# 1997 Tax Law Changes

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S.L. 1997-6 (Senate Bill 33, Senator Cochrane)

**AN ACT TO MAKE TECHNICAL AND CONFORMING CHANGES TO THE REVENUE LAWS AND RELATED STATUTES.**

This act makes numerous technical and clarifying changes to the revenue laws and related statutes. These changes were recommended to the 1997 General Assembly by the Revenue Laws Study Committee. The following table provides a section-by-section analysis of the proposed changes.

| Section | Explanation |
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| 1 | Repeals an obsolete statute that requires gun owners to list their guns for property taxes. This statute is not needed because nonbusiness personal property is exempt from property taxes and the listing requirements for business personal property are contained in the Machinery Act. |
| 2 | Increases the inheritance tax return filing threshold for Class A beneficiaries from $450,000 to $600,000 to conform to the increased credit enacted in 1996. This change became effective January 1, 1997, and applies to estates of decedents dying on or after that date. |
| 3 - 4 | Correct incorrect cross-references to the North Carolina Building Code and Building Accessibility Section of the Department of Insurance and modernize language. |
| 5 | Places definitions in alphabetical order and renumbers them. The definition of "security" was out of order and could not be included in the correct order without renumbering the list of definitions. |
| 6 | Deletes the definition of "fiduciary" from the with-holding tax Article because the term is not used in the Article. |
| 7 | Removes improper quotation marks. |
| 8 | Restores language that was inadvertently deleted in 1996 due to a redlining error. |

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| 9 | Corrects a grammatical error. |
| 10 | Restores the missing word "the". |
| 11 | Restores the missing word "or". |
| 12 - 15 | Make it clear that the per gallon motor fuel tax refunds do not apply to the inspection tax. |
| 16 | Repeals three obsolete subsections concerning taxes payable by electric membership corporations for 1965 and 1966. |
| 17 - 18 | Make it clear that a motor fuel supplier that sells kerosene is not required to have a separate license as a kerosene supplier. |
| 19 | Makes a conforming change to a cross-reference to a subdivision and modernizes language. |
| 20 | Deletes an improper comma and modernizes language. |
| 21 | Provides a savings clause. |
| 22 | Provides that the act became effective when it became law, March 21, 1997. |

S.L. 1997-17 (Senate Bill 388, Senator Hoyle)

**AN ACT TO PROHIBIT THE ASSESSMENT OF INTANGIBLES TAX FROM TAXPAYERS WHO BENEFITED FROM THE TAXABLE PERCENTAGE DEDUCTION IN THE FORMER INTANGIBLES TAX STATUTE.**

On February 10, 1997, the North Carolina Supreme Court held that the taxable percentage deduction in the North Carolina intangible tax on stock violated the commerce clause by discriminating against out-of-state companies. The deduction reduced a taxpayer's liability for the tax in proportion to the amount of business the corporation did in North Carolina. The court did not order refunds. Instead, it allowed the possibility of curing the past discrimination by the assessment of intangibles tax on those who did not pay in reliance on the unconstitutional taxable percentage deduction. Upon the advice of the Attorney General's Office, the Secretary of Revenue began preparing to assess the intangibles tax on those who did not pay the tax in reliance on the unconstitutional taxable percentage deduction.

In response to the Secretary's preparations, the General Assembly ratified this act. This act directs the Secretary of Revenue to take no action to collect or

assess back intangibles tax for tax years 1990 through 1994. In effect, this act foreclosed the possibility of assessments on those who relied on the taxable percentage deduction. The passage of this act made the State liable for refunds to those intangibles taxpayers who paid tax on shares of stock and who protested the payment of the tax within 30 days of payment. The General Assembly enacted House Bill 96, S.L. 1997-318, on July 21, 1997. S.L. 1997-318 directs the Secretary of Revenue to make refunds of the intangibles tax to taxpayers who filed a timely protest.

The General Assembly repealed the intangibles tax in 1995. The potential for the Department of Revenue to assess and collect the intangibles tax on those taxpayers who did not pay intangibles tax prior to 1995 in reliance on the unconstitutional taxable percentage deduction resulted from the North Carolina Supreme Court's decision in the Fulton case. In 1995, the Department estimated that eliminating the taxable deduction in the North Carolina intangibles tax on stock would generate $55 to $75 million dollars. As a practical matter, however, it would be difficult for the Department to discover and value taxable shares in those North Carolina corporations that are not publicly traded because there is no public information on these holdings.

S.L. 1997-23 (House Bill 295, Representative Cansler)

**AN ACT TO EXEMPT MOST INTANGIBLE PERSONAL PROPERTY FROM PROPERTY TAX.**

This act exempts from local property taxes all intangible property except leasehold interests in exempted real property. The act became effective July 1, 1997, and applies to taxable years beginning on or after that date. The act is not expected to result in a significant decrease in local government property tax revenues.

Intangible personal property has been subject to property taxes for over 100 years. The property is taxable unless specifically excluded. Although cash and bank deposits have been excluded from property tax since 1985, it was not until 1995 that the General Assembly excluded other forms of financial intangibles, such as stocks, bonds, accounts receivable, and beneficial interest in trusts, from property tax. These financial intangibles were taxed by the State and the revenues generated by the tax were distributed to local government units. The intangibles tax repeal in 1995 repealed the tax on intangible property that was levied by the State; it did not affect the local governments' power to tax intangible property that had not been taxed by the State and was not otherwise excluded from local property taxation.

This act exempts most of the remaining forms of intangible personal property, such as franchise rights, patents, copyrights, trademarks, and goodwill, from property taxation. The tax situs of a business intangible is generally the location of the company's headquarters. Most counties have never taxed this type of property even though it was clearly subject to tax. Two recent developments raised county tax assessors' awareness of this potential revenue source. First, the Uniform State Abstract for listing business personal property, prepared by the Department of Revenue, was revised for use beginning in tax year 1997 to include a specific schedule D for intangible property. The memorandum accompanying the new abstract advised that the appraisal of intangible property would be a first time endeavor for many appraisers across the State. At the beginning of the 1997 tax year, 23 counties asked taxpayers to list intangible assets, such as patents, copyrights, secret processes, formulae, goodwill, trademarks, trade brands, and franchises, on their 1997 business personal property tax form. Before 1997, only a few counties were listing this type of property. Second, a recent case before the North Carolina Court of Appeals, Edward Valves, Inc., highlighted both the potential and the difficulties of taxing intangible personal property. In that case, Wake County levied a property tax on a set of exclusive engineering drawings. The drawings were valued at more than $12 million. The court found that the county's methodology for taxing self-created intangible property was unconstitutional and that it violated the statutory requirement that property taxes be levied uniformly.

The act also clarifies that the exclusion of intangible property from property tax does not affect the appraisal of real property or tangible personal property. One of the most commonly used methods of valuing commercial property is the income approach to value. Under the income approach, the contribution of intangible assets to a business' income is an inherent part of the valuation process. The act will allow counties and cities to continue considering intangible personal property, such as trademarks and goodwill, when they assess other real property and tangible personal property.

The act discourages counties and cities from discovering prior years' taxes on intangible personal property excluded by this act on or after January 1, 1997. It does so by reducing the annual State reimbursement to a county or municipality for the repeal of the intangibles tax on money, accounts receivable, bonds, stock, and beneficial trust interests by the amount of taxes collected in that year on intangible property for a year prior to the 1997 tax year. This part of the act is repealed effective September 1, 2002, because the five-year discovery period will have expired then.

Lastly, the act seeks to preserve the legislature's authority to classify property for taxation by providing a non-severability clause in the current

software property tax exemption. If any part of the exemption is ever ruled unconstitutional, then the entire exemption will be defeated. Consequently, all computer software will be subject to property tax unless the General Assembly acts to re-classify it for exemption. In 1994, the General Assembly carefully crafted an across-the-board property tax exemption for all computer software other than embedded software and software that is required by generally accepted accounting principles to be treated as a capital asset. This exemption was the result of a compromise between the North Carolina Association of County Commissioners and a taxpayer group called the North Carolina Software Coalition.

S.L. 1997-55 (House Bill 59, Representative Neely)

**AN ACT TO UPDATE THE REFERENCE TO THE INTERNAL REVENUE CODE USED IN DEFINING AND DETERMINING CERTAIN STATE TAX PROVISIONS.**

This act rewrites the definition of the Internal Revenue Code used in State tax statutes to change the reference date from March 20, 1996, to January 1, 1997. It was recommended by the Revenue Laws Study Committee. Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the State to the extent that State tax law previously tracked federal law. This update generally has the greatest effect on State corporate and individual income taxes because these taxes are based on federal taxable income and are therefore closely tied to federal law. The franchise tax, gift tax, highway use tax, inheritance tax, and insurance company premiums tax also determine some exemptions based on the provisions of the Code.

Congress made significant changes to the Code in 1996 that will affect federal taxable income. Because federal taxable income is the starting point for calculating State corporate and individual income taxes, these federal changes adopted by this act will affect State policies and revenues. The act is expected to reduce General Fund revenues by approximately $8.5 million in 1997-98, $16.8 million in 1998-99, $11.5 million in 1999-2000, $13 million in 2000-01, and $17 million in 2001-02.

The federal Small Business Job Protection Act made two tax changes that will affect the General Fund proportionally more than the other tax changes: the amount of property that may be expensed under Code section 179 is increased from $17,500 to $25,000 over a period of 5 years and the amount a self-employed person may deduct for health insurance costs is increased from 30% to 80% over a period of 10 years. The Small Business Job Protection Act made major changes to the S Corporation rules, introduced a new type of retirement plan (SIMPLE),

and narrowed the exclusion for punitive damages received on account of personal injury or sickness. It also created a new adoption credit and exclusion and increased the amount a nonworking spouse could contribute to an IRA.

The federal Health Insurance Portability and Accountability Act created a pilot test program for tax-favored medical savings accounts (MSAs) and added two new exceptions to the 10% penalty for premature withdrawals from IRAs. It provided that costs of long-term care services and some long-term care insurance premiums will be considered medical expenses for itemized deduction purposes. The Health Insurance Portability and Accountability Act also allowed an income tax exclusion for long-term care benefits to chronically ill insureds and extended the income tax exclusion for life insurance death benefits to benefits paid during life to the terminally ill.

This act provides that the federal tax law changes that could increase an individual's or corporation's North Carolina taxable income for the 1996 tax year will not become effective for 1996 tax years but will instead apply only to taxable years beginning on or after January 1, 1997. Under Section 16 of Article 1 of the North Carolina Constitution, the legislature cannot pass a law that will retroactively increase the tax liability of any taxpayer. There are a few provisions in the federal tax law changes that could increase taxable income for the 1996 tax year. Because this act could not be ratified until after the 1997 General Assembly convened, theses changes were given a delayed effective date.

Since the State corporate income tax was changed to a percentage of federal taxable income in 1967, the reference date to the Internal Revenue Code has been updated periodically. In discussing bills to update the Code reference, the question frequently arises as to why the statutes refer to the Code on a particular date instead of referring to the Code and any future amendments to it, thereby eliminating the necessity of bills like this one. The answer to the question lies in both a policy decision and a potential legal restraint.

First, the policy reason for specifying a particular date is that, in light of the many changes made in federal tax law from year to year, the State may not want to adopt automatically federal changes, particularly when these changes result in large revenue increases or decreases. By pinning references to the Code to a certain date, the State ensures that it can examine any federal changes before making the changes effective for the State.

Secondly, and more importantly, however, the North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Section 2(1) of Article V of the Constitution provides in pertinent part that the "power of taxation … shall never be surrendered,

suspended, or contracted away." Relying on this provision, on the North Carolina court decisions on delegation of legislative power to administrative agencies, and on an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would … be invalidated as an unconstitutional delegation of legislative power."

S.L. 1997-60 (Senate Bill 98, Senator Kerr)

**AN ACT TO IMPROVE THE ADMINISTRATION OF THE MOTOR FUEL TAX LAWS.**

This act makes changes to the method of collecting motor fuel taxes commonly referred to as "tax at the rack", that was enacted by the General Assembly in the 1995 Session and became effective January 1, 1996. The method bears this name because it imposes the per gallon excise tax when motor fuel is delivered to a transport truck or railroad tank car by means of a "rack" at a refinery, terminal, or bulk plant. This act changes the licensing requirements for exporters and makes several conforming changes as described below.

Section 1 of the act ensures that the State's motor fuel tax will be considered a "pass-through" tax, by expressly stating that the tax is collected from the supplier or importer of the fuel but that the tax becomes part of the cost of the fuel and is consequently paid by the consumer. This statutory language was added in order to protect the State from a challenge to its motor fuel tax laws similar to that in the U.S. Supreme Court case of Oklahoma Tax Commission v. Chickasaw Nation (decided June 14, 1995). There the Oklahoma gas tax was held not to apply to Native American retailers because of tribal sovereign immunity, even though the tax was collected by the fuel distributor and passed through the chain of distribution on to the ultimate consumer. The Court emphasized that the Oklahoma statute imposing this tax did not expressly identify the party that bears the burden of the tax, and more importantly, did not contain a pass-through provision requiring distributors and retailers to pass the tax on to consumers.

Sections 2 and 4 of the act require exporters to be licensed. Under prior law, an exporter could have been but was not required to be licensed. A licensed exporter paid tax at the destination state rate, while an unlicensed exporter had to pay tax at the North Carolina rate. This difference in treatment resulted in the unlicensed exporter paying both the North Carolina tax and the tax of the destination state and then having to apply to North Carolina for a refund. The

requirement under this act, that all exporters be licensed, parallels the existing requirement that all importers be licensed.

Section 3 of the act makes the following changes to the importer licensing provisions for a bulk-end user, such as a trucking company:

1. Allows bulk-end users to be bonded importers and thereby buy fuel at an out-of state terminal that does not precollect the North Carolina motor fuel tax. Prior law prohibited a bulk-end user from obtaining a bonded importer license.

1. Relieves bulk-end users of the importer licensing requirement if they buy all their imported fuel at an out-of-state terminal that precollects the North Carolina tax. Prior law required an occasional importer license in this circumstance. This change parallels the existing treatment of distributors, i.e., a distributor that imports only from a terminal that precollects the North Carolina tax is not required to have an importer license.

