

## **1996 Tax Law Changes**

### **1996 Second Extra Session**

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Chapter 13, 1996 Second Extra Session (House Bill 18, Representative Gray)

#### **AN ACT TO REDUCE TAXES FOR THE CITIZENS OF NORTH CAROLINA AND TO PROVIDE INCENTIVES FOR HIGH QUALITY JOBS AND BUSINESS EXPANSION IN NORTH CAROLINA**

This act is the William S. Lee Quality Jobs and Business Expansion Act. It represents the major tax reduction legislation passed in 1996 by the 1995 General Assembly. The act cuts taxes by \$186.5 million in fiscal year 1997-98. This act, coupled with the 1995 tax cuts, reduce taxes by more than \$624 million in fiscal year 1997-98. The act does many things: it reduces the sales tax on food, reduces the corporate income tax, provides tax credits for quality jobs and business expansion, phases out the excise tax on soft drinks, modifies the bundled transaction sales tax, reduces inheritance and gift taxes, creates a nonitemizer charitable contribution tax credit, excludes certain severance pay from income tax, and reduces the sales tax on farm and industry fuel. Other major tax cuts were made in Senate Bill 6, ratified as Chapter 14 of the 1996 Second Extra Session, in House Bill 30, ratified as Chapter 19 of the 1996 Second Extra Session, and in House Bill 53, ratified as Chapter 18 of the 1996 Second Extra Session.

#### **Reduce Sales Tax on Food**

Under current law, food stamp items that are purchased with food stamps are exempt from both State and local sales taxes, and food stamp items that are not purchased with food stamps are subject to both the State 4% sales tax and the local 2% sales tax. Effective January 1, 1997, this act reduces the State sales tax on food stamp items from 4% to 3% but does not repeal or reduce the local sales tax on these items. This part of the act reduces General Fund revenues by \$36.7 million in fiscal year 1996-97 and by \$87 million in fiscal year 1997-98.

Federal law determines what can be purchased with food stamps and, therefore, what would be exempt from State sales tax under this act. Food stamps can be used to purchase the following from a retailer that has decided to

participate in the food stamp program: food for humans for home consumption, seeds and plants for use in gardens to produce food for human consumption, and certain meals served by meal delivery services and communal dining facilities.

Examples of food items that would be exempt are fruits, vegetables, bread, meat, fish, milk, snack foods such as candy, gum, soft drinks, and chips, distilled water, ice, tomato plants, fruit trees, and cold prepared food for home consumption. Items that are not considered food items under federal law and would therefore remain subject to tax include alcoholic beverages, tobacco products, pet food, prepared foods that are hot at the point of sale and are therefore ready for immediate consumption, such as a broiled chicken kept in a heated display case, and food, such as a hamburger, a pastry, or soup, that is marketed to be heated on the premises of the retailer in a microwave oven or other heating device.

Food has been subject to sales tax in North Carolina since 1961. From the enactment of the sales tax in 1933 until 1961, either essential food items or food purchased for home consumption was exempt, except during the two years from 1935 to 1937.

### **Reduce Corporate Income Tax**

Part II of the act reduces the corporate income tax rate from 7.75% to 6.9% over a four-year period, beginning with tax year 1997. This part of the act will reduce General Fund revenues by \$14.2 million in fiscal year 1996-97, \$46.2 million in fiscal year 1997-98, \$79 million in fiscal year 1998-99, \$103.2 million in fiscal year 1999-2000, and \$110.2 million in fiscal year 2000-01. The act also adjusts the percentage of corporate tax revenue that is automatically credited to the Public School Building Capital Fund to keep the amount of revenue that goes to this Fund at its current level.

Until 1987, North Carolina's corporate income tax rate was 6% of a corporation's State net income. In 1987, as part of a tax package that included repeal of the property tax on inventories, the corporate income tax was increased to 7%. One-half of the additional 1% was dedicated to public school capital needs. In 1991, as part of a legislative package that cut spending and raised revenues to make up a \$1.2 billion shortfall, the corporate income tax rate was increased to 7.75% and a 4% surtax was enacted. The surtax was phased out over four years and expired January 1, 1995.

### **Quality Jobs and Business Expansion Tax Credits**

The act establishes several tax incentives to encourage new and expanding businesses and a general business tax credit that will be more beneficial for small and existing businesses. With the exception of the worker training tax credit, the tax credits become effective for taxable years beginning on or after January 1, 1996, and apply to property placed in service and jobs created on or after August 1, 1996, and to research and development expenditures made on or after July 1, 1996. The worker training credit becomes effective January 1, 1997, and applies to training expenses made on or after July 1, 1997.

All of the credits are allowed against either the franchise tax or the income taxes; they may not exceed 50% of the tax against which they are claimed for the taxable year, and any unused credit may be carried forward for the succeeding five years. It is estimated that the credits will reduce General Fund revenues by more than \$19 million in fiscal year 1997-98; this loss will increase to more than \$72 million by fiscal year 2000-01. Reports will be submitted each year detailing the number of credits claimed, the number of new jobs created, the cost of tangible personal property with respect to which credits were claimed, and the costs to the General Fund of the credits claimed. The credits will expire January 1, 2002.

The tax incentives for new and expanding businesses were part of the Governor's proposals for economic development and were designed and recommended by the Governor's Economic Development Board. They include expansion of the current jobs tax credit and establishment of new tax credits for worker training expenses, for increasing research activities, and for investing in machinery and equipment. To be eligible for the credits, a taxpayer must engage in manufacturing or processing, warehousing or distributing, or data processing and the jobs must pay at least 10% above the average weekly wage in the county where the job is created.

The act expands the current jobs tax credit to include all 100 counties, to include data processing and warehousing and distribution jobs, to include employers with five or more employees, to apply to corporate franchise tax as well as corporate and individual income tax, and to significantly increase the amount of the credit for the most distressed counties. The current credit applies to 50 counties, is limited to manufacturing and processing jobs, is limited to employers with nine or more employees, is limited to corporate and individual income tax, and is a set amount (\$2,800) in all 50 counties. The act divides the counties into five "enterprise tiers" based on their per capita income, unemployment rate, and population growth. The ten poorest counties are in tier one and the next fifteen counties are in tier two. The remaining seventy-five counties are divided evenly among tiers three, four, and five. The jobs tax credit is \$12,500 for each eligible new job created in an enterprise tier one area, \$4,000 in

a tier two area, \$3,000 in a tier three area, \$1,000 in a tier four area, and \$500 in a tier five area.

