

# 2006 Finance Law Changes

## S Corp Income Tax Adjustments.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-17	HB 1898	Representative Wilkins

### **AN ACT TO MAKE CORPORATE INCOME TAX ADJUSTMENTS INAPPLICABLE TO S CORPORATIONS.**

**OVERVIEW:** This act, which was a recommendation of the Revenue Laws Study Committee, provides that an individual's pro rata share of income from an S Corporation is subject only to individual income tax adjustments, rather than being subject to both individual and corporate income tax adjustments. The act also preserves an addition to federal taxable income for a shareholder's share of the built-in gains tax paid by an S Corporation at the federal level for purposes of determining State taxable income, since North Carolina does not assess a built-in gains tax.

**FISCAL IMPACT:** Minimal impact.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** This act is effective for taxable years beginning on or after January 1, 2006.

**ANALYSIS:** The act provides that an individual's pro rata share of income from an S Corporation is subject only to individual income tax adjustments, rather than being subject to both individual and corporate income tax adjustments. Prior to this act, an individual's pro rata share of S Corporation income attributable to North Carolina was subject to corporate income tax adjustments, while S Corporation income not attributable to North Carolina was subject to individual income tax adjustments. This change, which was recommended to the Revenue Laws Study Committee by the Department of Revenue, will provide consistency in the tax treatment of S Corporations since S Corporation income flows through to its shareholders who are required to be individuals or trusts and who are taxed at the individual level as opposed to the corporate level. The change also simplifies tax form preparation. Section 3 of the act, however, preserves an addition to federal taxable income for a shareholder's share of the built-in gains tax paid by the corporation at the federal level for purposes of determining State taxable income. This add-back to federal taxable income is required under current law.

The 'built-in gains tax' in Section 1374 of the Internal Revenue Code imposes a corporate-level tax on S Corporations that dispose of assets that appreciated in value during the years when the corporation was a C Corporation. The built-in gains tax applies only to assets that are disposed of within 10 years of the date on which S Corporation status is chosen. The shareholders of the S Corporation are also taxed on the gains. To provide some measure of relief from double taxation, each shareholder's share of income from the S Corporation is reduced by the shareholder's proportionate share of the built-in gains tax paid

by the S Corporation.<sup>1</sup> The built-in gains tax is designed to prevent corporations that have unrecognized gain on assets during the years the corporation is a C Corporation from converting to S status and then distributing the assets tax free.

North Carolina does not assess a built-in gains tax. Therefore, there is no double taxation at the State level and no reason to allow the deduction for the shareholder's share of the built-in gains tax. Under existing law, there is a corporate income tax provision requiring an add-back for the built-in gains tax deduction. Since this act subjects S Corporations to individual income tax adjustments only, the act modifies existing law to require an S Corporation shareholder to add to taxable income the amount by which the shareholder's share of the S Corporation's income was reduced for federal purposes by the amount of the built-in gains tax imposed on the S Corporation.

An S Corporation is a corporation that has elected to have the corporation's income pass through to the shareholders. Thus, the business profits are taxed at individual tax rates. An S Corporation election allows the shareholders to preserve the benefit of limited liability for the corporate form while at the same time being treated as partners for federal income tax purposes. The S Corporation itself does not pay any income tax, but an S Corporation is required to file an informational return with the IRS, similar to a partnership tax return, to inform the IRS of each shareholder's ownership interest in the S Corporation. To be eligible for S Corporation status, a corporation must meet all of the following requirements:

- The corporation may have no more than 75 shareholders.
- The corporation may have only one class of stock, although different voting rights among shareholders are allowed.
- All shareholders must be individuals or trusts.
- The corporation must be formed in the United States.
- No shareholder may be a non-resident alien.
- The corporation may not be an insurance company or a domestic international sales corporation.

A C Corporation, on the other hand, assumes a separate legal and tax life distinct from its shareholders. It pays taxes at its own corporate income tax rates and files its own corporate tax forms each year. C Corporations may choose to retain their profits and earnings as part of their operating capital, or they may choose to distribute some or all of their profits and earnings as dividends paid to shareholders. Dividends paid to shareholders are essentially taxed twice, once at the corporate level and again at the individual level.

As previously noted, C Corporations cannot be shareholders of an S Corporation. All S Corporation shareholders must be individuals or trusts and are taxed at the individual income tax rates.

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<sup>1</sup> IRC Section 1366(f)(2).