Section 5 of the act deletes the requirement that an exporter file a bond. This change was made because the act requires all exporters to be licensed. The purpose of licensing is primarily to track cross-border shipments of fuel, and the bonding requirement is not necessary for this purpose. Prior law required an exporter who chose to be licensed to pay a bond or provide an irrevocable letter of credit in an amount not less than $2,000 or more than $250,000.

Section 6 of the act deletes all references to unlicensed exporters, since sections 2 and 4 of the act require all exporters to be licensed.

Section 7 of the act imposes potential liability on an unlicensed exporter for the North Carolina tax on the fuel exported. If an unlicensed exporter buys fuel, the Department of Revenue can assess tax on the fuel purchased at the North Carolina rate.

Sections 8 and 22 of the act reduce the marking requirements for dyed diesel storage tanks so that they only apply to a person who is a retailer of dyed diesel fuel or who stores both dyed fuel and undyed diesel fuel for use by that person or another person. Prior law required all dyed diesel storage tanks to be labeled "For Nonhighway Use" unless the fuel in the tank was for home heating, drying crops, or manufacturing and the tank was installed so that use of the fuel for any other purpose was made improbable.

Section 9 of the act clarifies the tax liability concerning the use of exempt cards and exempt access codes. A supplier is not liable for any tax due on fuel

sold to a distributor or importer who represented that the fuel would be resold to an exempt governmental entity but who did not resell the fuel to a tax-exempt entity. Distributors and importers make this representation by using a card or access code issued by the supplier when getting the fuel at the terminal, and this card or code allows the distributor or importer to buy the fuel tax-free. If a distributor or importer in this circumstance sells tax-free fuel to a person who is not exempt, the distributor or importer is liable for any tax due on the fuel. The act also makes clear that a supplier that issues a card or code, enabling a person to buy fuel at retail without being charged the tax already paid on the fuel, has a duty to determine if the person is actually tax-exempt. A supplier is responsible for any tax due if the person to whom the supplier issued the card is not an exempt entity.

Section 10 of the act requires an out-of-state bulk-end user that buys fuel at a North Carolina terminal, as opposed to a bulk plant, to be licensed as a distributor or exporter. This change accompanies the changes made by Sections 2 and 4 of the act that require all exporters to be licensed. Unless the bulk-end user falls within the grandfather group of users that can get distributor licenses, the user will need to be licensed as an exporter.

Section 11 of the act changes the due date of a tax return of an occasional importer from the first of each month to the third of each month. This change was made at the request of sellers of racing gasoline who pointed out that if they buy fuel on the last day of a month it is difficult to prepare the return and send it in the next day. G.S. 105-449.66 defines an "occasional importer" as any of the following that imports motor fuel by any means outside the terminal transfer system:

1. A distributor that imports motor fuel on an average basis of no more than once a month during a calendar year.

1. A bulk-end user that is not a distributor.

1. A distributor that imports motor fuel for use in a race car.

Section 12 of the act deletes references to unlicensed exporters.

Section 13 of the act deletes references to an exporter.

Section 14 of the act adds imports to the categories of information contained on a supplier's return. It does this by replacing references to specific license holders in some places with the generic reference to "person receiving the fuel" and by adding references to "importer" in others.

Section 15 of the act allows a supplier to take a deduction on the supplier's return for taxes paid by the supplier on fuel that was subsequently sold at retail to a person who is exempt from tax and who used a card issued by the supplier to indicate his or her tax-exempt status when buying the fuel.

Section 16 of the act adds importers to the groups of license holders that must receive certain information from suppliers and about whom the suppliers must notify the Department of Revenue.

Section 17 of the act clarifies that anyone who pays tax on fuel that is exempt from tax can apply for a refund of the tax paid.

Section 18 of the act adds a civil penalty for failure to get an importer confirmation number. The penalty is the same as the penalty for transporting motor fuel without a shipping document or with a false or incomplete document or for delivering motor fuel to a destination state other than as shown on the document. Prior law contained no penalty.

Section 19 of the act clarifies that the penalty for using dyed diesel or other non-tax-paid fuel in a highway vehicle applies to all fuel used in the vehicle. Prior law applied the penalty to fuel used "for highway use". This language could have been construed to mean that a vehicle that is parked at a rest area or the parking lot of a business and that had dyed diesel in its tanks was not subject to the penalty, because the fuel was not at that moment being used for a highway use.

Section 20 of the act clarifies that failure to pay a tax under the prior motor fuel tax laws is to be treated the same as a failure to pay under the revised laws. When tax at the rack was implemented, the existing motor fuel tax laws were repealed and replaced by the new provisions. Many assessments for taxes owed under the prior laws have not been paid.

Section 23 of the act requires a retailer or bulk user of alternative fuel that will be the taxpayer for the fuel to file a bond or irrevocable letter of credit with the Secretary of Revenue.

Section 24 of the act changes when the liability for tax on certain alternative fuel accrues. The section allows those retailers and users that use the same storage tank for highway and nonhighway alternative fuel to pay tax on the highway alternative fuel when it is metered from the tank. Prior law required taxes on alternative fuel to be paid when the fuel was delivered to the retailer of the fuel or the bulk user of the fuel. This created a problem when alternative fuel was used for a dual purpose, since the provider of the fuel did not know how

much fuel would be used for a highway purpose when the fuel was delivered to the retailer or user.

Section 25 of the act allows retailers and bulk-end users of alternative fuel to store the fuel in a tank that holds both highway and nonhighway alternative fuel if the tank has separate metering devices to measure the fuel that is used for a highway use and fuel that is used for some other purpose.

All sections of the act, except three clarifying changes, became effective October 1, 1997. The clarifying changes became effective when the act became law (May 16, 1997).

S.L. 1997-77 (House Bill 36, Representative Capps)

**AN ACT TO RELIEVE CONSUMERS OF THE REQUIREMENT OF FILING MONTHLY USE TAX RETURNS.**

This act was a recommendation of the Revenue Laws Study Committee. It establishes an annual filing period for the payment of use taxes owed by consumers on mail-order purchases. The annual filing period relieves consumers of the need to file either monthly or quarterly returns. The act became effective May 15, 1997, and applies to purchases made on or after January 1, 1997.

In 1991, the Department of Revenue began including an annual use tax return (Form E-554) on the individual income tax booklets. Under the State sales and use tax law, a person is responsible for paying use tax on their out-of-state purchases. Prior law specified only two reporting periods – a quarterly period if the tax owed was less than $50.00, and a monthly period if the tax owed was more. Arguably, therefore, North Carolina customers of mail-order catalog companies should have been filing either monthly or quarterly returns.

The act improves the collection of the use tax by minimizing the compliance burden. Individuals who owe use tax on goods purchased out-of-state for a non-business purpose are now able to file an annual return. The return and the tax are due at the same time as the individual income tax return. In theory, residents who are subject to use tax for out-of-state purchases are more likely to comply if the reporting and payment procedure is not unduly burdensome.

The use tax complements the sales tax by taxing transactions that are not subject to the sales tax because of movement in interstate commerce. Like the sales tax, the use tax is imposed on the purchaser. Unlike the sales tax, the responsibility for remitting the tax to the Department is also on the purchaser. In the 1980s, states around the country became increasingly aware of the revenue

loss from taxpayer avoidance of the use tax. The Department estimated in 1995 that the potential increase in State and local revenue for North Carolina, if full taxpayer compliance were achieved, would be $71.1 million.

The most cost-effective manner to collect the tax, from a state's point-of-view, is to require the out-of-state retailers to collect and remit the use tax. However, in 1967, the U.S. Supreme Court ruled in Bellas Hess that a state cannot require an out-of-state retailer to collect its use tax unless the retailer has enough contacts with the state to subject it to the state's taxing jurisdiction. The Supreme Court reaffirmed this decision in 1992 in Quill Company v. North Dakota.

The Direct Marketers Association, the Federation of Tax Administrators, the Multi-state Tax Commission, and the National Governors' Association have been 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. The group is likely to have a final agreement by July 1, 1998. If a final proposed agreement is reached, it will then be up to the states and the marketers to enter into the agreement.

In an effort to collect a larger percentage of this tax, North Carolina has entered a cooperative agreement with other southeastern states called the Southeastern States Exchange Agreement. The member states to this agreement exchange information gained through tax audits of businesses, such as the names and addresses of North Carolina customers to whom untaxed sales were made. The Department of Revenue may then contact these customers for the collection of the use tax, plus penalties and interest.

S.L. 1997-109 (House Bill 57, Representative Neely)

**AN ACT TO REQUIRE WITHHOLDING FROM CERTAIN PAYMENTS TO NONRESIDENTS IN ORDER TO PREVENT NONRESIDENTS FROM AVOIDING NORTH CAROLINA INCOME TAXES, TO MODIFY THE DEFINITION OF EMPLOYMENT WITH RESPECT TO AGRICULTURAL LABOR, AND TO CONFORM TO FEDERAL RULES ON WAGE WITHHOLDING BY FARMERS.**

This act makes two changes concerning the collection of taxes owed to North Carolina. First, it requires withholding from compensation paid to nonresident individuals and nonresident entities for personal services performed in North Carolina. Second, it conforms State law to the federal law regarding agricultural employees' wages (both withholding from the wages and unemployment insurance tax on the wages).

The changes made by the act become effective at different times. The requirement to withhold from compensation paid to nonresident individuals and from compensation for athletic, entertainment, and construction services paid to nonresident partnerships, corporations, or limited liability companies becomes effective January 1, 1998. The requirement to withhold from all other compensation paid to these nonresident entities for personal services becomes effective January 1, 1999. This phase in of the withholding requirement was requested by North Carolina Citizens for Business and Industry. The nonresident withholding provisions of the act were suggested by the Department of Revenue and recommended by the Revenue Laws Study Committee. It is anticipated that the collection of income taxes owed by nonresident companies and individuals to the State will increase by $8 to $10 million a year as a result of these provisions.

The requirement to withhold from agricultural wages to the same extent as is required under federal law becomes effective January 1, 1998. Conformity to the federal unemployment tax exemption for certain aliens performing agricultural labor, as requested by the Farm Bureau, becomes effective immediately.

North Carolina taxes the income of its residents and also that income derived by nonresidents from businesses, trades, and occupations carried on in this State. Most other states that have an income tax apply the tax to nonresidents' income in this way. Like North Carolina, these states generally give their residents a credit for income tax paid to other states on income derived from those states.

Many nonresidents who derive income from North Carolina do not pay the North Carolina tax due on this income. This problem is particularly troublesome with respect to single event performers such as athletes or entertainers who may be paid large amounts for their work in North Carolina. It is difficult, expensive, and inefficient for the Department of Revenue to trace and pursue these nonresidents who do not pay the tax they owe.

This act imposes a withholding requirement on payments made to nonresidents for services performed in this state. This requirement is similar to the existing law which requires employers to withhold taxes from wages paid their employees. The new requirement will not apply to wages, which are already covered under the existing law; the new requirement applies to payments to independent contractors.

Examples of nonresidents targeted by the new withholding requirement are musicians, actors, and individual athletes. Because these individuals may be paid through a partnership, limited liability company, or corporation that does

not have ties to this State, the withholding requirement applies to payments to these entities as well. If the entity is registered in this State or maintains a permanent office in this State, payments to it are not subject to withholding. Payments it makes to nonresidents for their services will, however, be subject to withholding, under either the new requirement for contract payments or the existing requirement for wages.

Under this act, a person or entity who, in the course of a trade or business, pays a nonresident more than $600 for personal services in this State will be required to withhold 4% of the payment and deposit the withheld taxes with the Department of Revenue. The withholding agent must register with the Department of Revenue. The withheld taxes are due by the last day of the first month after the end of the calendar quarter in which the withholding agent paid the nonresident. As is the case with employers who withhold from employees' wages, the withholding agent will be required to give each nonresident a statement similar to a W-2 form in January and to provide a compilation of these statements to the Department of Revenue. Filing these documents relieves the agent of the existing information reporting requirement of G.S. 105-154.

The withheld taxes will be credited to the nonresident individual or entity from which they were withheld. If the entity is a pass-through entity such as a partnership, Subchapter S corporation, or limited liability company, the credit will pass through to the partners or other owners of the entity. The nonresident will receive credit for the withheld taxes by filing a North Carolina income tax return; any excess will be refunded to the taxpayer.

A number of other states have instituted withholding programs and special audit programs to close the loophole that allows nonresidents to avoid paying state income taxes they owe. California, Connecticut, Minnesota, New Jersey, and South Carolina have withholding requirements. Michigan, Missouri, and New York have special audit programs.

S.L. 1997-111 (House Bill 474, Representative Sutton)

**AN ACT TO CLARIFY WHICH PREINDUCEMENT EXPENDITURES MAY BE FINANCED WITH INDUSTRIAL REVENUE BONDS.**

This act clarifies the Department of Commerce's current policy of what costs may be reimbursed with Industrial Revenue Bond proceeds. The policy is derived from federal tax law. Under federal law, two types of expenditures may be reimbursed from bond proceeds:

1. An expenditure that is incurred or paid within 60 days of the date the Financing Authority took some action indicating its intent that the expenditure would be financed or reimbursed from bond proceeds.

1. Incidental expenditures that are incurred prior to the commencement of the acquisition, construction, or rehabilitation of a project. Examples of this type of expenditure include architectural costs, engineering costs, surveying costs, soil testing costs, and bond issuance costs.

Industrial Revenue Bonds offer manufacturing companies long-term debt financing at interest rates substantially below the current prime rate. Under the program, a local Financing Authority may enter into a financing agreement with a company to provide revenue bond proceeds to the company to be used to finance capital expenditures, such as fixed assets, land, buildings, new equipment, existing equipment, etc. The amounts payable by the company to the authority under the financing agreement must be sufficient to pay all of the principal and interest on the bonds.

Bond proceeds cannot be used to refinance existing debt or as venture capital. Current law does not define the term "refinance." Under federal law, bond proceeds may be used to reimburse certain expenses the company incurs prior to any action of the authority indicating its intent that the expenditure would be financed or reimbursed from bond proceeds. This act allows North Carolina the full flexibility available under federal law to reimburse certain preinducement expenditures.

