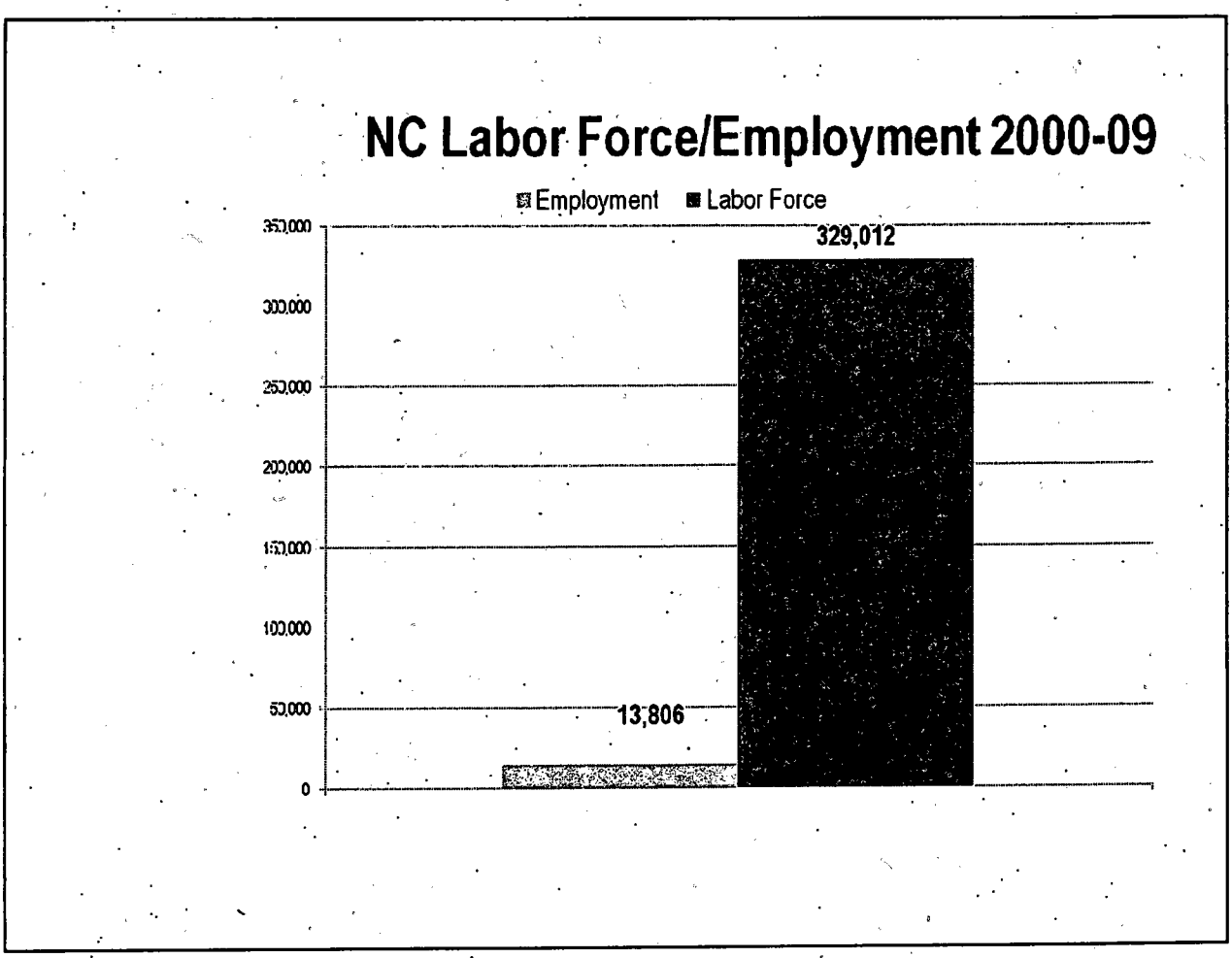


North Carolina Ranked *"Best Business Climate"* 8 of last 9 years by *Site Selection* magazine

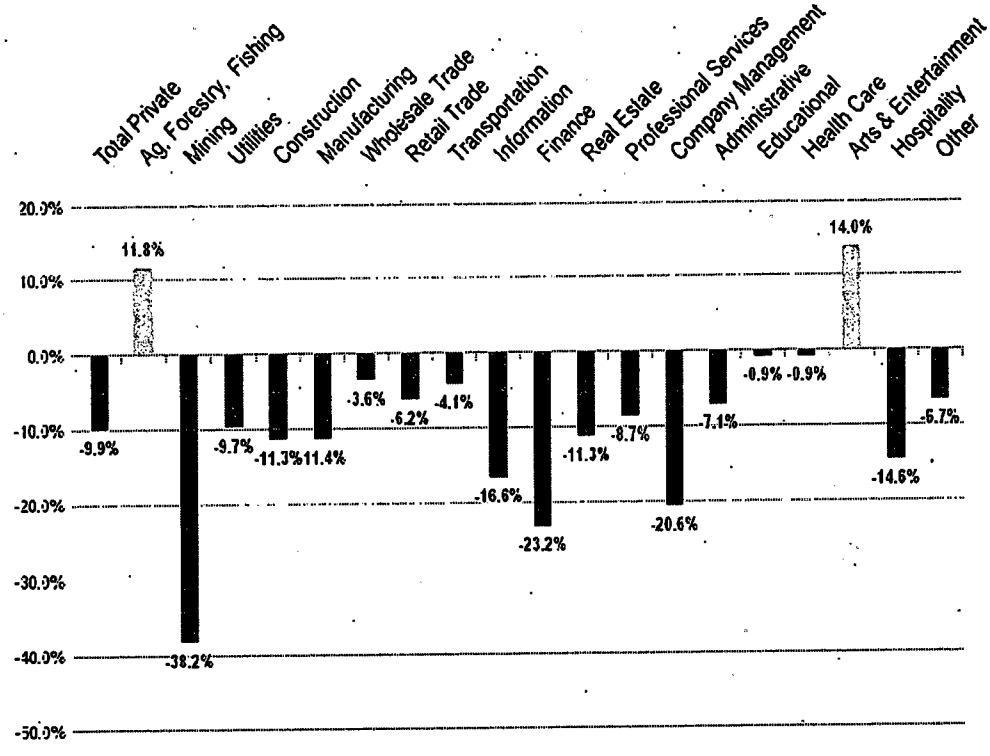
Site Selection's 2009 Top State Business Climate Rankings

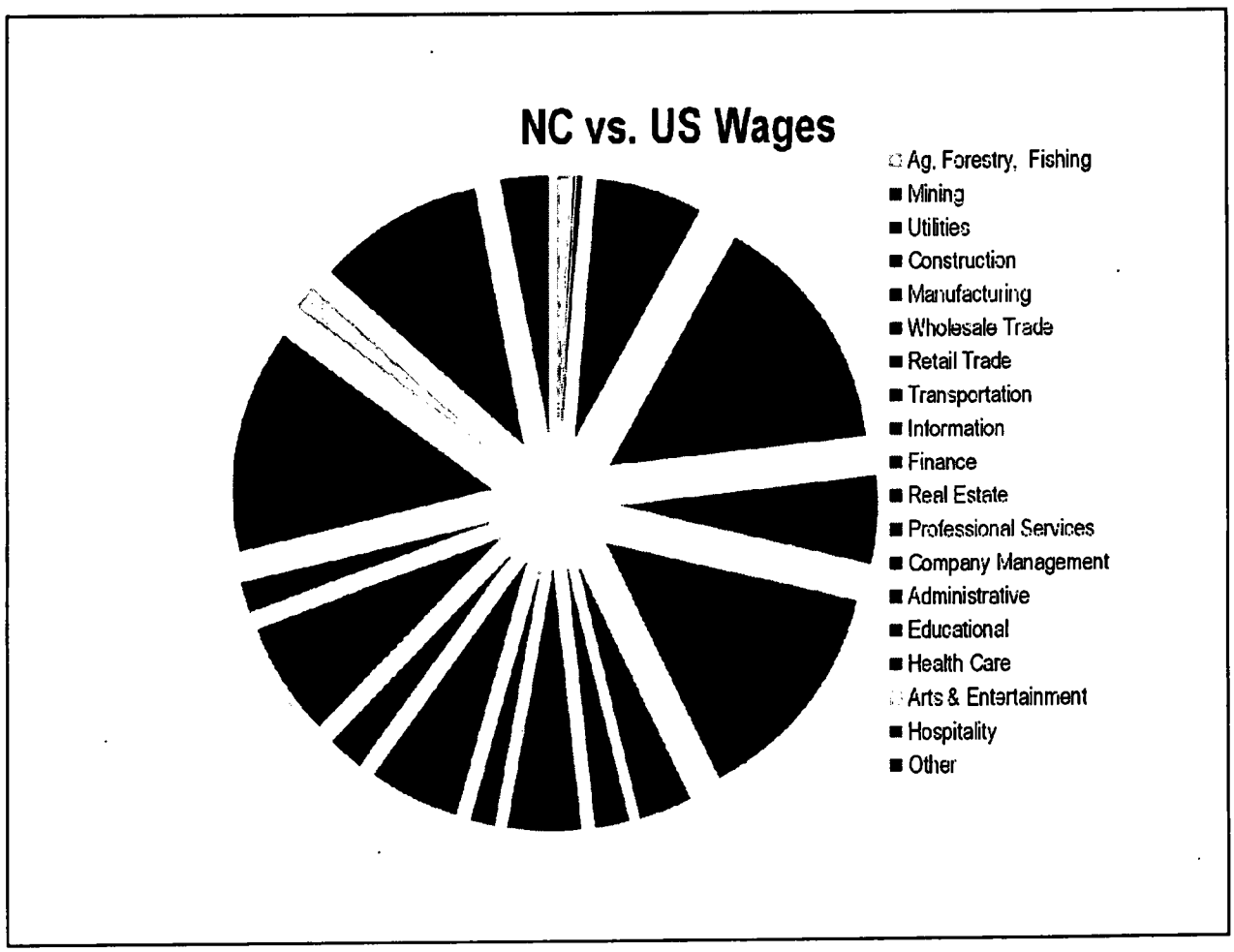
Overall Ranking		Executive Survey Rank	2008 New Plant Rank	2006-2008 New Plant Rank	New Plant Rank per Million Pop.	2009 New Plant Rank (Jan. – Aug.)	Final Total Points
1	North Carolina	2	5	4	6	3	382
2	Texas	1	2	1	14	6	381
3	Virginia	6	8	7	9	1	359
4	Ohio	8	1	2	1	14	358
5	Tennessee	5	11	6	11	15	344


NC Labor Force/Employment
Employment
LaborForce
4,600,000
4,500,000
4,400,000
4,300,000
4,200,000
4,100,000
4,000,000
3,900,000
3,800,000
3,700,000
3,600,000
3,500,000
4,194,271
4,523,283
4,015,269
4,029,075
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009


NC Labor Force/Employment 2000-09
Employment
Labor Force
350,000
300,000
250,000
200,000
150,000
100,000
50,000
0
329,012
13,806

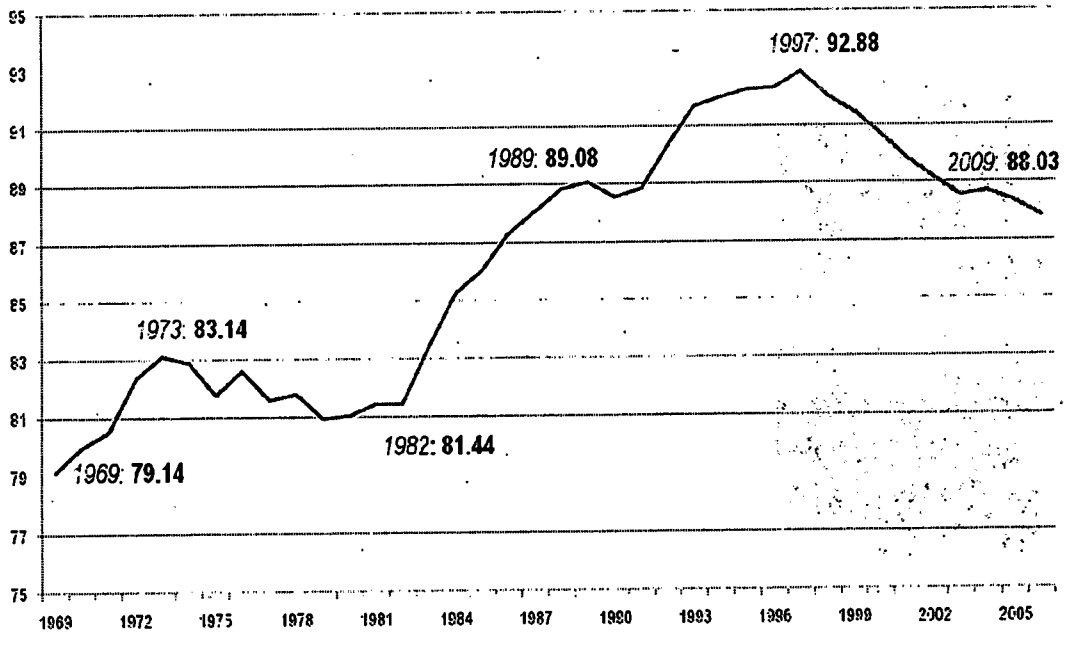
NC vs. US Wages by Industry (2008)




NC vs. US Wages
Ag. Forestry, Fishing
Mining
Utilities
Construction
Manufacturing
Wholesale Trade
Retail Trade
Transportation
Information
Finance
Real Estate
Professional Services
Company Management
Administrative
Educational
Health Care
Arts & Entertainment
Hospitality
Other

NC Per Capita Income

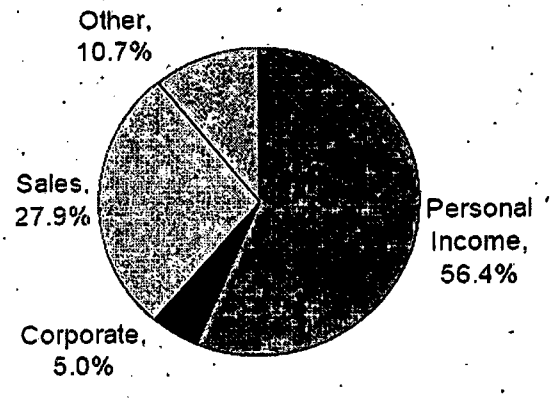
From 93% of US in 1997 to 88% in 2009



NC Per Capita Income

- NC per capita income grew from 79% of US in 1969 to more than 93% of US in 1997
- Since 1997 NC's per capita income has fallen to 87% of US, **from 31st to 37th**
- If this trend continues, by 2020 NC's per capita income will decline to 80% of US
- The same level as in 1970

NC's Tax Structure, FY 2008-09



Tax Reform = Economic Development

Tax reform can replace ineffective tax incentives with systemic enhancements

- Existing economic development efforts, even when successful, are insufficient
- Selective tax incentives found generally ineffective in stimulating employment
- Current higher taxes on productive sectors, lower taxes on less productive

Tax Reform = Economic Development

- NC has systemic weaknesses that must be addressed comprehensively
- NC must have a stable revenue base to make and sustain the public investments required by a dynamic economy

Tax Reform = Economic Development

- Regardless of recovery status, history reveals the decline in the quality of NC's economy
- NC has systemic economic weaknesses that must be addressed comprehensively
- A stable revenue base is needed to make and sustain the public investments required by a dynamic economy

Financing the Future: Fiscal Modernization in North Carolina

Roby B. Sawyers, CPA, Ph.D.
College of Management
April 28, 2010

NC STATE UNIVERSITY

The Need for Fiscal Modernization

- North Carolina's tax system was largely set in place in the 1920s and 1930s.
- While it was a model tax system then, it is not sufficient for North Carolina today or in the future
- Over the last twenty or so years, state lawmakers have enacted a series of temporary sales tax and income tax rate increases and surtaxes to deal with budget shortfalls.