## IRC Update.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-18	HB 1892	Rep. Wainwright; Luebke; Carney; Wilkins; (Primary Sponsors)

### **AN ACT TO UPDATE THE REFERENCE TO THE INTERNAL REVENUE CODE USED IN DEFINING AND DETERMINING CERTAIN STATE TAX PROVISIONS AND TO MAKE OTHER CHANGES TO MORE CLOSELY CONFORM TO FEDERAL TAX LAW.**

**OVERVIEW:** This act, which was a recommendation of the Revenue Laws Study Committee, does the following:

- Updates the reference to the Internal Revenue Code used in defining and determining certain State tax provisions.
- Shortens the time span which a taxpayer has to file an amended estate, income, or gift tax return when the federal government corrects or otherwise determines the amount on which the tax is based.
- Conforms the filing date for income tax returns for a nonresident alien to the federal dates.
- Conforms the amounts for the credit for child care and certain employment-related expenses to the amounts allowed for the corresponding federal credits.

**FISCAL IMPACT:** Annual revenue loss is estimated to be \$5.1 million in 2006-07 and 2007-08.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATES:** The update to the reference to the Internal Revenue Code became effective when signed into law by the Governor on June 21, 2006. The part of the act concerning federal determinations became effective July 1, 2006, and applies to federal determinations made on or after that date. The parts of the act conforming the filing date for tax returns for nonresident aliens and the credit amounts for child care are effective for taxable years beginning on or after January 1, 2006.

**ANALYSIS:** The act makes the following changes to the revenue laws.

#### *Federal Determinations*

This act reduced the period of time in which a taxpayer must report a federal change from two years to six months. When the federal government corrects or otherwise determines the amount of an estate, gift, or income that is subject to tax, the taxpayer must file a State return that reflects that change. This is so because the State estate, gift, and income taxes are,

to varying degrees, based on amounts determined with respect to federal law. The Multistate Tax Commission has adopted a model uniform statute for reporting federal changes. That model uniform statute requires a taxpayer to report those changes within six months. The model statute is intended to bring uniformity to this area among the states. Currently there is a great deal of variety with some states requiring changes to be reported in as little as 90 days to as much as two years. This provision became effective July 1, 2006, and applies to federal determinations made on or after that date.

#### *Filing Period for Nonresident Aliens*

Section 6072(c) of the Code requires a nonresident alien to file an income tax return on or before the fifteenth day of the sixth month following the close of the taxable year (June 15<sup>th</sup> for taxpayer whose taxable year is the calendar year). Under previous State law, nonresident alien corporate taxpayers were required to file a State return by the fifteenth day of the third month following the close of the taxable year (March 15<sup>th</sup> for a calendar year taxpayer) and nonresident alien individual taxpayers were required to file a State return by the fifteenth day of the fourth month following the close of the taxable year (April 15<sup>th</sup> for a calendar year taxpayer). Thus, under previous State law a nonresident alien was required to file a State income tax return before the federal tax return was due. This provision conforms the State filing deadlines to the federal filing deadlines for nonresident aliens and eases compliance burdens on those taxpayers. These provisions are effective for taxable years beginning on or after January 1, 2006.

#### *Credit for Child-Care and Certain Employment-Related Expenses*

Previous State law allowed a credit to a taxpayer who was eligible for the federal credit for child-care and employment-related expenses. The amount of the credit is based on a percentage of those expenses up to a certain amount. For the State credit, the amount of expenses that were taken into consideration when computing the credit were capped at \$2,400 when there was one qualifying individual in the household and \$4,800 when there was more than one qualifying individual in the household. Until 2003, these limits were the same as those at the federal level. In 2003, the federal limits increased to \$3,000 and \$6,000 respectively. This provision conforms the State limits to the federal limits. This provision also clarifies that the amount of expenses used in calculating the credit may not include any amount excluded from gross income. This provision is effective for taxable years beginning on or after January 1, 2006.

#### *Updated References to Internal Revenue Code*

North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.<sup>2</sup> The General Assembly determines each year whether to update its reference to the Internal Revenue Code.<sup>3</sup> Updating the Internal Revenue Code reference

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<sup>2</sup> 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.

<sup>3</sup> 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 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

makes recent amendments to the Code applicable to the State to the extent that State law tracks 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. This act changes the reference date from January 1, 2005, to January 1, 2006.

Between January 1, 2005, and January 1, 2006, there were four major pieces of federal legislation that made changes to the Internal Revenue Code. This federal legislation includes the Energy Tax Incentive Act of 2005 (P.L. 109-58) signed into law on August 8, 2005, the Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005 (P.L. 109-59) signed into law on August 10, 2005, the Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) signed into law on September 23, 2005, and the Gulf Opportunity Zone Act of 2005 (P.L. 109-135) signed into law on December 21, 2005.