S.L. 1997-118 (Senate Bill 34, Senator Cochrane)

**AN ACT TO ADJUST THE SHARE THE CITIES RECEIVE FROM THE STATE GROSS RECEIPTS TAX TO MAKE THE DISTRIBUTION MORE EQUITABLE AND TO ALLOW THE DEPARTMENT OF REVENUE TO GIVE CITY FINANCE OFFICIALS INFORMATION NEEDED TO VERIFY THE ACCURACY OF A CITY'S DISTRIBUTION.**

This act increases the amount of State franchise tax that is distributed to 40 cities. The cities whose distributions are increased are those whose 1995-96 distributions were less than 95% of their 1990-91 distributions. The act increases the distributions for these cities by reducing the "hold-back amount" that is deducted from a city’s share. The act applies to distributions made for fiscal year 1995-96 and subsequent years. The act increases the annual distribution to the affected cities by a total of $194,841. The annual distribution to the other 500

cities is reduced by the same amount, so that the State share of the franchise tax is not reduced under this act. This act was recommended by the Revenue Laws Study Committee.

The State distributes part of the State franchise tax imposed on utilities to the cities. The franchise taxes that are distributed are the taxes on electricity, piped natural gas, and telephone service. The State imposes a franchise tax on these utilities at the rate of 3.22%. The State distributes to cities the amount of tax collected from service provided inside the cities that equals a tax of 3.09%. Thus, the cities receive the majority of these taxes.

The amount to be distributed to a city is reduced by that city's "hold-back" amount. The "hold-back" amount is the amount by which the city's distribution of these franchise taxes increased from fiscal year 1990-91 to fiscal year 1994-95. During this period, the total amount distributed was frozen but the relative share of each city changed based on the proportion of that city’s receipts compared to the total of all cities’ receipts. When the freeze was lifted in 1995-96, a requirement was imposed to calculate and deduct a "hold-back" amount. The effect of the deduction of a hold-back amount from the cities’ distribution is the retention by the State of the growth that occurred in the franchise tax base during the freeze years. The hold-back amount is considered the cities' contribution to the State budget crisis in the early 1990s.

The "hold-back" amount reduced the amount distributed in fiscal year 1995-96 to some cities below the amount that was distributed to them in 1990-91. This occurred to cities that experienced a temporary franchise tax base growth in the freeze years (1990-91 through 1994-95) and then a reduction of the base in 1995-96. The hold-back deduction requires these cities to deduct taxes attributable to growth that is no longer in their tax base.

The act adjusts for this loss of tax base growth by reducing the hold-back amount. The amount distributed to a city in 1995-96 is compared to the amount distributed in 1990-91. If the 1995-96 amount is less than 95% of the 1990-91 amount, the hold-back amount is reduced in accordance with the formula in the act to the greater of zero or the amount that would have caused the city's 1995-96 distribution to equal the 1990-91 amount.

In the course of developing this proposal, a number of reporting errors from utilities were discovered. To address this concern, the act amends the tax secrecy provisions to allow the Department of Revenue to give finance officials of a city a list of the utility taxable gross receipts that were derived from sales within the city and used to determine the franchise tax distribution to the city.

This provision will allow cities to verify the data that determines their share of the State franchise tax distribution.

S.L. 1997-121 (Senate Bill 106, Senator Cooper)

**AN ACT TO ALLOW REGIONAL SALES OF PERSONAL PROPERTY SEIZED FOR UNPAID TAXES TO BE HELD IN ANY COUNTY.**

This act gives the Department of Revenue the ability to sell in any county in this State personal property the Department has seized for payment of delinquent State taxes. Current law requires this property to be sold in Wake County or the county in which the property was seized. It was recommended to the 1997 General Assembly by the Revenue Laws Study Committee.

G.S. 105-242(a)(2) authorizes the Secretary of Revenue to levy on a taxpayer's personal property to collect delinquent unpaid taxes and to sell the property either in Wake County or in the county in which it was seized. This statute is used almost exclusively by the Controlled Substance Tax Division, which collects the tax on illegal drugs. The 1997 General Assembly expanded the tax on illegal drugs to include a tax on illegal liquor. Vehicles and other property are often seized for these taxes pursuant to G.S. 105-113.111 and sold at auction. Seventy-five percent of the proceeds of these sales are distributed among the law enforcement agencies whose investigation led to the assessment and the remaining 25% is credited to the General Fund.

The current practice of the Department is to store and sell all seized property in Wake County. The Department does this because it is too costly to store and sell property in all 100 counties. The Department contracts to have seized property hauled from the counties in which it is seized to Wake County where it is stored until an auction site is available. Rental of auction sites in Wake County is expensive and, because of delays due to waiting for a site, the Department incurs extra costs for storing the property.

The Department plans to implement this act by establishing regional sites in Eastern, Central, and Western North Carolina for the sale of seized property. Expanding the permissible locations for sales will reduce costs because the property will not have to be hauled as far and there will be less storage time waiting for an auction site to become available. In addition, more companies will be able to compete for the transportation, storage, and sale business because they will no longer have to have Statewide operations in order to qualify, and this increase in competition could yield a lower contract price. The Department

estimates that it will be able to reduce expenses incurred in selling seized property by at least $39,000 a year.

S.L. 1997-139 (Senate Bill 323, Senator Horton)

**AN ACT TO ALLOW AN INCOME TAX CREDIT FOR EXPENDITURES TO REHABILITATE HISTORIC STRUCTURES.**

This act expands the current State income tax credit for rehabilitating an income-producing historic structure, effective beginning in the 1998 tax year. It is expected to reduce General Fund revenues by approximately $56,000 in 1998-99, $965,000 in 1999-2000, $2 million in 2000-01, and $3.5 million in 2001-02.

The act increases the credit for rehabilitating income-producing structures from 5% to 20% of the rehabilitating expenditures and allows a new 30% credit for rehabilitating non-income producing structures. The 20% credit will yield a combined federal and State credit equal to 40% of the rehabilitating expenditures for income-producing historic structures. A taxpayer is allowed the 30% State tax credit for rehabilitating non-income producing historic residential structures only if the taxpayer does not qualify for the federal tax credit for income-producing historic structures.

The act also provides that the credits may not be taken in one year but must be spread out in installments over five years after the historic structure is placed in service. Any unused portion of a credit may be carried forward for a five-year period.

Federal law provides a federal income tax credit equal to 20% of qualified rehabilitation expenditures for certified historic structures that are used in connection with a trade or business or held for the production of income. This credit is available for both residential rental buildings and nonresidential buildings that are listed in the National Register or that are located in a registered historic district and certified as being of historic significance. Former State tax law provided an individual and corporate income tax credit for rehabilitating a certified historic structure for which the taxpayer was allowed a credit under federal law if the historic structure was located in North Carolina. Federal tax law does not provide an income tax credit for rehabilitating an historic structure that is used as the owner's residence and thus is not income-producing. This act expands the existing State credit to include certified historic structures that are not otherwise eligible for the federal tax credit because they are not income-producing. To be eligible for the credit for rehabilitating a non-income producing historic structure, a taxpayer must attach a copy of the

certification received from the State Historic Preservation Office verifying that the improvements made are consistent with the Secretary of the Interior's Standards for Rehabilitation. In addition, the costs of the improvements must exceed $25,000 over a 24-month period.

S.L. 1997-205 (Senate Bill 1064, Senator Hoyle)

**AN ACT TO ALLOW A TAXPAYER WHO PREVAILS IN A PROPERTY TAX APPEAL TO RECEIVE INTEREST ON ANY OVERPAYMENT OF TAX AND TO AUTHORIZE THE LEGISLATIVE RESEARCH COMMISSION TO STUDY VARIOUS PROPERTY TAX ISSUES.**

This act allows a taxpayer who has prevailed in a property tax appeal to receive interest on the overpayment of property taxes, effective for appeals made to the Property Tax Commission on or after July 1, 1997. The Property Tax Commission hears and decides appeals from decisions concerning the listing, appraisal, or assessment of property made by county boards of equalization and review and boards of county commissioners. Any property owner who is dissatisfied with the decisions of these county boards may appeal to the Commission. Under prior law, if the Property Tax Commission determined that a taxpayer's property had been overvalued and that the taxpayer had therefore paid more tax than was owed on the property, there was no payment of interest on the overpayment. The act provides that the overpayment will bear interest at the rate borne by all other assessments of tax. Under current law this rate is determined in accordance with G.S. 105-241.1(i). The statute permits the Secretary of Revenue to set interest paid on State taxes semiannually after giving due consideration to current market conditions and to the rate that will be in effect on that date pursuant to the Internal Revenue Code.

The act authorizes the Legislative Research Commission to study methods used by counties to develop the schedules of value for a general reappraisal of real property, the process for appealing the value or listing of property, and the octennial revaluation schedule. In conducting this study, the Commission may determine whether the procedures used in developing schedules of value produce unrealistic values on nonresidential real property, whether representatives of the Department of Revenue should be given more authority in resolving taxpayer appeals, and whether the Property Tax Commission should be replaced with a State Tax Court. The Commission may assign these property tax issues to a tax study committee or create a separate study committee to study these issues. The Commission may make an interim report of its findings to the 1998 Regular Session of the 1997 General Assembly and a final report to the 1999 General Assembly.

S.L. 1997-209 (Senate Bill 153, Senator Odom)

**AN ACT TO EXTEND THE SCRAP TIRE DISPOSAL TAX AT ITS CURRENT RATE FOR FIVE MORE YEARS, TO AMEND THE SCRAP TIRE DISPOSAL ACT TO DISCOURAGE THE DISPOSAL OF SCRAP TIRES FROM OUTSIDE THE STATE, AND TO COMPLETE THE CLEANUP OF NUISANCE TIRE COLLECTION SITES, AS RECOMMENDED BY THE ENVIRONMENTAL REVIEW COMMISSION.**

This act makes a number of changes to the scrap tire tax and the use of the tax proceeds. It was recommended by the Environmental Review Commission. The scrap tire disposal tax was enacted in 1989 and applies to tires sold at retail and tires sold for placement on vehicles to be sold or leased at retail. The tax generates almost $10 million a year in revenue.

The act moves the sunset date on the 1993 increase in the tax from June 30, 1997, to June 30, 2002. Therefore, the 1993 tax increase will expire five years later than it would have if this act had not been enacted. Effective October 1, 1993, the tax rate was increased from 1% to 2% for tires with a bead diameter of less than 20 inches. Bead width is the width of the inside opening of the tire. Tires for cars, vans, and pick-up trucks have a bead width of less than 20 inches. When the tax increase sunsets, the tax on these tires will revert back to 1%.

The scrap tire tax proceeds are distributed as follows: 27% to the Scrap Tire Disposal Account, 5% to the Solid Waste Management Trust Fund, and 68% to the counties on a per capita basis. This act repeals a provision that, effective June 30, 1997, would have sunset the Scrap Tire Disposal Account and discontinued the 27% earmarking to the Account, increased from 5% to 10% the earmarking to the Solid Waste Management Trust Fund, and increased from 68% to 90% the percentage distributed to counties.

The act increases from 25% to 50% the maximum amount in the Scrap Tire Disposal Account that may be used for grants to local governments to assist in the disposal of scrap tires, and allows up to 40% of the amount in the Account to be used for grants to encourage the use of processed scrap tire materials. The remaining funds in the Account will continue to be used to clean up nuisance scrap tire collection sites. Under prior law, the Department of Environment and Natural Resources (DENR) could use up to 25% of the funds in this Account to make grants to counties for scrap tire disposal and was required to use the remaining funds in the Account to clean up nuisance scrap tire collection sites.

The act adds a factor for DENR to consider when making grants to local units from the Scrap Tire Disposal Account to assist them in disposing of scrap

tires. That factor is the effort made by the local unit to prevent out-of-state tires from being disposed of for free. G.S. 130A-309.58(e) prohibits counties from charging a fee for scrap tire disposal unless the tires are defective new tires or tires that have a certificate indicating they came from outside the State and therefore were not replacements for tires on which the scrap tire tax was paid. Despite the certificate requirement, many out-of-state tires are being disposed of for free in this State's disposal sites.

S.L. 1997-213 (House Bill 15, Representative Cansler)

**AN ACT TO CONFORM TO FEDERAL TAX TREATMENT OF INCOME RESTORED UNDER A CLAIM OF RIGHT.**

This act conforms North Carolina's income tax law to the Internal Revenue Code with respect to the tax treatment of "restored income." Restored income is $3,000 or more of income that a taxpayer receives from a person in one year but then has to pay back in a later year. It was recommended by the Revenue Laws Study Committee. The act applies retroactively to the 1995 tax year to address a specific situation that was brought to the attention of the Revenue Laws Study Committee.

A taxpayer may receive a substantial amount of income in year one and pay tax on the income for that year. Then, in year two, for example, the taxpayer may be required to pay back some of the income that was received in year one and taxed. If this occurs and the amount given back is at least $3,000, the taxpayer may deduct in year two the amount of income that was paid back. The deduction in year two of the "restored" income offsets the inclusion of the income in year one if the taxpayer's income in year two is large enough to be able to take the deduction.

If the taxpayer's income in year two is smaller than the amount to be deducted, the taxpayer is in the position of having paid taxes on income that, as it turns out, did not belong to the taxpayer. Even with individual net loss deductions, the taxpayer may never have enough income to deduct the amount the taxpayer had to pay back. The taxpayer is not allowed to file an amended return for year one to subtract the restored income because the taxpayer did in fact receive the income in year one. If the taxpayer had restored the income in year one rather than year two, however, the two events would have offset one another and there would have been no tax consequence.

For federal purposes, the Internal Revenue Code provides relief in these cases if the amount restored is at least $3,000 and there is insufficient income in

the later year to offset the deduction and thus reduce the taxpayer's tax by the amount it was increased in year one because of the inclusion of the restored amount. Section 1341 of the Code gives the taxpayer, in effect, instead of a deduction in year two, a credit for the amount by which the taxpayer's tax would have been reduced in year one if the restored amount had not been included in taxable income for that year. The credit is treated as a payment of tax made by the taxpayer, which can then be refunded.

