2002 Tax Law Changes

Remove Scrap Tire Tax Sunset

Session Law	*Bill #*	*Sponsor*
S.L. 2002-10	**HB 1578**	**Representative Gibson**

AN ACT TO REMOVE THE SUNSET ON THE SCRAP TIRE DISPOSAL TAX.

OVERVIEW: This act removes the sunset on a 1993 provision that increased the scrap tire disposal tax from 1% to 2% for tires for car, vans, and pick-up trucks, as recommended by the Environmental Review Commission.

FISCAL IMPACT: Because none of the tax proceeds goes to the General Fund, this act has no impact on the General Fund. Removing the sunset is expected to generate about $5.35 million annually that would have otherwise been eliminated by the sunset on the higher tax rate. The tax proceeds are distributed among the Scrap Tire Disposal Account, the Solid Waste Management Trust Account, and counties.

EFFECTIVE DATE: June 27, 2002.

ANALYSIS: The scrap tire disposal tax was enacted in 1989. It applies to tires sold at retail and to tires sold for placement on vehicles to be sold or leased at retail. In 1993, the tax rate on tires with a bead diameter of less than 20 inches was increased from 1% to 2%. Bead diameter is the width of the inside opening of the tire. Tires for cars, vans, and pick-up trucks have a bead diameter of less than 20 inches.

The increase in the tax rate for these smaller tires was set to sunset on June 30, 2002, which would have reduced the rate back to 1%. This act deleted the sunset so the tax rate will remain at 2% on tires with a bead width of less than 20 inches.

The net proceeds of the scrap tire disposal tax are distributed as follows: 27% to the Scrap Tire Disposal Account[1], 5% to the Solid Waste Management Trust Fund, and 68% to the counties on a per capita basis. Counties may use the proceeds of the scrap tire disposal tax distributed to them only for the disposal of scrap tires or for the abatement of nuisance tire collection sites. The Department of Environment and Natural Resources may use up to 50% of the revenue in the Scrap Tire Disposal Account for grants to local governments to assist in the disposal of scrap tires and may use up to 40% of the amount in the Account for grants to encourage the use of processed scrap tire materials. The remaining funds in the Account

[1] Section 2.2(j) of the Current Operations and Capital Improvement Appropriations Act of 2001 provided that the net proceeds of the Scrap Tire Disposal tax collected in 2001-02 would be credited to the General Fund instead of the Scrap Tire Disposal Account.

may be used for assistance to local governments in managing scrap tire programs, and to clean up nuisance scrap tire collection sites if no other funds are available for that purpose. The Department of Environment and Natural Resources must report to the Environmental Review Commission each year on the balances in the Account and the use of the money in the Account. The money in the Solid Waste Management Trust Fund is used to fund activities of the Department of Environment and Natural Resources to promote waste reduction and recycling, to fund research on the solid waste stream in North Carolina, to fund activities related to the development of secondary materials markets, to fund demonstration projects, and to fund research by in-State colleges and universities.

Conform Mobile Telecommunications Sourcing

Session Law	*Bill #*	*Sponsor*
S.L. 2002-16	**HB 1521**	**Representative Allen**

AN ACT TO CONFORM SOURCING OF MOBILE TELECOMMUNICATIONS SERVICES TO THE FEDERAL MOBILE TELECOMMUNICATIONS SOURCING ACT AND TO CODIFY THE SOURCING PRINCIPLES FOR OTHER TELECOMMUNICATIONS SERVICES.

OVERVIEW: This act conforms State sales tax law to the federal Mobile Telecommunications Sourcing Act and codifies the sourcing rules for other types of telecommunications, as recommended by the Revenue Laws Study Committee.

FISCAL IMPACT: While this legislation may redistribute tax revenue between jurisdictions because of changes in sourcing, the total amount available to local governments will not change.

EFFECTIVE DATE: Most of the act became effective for taxable services reflected on bills dated on or after August 1, 2002. This effective date corresponds with the effective date of the federal Mobile Telecommunications Sourcing Act. Two provisions are delayed until January 1, 2004: a new sourcing principle for private lines and a requirement that postpaid calling service be sourced based on the origination point of the signal.

ANALYSIS:

Prior Law: In 2001, the General Assembly simplified the taxation of telecommunications services by providing one tax at one rate for all telecommunication services, including interstate telecommunications service. Under the law, mobile telecommunications service is considered to be taxable in this State if the customer's service address is in this State and the call originates or terminates in this State. However, under the federal Mobile Telecommunications Act, mobile telecommunications service is taxable by the state of the customer's place of primary use, regardless of whether or not the call originates or terminates in the state. A mobile customer's service address and place of primary use are the same: the residential street address or the primary business street address of the customer that is within the licensed service area of the service provider. Therefore, it is the requirement that the call originate or terminate in the State that must be changed to conform to the federal mobile telecommunications sourcing rules.

Background: "Sourcing" is the determination of the jurisdiction within which a transaction is considered to take place for tax purposes. Jurisdictions that tax interstate and international telecommunications generally follow the "*Goldberg* Rule", which is based on an Illinois tax that was upheld by the U.S. Supreme court in *Goldberg v. Sweet*, 488 U.S. 252 (1989). Under the *Goldberg* Rule a jurisdiction may tax a telephone call if the call meets one of the following two criteria:

- It both originates and terminates in that jurisdiction.
- It originates *or* terminates in that jurisdiction ***and*** is charged to a service address in that jurisdiction.

Because of the complexity of identifying the source of mobile telecommunications, federal legislation was enacted effective August 1, 2002, that sources mobile telecommunications transactions at the place of primary use, which is the same as the service address – the residential address or business premises of the purchaser.

Under the federal legislation, states may furnish service providers with a database[2] matching street addresses with taxing jurisdictions.[3] Service providers would be held harmless for any errors resulting from their use of the database. If a database is not provided for a state, then the service provider may determine the appropriate taxing jurisdiction by using an enhanced zip code[4] to assign each street address to a specific taxing jurisdiction in that state. Service providers would be held harmless from any tax liability that otherwise would be incurred solely as a result of an assignment of a street address to an incorrect taxing jurisdiction under this method. The accuracy of the method used is important to protect the tax base of local taxing jurisdictions. The hold harmless provision is important to service providers who provide service in a state with multiple taxing jurisdictions.

The Streamlined Sales Tax Project is working with the telecommunications industry on uniform provisions for sourcing as well as refund limitation provisions based upon the hold harmless provisions in the federal Mobile Telecommunications Sourcing Act. The Streamlined Sales Tax Project and the implementing states[5] have adopted principles for sourcing. The principles do not differ from North Carolina's current sourcing principles. This act codifies those principles. The Streamlined Sales Tax Project has not yet completed its work on the refund limitation provisions. Since North Carolina does not have multiple

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[2] The Multi-State Tax Commission and the Federation of Tax Administrators are currently involved in a project to specify the format of the database.

[3] Some states allow local governments to impose a tax on telecommunications services, resulting in multiple taxing jurisdictions within a state.

[4] The level of accuracy for the nine-digit zip code ranges from 85% to 99%. A more accurate system may be developed using a geographic mapping system. The federal law gives each state the ability to develop a more accurate system if it so chooses.

[5] There are 27 states that have enacted legislation based on either the Uniform Sales and Use Tax Administration Act or the Simplified Sales and Use Tax Administration Act: AR, FL, IL, IN, KY, LA, ME, MD, MI, MN, NE, NV, NJ, NC, ND, OH, OK, RI, SD, TN, TX, UT, WA, WI, WV, WY, and the District of Columbia.

taxing jurisdictions[6], it does not currently need these provisions. Therefore, this act does not include any provisions on this issue.

SECTION-BY-SECTION ANALYSIS: This act conforms North Carolina's sourcing of mobile telecommunications to the federal Mobile Telecommunications Sourcing Act and codifies the sourcing principles adopted by the Streamlined Sales Tax Project and the 27 implementing states, as follows:

Sections 1, 3, and 15:	Replace the term "service address" and "billing address" with the term "place of primary use" because that is the terminology used in the federal Mobile Telecommunications Sourcing Act.
Sections 2, 8, 12, and 13:	Change the term "prepaid telephone calling arrangement" to the term "prepaid telephone calling service" so that the terminology is consistent with the other forms of telecommunication services.
Sections 4 and 5:	Prepaid telephone calling services are taxed as tangible personal property, not as a telecommunications service. Section 4 removes the sourcing language from the statute that sets the sales tax rates and Section 5 modifies the sourcing principles that apply to tangible personal property to accommodate the taxation of prepaid telephone calling services.
Section 6:	Deletes the sentence that sources mobile telecommunications based on the call originating or terminating in this State because it conflicts with the sourcing principle in the federal Mobile Telecommunications Sourcing Act. It also specifies that mobile telecommunications services are taxed in accordance with federal law. This reference alerts the reader that there is applicable federal law on this issue.
Sections 7 and 11:	Under the federal Mobile Telecommunications Sourcing Act and the Streamlined Sales Tax Project, telecommunications service is sourced based on the type of service provided rather than the type of call. These sections define the different types of services and repeal the terms associated with the types of calls.
Sections 9 and 10:	Set forth the mobile telecommunications sourcing principle in the federal Mobile Telecommunications Sourcing Act, and codify the principles currently used by the State to source other telecommunications services. Section 10 rewrites the sourcing principles for private telecommunications service in a more understandable format and adds a sourcing principle that is not currently applicable to private lines in the State, but may be

[6] North Carolina distributes a portion of the State-imposed telecommunications tax to the cities.

applicable in the future. The principles codified are the same principles adopted by the Streamlined Sales Tax Project and the implementing states in March of 2002. Under the act, at the request of the telecommunications industry, the new sourcing principle applicable to private telecommunications service does not become effective until January 1, 2004.

Sections 9 and 14: Under the Streamlined Sales Tax Project, postpaid calling service will be sourced based on the origination point of the telecommunications signal as first identified by the seller's telecommunications system. However, not every company in the telecommunications industry has the capability to determine the origination point of the signal. The act gives the seller two options to source postpaid calling service until 2004; beginning in 2004, the seller must source based on the origination point of the telecommunications signal.

Certain Counties Delinquent Taxes

Session Law	*Bill #*	*Sponsor*
S.L. 2002-51	**HB 1533**	**Representative Hunter**

AN ACT TO AUTHORIZE CERTAIN COUNTIES TO REQUIRE THE PAYMENT OF DELINQUENT PROPERTY TAXES BEFORE RECORDING DEEDS CONVEYING PROPERTY AND TO MODIFY THE TIMETABLE FOR STOKES COUNTY OR ANY OF ITS MUNICIPALITIES TO ADOPT A SCHEDULE OF DISCOUNTS FOR PREPAYMENT OF PROPERTY TAXES.

OVERVIEW: S.L. 2002-51 authorizes the county commissioners in Bertie, Clay, Durham, Henderson, Hertford, Macon, Northampton, Polk, Rutherford, and Transylvania Counties to require the register of deeds to refuse to register a deed unless the county tax collector has certified that no delinquent taxes are due on the property. In addition, this act allows the governing body of Stokes County or any of its municipalities to provide a schedule of discounts for property taxes paid prior to November 1, 2002.

FISCAL IMPACT: This act has no impact on the General Fund.

EFFECTIVE DATE: This act became effective when it became law, July 30, 2002.

ANALYSIS: Since 1963, the General Assembly has prohibited the register of deeds in several counties and municipalities from recording deeds unless the tax collector certifies that no delinquent taxes are due: Avery County (1963); Mitchell County (1987); Ashe County (1993); the Towns of Newland and Spruce Pine and Alleghany County (1997); the Town of Banner Elk (1998); and the Town of Bakersville (1999).

In 2001, the General Assembly gave the county commissioners in 35 counties the authority to adopt a resolution requiring the county tax collector to certify that no delinquent taxes the collector is charged to collect are due on the property before a deed transferring the property can be recorded. S.L. 2001-464 gave this authority to the following 25 counties: Alleghany, Anson, Beaufort, Cabarrus, Camden, Cherokee, Chowan, Currituck, Forsyth, Graham, Granville, Harnett, Haywood, Jackson, Lee, Madison, Montgomery, Pasquotank, Perquimans, Pitt, Stanley, Swain, Vance, Warren, and Yadkin Counties. S.L. 2001-513 gave this authority to the following 10 counties: Carteret, Cleveland, Davidson, Gaston, Iredell, Martin, Person, Rockingham, Rowan, and Washington Counties. Unlike the previous local acts, the authority given by these two 2001 acts is permissive. To use this collection tool, the board of county commissioners must adopt a resolution on the matter. The resolution may describe the form the certification must take.

S.L. 2002-51 extends to the following 10 counties the permissive authority given to the 35 counties in 2001: Bertie, Clay, Durham, Henderson, Hertford, Macon, Northampton, Polk, Rutherford, and Transylvania Counties.

In addition, S.L. 2002-51 allows Stokes County and it municipalities to institute, without the approval of the Department of Revenue, a schedule of discounts to be applied to property taxes paid prior to November 1, 2002. The governing body that adopts the resolution must submit a certified copy to the Department of Revenue and must publish the discount schedule at least once in a newspaper of general circulation in the taxing unit. In general, under G.S. 105-360(c), a county or municipality that levies a property tax may adopt a resolution or ordinance to establish a schedule of discounts for taxes paid prior to the due date. In order to exercise this authority, the county or municipality must 1) adopt the resolution or ordinance specifying the schedule of discounts prior to May 1, 2) submit the resolution or ordinance to the Department of Revenue for approval, and 3) upon approval of the resolution or ordinance, publish the discount schedule at least once in a newspaper of general circulation in the taxing unit.

Revenue Laws Technical Changes

Session Law	*Bill #*	*Sponsor*
S.L. 2002-72	**SB 1160**	**Senator Hartsell**

AN ACT TO MAKE TECHNICAL AND CLARIFYING CHANGES TO THE REVENUE LAWS AND RELATED STATUTES AND TO PROVIDE A ONE-TIME EXTENSION TO THE TIME PERIOD IN WHICH A TAXPAYER MAY SIGN A LETTER OF COMMITMENT WITH THE DEPARTMENT OF COMMERCE TO QUALIFY FOR A LOWER TIER DESIGNATION.

OVERVIEW: Senate Bill 1160 makes numerous technical and clarifying changes to the revenue laws and related statutes. It also makes one substantive change. The original bill was a recommendation of the Revenue Laws Study Committee.

FISCAL IMPACT: Section 1 of this act, which allows a one-time exception to the requirement that a letter of commitment be signed before year's end, has an annual cost to the General Fund of $725,000 through the 2006-2007 fiscal year and an annual cost of $25,000 for three years thereafter. The remainder of this act has no fiscal impact.

EFFECTIVE DATE: Except for Section 9 of the bill, which conforms the payment date for the insurance regulatory charge on HMOs to the date they file their premium tax returns and which becomes effective for taxable years beginning on or after January 1, 2003, this act became effective when it became law on August 12, 2002.

ANALYSIS:

SUBSTANTIVE CHANGE: Section 1 of the bill was introduced by Senator Soles as Senate Bill 1344. It allows a taxpayer that signed a letter of commitment with the Department of Commerce on or before February 28, 2002, to calculate its Bill Lee jobs creation tax credit and machinery and equipment investment tax credit based on the location's enterprise tier and development zone designation for 2001 rather than 2002. This change would benefit taxpayers creating jobs or making eligible investments in areas whose tier designations increased for the calendar year 2002.

Under the Bill Lee Act, all counties are divided into five enterprise tiers, ranked by economic distress as measured by a formula that combines unemployment, per capita income, and population growth. The Department of Commerce must designate the counties' tier designations for the following year on or before December 31 of each year, based on the most recent data available. The Department of Commerce did not make the counties' tier designations for the 2002 calendar year until April 2002. It appears some taxpayers signed letters of commitment by February 28, 2002, under the belief they would be able to calculate the credit for which they qualified based on the location's enterprise tier designation for 2001. However, this was not possible under then existing law for locations whose tier designation changed for 2002.

Section 1 of this bill allows a taxpayer that signed a letter of commitment with the Department of Commerce during January or February 2002 for future planned expansion to calculate its Bill Lee jobs creation tax credit and investment tax credit based on the location's enterprise tier designation for 2001 rather than 2002. Because this section is permissive, its effect is to benefit taxpayers creating jobs or making eligible investments in areas whose designations increased for the calendar year 2002. The Department of Commerce reports that it has eight letters of commitment signed on or before February 28, 2002, in counties whose tier designations increased from 2001 to 2002.[7] The following chart shows the counties that will be affected by this section and the difference the section will make in the credit amounts the taxpayers qualify for:

COUNTY[8]	# LETTERS OF	2001 TIER DESIGNATION	2002 TIER DESIGNATION

[7] Although the bill also applies to areas designated as a development zone, it has no practical application for development zones because there were no letters of commitment signed with the Department of Commerce for a project in a development zone on or before February 28, 2002.

[8] Onslow County moved from a Tier 2 county designation in 2001 to a Tier 3 county designation in 2002. However, it is not affected by this act because there were no letters of commitment signed with the Department of Commerce for a project located in that county on or before February 28, 2002.

	COMMITMENT SIGNED BY 2/28/02	*The credit and threshold amounts the taxpayer will receive under this section.*	*The credit and threshold amounts the taxpayer would have received if this act had not been enacted.*
Columbus	3	Tier 1: Jobs tax credit = $12,500 Threshold amount = $0	Tier 2: Jobs tax credit = $4,000 Threshold amount = $100,000
Richmond	1	Tier 1: Jobs tax credit = $12,500 Threshold amount = $0	Tier 2: Jobs tax credit = $4,000 Threshold amount = $100,000
Montgomery	1	Tier 2: Jobs tax credit = $4,000 Threshold amount = $100,000	Tier 3: Jobs tax credit = $3,000 Threshold amount = $200,000
Cumberland	1	Tier 3: Jobs tax credit = $3,000 Threshold amount = $200,000	Tier 4: Jobs tax credit = $1,000 Threshold amount = $500,000
Franklin	2	Tier 4: Jobs tax credit = $1,000 Threshold amount = $500,000	Tier 5: Jobs tax credit = $500 Threshold amount = $1,000,000

TECHNICAL CHANGES: the Revenue Laws Study Committee recommended The Revenue Laws Technical Changes bill. The following table provides a section-by-section analysis of the technical changes.

SECTION	G.S./S.L.	EXPLANATION
2	S.L. 1967-1096, as amended by S.L. 2001-414	Corrects a grammatical error.
3	S.L. 2001-264	Clarifies S.L. 2001-264, An Act To Provide Uniform Penalties For Local Meals Taxes. That act made all local meals tax penalties uniform by applying the existing State sales and use tax penalties to meals taxes. The act was intended to improve tax administration by making uniform the tax penalties for each local meals tax. After the act became law, staff noticed that its language might not be sufficiently clear to assure that the penalties will be uniform in each jurisdiction. This section adds language to clarify that additional or higher local penalties are repealed.
4	S.L. 2001-414	Corrects an incorrect cross-reference.
5	S.L. 2001-472	Corrects a typographical error. Although Section 3(a) of S.L. 2001-427 purports to amend just subsection (a) of G.S. 105-472, it actually amends the entire statute. This section conforms the law to accurately state that it amends the entire statute.
6	G.S. 20-10.1	Updates a cross-reference to a definition.
7	G.S. 20-17.4	Adds a missing phrase.
8	G.S. 20-87	Restores language intended to be enacted in 2001 but omitted due to a redlining error.
9	G.S. 58-6-25	Conforms the payment date of the insurance regulatory charge on HMOs

SECTION	G.S./S.L.	EXPLANATION
		to the date they file their premiums tax return. This has no substantive effect because the dates are the same in current law.
10	105-116	Deletes an obsolete cross-reference to a tax credit that is no longer allowed against franchise tax.
11	G.S. 105-127	Repeals two obsolete subsections. These subsections exempt certain stock from property tax. All stock is now exempt from property tax under G.S. 105-275(31).
12	G.S. 105-129.4	Corrects an incorrect word.
13	G.S. 105-129.12A	Conforms terminology to a change in procedure that was enacted in 2001.
14	G.S. 105-130.5	Clarifies that the corporate income tax deduction for 911 charges applies only if the taxpayer included the charges in federal taxable income. Without this correction, there could be an unintended double deduction for these charges.
15	G.S. 105-130.34 and G.S. 105-151.12	Clarifies that the credit for conservation donations applies only if the interest in real property is donated in perpetuity. This conforms the statute to interpretations by DOR and DENR[9]. Comparable federal law requires that a donation be (1) the entire interest of the donor, (2) a remainder interest, or (3) a restriction in perpetuity. This provision was introduced as Sections 1 and 2 of Senate Bill 1252, recommended by the Environmental Review Commission.
16	G.S. 105-163.7	Repeals an obsolete subsection. The Industrial Commission receives the same information from another source now and no longer wants to get it from the Department of Revenue
17	G.S. 105-164.23	Conforms and updates language.
18	G.S. 105-164.27A	Deletes extra language intended to be deleted in 2001 but retained due to a redlining error.
19	G.S. 105-187.1, 20-4.01, 20-116, & 20-305.2	Conforms the definition of "recreational vehicle" in the highway use tax to the definition in the motor vehicles law, and eliminates inconsistent usage of the term. Also, clarifies and reorganizes the statute governing vehicle length.
20	G.S. 105-269.14	Conforms the use tax distribution percentage to reflect past and future rate changes.
21	G.S. 159I-1	Conforms the statutory short title in G.S. 159I-1 to match the title of G.S. Chapter 159I, which was amended in 2001.

[9] Under 15A NCAC 1F .0001 through .0006, DENR will certify donated property for the credit only if it provides a perpetual public benefit.