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The Need for Fiscal Modernization

- We rely heavily on the individual income tax, a volatile source of revenue
- Our sales tax base is narrow and shrinking
- The corporate income tax has become less and less important
- The franchise tax is not well crafted to address the proliferation of newer business entities

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Problems with the Individual Income Tax

- Volatile
- Depends on "bracket creep"
- Uncompetitive rates: High rates, paid by small businesses operating as proprietorships, owners of flow through entities as well as individuals

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Problems with the Sales Tax

- Discriminates against manufacturing (services are largely not subject to tax)
- Relies on a shrinking base

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Problems with the Corporate Income Tax and Franchise Tax

- Corporate income tax base is shrinking
- Tax incentives and credits reduce tax revenue and may not be effective
- Franchise tax is not well-tailored to capture a "minimum tax" from newer forms of business such as LLCs and LLPs.

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Financing the Future

- How should North Carolina go about financing its future?
- A sound tax system should be:
  - Sufficient,
  - Efficient, and
  - Equitable

Overall Recommendations

1. Tax reform must be **comprehensive** in order to be successful.
2. Income and sales tax bases should be broadened and tax rates should be reduced so that overall changes at the state level are **revenue neutral.**
3. To the extent that base broadening results in increased tax burdens for low-income taxpayers, the State should provide **relief for low-income taxpayers**

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Recommendations: Income Tax

- Broaden the individual income tax base, reduce individual rates and eliminate tax filing and payment responsibilities for low income taxpayers
- Reduce the corporate income tax rate and adopt combined (unitary) reporting.
- Review the corporate franchise tax – is it doing what you intend?

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Recommendations: Sales Tax

- Broaden sales tax base to include services.
- Lower the sales tax rate.
- Eliminate special rates and exemptions.
- Convert excise taxes to *ad valorem,* set at the general state and local rate.

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2010 Recommendations of the Debt Affordability Advisory Committee

T. Vance Holloman
Deputy State Treasurer

NORTH CAROLINA
Debt Affordability Advisory Committee

Debt Affordability Advisory Committee - Background

- The Committee is legislatively directed to:
  - Annually advise the Governor and the General Assembly of the estimated debt capacity of the State (General Fund) for the upcoming ten years.
  - Annually advise the Governor and the General Assembly of the estimated debt capacity of the Transportation and Transportation Trust Funds for the upcoming ten years.
  - Recommend other debt management policies it considers desirable and consistent with the sound management of the State's debt.
  - Study makes no recommendations regarding the use of available debt capacity.

Members of the Debt Affordability Advisory Committee

Janet Cowell
State Treasurer

Kenneth Lay
Secretary of Revenue

Charles Perusse
State Budget Officer

Beth Wood
State Auditor

David McCoy
State Controller

Senate Appointees
Stuart Bell
J.W. Davis

House Appointees
James V. Porto
Jack Vogt

Review
What is Debt Affordability?

- The amount of debt that may be prudently authorized and issued in a given period of time without negatively affecting the credit position or impairing the budget flexibility of the issuer.
  - The amount of debt that is affordable ("capacity") is finite
  - Capacity can be measured and compared
  - Issuance beyond a prescribed level can erode credit ratings

What is Tax-Supported Debt?

- The three bond rating agencies view all debt supported by state-wide taxes, fees, or levies as "tax-supported debt" and measure it on a combined basis. The measurement includes both General Fund and Transportation debt.
- For example, debt supported by both NC's Motor Fuels Tax and/or Vehicle registration and title fees would count as tax-supported debt.
- Debt supported by specifically pledged project revenues (e.g. tolls) would not count as tax-supported debt.

Outstanding Debt by Type at June 30, 2009 (millions)

General Obligation Bonds	
General Fund GO Bonds	**$ 4,575.3**
Highway GO Bonds	**593.9**
Total General Obligation Bonds	**$5,169.3**
Net Tax-Supported Special Indebtedness (Limited Obligation Bonds, COPs, Lease Revenue Bonds, installment purchase contracts)	**$1,430.8**
Total GF and Transportation Tax-Supported Debt	**$6,600.1**
Other Debt	
GARVEEs (as of 9/30)	**$484.3**
Other (energy and other non-GF supported)	**$397.9**

Totals may not add due to rounding

NORTH CAROLINA
Debt Affordability Advisory Committee

Authorized but Unissued Tax-Supported Debt* as of December 31, 2009

Total	General Obligation	Special Indebtedness
$1,901.0 million	$487.7 million	$1,413.3 million

*Excludes special indebtedness supported by non-tax revenues, trust funds and energy performance contracts.

NORTH CAROLINA
Debt Affordability Advisory Committee

2009 GA Session
New Debt Authorizations (millions)

Maury Correctional Institution	$ 16
Biomedical Research Imaging Center	$223
Repair & Renovation Projects	$ 50
subtotal	$289
Less project savings, etc.	- 131
Total net new authorizations	**$158**

"Triple-Triple A" States

- "Triple-Triple A" States are those achieving the highest rating from each of the three major bond rating agencies.
- Only seven states currently have that distinction and we consider them to be our peer group

Delaware	Georgia
Maryland	Missouri
North Carolina	Utah
Virginia	

"AAA" States Debt Comparisons

State	Debt/Personal Income	Debt per Capita	DS % Gov Expenditures
Delaware	5.4%	$2,128	5.2%
Georgia	3.0%	984	5.3%
Maryland	3.3%	1,507	4.3%
Missouri	2.0%	670	3.0%
North Carolina	2.5%	832	2.0%
Utah	1.5%	447	3.9%
Virginia	1.9%	782	3.4%
Median	**2.5%**	**$832**	**3.4%**
Source: Moody's 2009 State Debt Medians and S&P 2009 State Debt Review	Note: Rating Agency comparisons are historic in nature and do not include authorized by unissued debt		

GF Model Assumptions

- Tax-Supported Debt Service as a % of DAAC Revenues preferred calculation basis b/c both numerator & denominator directly controlled by policymakers.
  - 4% Guideline
  - 4.75% Ceiling
- Other Measures Evaluated
  - Debt to Personal Income (2.5%/3.0%)
  - 10-year Payout Ratio (55%/50%)
  - Level of GF Unreserved Fund Balance and/or reserves
  - Debt per Capita
  - GO Debt as a % of Total Debt

North Carolina General Fund Tax-Supported Debt Statistics
February 2010 DAAC Study

	Debt to Personal Income	Debt per Capita	Debt Service as % Revenues	10-Year Payout Ratio
6/30/09	1.9%	$643	3.75%	56%
6/30/10 (proj.)	1.9%	$639	3.59%	59%
6/30/11 (proj.)	1.9%	$663	**3.99%**	63%

February 1, 2010 Debt Affordability Study (General Fund) Results (in millions)

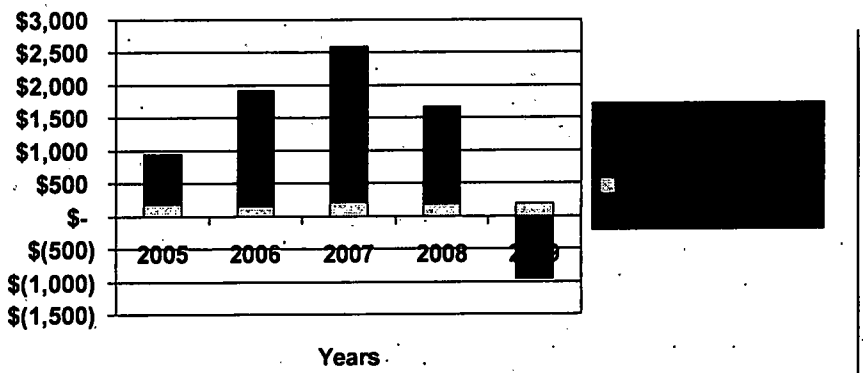
4 %	2010	2011	2012	2013	2014
Total Capacity	$18.1	$0	$91	$626	$361
Annual Capacity	$9.1	$9.1	$9.1	$9.1	$9.1

2010 DAAC Other Recommendations

- Achieve structural budget balance and replenish reserves.
- Establish a preference for General Obligation debt (versus special indebtedness).
- State should maintain its historically conservative debt management practices.

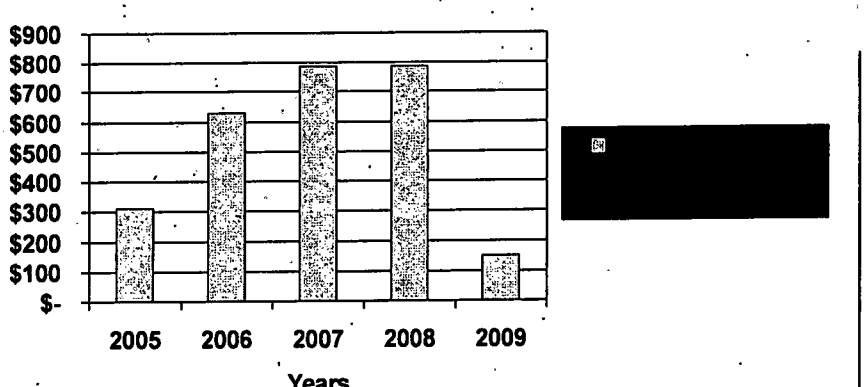
NORTH CAROLINA
Debt Affordability Advisory Committee

Structural Budget Balance and Replenish Reserves (millions)



NORTH CAROLINA
Debt Affordability Advisory Committee

Rainy Day Fund



General Obligation versus Special Indebtedness

- Since 2000, the State has relied extensively on the authorization of Special Indebtedness (Limited Obligation Bonds, COPs, other)
- Special Indebtedness as a % of all Tax-supported debt will exceed 40% in FY 2014 (even with 2/3 bonds authorized)
- Peer Group around 26%

Conservative Debt Management Practices

- Conservative Debt Management Practices include:
  - **Centralized Debt Authorization**
  - **Centralized Debt Management and Issuance**
  - **All debt and debt-like obligations counted in debt burden**
- Recommendation that GA clarify its intent regarding individual agencies' ability to borrow by adopting limits, terms and taking into consideration the impact on debt burden (not unanimously adopted).

Transportation Debt Capacity

- Highway and Highway Trust Fund capacity combined
- All State-level Transportation revenues used (DOT projection)
- Federal Revenues and GARVEES excluded
- Guideline Adopted: Transportation-related debt service should not exceed 6% of the State's Transportation Revenues

Transportation Liabilities

- Outstanding Highway GOs
- "Gap Funding" support for NCTA ($25 million-$99 million/year)
- P3 and/or "design/build/finance" obligations would count depending upon revenue source
- **Transportation debt service is projected to exceed its limits and capacity has been exhausted until FY 2013**

NORTH CAROLINA
Debt Affordability Advisory Committee

February 1, 2010 Debt Affordability Study
Transportation Capacity (in Millions)

	2010	2011	2012	2013	2014
Total Capacity	$0	$0	$33	$21	$299
Annual Capacity	$0	$0	$0	$0	$0
Actual Ratios	3.92%	6.90%	6.41%	6.17%	5.94%
Revenue Shortfall to Breakeven		$398	$190	$81	

21

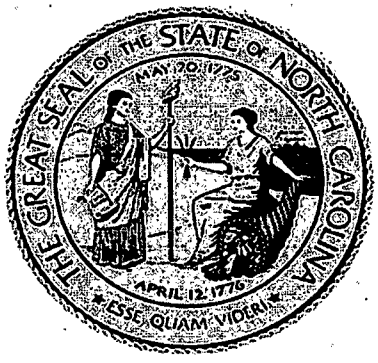
NORTH CAROLINA
Debt Affordability Advisory Committee

Combined General Fund and Transportation Tax-Supported Debt Burden

2012 actual projection	Target D.S. % Revenues*	Ceiling*
General Fund (3.99%)	4.0%	4.75%
Transportation (6.41%)	6.0%	6.0%
Combined Result (4.30%)	4.27%	4.92%
*Based on 2007 revenues		

22

State of North Carolina



Debt Affordability Study

February 1, 2010

Debt Affordability Advisory Committee

Department of State Treasurer
325 North Salisbury Street
Raleigh, NC 27603-1385
Phone: 919-508-5176

STATE OF NORTH CAROLINA
DEBT AFFORDABILITY ADVISORY COMMITTEE

February 1, 2010

To: Governor Beverly Perdue
Lieutenant Governor Walter Dalton, President of the North Carolina Senate
Senator Marc Basnight, President Pro Tempore of the North Carolina Senate
Representative Joseph Hackney, Speaker of the North Carolina House of Representatives
Members of the 2010 General Assembly through the Fiscal Research Division

Attached is the February 1, 2010 report of the Debt Affordability Advisory Committee submitted to you pursuant to North Carolina General Statute §142-101. The report was created to serve as a tool for sound debt management practices by the State of North Carolina.