North Carolina's individual and corporate income taxes piggyback the federal Code to a large extent but, under prior law, did not conform to section 1341 because that section is structured as an alternative tax rather than as a reduction in taxable income. Because there was no corresponding provision in the North Carolina income tax law, a taxpayer would end up paying North Carolina income tax on income the taxpayer later had to repay to another. This act conforms the North Carolina law to the federal on this issue by allowing the excess tax paid to be refunded.

The circumstances addressed by this act are rare and its fiscal impact is minimal. The situation sometimes occurs with taxpayers who receive employer disability payments while an application for federal disability payments is pending. A federal disability application may take a year or two to process and, if federal benefits are approved retroactively, the taxpayer is usually required to pay back to the employer the amount of employer disability payments received while the federal case was pending.

The case that was brought to the attention of the Revenue Laws Study Committee involved an individual who invented a formula for producing a chemical product and sold the formula to a manufacturer for nearly $2 million in 1994. The inventor's former employer sued the inventor claiming that the employer had licensing rights to the formula. The inventor settled the suit by paying the employer more than $400,000 of the $2 million sales proceeds in 1995. The inventor paid tax on the full $2 million in 1994; in 1995, the inventor had little income to offset the $400,000 deduction for the amount restored to the employer. Thus, without this act, the inventor would have forfeited the more than $25,000 in North Carolina income tax paid on the remainder of the $400,000 in 1994.

S.L. 1997-226 (House Bill 260, Representative Gray)

**AN ACT TO INCREASE THE CAP ON THE INCOME TAX CREDIT FOR REAL PROPERTY DONATED FOR CONSERVATION PURPOSES, TO ENSURE THAT CONSERVATION AND PRESERVATION AGREEMENTS ARE**

**CONSIDERED IN DETERMINING THE APPRAISED VALUE OF LAND AND IMPROVEMENTS, AND TO ESTABLISH THE CONSERVATION GRANT FUND.**

This act directs the Department of Environment and Natural Resources (DENR) to develop a program to encourage a Statewide network of protected natural areas, riparian buffers, and greenways. The success of the program lies in the voluntary donation by property owners of conservation easements in land that is important to the ecological system of the State. A conservation easement is a written agreement between a landowner and a qualifying conservation organization or public agency. The landowner agrees to keep the property covered by the easement in its natural condition, without extensive disturbance. The organization or agency is granted the right to enforce the covenants of the easement and to monitor the property.

The act provides two different methods of carrying out its purpose. First, it increases the tax credit for certain real property donations where the land is useful for land conservation purposes. Second, it creates a Conservation Grant Fund to stimulate the use of conservation easements, to improve the capacity of private nonprofit land trusts to successfully accomplish conservation projects, to better equip real estate related professionals to pursue opportunities for conservation, to increase citizen participation in land and water conservation, and to provide an opportunity to leverage private and other public monies for conservation easements. The fiscal impact of the act from the increase in tax credits is estimated to be a loss of $3.2 million a year. The increase in tax credits was effective beginning on or after January 1, 1997. The Conservation Easements Fund became effective July 1, 1997.

Under prior law, a taxpayer could receive a tax credit equal to 25% of the fair market value of a property interest donated to the State, a unit of local government, or a body organized to receive and administer lands for conservation purposes. The act increases the $25,000 cap on this credit to $100,000 for individual income taxes and $250,000 for corporate income taxes.

The act also makes a conforming change to ensure that a taxpayer who chooses to claim the State credit does not also claim and receive a deduction for federal income tax purposes. This is necessary since federal taxable income is the starting point for calculating State taxable income.

The act further provides that county property tax assessors shall take into account changes in the property's value resulting from conservation or preservation agreements.

The act directs DENR to develop a nonregulatory program, known as the Conservation Easements Program, that uses conservation tax credits as a prominent tool to accomplish conservation purposes and that creates the Conservation Grant Fund to be administered by DENR. Grants from the Fund may be used only to pay for one or more of the following costs and may not be used to pay the purchase price for any interest in land:

1. Reimbursement for all or part of the transaction costs associated with a donation of property.

1. Management support.

1. Monitoring compliance with conservation easements, the related use of riparian buffers, natural areas, and greenways, and the presence of ecological integrity.

1. Educational materials that will encourage conservation purposes.

1. Stewardship of land.

1. Transaction costs, including legal expenses, closing and title costs, and unusual direct costs, such as overnight travel.

1. Administrative costs for short-term growth or for building capacity.

The grant money under the Conservation Grant Fund is available for land that possesses or has a high potential to possess ecological value, is reasonably restorable, and qualifies for the conservation tax credits. A private nonprofit land trust organization is eligible for grant money if it qualifies for the conservation tax credits and is certified under section 501(c)(3) of the Internal Revenue Code.

The Conservation Grant Fund consists of any monies appropriated from the General Fund and any monies received from public or private sources. Any unspent General Fund money appropriated to the Fund reverts at the end of the fiscal year unless the General Assembly provides otherwise. Unexpended monies in the Fund from other sources do not revert at the end of the fiscal year. No money was appropriated to the Fund by this act, nor was any money appropriated in the 1997 General Assembly's budget bill.

S.L. 1997-272 (Senate Bill 508, Senator Plyler)

**AN ACT TO PROVIDE THAT A TURKEY GROWER SHALL NOT BE DISQUALIFIED FROM USE VALUE**

**TAXATION FOR A TWO-YEAR PERIOD IF THE GROWER'S LAND IS TAKEN OUT OF PRODUCTION SOLELY BECAUSE OF THE PRESENCE OF TURKEY DISEASE IN THE AREA.**

This act allows agricultural land used in the production of turkey growing within the preceding two years to continue to qualify for present-use value for property tax purposes, even if the property has been taken out production because of an infectious, transmissible disease known as Poult Enteritis-Mortality Syndrome. This disease is characterized by growth depression and high mortality among turkeys. To eradicate the disease, turkey farmers must suspend their production of turkeys. The act is effective for taxes imposed for taxable years beginning on or after July 1, 1997.

Many turkey farmers participate in the use value deferment program. Under this program, agricultural land, forestland, and horticultural land are valued for property tax purposes based upon their present use value rather than fair market value. The difference between the taxes due on the property's use value and its fair market value is deferred until the property loses its eligibility for the program. At that time, taxes for the preceding three fiscal years which have been deferred, together with interest which accrues on the deferred taxes as if they had been payable on the dates on which they originally became due, become immediately due and payable.

To qualify for use value treatment, property must meet certain ownership, use, and income requirements. Besides being individually owned, agricultural land must be in actual production and it must have produced an average gross income of at least $1,000 for the three years preceding January 1 of the year for which the tax benefit is claimed. When turkey farmers must suspend their production of turkeys in an effort to eradicate the disease, they may lose their eligibility for the use value deferment program because the land is no longer in actual production or because the agricultural income is reduced below the $1,000 threshold. This act provides that these farmers will not lose their eligibility for the program solely on the grounds that the land is being held out of production for the purposes of eradicating the disease of Poult Enteritis-Mortality Syndrome. This exception, however, lasts for only two years. The two-year period should allow farmers to remain in the use value deferment program until they recover.

S.L. 1997-277 (Senate Bill 316, Senator Kerr)

**AN ACT TO AMEND THE WILLIAM S. LEE QUALITY JOBS AND BUSINESS EXPANSION ACT.**

This act began as an agency bill requested by the North Carolina Department of Commerce. It amends several of the business tax credits that were expanded or enacted by the 1996 General Assembly. As part of the 1996 William S. Lee Quality Jobs and Business Expansion Act, the General Assembly extended the jobs tax credit to all 100 counties, enacted a new tax credit for worker training expenses, enacted a new tax credit for increasing research activities, and enacted two new tax credits for investing in machinery and equipment. To be eligible for the jobs credit, the worker training expense credit, the credit for research activities, and one of the investment credits, the taxpayer had to be engaged in manufacturing or processing, warehousing or distributing, or data processing and the wages of the jobs affected had to be at least 10% above the average weekly wage in the county where the job was created or the business claiming the credit was located, as appropriate.

This act expands the types of businesses eligible for the credits to include air courier services, effective January 1, 1998. Air courier services are businesses primarily engaged in furnishing over-night delivery of individually addressed letters, parcels, and packages. Examples of air courier services include UPS and Federal Express.

This act expands the types of businesses eligible for the credits to include central administrative offices, effective October 1, 1997. Central administrative offices are businesses engaged in providing management and general administrative functions for other businesses of the same enterprise. They may perform such services as general management, accounting, computing, tabulating, or data processing, purchasing, engineering and systems planning, advertising, public relations or lobbying, and legal, financial, or related managerial functions. For a business to qualify for these credits as a central administrative office, it must create at least 40 new full time jobs (not including jobs transferred from elsewhere in the State).

The act also creates a new tax credit for taxpayers who purchase or lease real property to be used as central administrative office property, effective October 1, 1997. The amount of the credit is equal to 7% of the eligible investment amount. The eligible investment is the lesser of: (1) the cost of the property or (2) the cost of the taxpayer's total North Carolina property used as central administrative offices on the last day of the taxable year minus the cost of the taxpayer's total North Carolina property used as central administrative offices on the last day of the base year. The base year is that year, of the three immediately preceding taxable years, in which the taxpayer was using the most property as central administrative offices in this State. This calculation prevents a taxpayer from receiving a credit for an office moved from one part of the State to another. For leased property, the cost of the property equals the lease payments over a seven-

year period, plus any expenditures made by the taxpayer to improve the property before it is used as the taxpayer's central administrative office if the expenditures are not reimbursed or credited by the lessor. The tax credit for investing in central administrative office property may not exceed $500,000, and is taken in seven equal installments over the seven years following the taxable year in which the property is first used as a central administrative office. If the property ceases to be used as a central administrative office during the seven-year period, then the credit expires and the taxpayer may not take any remaining installment of the credit. The credit also expires if the total number of the taxpayer's employees at all of its central administrative offices drops by 40 or more.

The act expands the credit for investing in machinery and equipment and the business property credit to include leased personal property. This change is effective for taxable years beginning on or after January 1, 1997.

The act changes the formula for determining a county's ranking and tier designation for several of the tax credits in two ways. First, it changes the factors in the formula. Under prior law, the Secretary of Commerce assigned an enterprise factor to each county each year based on the county's rank in a ranking of counties by unemployment (from lowest to highest), by per capita income (from highest to lowest), and by population growth (from highest to lowest). The act changes the unemployment and per capita income components from a one-year standing to a standing based on the average of the most recent three years. Second, the act guarantees that a county that obtains Tier 1 status cannot lose that status for two years regardless of what the annual rankings would otherwise require. The first of these changes is effective when the act becomes law and applies to designations for the 1998 and later calendar years. The guarantee of at least a two-year Tier 1 status applies retroactively to 1997 and subsequent years.

The act changes the wage standard that applies to all but one of the investment credits in two ways. The prior wage standard was 110% of the average weekly wage in the county. The wage standard for Tier 1 counties now equals the lower of three figures: the average private sector weekly wage in the county; the average private sector weekly wage in the State; and the average private sector weekly wage in the county multiplied by the "county income/ratio wage adjustment" factor. The "county income/wage adjustment" determines a single county's ratio per capita income to its annualized private sector wages, and compares this ratio to the same measure for the State as a whole. The act also replaces the prior wage standard for the other tier areas with a standard 10% above the lower of the three figures described above. These changes are effective for the 1997 tax year and later years. The purpose of these changes is to provide

an appropriate standard for counties that have unusual situations, such as a single, large employer.

The act allows a taxpayer to specify the tax (income or franchise) against which the credit is claimed when filing a tax return rather than when applying for the credit with the Department of Commerce. This change is effective retroactively to the 1996 tax year and applies to all future years. This change was needed because, when initially applying for the credit, the company may not yet know which tax it will claim the credit against.

The act amends the credit for investing in machinery and equipment by providing that a taxpayer that signs a letter of commitment to place specific machinery and equipment in service in an area within two years after the date the letter is signed, and in fact does so, may calculate the credit based upon the tier the county was in when the taxpayer signed the letter. This same provision is already allowed for purposes of the jobs tax credit. This change, which allows companies to plan major investments without risking a possible tier redesignation for the location of the planned investment, becomes effective for taxable years beginning on or after January 1, 1998.

The act directs the Department of Commerce to study tax incentives for new and expanding businesses enacted in 1996, including their effects on tax equity, their distribution across new and existing businesses, the patterns of business development before and after their enactment, and their costs and benefits, and to study the use of tax incentives by other states. The Department of Commerce must report the results of its study to the General Assembly by April 1, 1999.

The fiscal impact of the act is estimated to be a loss to General Fund revenues beginning at $ .2 to $ .5 million for fiscal year 1997-98, and growing to a maximum of $14.5 million for fiscal year 2001-02.

S.L. 1997-292 (House Bill 754, Representative Dickson)

**AN ACT TO LEVY AN EXCISE TAX ON ILLICIT SPIRITUOUS LIQUOR, AN EXCISE TAX ON MASH, AND AN EXCISE TAX ON ILLICIT MIXED BEVERAGES.**

This act expands the excise tax on controlled substances to include a tax on illicit spirituous liquor, mash, and illicit mixed beverages, effective October 1, 1997. Mash is a fermentable starchy mixture from which spirituous liquor can be distilled. Illicit spirituous liquor and illicit mixed beverages are primarily non-tax-paid liquor and mixed beverages that contain non-tax-paid liquor. The new tax is expected to generate between $300,000 and $500,000 annually, of which

approximately 75% will be distributed to State and local law enforcement agencies and 25% will be credited to the General Fund.

The tax rate on illicit spirituous liquor is $31.70 for each gallon or fraction thereof sold by the drink and $12.30 for each gallon or fraction thereof not sold by the drink. The tax rate on mash is $1.28 for each gallon or fraction thereof. The tax rate on illicit mixed beverages is $20.00 on each four liters and a proportional sum on lesser quantities. These tax rates are equivalent to the mixed beverage taxes that would be due on the liquor or mixed drinks or on liquor made from the mash. Failure to pay the tax due triggers a penalty equal to 50% of the tax due, the same as the tobacco tax.