Housing Tax Credit Chngs/Estate Tax Chngs

Session Law	*Bill #*	*Sponsor*
S.L. 2002-87	**SB 1416**	**Senator Kerr**

AN ACT TO IMPROVE THE LOW-INCOME HOUSING TAX CREDIT BY MAKING IT SIMPLER AND LESS COSTLY WHILE PROVIDING THE SAME LEVEL OF INCENTIVES FOR THE CONSTRUCTION OF LOW-INCOME HOUSING AND TO MODIFY THE FORMULA FOR CALCULATING NORTH CAROLINA ESTATE TAX ON ESTATES WITH PROPERTY IN MORE THAN ONE STATE.

OVERVIEW: This act modifies the low-income housing tax credit to make it simpler and more efficient and modifies the formula for calculating estate tax on estates with property in more than one state.

FISCAL IMPACT:
The projected revenue impact of the housing tax credit changes are as follows:

FY 2004-05	- $8 million
FY 2005-06	- $9.8 million
FY 2006-07	$2.9 million
FY 2007-08	$24.5 million

The other sections of the act are assumed to have little or no impact on the General Fund.

EFFECTIVE DATE: The low-income housing tax credit changes became effective beginning with the 2002 tax year for the existing credit and in 2003 for buildings that are awarded a federal credit allocation on or after January 1, 2003. The estate tax change became effective for the estates of decedents dying on or after January 1, 2002.

ANALYSIS:
LOW-INCOME HOUSING TAX CREDIT: Congress enacted the Low Income Housing Tax Credit in 1986 to fund housing for low- and moderate-income households. Each state receives a limited amount of credit each year. The IRS allocates the per capita low-income housing tax credit to state housing agencies, such as the North Carolina Housing Financing Agency, who in turn allocate the credit to project developers who agree to lower project rents for low-income tenants. In 1999, North Carolina authorized a State income tax credit equal to a percentage of the developer's federal tax credit for low income housing constructed in North Carolina. A project developer sells the tax credits to receive funds to finance the project. Developers indicate that the State tax credit sells for no more than 45 cents on the dollar.

During the 2002 session, the General Assembly became aware of several concerns with the low-income housing tax credit:

- The sale of a dollar tax credit for less than 45 cents is an inefficient use of State tax expenditures.

- The process of selling the tax credits is complex. It involves finding investors, negotiating prices, and completing legal documents.
- The pool of investors interested in purchasing the credit is limited and is diminishing.

This act addresses these concerns in two ways:

- To address the short-term problem of utilizing the tax credits allocated to developers, the act reduces the tax basis required of a purchaser from 100% to 40%.
- To address the long-term problem of the complexity and inefficiency of the credit, the act converts the State credit, which is sold to investors, to a refundable credit, received directly by the owner and invested directly in the project.

New, Refundable Credit for Housing with Federal Allocations beginning 1/1/03: A taxpayer who is allocated a federal low-income housing tax credit is allowed a credit equal to a percentage of the development's eligible basis. Unlike the existing credit that must be taken over five years, the new refundable credit is taken in one year. The existing State credit is a percentage of the federal credit and the percentage varies depending on the tier designation of the county. The new refundable credit is a percentage of the basis for which a federal credit is allowed and the percentage varies depending on the type of development. The eligibility of a development is based upon two factors:

- <u>Income designation of the county or city in which it is located.</u> – The designation of a county or city as "low income", "moderate income", or "high income" is made by the North Carolina Housing Finance Agency ("HFA") in accordance with the Qualified Allocation Plan in effect as of the time the federal credit is allocated. The Qualified Allocation Plan is adopted annually. The Governor must approve it after a public hearing and publication in the North Carolina Register. A change in the income designation does not affect the developer's eligible basis for which a credit is allowed.

- <u>Affordability requirements.</u> – The affordability requirements are set in the statute and apply for the duration of the federal tax credit compliance period. If in any year a taxpayer fails to meet these affordability requirements, the credit is forfeited.

The chart below sets out the percentage of the developer's eligible basis for which a credit is allowed:

Type of Development	Percentage of Basis for which Credit is Allowed
• Units are in a "low income" county or city • 40% of the qualified residential units are affordable to households whose income is 50% or less of area median income	30%
• Units are in a Moderate Income county or city • 50% of the qualified residential units are affordable to households whose income is 50% or less of the area median income	20%

Type of Development	Percentage of Basis for which Credit is Allowed
• Units are in a High Income county or city • 50% of the qualified residential units are affordable to households whose income is 40% or less of the area median income	10%
• Units are in a High Income county or city • 25% of the qualified residential units are affordable to households whose income is 30% or less of the area median income	10%

Credit Election: A taxpayer entitled to the new, refundable low-income housing tax credit may elect to receive the credit in the form of either a direct tax refund or a loan generated by transferring the credit to the HFA. Neither a direct tax refund nor a loan received as a result of the transfer of the credit is considered taxable income by the State. The IRS would consider a direct tax refund taxable. A letter ruling will be submitted to the IRS to clarify whether the loan proceeds would be taxable. The initial indication is that the proceeds would not be taxable.

If a taxpayer chooses the loan method for receiving the credit, the Secretary must transfer to the HFA the amount of credit allowed the taxpayer. The HFA must loan the amount of the credit to the taxpayer on terms consistent with the Qualified Allocation Plan. The HFA is not required to make the loan until the Secretary transfers the credit amount to it.

If a taxpayer chooses the direct tax refund method for receiving the credit, the Secretary must transfer to the HFA the refundable excess of the credit allowed the taxpayer. The HFA holds the refund in escrow, with no interest accruing to the taxpayer during the escrow period. The HFA must release the refund to the taxpayer upon the occurrence of the earlier of the following:

- The HFA determines that the taxpayer has complied with the Qualified Allocation Plan and has completed at least 50% of the activities included in the development's eligible basis.
- The expiration of 30 days after the development's placed in service date.

Forfeiture: If a taxpayer fails to meet the State's affordability requirements for the duration of the federal tax credit compliance period, the State credit is forfeited. If the taxpayer is required to recapture all or part of the federal credit with respect to a qualified North Carolina low-income development, the State credit is also forfeited. A taxpayer that forfeits all or part of the State credit is liable for all past taxes avoided and any refund claimed as a result of the credit plus interest. This amount is payable 30 days after the date the credit is forfeited. The interest is computed from the date the Secretary transferred the credit amount to the HFA.

A taxpayer that is required to recapture all or part of the federal credit with respect to a qualified North Carolina low-income development does not forfeit the corresponding State credit amount in the following circumstances:

- The recapture is the result of an event that occurs in the sixth or subsequent calendar year after the calendar year in which the development was awarded a federal credit allocation.
- The taxpayer elected to transfer the State credit amount to the HFA and received a loan from the HFA for that amount.

Report: The Department of Revenue must report to the Revenue Laws Study Committee and the Fiscal Research Division of the General Assembly by May 1 of each year the following information for the 12-month period ending the preceding April 1:

- The number of taxpayers that claimed the low-income housing credit.
- The location of each qualified North Carolina low-income building or housing development for which a credit was claimed.
- The total cost to the General Fund of the credits claimed.

Sunset: Like the existing low-income housing tax credit, this new refundable credit is repealed effective January 1, 2006.

Modifications for Existing Credit for Housing with Federal Allocations before 1/1/03: Often the investment group financing a low-income housing project is a pass-through entity. In 2001, the General Assembly provided that the low-income housing credit could be allocated among any of the entity's owners, in the entity's discretion, as long as the amount of credit allocated did not exceed the owner's adjusted basis in the pass-through entity. This tax basis requirement means the investor must invest $1 into the project for each $1 of the State credit received. However, the General Assembly determined in 2002 that the market rate for the credit was about 45 cents for each $1 of State credit. The pool of investors willing and able to meet the tax basis requirement was smaller than the need for investment. Without a change in the tax basis requirement, many developers with projects underway may have lost money on those projects. To encourage more investment immediately, the act reduced the tax basis required of a purchaser from 100% to 40%.

The act also addresses the issue of forfeiture of the existing credit by providing that the taxpayer does not forfeit the State credit if a recapture of the federal credit occurs after the State five-year credit period has expired. The federal credit is taken over a 10-year period.

ESTATE TAX CHANGES: Section 9 of the act incorporates a proposal from the Estate Tax Section of the North Carolina Bar Association.[10] It changes the calculation of estate tax due when property is located in more than one state from a net value ratio to a gross value ratio. Before this act became law, North Carolina was one of only three states that prorated based on the net value of the federal taxable estate. At least 36 states prorate based on gross values, including the neighboring states of South Carolina and Virginia.

For estates with property only in North Carolina, the North Carolina estate tax equals the credit for state death taxes allowed on the federal estate tax return.[11] If an estate has property in more than one state, the federal credit must be prorated between North Carolina and the other states in which the estate has property. Under prior law, the percentage of the

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[10] Representative Haire introduced a bill on this issue in 2001, House Bill 276.

[11] The credit for state death taxes allowed on the federal estate tax return is being phased out over the next four years. As a result of legislation enacted in 2002 (S.L. 2002-126), North Carolina does not conform to the phase-out of this credit for 2002 and 2003.

federal credit allocated to North Carolina was determined by dividing the net value of the property in North Carolina by the total net value of the property in the estate.

Net value equals the gross value of the property less any debts associated with the property, such as a mortgage. The prior law was attempting to allocate the credit based on the value of the property that was includible in the taxable estate for federal purposes. The federal estate tax is calculated on the taxable estate, which is the gross estate less allowable deductions such as debts.

The Estate Tax Section of the North Carolina Bar Association asserted that a state's share of federal estate tax is more appropriately based on the gross property located in a state whether or not the property generates any federal estate tax. It proposed that this approach is fair because each state has a responsibility for protecting and supervising the distribution of property regardless of whether it generates federal tax. Also, the use of a net value calculation sometimes results in a North Carolina resident paying more tax than 100% of the amount of the credit.[12] In other instances it may result in a loss of revenue to North Carolina[13]; this may be particularly true in estates in which property qualifies for the marital deduction.

Extend Qualified Business Venture Tax Credit

Session Law	*Bill #*	*Sponsor*
S.L. 2002-99	**HB 1520**	**Representative Allen**

AN ACT TO EXTEND THE SUNSET ON TAX CREDITS FOR QUALIFIED BUSINESS INVESTMENTS, TO AMEND THE DEFINITION OF QUALIFIED GRANTEE BUSINESS, TO EXTEND THE SUNSET ON THE STATE PORTS TAX CREDIT, AND TO CLARIFY AND AMEND THE NORTH CAROLINA STATE PORTS AUTHORITY'S FEE-SETTING AUTHORITY.

OVERVIEW: This act extends the tax credit on qualified business investments and the State ports tax credit from January 1, 2003 to January 1, 2004, and revises the definition of "qualified grantee business" to alleviate a constitutional concern by replacing specific named entities with general descriptions of entities. The act also clarifies that the North Carolina State Ports Authority has fee-setting authority for its rates and tariffs, gives the Authority guidelines to use in setting those fees, requires the Authority to report to the Joint Legislative Commission on Governmental Operations no later than 30 days after it establishes or

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12 A Charlotte resident has a gross estate worth $10,000,000, including a $2,000,000 home in South Carolina with a $1,000,000 mortgage. The South Carolina portion of the credit is 20% because South Carolina uses a gross value calculation: 2,000,000 divided by 10,000,000. The North Carolina portion of the credit is 88%: 8,000,000 divided by 9,000,000.

13 A Charlotte resident has a gross estate worth $10,000,000, including a $2,000,000 home in South Carolina. The North Carolina property has a $1,000,000 mortgage. The South Carolina portion of the credit continues to be 20%. However, the North Carolina portion of the credit is reduced to 77%: 7,000,000 divided by 9,000,000.

increases a fee, and exempts the Authority's fee-setting from the rule-making portion of the Administrative Procedure Act.

FISCAL IMPACT: The amount of the tax credit on qualified business investments that is given each year is capped at $6 million. Because requests for credits have exceeded this cap for four out of the last five years, it is likely that the $6 million annual cost of the program will continue until its sunset in 2004. The General Fund impact due to the extension of this tax credit will occur in the 2003-2004 fiscal year because the investments made in 2003 will be awarded credits on returns filed in the spring of 2004. The extension of the State Ports Authority tax credit is estimated to cost the General Fund $650,000 in the 2003-2004 fiscal year. The changes to the State Ports Authority fee-setting power have no fiscal impact.

EFFECTIVE DATE: The change to the definition of "qualified grantee business" is effective January 1, 2003. The remainder of this act became effective August 29, 2002.

ANALYSIS:

QUALIFIED BUSINESS INVESTMENT TAX CREDIT: The qualified business investment tax credit was enacted in August 1987 to promote economic development for North Carolina businesses. The initial credits applied to both corporations and individual taxpayers, and there was a $12 million cap on the total amount of all tax credits. In response to a 1996 United States Supreme Court decision in Fulton Corp. v. Faulkner, the General Assembly reduced the $12 million cap to $6 million, limited the credit to individuals and small pass-through entities, and removed the requirement that the qualified businesses be headquartered or operating in North Carolina. The credit was to expire for investments made on or after January 1, 1999. In 1998, as part of the appropriations bill, the credit was extended for four additional years until January 1, 2003. This act extends the sunset for one additional year until January 1, 2004.

Explanation of the credit: The qualified business investment tax credit is allowed for an individual taxpayer who purchases the equity securities or subordinated debt of a qualified business venture or a qualified grantee business directly from that business. The credit is equal to 25% of the amount invested and may not exceed $50,000 per individual in a single taxable year. An individual investor may also claim the allocable share of credits obtained by "pass-through entities" of which the investor is an owner. Pass-through entities include limited partnerships, general partnerships, S corporations, and limited liability companies. The credit may not be taken in the year the investment is made. Instead, the credit is taken in the year following the calendar year in which the investment was made, but only if the taxpayer filed an application with the Secretary of State. The unused credit may be carried forward for the next five years. The total amount of credits allowed to all taxpayers for investments made in a calendar year may not exceed $6 million. The Secretary of Revenue calculates the total amount of tax credits claimed from applications filed with the Secretary of State. If the amount exceeds the cap, then the Secretary allows a portion of the tax credits claimed by allocating the total of $6 million in tax credits in proportion to the size of the credit claimed by each taxpayer. In general, a taxpayer forfeits the credit if the taxpayer transfers the securities within one year or the qualified business redeems the securities purchased by the taxpayer within five years after the investment was made.[14]

Impact of Fulton Corp. v. Faulkner: Under the 1996 Fulton case, the original credit provisions clearly violated the interstate commerce clause of the federal constitution because they reduced a taxpayer's tax liability by an amount equal to 25% of the cost of purchasing stock in either a North Carolina business or an investment company whose purpose is to invest in North Carolina businesses, while no tax reduction was allowed for purchasing similar stock in out-of-state businesses or investment companies whose purpose is to invest in businesses that may not be North Carolina businesses. In response to the Fulton case, the Revenue Laws Study Committee discussed this credit, along with several others, at great length. The original proposal of the Committee was to repeal all qualified business investment credits, effective January 1, 1997. In response to appeals to the Committee and to the General Assembly, the credit was expanded to include investments in businesses located both inside and outside North Carolina. However the credit was no longer allowed for investments in investment companies and was limited to investments made by individuals and small pass-through entities under the theory that these investors are not likely to invest outside a 50-mile radius of their homes.

Amendment to definition of "qualified grantee business": In order to be a business in which investments are eligible for a credit, the business must be either a "qualified business venture" or a "qualified grantee business." Both types of businesses must be registered with the Secretary of State. The definition of "qualified business venture" includes several general requirements related to the line of business, gross revenues of the business, and the organization date of the business. Prior to this act, the definition of "qualified grantee business" included a requirement that the business have received a grant or other funding in at least one of the three previous years from one of several named entities. Arguably, this definition violated the rule of uniformity since a credit is allowed only for investments in businesses that have received a grant from one of several specifically named entities, and not for investments in similar businesses that have received grants from similar entities. To address this constitutional issue, the act amends the definition of "qualified grantee business" by replacing the named entities with descriptions that would encompass the following previously named entities: the North Carolina Biotechnology Center, MCNC, and the Kenan Institute for Engineering, Technology, and Science. The only previously named entity that these descriptions do not encompass is the Technological Development Authority. It is unknown if any other entity qualifies under these descriptions.

STATE PORTS TAX CREDIT: This act extends the sunset on the tax credit for North Carolina State Ports Authority wharfage, handling, and throughput charges for one year, from January 1, 2003 to January 1, 2004. When first enacted, this credit was effective for taxable years beginning on or after March 1, 1992, and ending on or before February 28, 1996. The sunset has been extended four times.

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[14] There are two exceptions to this forfeiture provision. First, if the transfer occurs as a result of the death of the taxpayer, the liquidation of the taxpayer, or certain reorganizations of the qualified business, within the one-year period, the transfer does not require forfeiture. Second, the 1998 legislation created an exception to this forfeiture provision for projects in the film industry, since it is unusual for a project in that industry in which a person might invest to last for more than five years.

Explanation of the credit: The State Ports Authority tax credit is allowed to a taxpayer who loads or unloads waterborne cargo from an ocean carrier at the State-owned port terminal at Wilmington or Morehead City. The credit is allowed against the taxpayer's income tax. The taxpayer may be either an individual (G.S. 105-151.22) or a corporation (G.S. 105-130.41). The amount of the tax credit is equal to the amount of wharfage, handling, and throughput charges paid to the North Carolina State Ports Authority in the taxable year that exceeds the average amount of charges paid to the Authority for the current tax year and the two previous tax 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 maximum cumulative credit that one taxpayer may claim is $2 million.

In 1992 the General Assembly enacted the State Ports income tax credit to encourage exporters to use the two State-owned port terminals in Wilmington and Morehead City. When enacted, the credit applied to amounts paid by a taxpayer on any 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 some imports by allowing 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. In addition, the credit for bulk exports was then limited to bulk exports at only the Morehead City terminal. In 1996, the General Assembly expanded the State ports income tax credit to include the importing and exporting at either terminal of one specific type of bulk cargo: forest products. All imports and exports of bulk cargo at the Morehead City terminal were already covered, so the effect of this change was to allow a credit for forest product imports and exports at the Wilmington terminal. In 1997, the General Assembly extended the sunset of the State ports income tax credit from February 28, 1998 to the taxable year ending on or before February 28, 2001, and increased the maximum cumulative credit from $1 million to $2 million per taxpayer. In 2001, the General Assembly extended the sunset to January 1, 2003.

Although not defined by the relevant statutes, the various types of cargo differ as follows:

- Bulk cargo is a type of commodity that is loose and usually stockpiled. Examples of this type of commodity include coal, grain, salt, and wood chips.
- Break-bulk cargo consists of commodities that are packaged and stored on pallets or in cases that must be handled and stacked onto a ship by hand, crane, etc. Break-bulk cargo also includes machinery.
- Container cargo consists of 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.

NORTH CAROLINA STATE PORTS AUTHORITY: This act clarifies and amends the fee-setting power of the North Carolina State Ports Authority in the following ways:

- Clarifies that the Authority has fee-setting authority for its services.
- Sets out statutory guidelines that the Authority must consider in setting fees for its services. These guidelines include the cost of providing service, revenue

requirements, the cost of similar services at other seaports in the South Atlantic region, and any other factors the Authority considers relevant.

- Requires the Authority to report to the Joint Legislative Commission on Governmental Operations no later than 30 days after the Authority establishes or increases a fee.[15]
- Exempts the Authority's fee-setting power from the rulemaking portion of the Administrative Procedure Act.

Amend Pollution Abatement Tax Exclusion

Session Law	*Bill #*	*Sponsor*
S.L. 2002-104	**SB 1253**	**Senator Odom**

AN ACT TO PROVIDE THAT CERTAIN ANIMAL WASTE MANAGEMENT SYSTEMS SHALL NOT QUALIFY FOR SPECIAL PROPERTY CLASSIFICATION AND EXCLUSION FROM THE TAX BASE PURSUANT TO G.S. 105-275(8) AND TO DIRECT THE REVENUE LAWS STUDY COMMITTEE TO STUDY ISSUES RELATED TO THE TAX EXCLUSION, AS RECOMMENDED BY THE ENVIRONMENTAL REVIEW COMMISSION.

OVERVIEW: This act provides that an animal waste management system may not qualify for property tax exclusion as a pollution control device unless it eliminates or substantially eliminates certain discharges, emissions, and contamination. The act also requires the Revenue Laws Study Committee to study property tax exemptions for pollution control equipment. The act was recommended by the Environmental Review Commission.

FISCAL IMPACT: The State General Fund is not affected. The legislation will affect revenue from the property tax base in each county. There are currently no exclusions that have been granted to facilities, thus there are no changes in current county revenues. However, had the legislation not been enacted, potential revenue losses would have been split among counties based on the number of animal waste management systems maintained in each county. Potential losses were estimated using the total property value of the swine, poultry, and turkey facilities in a county. The potential property tax revenue losses statewide could have totaled approximately $9.9 million per fiscal year.

EFFECTIVE DATE: Property tax years beginning on or after July 1, 2002.

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[15] In S.L. 2001-427, the General Assembly increased its oversight of agency setting and raising of fees by requiring an agency that wishes to establish or increase any fee to have either express authorization from the General Assembly for the amount of the fee or general authorization and to consult the Joint Legislative Commission on Governmental Operations **prior** to putting the new fee into effect. S.L. 2002-99 allows the State Ports Authority to report to Governmental Operations **after** increasing or establishing a fee.

<u>ANALYSIS:</u> Since 1955, North Carolina has excluded from property taxes property used exclusively for pollution control or waste disposal. The statute specifies waste lagoons as one type of property that may qualify for property tax exclusion. Before property could qualify for exclusion, the law as of 2001 required that the Environmental Management Commission (EMC) certify that the property complies with all EMC requirements, is operated in accordance with its permit, and has as its primary purpose the reduction of pollution.