The report provides the Governor and the General Assembly with a basis for assessing the impact of future debt issuance on the State's fiscal position and enables informed decision-making regarding both financing proposals and capital spending priorities. A secondary purpose of the report is to provide a methodology for measuring, monitoring and managing the State's debt levels, thereby protecting North Carolina's bond ratings of AAA/Aaa/AAA.

The methodology used by the Committee to analyze the State's debt position incorporates trends in debt levels, peer group comparisons and provides recommendations within adopted guidelines. The Committee has also provided recommendations regarding other debt and financial management related policies considered desirable and consistent with the sound management of the State's debt.

Respectfully submitted,

Janet Cowell, State Treasurer
Chair, Debt Affordability Advisory Committee

Debt Affordability Advisory Committee Membership

Ms. Janet Cowell, State Treasurer, Chair

Mr. Kenneth Lay, Secretary of Revenue

Mr. David McCoy, State Controller

Mr. Charles Perusse, State Budget Officer

Ms. Beth Wood, State Auditor

Mr. Stuart Bell, Senate Appointee

Mr. J.W. Davis, Senate Appointee

Dr. James V. Porto, House Appointee

Dr. Jack Vogt, House Appointee

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SUMMARY

Background and Context

Studies of debt affordability are essential management tools that help to provide a comprehensive assessment of a government's ability to issue debt for its capital needs. Standard & Poor's, one of the three major bond rating agencies, stated in a 2005 report that "Most of the 'AAA' states have a clearly articulated debt management policy. Evaluating the impact of new or authorized but un-issued bond programs on future operating budgets is an important element of debt management and assessing debt affordability." Control of debt burden is a key factor used by rating agencies' analysts in assessing credit quality.

The Debt Affordability Advisory Committee (the "Committee" or "DAAC") is required to annually advise the Governor and the General Assembly of the estimated debt capacity of the General, Highway and Highway Trust Funds for the upcoming ten fiscal years. The legislation also directs the Committee to recommend other debt management policies it considers desirable and consistent with the sound management of the State's debt. The Committee hereby presents its Study for 2010.

Debt Controls and Ratings

Debt capacity is a limited and scarce resource. It should be used only after evaluating the expected results and foregone opportunities. The Study enables the State to structure its future debt issuances within existing and future resource constraints by providing a comparison of its current debt position to relevant industry and peer group standards. The Study can thus be used to help develop and implement the State's capital budget and is premised on the concept that resources, not only needs, should guide the State's debt issuance program. The Committee's adopted guidelines attempt to strike a balance between providing sufficient debt capacity to allow for the funding of essential capital projects and imposing sufficient discipline so that the State does not create a situation that results in a loss of future budgetary flexibility and deteriorating credit position.

During the year, the State's ratings were affirmed at Aaa (Moody's), AAA (S&P) and AAA (Fitch).. Currently, all of the State's debt ratios are at or below the median levels for the State's peer group composed of all states rated "triple A" by all three rating agencies. North Carolina's debt is considered manageable at current levels

The Committee has adopted the ratio of debt service as a percentage of revenues as the controlling metric that determines the State's debt capacity. Although the State currently anticipates a modestly positive tax revenue environment over the biennium buoyed by temporary tax increases and surcharges, the model's revenue component also reflects the expiration of these measures. In addition, the model factors in the issuance of the State's balance of already authorized but unissued debt of approximately $1.9 billion. The outcome is that the State has substantially exhausted its General Fund debt capacity until FY 2012. The ratio of debt service to revenues is projected to stand at 3.99% and 3.95% in FY 2012 and FY 2013.

The combined debt capacity of the Highway Fund and the Highway Trust Fund has been more than utilized until FY 2013 even after making adjustments resulting from the delay of certain NC Turnpike Authority projects and the resulting gap funding requirement. The ratio of transportation debt service to revenues is projected to reach 6.9% in FY 2011, well above its

limit. On a combined basis, the General Fund and Transportation Funds debt service is projected to peak at approximately 4.30% of revenues in FY 2012.

Table 1

General Fund

Net Tax-Supported Debt Capacity using 4.0% debt service/revenues target ratio

(In Millions of dollars)

Fiscal Year	2010	2011	2012	2013	2014
Total Additional Debt Capacity per Year *	$18.1	$0.0	$90.9	$626.4	$361.1
Debt Capacity Available Each and Every Year	$9.1	$9.1	$9.1	$9.1	$9.1

* In addition to that already Authorized but Unissued. Assumes additional debt capacity is authorized and issued in stated fiscal year.

Table 2

Transportation

Net Tax-Supported Debt Capacity using 6.0% debt service/revenues target ratio

(In Millions of dollars)

Fiscal Year	2010	2011	2012	2013	2014
Total Additional Debt Capacity per Year *	$0.0	$0.0	$0.0	$21.4	$298.6
Debt Capacity Available Each and Every Year	N/A	N/A	N/A	N/A	N/A

* In addition to that already Authorized but Unissued. Assumes additional debt capacity is authorized and issued in stated fiscal year.

Table 3

General Fund and Transportation Funds

Combined Debt Service / Revenue Percentages

Fiscal Year	2010	2011	2012	2013	2014
General Fund	3.59%	3.70%	3.99%	3.95%	3.69%
Transportation *	3.92%	6.90%	6.41%	6.17%	5.94%
Combined	3.63%	4.09%	4.30%	4.24%	3.98%

Note: Percentages are based on forecasted revenues and debt service.

* GAP Funding for North Carolina Turnpike Authority projects assumed to reach $99 million in FY 2011 and thereafter.

Other Recommendations

Structural Budget Balance

The Committee confirms its view that North Carolina's priorities of achieving structural budgetary balance and rebuilding the State's reserve funds are strong evidence of financial stability and flexibility. The Committee also recognizes that past legislative action targeting an 8% level of reserves in the State's Budget Stabilization Fund (also known as the "Rainy Day Fund") should serve the State well in the event of future economic turndowns.

In the current economic climate, the Committee recognizes that utilization of the State reserves and other short term measures may have been inevitable. The Committee also recognizes that utilization of the federal stimulus funds was a key in balancing the State's budget. However, the Committee recommends that permanent solutions be devised that promote long term budgetary stability and reserve replenishment be developed as quickly as possible. These are key factors in maintaining our "triple A" bond rating,

General Obligation Bonds versus Special Indebtedness

The State has relied extensively on the authorization of Special Indebtedness (for example, Certificates of Participation and lease revenue bonds) to provide debt financing for capital projects since 2000. Such indebtedness is not subject to a vote of the people and its repayment is based on the State's annual debt service appropriation. For these reasons, Special Indebtedness is rated lower than the State's General Obligation "GO" bonds and typically carries a higher interest rate, which increases the cost of projects so financed. The State's General Fund percentage of non-voter approved Special Indebtedness is projected to exceed the median level for states in its peer group. Therefore the Committee recommends that the State consider the authorization of General Obligation debt as the preferred method to provide debt financing for its capital needs.

Control of Debt Authorization Authority *

The Committee strongly recommends that the State of North Carolina maintain its historically conservative debt management practices with regard to (1) centralized debt authorization; (2) debt management and issuance; and (3) classification of debt and debt-like obligations when determining the debt burden. These practices are among those considered by the rating agencies when assigning their "triple A" ratings to the State and ultimately allow the State to maintain a healthy financial position.

We recommend the General Assembly clarify its legislative intent regarding any agency's ability to enter into alternative financial arrangements that may include debt and debt-like obligations. Specifically, the Committee believes that such legislation should include but is not limited to: (1) borrowing amounts; (2) the terms of the obligation; and (3) the impact on the State's debt affordability as determined by the State Treasurer.

*Mr. Perusse and Mr. Lay voted not to include this recommendation in the 2010 Study.

SECTION I
GENERAL FUND DEBT AFFORDABILTIY

Review of General Fund Debt

Outstanding Debt

The State issues two kinds of tax-supported debt: General Obligation ("GO") Bonds and various kinds of "Special Indebtedness", which are also known as non-GO debt or appropriation-supported debt. GO Bonds are secured by the full faith, credit and taxing power of the State. The payments on all other kinds of long-term debt, including Limited Obligation Bonds, Certificates of Participation ("COPs"), lease-purchase revenue bonds, capital lease obligations and installment purchase contracts are subject to appropriation by the General Assembly. Appropriation-supported debt may sometimes also be secured by a lien on facilities or equipment.

Debt that is determined to be self-supporting or supported by non-General Fund tax revenues does not constitute net tax-supported debt but is included in the definition of "gross" tax-supported debt used by some rating analysts. The State's outstanding gross and net tax-supported debt positions as of June 30, 2009 are shown below.

Chart 1

State of North Carolina Outstanding Net Tax-Supported Debt

	June 30, 2009
General Obligation Bonds Total	$ 5,169,265,000
Less: Payable from Highway Trust Fund	593,935,000
Net General Fund Tax-Supported General Obligation Bonds	$ 4,575,330,000
Appropriation Supported Indebtedness:	
Certificates of Participation / Lease Revenue Bonds	$ 1,776,841,764
Less: Self-Supporting payable from Energy Performance Contracts, [1] Tobacco and Health and Wellness Trust Funds	397,889,441
Net Tax-Supported Certificates of Participation / Lease Revenue Bonds	$ 1,378,952,323
Plus: Installment Purchase Contracts / Equipment & Capital Leases [2]	51,823,046
Net Appropriation-Supported Indebtedness	$ 1,430,775,369
Total General Fund and Highway Tax-Supported Debt	$ 6,997,929,810
Less: Self - Supporting / HighwayTrust Fund Debt	991,824,441
Net General Fund Tax-Supported Debt	$ 6,006,105,369

[1] HB 1264 Debt Supported by the Clean Water, Natural Heritage and Parks and Recreation Trust Funds is not considered to be self-supporting because these Trust Funds flow through the General Fund.
[2] Source: Office of State Budget & Management pursuant to G.S. 147-33.72H.

Trends in Amounts of General Fund Debt

After showing substantial growth in the early 2000's, it is now accurate to portray the State's net tax-supported debt position as having reached a plateau. Chart 2 below illustrates the outstanding amounts of General Fund net tax-supported debt over the last five years and projects the amount outstanding through FY 2014. As the State continues to issue debt that has already been authorized, the absolute level of General Fund tax-supported debt is projected to increase and will stand at approximately $6.4 billion by the end of FY 2011 and FY 2012.

Chart 2

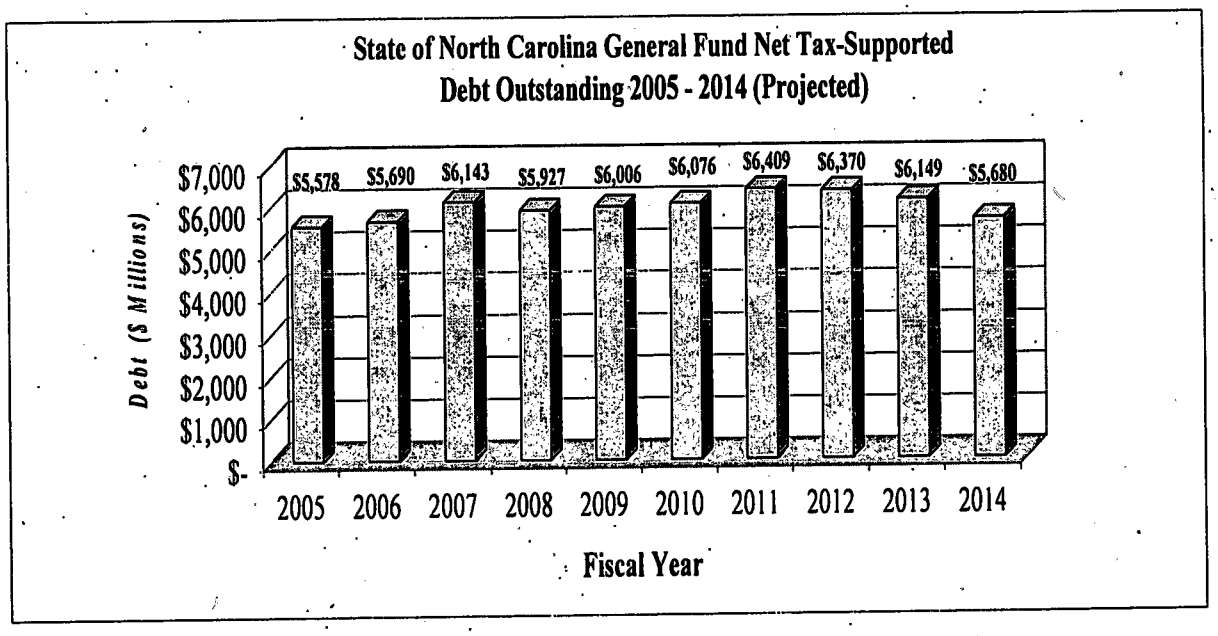
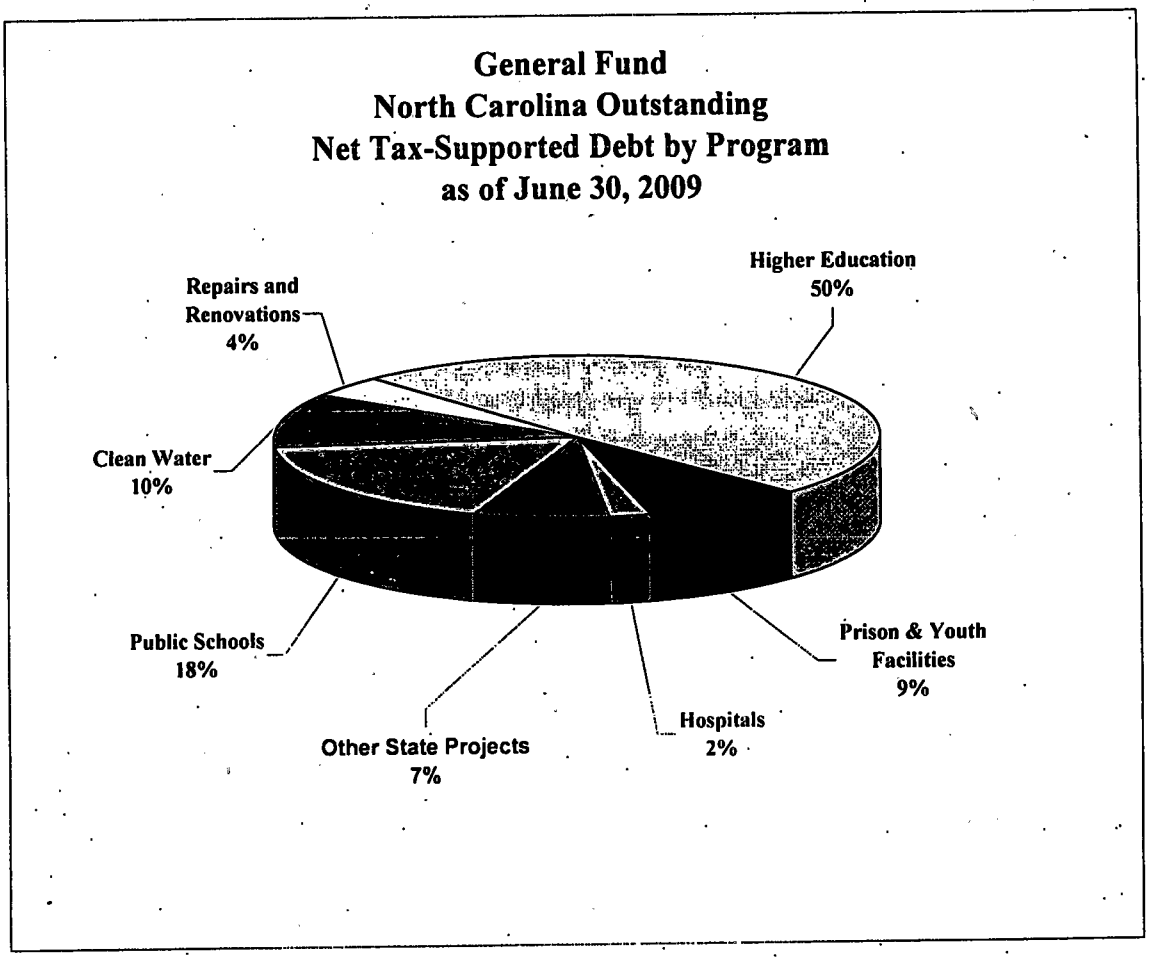