The General Assembly enacted the excise tax on controlled substances in 1989 as a means of generating revenue for State and local law enforcement agencies and for the General Fund. Under the law, a person who acquires illegal drugs is required to pay tax on them within 48 hours of acquiring possession if the tax has not already been paid as evidenced by a tax stamp. A person paying the tax is not required to disclose his or her identity and any information obtained in assessing the tax is confidential and cannot be used in a criminal prosecution other than a prosecution for failure to comply with the tax statute itself. Seventy-five percent of the revenue generated by assessments of the tax is distributed to the law enforcement agencies whose investigation led to the assessment. The remainder of the revenue is credited to the General Fund. The excise tax on illicit liquor, mash, and illicit mixed beverages will be administered and distributed in the same manner as the excise tax on controlled substances.

The North Carolina Court of Appeals upheld the constitutionality of the State's excise tax on controlled substances in 1996 and the North Carolina Supreme court affirmed March 7, 1997. The case, State v. Ballenger, was based on the United States Supreme Court's 1995 opinion holding Montana's illegal drug tax unconstitutional because it was a second punishment, not a true tax, and thus violated the double jeopardy clause of the Fifth Amendment. The United States Supreme Court decision was based on two key aspects of Montana's tax: it was at an unusually high rate when applied to certain low-value drugs and it did not apply until a person was arrested for a drug violation. Our Attorney General's office reviewed the Montana case and concluded that our drug tax is not unconstitutional because it applies whether or not a person is arrested for a drug violation. The General Assembly enacted several changes to the law in 1995 to further clarify that the tax is not a punishment, but is in fact a true tax designed to raise revenue.

S.L. 1997-300 (Senate Bill 784, Senator Webster)

## AN ACT TO PROVIDE TAX RELIEF AND SIMPLIFICATION BY CONFORMING STATE TAX LAW TO THE FEDERAL RULE THAT GRANTS A FILING EXTENSION EVEN IF THE REQUEST IS NOT ACCOMPANIED BY PAYMENT.

This act conforms the State tax law on filing extensions for certain taxes with federal law by authorizing an extension for filing a return whether or not the tax is paid. The filing extension is not an extension of time for paying the tax, however. The act becomes effective for returns due on or after January 1, 1998.

Under current State law, to obtain an extension of time for filing an income tax return, a corporate franchise tax return, or a gift tax return, the taxpayer must pay the amount expected to be due. If the taxpayer does not pay the tax, the filing extension is not granted and the taxpayer faces penalties for both late filing and late payment. This law was enacted in 1990 to bring State law in conformity with federal law. The federal law has since changed, however. The Internal Revenue Service recently adopted a rule granting a filing extension whether or not the tax is paid. The filing extension is not an extension of time to pay the tax, however. If the tax is not paid by the original due date, a taxpayer who pays when filing the return on the extended date still faces a late payment penalty but not a late filing penalty.

The purpose of granting a filing extension whether or not the tax is paid is to obtain a record of the taxpayer. A taxpayer who could not pay the tax by the due date and thus could not obtain a filing extension under prior law had no incentive to file a request for an extension or to file a return by the extended date. In fact, the accumulated filing penalties could have made the taxpayer less likely to file at all. If a taxpayer does not request an extension or file a return, the Department of Revenue might have no record of the taxpayer and thus might not be able to pursue the unpaid taxes. If the taxpayer requests an extension but does not pay the tax, the Department can contact the taxpayer and try to collect the unpaid taxes, perhaps through an installment agreement.

Conforming the State law to the federal law will simplify tax compliance for taxpayers, who will not have to track separate State and federal rules for obtaining a filing extension. The proposed change will result in some nonrecurring computer programming costs for the Department of Revenue. The Department is authorized to draw these one-time costs from 1997-98 fiscal year income tax collections.

S.L. 1997-307 (Senate Bill 249, Senator Carpenter)

**AN ACT TO CLARIFY WHAT FUNDS MAY BE USED TO REPAY SPECIAL OBLIGATION BONDS AND TO MAKE OTHER CHANGES IN THE LAWS CONCERNING THESE BONDS.**

This act changes the law on special obligation bonds issued by a unit of local government for a solid waste project, such as a landfill or an incinerator, in the following ways:

1. It allows a local unit that has issued a solid waste special obligation bond to pledge additional nontax revenue in payment of the bond after the bond has been issued.

1. It applies the terms and conditions that apply under G.S. 160A-20 to security interests granted in installment financing agreements to security interests in property to be financed by a local solid waste special obligation bond. Applying these criteria makes it clear that the security interest may extend to land already owned as well as the building to be financed, requires the local government to hold a public hearing before granting the security interest, and requires approval by the Local Government Commission before granting the security interest.

1. It clarifies that local solid waste special obligation bonds are secured by the nontax funds that are pledged for their payment but can be paid from other funds.

In 1989, the General Assembly authorized local governments to issue special obligation bonds to finance solid waste management projects. A special obligation bond does not require a vote of the people. A solid waste special obligation bond must be secured by a pledge of designated nontax revenues. The nontax revenues can be fees or can be taxes that are levied by another unit of government and shared with the local government that proposes to issue the special obligation bonds. For example, a city can pledge its share of local sales and use taxes because the county levies those taxes. A county can pledge landfill fees or State-shared tax revenue, such as franchise tax revenue.

S.L. 1997-318 (House Bill 96, Representative Dickson)

**AN ACT TO DIRECT THE SECRETARY OF REVENUE TO (1) MAKE REFUNDS OF THE INTANGIBLES TAX TO TAXPAYERS WHO PRESERVED THEIR RIGHT TO A REFUND BY PROTESTING PAYMENT WITHIN THE TIME LIMITS SET BY G.S. 105-267 AND (2) NOTIFY AFFECTED INTANGIBLES**

**TAXPAYERS BY MAIL AS SOON AS POSSIBLE OF THE COURT NOTICE IN THE CLASS ACTION LAWSUIT REGARDING REFUNDS.**

This act provides a refund of the intangibles tax on stock, with interest, to taxpayers who made a timely protest for the 1990 through 1994 tax years. The State obligated itself to pay protesters their refunds when the General Assembly enacted S.L. 1997-17. In that act, the General Assembly directed the Secretary of Revenue to take no action to collect or assess back intangibles tax for tax years 1990 through 1994 from those taxpayers who did not pay the intangibles tax on North Carolina stock in reliance on the unconstitutional taxable percentage deduction.

On February 10, 1997, in Fulton Corp. v. Faulkner, the North Carolina Supreme Court held that the taxable percentage deduction in the North Carolina intangible tax on stock violated the commerce clause by discriminating against out-of-state companies. The deduction reduced a taxpayer's liability for the tax in proportion to the amount of business the corporation did in North Carolina. The court did not order refunds. Instead, it allowed the possibility of curing the past discrimination by the assessment of intangibles tax on those who did not pay in reliance on the unconstitutional taxable percentage deduction. The General Assembly prohibited the assessment of the tax from taxpayers who benefited from the taxable percentage deduction in S.L. 1997-17.

This act does not provide relief to nonprotesters. The Attorney General's office issued an opinion in April 1997 that it would be unconstitutional for the General Assembly to refund intangible taxes not filed under protest. Because the State has no legal obligation to these taxpayers, any payments would be an exclusive emolument prohibited by Article I, Section 32 of the North Carolina Constitution. The exclusive emoluments provision of the State Constitution prohibits the legislature from extending special privileges to a select group of individuals except in consideration of public services.

Prior to the ratification of this act, the Wake County Superior Court certified Smith v. State as a class action case representing all taxpayers who paid intangibles tax under timely protest. On June 11, 1997, the court entered judgment in favor of the protesters, awarding them full refunds with interest. The attorneys for the protesters requested attorneys fees equal to 16% of the total amount to be paid to protesters. Any such award will be deducted from the interest paid on refunds to the protesters who are members of the class.

In late June and early July of 1997, the court published a notice of the lawsuit and the possibility of opting out in the classified section of the newspapers. The

deadline for opting out was July 28, 1997. By opting out, a taxpayer could avoid having attorneys fees deducted from the taxpayer's intangibles tax refund. A taxpayer who opted out will still receive a refund for any of the tax years from 1992 through 1994 for which the taxpayer was a timely protester. Most taxpayers who protested did so only for 1993, 1994, or both. If a taxpayer paid under protest for 1991 but did not "preserve" the protest by filing suit, the taxpayer will not receive a refund for that year unless the taxpayer remained in the class. Most taxpayers did not pay under protest for the 1991 tax year, however.

The Department of Revenue and the State of North Carolina are opposing any award of attorneys fees on the grounds that the Department of Revenue would pay all protesters for the 1992 through 1994 tax years anyway, whether or not there is a court order. To ensure that as many affected taxpayers as possible received actual, complete information before the deadline set by the court for taxpayers to make a decision regarding the class action lawsuit, the General Assembly directed the Secretary of Revenue to mail a copy of the court's notice to as many affected taxpayers as possible.

S.L. 1997-328 (Senate Bill 466, Senator Hartsell)

**AN ACT TO EXEMPT FROM STATE INCOME TAX ALL OF THE ANNUAL INVESTMENT INCOME EARNED BY CONTRIBUTORS ON DEPOSITS IN THE PARENTAL SAVINGS TRUST FUND AS WELL AS THE DISTRIBUTIONS TO BENEFICIARIES OF THAT FUND.**

This act excludes two types of income from State individual income tax. The items excluded are the annual earnings on amounts contributed to the Parental Savings Trust Fund for the future payment of room or board at an institution of higher education and the earnings distributed to a beneficiary of the Fund that are used to pay for higher education expenses. The act is effective for taxable years beginning on or after January 1, 1998. The revenue loss to the General Fund is expected to be a little over $3,000 in fiscal year 1998-99. The revenue loss will increase to as much as $819,000 by the year 2007.

The Parental Savings Trust Fund is part of the State Education Assistance Authority. The Fund is authorized by G.S. 116-209.25, which was enacted by the 1996 General Assembly. A person can contribute amounts into the Parental Savings Trust Fund for a child who is less than 16 years old. The amount contributed in the account, along with its interest and investment earnings, can be used to pay the expenses of the beneficiary at any accredited public or private college or community college. Either the child or the person making the contributions must be a resident of this State. The Authority plans to begin the

Fund in the fall of 1997. The Parental Savings Trust Fund is a kind of qualified state tuition program under section 529 of the Internal Revenue Code.

Section 529 of the Code excludes some of the amounts earned by contributors to a qualified state tuition program from federal tax and, therefore, North Carolina tax as well. Under federal law, earnings on amounts contributed for the payment of tuition, fees, books, supplies, and equipment at an institution of higher education are excluded from tax but not the earnings on amounts contributed for room and board. Earnings on amounts contributed for room and board are taxable. The taxation of amounts contributed for room and board is consistent with section 117 of the Code concerning the taxation of scholarships. Under that section, an amount received as a scholarship is excluded from taxable income to the extent the amount is for tuition, fees, books, supplies, and equipment required for courses of instruction. The amount of a scholarship that is intended for living expenses (room and board) is subject to tax.

Also under federal law, the amount distributed to a beneficiary of the Parental Savings Trust Fund for tuition, fees, books, supplies, and equipment that exceeds the amount contributed is taxable. Thus, under federal law, the tax on the investment earnings is simply deferred until a distribution is made, at which time the earnings are taxable to the beneficiary rather than the contributor.

The two exclusions allowed by the act will result in a lack of conformity with federal income tax law on these items and with the State and federal law on the subject of income received for the payment of room and board at an educational institution. Because federal taxable income is the starting point for determining State taxable income and the two exclusions in the act differ from federal law, the new exclusions will require new deduction calculations to be made on the State income tax return and necessitate the revision of the form.

S.L. 1997-340 (House Bill 1044, Representative Rogers)

**AN ACT TO AUTHORIZE COUNTIES TO DESIGNATE AN OFFICIAL TO RECEIVE SALES TAX REFUND INFORMATION.**

The act authorizes a board of county commissioners, in a resolution adopted by the board, to designate a county official to receive certain sales tax refund information from the Secretary of Revenue. Prior law provided for only the chair of the board of county commissioners to receive this information. If the board does not adopt a resolution, then the Secretary will continue to send the requested information to the chair of the board of county commissioners.

In 1995, the General Assembly gave counties access to information regarding local sales tax refunds paid to certain nonprofit entities and governmental entities. Under G.S. 105-164.14, these entities may seek a refund of State and local sales taxes they pay on their purchases by filing a written request for refund with the Department of Revenue and naming the counties where the purchases were made. The Secretary of Revenue then deducts the claimed refunds of local sales taxes from tax revenue distributed to the counties. Prior to 1995, counties did not have access to information regarding local sales tax refunds because the local sales tax is collected by the State and the tax secrecy statute, G.S. 105-259, prevented the Department of Revenue from disclosing information about individual taxpayers. Without this information, counties were not able to audit claims for refunds against them. The counties had to rely on the Department of Revenue to audit the claims, but the Department did not have enough resources to provide the level of audit some counties wished to provide for themselves.

To obtain information concerning local sale tax refunds, a county must request the information in writing from the Secretary of Revenue. The Secretary has 30 days to provide the designated county official with a list of each nonprofit entity or governmental entity that received a refund of at least $1,000 of that county's local taxes within the last 12 months. The county uses the list it receives from the Department of Revenue to identify entities whose refund claims the county may wish to audit. Upon the written request of the county, the entity that has received a refund must provide the county with a copy of the request for refund, along with supporting documentation requested by the county in order to verify the request. If an entity determines that a refund it has received has been charged to the wrong county, it must file an amended return for the refund. The amended return enables the Department to make the appropriate adjustments in the subsequent quarterly distribution of local sales tax revenue.

The act makes a conforming change to the local sales tax exception to the tax secrecy statute, set out in G.S. 105-259(b)(6a), by providing that a list of claimants that have received a refund may be furnished to a designated county official.