As the entity responsible for certifying property for the tax exclusion, the EMC approached the Environmental Review Commission requesting clarification of the policy conflict between the potential property tax exclusion for swine waste lagoons and spray fields and the moratorium the General Assembly has placed on constructing swine waste lagoons and spray fields unless they comply with strict environmental standards. The Environmental Review Commission recommended that the General Assembly act on this issue in 2002.

To evaluate the issue, the General Assembly sought input from the EMC, individual taxpayers, the Attorney General's Office, the Department of Revenue, and other interested parties. There was testimony from experts that in the 1950s when the statute was enacted, there was much less use of animal waste lagoons and spray fields than there is today, indicating that the policy established in the 1950s may no longer be appropriate. The Department of Revenue noted that spray fields are not used exclusively for waste disposal and thus appear to be ineligible for the property tax exclusion. The Southern Environmental Law Center commented that, because waste lagoons do not reduce pollution and in fact accelerate air pollution, they do not meet the statutory requirement for exclusion that their primary purpose is the reduction of pollution. The EMC pointed out that since 1997 the General Assembly has maintained a moratorium on the construction of swine waste lagoons and spray fields with an exception only for swine waste management systems that meet the following environmental performance standards:

1. Eliminate the discharge of animal waste to surface waters and groundwater through direct discharge, seepage, or runoff.
2. Substantially eliminate atmospheric emissions of ammonia.
3. Substantially eliminate the emission of odor that is detectable beyond the boundaries of the parcel or tract of land on which the farm is located.
4. Substantially eliminate the release of disease-transmitting vectors and airborne pathogens.
5. Substantially eliminate nutrient and heavy metal contamination of soil and groundwater.

The General Assembly resolved the conflict between the moratorium and the tax exclusion by providing in this act that an animal waste management system may not qualify for the property tax exclusion unless the EMC determines that it meets the same five standards listed above. This requirement will ensure that the property tax exclusion is allowed only for animal waste management systems that meet strict environmental performance standards. This change becomes effective beginning with the 2002 property tax year.

The act also directs the Revenue Laws Study Committee to study the property tax exclusions for various types of property used for environmental reasons, in consultation with representatives of cities and counties. The Committee is directed to report the results of its study to the 2003 General Assembly.

Revenue Law Enforcement Enhancements

Session Law	*Bill #*	*Sponsor*
S.L. 2002-106	**SB 1218**	**Senator Dalton**

AN ACT TO IMPROVE THE ENFORCEMENT OF TAX LAWS BY CRIMINALIZING OR INCREASING THE PENALTY FOR CERTAIN FORMS OF TAX FRAUD AND BY ALLOWING THE DEPARTMENT OF REVENUE TO DISCLOSE CERTAIN INFORMATION TO LAW ENFORCEMENT AGENCIES.

OVERVIEW: This act improves the enforcement of tax laws by allowing for enhanced punishment when an income tax return preparer aids or assists in the filing of false or fraudulent documents with the Department of Revenue, by creating an offense for fleecing taxpayers, and by allowing the Department of Revenue to share information concerning the commission of any offense with appropriate state or federal law enforcement agencies. This act was a recommendation of the Revenue Laws Study Committee.

FISCAL IMPACT: The cost of additional court trials and prison beds due to the increased felonies is as follows:

FISCAL YEAR	COST
2002-2003	$ 9,035
2003-2004	$ 94,395
2004-2005	$204,839
2005-2006	$294,200
2006-2007	$388,752

EFFECTIVE DATE: The sections allowing for enhanced punishment and creating a new offense become effective December 1, 2002, and apply to actions committed on or after that date. The section allowing disclosure between the Department of Revenue and appropriate State or federal law enforcement agencies became effective September 6, 2002.

ANALYSIS: Under sections 1 through 3 of this act, beginning December 1, 2002, an income tax return preparer who aids or assists in the filing of false or fraudulent documents will be guilty of a Class F felony, if the amount of tax fraudulently avoided in one taxable year on all returns is less than $100,000. If the total amount of tax fraudulently avoided in one taxable year on all returns equals or exceeds $100,000, the income tax return preparer will be guilty of a Class C felony. These punishments are the same as the punishments for embezzlement under Article 18 of Chapter 14 of the General Statutes. The act incorporates the definition of "income tax return preparer" used under the Internal Revenue Code, and makes a conforming change in G.S. 105-159.1(e) to incorporate this definition.

Under the law in effect until December 1, 2002, it is a Class H felony to aid, assist, procure, counsel, or advise the preparation, presentation, or filing of a return, affidavit, claim, or other document that is fraudulent or false as to any material matter. The Department of Revenue requested the enhanced punishment because of the increasing number of fraudulent return cases involving an income tax return preparer. According to the Department, these cases generally involve income tax return preparers that intentionally inflate the itemized deductions claimed on a return or include fictitious business losses on the return. This fraud is carried out in order to reduce taxable income, thereby reducing tax liability. The Department has also noticed an increase in the number of fictitious returns. These are returns that are based on fictitious wage and tax statements.

Under section 4 of this act, beginning December 1, 2002, it will be a Class F felony for a person to receive money from a taxpayer with the understanding that the person would remit the money to the Secretary of Revenue for application on a tax liability and then willfully fail to remit the money to the Secretary. The Department reported that several times a year it will have a situation where an accountant receives money from a taxpayer to satisfy a sales or withholding tax liability. The accountant then files a fraudulent return showing reduced or zero tax due and then pockets the taxpayer's money. Although the Department can and does bring charges against the accountant for filing a fraudulent return, the taxpayer still owes the money that he or she has lost. The taxpayer must then get the local district attorney to file embezzlement charges. The district attorneys have indicated that they prefer that the Department handle this situation since it involves taxes and since the Department is already involved. By creating the offense for fleecing taxpayers, this act places the remedy with the Department. The penalty is the same as for embezzlement totaling less than $100,000.

Section 5 of this act allows the Department of Revenue to share information it discovers during a criminal investigation of a taxpayer with appropriate State or federal law enforcement agencies. Under prior law, the Department could only provide information concerning a tax imposed by Article 2A, 2C, or 2D of the revenue laws to law enforcement agencies. These Articles deal with the tobacco products tax, alcoholic beverage license and excise taxes, and unauthorized substance taxes. However, the Criminal Investigation Division of the Department occasionally discovers evidence of criminal activity unrelated to the taxes imposed in these Articles. Under prior law, the Department was not allowed to disclose that information to law enforcement. This act alleviates this prohibition.

Contracts to Reimburse Fuel Tax/Fuel Tax Chg.

Session Law	*Bill #*	*Sponsor*
S.L. 2002-108	**SB 1407**	**Senator Kerr**

AN ACT TO ESTABLISH A CONTRACT RIGHT REGARDING THE TIMING OF PAYMENTS UNDER CONTRACTS REQUIRING REIMBURSEMENT OF FEDERAL FUEL EXCISE TAXES AND TO MAKE VARIOUS MOTOR FUEL EXCISE TAX CHANGES.

<u>OVERVIEW</u>: This act gives local distributors a contract right to delay reimbursing federal fuel tax to the supplier until one day before the supplier is required to remit the tax to the federal government. The act also converts the local government fuel tax refund to an exemption and makes several other changes to the motor fuel tax laws.

<u>FISCAL IMPACT:</u> The only provision with a fiscal impact is the one converting the local government fuel tax refund to an exemption. The exemption will be slightly revenue positive for local governments because of the interest earned on funds that once went to fuel tax payments before being refunded. Based on refund amounts for past years, Fiscal Research estimates the annual float gain for locals would have been $227,030 for fiscal year 2000-01 and $252,860 for fiscal year 1999-00.

<u>EFFECTIVE DATE:</u> The contract right provision became effective September 1, 2002. The motor fuel tax provisions become effective January 1, 2003.

<u>ANALYSIS:</u>

<u>Contract Rights Regarding Tax Reimbursements</u>

The State and federal motor fuel excise taxes are payable by the distributor, but collected and remitted to the respective tax collection agencies by the supplier. G.S. 105-449.91 gives the distributor the right to defer the remittance of any state tax to the supplier until the date the supplier, as trustee, must pay the tax to this State or to another state. This allows the distributor to retain the interest on the state tax monies until they are due for payment. Federal law does not address the distributor's right to defer the remittance of any federal tax due. The distributor's right as to the timing of the remittance of the federal tax due to the supplier is subject to the terms of the contract between the distributor and the supplier.

Section 1 of this act provides that a contract subject to North Carolina law must afford the distributor the same election for the timing of federal tax remittance that the distributor has for state tax remittance. It provides that the distributor may elect to remit the federal tax due to the supplier one day before the tax is due to the federal Internal Revenue Service. Exercising this option allows the distributor to receive the benefit of any float associated with the federal tax monies. To exercise this right, the distributor must notify the supplier in writing of the intent to make this election and the effective date of the election. The effective date cannot be earlier than the beginning of the next federal tax quarter or 30 days after the notice of intent is received, whichever is later. To secure the receipt of the tax monies, the supplier can require security for the payment of the taxes in proportion to the amount the taxes represent compared to the security required on the contract as a whole.

In practice, this change in the law will not affect contracts between suppliers and distributors for branded fuel[16] when the contract names another state as the controlling state law. Currently, Georgia, Alabama, Mississippi, and Tennessee[17] have similar statutes. If no particular state's law is designated as controlling in the contract, then this State's law will control. If a supplier offers unbranded fuel[18] at a North Carolina terminal and a distributor

[16] Branded fuel is fuel supplied to a distributor pursuant to a contract.
[17] Tennessee collects federal and state excise tax at the rack like North Carolina.
[18] Unbranded fuel is fuel offered by a supplier at the terminal rack to any distributor who wishes to purchase it.

lifts from that terminal rack, North Carolina law will control because the contract for the fuel is accepted in North Carolina.

This section of the act became effective September 1, 2002, and applies to contracts entered into or renewed on or after that date and to all continuing contracts that are in effect on that date and have no expiration date. It does not apply to a contract in effect on September 1, 2002 that, by its terms, will terminate on a later date; nor does it impair the obligation arising under any contract executed before September 1, 2002. Because the act did not become law until September 6, the constitutional prohibition against impairing contracts would prevent it from applying to contracts executed between September 1 and September 6 that have an expiration date.

Motor Fuel Enforcement Tax Changes

Section 2 of this act repeals the Class 1 misdemeanor for willfully and knowingly making a false statement for the purposes of obtaining or assisting someone else to obtain a credit, refund, or reduction of motor fuel tax liability. Repeal of this statute means that the general penalties in G.S. 105-236 will apply. It is a Class H felony under G.S. 105-236(7) to attempt to willfully evade a tax and it is a Class H felony under G.S. 105-236(9a) to willfully help someone else evade a tax.

A motor carrier subject to the International Fuel Tax Agreement must register with the carrier's base state and a motor carrier not subject to that Agreement must register with the Secretary of Revenue. It is unlawful for a motor carrier to operate motor vehicles in the State unless the motor carrier is registered. To indicate to enforcement officers that the carrier is properly registered, the vehicles must display identification markers, or decals. Section 3 of this act requires a motor carrier to keep records of the decals issued to it and to be able to account for those decals. Section 4 of this act establishes a civil penalty for unaccounted for decals and for decals unlawfully obtained. The penalty for being unable to account for decals is $100 per decal. The penalty for displaying a decal unlawfully obtained is $1,000 per decal. The motor carrier whose vehicles display the decal and the motor carrier who obtained the decals are jointly and severally liable for the penalty.

Section 15 of this act simplifies the penalty for transporting motor fuel without a shipping document or with a false or an incomplete shipping document and the penalty for delivering motor fuel to a destination state other than the one shown on the shipping document. Under prior law, the amount of the penalty depended on whether the person against whom the penalty is assessed had previously been assessed a penalty under this statute. If the answer is "no", the amount of the penalty was $1,500. If the answer is "yes", the amount of the penalty was $7,500. To determine whether the person has previously been assessed a penalty under this statute required the enforcement officer to obtain detailed information, which the officer forwarded to the Motor Fuels Tax Division so that the Division could check its records and then assess the correct penalty. The penalty was seldom imposed because the enforcement officers could not enforce the penalty at the time the offense occurred. This section enables the enforcement officer to immediately assess the penalty by providing a flat penalty amount of $5,000.

Section 16 of this act will enable the Motor Fuels Tax Division to be able to track motor fuel transported by a tank wagon after the fuel has left the terminal. A tank wagon is a truck that has a compartment designed or used to carry at least 1,000 gallons of motor fuel.[19] Under this section, a person may not transport motor fuel by tank wagon unless the person has an invoice, bill of sale, or shipping document that contains the following information: the name and address of the person from whom the motor fuel was received, the date the fuel was loaded, the type of fuel, and the gross number of gallons loaded. The person must carry this documentation when transporting the fuel and show the documentation upon request. These requirements are similar to, but less onerous than, the requirements for motor fuel transported by a railroad tank car or transport truck.[20] A violation of this statute would be grounds for a civil penalty in the amount of $1,000.

Section 17 simplifies the penalty for dispensing, or allowing to be dispensed, non-tax-paid fuel into a highway vehicle. Currently, the amount of the penalty varies depending upon the number of gallons dispensed. However, it is often impossible to know how many gallons have been dispensed. This section simplifies the penalty by providing a fixed penalty amount of $250 per occurrence.

Biodiesel and Fuel Alcohol Tax Law Changes

Before this act went into effect, North Carolina's motor fuel tax laws addressed fuel alcohol, but not biodiesel. Both types of fuel are special fuels that may be used to operate a motor vehicle. Biodiesel fuel is a mixture of fuels derived in whole or in part from agricultural products or animal fats or wastes from these products or fats. The General Assembly became aware of a person planning to produce biodiesel fuel in North Carolina using, among other fats, discarded french fry grease from fast food restaurants. Sections 6 and 7 make existing fuel tax provisions applicable to biodiesel, and also provide that small providers of biodiesel and fuel alcohol are not subject to the bonding requirements applicable to refiners.

Under existing law, a person who produces fuel that can be used to operate a motor vehicle is considered a refiner and is subject to a $2 million bonding requirement. There are no refiners in North Carolina. However, it was anticipated that this definition and the large bonding requirement might become applicable to providers of fuel alcohol and biodiesel because it is possible that a vehicle can be operated with biodiesel alone or with fuel alcohol alone. To avoid subjecting small producers of biodiesel and fuel alcohol to the large surety bond requirements for refiners, this act provides a smaller surety bond requirement for smaller producers of biodiesel and fuel alcohol. To accomplish this, Section 6 defines a biodiesel provider and a fuel alcohol provider as a person who produces an average of no more than 500,000 gallons of biodiesel or fuel alcohol a month during a calendar year. It also excludes from the definition of "refiner" these biodiesel providers and fuel alcohol providers. Under Section 7, biodiesel providers and fuel alcohol providers are subject to a bonding requirement of no less than $2,000 and no more than $250,000. The amount of the bond is determined by the provider's average expected monthly tax liability.

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[19] Section 6 amends the term "tank wagon" to require that it be used to carry at least 1,000 gallons of motor fuel. This modification exempts trucks carrying less than that amount from the requirements imposed by this Section 16.

[20] Tank wagons would not be required to be registered, to have a tax responsibility statement, to have a machine-printed shipping document, or to have a destination state. Also, the penalty imposed on a tank wagon for failure to have the proper documentation is $1,000 as opposed to $5,000.

Section 6 adds biodiesel to the definition of diesel fuel and adds biodiesel providers to the definition of supplier. These changes bring biodiesel within the scope of the existing fuel tax laws.

Special Mobile Equipment

Special mobile equipment is a vehicle that has a permanently attached crane, mill, ditch-digging apparatus, or similar attachment. The vehicle is driven on the highway only to get to and from a non-highway job. It is not designed or used primarily for the transportation of persons or property. Under prior State law, special mobile equipment was allowed to use dyed (untaxed) diesel fuel. However, federal law prohibited special mobile equipment from using dyed diesel fuel. This contradiction caused confusion and, as a result, operators of special mobile equipment were sometimes assessed federal penalties. Section 10 conforms North Carolina law to the federal law. Special mobile equipment will continue to be entitled to a quarterly refund of motor fuel tax paid to operate the equipment off-highway.[21]

Diverted Fuel

A person may not transport motor fuel by railroad tank car or by truck unless the person has a shipping document indicating, among other things, the destination state of the motor fuel. The tax on the motor fuel is collected at the rack based on the motor fuel tax rate of the state named on the shipping document as the destination state. The person transporting the motor fuel must deliver it to the state printed on the shipping document.

If the fuel is diverted to another state, the person transporting the fuel must notify the Secretary of Revenue of the diversion and receive a confirmation number authorizing the diversion. The state tax is owed on the fuel changes when the fuel is diverted to a different state. Under prior law, the distributor would notify the supplier of the diversion and the supplier would make the correction based on its business practices. The diversion could be accounted for in several different ways on one of four different motor fuel tax forms. The supplier's responsibility for making the correction was inconsistent with the fact that the supplier is not the party responsible for paying the tax; the supplier's tax collection obligations ended once the fuel left the terminal.

Section 10 clarifies that North Carolina motor fuel excise tax is due on motor fuel that is diverted to this State. It also specifies that the person who authorizes the fuel to be diverted to a different state is liable for the tax owed to that state; likewise the person is entitled to a refund of the North Carolina tax paid on the fuel. The diversion corrections must be made on the backup tax form.

Motor Fuel Tax Exemption for Local Governments

Under prior law, counties and municipalities were entitled to a quarterly refund of motor fuel excise taxes paid by them during the preceding quarter. The refund was calculated at the rate equal to the amount of the flat cents-per-gallon rate plus the variable cents-per-gallon rate in effect during the quarter for which the refund was claimed, less one-cent per gallon. This act

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[21] G.S. 105-449.106(c).

gives counties and cities an exemption in lieu of a refund. Section 11 removes counties and municipalities from the list of entities entitled to a refund and Section 13 adds them to the list of entities exempted from the motor fuel excise tax. Other entities exempted from the tax include the federal government, the State government, local boards of education, charter schools, and community colleges.

Administrative and Technical Changes
A refiner, a terminal operator, a supplier, an importer, a blender, a permissive supplier, and a distributor must file a bond with the Secretary in order to be licensed. The bond is conditioned upon compliance with the motor fuel tax laws. Whenever a license holder changes bonding companies or decides to go out of business, the license holder must notify the Secretary. After determining that all taxes and penalties due under the motor fuel tax laws have been paid, the Secretary must return the previously filed bond and notify both the bonding company and the license holder that the person is released from liability on the bond. The Motor Fuels Tax Division often receives returned mail on the notice sent to the license holder because the license holders have moved. Section 8 relieves the Division from the requirement that it notify the license holder; it need only return the previously filed bond and the notice of release from liability to the bondholder.

The Motor Fuels Tax Division must keep a record of all the license holders under the fuel tax statutes and it must send this list to all the license holders along with a monthly update. Many license holders have expressed a desire not to receive the list this often. Section 9 relieves the Division of the necessity of sending the monthly updates to all license holders. Under this section, the Division must send an annual list to each license holder of all the license holders. Thereafter, the Division need send a monthly update only to each licensed refiner or licensed supplier and to any other license holder that requests a copy of the list.

Section 6 includes within the definition of "motor fuel transporter" a person who transports motor fuel by pipeline. Sections 12 and 14 correct incorrect terminology.

Secure Local Revenues

Session Law	*Bill #*	*Sponsor*
S.L. 2002-120, as amended by Section 65 of S.L. 2002-159	**HB 1490**	**Representative Gibson**

AN ACT TO PROVIDE THAT LOCAL REVENUES MAY NOT BE WITHHELD OR IMPOUNDED BY THE GOVERNOR AND TO CLARIFY THE FRANCHISE TAX ON ELECTRIC POWER COMPANIES.

OVERVIEW: This act provides that certain shared tax revenues are local revenues and may not be withheld or reduced by the Governor and that funds otherwise committed to local governments may not be reduced unless all other revenue sources, including treasury surplus, have been exhausted. The act also clarifies that an electric power company that pays the annual franchise or privilege tax is not subject to an additional franchise or privilege tax imposed by a city or county.

FISCAL IMPACT: No estimate available. This legislation has no direct impact on the budget passed by the General Assembly, as these shared revenues have not been used in the legislative process for state expenditures. However, the legislation could limit the options available to the Governor in future years.

EFFECTIVE DATE: This act became effective September 24, 2002. It applies prospectively only and does not apply to pending litigation or claims that accrued prior to September 24, 2002.

BACKGROUND: For the last two years, the Governor has withheld reimbursement funds from local governments, and he recommended suspending additional reimbursement funds for fiscal year 2002-03 as well. Specifically, in fiscal year 2000-2001 the Governor placed in escrow $95 million of inventory tax reimbursement funds, representing one-half of the total annual payment, in anticipation of a budget shortfall. These funds were later released, however, to local governments. In fiscal year 2001-2002, the Governor again withheld $95 million in inventory tax reimbursement funds plus $114 million in state-shared taxes and the homestead reimbursement in order to balance the budget as of June 30, 2002.

By withholding these funds despite the statutory directive to distribute the funds to local governments, the Governor has invoked his constitutional authority pursuant to Section 5(3) of Article III of the North Carolina Constitution to balance the budget. Section 5(3) of Article III of the North Carolina Constitution sets out the Governor's budgetary duties. Specifically, it directs the Governor to prepare and recommend to the General Assembly a comprehensive budget of the anticipated revenue and proposed expenditures of the State for the ensuing fiscal period. Furthermore, it provides that the State may not operate at a deficit during the fiscal period covered by a budget. To ensure that the State does not incur a deficit, the Constitution requires the Governor to continually survey the collection of revenue. If, as a result of his surveys, he determines that actual receipts for the fiscal period, when added to the surplus remaining in the State Treasury, will not be sufficient to pay budgeted expenditures, the Governor must effect the necessary economies in State expenditures to keep the deficit from occurring. Arguably, the distribution of monies to local governments is a "State expenditure," and the Governor's constitutional obligation to maintain a balanced budget overrides the statutory directive to distribute the funds.