The worker training tax credit applies to expenses to train an employee for whom a jobs tax credit is allowed. The credit is 50% of the eligible training expenses, not to exceed \$1,000 per worker in enterprise tier one counties and \$500 per worker in other counties. The eligibility of training expenses is certified by the Community College system based on existing requirements for State-funded training for new and expanding industry.

The research and development tax credit uses the federal credit as its starting point. The credit is equal to 5% of eligible expenses incurred in North Carolina. Congress has reenacted the federal research and development credit for the period July 1, 1996, to June 30, 1997.

The credit for investment in machinery and equipment applies to property placed in service in this State and capitalized by the taxpayer for tax purposes under the Code. The credit is 7% of the cost of the taxpayer's net new investment that exceeds the county's threshold amount. The threshold amount varies depending on the county's enterprise tier, as indicated in the following table:

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Tier One	\$ -0-
Tier Two	100,000
Tier Three	200,000
Tier Four	500,000
Tier Five	1,000,000

The credit must be taken in seven equal installments, beginning the year after the equipment is placed in service.

The act also provides a tax credit for investing in tangible personal property that is used by the taxpayer in connection with a business or for the production of income and is capitalized by the taxpayer for tax purposes under the Code. The amount of the credit is 4.5% of the cost of the property placed in service, not to exceed \$4,500 per taxpayer per year. The credit must be taken in five equal installments beginning in the year the property is placed in service. This credit is less restricted than the credit for investment in machinery and equipment in that there is no minimum wage requirement, no minimum amount of investment requirement, and no type of business requirement.

The act provides several benefits for the ten poorest counties, which are in enterprise tier one. These counties will have access to a special Utility Account within the Industrial Development Fund of the Department of Commerce. The General Assembly appropriated \$2 million to this account in the Current Operations Appropriations Act of 1996. The money in the Utility Account can be used for construction or improvements to new or existing water, sewer, gas, or electrical utility distribution lines or for existing, new, or proposed industrial buildings to be used in manufacturing and processing, warehousing and distribution, or data processing. Enterprise tier one counties will also be exempt from local match requirements for Industrial Development Fund grants and loans and Community Development Block Grants Economic Development grants and loans. To the extent practical, they will receive priority consideration for Community Development Block Grant Economic Development financing.

The act also expands the Industrial Development Fund program in all counties by increasing the maximum grant or loan from \$2,400 per job to \$4,000

per job, and from \$250,000 per project to \$400,000 per project. Finally, the act directs the Department of Commerce to annually review the level of development in each of the State's multi-county economic regions and to strive for balance and equality of development within each region.

### **Phase Out Soft Drink Tax**

During the 1995 Regular Session, the General Assembly reduced the excise tax on soft drinks by 25%, effective July 1, 1996. This act continues the reduction started in 1995 by phasing out the tax over a three-year period, beginning July 1, 1997. This part of the act, when fully implemented in fiscal year 1999-2000, will reduce General Fund revenues by \$31.8 million.

The soft drink excise tax was enacted in 1969. The purpose of the tax is to provide an additional source of revenue to the General Fund. A soft drink is defined as a beverage that is not an alcoholic beverage. An alcoholic beverage is a beverage containing at least 0.5% alcohol.

### **Modify Bundled Transaction Sales Tax**

This part of the act specifies how the amount of State and local sales and use tax due on a "bundled transaction" is to be calculated. Its primary application is in the taxation of cellular phones transferred at no cost or substantially below cost in conjunction with agreements to obtain cellular phone service for a specified minimum period of time. The provision becomes effective November 1, 1996, and is expected to reduce General Fund revenues by \$6.7 million a year and local government revenues by \$3.3 million a year.

As defined in the act, a "bundled transaction" is one in which an item, such as a cellular phone, is transferred without charge or below the seller's cost on condition that the purchaser enter into an agreement to purchase services for at least six months and to pay a cancellation fee if the purchaser cancels the service agreement before the end of the minimum period. Under current law, when an item is transferred in a bundled transaction, the seller is liable for use tax computed on the wholesale cost of the item. If, for example, a retailer gives a phone away in conjunction with a service agreement or sells a phone for \$1 in conjunction with a service agreement and the wholesale cost of the phone to the retailer is \$100, a tax of \$6 (6% of \$100) is due. To base the tax due on the amount charged for the item would produce the anomalous result that \$6 use tax is due if the retailer gives the phone away but only 6¢ sales tax is due if the retailer "charges" \$1 for the phone.

Under the act, tax is due on any price, such as \$1, charged for the item when the transaction occurs and is due on the difference between the price charged and the normal retail price of the item only if the services the purchaser agrees to receive are not subject to a tax of at least 6%. If the services the purchaser agrees to receive are subject to a tax of at least 6%, no tax is due on the balance of the retail price of the item transferred unless the purchaser cancels the service agreement and is required to pay the cancellation fee. If this occurs, tax is due on the amount of the cancellation fee.

The effect of the act is to exclude part or all of the retail price of a cellular phone from sales and use tax when the phone is transferred in a bundled transaction. This would occur because telephone service is subject to a tax of at least 6% (State sales and use tax combined with State gross receipts franchise taxes). Cellular phones sold in transactions that are not bundled with service agreements would continue to be subject to State sales and use tax based on the retail price and the telephone service acquired to use the phone would also be taxed. Thus, under the act, if a person is charged \$1 in a bundled transaction for a cellular phone that has a wholesale value of \$100 and a retail value of \$160, the person will pay tax of 6¢ (6% of \$1). If that person buys the same phone in a transaction that is not bundled, the person will pay tax of \$9.60 (6% of \$160). Under current law, the person would pay \$6 tax in the bundled transaction and \$9.60 in the unbundled transaction.

### **Reduce Inheritance and Gift Taxes**

This part of the act increases the Class A inheritance tax credit from \$26,150 to \$33,150, adopts the federal estate and gift tax provisions on qualified terminable interest trusts, prevents a double deduction for certain administrative expenses, and allows for the installment payment of inheritance taxes on closely held businesses and farms. The inheritance and gift tax changes become effective January 1, 1997, and apply to the estates of decedents dying on or after that date and to gifts made on or after that date. The changes will reduce General Fund revenues by \$3.5 million a year beginning in fiscal year 1997-98.