Chart 2 above incorporates all of the State's authorized, but unissued, debt. The State issues debt on a cash flow basis. Bond issues are timed to provide funds as they are actually needed and there is typically a lag between when debt is authorized and when it is actually issued. As of December 31, 2009, the total amount of authorized but unissued tax-supported debt totaled approximately $1.9 billion, consisting of approximately $488 million of GO debt with appropriation-supported debt comprising the balance. For planning purposes, the State anticipates issuance of all currently authorized but unissued debt by the end of FY 2013.

Uses of Outstanding General Fund Tax-Supported Debt

The following chart illustrates the uses for which the State has issued net tax-supported debt calculated on the amount outstanding. The State has used the proceeds of its debt programs for many purposes with the two largest being to provide facilities and infrastructure for higher education (50%) and public schools (18%).

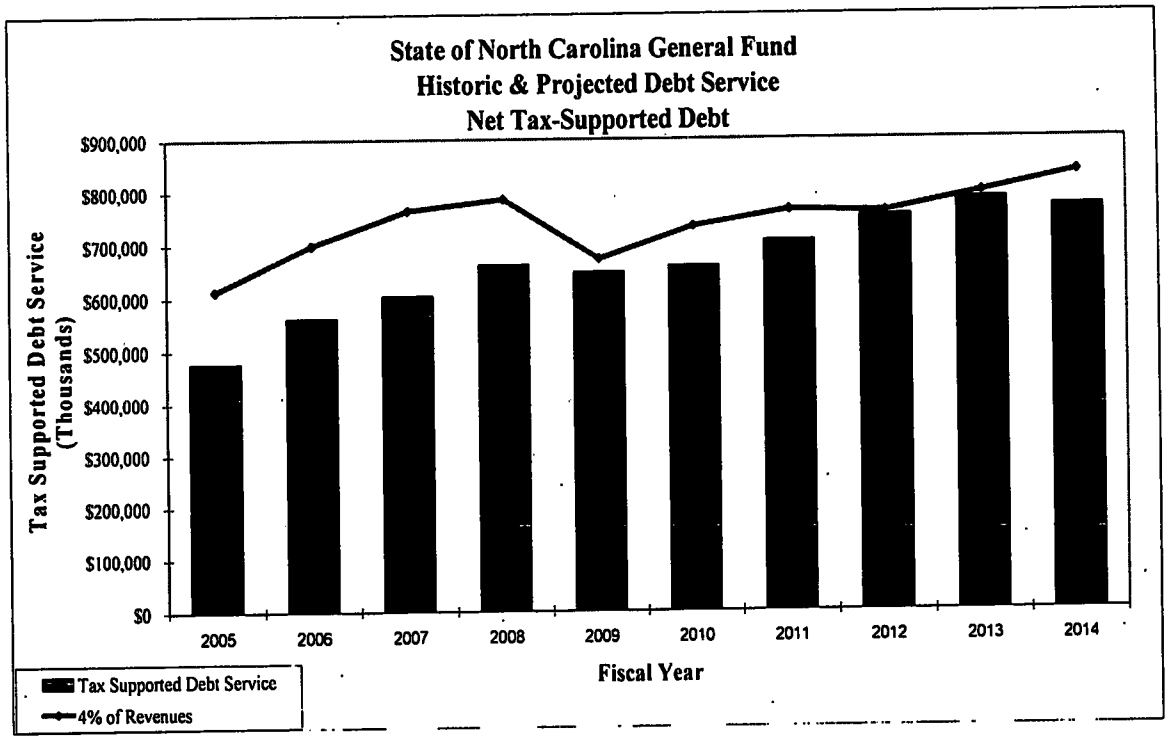
Chart 3



Debt Service

Over the last five years, the amount the State spends on debt service has increased, both on an absolute basis and as a percentage of general tax revenues. This trend is expected to continue, as the absolute amount of outstanding debt increases. Both the State's historic and projected debt service, incorporating the debt service on all authorized but unissued amounts, is illustrated below in Chart 4. The absolute amount of annual debt service is projected to peak in FY 2013 at approximately $785 million. As a percentage of general tax revenues, General Fund-supported debt service peaks in FY 2012 at 3.99%.

Chart 4



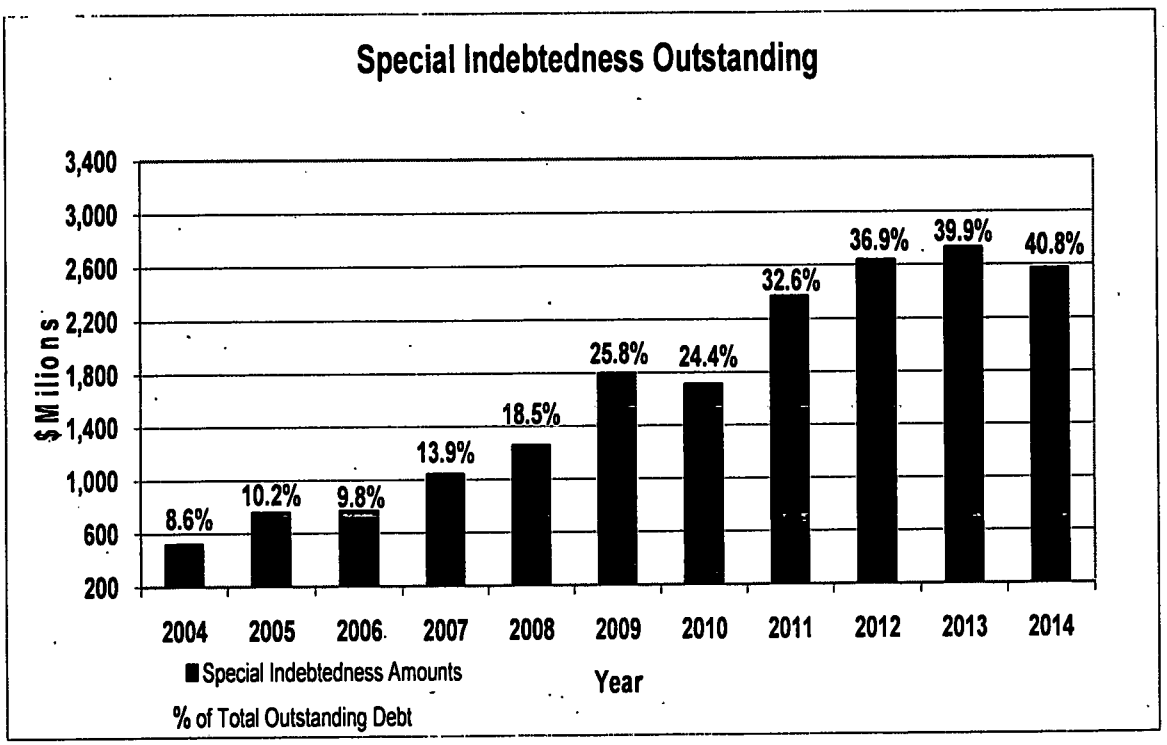
General Obligation Bonds versus Special Indebtedness

Prior to 2001, the State issued only GO debt. Such debt is usually considered to be the highest quality of all the various types of debt or debt-like instruments and usually carries the highest credit rating. Several factors contribute to the high rating including the legal protections inherent in constitutionally permitted debt, investor confidence in the pledge of the full faith and credit of the State and the presumption of the availability of the government's full resources. GO bonds are generally the most transparent of the various types of State debt obligations and typically carry the lowest interest cost. The State is in the process of fully utilizing its capacity to issue non-voter approved GO debt (approximately $488 million) as authorized by the General Assembly.

Special Indebtedness (as defined in G.S. §142-82), is a relatively recent financing vehicle employed by the State. Sometimes secured by a specific stream of revenues, a lease payment or financing agreement (and sometimes by a security interest in the project being financed), or totally unsecured, such obligations are paid from annual appropriated amounts for debt service. Depending upon the credit and structure, appropriation-supported debt is usually assessed an interest rate penalty ranging from 5 to 20 basis points when compared with the State's GO bonds. Although modest, the interest rate penalty does increase the cost of the projects being financed. Most states have diversified their debt portfolios and utilize one or more of the various types of non-GO structures. However, the State of North Carolina has relied extensively on authorizing this type of financing since 2000.

The amount of the State's historic and projected outstanding appropriation-supported debt is shown below in Chart 5, with the percentage of appropriation-supported debt to total debt noted.

Chart 5



Note: % of Total Outstanding Debt includes debt funded by the Highway and the Highway Trust Fund.

In December 2006, Fitch published a report analyzing the amount of non-GO debt by all 50 states. They found that the higher-rated states tend to have the highest amount of GO debt relative to their total debt positions. For example, for "triple A" states, the median ratio of GO debt to total tax-supported debt was 74%, while the ratio for all "double A" states (without modifiers) was 70%. Conversely, the ratio of special indebtedness to total debt was 26% and 30% for "triple A" and "double A" states respectively. The State of North Carolina's debt is currently in the range of the medians reported for the "triple A" states. However, including all authorized but unissued debt, the percentage of non-GO debt is projected to increase well beyond the medians for "triple A" states and exceed the median for "double A" states as well.

The Committee therefore recommends that the State consider the authorization of GO debt as the preferred method to provide debt financing.

Review of State Credit Ratings and Comparative Ratios

Credit ratings are the rating agencies' assessment of a governmental entity's ability and willingness to repay debt on a timely basis. As a barometer of financial stress, credit ratings are an important factor in the public credit markets and can influence interest rates a borrower must pay.

Chart 6

North Carolina Credit Rating Matrix

State of North Carolina

General Obligation Bond Credit Ratings

Rating Agency	*Rating*	*Outlook*
Fitch Ratings	AAA	Stable
Moody's Investors Service	Aaa	Stable
Standard & Poor's Rating Services	AAA	Stable

The State's general obligation bonds are rated AAA with a "stable" outlook by Fitch, AAA with a "stable" outlook by Standard & Poor's Ratings Services and Aaa by Moody's Investors Service with a "stable" outlook. These ratings are the highest ratings attainable from all three rating agencies.

Comparison of Debt Ratios to Selected Medians

A comparison to peer group medians is helpful because absolute values are more useful with a basis for comparison. In addition, the rating agencies combine General Fund and Transportation tax-supported debt in their comparative analysis. The primary source for this information is Moody's 2009 State Debt Medians and Standard & Poor's 2009 State Debt Review. These publications incorporate FY 2008 year-end data.

How North Carolina compares with its peers for the three debt ratios evaluated is presented below. The peer group is composed of states rated "triple A" by all three credit rating agencies. As shown in Chart 7, the State's debt ratios are at or below the median levels for its peer group.

Chart 7

General Fund
North Carolina Comparative Debt Ratios *

State	Ratings (Fitch/S&P/Moody's)	Debt to Personal Income	Debt per Capita	Total Debt Service as % of General Fund Expenditures
Delaware	AAA/AAA/Aaa	5.4%	$2,128	5.2%
Georgia	AAA/AAA/Aaa	3.0%	984	5.3%
Maryland	AAA/AAA/Aaa	3.3%	1,507	4.3%
Missouri	AAA/AAA/Aaa	2.0%	670	3.0%
North Carolina	AAA/AAA/Aaa	2.5%	832	2.0%
Utah	AAA/AAA/Aaa	1.5%	447	3.9%
Virginia	AAA/AAA/Aaa	1.9%	782	3.4%
	Peer Group Median	2.5%	$832	3.9%

Tax-Supported Debt Ratios North Carolina	Debt to Personal Income	Debt per Capita	Tax-Supported Debt Service as a % of DAAC Revenues
2009 (Actual)	1.9%	$643	3.75%
2010	1.9%	$639	3.59%
2011	1.9%	$663	3.70%
2012	1.9%	$646	3.99%

* Source: Moody's 2009 State Debt Medians, Standard & Poor's 2009 State Debt Review based on 2008 data.

North Carolina projections are based on February 1, 2010 DAAC Report.

General Fund Guidelines, Debt Affordability Model and Results

General Fund Debt Capacity Recommendations

The Committee has adopted targets and outside guidelines to analyze and/or serve as the basis of calculating the recommended amount of General Fund–supported debt that the State could prudently authorize and issue over the next 10 years. Each measure is discussed in more detail below.

1. Net Tax-Supported Debt Service as a percentage of General Tax Revenues should be targeted at no more than 4% and not exceed 4.75%;
2. Net Tax-Supported Debt as a percentage of Personal Income should be targeted at no more than 2.5% and not exceed 3.0%; and
3. The amount of debt to be retired over the next ten years should be targeted at no less than 55% and not decline below 50%.