Based on the current information available, it is unclear whether this legislation will be effective in preventing the Governor from withholding these funds from local governments. If the Governor withholds the funds despite the enactment of this legislation, enforcement of this limitation on the Governor’s authority may have to be resolved by a court. As of October 2002, several counties and municipalities have initiated or are considering initiating lawsuits challenging the Governor's withholding of funds.[22]

[22] As of November 2002, one of the pending cases is *Cabarrus County, et al. v. Tolson*, Wake County Superior Court Case No. 02 CVS 12518.

ANALYSIS: Sections 1 through 7 of this act limit the Governor's budgetary authority to withhold or reduce local revenues and to reduce certain State expenditures as follows:

Tax-Sharing Statutes

Sections 1 through 6 of this act amend the tax-sharing statutes by characterizing the portion of the revenue distributed to cities and counties as distributions of "local revenue" rather than "State expenditures" for purposes of interpreting Section 5(3) of Article III of the North Carolina Constitution. Section 5(3) of Article III of the North Carolina Constitution sets out the Governor's duties and the scope of authority with regard to balancing the budget. Arguably, since the Constitution authorizes the Governor to reduce only "State expenditures," the classification of these shared tax revenues as "local revenues" prohibits the Governor from reducing or withholding the distributions. Moreover, each of the tax-sharing statutes has been amended to expressly state that the Governor may not reduce or withhold these distributions.

Tax-sharing statutes are a source of "financial aid" for local governments. Under these tax-sharing statutes, cities or counties, or both, receive a portion of certain taxes levied by the State. The shared tax revenues are derived from the levy of the following taxes:

- Beer and wine taxes[23]
- Franchise gross receipts tax[24]
- Piped natural gas tax[25]
- Sales tax on telecommunications[26]
- Powell bill funds[27]

Funds Appropriated or Otherwise Committed to Local Governments

Section 7 of the act limits the Governor's authority to reduce funds that the General Assembly has "appropriated or otherwise committed to local governments" by amending the Executive Budget Act to require that the Governor exhaust all other sources of revenue first,

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[23] Cities and counties in which beer and wine may be sold receive a portion of the State excise tax levied on beer and wine. They receive a percentage of the net amount of excise taxes collected, and the percentage depends on the type of beverage sold: 23 ¾% for beer, 62% for unfortified wine, and 22% for fortified wine. The local governments that share in the proceeds do so on a per capita basis, with counties receiving credit for their nonmunicipal population only.

[24] The State levies a gross receipts tax on electric power companies at a rate of 3.22%. From these proceeds, each city or town is entitled to an amount equal to 3.09% of gross receipts arising from sales within that city or town. Most cities receive their share of franchise tax revenue under G.S. 105-116.1. However, there are approximately 51 cities that own their own electric generation and distribution systems. These cities pay tax and receive their distribution under a separate statute – G.S. 159B-27 – but at the same rate as other cities.

[25] The State levies an excise tax on piped natural gas, and the rate is based on the monthly volume of natural gas received by the final user. The rate decreases as the amount of therms of piped gas consumed in a month increases. Cities receive 50% of the proceeds of the tax attributable to that city.

[26] The State imposes a 6% sales tax on telecommunications. The cities receive 18.26% of the net proceeds of the taxes collected minus a "freeze deduction" amount totaling $2,620,948.

[27] North Carolina's state gasoline tax is 17 ½ cents per gallon, plus the greater of 7% of the average wholesale price or 3.5 cents per gallon. Of this, an amount equal to the proceeds of 1.75 cents per gallon plus an additional 6.5% of the net proceeds of the North Carolina Highway Trust Fund is distributed among North Carolina's cities and towns. The legislation that first established this distribution system is known as the *Powell Bill*, after its principal sponsor, and the monies distributed to the cities and towns are generally known as Powell Bill funds. The use of these funds by municipalities is restricted to maintaining, repairing, constructing, reconstructing or widening streets, sidewalks, bridges, curbs and gutters, bikeways, and other necessary appurtenances within the corporate limits of the municipality.

including any surplus in the treasury at the beginning of the fiscal period. This section takes a different approach than the sections dealing with the tax-sharing statutes. Under this section, the Governor is required when balancing the budget to prioritize the reduction of certain State expenditures by reducing the funds distributed to local governments only as a last resort. Under the previous sections, the General Assembly removed the local portion of shared tax revenues from the scope of the Governor's budgetary authority by stating they are not "State expenditures," and thus not capable of being reduced by the Governor under any circumstances.

Section 7 of this act was primarily intended to restrict the Governor's ability to withhold reimbursement money. State reimbursements are amounts distributed to local units to compensate them for revenue lost as the result of the removal by the General Assembly of property from the local sales and use tax base, the property tax base, or the intangibles tax base. The reimbursement programs include reimbursements for the repeal of the property tax on inventories and on poultry and livestock, the repeal of the intangibles tax, the homestead exemption from property tax, and the repeal of local sales and use taxes on food purchased with food stamps. However, Section 30A.1 of The Current Operations, Capital Improvements, and Finance Act of 2002. (S.L. 2002-126) repeals all of the State reimbursement payments to local governments, effective July 1, 2002. Nevertheless, funds "appropriated or otherwise committed to local governments" would also include:

- Low wealth school money.
- Earmarking of corporate income tax money for Public School Building Capital Fund.
- Scrap tire disposal tax.
- White goods disposal tax proceeds.
- Aid to public libraries.
- Certain grant monies.

Clarify Taxation of Electric Power Companies

Section 8 of this act clarifies that an electric power company that has collected and remitted to the State the annual franchise gross receipts tax may not be subject to any additional franchise or privilege tax imposed upon it by any city or county.

This clarification was primarily the result of responses by some cities to the seizure by the Governor of funds that would have otherwise been distributed to the cities as shared tax revenues. In response to the seizure, some cities enacted ordinances imposing their own franchise or privilege tax on electric power companies to recapture their lost revenue. This provision is intended to prevent the electric power companies from being taxed by both the State and the municipalities.

Local Sales Tax Acceleration

Session Law	*Bill #*	*Sponsor*
S.L. 2002-123	**SB 1292**	**Senator Kerr**

AN ACT TO ACCELERATE THE ADDITIONAL ONE-HALF CENT LOCAL OPTION SALES AND USE TAX AND TO MAKE CONFORMING AND TECHNICAL CHANGES.

OVERVIEW: This act accelerates the effective date of the third half-cent local option sales tax from July 1, 2003, to December 1, 2002.

FISCAL IMPACT: There is no General Fund impact. The total estimated potential revenue available to local governments from this additional half-cent if all 100 counties were to enact the tax in December 2002 is approximately $188.1 million. After deductions for administration by the Department of Revenue, the amount is reduced to $187.8 million. However, since the act is permissive and counties can decide to enact the tax at any time, no exact fiscal estimate is possible.

EFFECTIVE DATE: The act became effective September 26, 2002, but local units cannot levy the sales tax itself until December 1, 2002.

ANALYSIS: In 2001, the General Assembly authorized counties to levy additional local sales taxes of ½%, effective July 1, 2003. Under this act, the tax may become effective as early as December 1, 2002. To accomplish the sales tax acceleration, the act provides for the following:

- It allows the counties to enact the tax for the first two months (December 2002 and January 2003) with a shortened notice to the Department of Revenue. Under general law, a county must give the Secretary of Revenue at least 90 days' advance notice of a new tax levy or tax rate change; and a new tax levy or a tax rate change may become effective only on January 1 or July 1. This act provides for an expedited levy. If the county enacts the tax to become effective on or before January 1, 2003, the county must give the Secretary only 30 days' advance notice of the tax levy. Thereafter, the current law requirements of 90 days' notice and a January 1 or July 1 effective date are reinstated.
- It authorizes the Department of Revenue to withhold up to $275,000 for 2002-2003 to cover its excess nonrecurring costs for implementing the new sales tax on short notice.
- It exempts the Department of Revenue from the public contract bidding requirements for the procurement of supplies, materials, equipment, and contractual services related to the provision of notice and the development of computer software necessitated by the expedited provisions of the act.
- It provides that a retailer is not liable for the additional ½% tax levied by counties effective December 1, 2002, that it fails to collect from purchasers due to an inadvertent error during the month of December 2002 if the retailer can demonstrate to the Secretary the reason for the inadvertent error.

The act does not make the following changes to the law:

- It does not accelerate the State ½% sales tax repeal that is effective July 1, 2003. Therefore, there may be a 7% sales and use tax rate in counties that impose the additional ½% sales tax rate from December 1, 2002, until July 1, 2003.

- It does not accelerate the local sales tax distributions from quarterly to monthly. Under current law, counties are authorized to levy up to 2% local sales and use taxes[28]. All counties levy the maximum rate. The State collects the tax and distributes it quarterly to the counties and municipalities. In 2001, the General Assembly provided that local sales taxes must be distributed monthly rather than quarterly, effective July 1, 2003.
- This act does not provide a local government hold-harmless provision. Section 30A.1 of The Current Operations, Capital Improvements, and Finance Act of 2002. (S.L. 2002-126) repealed all of the State's reimbursement payments to local governments, effective beginning with the 2002-2003 fiscal year.[29] The 2001 legislation provided local governments "hold harmless" payments beginning in 2003-2004 if the amount they could potentially realize from the levy of the half-cent sales tax was less than the amount they would lose from the reimbursements. This act neither accelerates the hold harmless provision nor provides another.

Current Operations, Capital Improvements, and Finance Act of 2002

Session Law	*Bill #*	*Sponsor*
S.L. 2002-126	**SB 1115**	**Senator Plyler**

AN ACT TO MODIFY THE CURRENT OPERATIONS APPROPRIATIONS ACT OF 2001 AND TO MAKE OTHER CHANGES IN THE BUDGET OPERATION OF THE STATE.

OVERVIEW, DESCRIPTION, EFFECTIVE DATES, AND FISCAL IMPACT:

Section #	*Description and Effective Dates*	*Fiscal Impact*
30A.1	**Local Government Revenues** Accelerates the repeal of the tax reimbursements from July 1, 2003, to July 1, 2002. Also authorizes local governments to raise or lower property taxes between July 1 and the following January 1 to account for unanticipated revenue increases or decreases.	This will produce a General Fund revenue gain of $333.4 million per year beginning in FY 2002-03.
30B.1	**Delay 2001 Tax Break: Elimination of Marriage Penalty for Standard Deduction** Delays the enactment by one year of the tax break enacted in 2001 eliminating the	The net gain to the General Fund as the result of delaying the first $500 increase is $31.9 million for FY 2002-03. For the $6,000 standard deduction

[28] Mecklenburg County is authorized to levy up to 2 ½% local sales and use taxes.

[29] The Appropriations Act of 2001 (S.L. 2001-424, Section 34.15) provided that the reimbursements would be repealed effective for the 2003-04 fiscal year. The Current Operations, Capital Improvements, and Finance Act of 2002 (S.L. 2002-126, Section 30A.1) accelerated that repeal.

Section #	*Description and Effective Dates*	*Fiscal Impact*
	marriage penalty in the standard deduction, originally effective beginning with the 2002 tax year. Now, the standard deduction for married filing jointly taxpayers will increase from $5,000 to $5,500 in tax year 2003, and then to $6,000 in tax year 2004.	delayed until 2004, the General Fund will gain $12.6 million that year.
30B.2	**Delay 2001 Tax Break: Increase of Tax Credit for Children** Delays the enactment by one year of the increased tax credit for children enacted in 2001. Beginning with tax year 2003, the tax credit for children is increased from $60 to $75 per child and then to $100 in tax year 2004.	The delay will eliminate the $19.8 million General Fund loss originally projected for FY 2002-03 and result in a General Fund revenue gain of an equal amount. There will be a revenue gain of $34.9 million in FY 2003-04.
30C.1	**Update IRC Reference** Updates the Internal Revenue Code reference from January 1, 2001 to May 1, 2002, with exceptions for accelerated depreciation and the estate tax credit. This update conforms North Carolina law to federal law with regard to recent pension tax changes, education initiatives, the increased estate tax exemption limitations, and the extension of the carryback period for net operating losses for tax years ending 2001 and 2002.	The following General Fund revenue loss is expected[30]: FY2002-03 $16.9 million FY2003-04 $25.5 million FY2004-05 $49.7 million FY2005-06 $76.9 million FY2006-07 $77.3 million

30 These estimates do not reflect conformity to the increased estate tax exemption limitations. See summary for Section 30C.3 of S.L. 2002-126 for fiscal impact of the estate tax law changes.

Section #	*Description and Effective Dates*	*Fiscal Impact*
30C.2	**Accelerated Depreciation Provisions** Decouples North Carolina law from federal law by requiring taxpayers to add back to federal taxable income a percentage of the additional 30% accelerated depreciation allowed under federal law, effective for taxable years beginning on or after January 1, 2002. Taxpayers will continue to be able to deduct the same amount of an asset's basis under both federal and State law, but the timing of the deduction will differ.	The impact of the changes is essentially revenue neutral over the long-term since the conformity deals with an acceleration of depreciation, not the total amount of the deduction over the life of an asset. Thus, there will be substantial revenue losses starting in FY 2006-07. The General Fund impact is estimated as follows: FY2002-03 $38.2 million FY2003-04 $8.6 million FY2004-05 -$60.8 million FY2005-06 - 0 - FY2006-07 - 0 -
30C.3	**Estate Death Tax Credit Provision** Decouples North Carolina law from the phase-out of the state death tax credit under federal law, effective for estates of decedents dying on or after January 1, 2002. This provision sunsets for decedents dying on or after January 1, 2004.	Although decoupling from the phase-out of the state death tax credit avoids the loss of revenue from full conformity to the federal phase-out of the credit for state death taxes, there is an overall net loss because the act conforms North Carolina estate tax law to the increased federal estate tax exemptions: FY2002-03 $5.5 million FY2003-04 $7.3 million FY2004-05 $3.8 million FY2005-06 $0
30C.5	**Federal Gift Tax Annual Exclusion** Conforms the North Carolina gift tax exclusion to the federal inflation-adjusted gift tax exclusion used by the federal government, effective January 1, 2002.	The General Fund revenue loss is estimated as follows: FY2002-03 $0.2 million FY2003-04 $0.2 million FY2004-05 $0.2 million FY2005-06 $0.4 million FY2006-07 $0.4 million

Section #	*Description and Effective Dates*	*Fiscal Impact*
30D.	**Unauthorized Substance Tax Expenses** Provides that local governments will bear 70% of the State's expenses in collecting the unauthorized substance tax, effective June 30, 2002. The expenses are drawn from local sales tax distributions. This section does not, however, change the amounts that are distributed to local law enforcement agencies.	The General Fund will be reimbursed for 70% of the Unauthorized Substance Tax Division's operating expenses resulting in an annual gain of $900,000.
30E.	**Insurance Regulatory Charge** Sets the insurance regulatory charge, which is assessed on the premiums tax paid by insurers, at 6.5% for the 2002 calendar year. The revenue generated by this charge is used to reimburse the General Fund for appropriations to the Department of Insurance to pay expenses incurred in regulating the industry.	The charge is expected to generate $25 million for FY 2002-03.
30F.	**Regulatory Fee for Utilities Commission** Sets the public utility regulatory fee at 0.1% for FY 2002-03. It also sets the electric membership corporation regulatory fee at $200,000 for FY2002-03. These are the same as the 2001 rates.	This fee, which funds the operations of the Utilities Commission and the Public Staff, is expected to produce $11,700,238 for FY 2002-03.
30G.1	**Close Corporate Tax Loophole: Broaden Definition of Business Income** Broadens the definition of "business income" to include all income that states can apportion for corporate income tax purposes under the U.S. Constitution, effective with taxable years beginning on or after January 1, 2002.	The General Fund revenue gain is estimated as follows: FY2002-03 $70.0 million FY2003-04 $50.0 million FY2004-05 $53.7 million FY2005-06 $56.7 million FY2006-07 $59.5 million
30G.2	**Close Corporate Tax Loophole: Equalize Franchise Tax on Corporate-Affiliated LLCs** Tightens 2001 legislation intended to close a loophole that allows corporations to escape franchise tax by transferring assets to a controlled LLC, effective beginning with payments due in March 2003.	The General Fund revenue gain is estimated as follows: FY2002-03 $20.0 million FY2003-04 $21.2 million FY2004-05 $22.5 million FY2005-06 $23.8 million FY2006-07 $25.2 million

Section #	*Description and Effective Dates*	*Fiscal Impact*
30H.	**Housing Tax Credit** Enlarges the class of taxpayers eligible for an enhanced credit for investing in low-income housing in a county that sustained severe or moderate damage from a hurricane in 1999 by backdating the effective date for eligibility from 2001 to 2000.	Assuming the project investors use 100% of the available tax credit, the annual General Fund loss is $2.15 million for Fiscal Years 2002-03 to 2006-07.
30I.	**No Estimated Income Tax Penalty for 2002 Tax Year** Provides that no estimated income tax penalty applies for the 2002 tax year to the extent the underpayment was created or increased by a provision of this act	

ANALYSIS:

LOCAL GOVERNMENT REVENUES

In 2001, the General Assembly repealed all of the State's reimbursement payments to local governments, effective beginning with the 2003-2004 fiscal year. Part 30A accelerates the repeal, effective July 1, 2002.

State reimbursements are amounts distributed to local units to compensate them for revenue lost as a result of the removal by the General Assembly of property from the local sales and use tax base, the local property tax base, or the intangibles tax base. State reimbursements consist of reimbursements for the repeal of the property tax on inventories and on poultry and livestock, the repeal of the intangibles tax, the "homestead exclusion" from property tax, and the repeal of local sales and use taxes on food purchased with food stamps. This act does not repeal or reduce the distribution of local government tax-sharing revenues: excise tax on beer and wine, franchise tax on electricity, gross receipts tax on piped natural gas, sales tax on telecommunications service, and the Powell bill revenues.

Part 30A also allows counties and cities to amend their budget ordinances between July 1st and the following January 1st to increase or reduce their property tax levy to account for unanticipated revenue increases or decreases.

DELAY 2001 TAX BREAKS

Last session, the General Assembly enacted two income tax breaks to become effective for the 2002 tax year[31]: elimination of the marriage tax penalty in the standard deduction[32] and an increased tax credit for children. Part 30B of this act delays the enactment of these tax benefits.

Delay Elimination of Marriage Tax Penalty for the Standard Deduction: Last session, the General Assembly reduced North Carolina income taxes on married couples that claim the standard deduction[33] by increasing the amount of the standard deduction for married filers so that it would be twice that of a single taxpayer. Since 1989, the basic standard deduction for a single person in North Carolina has been $3,000 while that for a married couple filing jointly has been $5,000. The increase in the deduction enacted in 2001 was to be phased in over the 2002 and 2003 tax years. The standard deduction for married persons filing separately is one-half that for a married couple filing jointly, so the 2001 act also phased it up from $2,500 to $3,000 over the 2002 and 2003 tax years. Part 30B of this act delays by one year the phase-in of the increased deduction, so that it will occur over the 2003 and 2004 tax years.

Delay Increase in Tax Credit for Children: In 2001, the General Assembly increased the $60 tax credit per child to $75 for the 2002 tax year and to $100 for the 2003 tax year. Part 30B of this act delays the phase-in of the credit increase until the 2003 and 2004 tax years. The 1995 General Assembly enacted the tax credit of $60 per child for taxpayers who have dependent children and have family adjusted gross income below $100,000 for a married couple and $80,000 for a head of household. Neither the 2001 act nor this act changes the income thresholds. The credit is in addition to the federal and state tax credits or exclusions for child care expenses. The credit is allowed for each dependent child for whom the eligible taxpayer could take a federal personal exemption under section 151(c)(1)(B) of the Internal Revenue Code. That Code section allows an exemption for each dependent child who either is less than 19 years old at the end of the taxable year or is a student and is less than 24 years old at the end of the taxable year. A child is a son, stepson, daughter, or stepdaughter. A dependent child is a child over half of whose support is provided by the taxpayer.

UPDATE IRC REFERENCE

North Carolina's tax law tracks many provisions of the federal Internal Revenue Code, by reference to the Code.[34] The General Assembly determines each year whether to update its reference to the Internal Revenue Code.[35] Updating the Internal Revenue Code reference

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[31] S.L. 2001-424, as amended by S.L. 2001-476, 2001-497, and 2001-489.

[32] The so-called married tax penalty is the result of a tax system that recognizes that a married couple's living expenses are less than the expenses of two single people living separately but more than the expenses of one single person. In addition, if one spouse is not employed full-time, a married couple's income would be less than that of two comparable single people who work full-time, but more than that of one single person. The tax law addresses these situations through the tax brackets, the personal exemptions, and the standard deduction. The result of these tax provisions is that a married couple with only one spouse working experiences a tax reduction when they marry, a married couple where one spouse earns substantially more than the other experiences no tax reduction or increase when they marry, and a married couple with both spouses earning roughly the same amount experience a tax increase when they marry.

[33] Roughly 70% of North Carolina taxpayers claim the standard deduction.

[34] North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

[35] The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of

makes recent amendments to the Code applicable to the State to the extent that State law previously tracked federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made.