North Carolina inheritance and gift tax rates are based on the relationship of the person transferring the property to the person receiving the property. State law classifies beneficiaries into three classes, Class A, Class B, and Class C, and sets different tax rates for each class. A Class A beneficiary is a lineal ancestor, a lineal descendant, an adopted child, a step-child, or a son-in-law or daughter-in-law whose spouse is not entitled to any of the decedent's property; a Class B beneficiary is a sibling, a descendant of a sibling, or an aunt or uncle by blood; and a Class C beneficiary is anyone who is not a Class A or Class B beneficiary. Class A beneficiaries have the lowest tax rates, Class B beneficiaries have higher

rates, and Class C beneficiaries have the highest rates. Thus, North Carolina's rate structure favors transfers to children and parents by giving these transfers the lowest rates and prefers transfers to other close family members over transfers to more distant relatives or to persons who are not related by giving these transfers the in-between rate.

North Carolina's inheritance and gift tax laws are in contrast to federal law, which has a single rate schedule for gifts and estates. As under federal law, however, all transfers to a spouse are exempt from State inheritance and gift taxes. The Revenue Laws Study Committee recommended to the 1996 General Assembly that the current inheritance tax be phased out over five years and that the federal "pick-up" tax, which is the federal state death tax credit, be retained as the State estate tax.

The 1996 General Assembly did not choose to phase out the tax, but it did increase the Class A beneficiary inheritance tax credit so that the amount exempted by the credit would be the same as the amount that is exempted from federal estate and gift taxes by application of the federal unified credit. The federal unified credit is \$192,800, which exempts \$600,000 of property from federal estate or gift taxes. The federal credit is unified in that it applies to both federal estate and gift taxes. Any part of the credit that is not used on gift taxes is applied to estate taxes.

The State Class A inheritance tax credit is not a unified credit. It does not apply to State gift taxes. State law provides a separate \$100,000 lifetime exemption for gifts made to Class A beneficiaries. Under current law, therefore, the combination of the State gift tax lifetime exemption for Class A beneficiaries and the Class A inheritance tax credit exempts the same amount of property as the federal unified credit. Under this act, the increase in the Class A inheritance tax credit to \$33,150 will exempt an additional \$100,000 from inheritance tax. If a person fully uses both the State \$100,000 gift tax lifetime exemption and the State Class A inheritance tax credit, the person can exempt more property from gift and inheritance taxes under State law than under federal law.

The act further conforms to federal law by exempting from State inheritance and gift tax property that is exempt from federal estate and gift taxes because it is considered qualified terminable interest property (QTIP property). Conforming to federal law on this topic will provide consistent treatment at the federal and State level. Also, because this type of property is more like an outright transfer to a spouse than it is like any other kind of transfer, this act intends to further the State's policy of exempting transfers to spouses from inheritance or gift tax by providing that no inheritance tax will be due until the



spouse subsequently dies and passes the property on to the ultimate beneficiaries.

QTIP property is property placed in a trust in which a person's spouse has an income interest for life and the person's children or other designated beneficiaries have a remainder interest. Under federal law, a transfer of property that qualifies as QTIP property is not taxable when the transfer is made. Instead, it is taxed when the spouse who had the lifetime income interest in the property dies. At that time, the value of the QTIP property is included in the spouse's gross estate.

Under current North Carolina law, when property is transferred by means of a QTIP trust, two transfers are considered to have been made. One transfer is the transfer to the spouse of a life estate in the trust income. The transfer of the life estate to the spouse is not taxed because all property that passes to a spouse is exempt from State inheritance and gift taxes. The value of the spouse's life estate is the present value of the stream of income based on the life expectancy of the spouse. The other transfer is a transfer of the remainder interest in the trust property to the transferor's children or other designated beneficiaries. The transfer of the remainder interest is subject to inheritance or gift tax. The value of the remainder interest is its present value as of the date of death or date of the gift.

Under this act, the remainder interest in QTIP property would no longer be taxable under North Carolina law when the QTIP trust is established. Instead, it would be taxable when the spouse with the life estate in the income died and would be taxed on the basis of the value at the spouse's death. In some cases, taxes would be collected at a later time than under current law, but in other cases less tax would be collected than under current law. Further reductions in tax would occur if the value of the trust property declined over time. No tax would be collected at a later date if the spouse moved out of the State before death and the trust consisted of securities rather than real property located in the State. By the same token, some tax would be collected that is not now collected if a spouse with a QTIP trust moves into the State.

A QTIP trust need not be established before a gift is made or the decedent dies. If the transfer is a gift, the trust can be established any time before the gift tax return is filed. If the transfer is a devise upon death, the trust can be established any time before the estate tax return is due if the will gives the personal representative the option of establishing a QTIP trust. The decision of whether or not to establish a QTIP trust is made after considering tax consequences and other factors.

Current law allows the costs of administering an estate to be deducted when determining the amount of inheritance tax payable on property in the estate. Costs of administration include attorney fees, accountant fees, and executor fees. The law, however, does not limit the inheritance tax deduction to costs that are not deducted on a fiduciary income tax return filed for the estate. If the same cost is deducted on both returns, the taxpayer receives an unintended double deduction for the same item.

A double deduction for the same item of cost is most likely to result when, because of the small size of an estate, no federal estate tax return is filed but a federal fiduciary income tax return is filed. In this instance, all costs will be deducted on the federal fiduciary income tax return.

North Carolina's income tax uses federal taxable income as the starting point in computing North Carolina taxable income. A result of this is that deductions taken on the federal return are automatically passed through on the North Carolina return. Thus, any item that is deducted on the federal fiduciary income tax return is also deducted on the State fiduciary income tax return. To prevent a double deduction, this act prohibits the deduction of an item on an inheritance tax return if the item was deducted on the federal fiduciary income tax return.

Finally, this part of the act allows for the installment payment of inheritance taxes on closely held businesses and farms if the personal representative of the estate elects under section 6166 of the Internal Revenue Code to make annual installment payments of federal estate tax. Payments are due at the same time and in the same proportion to the total tax due as payments due to the Internal Revenue Service under section 6166 of the Code. An acceleration of federal payments will also accelerate the North Carolina payments.