Net Tax-Supported Debt Service as a Percentage of General Tax Revenues (4% Target, 4.75 Ceiling)

The Committee has adopted the measure of annual debt service arising from net tax-supported debt as a percentage of general tax revenues as the basis to evaluate the State's existing and projected debt burden for the General Fund and as the basis for calculating how much addition debt the State can prudently incur. The Committee notes that policymakers control both variables that determine this ratio. In addition, the Committee believes that by measuring what portion of the State's resources is committed to debt-related fixed costs, this ratio is a measure of the State's budgetary flexibility and its ability to respond to economic downturns.

Because there is often a time lag, sometimes of multiple years, between when debt is authorized and when it is issued, the Committee determined that calculating the amount of debt that could be authorized and issued each and every year over the model horizon is a more useful management tool than a measure that assumes that all available debt capacity is utilized in the year in which it is available. In practice, the limit imposed by the year of the least capacity over the model horizon (FY 2012) drives the calculation process. Without assuming any new debt is authorized, the State will be virtually hit the 4% target (3.99%) in FY 2012.

DAAC Revenues

The model uses general tax revenues adjusted for one-time or non-recurring items plus certain investment income and miscellaneous revenues ("DAAC Revenues"). These revenue items are contained in the State's Comprehensive Annual Financial Report. Due to both the adoption of, and the scheduled expiration of sales and use tax increases and individual income and corporate income tax surcharges, the Committee has departed from its historic practice of assuming a conservative 3% average annual growth assumption for the revenues used in the model. The Office of State Budget and Management ("OSBM") has been consulted to provide actual projections through FY 2014 that incorporate the sunset of these taxes and surcharges. See Appendix A for more details on the specific revenue items utilized by the model and the revenue projections utilized throughout the model horizon.

Debt Used in the General Fund Model Calculation

The model uses a definition of net tax-supported debt that includes all outstanding and

authorized but unissued General Obligation Bonds, Special Indebtedness, Capital Lease Obligations, Installment/Equipment Leasing Obligations and any other such obligations that are owed to a third party over a predetermined schedule payable from General Fund tax revenues. Obligations of Component Units, Highway Fund debt actually paid from Highway Fund revenues and non tax-supported special indebtedness paid from non-general fund trust funds are excluded. Other self-supporting or non-tax supported debt such as revenue bonds and short term tax anticipation notes (if they are not supported by General Fund tax revenues) are also excluded from the definition of net tax-supported debt. Energy Performance Contracts are excluded if they are performing as expected (debt service paid from energy savings). Consistent with rating agency practice, Other Post Employment Benefits ("OPEB") liabilities are also excluded unless the State actually issues debt to fund such obligations. See Appendix A for further details.

Debt Structuring Assumptions

The following assumptions were used in this year's debt affordability model calculations:

- The interest rate on existing Variable Rate Debt will average 4%.
- The State has approximately $488 million and $1.4 billion of GO and non-GO authorized but unissued debt. This debt is assumed to be structured with a 20-year level principal profile and the interest cost is estimated to be 5% (GO) and 6% (non-GO).
- Incremental model debt will be structured with a fixed rate 20-year maturity, a 6% interest rate, and an overall level principal payment profile after the initial year.

Model Solution

Illustrated below is the actual amount of new tax-supported debt that could be authorized and issued, by year, and remain within the 4.0% target ratio. In addition, the amount that could be authorized and issued each and every year over the model horizon is presented ($9.1 million).

Table 4

General Fund

Net Tax-Supported Debt Capacity using 4.0% debt service/revenues target ratio

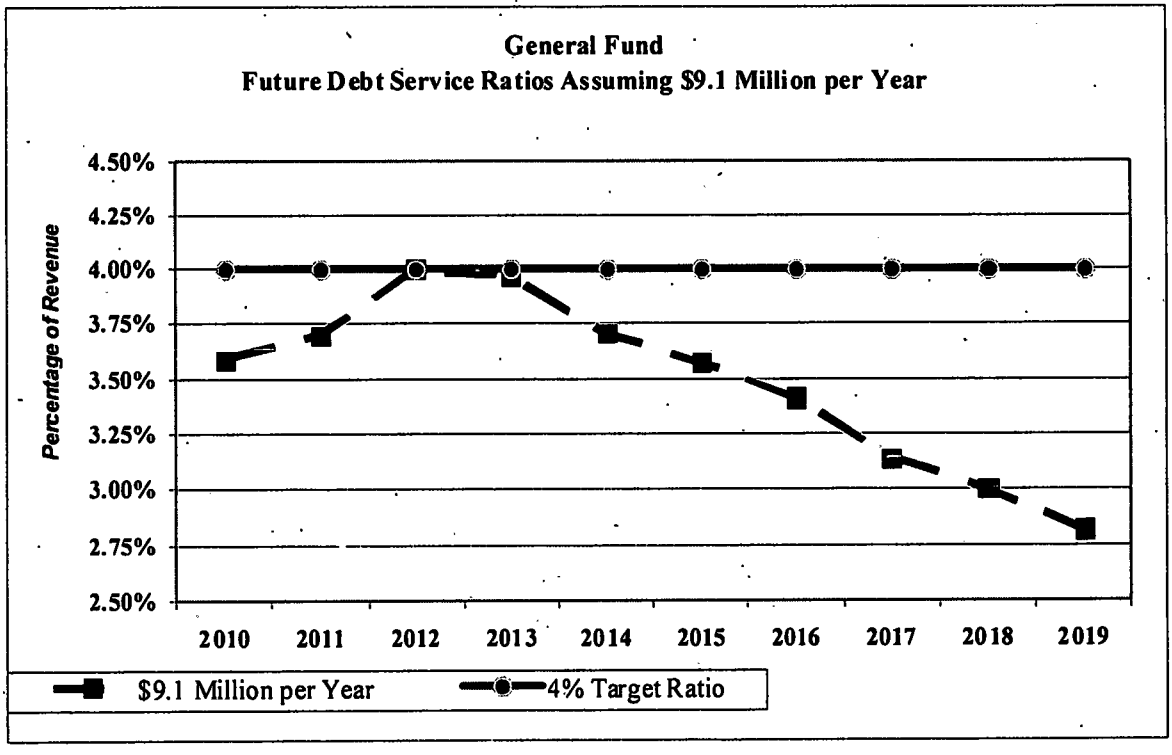
(In Millions of dollars)

Fiscal Year	2010	2011	2012	2013	2014
Total Additional Debt Capacity per Year *	$18.1	$0.0	$90.9	$626.4	$361.1
Debt Capacity Available Each and Every Year	$9.1	$9.1	$9.1	$9.1	$9.1

* In addition to that already Authorized but Unissued. Assumes additional debt capacity is authorized and issued in stated fiscal year.

The model provides the annual figure as an optimized solution that answers the question "how much new debt could be authorized and issued in every year and not exceed the targeted guideline of 4%?" Graphically, that solution is illustrated below. Any authorization and issuance above $9.1 in FY 2010 and 2011 will cause the State to violate the 4% parameter.

Chart 8



Sensitivity Analysis on 4% Target Solution

The model results are highly sensitive to changes in revenue and interest rate assumptions. Specifically, a one percent change, either up or down, in general tax revenues in each and every year of the model solution horizon will change the amount of annual debt capacity each and every year by approximately $19 million. A variation in revenues of $100 million per year will impact the amount of new debt that may be prudently issued each and every year by approximately $9 million. If the interest rate assumption for all authorized but unissued non-GO debt is reduced to 5%, approximately $44 million of additional annual capacity is created.

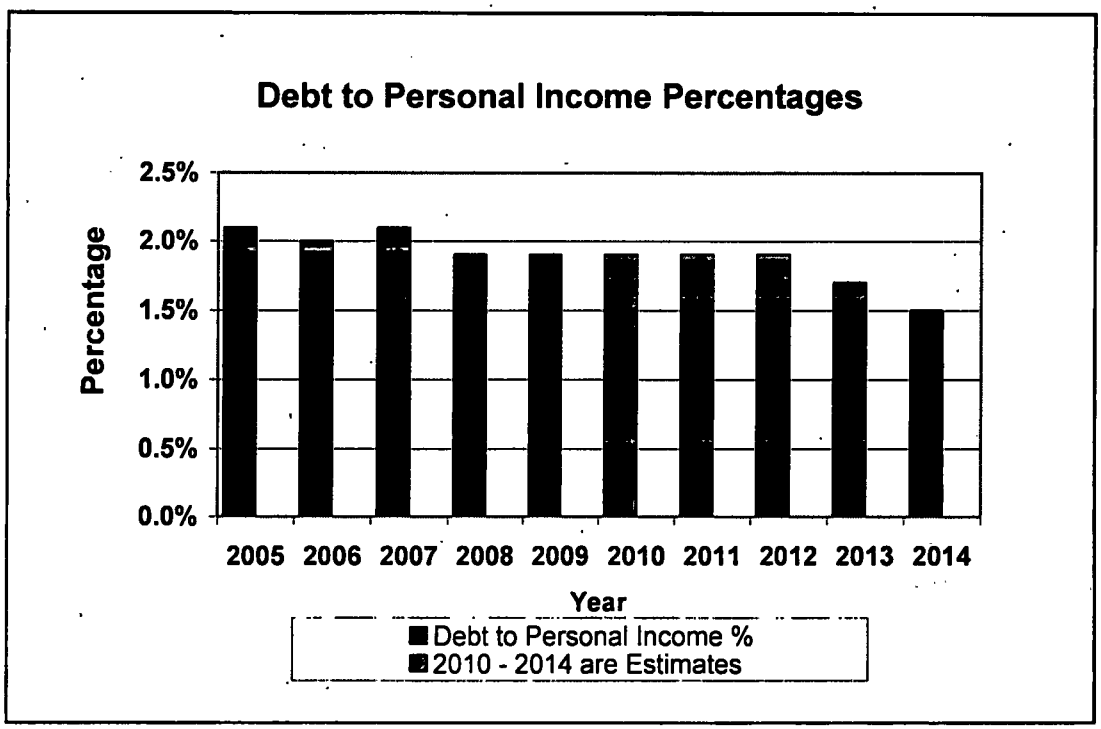
General Fund Analysis – Other

Net Tax-Supported Debt to Personal Income (2.5% Target, 3% Ceiling)

As required by statute, the Committee has also established guidelines for evaluating the State's debt burden as a measure of personal income.

The ratio of debt to personal income is projected to remain constant at 1.9% through FY 2012 and to decline thereafter. Chart 9 below shows that the amount of tax-supported debt as a percentage of personal income peaked in FY 2007.

Chart 9

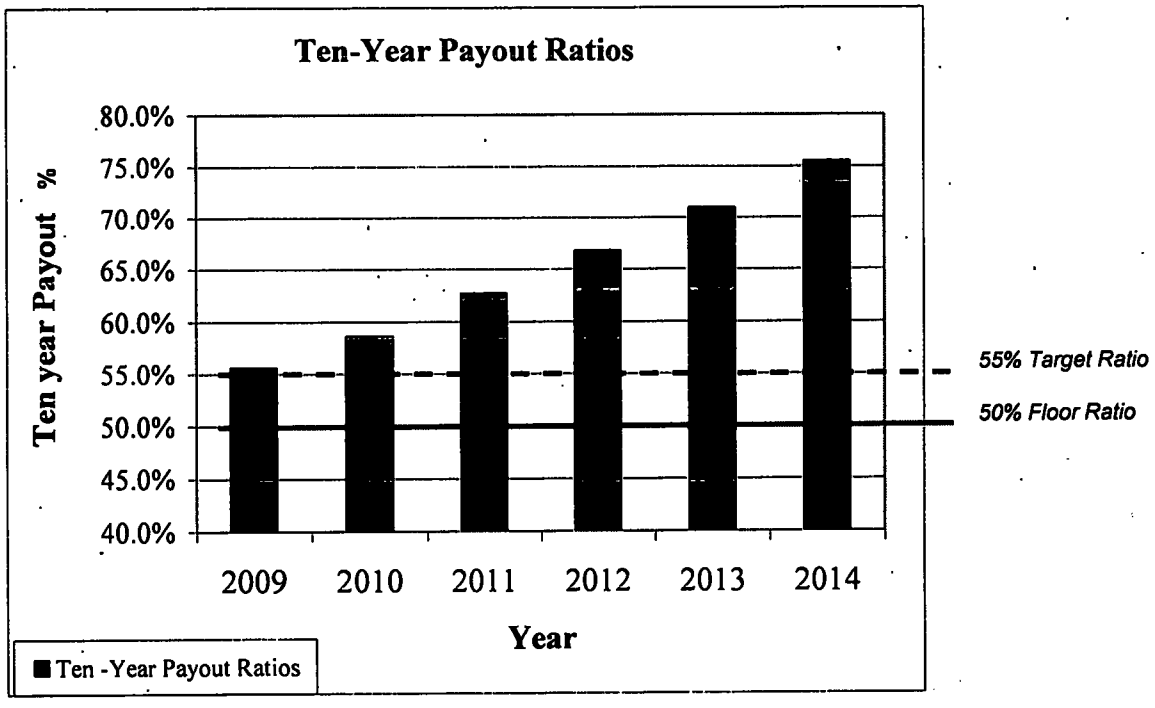


Source: Population and Personal Income statistics provided by "Moody's Economy.com", courtesy of the North Carolina General Assembly Fiscal Research Division.

Ten-Year Payout Ratio (55% Target, 50% Minimum)

The rating agencies view the payout ratio as a measure of the period of time over which a State pays off its debt, as a credit factor. A fast payout ratio is a positive credit attribute as a measure of budgetary flexibility. As illustrated in Chart 10 below, the State's payout ratio has reached its targeted level and is projected to improve further. The ten-year payout ratio, which stood at approximately 55% at June 30, 2009, is projected to meet or exceed its target through the model horizon.