Congress enacted two bills that have changed the Code significantly since January 1, 2001:

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), enacted on June 7, 2001, includes numerous changes to the taxation of pension benefits, accounts, distributions, and rollovers; of education initiatives; and of estates. All of the provisions of EGTRRA will expire on December 31, 2010, unless the provisions are renewed or modified by Congressional action.[36]

The federal Job Creation and Worker Assistance Act of 2002, enacted March 9, 2002, includes an accelerated 30% bonus depreciation allowance for certain assets placed in service after September 10, 2001, and before September 11, 2004, and an extension of the carryback period for net operating losses occurring in tax years ending in 2001 and 2002 from two years to five years.

Both of these acts will substantially affect a taxpayer's federal taxable income. Since North Carolina begins its corporate and individual income tax calculations with federal taxable income, these acts also have a substantial impact on North Carolina's tax revenues to the extent the State chooses to conform to those changes.

Part 30C of this act rewrites the definition of the Code to change the reference date from January 1, 2001, to May 1, 2002. It then provides that a taxpayer must add to federal taxable income the amount allowed as an accelerated depreciation deduction under section 168(k) or 1400L of the Code and that a taxpayer's estate tax liability is determined without regard to the phase-out of the state death tax credit. In effect, Part 30C would do the following:

- Conform to all of the pension tax changes in the Code.
- Conform to all of the education initiatives in the Code.
- Conform to the increased estate tax exemption limitations.
- Not conform to the phase-out of the state death tax credit.
- Conform to the extension of the carryback period for net operating losses occurring in tax years ending in 2001 and 2002.
- Delay the accelerated 30% bonus depreciation allowance.

<u>Pension Tax Provisions:</u> Part 30C conforms North Carolina's tax treatment of pension benefits and distributions to federal law. EGTRRA made the following notable changes to the pension laws:

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taxation … shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and 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."

[36]The Congressional Budget Act of 1974 mandates this sunset provision.

- It allows taxpayers to contribute more to their tax-deferred retirement accounts. It gradually increases the amount that may be contributed to a 401(k), 403(b), and 457 accounts between 2002 and 2006. The contribution limit will increase to $15,000 in 2006. Starting in 2007, the limit will be indexed for inflation in $500 increments. It also allows persons who are 50 or older to make an additional catch-up contribution to their tax-deferred retirement accounts.
- It increases the amounts that may be contributed to both traditional IRAs and Roth IRAs from $2,000 in 2001 to $3,000 in 2002. This amount gradually increases to $5,000 for 2008. After 2008, this amount will be indexed annually for inflation. It also allows people over the age of 50 to make catch-up contributions to an IRA.
- It modifies the distribution rules for governmental 457 plan participants so that their deferred compensation funds will be taxed when they receive the distribution, not when it is made available to them.
- It repeals the coordination of deferrals between 457 and other elective deferral plans. Under former law, the maximum deferral amount for a 457 plan was reduced dollar for dollar by any contribution made to other types of retirement plans. The tax law change means that a person may defer the maximum annual contribution limit to a 457 plan as well as the maximum amount in a 401(k) or 403(b) plan.
- It expands the types of eligible tax-free rollover distributions to include distributions from qualified plans, 403(b) annuities, and 457 plans to other such plans and distributions from IRAs to qualified plans, 403(b) annuities, and 457 plans.
- It allows a surviving spouse to roll over distributions from a deceased spouse's plan to his or her own plan. Prior to this change, the tax-free rollover had to be made to an IRA.

Education Tax Provisions: Part 30C conforms North Carolina tax law on education incentives to the federal changes enacted last year. The more notable tax changes affecting education incentives include:

- It increases the annual maximum contribution limit to an Education IRA from $500 to $2,000 per beneficiary.
- It allows education IRA dollars to be used to cover expenses of students in grade, middle, and high schools.
- It eases the restrictions and limitations when using an Education IRA with other education initiatives, such as the Hope or Lifetime Learning tax credit.
- It moves the annual contribution deadline for Education IRAs from December 31 to April 15 of the following year.
- It provides that distributions from Section 529 Plans will be income-tax free up to the amount that is used to pay qualified higher education expenses.[37] Under former law, participants enjoyed only the benefit of tax-deferred contributions and investment growth.
- It allows a person to transfer 529 plan credits from one program to another for the benefit of the same beneficiary without incurring a taxable event.
- It extends the deduction for employer-paid college expenses to include graduate courses.

[37] North Carolina currently allows tax-free distributions for North Carolina plans. Section 30C.4 of this act repeals the State deduction.

Estate Tax Provisions: North Carolina repealed its inheritance tax in 1998, effective for deaths occurring on or after January 1, 1999. It replaced its inheritance tax with an estate tax that is equivalent to the federal state death tax credit allowed on a federal estate tax return. This type of state estate tax is known as a "pick-up" tax because it picks up for the state the amount of federal estate tax that would otherwise be paid to the federal government.[38] EGTRRA made two changes that affect the estate tax:

- It phases out the estate tax over the next eight years by increasing the exclusion amount from $675,000 in 2001 to $1 million in 2002-03, $1.5 million in 2004-05, $2 million in 2006-08, and $3.5 million in 2009. There is no need for an exemption amount after 2009 since the tax is repealed in 2010. However, the tax is scheduled to reapply in 2011 unless a future Congress makes the repeal permanent. If the tax were reinstated in 2011, the exclusion amount would be $1 million. This act conforms North Carolina's exemption limits to the federal exemption limits to ensure that estates in North Carolina do not have to pay State tax if there is no federal tax due.
- It phases out the state death tax credit over the next four years by reducing it 25% in 2002, 50% in 2003, and 75% in 2004, and by repealing it entirely in 2005. This act does NOT conform to the phase out of the state death tax credit for two years.[39] Therefore, under this act an estate of a decedent dying on or after January 1, 2002, and before January 1, 2004, would owe North Carolina estate tax to the same extent that it would be owed without regard to the phase-out of the credit. The January 1, 2004, sunset ensures that the State will have to revisit this issue next year.

Because North Carolina's estate tax is based upon the federal credit for state death taxes, the repeal of the state death tax credit in 2005 and the ultimate repeal of the federal estate tax in 2010 will mean that the State must decide whether to replace or repeal its estate tax in the future.

Accelerated Depreciation Provisions: Under the Job Creation and Worker Assistance Act of 2002, a taxpayer is allowed an accelerated 30% bonus depreciation allowance for certain assets placed in service after September 11, 2001, and before September 11, 2004. The taxpayer is still entitled to the normal first-year depreciation on the remaining basis of the asset after reducing the basis by the bonus depreciation. This provision affects both corporate and individual income taxpayers.

The change in federal law results in a taxpayer recovering the basis in the asset sooner than under former law; however, over the life of the asset the taxpayer still receives the same benefit. This act does not conform State law to the accelerated depreciation schedule allowed under federal law.[40] However, under this act a taxpayer will continue to be able to

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[38] As of July 1, 2002, 37 other states, plus the District of Columbia, impose only the "pick-up tax".

[39] As of October 2, 2002 the following 10 states, in addition to North Carolina, have acted to decouple from the phase-out of the state death tax credit: Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, Pennsylvania, Rhode Island, Vermont, and Wisconsin. The following 5 states, plus the District of Columbia, will remain decoupled automatically under their current law unless they take legislative action: Kansas, New York, Oregon, Virginia, and Washington.

[40] As of September 26, 2002, the following 23 states, plus the District of Columbia, which previously followed federal depreciation rules, are now decoupled as the result of explicit legislative action: Arizona, Connecticut, Georgia, Hawaii, Illinois, Indiana, Iowa, Maryland, Massachusetts, Minnesota, Mississippi (per ruling of state tax commissioner), Missouri (for one year), Nebraska, New Jersey, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont (for corporate income tax filers only), Virginia, and Wisconsin. In

deduct the same amount of an asset's basis under both federal and State law; it is just that the timing of the deduction will differ. To accomplish this decoupling from the federal accelerated bonus depreciation, the act does two things:

- For the first three years of the federal accelerated depreciation, it provides that a taxpayer must add back to federal taxable income a percentage of the additional 30% accelerated depreciation in the year the accelerated depreciation is claimed for federal purposes.[41] The percentage is 100% for the 2001 and 2002 taxable years and 70% for the 2003 taxable year. There is no add-back for the 2004 taxable year. The add-back for the first three years of the accelerated depreciation means that for State tax purposes, a taxpayer would deduct less in tax years 2001-2003 than the taxpayer would have deducted if the State conformed to the accelerated depreciation law. The amount of the deduction will be the normal first year depreciation on the remaining basis of the asset after reducing the basis by the bonus depreciation amount allowed under federal law plus 30% of the bonus depreciation in 2003. In 2004, the State will have in effect conformed to the federal law and the entire bonus depreciation may be deducted.

- In tax years beginning on or after January 1, 2005, it provides that the taxpayer may deduct from federal taxable income the total amount of the add-backs required in earlier years, divided into five equal installments. This means that for State tax purposes, a taxpayer would be allowed to deduct a greater depreciation amount in the outlying tax years – the normal depreciation amount plus 20% of the accelerated depreciation amount the taxpayer had to add back. The purpose of this recovery provision is to enable the taxpayer to have the same basis in assets for federal and State purposes. Without this deduction provision, a taxpayer would have a different basis in the depreciable asset for State and federal purposes and would have to keep separate books and records for State and federal purposes until the disposal of the asset. In effect, the add-back and subsequent deduction will affect the timing of the impact of bonus depreciation on the State but it will not increase or decrease the total amount of revenue the State receives over the affected years.

Gift Tax Change: North Carolina imposes a gift tax on property transferred during the life of a donor. Gifts to a spouse are exempt from tax. The gift tax law allows an annual exclusion of $10,000.

The federal gift tax annual exclusion is more complex. Since 1998, the $10,000 federal gift tax annual exclusion has been subject to an inflation adjustment. The adjustment happens only in increments of $1,000 however. From 1998 until 2001, inflation had not grown enough to reach the first $1,000 increment. In 2002, that threshold was reached and the federal annual exclusion increased to $11,000. This amount won't increase to $12,000 until the cumulative inflation adjustment is at least 20%.

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addition, New York City has decoupled from the bonus depreciation allowance. Six other states are decoupled automatically under pre-existing tax law: Arkansas, Idaho, Kentucky, New Hampshire, South Dakota, and Texas.

[41] For tax years beginning before January 1, 2002, the add-back must be taken in the first taxable year beginning on or after January 1, 2002, so that the taxpayer will not recognize any retroactive tax increase.

Part 30C amends North Carolina's gift tax annual exclusion to piggyback the federal amount, effective January 1, 2002.

UNAUTHORIZED SUBSTANCE TAX EXPENSES

Part 30D of this act allocates to local governments 70% of the State's expenses in collecting the unauthorized substance tax. The expenses would be drawn from local sales tax revenues. Under existing law, the following expenses are deducted from local sales tax distributions: costs of the Property Tax Division within the Department of Revenue, costs of the Property Tax Commission, the costs of the Institute of Government in operating a training program in property tax appraisal and assessment, and the costs of the Local Government Commission.

The General Assembly first imposed the unauthorized substances tax in 1989 to generate revenue for State and local law enforcement agencies and for the General Fund. Seventy-five percent of the tax collected is distributed to the State or local law enforcement agency that conducted the investigation that led to the tax assessment. The remaining 25% is credited to the General Fund. This act does not change this revenue allocation.

INSURANCE REGULATORY CHARGE[42]

Part 30E of this act sets the insurance regulatory charge at the same rate as last year's rate: 6.5% for the 2002 calendar year. The insurance regulatory charge is a fee that was enacted in 1991 to defray the State's cost of regulating the insurance industry. The charge is a percentage of each insurance company's premiums tax liability. The insurance regulatory charge is imposed on insurance companies, health maintenance organizations, and medical service corporations. For health maintenance organizations and medical service corporations, the fee is levied on each company's hypothetical gross premiums tax liability determined at the 1.9% gross premiums tax rate applied to its premiums base. The hypothetical calculation is necessary because medical service corporations and health maintenance organizations pay premiums tax at a lower rate.

REGULATORY FEE FOR UTILITIES COMMISSION

Part 30F of this act sets the tax rate for the public utility regulatory fee for the 2002-2003 tax year at the same rate as last year's rate: 0.1%. This rate must be set by the General Assembly each year. The utility regulatory fee is a tax that was first imposed in 1989. The proceeds of the fee are credited to the Utilities Commission and Public Staff Fund and used to defray the State's cost in regulating public utilities. The regulatory fee is imposed on all utilities that are subject to regulation by the North Carolina Utilities Commission. The fee is a percentage of the utility's North Carolina jurisdictional revenues. In general, jurisdictional revenue is revenue derived from providing utility service in North Carolina.

In addition to funding the State's cost in regulating public utilities, the money in the Utilities Commission and Public Staff Fund is currently used to finance the work of the Study Commission on the Future of Electric Service in North Carolina. The General Assembly established the Commission in 1997 to examine the cost, adequacy, availability, and pricing of electric rates and service in North Carolina to determine whether legislation is necessary to assure an adequate and reliable source of electricity and economical, fair, and equitable

[42] See the summary for S.L. 2002-144 for additional changes made to the insurance regulatory charge.

rates for all consumers of electricity in North Carolina. Section 14.10 of S.L. 2000-67, the Current Operations and Capital Improvements Appropriations Act of 2000, extended the life of the Study Commission and its funding from the Utilities Commission and Public Staff Fund through June 30, 2006.

Part 30F also sets at $200,000 for the 2002-2003 fiscal year the annual public utility regulatory fee imposed on electric membership corporations whose principal purpose is to furnish or cause to be furnished bulk electric supplies at wholesale. This is the same rate that was in effect for the 2001-2002 fiscal year. The North Carolina Electric Membership Corporation is the only electric membership corporation that fits this description. The proceeds of the fee are credited to the Utilities Commission and Public Staff Fund and used to defray the State's cost in regulating electric membership corporations.

The 1999 General Assembly authorized electric membership corporations to form subsidiary corporations that may provide energy services and products, telecommunications services and products, and water and wastewater collection and treatment. The subsidiaries must fully compensate the electric membership corporation for its use of the corporation's personnel, services, equipment, and property. The Utilities Commission is charged with regulating this aspect of the subsidiary's business and, to pay for this regulation, the 1999 legislation levied a flat-rate regulatory fee to be paid annually by the North Carolina Electric Membership Corporation. The General Assembly must establish the fee amount each year. The North Carolina Electric Membership Corporation is the only electric membership corporation whose principal purpose is to furnish or cause to be furnished bulk electric supplies at wholesale, as provided in G.S. 117-16. It is a "generation and supply cooperative" owned by its members. Its members are all but one of the existing North Carolina electric membership corporations, which are "distribution cooperatives." Thus, the fee imposed on the North Carolina Electric Membership Corporation will be passed on to its member electric membership corporations.

CLOSE CORPORATE TAX LOOPHOLES

This Part closes two corporate tax loopholes that allow some corporate profits to escape taxation and give corporate tax planners an opportunity to avoid existing taxes on corporate income and assets. The first loophole is caused by the definition of business income used in the corporate income tax law; the second loophole is caused by the different franchise tax treatment of corporations and limited liability companies.

Definition of Business Income: The first section of this Part amends the definition of "business income" to include all income that is apportionable under the U.S. Constitution, effective for taxable years beginning on or after January 1, 2002.

Corporations that do business in more than one state divide up their income among those states for income-tax purposes. Business income is apportioned based on a formula that takes into account how much sales, property, and payroll the corporation has in each state. Nonbusiness income is allocated to a state based on its connection with that state. In the most basic terms, nonbusiness income could be described as income that is earned in an unrelated sideline activity of the corporation.

As an analogy, each interstate corporation's income is in two "pies" – a business income pie that is divided up among the states in which it does business, and a nonbusiness income pie that is given entirely to the state it is connected to.

In an ideal system, all states would follow the same rules for dividing up interstate corporations' income for tax purposes, so that no more and no less than 100% of every corporation's net income would be subjected to state income tax. However, different states have different laws and even when the laws are the same, they may be interpreted differently. In theory, this can result in the taxation of more than 100%, as well as less than 100%, of a corporation's net income. In practice, corporate tax planners take the opportunity to create "nowhere" income – income that no state can tax. Instead of each state receiving its piece of the business income pie, some pieces are thrown away. Thus, although a corporation may do substantial business in North Carolina, much of its otherwise taxable business income may be characterized as nonbusiness, so that North Carolina gets no piece of it.

These tax avoidance schemes are possible not only because different states have different laws, but also because states have laws that are vague or too narrow. In North Carolina, before this act, income was defined as business income if it related to the regular trade or business of the taxpayer. This definition is vague and narrower than what is allowed under the United States Constitution. If North Carolina was entitled to tax a significant percentage of a corporation's business income, the corporation could try to shift much of its income into the nonbusiness pie, which North Carolina does not share in. This could be true even though the corporation had deducted as a business expense the same items that it later claimed were not business items when the time came to pay tax on profits. Court decisions in North Carolina upheld this tax avoidance technique under the law prior to this act. Examples of the types of business income that corporations most often recharacterize are rents, royalties, gain or loss from the sale of property, interest, and dividends.

This Part changes the definition of business income to include any income that the United States Constitution allows a state to treat as business income. This change eliminates the prior statute's vagueness and narrowness, which allowed it to be used by corporations to create "nowhere" income that should otherwise be taxable in North Carolina. One effect of this change is to include income from extraordinary events, such as a liquidation of a division, in apportionable income. This effect is consistent with the Department of Revenue's historical position, as illustrated by its administrative rules, before the North Carolina Supreme Court's decision in *Lenox v. Tolson.*[43] A corporation's income earned out of state from unrelated business activity that makes up a discrete business enterprise will continue to be nonbusiness income that cannot be apportioned – it would continue to be allocated to the state to which it is connected.

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[43] 353 N.C. 659, 548 S.E.2d 513 (S.Ct. 2001). In this case, Lenox, a New Jersey-based corporation, disposed of a subsidiary, ArtCarved, by selling all of its assets. Lenox did not retain any of the liquidation proceeds for use in its ongoing operations but distributed all of those proceeds to its sole shareholder. Lenox classified the gain from the sale as "nonbusiness income" on its North Carolina tax return and therefore did not pay taxes on the gain. The NC Department of Revenue reclassified the gain as business income and assessed corporate income tax. Lenox paid the tax under protest and sought a refund. Of the two tests used to determine business income, only the "functional test" applied to this transaction. The functional test focuses on income from property if the acquisition, management, and/or disposition of the property was an integral part of the corporation's regular business operations. The Court concluded that, under this test, a liquidation was an extraordinary event and not a recurring transaction made in the regular course of business. The Court further held that when a transaction involves a complete or partial liquidation and cessation of a company's particular line of business, and the proceeds are distributed to shareholders rather than reinvested in the company, any gain or loss generated from that transaction is nonbusiness income. In so holding, the Court expressly disavowed statements by the Court three years earlier in *Polaroid v. Offerman* with regard to its interpretation of the functional test.

Before this act, North Carolina was one of 26 states that used the vague, unnecessarily narrow definition of business income. Eighteen states have a broader definition of business income. Five other states have the same law as enacted by this Part (define business income as all that the U.S. Constitution allows state to apportion). Thirteen states apportion all corporate income. A state using this approach receives less revenue than if it used the approach taken by this Part, because it relinquishes the right to tax true nonbusiness income of businesses headquartered in the state. The 13 states include Georgia, South Carolina, and Virginia.

LLC Franchise Tax: In 2001, the General Assembly enacted S.L. 2001-327 to close a loophole that allowed corporations to avoid franchise tax on their assets by transferring their assets to a controlled limited liability company (LLC). Corporations pay franchise tax on their assets but LLCs do not pay franchise tax on their assets. Tax planners helped many corporations avoid most of the franchise tax they would otherwise owe by setting up an LLC for the purpose of holding the assets on behalf of the corporation. Although the corporation's business continued in the same way, the corporation eliminated most of its franchise tax through this paper transaction.

The 2001 legislation tried to address this problem by requiring a corporation to pay tax on assets owned by the LLC if the corporation, including its affiliated corporations, indirectly owned[44] at least 70% of the LLC's assets. Unfortunately, tax planners found that the tax could still be avoided by using an additional paper transaction. If the corporation interposed a partnership between itself and the LLC holding its assets, then technically the 2001 legislation would not apply and the assets would continue to escape franchise tax.

The second section of this Part broadens the approach of the 2001 legislation to include "related members" (other entities and individuals) who may partner with one or more corporate entities to own the LLC to which the corporate assets are transferred. This section is effective beginning with payments due in March 2003. "Related members" is a defined term and includes shareholders, partnerships, etc.

If a corporation and its related members together indirectly own at least 70% of an LLC's assets, this Part provides that each corporation pays franchise tax on its relative share of the LLC's assets. The relative share is calculated after excluding those related members who are not corporations. Thus, the entire assets are subject to franchise tax, with the tax burden shared proportionally by the corporations that are involved in the ownership scheme.

Here is an example:

A parent corporation, its subsidiary, and a major shareholder of the parent form a partnership to own an LLC that will own assets on behalf of the parent and subsidiary. The LLC's documents provide that upon dissolution its assets are distributed as follows:

Parent Corporation:	20%
Subsidiary Corporation:	45%
Shareholder:	35%

Under prior law, the assets would remain free of franchise tax. Under the changes in this Part, the parent corporation will pay franchise tax on 31% of the assets and the subsidiary

[44] Indirect ownership of an LLC's assets is determined based on who is entitled to receive those assets upon dissolution of the LLC.

corporation will pay franchise tax on 69% of the assets. Those are their relative shares of the total once you exclude the non-corporate owner.