### **Nonitemizer Charitable Contribution Tax Credit**

This part of the act creates an individual income tax credit for charitable contributions made by individuals who do not itemize their deductions. The credit is 2.75% of the amount of charitable contributions that exceed 2% of the individual's adjusted gross income. Two percent is the average percentage of income that North Carolinians contribute to nonprofits. By setting the floor at 2%, the act encourages and acknowledges giving that is above average. It is effective for taxable years beginning on or after January 1, 1997, and will reduce General Fund revenues by approximately \$5 million a year.

Under the federal Internal Revenue Code, an individual who itemizes deductions may deduct contributions to nonprofit charitable organizations. Individuals who elect the standard deduction, however, may not deduct charitable contributions. An individual's North Carolina's income tax is based on the federal calculation of taxable income, with some adjustments. The federal disallowance of charitable deductions for nonitemizers is "piggybacked" by North Carolina tax law, so there is no income tax incentive under federal or North Carolina law for nonitemizers to make charitable contributions. Legislation was introduced in Congress to allow nonitemizers to deduct charitable contributions. If federal legislation were enacted, North Carolina could "piggyback" the federal tax incentive. However, the federal legislation did not pass.

Individuals who elect the standard deduction are those whose total itemized deductions (such as mortgage interest, State and local property and income taxes, medical expenses, and charitable contributions) do not exceed the standard deduction amount. The amount of the standard deduction varies depending upon the individual's filing status. The North Carolina standard deduction amounts for 1996 are \$5,000 for a married couple filing a joint return; \$4,400 for a head of household; \$3,000 for single taxpayer; and \$2,500 for a married taxpayer filing separately. Approximately 71% of North Carolina taxpayers elect the standard deduction.

This provision was one of the recommendations of the House of Representatives' Select Committee on Nonprofits; it is intended to increase charitable giving. The Committee studied the question of whether tax incentives make a difference in charitable giving and learned that federal tax incentives probably do but State tax incentives probably do not because the State income tax is so low compared to the federal income tax that it does little to influence individuals' economic decisions. The Committee believed, however, and the General Assembly agreed, that State incentives may affect perceptions, and thus behavior, even if the tax is too small to provide a significant economic incentive.

#### **Exclude Certain Severance Pay from Income Tax**

This part of the act exempts from State individual income tax severance pay a taxpayer receives due to the permanent closure of a manufacturing or processing plant, not to exceed a maximum of \$35,000 for the taxable year. This part is effective for taxable years beginning on or after January 1, 1996. The exemption will reduce General Fund revenues by approximately \$4 million a year.

#### **Reduce Sales Tax On Fuel Used By Farmers and Industry**

This part of the act reduces the sales tax rate on electricity and piped natural gas used by farmers, manufacturers, laundries, and dry cleaners from 3% to 2.83%, effective August 1, 1996. This change affects General Fund revenue but not local revenue because no local sales tax applies to electricity and piped natural gas. It will reduce General Fund revenue by over \$5 million dollars a year.

Chapter 14, 1996 Second Extra Session (Senate Bill 6, Senator Kerr)

**AN ACT TO PROVIDE TAX REFORM AND TAX RELIEF FOR THE CITIZENS OF NORTH CAROLINA BY REPEALING THE UNCONSTITUTIONAL CORPORATE TAX CREDIT FOR NORTH CAROLINA WINE, REPEALING THE UNCONSTITUTIONAL CORPORATE TAX DEDUCTION FOR NORTH CAROLINA DIVIDENDS, REPEALING THE UNCONSTITUTIONAL INDIVIDUAL INCOME TAX CREDIT FOR NORTH CAROLINA DIVIDENDS, REVISING THE UNCONSTITUTIONAL TAX CREDIT FOR QUALIFIED BUSINESS INVESTMENTS, CLARIFYING THE TAX TREATMENT OF REFUNDS OF UNCONSTITUTIONAL TAXES, CLARIFYING THE SALES AND USE TAX TREATMENT OF ITEMS GIVEN AWAY BY MERCHANTS, PROVIDING THE SECRETARY OF REVENUE AUTHORITY TO IMPROVE USE TAX COLLECTION, EXEMPTING FROM SALES AND USE TAX INVENTORY THAT IS DONATED BY A MERCHANT TO A CHARITABLE NONPROFIT ORGANIZATION, AND REPEALING MOST STATE PRIVILEGE LICENSE TAXES.**

This act contains several different provisions recommended to the 1995 General Assembly by the Revenue Laws Study Committee. It repeals or revises four North Carolina tax provisions that the Committee identified as having the same flaw as the intangibles tax stock deduction that was declared unconstitutional by the United States Supreme Court in the Fulton decision. In addition, it clarifies the tax treatment of refunds of unconstitutional taxes, extends the time a taxpayer has to challenge the unconstitutionality of a tax from 30 days to one year, enables the State to enter into agreements to accept voluntary payments of State and local use tax, directs the Department of Revenue to instruct mail-order companies to obtain the purchaser's county of residence for proper allocation of use tax revenue, clarifies the sales tax treatment of items given away by merchants, exempts from sales and use tax tangible personal property that is donated by a manufacturer or retailer to a nonprofit

organization for a charitable purposes, and repeals most State privilege license taxes. The act results in a revenue gain for the General Fund of approximately \$18.27 million in fiscal year 1996-97. After the privilege license repeal becomes effective in 1997, the act will increase General Fund revenues by only about \$2 million a year.

### **Unconstitutional Tax Preferences**

The tax preferences addressed in Part I of the act are:

(1) The current \$300 individual income tax credit for dividends received from North Carolina companies: Effective for the 1996 tax year, the act repeals this credit.

(2) The \$15,000 corporate income tax deduction for dividends received from North Carolina companies: Effective for the 1996 tax year, the act repeals this deduction.

(3) The income tax credits for investing in North Carolina Enterprise Corporations and for qualified business investments in North Carolina companies: The act repeals the credit for investing in North Carolina Enterprise Corporations and the corporate income tax credit for qualified business investments, effective for investments made on or after January 1, 1997. It restricts the remaining tax credits for qualified business investments to those made by individuals or small partnerships directly in qualified businesses and removes the requirement that qualified businesses be headquartered and operating in North Carolina, effective for investments made on or after January 1, 1997. It also caps the credits at \$6 million a year, effective for investments made on or after January 1, 1996.