Chart 10



Level of Unreserved Fund Balance

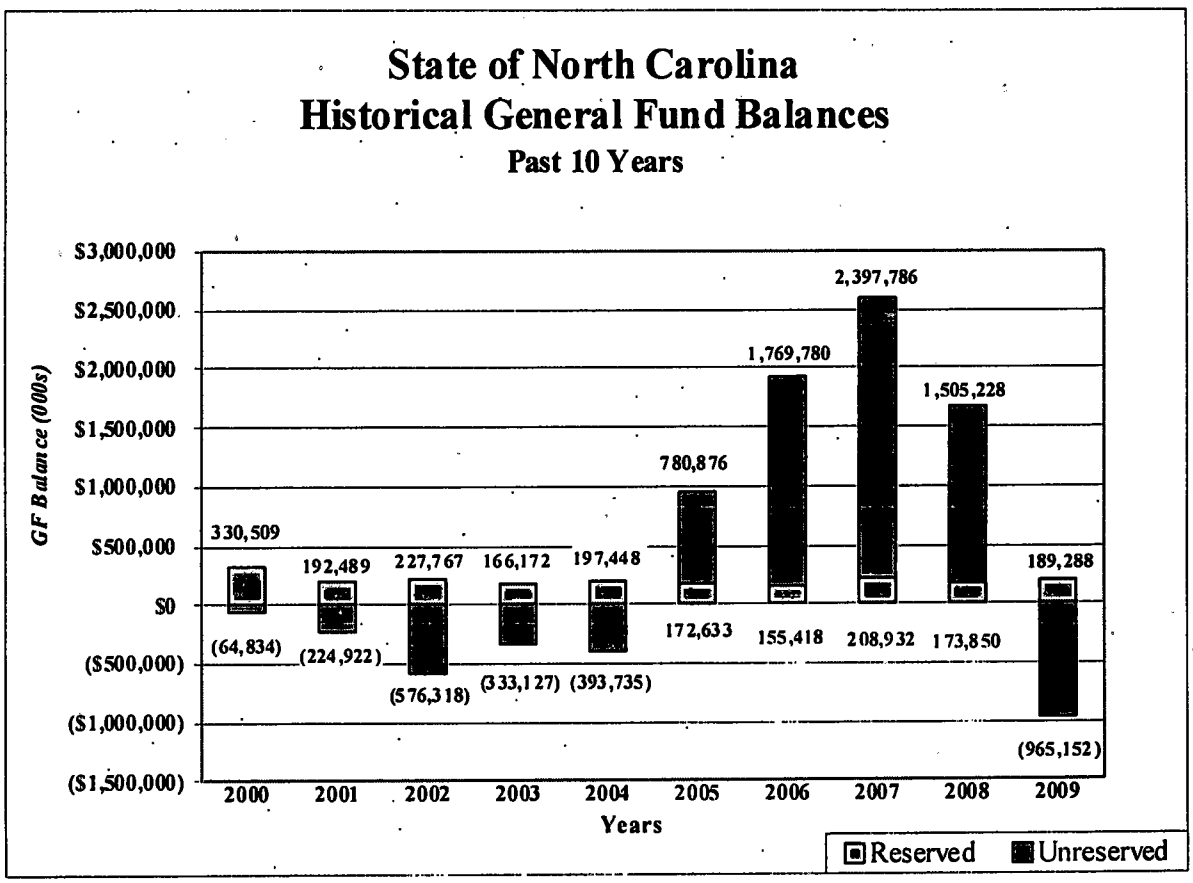
As discussed previously, the rating agencies place emphasis on budgetary reserves. In a report dated December 22, 2005, Standard & Poor's stated that "...reserves are critical to managing economic cycles and providing substantial flexibility to manage the budget and capital requirements of a government."

The State ended FY 2009 with a negative General Fund balance of approximately $776 million as calculated under generally accepted accounting principals ("GAAP"). This represents a swing of approximately $2,455 million from the prior year. The Rainy Day Fund was drawn down by approximately $637 million over the fiscal year to provide funding for the State Health Plan and other unanticipated budgetary needs, ending the year with a balance of $150 million. The Committee recognizes that the State has faced serious financial and budgetary pressures and needed to draw down reserves, use federal stimulus monies and enact temporary taxes in order to achieve budgetary balance. However, the Committee recommends that permanent sustainable solutions be devised to address the State's ongoing revenue needs and achieve long term

budgetary structural balance and that provides for the replenishment of the State's reserves, including the Rainy Day Fund, as quickly as possible.

Chart 11 depicts the State's historic General Fund Balance on a GAAP basis over the last ten years. The Rainy Day Fund is a budgetary reserve account and is not reported in the GAAP basis financial statements. The funds which make up the Rainy Day Fund are reported as part of the GAAP basis unreserved fund balance.

Chart 11



SECTION II
TRANSPORTATION DEBT AFFORDABILITY

Review of Transportation Funds, Debt and Other Commitments

Highway Fund

The Highway Fund accounts for most of the activities of the Department of Transportation ("DOT"), including the construction and maintenance of the State's primary and secondary road systems. In addition, it supports areas such as the NC Ferry System and the Division of Motor Vehicles and provides revenue to municipalities for local street projects (termed "Powell Bill Transfers") and to other State agencies. The principal revenues are motor fuels taxes, motor vehicle registration fees, driver's license fees and federal aid.

Highway Trust Fund

The Highway Trust fund was established by Chapter 692 of the 1989 Session Laws to provide a dedicated funding mechanism to meet the State's highway construction needs. The Highway Trust Fund also provides allocations for secondary road construction, to municipalities for local street projects and provides transfers to both the General Fund and the Highway Fund. The principal revenues are highway use taxes, motor fuels taxes and various fees.

The Highway Fund and the Highway Trust Fund are in many ways managed as a combined entity. Certain transportation revenues are deposited in each fund on a formulaic basis. For example, the Highway Fund receives ¾ of the Motor Fuels Tax and the Highway Trust Fund receives the remaining ¼. However, various combined expenditures are routinely paid from one fund or another. For example, salary expenses associated with the management of the Highway Trust Fund are actually paid out of the Highway Fund and debt service on the existing Highway GO Bonds is paid from the Highway Trust Fund. Powell Bill transfers are made from both Funds. Due to the interdependent nature of these Funds, the Committee has determined that it is most useful to calculate the available debt capacities of these Funds ("Transportation Funds") on an aggregate, rather than individual, basis. The resulting debt capacity is termed the "Transportation" debt capacity.

On a combined basis, the Highway Fund and Highway Trust Fund are primarily involved with construction and maintenance of the State's highways. From total budgeted sources for FY 2009, the Transportation Funds allocated approximately 38.3% ($1.5 billion) to Transportation Improvement Plan ("TIP") Construction, 24.5% ($958 million) to Highway Maintenance and 4.5% ($220 million) to Other Construction. In total, over 68% of the budget was dedicated to capital intensive infrastructure improvements.

Highway Debt

The State has a long history dating back to 1921 of authorizing debt to fund transportation projects. The most recent authorization of $950 million of GO Bonds (the "1996 Bonds") was enacted in 1996 by Chapter 590 of the Session Laws of the 1995 General Assembly, as amended ("The State Highway Bond Act of 1996" or "the 1996 Act"). The 1996 Bonds authorized debt to finance the capital costs of urban loops ($500 million, Intrastate System projects ($300 million) and secondary highway system paving projects ($150 million). All the Bonds authorized by the 1996 Act have been issued and as of June 30, 2008 the amount outstanding was $648 million. These are the only Highway Bonds currently outstanding.

The 1996 Act stated the General Assembly's intention to pay the debt service on the Bonds from the Highway Trust Fund, but did not pledge the Highway Trust Fund revenues to make such payments. Although the Act contained amendments regarding the priorities of the payment of funds from the Highway Trust Fund to provide for the payment of debt service, *such funds are not pledged* to secure the Bonds. Instead, the bonds are secured by "the faith and credit and taxing power of the State". As such, the bond rating agencies did not analyze the ability of the Highway Trust Fund to service the debt when assigning their ratings.

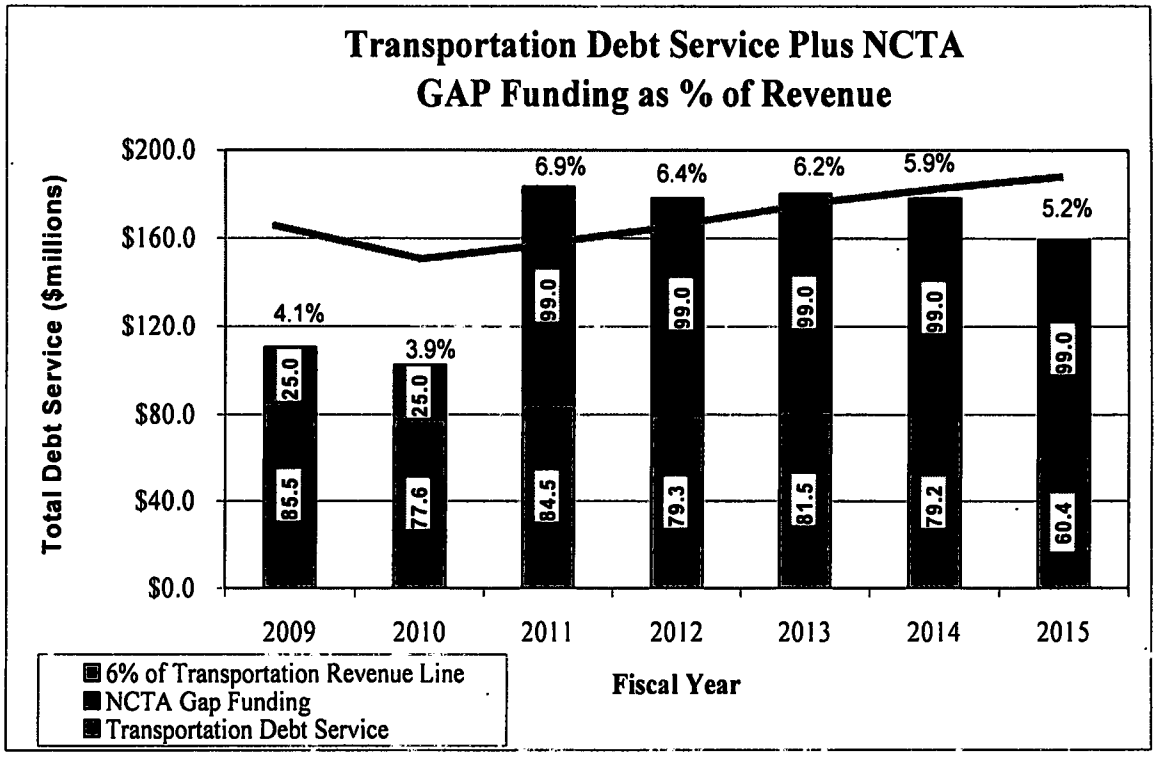
General Obligation Bonds versus Special Indebtedness-Transportation Implications

As discussed above, the State's outstanding Highway Bonds were issued as GO Bonds and are not secured by any Transportation revenues. As a result, the bonds were rated on a parity with the State's other GO Bonds. Therefore the Bonds were able to achieve the lowest possible interest rates, consistent with the State's high credit ratings. Potentially, the Bonds would not have been rated at the same level as the State's GO Bonds on a stand-alone basis. In addition, Bond Counsel has determined that any structure that pledged Transportation revenues consisting of state-wide taxes or user fees would most likely require a voter referendum. Therefore, the Committee advocates the use of GO Bonds for Transportation debt.

Debt Service

Debt Service on Highway Bonds peaked in FY 2006 at $93.6 million. In the future, the amount of actual debt service will decline as outstanding Bonds are retired. Debt service, both on an absolute basis and as a percentage of Transportation revenues, is illustrated below. As discussed in more detail in Appendix B, appropriation of funds to support debt obligations issued by the North Carolina Turnpike Authority are treated the same as any other debt service obligation. Including those commitments causes the Transportation Debt Affordability limits to be exceeded in FYs 2011-2014 by approximately $24, $11 and $5 million of debt service, respectively.

Chart 12



Grant Anticipation Revenue Vehicle Bonds ("GARVEEs")

A review of Transportation-related debt would be incomplete without a discussion of the State's GARVEE program. Although not supported by State Transportation or General Fund revenues and, therefore, not technically a part of the Transportation debt affordability model, GARVEEs do represent a financing vehicle that provides significant funds to the State to accelerate transportation projects.

North Carolina General Statute §136-18 (12b) as codified by Session Law 2005-403 ("the GARVEE Act") authorized the State to issue GARVEEs to accelerate the funding of transportation improvement projects across the State. GARVEEs are a revenue bond-type debt instrument where the debt service is to be paid solely from future federal transportation revenues and has no other State support. The State has issued two series of GARVEEs totaling $530 million and the program is targeted to reach nearly $1 billion over the next several years. The ratings assigned by Fitch, Standard & Poor's and Moody's are, respectively: AA-/AA-/Aa3, two steps lower than the State's typical non-GO debt ratings. The lower rating reflects the absence of any State backing for the GARVEEs.

Other Transportation Expenditures

Consistent with its treatment for General Fund debt affordability, the Committee does not advocate including non-debt related Transportation obligations or commitments in the definition

of liabilities when measuring debt capacity. It is useful, however, to review the level of ongoing administrative and other recurring expenses/transfers when analyzing the level of flexibility in the Transportation Funds. Historically, the levels of these commitments are shown below both with and without debt service as a percentage of total Transportation Revenues, including federal revenues. On average, approximately 24% of the total Transportation revenues are allocated to administrative costs, transfers and debt service.

Chart 13

Transportation Expenses by Year

($ Dollars in Millions)

	2005	2006	2007	2008	2009
Total Transportation Revenues [1]	$3,650.1	$3,787.5	$3,800.6	$3,852.1	$3,829.8
Administration [2]	$220.1	$240.5	$255.6	$254.4	$249.3
Powell Bill Transfers	135.3	136.8	137.9	158.1	145.0
Transfers to Other State Agencies	239.1	244.3	255.2	287.8	278.4
General Fund Transfers	242.5	252.6	57.5	172.7	147.5
Expenditures excluding Debt Service	$837.0	$874.2	$706.2	$873.0	$820.2
% Total Transportation Revenues	23%	23%	19%	23%	21%
Debt Service	$69.0	$93.5	$91.2	$88.1	$85.5
Total Expenditures	$906.0	$967.7	$797.4	$960.9	$905.7
% Expenditures/Revenues	25%	26%	21%	25%	24%

(1) Includes Federal Revenues.

(2) Prior year administrative expenses have been restated to be net of receipts.