- Energy Tax Incentive Act of 2005 (P.L. 109-58) (hereinafter Energy Act): Many of the changes made in this act involve tax credits for various activities. Because they are tax credits, these provisions do not have a direct impact at the State level. There are, however, several provisions that could have an impact at the State level, most of which involve the depreciation, amortization, or expensing of certain items.
  - *Elimination of deduction for clean-fuel vehicles.* Under previous law, a taxpayer was allowed a deduction for the purchase of a qualified clean-fuel vehicle. A 'qualified clean-fuel vehicle' is any motor vehicle that may be propelled by a clean-burning fuel such as natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity, or any other fuel at least 85% of which is methanol, ethanol, or other alcohol or ether. The maximum amount of the deduction varied depending on the type of vehicle purchased. The deduction began to be phased out in 2004, and was set to be eliminated after the 2006 taxable year. This act moves up the phase-out so that the deduction is eliminated after the 2005 taxable year. In place of the deduction, this act creates a new federal credit for alternative fuel motor vehicles.
  - *Tax deferral for gains on electric transmission assets.* Under previous law, a taxpayer could elect to recognize qualified gain from a qualifying electric transmission transaction over an eight-year period. In order for a transaction to be a 'qualifying electric transmission transaction', numerous conditions had to be satisfied, one of which was that the transaction must have been completed before January 1, 2007. This act extends that date by one year to January 1, 2008.
  - *Deduction for nuclear decommissioning costs.* Utilities that own or operate a nuclear power plant are required by law to decommission the plant at the end of its useful life. A utility may elect to deduct contributions it makes to a nuclear decommissioning reserve fund established to help pay the costs associated with the eventual decommissioning. For previous tax years, contributions to such a reserve fund were limited to the lesser of the amount of nuclear

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reference future amendments to the Internal Revenue Code would ... be invalidated as an unconstitutional delegation of legislative power.”

decommission costs allocable to the fund that is included in the taxpayer's cost of services for ratemaking purposes for the taxable year and the ruling amount. The 'ruling amount' is a schedule obtained from the IRS that specifies the annual payments that must be made into the fund to cover the amount of the decommission costs allocable to the fund over its existence. This act eliminates the 'lesser of' test for taxable years beginning on or after January 1, 2006, and instead limits the deduction to the ruling amount.

- *Energy efficient commercial buildings property deduction.* Despite the fact that large commercial buildings use approximately one-fourth of the electrical energy consumed in the nation, there was previously no federal tax incentive to encourage the use of energy-efficient property in the construction or renovation of commercial buildings. This act allows taxpayers to claim a deduction (as opposed to depreciation or amortization) with respect to costs associated with energy-efficient commercial building property placed into service between January 1, 2006, and January 1, 2008. The maximum amount that may be deducted is \$1.80 per square foot of the building, less any amount deducted under this provision with respect to the same building in previous tax years. In order to qualify for the deduction, the following conditions must be satisfied: 1) the costs must be associated with depreciable or amortizable property that is installed in a commercial building that meets certain standards for energy efficiency; 2) the property is installed as part of the interior lighting, heating, cooling, ventilation, or hot water systems or the building envelope; and 3) the property is installed as part of a plan to reduce the total annual energy costs of the building with respect to the interior lighting, heating, cooling, ventilation, and hot water systems by at least 50% as compared to a similar building that meets certain minimum standards for energy efficiency. The IRS is required to issue regulations relating to eligibility for a partial deduction and to the transfer of a deduction from a public entity (like the State) to the person responsible for designing the property.
- *Recapture of section 197 amortization.* Generally, property subject to amortization under section 197 of the Code is intangible property that is purchased and held by a taxpayer in the course of a business. Section 197 property includes goodwill, covenants not to compete, patents, copyrights, trademarks and certain licenses. The cost of section 197 property is recoverable over fifteen years using straight-line depreciation. Under general rules, gain on the sale of depreciable property must be recaptured as ordinary income to the extent of depreciation deductions previously claimed. Under general rules, the recapture amount is computed separately for each piece of property. This act provides that if multiple pieces of section 197 property are sold or disposed of in a single transaction or series of transactions, then the taxpayer must compute the recapture as if all of the property were a single asset. The effect of this change is to maximize the amount of income treated as recapture, and thus as ordinary income, and to lessen the amount treated as a capital gain, which is taxed at a lower rate.