(4) The North Carolina income tax credit for distributing North Carolina wine: The act repeals this credit effective for the 1996 tax year.

There is no disagreement on whether these tax preferences are flawed. The Attorney General's Office advised the Department of Revenue that, if the General Assembly did not resolve the constitutional problems with these preferences, the Department of Revenue had the option of either denying the preferences to North Carolina companies or extending the preferences to all out-of-state companies. Enforcing the preferences as written on the books was not an option because of the risk of personal liability on the part of Department of

Revenue personnel in enforcing provisions that were so clearly flawed in the wake of the Fulton decision.

One unconstitutional tax preference identified by the Revenue Laws Study Committee that is not addressed in this act is the 100% deduction allowed to North Carolina parent companies for subsidiary dividends received by them with no requirement that expenses be deducted from the tax-free income. Out-of-state parent companies are allowed an exclusion for subsidiary dividends but are required to adhere to the basic tax principle that expenses incurred to generate the tax-free dividend income cannot also be deducted. The Revenue Laws Study Committee recommended revising this preference to apply the basic tax principle to in-state parent companies. However, this provision is omitted from this act. Inaction on this item by the General Assembly will result in a revenue loss of approximately \$3.5 million annually because the Department of Revenue will probably extend the current preference for in-state parents to out-of-state parents.

Part I of this act also extends the time a taxpayer has to challenge the unconstitutionality of most taxes from 30 days to one year, effective for taxes paid on or after November 1, 1996. The time limit remains at 30 days for excise taxes on alcoholic beverages, soft drinks, tobacco products, and controlled substances. In North Carolina, if a taxpayer believes a tax is unconstitutional, the taxpayer must pay the tax and contest the tax by requesting a refund within 30 days after paying the tax. This procedure is known as "paying under protest". The North Carolina Supreme Court has upheld the constitutionality of the State's 30-day rule and the United States Supreme Court, by deciding not to hear the case, upheld the State court's ruling.

States that require a taxpayer to contest a tax by paying under protest are called "postdeprivation remedy" states. Most postdeprivation remedy states have a statute of limitations that is longer than 30 days. The most common statute of limitations utilized by the postdeprivation remedy states is known as the "three-year/two-year" rule. Under this rule, in order for a taxpayer to recover a refund of money paid under a tax later declared to be illegal, the taxpayer must have filed for a refund within three years after the date that the taxpayer filed the return, or two years after the date the taxpayer paid the tax, whichever is later. South Carolina recently repealed its 30-day rule and replaced it with a three-year rule.

Finally, Part I of this act clarifies the tax treatment of refunds of unconstitutional taxes and other similar recoveries. Under Section 111 of the Code, if a taxpayer recovers an amount that the taxpayer had previously deducted, the taxpayer must add the amount of the recovery back to gross

income. The typical example is a State income tax refund, which must be included in gross income if the taxpayer deducted it as an itemized deduction. The principle is that if the taxpayer received a tax benefit from deducting an expenditure, when the expenditure is refunded to or recovered by the taxpayer, the taxpayer should give back the corresponding tax benefit. This adjustment normally carries through from the Code to North Carolina income tax statutes because North Carolina piggybacks the Code. In some situations, such as the alternative minimum tax, however, North Carolina does not piggyback the Code. A refund or recovery might represent a tax benefit under the Code but not North Carolina law, or vice versa. This part of the act provides consistency in requiring State add-backs of only those refunds and recoveries that represent State tax benefits. It prevents situations in which a taxpayer would receive a double deduction or be subject to double taxation because a refund (of an unconstitutional tax, for example) represented a tax benefit under the Code but not State law, or vice versa.

### **Sales and Use Tax**

Part II of this act makes three changes to the State's sales and use tax laws, effective August 1, 1996:

- (1) It enhances compliance and enforcement of existing sales and use tax laws by authorizing the Department of Revenue to enter into agreements to accept voluntary payments of State and local use tax and by directing the Department of Revenue to instruct mail-order companies to obtain the purchaser's county of residence for proper allocation of use tax revenue.
- (2) It clarifies the sales tax treatment of items given away by merchants.
- (3) It exempts from sales and use tax tangible personal property that is donated by a manufacturer or retailer to a nonprofit organization for a charitable purpose.

The State cannot require a mail-order marketer to collect and remit the use tax owed this State on sales to North Carolina residents unless the marketer has a store in North Carolina or other ties sufficient to give the State jurisdiction over it. If the direct marketer does business with North Carolina residents only through telephone, mail, and freight transactions, it does not have "nexus" with this State and is not required to collect the tax. The United States Supreme Court has held that states' efforts to require these out-of-state marketers to collect sales

or use tax on sales to residents violate the interstate commerce clause of the United States Constitution.

As a result of these constitutional restrictions, out-of-state direct marketers have a competitive advantage over in-state merchants, and states lose significant amounts of revenue. Some direct marketers collect and remit use taxes voluntarily as a convenience to their customers. The Direct Marketers Association, the Federation of Tax Administrators, and the Multi-state Tax Commission are currently negotiating a possible agreement under which more direct marketers would voluntarily collect use tax on behalf of customers in states in which the marketers do not have nexus. Under this agreement, tax collection would be simplified by using the same form and payment deadlines in every state. In addition, the direct marketers would collect at only one rate per state; non-uniform county and city rates would be disregarded. If these parties are able to design a system that would be acceptable to all involved, North Carolina would need authority to enter into such an agreement. The act would provide that authority and set out some of the parameters for the agreement. If the ongoing negotiations result in a viable multi-state program for collection of use taxes by direct marketers and North Carolina enters into agreements pursuant to the program, the Department of Revenue could potentially collect millions of dollars in use taxes that are owed under current law but are not being paid.

The act also clarifies the sales tax treatment of items given away by merchants. It provides that property given away or otherwise used by a merchant is not exempt from use tax, except in the case of restaurants and caterers that give free meals to employees or free bar food to patrons and in the case of retailers that give a free item of inventory to a customer on the condition that the customer purchase similar or related property. As under former law, free books of matches would not be subject to use tax if they are given away along with the sale of cigarettes; matches given away where cigarettes are not sold would remain subject to use tax.