Comparative Transportation Ratios

When viewed as a stand-alone enterprise, the State's transportation-related debt service as a percentage of State transportation revenues appears modest when compared with a peer group composed primarily of states in the Southeast region but also certain other states selected after consultation with DOT. Within the peer group, both Missouri and South Carolina utilize an approach that limits transportation debt separately from other state-level debt. In contrast, Georgia measures available debt capacity on a combined basis, but has dedicated a great deal of that capacity toward transportation priorities as shown in Chart 14 below. Finally, Tennessee does not issue state debt for transportation purposes.

Chart 14

Transportation Peer Group Comparisons

State	Ratings (Fitch/S&P/Moody's)	2006 Transportation Debt Service as % of Transportation Revenues [1]	Typical Maturity / Years
Florida	AA+/AAA/Aa1	6.0%	20
Georgia [2]	AAA/AAA/Aaa	21.0%	20
Kentucky	AA-/AA-/Aa2	12.1%	20
Missouri	AAA/AAA/Aaa	6.7%	20
North Carolina	AAA/AAA/Aaa	3.4%	20
South Carolina	AAA/AA+/Aaa	10.8%	15
Tennessee	AA+/AA+/Aa1	0.0%	N/A
Texas	AA+/AA/Aa1	5.9%	20
Virginia	AAA/AAA/Aaa	3.8%	25
Median		6.0%	
Average		7.75%	

(1) Excludes Garvee debt service (if any) and Federal Revenues.
(2) Allocated Debt Service for 2007.

Transportation Debt Guidelines, Affordability Model and Results

The rating agencies view all debt supported by state-wide, generally applied taxes and/or user fees to be "Tax-Supported Debt". This combined treatment extends to all General Fund-supported, and to Highway Fund and Highway Trust Fund-supported ("Transportation Fund" – supported) debt. Some analysts apply the same treatment to debt supported by non-State revenues such as GARVEE bonds. The Committee recognizes that the rating agencies compare the State to its peers utilizing a broad measure of Transportation and General Fund debt, and has reviewed the State's relative status on this basis (see Chart 7).

However, the State of North Carolina has a long history of viewing the debt supported by the General Fund as tax-supported debt and its Highway Bonds as being non-tax supported (in this case, Highway Trust Fund-supported) debt. The State's existing debt affordability model excludes both transportation revenues and transportation debt service as components of the General Fund calculation. Continuing this practice, the Committee has determined that it should adopt a measure of Highway Fund and Highway Trust Fund debt capacity that is separate and distinct from that calculated for the General Fund. Although not common, this practice has been discussed with the rating agencies who understand North Carolina's incremental and separate approach to debt affordability measurement.

The Committee also recognizes the inherent differences between the General Fund and the Transportation Funds, not only in terms of the revenue streams, but also in terms of the commitments on those revenues. In addition, the State's transportation "enterprise" is, by its nature, a long-lived, capital intensive, rapidly growing program. As such, a customized individual debt capacity model is appropriate to measure the debt capacities of the Transportation Funds. Finally, the Committee believes that an individual Transportation debt capacity calculation is consistent with the legislative intent of S.L. 2007-551.

Due to the interdependent nature of the Highway and Highway Trust Funds as discussed earlier, the Committee has determined that it is more useful to calculate the available debt capacities of these Funds on an aggregate, rather than individual, basis. The resulting debt capacity is termed the "Transportation" debt capacity.

The Debt Affordability Advisory Committee has adopted the ratio of annual transportation-related debt service as a percentage of State transportation revenues as the measure to evaluate the level of Transportation debt capacity. By measuring what portion of the State's transportation resources is committed to debt-related fixed costs, this ratio reflects the flexibility (or lack thereof) to allocate transportation resources to other priorities.

Revenues Used in the Transportation Model Calculation

The model uses a definition of State transportation revenues that includes an aggregate of all State-level revenues deposited into the Highway Fund and the Highway Trust Fund including the motor fuels tax, highway use tax, motor vehicle license tax and certain non-tax revenue such as investment income. Consistent with the model mechanics for the General Fund, there is no deduction for projected transfers to the General Fund, Powell Bill transfers or other non-debt commitments. Federal transportation revenues are specifically excluded from the definition of revenues used to calculate Transportation debt capacity as federal revenues have been pledged to the State's GARVEE program and are not available to back other transportation-related debt.

Debt Used in the Transportation Model Calculation

The model uses a definition of State transportation debt service that includes outstanding Highway GO Bonds but excludes the GARVEEs supported by federal revenues. There are currently no capital lease or installment purchase contracts that need to be included. Highway Trust Fund support for debt issued by the North Carolina Turnpike Authority is included as a liability for model purposes.

Debt Structuring Assumptions

The following assumptions were used in this year's debt affordability model calculations:

- There is no remaining authorized but unissued GO or non-GO debt.
- Incremental model debt will be structured with a fixed rate 25-year maturity, a 6.15% interest rate and an overall level debt service profile after the first year.

It is the Committee's determination that a 25-year structure, with a correspondingly higher interest rate, can be justified for analyzing debt that will be used to finance long-lived transportation infrastructure projects. The Committee notes that Virginia also utilizes a 25 year structure for transportation debt.

Transportation Debt Capacity Guidelines

The Committee has adopted a guideline of 6% for transportation-related debt service as a percentage of state transportation revenues. In doing so, the Committee determined that the Transportation Funds enjoy a greater degree of budgetary flexibility than does the General Fund, and the Committee determined that the State's Transportation funds could support a higher ongoing level of debt service as a percentage of revenues than was deemed appropriate for the General Fund. However, the Committee also determined not to adopt the same 15% guideline for Transportation debt capacity as was contained in the GARVEE legislation because GARVEEs have higher annual debt service requirements due to their shorter maturity. Primarily due to the appropriation of substantial funds to support debt to be issued by the North Carolina Turnpike Authority, the model does not project any available Transportation debt capacity until FY 2013.

Table 5

Transportation
Net Tax-Supported Debt Capacity using 6.0% debt service/revenues target ratio
(In Millions of dollars)

Fiscal Year	2010	2011	2012	2013	2014
Total Additional Debt Capacity per Year *	$0.0	$0.0	$0.0	$21.4	$298.6
Debt Capacity Available Each and Every Year	N/A	N/A	N/A	N/A	N/A

* In addition to that already Authorized but Unissued. Assumes additional debt capacity is authorized and issued in stated fiscal year.

Model Assumptions regarding Revenue Growth and Sensitivity Analysis

The model uses NCDOT estimates for the revenues over the model horizon (see Appendix B). Transportation revenues would need to exceed projections in FY 2011 and FY 2012 by approximately $400 million and $190 million, respectively, to generate any Transportation debt capacity prior to FY 2013.

SECTION III

Transportation and General Fund Ratios Combined

The Committee adopted the 6% Transportation guideline after analyzing the State's position relative to its peer group on a combined (General Fund and Transportation Funds) basis. As stated previously, the rating agencies also analyze the State's debt on an aggregate basis. Illustrated below is how the State appears on a combined basis utilizing existing debt service as a percentage of revenue percentages for both the General Fund and the Transportation Funds. The Committee notes that the combined ratios exceed the 4% target, but are well below the 4.75% ceiling. Depending upon the reactions by the rating agencies and financial markets, the Committee may choose to revisit the 6% guideline for Transportation Debt in the future.

Table 6

General Fund and Transportation Funds
Combined Debt Service / Revenue Percentages

Fiscal Year	2010	2011	2012	2013	2014
General Fund	3.59%	3.70%	3.99%	3.95%	3.69%
Transportation *	3.92%	6.90%	6.41%	6.17%	5.94%
Combined	3.63%	4.09%	4.30%	4.24%	3.98%

Note: Percentages are based on forecasted revenues and debt service.

* GAP Funding for North Carolina Turnpike Authority projects assumed to reach $99 million in FY 2011 and thereafter.

Appendix A

General Fund Revenues and Liabilities and Debt Affordability Model 10-Year Solutions

DAAC Revenues

The model uses general tax revenues adjusted for one-time or non-recurring items plus certain other revenue items deemed available to service debt from the most recently available *Comprehensive Annual Financial Report.* The following items are included:

General Fund Tax Revenues

- Individual Income Tax
- Corporate Income Tax
- Sales & Use Tax
- Franchise Tax
- Insurance Tax
- Beverage Tax
- Inheritance Tax
- Other Taxes

Other General Fund Revenue Items

- Investment Income
- Miscellaneous Revenues

Revenue Growth and other Assumptions

Changes to revenue estimates have a significant impact on the calculation of available debt capacity because of the multiplier effect of compounding growth over the ten-year period. Such projections are especially important when they reflect changing or differing economic outlooks.

In consultation with OSBM, DAAC revenue projections are assumed to be as follows:

Table 7

General Fund Revenue ($ millions)

Fiscal Year	Revenues ($ millions)	Fiscal Year	Revenues ($ millions)
2009	$16,812.6	2015	$21,514.0
2010	18,350.0	2016	22,159.4
2011	19,106.8	2017	22,824.2
2012	18,893.8	2018	23,509.0
1013	19,890.8	2019	24,214.2
2014	20,887.4	2020	24,940.6

* Revenues through Fiscal Year 2014 per OSB. Fiscal Years 2015 - 2020 assume a 3% growth rate.

Liabilities

To calculate net tax-supported debt, credit analysts take into account all debt supported by general tax revenues. This debt position shows the amount of indebtedness serviced from an issuer's General Fund; that is, it reflects the debt service payments made directly from tax revenues and is known as net tax-supported debt. Although a consensus appears to exist among credit analysts as to the appropriateness of using net tax-supported debt as the standard for determining an issuer's debt position, there is less unanimity about the precise calculation. The Committee has determined to exclude self-supporting debt from its calculations.

The model uses a definition of net tax-supported debt that includes GO Bonds, Special Indebtedness, Capital Lease Obligations, and any other obligations that are owed to a third party over a predetermined schedule and paid from General Fund Revenues. Should mandatory payments be due to contractors or others under "Public Private" or "Design/Build/Finance" or other such arrangements, those payments would be counted as a liability for the model. Obligations of Component Units, Highway Fund debt that is paid from Highway Fund revenues, non tax-supported special indebtedness that is paid from trust funds and other self-supporting debt is excluded. Energy Performance Contract liabilities are also excluded.

Other Post Employment Benefits ("OPEB")
In order to comply with Governmental Accounting Standards Board (GASB) Statements No. 43 and 45, the State Health Plan had an actuarial study completed that estimates the size of the State's unfunded liability for Other Post Employment Benefits. The bond rating agencies have been clear that OPEB liabilities do not represent a hard liability in the same way that debt service does and should not be considered tax-supported debt unless bonds are actually issued to fund part or all of the liability. They have also consistently assured the State that these liabilities do not represent a threat to the State's credit rating in the short-term. Over the longer term, the State will need to develop a realistic plan to meet these obligations.

The model includes the actual debt service from all outstanding net tax-supported debt and for all authorized, but currently unissued tax-supported debt if such issuance does not require further action on the part of the General Assembly.

The following is a list of those liabilities that are included in the General Fund model (outstanding amounts as of June 30, 2009):

- General Obligation Bonds supported by General Fund Tax Revenue - $4.6 billion
- supported by General Funds
  - Limited Obligation Bonds - $441.8 million
  - Certificates of Participation- $712.1 million, which includes
    - Chapter 1264 projects supported by the Clean Water, Natural Heritage and Parks and Recreation Trust Funds where funds flow through the General Fund - $51.8 million
  - Capital Leases, Installment Purchase Contracts and Equipment lease obligations determined pursuant to G.S. 147-33.72H - $51.8 million
  - Lease Revenue or Lease-Purchase Revenue Bonds - $225.1 million

Liabilities not included in the General Fund model (outstanding amounts as of June 30, 2009):

- Highway Construction General Obligation Debt supported by separate taxes - $593.9 million
- Special Indebtedness (collectively appropriation-supported obligations)
  - Certificates of Participation supported by non-General Funds including
    - Chapter 1264 projects supported by the Health and Wellness/Tobacco Trust Funds - $365.7 million (issued), $58.6 (authorized but unissued)
- Short Term Tax Anticipation Notes (not supported by General Tax Revenue) - $0.
- Obligations of the University of North Carolina System, the North Carolina Housing Finance Agency or other Component Units – $8.6 billion
- Energy Performance Contract obligations where such obligations are guaranteed and approved pursuant to G.S. 142-64 and not supported by separate appropriations - $32.2 (issued)
- Other Post Employment Benefits ("OPEB")

Note: Although these liabilities do not constitute tax-supported debt, they are obligations of the State of North Carolina or various component units, and the State's General Fund, although not legally obligated to, could be called upon to service these obligations if necessary.

Debt Structuring Assumptions

The following assumptions were used in this year's debt affordability model calculations:

- The rate on existing Variable Rate Debt will average 4%.
- The State has approximately $488 million and $1.4 billion of GO and non-GO authorized but unissued debt. This debt is assumed to be structured with a 20-year level principal profile and the interest cost is estimated to be 5% (GO) and 6% (non-GO).
- Incremental model debt will be structured with a fixed rate 20-year maturity, a 6% interest rate, and an overall level principal payment profile after the initial year.

GAAP Unreserved General Fund Balance

The State's GAAP basis Unreserved General Fund Balance ("UGFB") is comprised both of Designated and Undesignated items. Designated items are those for which tentative plans for use in a future period have been established by the General Assembly. Examples include the Disaster Relief Fund and Repairs and Renovation Fund. Of the total UGFB of a negative $965.1 million at Fiscal Year end 2009, Designations totaled $189.3 million, bringing the total Reserved and Unreserved General Fund balance to a negative $775.9 million. The State's Rainy Day Fund is a budgetary reserve account which is not reported in the GAAP basis financial statements of the State. The funds which make up this account are reported as part of the GAAP Undesignated balance.

General Fund

10-Year Model Solutions

4% Debt Service/Revenue Target

Table 8

General Fund

Net Tax-Supported Debt Capacity using 4.0% debt service/revenues target ratio

(In Millions of dollars)

Fiscal Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Additional Debt Capacity per Year [1]	$18.1	$0.0	$90.9	$626.4	$361.1	$448.5	$765.3	$456.5	$597.5	$958.5
Debt Capacity Available each and every Year	$9.1	$9.1	$9.1	$9.1	$9.1	$9.1	$9.1	$9.1	$9.1	$9.1

* In addition to that already Authorized but Unissued. Assumes additional debt capacity is authorized and issued in stated fiscal year.