The approach taken by this Part is much broader than the 2001 legislation and is intended to anticipate the creative paper relationships tax planners may devise to try and avoid the franchise tax. The breadth of the provision is such that it could apply to a "legitimate" situation, such as an individual who is the sole shareholder of a corporation and who later forms an LLC with an associate. Under this Part, the corporation would pay tax on the LLC's assets. Unfortunately, there does not appear to be a way to distinguish this type of situation from one in which the corporation is manipulating relationships to avoid its franchise tax. With different tax treatment of similar entities, tax planners can try to manipulate relationships to fall into the untaxed category. Because corporations and LLCs are similar, there may not be a strong policy reason to treat them differently for franchise tax purposes.

HOUSING TAX CREDIT EFFECTIVE DATE CHANGE[45]

Part 30H of this act enlarges the class of taxpayers eligible for an enhanced credit for investing in low-income housing in a county that sustained severe or moderate damage from a hurricane in 1999. In 1999, the General Assembly enacted a new tax credit for rehabilitating or constructing low-income housing. The credit is equal to a percentage of the amount of the taxpayer's federal credit for low-income housing with respect to eligible North Carolina low-income housing. The credit is 75% for buildings located in tier one or two counties and 25% for buildings located in other tiers. In 2000, the General Assembly enacted legislation providing that the 75% credit is also allowed for buildings located in one of 26 counties that sustained severe or moderate damage from a hurricane in 1999. This increase in the amount of the credit was made effective for buildings that are allocated a federal credit on or after January 1, 2001. The federal tax credits are allocated in December of each year. Thus, those taxpayers who made investments in hurricane counties and were allocated federal credits in December 2000 are not eligible for the enhanced State credit. This act backdates the effective date for eligibility for the enhanced State credit from 2001 to 2000, thereby including those who were allocated federal credits for investments in hurricane counties during 2000.

Subsidiary Dividend Changes

Session Law	*Bill #*	*Sponsor*
S.L. 2002-136	**HB 1670**	**Representative Luebke**

AN ACT TO CLARIFY THE EXPENSE ATTRIBUTION LAW AS IT APPLIES TO DEDUCTIBLE DIVIDENDS AND TO PROVIDE LIMITS ON THE POTENTIAL TAX LIABILITY.

OVERVIEW: This act provides certainty and clarity to the expense attribution law as it applies to deductible dividends and provides limits on the potential tax liability.

[45] See the summary for S.L. 2002-87 for a more complete explanation of the substantive changes made to the housing tax credit.

FISCAL IMPACT: The act assures the State of the revenues relied upon in its budget availability estimates for 2001 and 2002. Under the act, the State may expect to receive approximately $57 million a year for 2001, 2002, and 2003 from the taxation of subsidiary dividends. Of this amount, the State expects to receive approximately $80 million in availability for the 2002-03 budget.

EFFECTIVE DATE: The act becomes effective for taxable years beginning on or after January 1, 2001.

BACKGROUND: The 2001 General Assembly enacted legislation conforming State law to the federal rules for the deduction of dividends received. This change eliminated the adjustments that had previously been required to reflect differences between the federal and State dividends deduction. Eliminating the adjustments also made the dividends subject to the general State law that expenses related to untaxed income cannot be deducted from taxable income. As a result, expenses related to deductible dividends must be netted from those dividends.[46] The law did not provide guidelines for calculating the amount of expenses that are related to deductible dividends.

Without knowing exactly how to determine the amount of related expenses, taxpayers were faced with uncertainty and potentially greater liability than they had anticipated when the legislation was debated. The new law was expected to have an especially significant impact on bank holding companies and electric power holding companies, because federal law requires them to have multiple subsidiaries.

ANALYSIS: The act provides clarity to the expense attribution law as it applies to deductible dividends and provides limits on the additional tax liability. These limits were calculated so that the act should yield revenue at least equal to what had been included in budget availability estimates based on the 2001 law.[47] The act states the intent of the General Assembly that it will be effective during 2001 and 2002 but will be studied and may be revised effective beginning with the 2003 tax year. However, the act does not sunset.

In summary, the act limits tax liability as follows:

- There are caps on the amount of related expenses that must be netted from deductible dividends as follows:
  - Most companies: 15% of dividends
  - Bank holding companies: 20% of dividends
  - Electric power holding companies: 15% of total interest expenses

[46] North Carolina has an exception to its general law where federal and State laws differ regarding the taxability of an income item. Prior to the 2001 changes, companies were able to use the exception to deduct expenses associated with deductible dividends earned from subsidiaries. The 2001 tax law change effectively eliminated the deduction of expenses associated with subsidiary dividends.

[47] After many discussions with the Department of Revenue and the interested parties about the impact of the expense attribution rules, it became clear that the 2001 estimate of $32.8 million understated the impact of the indirect change in the expense attribution rules. The reason for the under-estimate is that the Department of Revenue's analysis of the 2001 legislation, which used confidential tax returns for the 1994 tax year and an update of the 1994 data, did not include financial institutions. The budget enacted by the 2002 General Assembly included $50 million in additional budget availability from a re-estimate of the 2001 legislation.

- The additional tax that a bank holding company and its related companies must pay as a result of the expense netting is subject to a maximum of $11 million per corporate family.
- Bank holding company corporate families also receive a credit beginning in 2003. For bank corporate families that reach the $11 million maximum, the credit is $2 million. For other bank corporate families, the credit is equal to the amount of tax reduction that would result if bank holding companies were subject to a 15% cap rather than a 20% cap. These credits may be taken against income tax or franchise tax and are spread out over four tax years beginning in 2003.
- Electric power holding companies receive a credit equal to one-half of the additional tax that each must pay as a result of the expense netting. The credit is taken in the following year. The credit may be taken against income tax or franchise tax. As an alternative, an electric power holding company may elect to allocate the credit among the members of its affiliated group. If the electric power company makes this election, then the credit is spread out over four tax years, beginning in 2003.

SECTION-BY-SECTION ANALYSIS:

Section 1:	For federal tax purposes, dividends are deductible with no adjustment for related expenses. For State tax purposes, no deduction is allowed for expenses related to nontaxable income. Therefore, for State tax purposes, an adjustment must be made to federal taxable income to add-back any related expenses that were included in the federal deduction. This section provides that not all of the expenses must be added back by establishing a different adjustment for expenses related to dividends received that are not taxed.
Section 2:	This section establishes the adjustment for expenses related to dividends received that are not taxed, by providing a cap on the amount of tax payable: 15% of nontax dividends for most companies; 20% of nontax dividends for bank holding companies; and 15% of total expenses for electric power holding companies. The act also provides a credit for bank holding companies and electric power companies. Any unused portion of the credit may be carried forward to succeeding taxable years.
Section 3:	A conforming change to ensure that related expenses are deducted only once when calculating a corporation's net economic loss.
Section 4:	A conforming change that provides the same tax treatment for foreign source dividends as domestic source dividends.
Section 5:	States the intent of the General Assembly to address the issues raised by this act during the 2003 Regular Session. The Revenue Laws Study Committee is to study the treatment of expenses related to dividends received and other income not taxed, and the taxation of affiliated corporations, of holding companies, and of financial institutions under current law. The Committee must report its recommendations to the 2003 General Assembly.
Section 6:	Provides that a taxpayer will not be subject to additional tax or to penalties for underpayment of a tax to the extent the underpayment was created or increased by Section 3 of S.L. 2001-327 if the taxpayer pays all

	tax due that was created or increased by Section 3 of S.L. 2001-327 within 15 days after the date this act became law, October 3, 2002.

Insurance Regulatory Fund Changes

Session Law	*Bill #*	*Sponsor*
S.L. 2002-144	**HB 1105**	**Representative Hurley**

AN ACT TO FUND THE OPERATIONS OF THE DEPARTMENT OF INSURANCE FOR THE FISCAL YEAR 2002-2003 THROUGH THE INSURANCE REGULATORY FUND BY EXPANDING THE PURPOSES FOR WHICH THE FUND MAY BE USED AND BY CREDITING VARIOUS FEES COLLECTED BY THE DEPARTMENT AND OTHER AGENCIES UNDER THE DEPARTMENT INTO THE FUND FOR FISCAL YEAR 2002-2003, AND TO RESTORE THE 2002-2003 BUDGET REDUCTIONS SUSTAINED BY THE DEPARTMENT OF INSURANCE.

OVERVIEW: This act makes two changes relating to the Department of Insurance:

- It restores the $1.8 million budget cut the Department sustained for the 2002-2003 fiscal year in the Current Operations, Capital Improvements, and Finance Act of 2002. The increased appropriation from the General Fund will be reimbursed from the Insurance Regulatory Fund, which has a sufficient surplus.
- It provides that for the 2002-2003 fiscal year, certain fees collected by the Department of Insurance will no longer be retained as part of the Department's budget but will be credited to the Insurance Regulatory Fund and used to reimburse the General Fund for the Department of Insurance's expenses. The act was intended to appropriate to the Department for 2002-2003 the amount by which the fee changes reduce its budget, $3.2 million, but the appropriation was omitted by oversight. The Department is expected to receive these funds, however, through authorization from the legislative leadership.

FISCAL IMPACT: See Overview.

EFFECTIVE DATE: The act is effective for the 2002-2003 fiscal year only.

ANALYSIS: The two changes made by this act are not related, although both affect the Department of Insurance. Sections 9 and 10 of the act restore the $1.8 million budget cut the Department sustained for the 2002-2003 fiscal year in the Current Operations, Capital Improvements, and Finance Act of 2002. This restoration does not affect the General Fund. Although the Department of Insurance's budget is appropriated from the General Fund, the Insurance Regulatory Fund reimburses the General Fund for the appropriation. The additional $1.8 million is available as a surplus in the Insurance Regulatory Fund to reimburse the General Fund for the additional appropriation. Thus, neither the cut nor its restoration affected the General Fund.

The Department of Insurance regulates the insurance industry and other industries. Insurance companies pay an annual insurance regulatory charge that is measured as a percentage of each company's gross premiums tax. The proceeds of the charge are credited to the Insurance Regulatory Fund. Other industries regulated by the Department of Insurance also pay fees that are credited to the Insurance Regulatory Fund. The Fund is used to pay for the part of the Department's budget that goes to regulating the insurance industry and other industries. The funds are not paid to the Department of Insurance directly from the Insurance Regulatory Fund. Instead, the Department's budget is appropriated from the General Fund, and the Insurance Regulatory Fund reimburses the General Fund for the Department's costs of regulating the industries whose fees are credited to the Insurance Regulatory Fund.

In addition to regulating industries, the Department of Insurance has other functions relating to various State boards and commissions: the North Carolina Manufactured Housing Board, the State Fire and Rescue Commission, the Building Code Council, the North Carolina Code Officials Qualification Board, the Public Officers and Employees Liability Insurance commission, the North Carolina Home Inspector Licensure Board and the Volunteer Safety Workers Compensation Board. The Department's budget for these activities is supported by fees. The fees are collected and retained by the Department and used to cover these costs – there is no General Fund appropriation for these costs.

Sections 1 through 8 of this act change the way this part of the Department's budget is handled for the 2002-2003 fiscal year. Instead of retaining the fees, the Department of Insurance will deposit the fees in the Insurance Regulatory Fund. This eliminates the fee proceeds that would have been available to the Department to support these activities. The act was intended to appropriate additional funds from the General Fund to the Department of Insurance to support these activities. The additional appropriation would have been reimbursed to the General Fund from the Insurance Regulatory Fund, so there would have been no net fiscal impact, just an accounting change. Due to an oversight, the act failed to appropriate the additional funds to the Department of Insurance. The Department is expected to receive these funds, however, through authorization from the legislative leadership.

The act amends the Insurance Regulatory Fund statute to expand the purposes for which the Fund can be used for the 2002-2003 fiscal year, to cover not just regulating the insurance industry and other industries, but also carrying out other functions relating to boards and commissions. The insurance regulatory charge and the other fees paid into the Fund are not segregated from one another. Thus, a fee paid by one industry may end up being used for a function of the Department that relates to another industry. This pooling of the fees calls into question whether they can continue to be characterized legally as fees.

The issue of whether the insurance regulatory charge is a fee or a tax was raised in a recent case, *State Farm Mut. Auto. Ins. Co. v. Long*, 129 N.C.App. 164, 497 S.E.2d 451 (1998), aff'd 350 N.C. 84, 511 S.E.2d 303 (1999). In this case, the court evaluated the insurance regulatory charge under a three-part test used to distinguish a tax from a fee: (1) is it imposed by a legislative body or an administrative body; (2) is it imposed on a broad class or a narrow class of citizens; and (3) is it used for general public purposes, or used for the regulation or benefit of the parties upon whom the assessment is imposed. The court found that under the first two factors, the insurance regulatory charge could be either a fee or a tax. It held that the third factor was dispositive: the charge was a fee because it was credited to a segregated account and used only to regulate the insurance industry. Because this act broadens the purposes for which the charge may be used to include activities of the Department of Insurance that are not related to regulating the insurance industry, if the issue is raised in subsequent litigation, a court may find that the act changed the nature of the charge from a fee to a tax.

If the charge were ruled to be a tax rather than a fee, it would reduce the amount of revenue North Carolina receives as a result of the retaliatory premiums tax. The retaliatory premiums tax is imposed on foreign insurance companies doing business in North Carolina and is equal to the amount by which the NC premiums tax imposed on the company is less than the amount of premiums tax the company's home state would impose on an equivalent NC company doing business there. Because the insurance regulatory charge is considered a fee and not a tax, it is not added to the amount of NC tax used to calculate the retaliatory tax due. The lower the NC tax, the more retaliatory tax due.

Interstate Air Couriers – Bill Lee

Session Law	*Bill #*	*Sponsor*
S.L. 2002-146	**HB 1665**	**Representative Gray**

AN ACT TO AMEND TAX LAWS RELATED TO INTERSTATE AIR COURIERS AND TO AMEND THE WAGE STANDARD UNDER THE WILLIAM S. LEE QUALITY JOBS AND BUSINESS EXPANSION ACT TO ACCOUNT FOR THE VALUE OF HEALTH INSURANCE TO PART-TIME JOBS.

OVERVIEW: This act rewrites the wage standard under the William S. Lee Quality Jobs and Business Expansion Act (hereinafter Bill Lee Act) to allow part-time jobs for which the taxpayer provides health insurance to be counted as having wages at least equal to the standard multiplied by the applicable average weekly wage for the county in which the jobs will be located. The act also makes the following changes to the Bill Lee Act as it applies to air courier hubs:

- Rewrites the definition of interstate air courier hub to conform to industry practice.
- Extends the Bill Lee Act sunset of January 1, 2006, to January 1, 2010, for an interstate air courier that enters into a major real estate lease on or before January 1, 2006, with an airport authority.
- Allows an interstate air courier that has, or is constructing, a hub in North Carolina to qualify for enhanced incentives if the courier makes an investment of $150 million or more within a seven-year period.

- Extends the sunset on the Piedmont Triad Airport Authority's exemption from the bidding laws from January 1, 2008, to January 1, 2010.

<u>FISCAL IMPACT:</u> The initial estimates of the impact of the Fed Ex incentives in 1998 have not changed with the delay in the project. The 1998 estimates indicated that the lower sales tax rate on handling and storage equipment would amount to $.4 million for the first two years that the project is getting started and $.1 million per year thereafter. The impact of the sales tax exemption for lubricants and repair parts comes into play after the facility is up and running. The estimate for this incentive is $.2 million a year. The uncertainty surrounding the timing of the project means that it is impossible to predict which year the impacts begin. Under current scheduling, the first year of the handling and storage equipment incentive could be 2005-06. The costs of the sales tax incentives will not occur until at least 2005-06.

In addition, the extension of the Bill Lee Act's sunset from 2006 to 2010 for interstate air couriers will allow Fed Ex and other eligible taxpayers to take tax credits under the Act during the 2006-09 period. Data from the State's 1998 offer of financial benefits to Fed Ex indicated that Bill Lee Act credits of $2 million would be taken over a four-year period.

<u>EFFECTIVE DATE:</u> The air courier hub definition rewrite became effective October 1, 2002, and applies to sales made on or after that date. The bidding law exemption effective date change became effective when the act became law, October 7, 2002. The remaining provisions in the act are effective for tax years beginning on or after January 1, 2002.

<u>BACKGROUND:</u> The Bill Lee Act was enacted in 1996, effective beginning with the 1996 tax year with a 2002 sunset. The Act is a package of State tax incentives and has been modified in each subsequent year. The incentives are primarily in the form of tax credits for investment in machinery and equipment and real property, for job creation, for worker training, and for research and development. Counties are divided into five economic distress tiers based on the unemployment rate, per capita income, and population growth of the county. For many of the credits, the lower the tier of a county, the more favorable the incentive. The Act requires the Department of Commerce and the Department of Revenue to report periodically on the credits allowed by the Act.

Before 1996, North Carolina had made little use of tax incentives to lure businesses to the State. Even without incentives, North Carolina was consistently one of the top states in attracting industry. The array of credits authorized by the Bill Lee Act was viewed as an experiment, to be evaluated in five years to determine whether the incentives were cost effective and actually affected behavior, or merely provided tax reductions to businesses that would have located or expanded in any case. In 1997, the General Assembly amended the Bill Lee Act to make interstate air couriers[48] an eligible business under the Act. In 1999, the General Assembly extended the 2002 sunset to 2006.

To be eligible for the credits under the Bill Lee Act, jobs must meet the applicable wage standard. There is no wage standard for jobs located in tiers one and two.[49] The wage

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[48] An air courier is an air carrier that delivers individually addressed letters, parcels, and packages. Examples of air couriers include UPS and Federal Express.
[49] S.L. 2002-172 eliminated the wage standard in tiers one and two.

standard for tiers three through five is 110% of the applicable average weekly wage for the county. For the credit for worker training or the credit for creating new jobs, the average wage of the jobs for which a credit is claimed and the average wage of all jobs at the location are required to meet the applicable wage standard. For the credit for investing in machinery and equipment, the credit for research and development, and the credit for investing in central office and aircraft facility property, the average wage of all jobs at the location with respect to which a credit is claimed are required to meet the applicable wage standard.

In 1998, the General Assembly provided sales tax and property tax reductions for interstate air couriers in order to encourage the development of air courier hubs in North Carolina. Effective January 1, 2001, sales to an interstate air courier of equipment for handling and storing materials at its hub became subject to a reduced sales tax of 1%, capped at $80 per item. In addition, interstate air couriers enjoy a sales tax exemption for purchases of aircraft lubricants, aircraft repair parts, and aircraft accessories for use at the air courier's hub in this State. Effective beginning with the 2001 property tax year, there is a property tax exemption for aircraft owned by an air courier and apportioned for property tax purposes to the courier's hub in this State.

ANALYSIS: Section 1 of this act amends the definition of "hub" for interstate air couriers and recodifies the definition of "interstate air couriers" for sales tax purposes. The amendment to the definition of "hub" was needed because the prior definition did not accurately describe hubs. The prior definition stated, in part, that a hub is the airport in the State where the air courier has allocated at least 60% of its aircraft value apportioned to this State. Aircraft value is apportioned based on revenues generated and on the amount of time the aircraft is on the ground. In the case of air couriers, revenue is generated at the customer site, not at the hub. Additionally, aircraft spend very little time on the ground at the hub. For these two reasons, the definition of an air courier hub formerly in the statutes did not fit the factual situation. This act defines a hub as the primary airport in the State for sorting and distributing packages from which the air courier has, or expects to have, at least 150 departures a month. This definition is similar to the definition of "hub" under South Carolina law, but is a more stringent test as South Carolina requires only 25 departures a month.

The definition of "interstate air courier" is not substantively amended. Currently, for sales tax purposes, the definition of interstate air courier refers to the definition used in the Bill Lee Act. In this act, the definition of "interstate air courier" for sales tax purposes is made a stand-alone definition. There is no substantive change to the definition.

Section 2 of this act extends the sunset date on the Bill Lee Act until January 1, 2010, for certain interstate air couriers and Sections 4 through 7 of the act increase various time frames in the act from two years to seven years. The interstate air courier industry, and the construction of a hub in particular, face many regulatory, administrative, and legal hurdles not generally faced by other industries. Due to these extra burdens, time frames in this industry are generally longer than in other industries. There is generally a longer period between the time that a project is announced and a location is selected and the time the facility is placed in service. Due to these longer time frames, it was argued that an extension of the sunset and extensions of various time frames are needed to accommodate these projects.

Section 3 of this act amends the wage standards under the Bill Lee Act for all taxpayers. Currently, in order to be eligible for any of the credits under the Bill Lee Act, the average wage of all jobs at the location must meet or exceed the wage standard for the county in which the jobs are located.[50] Included in this calculation are part-time jobs, converted to a full-time equivalency. Some interested parties argued that because part-time jobs are not eligible for a credit for job creation, they should not be considered in this calculation. The inclusion of part-time jobs can disqualify a project since part-time jobs generally pay less than full-time jobs.

This act takes a middle ground. All part-time jobs must still be considered when the wage calculation is made. However, any part-time job for which the taxpayer provides health insurance will be considered to have a wage that at least meets the applicable average weekly wage. If a part-time job with health insurance has a wage that is less than the applicable average weekly wage, the applicable average weekly wage will be used in making the calculation. If a part-time job with health insurance has a wage that is greater than the applicable average weekly wage, the actual wage of the job will be used in making the calculation.

Section 8 of this act provides an extension of the bidding law exemption for the Piedmont Triad Airport Authority. When the General Assembly enacted certain tax incentives for interstate air couriers in 1998, one provision of that act granted a bidding law exemption for the Piedmont Triad Airport Authority. The exemption became effective beginning January 1, 1999, and applies to design and construction of an air freight distribution facility on airport property, and related supplies, equipment, and services. S.L. 2001-476 (Senate Bill 748) provided an extension of this exemption from January 1, 2004, to January 1, 2008. Upon the request of Fed Ex, this act extends the exemption to January 1, 2010. With this extension, the bidding law exemption would sunset at the same time as the Bill Lee Act for certain interstate air couriers.