A general sales and use tax principle is that a wholesale merchant or retailer who gives away products free of charge instead of selling them is liable for use tax on the products. The use tax, first enacted in 1939, is the complement of the sales tax and applies to the storage, use, or consumption in this State of tangible personal property. A merchant is liable for the use tax on property it uses in its business, whether furniture, equipment, decor, or promotional giveaways. Items sold by a merchant, however, are not subject to use tax because sales tax will apply when the items are sold at retail.



There are some gray areas in determining whether a product is sold or is given away. For example, if a merchant has a "buy one, get one free" sale, both items are considered sold for the price of the first one. Although the second item appears to be given away, in fact both items are being sold at a discounted price. Another example is paper napkins, catsup, and other items that accompany and are consumed along with meals. These items are considered sold as part of the meal.

Until 1993, the following items were considered used, not sold, and thus subject to use tax: meals provided free to the merchant's employees, food given away to the merchant's patrons, and matches given away to patrons, other than matches given along with the sale of cigarettes. A group of restaurants appealed the assessment of this tax, claiming that in their case these items should be considered sold. The restaurants were selling meals to patrons and, at the same time, giving some of the food to employees as meals and some to patrons as "bar food" such as chips. In addition, free books of matches were provided to patrons for use in the restaurant.

The North Carolina Court of Appeals agreed with the restaurants that these items should be considered sold along with the food the restaurant sold as part of its business. In its opinion, the court reasoned that the cost of these items was recovered by the sale of other items. This rationale could arguably be applied in a very broad way to mean that the cost of all of a merchant's purchases should be exempt from sales and use tax because they are covered by the price of sold items; a merchant's profits from its sales generate the funds to purchase furniture, equipment, decorations, and other items. Thus, taken literally, the court ruling could be interpreted to eliminate the use tax altogether for merchants.

Finally, Part II of the act includes a new sales and use tax exemption for tangible personal property that is donated to a nonprofit organization by a retailer or a wholesale merchant. Under current law, medicine and certain food donated to a nonprofit organization to be used for a charitable purpose are exempt from sales and use tax. This act repeals these two exemptions since they become redundant in light of the new, and broader, exemption created by it.

Under current law, a wholesale merchant or retailer who donates products to a nonprofit organization instead of selling them is liable for the sales and use tax. A wholesale merchant or retailer does not pay sales or use taxes when purchasing the products or the ingredients used to manufacture the products because the products are to be resold. Sales and use taxes do not apply to property purchased for resale or ingredients purchased to manufacture products for resale. If the wholesale merchant or retailer chooses not to sell the

goods, the wholesale merchant or retailer becomes liable for use tax on the goods because the resale exemption no longer applies. This is true no matter what the company chooses to do with the products. The act eliminates this liability for use tax by providing a specific exemption for tangible personal property purchased or manufactured by a wholesale merchant or retailer for resale and then withdrawn from inventory and donated to a nonprofit organization, contributions to which are deductible as charitable contributions for federal income tax purposes.

### **Repeal of Most Privilege License Taxes**

Part III of this act repeals most of the State privilege license taxes imposed under Article 2 of Chapter 105 of the General Statutes, effective July 1, 1997. This Part will reduce General Fund revenues by about \$11 million a year. The only privilege taxes retained are the taxes imposed by G.S. 105-37.1 (amusements); 105-38 (circuses and similar shows); 105-41 (professionals); 105-83 (installment paper dealers); 105-88 (loan agencies or brokers); 105-102.3 (banks); and 105-102.6 (newsprint publications). The tax on professionals was retained because its repeal would reduce General Fund revenues by more than \$3 million a year. The other taxes were retained because they have a gross receipts or other variable element (amusements, circuses, installment paper dealers, banks), are related to a tax that is retained (loan agencies), or were enacted for a regulatory purpose (newsprint publications).

The act preserves the status quo on privilege license taxation for cities and counties. Cities have general authority to impose privilege license taxes unless limited by Article 2; counties have no general authority to impose these taxes but are authorized by Article 2 to levy some specific taxes. The act provides that the current limitations and authorizations in Article 2 that apply to cities and counties will continue to apply. The act also preserves the itinerant merchant regulatory provisions but moves them to Chapter 66 of the General Statutes, Commerce and Business.

The Revenue Laws Study Committee found that the privilege license tax structure in Article 2 of Chapter 105 of the General Statutes is outmoded, inefficient, and not designed on proper principles of taxation such as tax fairness, ability to pay, responsiveness to growth, or administrative cost. There is no rationale for a tax on the privilege to work that applies only to a limited portion of businesses or the work force and that has a different and inconsistent tax rate for each different class of business. Because the tax is not indexed to any economic parameter, the cost to administer the tax has become increasingly high over time compared to the amount of tax collected. As a result, the tax has become more of a nuisance tax than a properly designed source of revenue for

the State. The Revenue Laws Study Committee plans to study the elimination of the remaining State privilege license taxes and reform of the provisions governing local privilege license taxes.

Chapter 18, 1996 Second Extra Session (House Bill 53, Representative Holmes)

**AN ACT TO MODIFY THE CONTINUATION  
BUDGET OPERATIONS APPROPRIATIONS ACT OF 1995,  
AND THE EXPANSION AND CAPITAL IMPROVEMENTS  
APPROPRIATIONS ACT OF 1995, AND TO MAKE OTHER  
CHANGES IN THE BUDGET OPERATION OF THE STATE.**

The Current Operations Appropriations Act of 1996 contains five tax law changes. It increases the property tax homestead exemption, modifies the State ports tax incentive, exempts milk drinks from the excise tax on soft drinks, allows the University of North Carolina Hospitals at Chapel Hill an annual refund of sales and use tax paid, and makes permanent the quarterly distribution of a portion of the excise tax on wine to the North Carolina Grape Growers Council.

The act expands the homestead exemption amount from \$15,000 to \$20,000 and increases the income eligibility amount from \$11,000 to \$15,000, effective for taxes imposed for taxable years beginning on or after July 1, 1997. Under the act, the State will reimburse the counties and cities 50% of the loss they incur as a result of these tax law changes for two years. This reimbursement will cost the General Fund \$3 million a year. The increase in the income eligibility amount will allow as many as 34,000 elderly and disabled homeowners to qualify for the homestead exemption who do not currently qualify. The increase in the homestead exemption amount will provide additional property tax relief to at least 155,000 elderly and disabled homeowners who currently qualify for the exemption.