S.L. 1997-355 (House Bill 1158, Representative R. Hunter)

**AN ACT TO PROVIDE THAT ANTIQUE AIRPLANES SHALL BE VALUED AT NO MORE THAN FIVE THOUSAND DOLLARS FOR PROPERTY TAX PURPOSES.**

This act grants property tax relief to owners of antique airplanes similar to the relief that the 1995 General Assembly gave to owners of antique automobiles. The act provides that antique airplanes that are not used for the production of income will be assessed at the lower of their true value or $5,000, effective for

taxable years beginning on or after July 1, 1998. The act is expected to reduce local government property tax revenues by less than $100,000 a year.

An airplane qualifies for this property tax reduction if it meets all of the following conditions:

- It is registered with the Federal Aviation Administration.
- It is a model year 1954 or older.
- It is maintained primarily for use in exhibitions, club activities, air shows, and other public interest functions.
- It is used only occasionally for other purposes.
- It is used by the owner for a purpose other than the production of income.

Non-business property has been exempt from property taxes since 1987. Non-business property means personal property that is used by the owner of the property for a purpose other than the production of income and that is not used in connection with a business. Non-business personal property includes household furnishings, clothing, pets, and lawn equipment. The term includes collectibles such as antique furniture, coins, and paintings. However, the term does not include aircraft. In 1995, the General Assembly granted property tax relief to owners of antique automobiles. Like the non-business personal property tax exemption, the antique automobile tax relief applied only to individuals, not other entities, and applied only if the automobile is not used in connection with a business. This act is not limited to non-business aircraft; it reduces property taxes on antique airplanes even if they are owned by a corporation or other entity and even if they are used in connection with a business.

S.L. 1997-369 (Senate Bill 374, Senator Odom)

**AN ACT TO EXEMPT FROM SALES AND USE TAX NUTRITIONAL SUPPLEMENTS SOLD BY CHIROPRACTORS.**

This act creates a new State and local sales and use tax exemption. The new exemption is for "nutritional supplements sold by a chiropractic physician at a chiropractic office to a patient as part of the patient's plan of treatment." The exemption became effective October 1, 1997; it will not result in a significant loss of revenue to either the State or the local governments.

The act does not define a nutritional supplement. The federal Dietary Supplement Health and Education Act of 1994 defines a dietary supplement as a product that meets the following three criteria: (i) is intended to supplement the diet and contains a vitamin, mineral, herb, or other botanical, amino acid, or other dietary substance (or a concentrate, metabolite, constituent, extract, or

combination of any such ingredient); (ii) is intended for ingestion in tablet, capsule, powder, softgel, gelcap, or liquid form; or if not in such form, is not represented as conventional food or as the sole item of a meal or of the diet; and (iii) is labeled as a dietary supplement.

There are no laws that require any dietary supplements to be sold only by health care providers. The dispensing of dietary supplements does not require a prescription. As a marketing tool, vendors of dietary supplements sell some of their products only to health care providers.

S.L. 1997-370 (House Bill 14, Representative Cansler)

**AN ACT TO MODIFY THE SALES TAX DEFINITION OF CUSTOM COMPUTER SOFTWARE.**

This act modifies the sales tax definition of custom computer software to make a clear distinction between software that is subject to State and local sales and use taxes and software that is not subject to these taxes. The act is based on a recommendation of the Revenue Laws Study Committee and reflects an agreement between the Department of Revenue and the North Carolina Electronic & Information Technologies Association on the definition of custom computer software. It becomes effective October 1, 1997, and is expected to cause a General Fund revenue gain of approximately $700,000 a year. Local governments will experience a local sales tax revenue gain of approximately $350,000 a year.

Canned software is subject to sales and use taxes and custom software is not subject to these taxes. The North Carolina sales and use tax law excludes custom computer software from tax to implement the policy that computer services are not subject to sales and use taxes. The cost for custom computer programs is attributable to the programming services provided rather than the cost of producing a tangible form of the program on a cd rom or tape. The definition of custom software in the prior law was very broad, however, and could include off-the-shelf "shrink-wrap" programs and programs that had been modified only slightly by the vendor. Under that definition, custom computer software included all software recommended to the purchaser by the seller after performing an analysis of the purchaser's needs. Thus, under prior law, a common product such as Microsoft's Word program became exempt from sales and use tax if the seller of the program analyzed the customer's needs and decided that Word was better for the customer than WordPerfect or another competing product. This act deletes an analysis of a customer's needs as a determining factor in whether a program is custom (exempt) or canned (taxable).

The definition of custom software in the prior law also included all programs adapted by the seller of the program to be used in a particular computer and its associated input/output devices such as printers. This type of adaptation can be slight, such as the completion of a "fill-in-the-blank" series in which the particular hardware to be used with the program is designated, or it can include extensive changes to the lines of source code in the software. Under the prior law definition, any slight adaptation of a program made the entire program exempt from State and local sales and use taxes. This act changes the law by providing that custom software does not include prewritten software that can be installed and executed with no changes to the software's source code other than changes made to configure hardware or software.

S.L. 1997-388 (House Bill 611, Representative Hackney)

**AN ACT TO INCREASE THE COMPENSATION PROVIDED TO PERSONS ERRONEOUSLY CONVICTED OF FELONIES WHO HAVE RECEIVED PARDONS OF INNOCENCE, TO EXEMPT THE COMPENSATION FROM STATE INCOME TAX, AND TO PROVIDE FOR THE INDUSTRIAL COMMISSION TO HANDLE THE CLAIMS OF THOSE PERSONS.**

This act makes several changes to the law that allows the State to compensate people who have been erroneously convicted and imprisoned of a felony:

- It increases the amount a person may be awarded.
- It changes the agency that determines the award from the Department of Correction to the Industrial Commission.
- It provides that the petition must be presented to the Industrial Commission within five years after the pardon was granted.
- It repeals the requirement that the claimant must have sustained pecuniary loss through the erroneous conviction and imprisonment.
- It allows the Industrial Commission to make the award, rather than the Governor upon the approval of the Council of State.
- It clarifies that the amount awarded to the claimant is exempt from State income tax.

Under prior law, a person who had been granted a pardon of innocence for the erroneous conviction and imprisonment of a felony could petition the State for compensation for the financial loss sustained by the person through the erroneous conviction and imprisonment. The petition was presented to the Department of Correction and the Parole Commission would conduct a hearing.

To support an award, the Parole Commission had to find that the person was erroneously convicted and imprisoned and that the person sustained a financial loss as a result. The Parole Commission would then report its conclusions and recommendations to the Governor. The Governor, upon the approval of the Council of State, was authorized to award the claimant the amount recommended by the Parole Commission. The Governor could not make an award that exceeded $500 for each year imprisoned or a total of $5,000.

Under this act, a person would have five years from the granting of the pardon to present a petition to the Industrial Commission for compensation from the State for the financial loss the person suffered because of an erroneous conviction and imprisonment. Upon finding that the person was granted a pardon of innocence, the Commission must determine the amount the claimant is entitled to be paid and must enter an award for that amount. A claimant will be entitled to an amount equal to $10,000 for each year or the pro rata amount for the portion of each year of the imprisonment. The compensation may not exceed a total of $150,000. The Commission must give written notice of its decision to all parties concerned. Its determination is subject to judicial review.

Section 4 of the act clarifies that the amount awarded to a claimant is not subject to State income tax. Under existing law, it is unclear whether the amount awarded to a claimant is exempt from federal income tax. Prior to 1996, section 104 of the Internal Revenue Code exempted amounts received as damages on account of personal injuries and sickness. In 1996, Congress amended this section to say that gross income does not include "the amount of damages received on account of personal physical injuries or physical sickness." Because of the 1996 federal tax law change, it is questionable whether the compensation would be exempt under federal law. To the extent the income is subject to federal income tax, it would automatically be subject to State income tax. Section 4 provides that to the extent the compensation is included in federal taxable income, it may be deducted for State income tax purposes.

The act is effective when it becomes law and applies to persons pardoned on or after July 1, 1995. The income tax clarification becomes effective for taxable years beginning on or after January 1, 1997.

S.L. 1997-392 (House Bill 225, Representative Weatherly)

**AN ACT TO PROVIDE FOR CLEANUP OF DRY-CLEANING SOLVENT CONTAMINATION IN NORTH CAROLINA, AS RECOMMENDED BY THE ENVIRONMENTAL REVIEW COMMISSION.**

This act requires owners and operators of dry-cleaning facilities to maintain financial responsibility for liability arising from dry-cleaning solvent pollution and creates a Dry-Cleaning Solvent Cleanup Fund to be used to reimburse persons who clean up sites polluted by dry-cleaning solvents that have contaminated the water or surface or subsurface soils of the State. The Fund will be administered by the Department of Environment and Natural Resources. No more than 20% of the amount of revenue in the Fund may be used by the Department for the costs of administering the Fund. The act is a recommendation of the Environmental Review Commission.

The major source of revenue for the Fund is the imposition of a dry-cleaning solvent tax on in-State retailers that sell solvent to dry-cleaning facilities and on dry-cleaning facilities that purchase solvent outside the State. The solvent tax is a per gallon privilege tax equal to $5.85 per gallon of chlorine-based solvents and 80¢ per gallon of hydrocarbon-based solvents. The tax is effective October 1, 1997, and expires January 1, 2010. The Department of Revenue will collect the tax in the same manner as a sales tax. The Secretary of Revenue may retain the Department's cost of collection, not to exceed $125,000 a year. After subtracting these costs and the Department of Environment and Natural Resources administration costs, the tax is expected to generate about $1 million a year for the Dry-Cleaning Solvent Cleanup Fund.

If the amount of claims exceeds the amount of revenue in the Fund, the claims with the highest priority will be paid first. The Department of Environment and Natural Resources must adopt rules to implement the act, including rules for the prioritization of sites and scheduling of funding for assessment and remedial response activities. A petitioner for money from the Fund must meet certain requirements and make a financial contribution. The amount a petitioner may receive from the Fund is capped at $200,000 a year unless the contamination poses an immediate threat to human health or a serious risk of irreparable damage to the environment, in which case a cap of $400,000 applies.

S.L. 1997-397 (Senate Bill 847, Senator Odom)

**AN ACT TO EXEMPT FROM SALES AND USE TAX REUSABLE INDUSTRIAL CONTAINERS USED AS PACKAGING FOR TANGIBLE PERSONAL PROPERTY.**

This act provides a sales and use tax exemption for containers that are used as packaging to enclose property delivered to a purchaser and must then be returned to the owner. Under prior law, packaging items were exempt from sales tax only if they constituted part of the property being sold and were delivered

with the property to the customer. The act becomes effective October 1, 1997. It is not known how much the act will reduce General Fund revenues and local government sales tax revenues.

The act applies to barrels used to transport chemicals and tanks used to transport gases, such as oxygen, acetylene, and propane. In a typical situation, barrels are leased by the barrel company to the chemical company, which fills them with chemicals that are then sold to the customer. The customer returns the barrel, which can then be reused. Under prior law, the chemical company (lessee) was required to pay sales tax to the barrel company (lessor) on the lease price of the barrel. If the barrels had been purchased by the chemical company and sold to the customer, however, they would have been tax exempt. The prior law was, therefore, a disincentive for recycling. The customer would likely discard a purchased barrel and buy a new one when buying more chemicals.

The act does not apply to railroad tank cars or to truck trailers because motor vehicles are not packaging. The act does not apply to railroad palettes because they do not enclose the property being delivered.

S.L. 1997-417 (House Bill 1231, Representative Miner)

**AN ACT TO AUTHORIZE SUPPLEMENTAL SOURCES OF REVENUE FOR LOCAL GOVERNMENT TRANSIT FINANCING.**

This act has four parts that provide local governments with revenue options to finance local public transportation systems, as follows:

I. It authorizes Mecklenburg county to levy a ½ cent local sales tax if approved by the voters of the county.
II. It authorizes most cities that have public transportation systems to levy an additional $5 motor vehicle tax.
III. It authorizes regional public transportation authorities to levy a gross receipts tax of up to 5% on short-term motor vehicle rentals.
IV. It authorizes the new Triad regional transportation authority to levy the same $5 vehicle registration tax that the existing Triangle regional public transportation authority levies. It also authorizes public transportation authorities organized under existing law and comprised of two or more counties to levy this same $5 vehicle registration tax.

Part I of the act authorizes Mecklenburg County to levy a ½ cent sales tax only if the tax is approved by the voters of the county. The tax does not apply to food. In

other respects, it will be administered in the same way as the existing local sales and use taxes.

The proceeds of the tax must be used to finance, construct, operate, and maintain local public transportation systems. A public transportation system is defined broadly in the act to include any combination of real and personal property established for purposes of public transportation. It does not include, however, streets, roads, and highways not dedicated to public transportation or related parking.

Mecklenburg County may not levy the sales tax authorized by Part I of this act unless it has developed a financial plan for equitable allocation of the proceeds it receives based on the identified needs of local public transportation systems in the county and planned expansion of public transportation to unserved areas. The sales tax authorized for Mecklenburg County will be distributed between the county and other local government units in the county that operate local public transportation systems, on a per capita basis. The county must allocate the tax proceeds it receives based on its financial plan.

Part II of the act authorizes most municipalities that operate public transportation systems to levy an additional $5 motor vehicle tax, to be used only to finance, construct, operate, and maintain local public transportation systems. Current law already authorizes municipalities to levy a $5 annual motor vehicle tax that may be used for any public purpose. Many municipalities already have local legislation authorizing them to levy an increased amount. This act adds an extra authorization for $5 more. If that $5 would cause the municipality's total local motor vehicle tax to exceed $30, however, the additional $5 tax may not be levied. The City of Charlotte and the Town of Matthews are authorized by local act to levy annual motor vehicle taxes of $30. These local units are the only ones that would currently be affected by the $30 limitation. The City of Durham and the cities and towns in Gaston County are specifically prohibited from levying this additional $5 for local transportation authorities.

Part III of the act authorizes a regional public transportation authority to levy a gross receipts tax of up to 5% on retailers within the region engaged in the business of renting private passenger motor vehicles and motorcycles. The tax applies only to short-term rentals, i.e., rentals for a period of less than one year. The tax will be collected by the authority but is otherwise administered in the same way as the optional highway use tax on gross receipts from vehicle rentals. This optional highway use tax is 8% on short-term rentals, so the combined tax within the jurisdiction of the authority would be 13%. Each authority may use the proceeds of the tax for its public transportation purposes. Before levying or

increasing the tax, the authority must obtain approval from each county in the region.