Amend Property Tax Laws

Session Law	*Bill #*	*Sponsor*
S.L. 2002-156	**HB 1523**	**Representative Hill**

AN ACT TO AMEND VARIOUS PROPERTY TAX LAWS.

OVERVIEW: This act is a recommendation of the Revenue Laws Study Committee based on proposals by the North Carolina Association of Assessing Officers and the Department of Revenue. It makes the following changes to the property tax law:

- Increases the minimum penalty for a worthless check from $1 to $25 and provides that the tax collector may waive or reduce the penalty. This change became affective when the act became law, October 9, 2002.

[50] As mentioned above, for the credits for job creation and for worker training, the average wage of the particular jobs for which the credit is claimed must also meet or exceed the applicable average weekly wage.

- Provides a uniform procedure for appeals regarding taxation of personal property and authorizes the board of equalization and review to meet year round to hear these appeals. These changes are effective beginning with the 2003 property tax year.
- Delays from 2002 until 2003 the effective date of a 2001 law that defined certain single-section manufactured homes as real property for tax purposes.
- Adds an additional collection assistance fee of $15 to debts owed to local governments and collected by the Department of Revenue through tax refund setoff, effective January 1, 2003. The fee will be used to pay local governments' costs of submitting debts for collection by setoff.

FISCAL IMPACT: Two provisions of the act are likely to have a fiscal impact. Increasing the minimum charge for a returned check will likely increase local fee revenues. However, granting the assessor the authority to waive the fee will offset some of the increase. The exact amount of this revenue change is unknown. The second potential impact relates to the debt setoff program. The act will reduce the cost of debt collection for local governments and will likely increase program usage. However, no firm estimate is available on the total financial impact for local governments.

EFFECTIVE DATE: See Overview.

ANALYSIS: This act makes a number of changes to the property tax laws. First, it modifies the penalty for giving a worthless check. It increases the minimum penalty from $1 to $25. The penalty is 10% of the amount of the check, subject to the minimum and to a maximum of $1,000. It also authorizes the tax collector to waive the worthless check penalty. Tax collectors do not have the general authority to waive property tax penalties. By comparison, the Secretary of Revenue has general authority to waive tax penalties.

Second, the act provides a uniform procedure and timetable for appeals relating to personal property, effective beginning with the 2003 property tax year. Under prior law, the statutes specified the procedure and timetable for real property appeals but not for personal property appeals; as a result, different counties had adopted different procedures and timetables. This act provides a uniform system: the taxpayer may appeal value, situs, or taxability within 30 days after receiving notice of value. The notice must inform the taxpayer of the 30-day period. The assessor is required to respond to each appeal and the taxpayer has 30 days to appeal the assessor's final decision to the board of equalization and review or the board of county commissioners. The act authorizes boards of equalization and review to sit year-round to hear personal property appeals. In 2001, the General Assembly authorized boards of equalization in review to sit year-round to hear appeals relating to discovered property, motor vehicle taxation, and annual audits of whether property qualifies for special tax treatment.

Third, the act delays from 2002 to 2003 the effective date of 2001 legislation that changed the way manufactured homes are classified for property tax purposes. A manufactured home is defined in G.S. 143-143.9 as:

> A structure, transportable in one or more sections, which, in the traveling mode, is eight feet or more in width or is 40 feet or more in length, or when erected on site, is 320 or more square feet, and which is built on a permanent

chassis and designed to be used as a dwelling with or without a permanent foundation when connected to the required utilities, and includes the plumbing, heating, air conditioning and electrical systems contained therein.

Since 1987, North Carolina law had provided that a manufactured home was considered real property for property tax purposes if it (i) consisted of two or more sections; (ii) had its hitch, wheels, and axles removed; and (iii) was placed upon a permanent foundation on land owned by the owner of the manufactured home. In 2001, the General Assembly removed the requirement that the home consist of two or more sections, effective beginning with the 2002 tax year. After the 2001 act became law, county assessors realized they would not have time to review all the manufactured homes in each county to determine which ones should be reclassified as real property for the 2002 tax year. The assessors had requested an extension until the 2004 tax year, but this act delays the change only until the 2003 tax year.

Fourth, the act imposes an additional collection assistance fee of $15 on debts owed to local governments and collected by the Department of Revenue through tax refund setoff. Under the Setoff Debt Collection Act, the Department of Revenue diverts the income tax refund of an individual who owes money to a State or local agency to pay the debt owed to that agency. The debt the individual owes the agency is set off against the individual's income tax refund. Under existing law, a collection assistance fee of no more than $15 is imposed on debts (other than child support debts) collected by setoff, to reimburse the State for its costs of operating the setoff debt collection program. This act adds an additional collection fee of $15 for debts (other than child support debts) owed to local governments and collected by setoff, effective January 1, 2003. The Department of Revenue will collect the fee as part of the setoff process and remit the fee to the clearinghouse that submits local debts on behalf of local governments. The purpose of the fee is to recover the cost to local governments of submitting debts for collection by setoff. The clearinghouse that submits debts on behalf of local governments was created through a joint agreement between cities and counties; the local governments have also contracted with a third party to process and compile local debts for setoff.

NC Economic Stimulus and Job Creation Act

Session Law	*Bill #*	*Sponsor*
S.L. 2002-172	**HB 1734**	**Representative Owens**

AN ACT TO ESTABLISH AND MODIFY VARIOUS ECONOMIC INCENTIVE PROGRAMS FOR BUSINESS AND INDUSTRY; TO AMEND PROVISIONS RELATING TO INDUSTRIAL AND POLLUTION CONTROL FACILITIES FINANCING; TO AUTHORIZE PLANNING AND DEVELOPMENT FOR A BIOPHARMACEUTICAL TRAINING CENTER AND A CANCER REHABILITATION TREATMENT CENTER; AND TO MAKE TECHNICAL AND CONFORMING CHANGES.

OVERVIEW: There are six parts to this act. Part 1 of this act amends the Bill Lee Act by scaling back the credit for machinery and equipment in tiers three, four, and five, by eliminating the wage standard in tiers one and two and in development zones, and by eliminating the wage standard for the credit for worker training. Part 2 of the act creates the Jobs Development Investment Grant Program, a discretionary program that awards grants to businesses based on a percentage of employee withholdings over a number of years. Part 3 of the act requires production companies to spend at least $1 million in North Carolina to be eligible for a grant from the Film Industry Development Account. Part 4 of the act makes a technical change to the North Carolina Railroad's condemnation authority. Part 5 of the act eases the public hearing requirements for Industrial Development Bonds to facilitate bonds for smaller manufacturers. Part 6 of the act provides authorization to initiate planning and development of a new biopharmaceutical training center and a cancer rehabilitation treatment center.

FISCAL IMPACT: The Bill Lee Act changes will generate approximately $3.45 million for fiscal year 2003-04, $7 million for fiscal year 2004-05, and $10.56 million for fiscal year 2005-06. No fiscal impact is expected from the changes to the film industry incentives. The Jobs Development Investment Grant Program represents a significant change from the structure of the Bill Lee Act incentives. It is impossible to determine the exact dollar cost of the Program. However, the Program is limited to 15 projects per year and $10 million in grants per year, and it sunsets on January 1, 2005. Thus the maximum grant amount that may be awarded during the 13 years the Program is in effect is $240 million.

EFFECTIVE DATE: See Analysis.

ANALYSIS: There are six main components to this act: changes to the William S. Lee Quality Jobs and Business Expansion Act (hereinafter Bill Lee Act)[51], the establishment of a new economic development grant program for new and expanding businesses, changes to film industry incentives, changes to the condemnation authority of a railroad company, changes to industrial and pollution control facilities financing law, and authorization to initiate planning and development of a new biopharmaceutical training center and a cancer rehabilitation treatment center.

Part 1. Bill Lee Act: Part 1 makes the following substantive changes to the Bill Lee Act:
Machinery and Equipment. A taxpayer is allowed a credit for the cost of machinery and equipment placed into service during a taxable year that exceeds the applicable threshold based on the location where the machinery and equipment are placed into service. Under prior law, the amount of the credit was equal to 7% of the cost of the machinery and equipment in excess of the applicable threshold. Section 1.1 of this act makes two changes to this credit. First, the amount of the credit is reduced in enterprise tiers three, four, and five. In those areas, the amount of the credit is reduced to 6%, 5%, and 4%, respectively, of the cost of the machinery and equipment in excess of the applicable threshold. Second, the amount of the threshold is increased in enterprise tiers four and five. In enterprise tier four, the threshold is increased from $500,000 to $1,000,000. In enterprise tier five, the threshold is increased from $1,000,000 to $2,000,000. This section is effective for taxable years

[51] For background on the Bill Lee Act, see the summary for S.L. 2002-146.

beginning on or after January 1, 2003, and applies to business activities that occur on or after that date, but does not apply to business activities that occur on or after January 1, 2003, that are subject to a letter of commitment signed before January 1, 2003.

Overdue Tax Debts. If the Secretary of Revenue discovers that any tax is due from a taxpayer, the Secretary must notify the taxpayer in writing of the Secretary's intent to assess the taxpayer for the tax. The notice must describe the basis for the assessment, the amount of tax to be assessed and any interest and penalties due. If the taxpayer disagrees with the assessment, the taxpayer has 30 days to request a hearing before the Secretary. The Secretary must then schedule a hearing to occur within 90 days of the request. Within 90 days after the hearing, the Secretary must issue a decision on the hearing. If the taxpayer does not request a hearing within the 30 days allowed, or if the Secretary finds that the tax is due after the hearing, the proposed assessment becomes a final assessment. If a taxpayer disagrees with a final assessment, the taxpayer may appeal the decision to the Tax Review Board, and then on to superior court, the Court of Appeals, and the Supreme Court. A tax debt is a final assessment after all possibilities for appeal have been exhausted. An overdue tax debt is any part of a tax remaining after 90 days. Section 1.2 would make a taxpayer ineligible for a credit under the Bill Lee Act if the taxpayer had any overdue tax debts. Section 1.5 defines an overdue tax debt. These two sections are effective for taxable years beginning on or after January 1, 2003.

Wage Standard. A taxpayer is eligible for a credit under the Bill Lee Act only if the jobs provided by the taxpayer meet a wage standard. Under prior law, the wage standard was 110% (100% in an enterprise tier one area or a development zone) of the applicable average weekly wage. The jobs that are included in calculating the wage standard vary depending on the particular credit.

Section 1.3 of this act makes three substantive changes to the wage standard. The changes are effective for taxable years beginning on or after January 1, 2003. First, this section eliminates the wage standard in enterprise tier one and two areas. Since the wage standard for a business located in a development zone is the same as for tier one counties, this section also eliminates the wage standard for a development zone area.

Second, this section eliminates the wage standard for the credit for worker training. In order to be eligible for the credit for worker training, the employee who is being retrained must either (i) occupy a job for which the taxpayer is eligible to claim a credit for creating jobs, or (ii) be trained to operate machinery and equipment for which a taxpayer is eligible to claim a credit for investing in machinery and equipment. Thus, the jobs for which the credit for worker training may be claimed have already been included in a larger group of jobs that has met the wage standard. Often the specific jobs for which worker training is required are lower-paying jobs that could not themselves meet the wage standard. This change allows the credit for worker training to be taken by more taxpayers.

Third, this section makes an allowance for a taxpayer that has a taxable year other than a calendar year. To perform the wage standard test, the taxpayer compares the average weekly wage of certain jobs to the wage standard determined on an annual basis. The test is performed for the calendar year that jobs are created or for which worker training is provided. However, performing a wage standard test based on a calendar year is not feasible because many companies have taxable years that do not coincide with the calendar year. Consequently, the taxpayer can engage in activity that qualifies for a credit during a taxable year that spans two calendar years. If the taxpayer creates jobs in different calendar years, it must compute the combined average weekly wage of the jobs created during its taxable year and compare this average to the county wage standard to determine if it qualifies for a tax credit. It cannot, however, compute this average "for the calendar year the jobs are created" as required by the prior law because the jobs are created over the course of two calendar years. Under this act, the wage standard test is based on the taxpayer's taxable year and not the calendar year. When a taxable year spans two calendar years, the applicable wage standard is that of the earlier calendar year. In addition to correcting a practical problem, this change generally will be favorable for taxpayers because county wage standards generally trend upward.

Development Zones. In 1998, the General Assembly amended the Bill Lee Act to provide additional incentives for businesses that locate or expand in development zones, which are economically distressed areas located within cities. The statutory conditions for qualifying as a development zone are designed to target only these relatively small, economically distressed areas.

A development zone is defined as an area that meets all of the following conditions: (1) it consists of one or more contiguous census tracts, block groups, or both, (2) it has a population of 1,000 or more, at least 20% of whom are below the poverty level, (3) it is located at least partly in a city with a population over 5,000, (4) every census tract and census block group in the zone is located in whole or in part within the primary corporate limits of the city, (5) every census tract and census block group in the zone has more than 10% of its population below the poverty level, or is immediately adjacent to a tract or group that has more than 20% of its population below the poverty level, and (6) none of the census tracts or census block groups is located in another development zone.

This act expands this definition of development zone to include all of a parcel of land that is located partially within the zone if all of the following conditions are met:

- At least 50% of the parcel is located within the zone.
- The parcel was in existence and under common ownership prior to the previous decennial federal census.
- The parcel is a portion of land made up of one or more tracts or tax parcels of land that is surrounded by a continuous perimeter boundary.

The following enhanced incentives apply in development zones: If a business locates in a development zone, its maximum worker training credit is $1,000 rather than $500, it receives an additional $4,000 per job on its jobs tax credit, and the credit for investing in machinery and equipment is calculated as if the zone were in a tier one county. In addition, a business located in a development zone does not have to meet a wage standard to be eligible for the credits. This section is effective for taxable years beginning on or after January 1, 2003.

Part 2. Job Development Investment Grant Program. Part 2 of this act creates a new economic development tool for new and expanding businesses in North Carolina. This tool would be used to attract businesses to the State by allowing a five-member committee to award grants to businesses. The amount of the grants would be based on income tax withholdings from new jobs created by the businesses. This part became effective October 31, 2002.

Which projects are eligible for a grant? In order to be eligible for a grant under this program, the business must create a minimum number of new jobs. The number of new jobs that must be created varies based on the enterprise tier designation of the location where the jobs will be located. For projects located in enterprise tiers one through three, the project must create at least 10 new full-time positions. For projects located in enterprise tiers four and five, the project must create at least 20 new full-time positions. If a project is located in more than one location, the enterprise tier designation of the location in the highest enterprise tier area determines the number of new jobs that must be created.

As with the Bill Lee Act, a business must provide health insurance for all full-time jobs associated with the project in order to be eligible for this new program. The test is the same as under the Bill Lee Act – the business must, for all full-time employees of the project, pay at least 50% of the premiums for health insurance that meets at least the minimum provisions of the basic health care plan of coverage recommended by the Small Employer Carrier Committee. In addition, the average wage of all jobs at the location with respect to which a grant is sought must meet the Bill Lee wage standard, as amended by this act. Finally, as with the Bill Lee Act, the business must have no citations under the Occupational Safety and Health Act that have become a final order within the previous three years for willful serious violations or for failing to abate serious violations with respect to the location for which the grant is made.

Unlike under the Bill Lee Act, there are few restrictions based on the industry in which the business is engaged. There are only two types of projects that are ineligible for consideration under this program: retail facilities and professional and semiprofessional sports teams and clubs.

More generally, the project must satisfy the following conditions in order to be eligible for a grant:

- The project will result in net new employment in the State by the business.
- The project will benefit the people of the State by increasing employment opportunities and strengthening the State's economy.
- The project is consistent with economic development goals for the State.
- A grant is needed in order to secure the project for the State.
- The total benefits of the project to the State outweigh the costs associated with the project.

How a grant is obtained? In order to obtain a grant under this program, the business must apply to the Economic Investment Committee for consideration. The Economic Investment Committee is a five-member committee consisting of the Secretary of Commerce, the Secretary of Revenue, the Director of the Office of State Budget and Management, one member appointed by the General Assembly upon the recommendation of the Speaker of the House of Representatives, and one member appointed by the General Assembly upon the recommendation of the President Pro Tempore of the Senate[52]. The members appointed by the General Assembly serve two-year terms. The Committee may act only upon a decision of at least three of its five members. The Committee is subject to the open meetings law and the public records law. Members of the Committee are

[52] The members of the Committee appointed by the General Assembly may not be members of the General Assembly.

forbidden to work for a business that receives a grant under this program for at least two years after the member is no longer on the Committee. A former member of the Committee who violates this prohibition against working for a business that receives a grant under this program must forfeit any compensation received for that work and is prohibited for an additional two years from working for a business that receives a grant under this program.

The application for a grant must be under oath, be on a form prescribed by the Committee, and contain any information required by the Committee. At a minimum, the application must contain the following information:

- The name of the business, the proposed location of the project, and the type of activity in which the business will engage at the project site.
- The names and addresses of the principals or management of the business, and the nature of the business, and the form of business organization under which the business is operated.
- The financial statements of the business prepared by a certified public accountant.
- The number of new jobs proposed to be created by the project.
- An estimate of the withholdings of personal income tax of employees of the project.
- Information concerning other possible locations of the project, and the benefits, including tax benefits or grants, associated with locating the project at that other location.
- Information concerning other State grants for which the business is applying or that it expects to receive.
- Certification that the project will provide health insurance to all full-time employees.

A group of related businesses involved in a project may submit a joint application for a grant under this program.

Any application for a grant must be accompanied by a fee in the amount of $5,000. This fee will be allocated by the Secretary of Commerce, the Secretary of Revenue, and the Director of the Office of State Budget and Management among their agencies.

The Committee will evaluate applications to determine which businesses will receive grants under this program. The awarding of a grant is solely in the discretion of the Committee. The Committee is required to develop criteria for evaluating applications. These criteria must take into consideration the economic impact of the project; the strategic importance of the project to the State, region, or locality; the quality of the jobs to be created; the quality of the industry and the project; the environmental impact of the project; and the degree to which the use of the program has been geographically dispersed throughout the State.

The Committee is required to be somewhat selective in choosing projects to receive a grant. The Committee may not enter into more than 15 agreements in any calendar year. However, there may be significantly more than 15 agreements outstanding at any time because the term of an agreement may be as long as 12 years. In addition, the Committee may not commit more than $10 million dollars annually with agreements entered into in any calendar year[53].

How is the amount of a grant determined? If the Committee approves a business's application, the Committee will then negotiate and enter into a community economic development agreement with the business. The agreement is a binding commitment on the part of the State to provide the grant for a set number of years, subject to the Committee's right or duty to amend or terminate the agreement under certain circumstances. Each agreement must include a description of the project, the term of the agreement, the number of positions expected to be subject to the grant and a method for determining the number of positions that are subject to the grant, and the amount of the grant as a percentage of the withholdings of personal income tax from eligible positions. The Committee has wide discretion in setting the percentage that determines the amount of a grant under an agreement. The Committee must develop criteria to be used when negotiating the appropriate percentage. At a minimum, the following conditions apply:

- The amount of the grant may not be less than ten percent (10%) or more than seventy-five percent (75%) of the withholdings associated with new jobs at the project.
- The term of the grant cannot exceed 12 years.
- The percentage used to determine the amount of the grant must be reduced by one-fourth for any eligible position located in an enterprise tier four or five area.
- Unless the Committee makes a specific determination that the grant should be calculated based on eligible positions created in additional years during the term of the agreement, the amount of the grant is calculated based only on eligible positions created during the base years (the first two years) of the agreement.
- Unless the Committee makes an explicit finding otherwise, the total amount of all grants provided by the State may not exceed seventy-five (75%) of the withholding of eligible positions.
- The amount of a grant associated with any specific position may not exceed $6,500 in a year.

In addition, the Committee must consider at least the following factors when negotiating a percentage to be used in determining the amount of a grant:

- The number of eligible positions to be created.
- The expected duration of those positions.
- The type of contribution the business can make to the long-term growth of the State's economy.
- The amount of other financial assistance the project will receive from the State or local governments.
- The total dollar investment the business is making in the project.
- Whether the project utilizes existing infrastructure.
- Whether the project is located in a development zone.

[53] The total annual commitment may be much more than $10 million dollars. For example, agreements entered into during each of the 2003 and 2004 calendar years could each make commitments of up to $10 million annually, for a total annual commitment of up to $20 million.

- The number of eligible positions that will be filled by residents of a development zone.
- The extent to which the project will mitigate unemployment in the State and locality.

Use of funds? There are no restrictions on the use of the grant fund by the business. South Carolina has a similar grant program. Under the South Carolina program, grant funds may be used for certain specific purposes only, such as worker training, worker relocation, purchase or construction of real property, and construction or repairs to certain transportation-related real property.

The withholdings retained by the State would be used in two different ways. First, the withholdings in excess of the percentage negotiated in the agreement would flow to the General Fund.[54] Second, the withholdings that are included in the agreement, but that are excluded from the grant because the percentage was reduced by one-fourth because the eligible position is located in an enterprise tier four or five area, would be transferred to the Utility Account of the Industrial Development Fund.[55] Funds in the Utility Account may be used to assist local governments in tiers one, two, and three in constructing or improving utility lines or equipment, including telecommunications and high-speed, broadband lines and equipment.[56]

Terms of agreement. The Committee has a great deal of flexibility in negotiating agreements. However, the legislation does require the agreements to include certain provisions, such as information on the new jobs created and a method to verify the positions, reporting requirements, and the reasons for which an agreement may be amended or terminated and the benefits recaptured. In addition, the Attorney General must review the terms of all proposed agreements and must personally sign each agreement.

Follow-up on grantee businesses. This act provides for monitoring of grantee businesses in several ways and requires the Committee to amend or terminate agreements if the business fails to live up to the terms of the agreement or the requirements of this new program.