The homestead exemption is a partial exemption from property taxes for the residence of a person who is either aged 65 or older or totally disabled and has an income of less than \$11,000. The current exemption amount is \$15,000. The exemption amount was last increased in 1993, when it was increased from \$12,000 to \$15,000. The income eligibility amount was last increased in 1987, when it was increased from \$10,000 to \$11,000. The income used to determine the income eligibility amount includes moneys received from every source other than gifts or inheritances received from a spouse, lineal ancestor, or lineal

descendant. For married applicants residing with their spouses, the income of both spouses is included, whether or not the property is in both names.

The revenue loss associated with this act will be borne equally between the local governments and the State for the first two years. Prior to 1987, local governments absorbed most of the cost of the homestead exemption. From 1987 to 1991, the State reimbursed counties and cities for 50% of their losses from the homestead exemption. In 1991, the General Assembly froze the amount of reimbursements made to local governments to the amount each city and county was entitled to receive in 1991. That amount is approximately \$7.9 million. No additional reimbursement was provided when the exemption amount was increased in 1993.

The act expands the State ports income tax credit to include the importing and exporting of forest products at the State-owned port terminal at Wilmington, effective for taxable years beginning on or after January 1, 1996. Forest products are a type of bulk cargo. Under current law, a taxpayer is not entitled to the income tax credit for bulk cargo imported or exported at the Wilmington terminal. This part of the act will reduce General Fund revenues by \$180,000 for fiscal year 1996-97.

Bulk cargo is a type of commodity that is loose and usually stock-piled. Examples of this type of commodity include coal, grain, salt, and wood chips. Break-bulk cargo and container cargo are different methods used to ship the same type of commodity. Commodities that are packaged in a metal trailer box that can be locked onto a tractor-trailer chassis and then detached and put on a ship without any other handling are considered "container cargo". Commodities that are packaged and stored on pallets or in cases that must be handled and stacked onto a ship by hand, crane, etc., are considered break-bulk cargo. Break-bulk cargo also includes machinery.

Under prior law, the income tax credit was available only for break-bulk cargo and container cargo imported or exported at the Wilmington terminal. The credit is available for bulk cargo, break-bulk cargo, and container cargo imported or exported at the Morehead City terminal. Since bulk cargo is generally imported and exported only at the Morehead City terminal, there has not been a need to extend the credit to this type of cargo at the Wilmington terminal. The credit is being narrowly extended to forest products because there is a customer at the Wilmington terminal who will be exporting wood chips and the Ports Authority believes all users of the Wilmington terminal should be entitled to the credit. The act does not extend the credit to all bulk products because the Wilmington terminal does not want to be seen as competing unfairly with other

terminals located in the Wilmington area that import or export other types of bulk products.

The amount of the tax credit allowed is equal to the amount of charges paid to the North Carolina Ports Authority in the taxable year that exceeds the average amount of charges paid to the Authority for the past three years. The credit is limited to 50% of the tax imposed on the taxpayer for the current year. Any excess credit may be carried forward and applied to the taxpayer's income tax liability for the next five years. The cumulative credit may not exceed one million dollars per taxpayer. The credit will expire in 1998.

The act also removes the requirement that a flavored milk drink must be registered with the Department of Revenue before it can be exempt from the excise tax on soft drinks and extends the exemption to cover all soft drinks that contain milk. This part of the act is effective retroactively to October 1, 1991. The act does not result in a significant revenue loss because:

- (1) Any assessments pending against a dairy that produces a flavored milk drink have not been paid and will not have to be paid under the provisions of this act.
- (2) Other registered flavored milk drinks are currently exempt and therefore are not paying any tax.

Under prior law, a flavored milk drink containing at least 35% milk was exempt from the excise tax on soft drinks if it was registered with the Department of Revenue. Natural liquid milk produced by a farmer or a dairy has always been exempt from tax without the necessity of registering the milk product. The Department of Revenue assessed tax on some dairies' chocolate milk products because they were not registered with the Department. The dairies contested the assessments.

As originally introduced, this provision would have exempted from the registration requirement chocolate flavored milk produced by a dairy. This approach raised some legal concerns, however, because it resulted in similarly situated taxpayers being treated differently. For example, one flavored milk drink registered with the Department is produced by three different people: a dairy in North Carolina, a dairy located outside the State, and a packer in North Carolina. Under the original provision, the two dairies would not have to register the milk drink to receive the tax exemption and the packer would. To avoid possible litigation, this provision was revised to exempt all milk products from the tax. Under Chapter 13 of the 1995 Session Laws, 1996 Second Extra Session, the excise tax on all drinks will be repealed effective July 1, 1999.

Fourthly, the Current Operations Appropriations Act of 1996 allows The University of North Carolina Hospitals at Chapel Hill to seek an annual refund of State and local sales and use tax they paid on direct purchases of tangible personal property. Sales and use tax liability indirectly incurred by the hospitals on building materials, supplies, fixtures, and equipment that become a part of or annexed to a building used by the hospitals is considered paid on a direct purchase by the hospitals. This part of the act becomes effective January 1, 1997, and applies to taxes paid on or after that date.

Under current law, nonprofit, private hospitals are allowed a semiannual refund of State and local sales and use taxes paid. For-profit hospitals are allowed a semiannual refund of State and local sales and use taxes paid on medicines and drugs. However, neither of these two refund provisions are applicable to hospitals owned or controlled by a governmental unit.

Under current law, local government agencies receive an annual refund of State and local sales taxes they pay but State agencies do not receive refunds of either State or local sales taxes. Local sales taxes paid by State agencies, including State-operated hospitals, are refunded quarterly to the General Fund rather than to the agency. State agencies do not receive refunds of State sales taxes because the appropriation of State funds for that agency includes the amount of sales tax payable by the agency.

As of the effective date of this act, the local sales taxes paid by the UNC hospitals will no longer be refunded to the General Fund and the State sales taxes paid by the UNC hospitals will no longer remain in the General Fund. These amounts will instead be paid directly to the UNC hospitals. Presumably, the appropriation to the UNC hospitals will be reduced to reflect this new refund.

This provision departs from the traditional policy that State sales taxes are not refunded to State-funded agencies. Refunding State sales taxes to agencies funded from the General Fund merely creates a loop of unnecessary administrative costs and paperwork as funds are paid into the General Fund as sales taxes then refunded by the Department of Revenue out of the General Fund. In all other cases, the same result is reached without the paperwork by including in the agency's General Fund appropriation an amount to cover the sales taxes paid into the General Fund. The latter approach saves the Department of Revenue and the State agency the administrative costs associated with periodic refunds.