A regional transportation authority is an entity created under either Article 26 or Article 27 of Chapter 160A of the General Statutes to provide a public transportation system for the region it represents. The authority created under Article 26, the Triangle Transit Authority for Wake, Durham, and Orange Counties, is governed by a board of trustees appointed by the counties creating the authority and larger cities within the counties. The 1997 General Assembly authorized the creation of a second regional transportation authority for the Triad region, in S.L. 1997-393. The Triad Transit Authority may be created by the four largest cities of the five counties served by the Authority in order to promote the development of sound transportation systems in the area served by the Authority. The Authority would be governed by a board of trustees consisting of the mayors of the four largest cities and the chair of each Metropolitan Planning Organization in the area. The counties served by the Authority would be Forsyth, Guilford, Randolph, Davidson, and Alamance. The four major cities involved in the creation of the Authority are Greensboro, High Point, Winston-Salem, and Burlington.

Part IV of the act authorize the proposed Triad regional transportation authority and any multi-county public transportation authorities organized under current law to levy a $5 vehicle registration tax identical to the tax already authorized for, and levied by, the existing Triangle Transit Authority. A public transportation authority is an entity created by one or more local government entities under Article 25 of Chapter 160A of the General Statutes to provide public transportation. There are three multi-county public transportation authorities. The Choanoke Public Transportation Authority consists of Bertie, Halifax, Hertford, and Northampton Counties. The Kerr Area Transportation Authority consists of Franklin, Granville, Person, Vance, and Warren Counties. The Inter-County Public Transportation Authority consists of Camden, Chowan, Currituck, Pasquotank, and Perquimans Counties.

An authority must obtain the approval of each county within its jurisdiction before it can levy the $5 vehicle registration tax. The Division of Motor Vehicles will collect the tax in counties that are entirely located within the authority's jurisdiction. If the authority's jurisdiction includes just a part of one or more counties, the authority will collect the registration tax in those parts of counties. The authority may contract with local governments to collect this tax. Authorization for authorities to levy this tax is organized into a new Article in Chapter 105 of the General Statutes; accordingly, the Triangle Transit Authority’s tax is recodified from Chapter 160A to the new Article in Chapter 105.

S.L. 1997-423 (House Bill 35, Representative Capps)

**AN ACT TO EXTEND THE TIME ALLOWED FOR CLAIMING SALES TAX REFUNDS, MOTOR FUEL TAX REFUNDS, AND ALTERNATIVE FUEL TAX REFUNDS, AND TO PROVIDE THAT A MOTOR FUEL TAX REFUND IS NET OF THE SALES TAX DUE ON THE FUEL.**

This act extends the time for claiming sales tax refunds for certain nonprofit entities, certain governmental entities, and drugs purchased by hospitals. A late application for a sales tax refund may now be filed with the Department of Revenue after 30 days but within three years after the due date, subject to a 50% penalty. The penalty for a late filing within 30 days after the due date is 25%. The Secretary of Revenue has the authority to waive penalties for good cause, but once a refund is barred the Secretary may not revive it. Prior law required that the application for a refund filed after 30 days be filed within six months after the due date in order to receive a refund subject to the 50% penalty. The due date for nonprofit entities and certain hospitals is October 15 following the first six months of a calendar year and April 15 following the second six months. The due date for governmental entities is six months after the end of each fiscal year. The Department of Revenue had suggested to the Revenue Laws Study Committee that the statute of limitations for late filings of applications for sales tax refunds for these nonprofit entities, governmental entities, and hospitals be extended from six months to three years in order to bring them in line with the due date for applications for tax refunds for all other taxes, except those on property, as set out in G.S. 105-266 and G.S. 105-266.1. In past years, bills have been introduced for refunds for nonprofit entities and State agencies whose refunds have been barred because their applications were filed six months after the due date. The Department of Revenue informed the Revenue Laws Study Committee that by increasing the filing deadline to three years, most of the refund legislation could be eliminated. The extension of sales tax refunds for these nonprofit entities, governmental entities and hospitals is effective January 1, 1998. However, notwithstanding the three-year extension, the act provides that an application for a refund of sales taxes paid by a nonprofit entity or hospital is timely filed if it is filed within four years after the due date and before July 1, 1998. This one-time provision is effective immediately, but the Department of Revenue will not issue a sales tax refund for these nonprofit entities or hospitals until July 1, 1998.

The act also extends the time for filing an application for a refund on motor fuel taxes and alternative fuel taxes from six months to three years. The act further amends the tax laws affecting motor fuel and alternative fuel by assessing sales and use tax on (1) motor fuel for which a refund of the motor fuel tax is allowed

because the motor fuel is accidentally mixed with some other type of fuel or the motor fuel is used in a boat, and (2) alternative fuel and motor fuel for which a refund of the fuel tax is allowed for fuel used for other than to operate a licensed highway vehicle or for fuel used in certain vehicles with power attachments. Prior law exempted motor fuel and alternative fuel from sales tax, regardless of whether the fuel was taxed or a refund of the tax paid was allowed.

The act provides that any sales and use tax due on motor fuel used other than to operate a licensed highway vehicle or used in certain vehicles with power attachments, is to be subtracted from any refund a taxpayer receives on motor fuel tax paid on that fuel. Prior law allowed a refund on motor fuel tax paid on fuel used for off-highway purposes or in certain vehicles with power attachments and no sales tax was deducted or payable. This refund was for the flat cents per gallon rate less one cent. The one cent was retained to liquidate highway bonds. The act sets out a formula for determining the sales and use tax to be deducted from the motor fuel tax refund. This formula provides that the price of motor fuel subject to sales tax is the average of the wholesale prices used to determine the fuel tax rates in effect for the two six-month periods of the year for which the refund is claimed. The one cent holdback is eliminated by the act, because the highway bonds have been paid off. The changes to the tax laws effecting motor fuel and alternative fuel taxes become effective January 1, 1998, and apply to taxes paid on or after that date.

The maximum loss to the General Fund from extending the refund period from six months to three years is not expected to exceed $200,000 annually. The gain in General Fund revenues from changes made to the sales tax on motor fuels is estimated to be $797,525 annually. The net revenue loss to the Highway Fund from the elimination of the one-cent holdback is $200,000 annually.

S.L. 1997-443 (Senate Bill 352, Senator Plyler)

**AN ACT TO MAKE BASE BUDGET APPROPRIATIONS FOR CURRENT OPERATIONS OF STATE DEPARTMENTS, INSTITUTIONS, AND AGENCIES, AND FOR OTHER PURPOSES.**

The Current Operations and Capital Improvements Appropriations Act of 1997 contains one tax law change. The act extends the sunset of the State ports income tax credit from February 28, 1998, to February 28, 2001, and increases the maximum cumulative credit from $1 million to $2 million per taxpayer. This increase is effective for taxable years beginning on or after January 1, 1998. The act is expected to reduce General Fund revenues by $500,000 in 1998-99. 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 taxable year. Any excess credit may be carried forward and applied to the taxpayer's income tax liability for the next five years.

The 1992 General Assembly enacted the State ports income tax credit to encourage exporters to use the two State-owned port terminals at Wilmington and Morehead City. When enacted, the credit applied to amounts paid by a taxpayer on cargo exported at either port. In 1994, the General Assembly expanded the credit to include all amounts assessed on exported cargo, regardless of who paid the shipping costs. In 1995, the General Assembly expanded the credit to include imports and allowed a credit for break-bulk cargo and container cargo imported at either Wilmington or Morehead City and for bulk cargo imported at Morehead City. It did not allow a credit for bulk cargo imported at Wilmington. The credit for bulk exports was also limited to bulk exports at the Morehead City terminal. The 1996 General Assembly expanded the State ports income tax credit to include the importing and exporting of forest products at the Wilmington terminal. Forest products are a type of bulk cargo.

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.

S.L. 1997-475 (Senate Bill 727, Senator Miller)

**AN ACT TO REDUCE THE STATE SALES TAX ON FOOD BY AN ADDITIONAL ONE CENT EFFECTIVE JULY 1, 1998, TO ESTABLISH THE PERCENTAGE RATES FOR THE INSURANCE REGULATORY CHARGE AND THE PUBLIC UTILITY REGULATORY FEE, TO CLARIFY THE BASIS OF THE PREMIUM TAX LIABILITY ON WHICH THE INSURANCE REGULATORY CHARGE IS LEVIED, TO INCREASE COURT FEES IN CRIMINAL CASES, TO INCREASE THE FEES FOR FILING CERTAIN DOCUMENTS, AND TO PROVIDE THAT ANNUAL REPORTS OF MOST BUSINESS CORPORATIONS SHALL BE FILED WITH THE**

**DEPARTMENT OF REVENUE RATHER THAN THE SECRETARY OF STATE.**

This act reduces the State sales tax on food, sets the insurance regulatory charge and the public utility regulatory fee, clarifies the basis for calculating the insurance regulatory charge, provides that most corporate annual reports will be filed with the Department of Revenue rather than the Secretary of State, and makes other changes not related to the tax law.

Part I of the act reduces the State sales tax on food from 3% to 2%, effective July 1, 1998, and is expected to reduce General Fund revenues by about $90 million a year. In 1996, the General Assembly reduced the State sales tax on food from 4% to 3%, effective January 1, 1997. This act does not repeal or reduce the local 2% sales tax on food. The reduced State sales tax rate applies to food that may be purchased with food stamps. Federal law determines what can be purchased with food stamps and, therefore, what food is subject to the reduced State sales tax.

Examples of food items that are subject to the reduced State sales tax rate 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 therefore remain subject to the 4% State sales 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.

Part II of the act increases the insurance regulatory charge from 7.25% to 8.75% for the 1997 tax year and is expected to generate an additional $3 million in revenue. The insurance regulatory charge was first imposed in 1991 in order to make the Department of Insurance receipt-supported and thereby eliminate General Fund support of the Department. The regulatory charge is imposed on insurance companies that pay the gross premiums tax, other than service corporations such as Blue Cross/Blue Shield and Delta Dental Corporation. Health maintenance organizations do not pay the regulatory charge because they do not pay the gross premiums tax. The charge is a percentage of the insurance company's premiums tax liability.

In 1995, the General Assembly eliminated the insurance audit and examination fees for insurance companies, HMOs, medical corporations, and guaranty associations. The revenue generated by these audit fees was an

estimated $4.5 million annually. Consequently, the costs of the audits is now paid for by the insurance regulatory charge as part of the costs of regulating the insurance industry. The increase in the regulatory charge proposed by this act will not fully compensate the General Fund for the 1995 change in the audit fee provisions. The regulatory charge will need to be increased another 0.35% to 9.10% in 1998-99 to fully fund the action taken by the General Assembly in 1995.

Part II of this act also clarifies that the premiums tax liability upon which the charge is levied is not reduced by any tax credits allowed a taxpayer for guaranty or solvency fund assessments. It also makes two technical changes. It deletes the reference to insurance companies regulated under Article 66 of Chapter 58 because no insurance company is regulated under that Article. That Article is the Hospital, Medical and Dental Service Corporation Readable Insurance Certificates Act. It also deletes references to tax paid under G.S. 97-100. Self-insurers pay premiums tax under Article 8B of Chapter 105 of the General Statutes.

Part III of this act decreases the public utility regulatory fee levied in G.S. 62-302 from 0.10% to 0.09% for the 1997 tax year and is expected to reduce the fee revenue by $870,000. The utility regulatory fee was imposed in 1989 in order to defray the State's cost in regulating public utilities. This act reduces the fee because the lower rate, combined with other available revenues, will generate sufficient funds for the estimated costs of operating the North Carolina Utilities Commission and the Public Staff. The regulatory fee is imposed on all utilities that are subject to regulation by the Utilities Commission. The fee is a percentage of the utility's North Carolina jurisdictional revenue. In general, jurisdictional revenue is revenue derived from providing utility service in North Carolina.

Parts IV and V of this act make changes that are not related to the tax law. Part VI of this act provides that most business corporations will file their corporate annual report with the Department of Revenue at the same time that they file their corporate income and franchise tax returns, and raises the annual report filing fee from $10.00 to $20.00. Increasing the fee will generate an additional $1.25 million in revenue each year and transferring the corporate report filing to the Department of Revenue will increase the Department's operating costs by about $112,000 a year. Under prior law, the corporate annual reports were filed with the Secretary of State on the anniversary of the business' incorporation. This Part becomes effective January 1, 1998, but reports filed with either the Department of Revenue or the Secretary of State during the 1998 calendar year will be considered filed with the correct agency.

This Part of the act is one of the recommendations of the General Statutes Commission. The change is designed to make filing annual reports easier for

corporations, to set the due date for the annual report at the due date for filing tax returns (which is a more familiar deadline than the current due date), to allow corporations the benefit of making a single filing with one agency rather than multiple filings with different agencies, and to reduce inadvertent failures to file the annual report. Any amendments to annual reports will continue to be filed with the Secretary of State.

Insurance companies will continue to file their annual reports with the Secretary of State, but on a day set with reference to tax filing dates rather than on the anniversary of their incorporation. The Secretary of State and the Secretary of Revenue are required to prescribe a form jointly for annual reports. The contents of the annual report are being changed to delete the requirement that the names of directors be included in the report because this information is considered not useful to the public. This Part also authorizes a corporation to certify that there are no changes from the previous annual report in order to eliminate the burden of filling out repetitious reports.

S.L. 1997-490 (Senate Bill 39, Senator Larry Shaw)

**AN ACT TO REVISE THE SETOFF DEBT COLLECTION ACT.**

This act modifies the Setoff Debt Collection Act, Chapter 105A of the General Statutes. Under that Act, the Department of Revenue sends the income tax refund of an individual who owes money to a State agency to that agency in payment of the debt rather than to the individual. The individual's income tax refund is therefore set off against the debt the individual owes the State agency .