The business must submit annual reports to the Committee. In addition, the Committee may audit at any time a business receiving a grant. At a minimum, the business must submit a copy of its federal and State income tax returns which show business and nonbusiness income, a report that shows withholdings, and a payroll report. This annual submission must also include any additional information the Committee considers necessary to implement the grant program.

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[54] Even though the maximum percentage that may be used to determine the amount of a grant is 75%, there may be no additional revenue from these positions that would flow to the General Fund. This is because most taxpayers over-withhold, meaning that more taxes are withheld than are actually due, resulting in a refund to the taxpayer. Because of this, a grant based on the maximum percentage of 75% could result in a net loss to the General Fund.

[55] The following example will clarify this. Assume a project that is located in an enterprise tier five area is allowed a grant based on 75% of the withholdings of the eligible positions. Because those positions are located in an enterprise tier five area, that percentage is reduced by one-fourth, so that the business is allowed a grant equal to 56.25% of the withholdings of eligible positions. (75% multiplied by ¾ equals 56.25%.) Twenty-five percent of the withholdings of eligible positions would flow to the General Fund, 56.25% would be given to the business in the form of a grant, and 18.75% would be transferred to the Utility Account of the Industrial Development Fund.

[56] Part 2 of this act amended the law regarding the Industrial Development Fund and the Utility Account.

This annual submission must be accompanied by a fee of $1,500. The Committee shall allocate the fee among the agencies responsible for evaluating the submission.

The Committee must also obtain information from the Department of Revenue before the disbursement of a grant. The Department of Revenue must certify the amount of withholdings from the eligible business.

The Committee is required to amend or terminate the agreement and to recapture all or part of a grant made in previous years under certain circumstances. If the business fails to meet or comply with any term of the agreement or with criteria developed by the Committee, the Committee must amend the agreement and may terminate the agreement. This amendment may take the form of a lower percentage being used to determine the amount of the grant or of a shorter term for the agreement. The reduction must be proportional to the failure to comply with the agreement. If the business fails to meet or comply with any term of the agreement or with criteria developed by the Committee for two consecutive years, the Committee must terminate the agreement. In addition, the Committee must include a provision in each agreement describing the conditions that will lead to recapture of a grant made in an earlier year.

As with the Bill Lee Act, as amended by this act, a business that has an overdue tax debt is penalized. A business that has an overdue tax debt may not receive an annual disbursement of a grant so long as that overdue tax debt is not satisfied or otherwise resolved.

Program evaluation. The act requires the Committee to report quarterly and annually.[57] The annual report must include information on the agreements entered into during the year as well as an update on the status of projects for which an agreement was entered into in the past. Additionally, the reports must provide information on the number of jobs created and the tax benefit derived from those positions, the types of jobs created, and the geographic distribution of the grants.

The authority of the Committee to enter into additional agreements begins as of January 1, 2003, and expires as of January 1, 2005. This sunset will allow the General Assembly an opportunity to review the program after it has been in effect for a few years in order to determine if the program is meeting its objectives.

Miscellaneous changes associated with the program. Section 2.2 of this act makes two significant changes to the Industrial Development Fund and to the Utility Account, which is part of that Fund. The Industrial Development Fund provides assistance to local governments for improvements to infrastructure to enable the locality to attract new businesses. Usually, this assistance is provided to make general improvements, such as improvements to or development of industrial parks, and is not tied to luring a specific project.

First, the purposes for which funds in both the Fund and the Account may be used are expanded to allow expenditures for telecommunications and high-speed broadband lines and equipment. Currently, funds under both the Fund and the Account may be used for construction of and improvements to water, sewer, gas, and electricity lines and equipment. This change recognizes the growing importance to industry of telecommunications and high-speed broadband.

[57] The Committee must report by April 30th of each year.

Second, under current law, funds in the Utility Account may be used to assist local governments located in enterprise tiers one and two only. This act would expand the focus of the Account to allow funds in the Account to be used to assist local governments in enterprise tier three as well.

Section 2.3 allows an exemption from the confidentiality requirements of the Department of Revenue. Generally, the Department of Revenue must keep confidential all information it receives in the course of administering the tax laws. There are numerous, specific exceptions to this requirement. This act would allow the Department of Revenue to share information with the Economic Investment Committee relating to businesses that are applying for a grant or that are subject to an agreement.

Section 2.4 of this act corrects a statutory reference in two laws dealing with the purposes for which a local government may levy a property tax.

Section 2.5 prohibits a member of the General Assembly from serving on the Economic Investment Committee. Under the constitutional doctrine of separation of powers, legislators cannot serve on executive boards exercising executive functions.

Section 2.6 of this act exempts the Economic Investment Committee from the rule-making process under the Administrative Procedure Act. However, Section 2.1, in G.S. 143B-437.48(d) as enacted by this act, requires the Committee to publish the proposed criteria on the Department of Commerce's web site at least 15 business days prior to the adoption of or an amendment to any proposed criteria. The Committee must also provide notice to persons who have requested notice of proposed criteria and it must accept oral and written comments on the proposed criteria.

Section 2.7 of this act requires the Revenue Laws Study Committee to study the use, the effectiveness, and the cost versus benefit of the Job Development Investment Grant Program, the Bill Lee Act, and the Industrial Recruitment Competitive Fund. Given that the Job Development Investment Grant Program is just starting up, the time frame for the study is longer than usual. Revenue Laws may report to the 2004 Regular Session of the General Assembly and a final report is due by March 15, 2005, to the 2005 General Assembly.

Part 3. Film Industry Incentives. Part 3 of this act amends the Film Industry Development Account to require a minimum expenditure in North Carolina before a project may be eligible for a grant from the Account. The Film Industry Development Account was established in 2000 with the intent of providing economic incentives to production companies for operations in North Carolina. Under the account, a production company is eligible for a grant based on expenditures made in the State. The grant may not exceed fifteen percent of those expenditures. The grant is not available for political or issue advertising or for any production that is considered obscene under G.S. 14-190.1. The amount of the grant may not exceed $200,000. This section adds an additional requirement that the production company have expenditures of at least $1 million in the State. This more narrowly targets this incentive to large productions.

Section 3.2 directs the Revenue Laws Study Committee to study other incentives for the film industry and to report to the 2003 General Assembly. This part became effective October 31, 2002.

Part 4. North Carolina Railroad Condemnation Authority. Part 4 of this act makes a technical correction to the condemnation authority of a railroad. In 1998, State responsibility for railroad regulation was moved from the Utilities Commission to the Department of Transportation. At that time, G.S. 62-232 was repealed. This section deletes a cross-reference to that statute. This does not appear to have any substantive effect on the power of a railroad to condemn property. This part became effective October 31, 2002.

Part 5. Industrial and Pollution Control Facilities Financing. The Department of Commerce hopes to reinstate a program begun in the late 1980's that would permit small companies to take advantage of industrial development bond financing by grouping several small loans into a single bond issue. In order to make that program workable, the process needs to be as streamlined as much as possible. As currently written, bonds issued under Article 1 of Chapter 159D (for industrial projects) require a public hearing at the local level - that is, by the county commissioners of the county in which the facility will be located. In addition, for those bonds the federal tax exemption rules require a hearing at the state level by the agency, with the result that there would be two public hearings. Bonds issued under Article 2 of Chapter 159D (which are special purpose projects and educational facilities) require a public hearing by the North Carolina Capital Facilities Finance Agency (NCCFFA), with notice to the governing bodies of the localities in which the facilities will be located.

Part 5 of this act modifies Article 1 of Chapter 159D so that the public hearing for a bond issue dealing with multiple projects would take place at a location determined by the NCCFFA – most likely at its headquarters in Raleigh. This change simply removes the requirement of multiple public hearings throughout the State for one bond issue. The local government would still have to approve the project in its jurisdiction under a different section of the statute. This change would not affect bond issues involving a single project.

This part also makes a conforming change to Article 1 of Chapter 159D. In both Chapter 159C (relating to industrial development bonds through local authorities) and Chapter 159D, Article 2 (relating to special purpose projects and educational facilities) the Local Government Commission is permitted to take into consideration credit enhancement when determining whether a project is feasible. That language was omitted from Article 1 of Chapter 159D. There appears to be no reason to treat an industrial development project differently when it comes through a local authority rather than the NCCFFA. Part 5 of this act becomes effective January 1, 2003.

Part 6. Capital Planning Costs for Biopharmaceutical Training Center and Cancer Rehabilitation Treatment Center. Part 6 of the act authorizes the initial planning and development of two capital projects, effective October 31, 2002. It authorizes the State Board of Community Colleges, the Board of Governors of the University of North Carolina, and the North Carolina Biotechnology Center to initiate planning and development of a new biopharmaceutical/bioprocess manufacturing training center to be centrally located and of related training facilities to be located at various community colleges. The State has invested greatly through the North Carolina Biotechnology Center to bring close to 150 biotechnology companies to the State over the past 15 years. The biopharmaceutical and bioprocessing industry anticipates the need for 3,000 to 5,000 new employees each year for the foreseeable future. These workers will require training and education at a variety of levels in biotechnology, bioprocessing, and biomanufacturing. An Alliance Council, representing the universities, community colleges, and biomanufacturing companies, will develop a comprehensive training and education program capable of training 3,000 to 5,000 people for the industry annually through a combination of large-scale equipment training and academic programs at a Central Training Center and programs at the Regional Training Centers.

It also authorizes the Board of Directors of the University of North Carolina Health Care System to initiate planning and development of a new cancer rehabilitation and treatment center to be located at the University of North Carolina Hospitals at Chapel Hill. The UNC Health Care System provides services for patients with cancer in the Gravely Building, a building that opened in 1953 as a tuberculosis sanitarium. This nearly 50-year-old facility has been remodeled to its fullest extent, and can no longer meet the needs of modern-day programs and services required to treat patients with cancer. The Gravely Building is also inadequate for the support of UNC's clinical research mission for clinical trials and for testing new medications that are essential for enhancing treatment options and increasing the knowledge base for new treatment opportunities. The UNC Health Care System proposes a replacement to the North Carolina Clinical Cancer Center to address these deficiencies and to provide a more appropriate environment for patients with cancer.

Amend Use Value Statutes and Other Tax Laws

Session Law	*Bill #*	*Sponsor*
S.L. 2002-184	**SB 1161**	**Senator Hartsell**

AN ACT TO AMEND THE PRESENT-USE VALUE STATUTES, TO CREATE A PROPERTY TAX SUBCOMMITTEE OF THE REVENUE LAWS STUDY COMMITTEE, TO CLARIFY THE SALES AND USE TAX EXEMPTION REGARDING CERTAIN AGRICULTURAL SUBSTANCES, AND TO MAKE VARIOUS ADMINISTRATIVE CHANGES IN THE TAX LAWS.

OVERVIEW: Sections 1 through 7 of this act amend the present-use value law to provide an updated method for calculating the value of farmland in its present use, to clarify the sound management requirement for qualifying for use value taxation, to allow land subject to a conservation easement to continue to qualify for use value taxation, and to make numerous clarifying and procedural changes. Most of the changes to the use value law were recommended by the Revenue Laws Study Committee.

Section 8 of the act establishes a property tax subcommittee of the Revenue Laws Study Committee.

Sections 9 through 12 of the act make changes to the administration of various sales tax laws. These changes were recommended by the Revenue Laws Study Committee.

FISCAL IMPACT: The provision related to the sales taxes on plant inhibitor equipment is likely to create a small but undefined revenue gain. The change in sales tax payment dates will result in a small revenue loss due to the loss of the float, but no exact estimate is possible. The use value changes will affect local governments, but data are not available to calculate the amount of the impact. The remaining items will all result in a slight but undefined loss or no loss to the General Fund.

EFFECTIVE DATE: The changes to the present-use value law are effective beginning with the 2003 property tax year. The remaining changes became effective in October 2002.

ANALYSIS:

Use Value Changes. This act provides for more accurate determination of the present use value of farmland. Since 1973, the General Assembly has provided that farmland (agricultural land, horticultural land, and forestland) may be appraised, assessed, and taxed at its present-use value, as opposed to its fair market value. The present-use value classification helps preserve farmland by insulating it from the rising property tax values caused by competing market pressures to develop farmland for commercial and residential purposes.

The difference between the taxes due based on the present use value and the taxes that would have been payable based on market value, together with any interest, penalties, or costs, are a lien on the property. This difference in taxes is carried forward in the records of the taxing unit as deferred taxes. The deferred taxes for the preceding three years become payable whenever the property loses its eligibility for the benefit of the special use value law.

In 1985, the General Assembly enacted the most recent methodology for calculating present-use value: The value was required to be based on capitalization of net income at the rate of 9%; for agricultural land, the net income was to be based on average corn and soybean yields. The Department of Revenue was required to prepare and distribute annually to each tax assessor a present-use value manual to assist in appraising and assessing farmland. A four-member Use-Value Advisory Board, under the supervision of the Agricultural Extension Service of North Carolina State University, would submit a recommended manual to the Department each year. The present-use value manual is advisory only, and each county remains free to develop its own present-use value schedules. Until several years ago, all counties used the manual. By 2002, an increasing number of counties were not using the manual because the present-use values in the manual could not be supported by credible market evidence. For example, corn and soybeans, which are used to determine net income for agricultural land, no longer represent the typical crops grown in the State and are not the major money crops. Using a method that did not result in realistic values was eroding the intent to foster uniformity and creating equity problems between similar types of properties.

This act updates the method of determining the present-use value of farmland in several ways. First, it changes the capitalization rate used to capitalize net income into value for agricultural and horticultural land. Instead of 9%, the rate to be used will be set by the Use-Value Advisory Board at a level between 6% and 7%. The Board will also recommend annually to the General Assembly whether this range should be changed. The capitalization rate for forestland will stay at 9%.

Second, the act changes the method the Board will use to set the net income for farmland. Instead of corn and soybean yields for agricultural land and horticultural product yields for horticultural land, the Board is required to use estimated cash rental rates for various classes of soil or for geographic areas. The Department of Revenue is given the responsibility of conducting studies of cash rents for agricultural land on a regional basis and providing this information to the Board. For forestland, the Board is required to use ranges furnished by the NC Cooperative Extension Service based on up to six classes of land within each region designated by the federal Soil Conservation Service. This requirement reflects the current practice of the Board with respect to forestland.

Third, the act caps the value the Board may establish for the best agricultural land at a maximum of $1,200 per acre. The Board will recommend annually to the General Assembly whether this maximum should be changed.

Fourth, the act adds five new members to the Use-Value Advisory Board. Under existing law, there were four members: The director of the Agricultural Extension Service at NCSU, a Department of Agriculture representative, a Forest Resources Division representative, and a representative of the Agricultural Extensions Service at N.C.A.&T. This act adds the director of the Property Tax Division of the Department of Revenue and one representative of each of the following four groups: the Farm Bureau, the Association of Assessing Officers, the Association of County Commissioners, and the Forestry Association.

To qualify for use value taxation, farmland must be in active commercial production under a sound management program, which is defined as a program of production designed to obtain the greatest net return from the land consistent with its conservation and long-term improvement. The act makes two changes relating to sound management. First, it provides that woodland that is part of agricultural or horticultural land is not required to be under a sound management program if it meets either of the following conditions:

1. It is less than 20 acres.
2. Its best use is as a barrier to wind erosion, a natural water purifier, or a buffer for hog or poultry operations.

Second, it specifies factors any one of which is sufficient to demonstrate that farmland is under a sound management program. For agricultural or horticultural land, these factors include compliance with an agency-administered management program, with a set of best management practices, or a minimum gross income test; evidence of net income from farming or that farming is the operator's principal source of income; and certification by a recognized local agency. For forestland, compliance with a written sound forest management plan for production and sale of forest products is sufficient.

In order to qualify for use value taxation, in addition to being in active production, the land must meet minimum income requirements and must satisfy certain conditions regarding ownership. This act creates an exception to these requirements and conditions for property that was being taxed at its present use value as farmland and then becomes subject to a conservation easement that dedicates it for conservation purposes in the hands of the State, a local government, or a nonprofit conservation organization.

The remaining changes the act makes relating to use value are procedural and technical.

County assessors are required to annually review 1/8 of the county's use value parcels to verify that they continue to qualify for use value taxation. This act clarifies that the 1/8 is a minimum – an assessor may review more than 1/8 in a year. This act also authorizes the assessor to request assistance in carrying out the review, clarifies the information that the assessor may require the owner to submit and the information that the assessor must consider as part of the review, and clarifies that the review is based on data for a three-year period. In addition, this act authorizes the county to assign county agencies or contract with federal agencies for any duties relating to use value accounts.

In order to qualify for use value taxation, the farmland must be owned by certain qualifying individuals, family business entities, or trusts. This act clarifies that the farmland may qualify if it is owned jointly by any of these owners as tenants in common. The act also clarifies an exception to the ownership requirements. Individual owners must live on the land or have owned the land in their family for four years. There is an exception if use value land is transferred to a person who continues to use it as farmland and meets the other conditions for use value treatment. This act clarifies that the deferred taxes that accrued while the land was owned by the first owner continue as a lien on the property in the hands of the new owner. In addition, the new owner must file an application for use value treatment within 60 days after acquiring the land, certifying that the present use will continue and that the new owner will be liable for the deferred taxes if the land is later disqualified. The act makes technical and conforming changes relating to the application for use value treatment.

To qualify for use value treatment, farmland must be part of a farm unit. This act defines the term "unit" to include one or more tracts under common ownership. If the tracts are in separate counties, they must share the same type of classification or the same equipment or labor force, and must be within 50 miles of a tract that meets the minimum size and income requirements for use value treatment.

Property Tax Subcommittee. Section 8 of the act creates a property tax subcommittee of the Revenue Laws Study Committee. The subcommittee will have six members and will study use value taxation and existing and potential tax incentives for farm use, conservation, and environmental protection of land.

Administrative Changes. The remaining sections of this act are administrative changes to the sales tax law. These changes were originally introduced in House Bill 1509 as a recommendation of the Revenue Laws Study Committee.

Section 9 of the act clarifies the sales and use tax exemption for certain agricultural substances. Included among the agricultural group of sales and use tax exemptions is an exemption for plant growth inhibitors, regulators, or stimulators when purchased for use on plants held or produced for commercial purposes. In a recent case, *American Ripener Company, Inc. v. Secretary of Revenue,*[58] the court ruled that the exemption for these substances could extend to generators used to control the release of the substance. The Department requested that the statute be clarified because the exemption was not intended to include any hardware or machinery, such as generators, used to apply the exempted substances. Section 9 clarifies that the exemption does not apply to any equipment or devices used to dispense the substances listed in the exemption.

[58] 147 N.C. App. 142 (2001), cert. denied, 355 N.C. 210 (2002)

Section 10 of this act changes the due date for quarterly sales tax returns from the 15th of a month to the end of a month. In 2001, the General Assembly lowered the threshold for monthly payments of withheld taxes from $500 to $250. Monthly withholding returns are due on the 15th of the month, the same day as monthly and quarterly sales and use tax returns. The withholding tax threshold change moved approximately 25,000 employers from a quarterly to a monthly filing status. As a result, the Department was receiving 25,000 additional returns in eight of the twelve months of the year. This act's change of the sales tax due date from the 15th to the end of the month will enable the Department to spread its work more evenly throughout the month. As of 2002, there were 91,000 quarterly sales tax filers. The change also makes the due date for quarterly sales tax returns consistent with the due date for quarterly withholding tax returns. This change went into effect October 1, 2002; it does not affect the timing of local sales and use tax distributions, nor does it shift any funds from one fiscal year to the next.

Section 11 of the act amends the method for calculating the underpayment penalty for semimonthly sales taxpayers, to conform to the requirements of the Streamlined Sales Tax Project. A taxpayer who is consistently liable for at least $10,000 a month in State and local sales and use taxes must pay the tax twice a month and file a return on a monthly basis. A payment is required for each semimonthly period. The first semimonthly payment covers the period from the first day of the month through the 15th day of the month, and the second semimonthly payment covers the period from the 16th day of the month through the last day of the month. The monthly return covers both semimonthly payment periods including any additional amount due and must be filed by the 20th day of the following month. Under prior law, a taxpayer was not subject to interest or penalties for an underpayment for a semimonthly payment period if the taxpayer timely paid at least 95% of the amount due for that payment period and included the underpayment with the monthly return for both payment periods.

A requirement of the Streamlined Sales Tax Project, in which North Carolina has participated since 2000, is that if the State requires more than one remittance per return, the amount of the additional remittance must be determined through a calculation method rather than actual collections. Effective October 1, 2002, Section 11 brings the underpayment penalty calculation for semimonthly sales taxpayers in line with the Project by providing an additional method of calculating the estimated tax liability: neither interest nor penalties will apply to the underpayment of sales tax remitted on a semimonthly basis if the taxpayer timely pays at least 95% of the lesser of (i) the amount due for the semimonthly payment period; or (ii) the average semimonthly payment for the prior calendar year. Just as under the prior law, the taxpayer must also include the underpayment with the monthly return for those semimonthly payment periods.

Section 12 of the act codifies a longstanding practice of the Department of Revenue which requires that a purchaser of tangible personal property that is exempt from sales tax or subject to a preferential rate of sales tax must obtain an exemption certificate from the Department in order to receive the exemption or preferential rate. The Department of Revenue administers many of the sales and use tax exemptions and preferential rates targeted at certain industries, such as farming and manufacturing, through the use of an exemption certificate. Prior to this change, the statutes did not address exemption certificates, except in the penalty provisions in G.S. 105-236(5a), which authorize the

Secretary to assess a penalty for the misuse of an exemption certificate. The Department recommended that the practice of using exemption certificates be incorporated into the statutes to avoid any questions about the ability of taxpayers to claim exemptions through this method.