This refund applies only to the UNC hospitals and not to other State hospitals and similar facilities. As well as the UNC hospitals, the State operates four psychiatric hospitals: Dorothea Dix Hospital, Broughton Hospital, Cherry

Hospital, and John Umstead Hospital. In addition, the State operates various Alcohol and Drug Treatment Centers and Mental Retardation Centers around the State. These centers are in-patient facilities similar to hospitals. In the case of all State-operated hospitals and treatment centers other than the UNC hospitals, the General Assembly appropriates money from the General Fund to pay for sales taxes, rather than reducing the institution's appropriation and requiring the institution and the Department of Revenue to process refunds.

Lastly, the act makes permanent a quarterly distribution of a portion of the excise tax on wine to the North Carolina Grape Growers Council. Under G.S. 105-113.81A, 94% of the net proceeds of the excise tax collected on unfortified wine bottled in North Carolina during the previous quarter and 95% of the net proceeds of the excise tax collected on fortified wine bottled in North Carolina during the previous quarter is credited to the Department of Agriculture. The amount credited may not exceed \$90,000 per fiscal year; any funds credited to the Department under this statute that are not expended during the fiscal year do not revert to the General Fund at the end of a fiscal year. The Department of Agriculture allocates these funds to the North Carolina Grape Growers Council to be used to promote the North Carolina grape and wine industry and to contract for research and development services to improve viticultural and enological practices in North Carolina.

This distribution has been in effect since 1987. Under the original legislation, the distribution would have terminated on June 30, 1997, and the funds would have been credited to the General Fund. This part of the act removes the sunset.

In 1973, the General Assembly enacted legislation providing that the tax on wine manufactured in North Carolina would be lower than the tax on other wines. In 1984, the United States Supreme Court decided in the Bacchus case that an unequal tax between in-state and out-of-state wine violated the Commerce Clause of the United States Constitution. As a result of this decision, the State and the local governments, who receive a percentage of the excise tax on wine, realized a revenue increase. In 1987, the General Assembly decided that a portion of this increased revenue should be used to promote and improve the State's grape and wine industry. This part of the act continues this philosophy.

In 1985, the General Assembly enacted an income tax credit for distributing North Carolina wine. Chapter 14 of the 1996 Second Extra Session repealed this credit because it had the same flaw as the intangibles tax stock deduction that was declared unconstitutional by the United States Supreme Court in the Fulton decision. The United States Supreme Court ruled that the

intangibles tax stock deduction violated the interstate commerce clause of the federal constitution.

Chapter 19, 1996 Second Extra Session (House Bill 30, Representative Grady)

**AN ACT TO REFUND TO FEDERAL RETIREES  
THE UNCONSTITUTIONAL TAXES THEY PAID ON THEIR  
PENSIONS FOR TAX YEARS 1985 THROUGH 1988.**

This act gives federal retirees income tax credits and partial refunds for the North Carolina income taxes they paid on their federal retirement benefits in 1985, 1986, 1987, and 1988. These credits and refunds will cost the General Fund more than \$117 million over three years. The amount a federal retiree may claim as a credit or refund is reduced by any amounts previously credited or refunded to the federal retiree for the same pension taxes. If a federal retiree paid the 1985-88 pension taxes under timely protest, the retiree already received a refund as required by existing law. Under this act, federal retirees who did not make a timely protest and who pay North Carolina income tax may take a State income tax credit in three equal installments beginning with the 1996 tax year. For a taxpayer whose 1996 tax liability is less than 5% of the tax the taxpayer paid on federal retirement benefits during 1985-88, a one-time refund is allowed in lieu of a credit. The taxpayer must claim this refund by April 1, 1997. The refund allowed is the lesser of 85% of the amount claimed or a reduced amount. The reduced amount occurs when the total refunds claimed exceed the \$25 million the General Assembly has set aside to pay for the refunds. If the \$25 million cap is reached, then the refunds are prorated based on the amount each taxpayer claimed. If a federal retiree who would otherwise be eligible for a credit or refund has died, the retiree's estate may claim the credit or refund.

In 1990, the General Assembly gave to federal retirees who had not made a timely protest an income tax credit for the amount of tax paid on their federal retirement benefits in 1988. This tax credit was not refundable and was not allowed to deceased federal retirees; it was allowed in three installments. This credit was granted as a result of the 1989 United States Supreme Court decision in Davis v. Michigan, which held that the doctrine of intergovernmental tax immunity prohibits a state from taxing federal retirement income at a higher rate than State retirement income. Prior to 1989, North Carolina allowed a full income tax exclusion for State retirement income and a \$3,000 annual exclusion for federal retirement income; there was no exclusion for private pension income. To comply with the Davis decision, the General Assembly in 1989 allowed all



government retirees (state, local, and federal) a \$4,000 annual exclusion. At the same time, it allowed private retirees a \$2,000 annual exclusion.

The tax credit for 1988 taxes was enacted in 1990 to equalize the treatment of those who paid under protest for 1988 and those who did not. The Davis decision was issued on March 28, 1989, the middle of the income tax filing period for the 1988 tax year. Those taxpayers who learned about the Davis decision in time paid under protest within the 30-day time limit prescribed by law or refused to pay tax on their federal retirement benefits. Those who had paid their taxes early or did not become aware of the Davis decision until later were not able to make a timely protest.

The State currently faces similar constitutional challenges to several of its other taxes. The United States Supreme Court declared North Carolina's intangibles tax on stocks unconstitutional in the 1996 Fulton decision. Other taxes that were collected until their repeal in the 1996 tax year, such as the individual income tax credit for North Carolina dividends and the corporate income tax deduction for North Carolina dividends, have been identified by the Revenue Laws Study Committee as having the same constitutional flaw as the intangibles tax. Furthermore, State, local, and federal retirees are currently challenging the constitutionality of the income tax levied on their pensions for the tax years from 1989 to the present. Taxpayers who paid the intangibles tax and other unconstitutional taxes without filing a timely protest will likely seek legislation granting them refunds of three years' back taxes, relief similar to that granted federal retirees by this act. The cost of granting relief to other taxpayers in the same position as the federal retirees aided by this act could cost the General Fund hundreds of millions of dollars.