4.75% Debt Service/Revenue Target

Table 9

General Fund

Net Tax-Supported Debt Capacity using 4.75% debt service/revenues target ratio

(In Millions of dollars)

Fiscal Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Additional Debt Capacity per Year [1]	$1,643.5	$0.0	$176.7	$712.1	$414.9	$504.0	$822.5	$515.4	$658.2	$1,021.0
Debt Capacity Available each and every Year	$575.0	$575.0	$575.0	$575.0	$575.0	$575.0	$575.0	$575.0	$575.0	$575.0

* In addition to that already Authorized but Unissued. Assumes additional debt capacity is authorized and issued in stated fiscal year.

Appendix B

Transportation Revenues and Liabilities and Debt Affordability Model 10-Year Solutions

The Transportation debt affordability model uses all state transportation revenues plus other revenue items deemed available to service debt for the most recent Fiscal Year. The following items are included:

State Transportation Revenues

- Motor Fuels Tax
- Highway Use Tax
- Motor Vehicle Revenues
  - Vehicle registration and title fees
  - Driver's license fees
  - International registration plan fees
  - Penalties
  - Equipment inspection fees
  - Other
- Investment Income
- Other misc.
- *Federal Transportation Revenues are excluded*

Revenue Growth

Changes to revenue estimates have a significant impact on the calculation of available debt capacity. In consultation with NCDOT, Transportation Revenue projections are assumed to be as follows:

Table 10

Transportation Revenues ($ millions)

Fiscal Year	Revenues ($ millions)	Fiscal Year	Revenues ($ millions)
2009	$2,720.0	2015	$3,079.3
2010	2,617.9	2016	3,133.9
2011	2,660.6	2017	3,165.0
2012	2,782.3	2018	3,173.9
2013	2,927.0	2019	3,213.7
2014	2,998.8	2020	3,235.5

* Revenue amounts per NC Department of Transportation (excluding federal revenues)

Transportation Liabilities

The model uses the debt service from all outstanding Highway Bonds and would include transportation-related capital lease obligations and installment purchase contracts if appropriate. There is no currently authorized but unissued transportation-related debt to include, but the model would count such debt and the resulting debt service as part of Transportation Liabilities if there were. At 6/30/09, there were $594 million outstanding Highway Bonds and maximum Highway related debt service peaked at $93.6 million in FY 2006.

Debt Service arising from the State's GARVEE program is not included as a State Transportation Liability because the GARVEEs are supported solely by federal transportation revenues.

In 2008, "GAP" funding was authorized by S.L. 2008-201 to "pay debt service or related financing costs" for revenue bonds issued by the North Carolina Turnpike Authority. The funds so appropriated are all legally pledged to support the bonds and bondholders will depend upon the appropriation continuing. Therefore, the model treats the gap funding as the equivalent of debt service since it represents ongoing Highway Trust Fund support of debt. $25 million of GAP funding is treated as debt service for FY 2010 and $99 million in FY 2011 and beyond over the 10-year model horizon. This represents a delay of one year for funds authorized to support the Mid Currituck and Monroe Connector projects. NCDOT has also pledged certain operating and maintenance funds to secure debt, if necessary to provide adequate coverage levels. At the present, it appears that such funding will not be required. However, these funds would be treated as additional GAP Funding for model purposes if NCDOT was required to make such payments. Note that Debt Issuing Assumptions

Debt-like obligations including mandatory "availability payments" to contractors or others which represent liabilities payable under Public Private, Design/Build/Finance and/or other arrangements with have debt or debt-like characteristics count as a liability for purposes of the model. Currently there are no such obligations outstanding.

This year's Transportation debt affordability model assumes that model debt is fixed-rate 25-year maturity debt with an average interest cost of 6.15% and a level debt service profile after the first year.

Transportation

10-Year Model Solution

Table 11

Transportation

Net Tax-Supported Debt Capacity using 6.0% debt service/revenues target ratio

(In Millions of dollars)

Fiscal Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Additional Debt Capacity per Year [1]	$0.0	$0.0	$0.0	$21.4	$298.6	$53.5	$0.0	$55.8	$0.0	$0.0
Debt Capacity Available each and every Year	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

* In addition to that already Authorized but Unissued. Assumes additional debt capacity is authorized and issued in stated fiscal year.

Revised General Fund Consensus Forecast and Budget Outlook

April 28, 2010

Barry Boardman, Ph.D.
Evan Rodewald
Fiscal Research Division
North Carolina General Assembly

Revised: May 2009 Consensus Forecast

- $391 M shortfall expected this fiscal year
  - Sales Tax continues to fall behind
  - Withholding improving but not enough to meet expectations
  - Refunds have been up on withholding and expected to mirror last year's high mark
  - Final payments will not meet expectations and estimated payments for this year reflect a still weakened economy

Revised: May 2009 Consensus Forecast

- **FY 2010-11 revenue adjusted down $703 M**
  - Key reasons:
    - Lower starting point than expected
    - Employment growth will remain slow through 2010
      - Personal income withholding growth reduced
      - Sales Tax collection growth scaled back
    - Significant losses keep income tax collections down
      - Non-withholding personal income
      - Corporate income

Estate Tax Expires 2010 tax year

- $85 M loss in Estate Tax Revenue
- Net budget reduction $788 M
  - ($703 M structural + $85 M Estate Tax)

Budget Outlook for FY 2010-11

Certified General Fund Appropriations	$19,560,000,000
Additional Spending Pressures	
Medicaid Shortfall	430,000,000
Enrollment Growth (Higher Education)	90,000,000
Potential Restoration of Continuation Reviews	35,000,000
Retirement System	180,000,000
Savings Reserve	?
Capital /Repair and Renovation	?
Subtotal of Additional Spending Pressures	**$735,000,000**

FY 2010-11 Budget Gap Scenario

Revenue Shortfall	($788,000,000)
Spending Pressures	(735,000,000)
Federal Medical Assistance (FMAP)	500,000,000
Medicare Part D Clawback	80,000,000
Unappropriated Balance	83,000,000
Budget Gap	**($860,000,000)**

Use of Fee Revenue in Recent Years

April 28, 2010

Rodney Bizzell
Fiscal Research Division
North Carolina General Assembly



STUDY OF NORTH CAROLINA'S TAX STRUCTURE
INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES

Overview

- General Assembly Oversight of Agency Fees
- Use of Fees to Increase General Fund Availability in Recent Years
- Guidelines for Future Consideration

General Assembly Oversight of Agency Fees

- Only the General Assembly has power to authorize an agency to establish or increase a fee (NC Constitution, Art. III, Sec. 23 and G.S. 12-3.1)
- All bills affecting fees go the finance committees

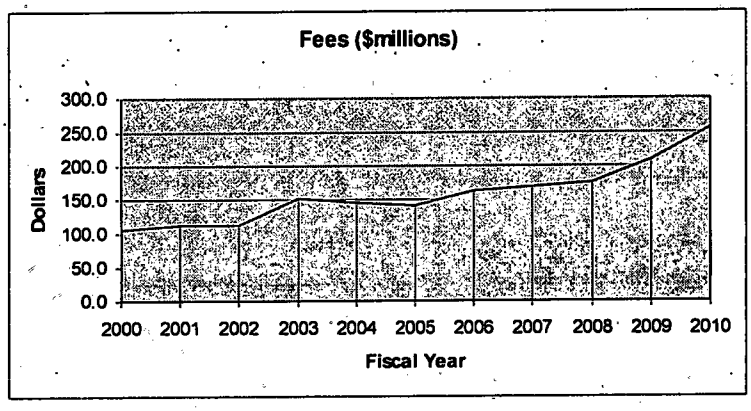
General Assembly Oversight of Agency Fees

- Statutes that grant authority to establish or increase a fee often establish a maximum/ceiling
  - Fees are to reflect the cost of a particular service or functions and thus, will change as the cost changes or as the client base changes
  - Statutorily authorized range allows for more expedited fee changes via rulemaking as conditions change
  - Consultation with GovOps provides a means of exercising legislative oversight of fee changes within authorized range

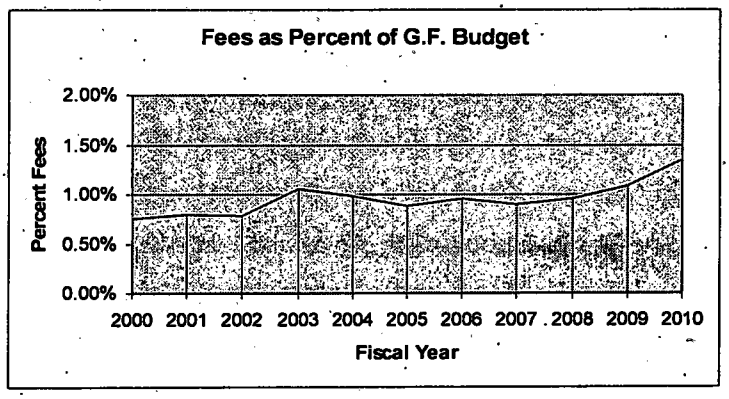
General Assembly Oversight of Agency Fees

- General Assembly has the sole authority to appropriate fee revenue (NC Constitution, Art. 5, Sec. 7)
  - Nontax Revenue (General Fund Availability)
  - Agency Receipts (Off-sets General Fund Requirements)
  - Special Funds

Fees Included in General Fund Availability



Fee Revenue as Percent of Total General Fund Availability



Guidelines for Consideration

- NCSL fee study found increasing reliance on fees at the state and local level since late-1970s. Factors contributing to the trend:
  - Property tax revolt of 1970s and 1980s
  - Policymaker and voter acceptance of user fees
  - The effectiveness of fees in influencing behavior

Source: The Appropriate Use of User Charges in State and Local Government, NCSL, 1999

Guidelines for Consideration

- **User charges may be appropriate when government is performing a service that narrowly benefits an individual taxpayer, or for certain activities that compete directly with private sector providers**
- **User charges may be appropriate to provide market-based incentives to encourage or discourage the use of public resources**

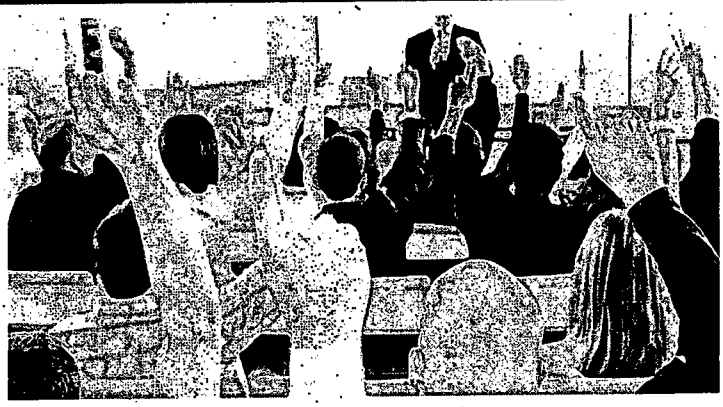
Source: The Appropriate Use of User Charges in State and Local Government, NCSL, 1999

Guidelines for Consideration

- Fee increases can impact low- and moderate-income citizens in greater proportion
- User charges may not be appropriate to fund services when states have a constitutional or statutory obligation to provide those services to all citizens
- User charges should cover the cost of the services provided; they should not generate excess revenues
- Fee conversion to tax

Source: The Appropriate Use of User Charges in State and Local Government, NCSL, 1999

Questions?



INTERIM JOINT HOUSE AND SENATE FINANCE COMMITTEES
State Legislative Building
Raleigh, North Carolina 27603

House Finance Committee *Senate Finance Committee*

November 4, 2009

Mr. Michael Mazerov
Center on Budget and Policy Priorities
820 First Street, NE, Suite 510
Washington, D.C. 20002

RE: Presentation to the Interim Joint House and Senate Finance Committees

Dear Mr. Mazerov:

This letter confirms your invitation to appear before the interim Joint House and Senate Finance Committee (Committee) at its meeting on Tuesday, December 1, 2009. The meeting is scheduled to begin at 10:00 a.m. and will be held in Room 643 of the Legislative Office Building in Raleigh, North Carolina.

Your role at the meeting is to provide an overview of options and issues related to an expansion of the sales tax base to services and answer any questions from members of the Committee.

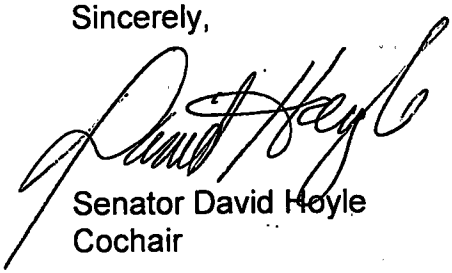
The Committee will reimburse your travel expenses for surface transportation to your airport of departure and from that airport to your home or office upon your return; round trip coach class airfare to Raleigh, North Carolina; surface transportation from Raleigh-Durham International Airport to your hotel and return; and one round trip between your hotel and the Legislative Office Building in downtown Raleigh. The Committee will reimburse you for up to two nights of overnight lodging if required and for meals at the rate allowed for employees of the State of North Carolina while in out-of-state status. We will need documentation in the form of original receipts for airfare, lodging expenses, and surface transportation, so please save your receipts. Receipts are not required for meals because the reimbursement amount is fixed. DeAnne Mangum, Committee Clerk, will assist you with your reimbursement.

Please bring at least **100** copies of any written materials that you wish to distribute to the Committee. As an alternative, we will be happy to make copies here if you will provide us with an electronic copy of the written materials by noon on Monday, November 30. A PowerPoint projector, laptop computer and screen will be available in

the meeting room. PowerPoint presentations are not expected, but are welcome. Your presentation can be preloaded if you send it electronically or you may bring your presentation on a jump drive or on a CD. Please contact DeAnne Mangum (**DeAnne.Mangum@ncleg.net**) by Monday, November 30 if you plan on using PowerPoint during your discussion.

We appreciate your willingness to attend this meeting and look forward to your presentation to the Committee. Please let us know if we may be of any assistance in connection with your appearance before the Committee.

Sincerely,



Senator David Hoyle
Cochair

cc: The Honorable Paul Luebke, Cochair
The Honorable Pryor Gibson, Cochair
The Honorable William Wainwright, Cochair
The Honorable Jennifer Weiss, Cochair
The Honorable Dan Clodfelter, Cochair
The Honorable Clark Jenkins, Cochair
Cindy Avrette, Committee Counsel
Sabra Faires, Senate Tax Counsel
Canaan Huie, House Tax Counsel
Rodney Bass, General Accounting Supervisor