The Revenue Laws Study Committee recommended this act to the 1997 General Assembly. The modifications made to the Setoff Debt Collection Act apply to tax refunds determined on or after January 1, 2000. The act expands and streamlines the setoff program as follows:

1. It requires all State agencies not given a waiver by the State Controller to use the setoff program to collect debts owed the agency. Under existing law, the State agencies that are included in a list in the statute must use the setoff program to collect debts and those that are not listed cannot use the setoff program.

1. It extends the setoff program to local units of government and their agencies and establishes the procedures local units and their agencies must follow to use the setoff program. The act allows, but does not require, local entities to use the setoff program.

1. It streamlines the setoff program by eliminating several unnecessary notices between the Department of Revenue and the claimant agencies. It accomplishes this by allowing the Department to place refunds of debtors of State agencies in escrow while the State agency finalizes the setoff.

1. It shifts the cost of the program from the agencies whose debts are collected to the debtors who owe the debts, sets a $15.00 cap on the fee imposed for collection through setoff, and shifts the cost of collecting child support debts from all the State agencies that use the setoff program to an earmarking of income tax collections.

1. It clarifies and reorganizes some of the provisions in the Setoff Debt Collection Act.

Expansion to All State Agencies: The Setoff Debt Collection Act currently requires certain named State agencies to participate. Other State agencies may not participate, even on a voluntary basis. The act extends the mandatory State program to all State agencies, as recommended by the State Controller's Office, which administers the Statewide accounts receivable program pursuant to G.S. 147-86.22. If a State agency's use of the program would not be practical or cost effective in certain cases, the State Controller could waive the requirement.

Expansion to Local Governments: The idea to expand the setoff program to local entities originated with Senate Bill 761 of the 1995 Session, introduced by Senator Conder. The act authorizes local governments to submit their debts for collection by setoff only after providing the debtor with notice, an opportunity to be heard before the local government, and an appeal process pursuant to the Administrative Procedure Act. After completing this process, the agency can submit the debt through the League of Municipalities, the Association of County Commissioners, or another clearinghouse. Funneling the debts through a clearinghouse rather than having each local government submit its own debts will avoid placing an undue administrative burden on the Department of Revenue.

Streamlining of Program: Under existing law, the setoff process requires three notices to the Department by the claimant agency, two notices by the Department to the agency, and two notices to the taxpayer. The act eliminates two of the notices to the Department by claimant agencies and one of the notices by the Department to claimant agencies.

Before the effective date of this act, the procedure is as follows: A State agency notifies the Department of a debt. The Department checks to see if the debtor will

be receiving a tax refund. If so, the Department notifies the agency that the debtor is entitled to a refund. The agency then sends the Department and the debtor a notice of intent to apply the refund to the debt. After any hearing requested by the debtor, the agency sends the Department a notice of certification of the debt. The Department then applies the tax refund to the debt and notifies the taxpayer and the agency of the setoff. If the debt is less than the refund, the Department sends the balance of the refund at the same time.

Under the act, a claimant agency sends the Department notice of the debt and the Department immediately sets off the debt against the refund and notifies the taxpayer and the claimant agency. A local agency cannot notify the Department of a debt until after the debt has been established through notice to the debtor and a hearing, if requested. A State agency can notify the Department of a debt, have the refund placed in an escrow for the agency, notify the debtor and hold any hearing requested, and then disburse the escrowed amount accordingly.

The act gives a debtor the same procedural and substantive rights as under existing law, including the right to interest on any part of the refund found not to be a valid debt. Under existing law, a debtor is notified of a potential setoff and the right to contest the setoff. The debtor receives the same notifications under this act. Also, under the act, if an agency fails to give the debtor the required notice, the agency must return the entire refund to the debtor even though a debt is owed.

Collection Assistance Fee Changes: Before the effective date of this act, the cost of administering the setoff debt collection program was paid by the State agencies whose debts were collected by setoff. Under both existing law and this act, each year, the Department of Revenue determines its costs of running the program and recovers these costs by charging a collection assistance fee as a percentage of each debt collected. The act caps this fee at no more than $15.00 per debt. The actual fee is expected to be less.

The act shifts the burden of paying the administrative costs of most setoffs from participating State agencies to the debtors. Under existing law, except in the case of child support debts, the Department of Revenue retained the collection assistance fee from each setoff and reduced the amount paid to the agency by the amount of the fee. The agency therefore absorbed the cost of collecting the debt by receiving less than the full amount of the debt. Under the act, the Department of Revenue still retains the collection assistance fee but the fee is added to the debt and paid by the debtor from the refund rather than subtracted from the amount payable to the agency. As a result, the debtor will pay the fee out of the tax refund that was set off. This change shifts approximately $270,000, which is the cost of collecting about 39,000 debts, from State agencies' budgets to debtors.

Under existing law, the Department of Human Resources and their county counterparts use the debt setoff program to collect child support arrearages pursuant to the federal Child Support Enforcement Program. Since January 1, 1996, rather than deducting its administrative costs from amounts collected for child support arrearages, the Department of Revenue has been required to spread among other State agencies the portion of the Department's administrative costs attributable to child support collections. That change shifted child support setoff administrative costs from child support collections to other setoff collections, resulting in an increase in the percentage deducted from those other collections. The act directs the administrative costs of collecting child support arrearages to be drawn from income tax collections rather than deducted from the amounts collected on behalf of other State agencies. The General Fund bears the cost in either case, but under the act the cost does not come from amounts appropriated to State agencies for other purposes.

S.L. 1997-499 (House Bill 537, Representative Grady)

**AN ACT TO PROVIDE RELIEF FOR FEDERAL RETIREES AND THE SURVIVING SPOUSES OF FEDERAL RETIREES.**

This act provides the following additional relief to federal retirees who paid unconstitutional North Carolina income tax on their federal retirement benefits in 1985, 1986, 1987, and 1988, but did not protest or request a refund within 30 days as required by law:

1. It allows federal retirees to carry forward for two years the unused portion of their tax credit for payment of these unconstitutional taxes if they cannot claim the entire credit because the credit exceeds their tax liability.

1. It allows the surviving spouse of a deceased federal retiree to claim the decedent's tax credit, including the two-year carryforward. If there is no surviving spouse, the decedent's estate may take the credit, but not the two-year carryforward.

The act is effective retroactively to the 1996 tax year. It requires the Secretary of Revenue to reimburse the General Fund for the costs of the additional tax relief by transferring $8 million of excess funds in a reserve account created in 1996.

In 1996, the General Assembly enacted legislation giving 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. If a federal

retiree paid these 1985-88 pension taxes under timely protest, the retiree already received a refund as required by existing law. The 1996 legislation, estimated to cost the General Fund $117 million over three years, provided relief to nonprotesters, who were not legally entitled to a refund or credit.

The 1996 legislation allowed partial refunds and credits as follows: federal retirees who did not make a timely protest and who would owe North Carolina income tax were authorized to take a State income tax credit equal to the amount of pension taxes they paid. The tax credit was allowed in three equal, annual installments, one for the 1996 tax year, one for the 1997 tax year, and one for the 1998 tax year. For a taxpayer whose 1996 tax liability was less than 5% of the pension taxes the taxpayer paid during 1985-88, a one-time refund equal to 85% of the pension taxes was allowed in lieu of the credit. The taxpayer was required to claim this refund by April 1, 1997. The 1996 legislation provided that if a federal retiree who would otherwise be eligible for a credit or refund had died, the retiree's estate could claim the credit or refund.

After the 1996 legislation was enacted, legislators began receiving complaints that this legislation did not provide sufficient relief for surviving spouses or for retirees who did not have enough current tax liability to claim the entire credit. If a retiree eligible for the first installment of the credit for the 1996 tax year died in 1996 or thereafter, the surviving spouse could not claim any of the remaining installments of the credit. The 1996 legislation authorized the estate to claim the credit, but estates often have little or no tax liability against which a credit could be claimed. This act addresses this complaint by allowing surviving spouses to claim the credit. The other complaint received was from taxpayers who were ineligible for the 85% refund because their tax liability equaled 5% or more of the amount of pension taxes they paid for 1985-88. Those taxpayers might receive a credit equal to anywhere from 15% to 100% of the pension taxes, depending upon whether they had enough tax liability against which to claim the credit. The credit allowed is nonrefundable, i.e., to the extent it exceeds the taxpayer's tax liability, it is lost. Taxpayers with lower liability would receive credit for less than 100% of their pension taxes. This act addresses this complaint by allowing taxpayers to carry the unused portion of the credit forward to the following two tax years: 1999 and 2000.

The legislative history of the 1996 legislation indicates that the General Assembly intended that some taxpayers would not receive 100% credit, either because they died in 1996 or later or because their potential credit exceeded their tax liability against which it could be claimed. In the 1996 Second Extra Session, the Senate and the House of Representatives had different approaches to granting relief to nonprotesters for the taxes they paid on their federal pensions from 1985 through 1988. The House passed House Bill 30 (Rep. Grady), which

would have provided a full refund of all taxes paid, through a refundable credit payable over four years. If the retiree died, the surviving spouse or estate was entitled to the refund. The estimated cost of the proposal was a total of $142.8 million. In contrast, the Senate passed a Senate Committee Substitute for House Bill 30 that provided only partial relief for an estimated total cost of $117.7 million. This version of the bill provided only nonrefundable credits and did not provide relief for surviving spouses of deceased retirees. The matter went to conference and the Senate plan prevailed. The two limitations now complained of are the reason the Senate plan cost less than the House plan in 1996.

S.L. 1997-503 (Senate Bill 853, Senator Conder)

**AN ACT AUTHORIZING THE SECRETARY OF THE DEPARTMENT OF REVENUE TO APPOINT EMPLOYEES OF THE DEPARTMENT AS REVENUE LAW ENFORCEMENT AGENTS TO ENFORCE THE EXCISE TAXES ON UNAUTHORIZED SUBSTANCES AND THE CRIMINAL PROVISIONS OF THE REVENUE LAWS.**

This act authorizes the Secretary of Revenue to appoint employees of the Criminal Investigations Division and the Unauthorized Substances Tax Division as revenue law enforcement officers. An employee must be certified as a criminal justice officer under the N.C. Criminal Justice Education and Training Standards Commission to serve as a revenue law enforcement officer.

The Unauthorized Substances Tax Division officers will have subject-matter jurisdiction to enforce the excise tax on unauthorized substances. The Criminal Investigations Division officers will have subject-matter jurisdiction to enforce the felony tax violations in G.S. 105-236 and to enforce any of the following criminal offenses when they involve a tax imposed under Chapter 105 of the General Statutes: embezzlement of State property, embezzlement of funds, obtaining property by false pretenses, forgery, and uttering forged paper. A revenue law enforcement officer has Statewide jurisdiction within the officer's subject-matter jurisdiction. The officer may serve and execute notices, orders, warrants, or demands issued by the Secretary of Revenue or the courts, and may use the powers of arrest in executing these papers.

As law enforcement officers, these Department of Revenue employees will be entitled to increased pension benefits such as a 5% contribution to a 401(k) plan, early retirement, enhanced compensation for work-related disability, and a separation allowance that increases benefits for an officer who retires before becoming eligible for social security (the allowance ends when the officer begins receiving social security). The act requires the Department of Revenue to use

$67,503 of its operating appropriations for the 1997-98 fiscal year to pay for the increased costs.

S.L. 1997-521 (House Bill 1057, Representative Grady)

**AN ACT TO EXEMPT FROM SALES TAX AUDIOVISUAL MASTER TAPES USED IN THE MOTION PICTURE, TELEVISION, AND AUDIO PRODUCTION INDUSTRIES.**

This act creates a new State and local sales and use tax exemption, effective October 1, 1997. The new exemption is for audiovisual masters. An audiovisual master is the film, tape, or other storage device that is made or used by a production company to make more copies of the film or tape. The act will reduce State sales tax revenues by approximately $1 million in fiscal year 1997-98 and by approximately $1.59 million in fiscal year 1998-99. The act will reduce local sales tax revenues by approximately $500,000 in fiscal year 1997-98 and by approximately $800,000 in fiscal year 1998-99.

Because it is levied on the retail price, the tax at issue in this act applies to the value of all production and post-production work that goes into creating a film, video, or commercial. Assume, for example, that a politician contracts with an advertising agency to have a political commercial made. The agency then films or contracts with others to film the politician in action. When the filming is completed, the agency contracts with a company to edit the film and put it in a finished form with sound and any narration. When the finished product (the audiovisual master) is delivered by the agency to the politician, a sales tax applies to the sale of that finished product. The tax is computed on the value of all the services that went into the finished product, such as acting fees or other charges.

According to the North Carolina Film Office, most post-production work on films is done in California or New York but the post-production work on commercials and videos is done in many other places. South Carolina and Virginia do not tax audiovisual masters, so a lot of production companies choose to do post-production work on commercials and videos is done in those states. The exemption provided by this act should remove a disincentive for production companies to work in North Carolina.

S.L. 1997-525 (Senate Bill 1065, Senator Hoyle)

**AN ACT TO EXPAND THE INCOME TAX EXCLUSION FOR SEVERANCE PAY TO INCLUDE SEVERANCE PAY DUE**

**TO AN EMPLOYEE'S INVOLUNTARY TERMINATION THROUGH NO FAULT OF THE EMPLOYEE.**

This act expands the income tax exclusion for severance pay received due to the closing of a manufacturing plant and modifies the cap on the exclusion, effective beginning with the 1998 tax year. It is expected to reduce General Fund revenues by a little more than $2 million in fiscal year 1998-99.

In 1996, the General Assembly enacted an income tax exemption for 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. The exemption was expected to reduce General Fund revenues by approximately $4 million a year. This act expands the tax exemption to include severance pay received due to any involuntary termination through no fault of the employee. The expanded exemption would include being fired without cause, being laid off due to a reduction in force, as well as being terminated due to a plant closure. It would not include voluntary early retirement or being fired for cause. The act also expands the tax exemption to cover any type of job in the private or public sector, not just a job at a manufacturing plant.

Some taxpayers were able to avoid the $35,000 cap by arranging to receive part of the severance pay in December and the rest in January. The act closes this loophole by clarifying that the $35,000 cap applies to the total amount paid to an employee by an employer for the same termination, regardless of when the taxpayer receives the money.