- *Depreciation of electric transmission property.* Generally, under the modified accelerated cost recovery system (MACRS), assets used in the transmission and distribution of electricity for sale have a 20-year recovery period. This act allows the costs of certain electric transmission property placed into service after April 11, 2005, to be recovered over 15 years instead of 20.
- *Expensing liquid fuel refineries.* Under previous law, petroleum refining assets were depreciated over a 10-year recovery period using the double declining balance method. Petroleum refining assets are assets used for distillation, fractionation, and catalytic cracking of crude petroleum into gasoline and other petroleum products. This act allows a taxpayer to make an election to expense 50% of the cost of qualified refinery property in the year in which the property is placed into service. 'Qualified refinery property' includes any portion of a qualified refinery that satisfies the following conditions: 1) The original use of the property commences with the taxpayer; 2) The property is placed in service between August 8, 2005, and January 1, 2012; 3) The property satisfies certain production capacity requirements; 4) The property satisfies all applicable environmental laws in effect when it is placed into service; 5) No written binding contract for the construction of the property was in effect on or before June 14, 2005; and 6) The construction of the property is subject to a written binding contract entered into before January 1, 2008. A 'qualified refinery' is one that is located in the United States and that is designed to serve the primary purpose of processing liquid fuel from crude oil or qualified fuels (including shale and tar sands and coal seams). The expensing election is not available with respect to a refinery that is used primarily as a topping plant, asphalt plant, lube oil facility, crude or product terminal, or blending facility.
- *Depreciation of natural gas distribution lines.* Under previous law, natural gas distribution lines installed by a gas company were depreciated over a 20-year period. This act allows natural gas depreciation lines placed in service between April 11, 2005, and January 1, 2011, to be depreciated over a 15-year period.
- *Depreciation of natural gas gathering pipelines.* Prior to the enactment of this act, there was a disagreement among the courts as to what asset class natural gas gathering pipelines owned by a nonproducer belonged. The IRS maintained, and this position was supported by the Tax Court, that these pipelines belonged to an asset class subject to depreciation over 15 years. The Courts of Appeals in the Sixth, Eighth, and Tenth Circuits, however, held that these pipelines belonged to an asset class subject to depreciation over seven years. There was agreement that natural gas gathering pipelines owned by a producer were part of the asset class subject to depreciation over seven years. This act clarifies that all natural gas gathering pipelines, regardless of ownership, are subject to depreciation over seven years. This provision applies to natural gas gathering pipelines placed in service after April 11, 2005.
- *Geological and geophysical costs amortized over two years.* Geological and geophysical costs are those incurred for the purpose of accumulating data that serves as

the basis for the decision about acquisition or retention of mineral rights by taxpayers in the business of exploring for minerals (including gas and oil). Courts have held these costs to be capital in nature and allocable to the property acquired or retained. If no property was acquired or retained, the costs were treated as a capital loss. This act provides that these costs, when incurred in the United States for oil or gas exploration, shall be amortized ratably over a 24-month period beginning on the mid-point of the taxable year in which the costs were incurred. The act does not affect the treatment of costs incurred outside of the United States or with respect to exploration for minerals other than oil or gas.

- *84-month amortization of air pollution control facilities.* Previous law allowed taxpayers to amortize over a 60-month period a certified pollution control facility used in connection with a plant that was in operation before January 1, 1976. For certified pollution control facilities placed in service after April 11, 2005, this act eliminates the requirement that the property be used in connection with a plant that was in operation before 1976 if the plant is an electric generation plant that is primarily coal fired. For property that satisfies this criteria, the amortization period is 84 months. The act does not lengthen the amortization period for property that was covered by previous law, it provides a favored, though not as generously favored, method of depreciation for another class of property.
- Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005 (P.L. 109-59) (hereinafter SAFE Act): Although this act makes numerous tax changes at the federal level, these changes have little to no direct impact at the State level.
- Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) (hereinafter Katrina Act): 2005 was a record-setting year on the meteorological front. Not only did the year see a record number of named storms (27) and a record number of hurricanes (14), the year also included the costliest Atlantic hurricane on record and one of the deadliest, Hurricane Katrina. Hurricane Katrina made landfall along the Gulf Coast on August 29, 2005, as a Category 3 storm. Hurricane Katrina resulted in the deaths of more than 1,400 people and caused over \$80 billion in property damage. In the aftermath of Hurricane Katrina, Congress took action to assist taxpayers in the affected region. On September 21, 2005, Congress passed the Katrina Emergency Tax Relief Act of 2005, which was signed into law by President Bush on September 23, 2005. The act is a collection of tax relief provisions for individuals and businesses. Below, the key provisions of this act that could have an impact on State revenues are summarized.
  - *General Provisions.* The act contains definitions of several key phrases that are used throughout the act. Under the act, 'Hurricane Katrina disaster area' means an area with respect to which a major disaster has been declared by the President before September 14, 2005, with respect to Hurricane Katrina. The states of Alabama, Florida, Louisiana, and Mississippi comprise the Hurricane Katrina disaster area. The act also defines the term 'core disaster area.' The core disaster area is a subset of the Hurricane Katrina disaster area that has been determined by the President to warrant individual or individual



and public assistance from the federal government. The core disaster area covers certain counties and parishes in Alabama, Louisiana, and Mississippi.

- *Retirement Funds.* The act contains a number of special rules related to retirement funds for people who lived in the Hurricane Katrina disaster area or the core disaster area. Generally, these provisions allow for a more liberal use of retirement funds for emergency needs than would otherwise be allowed without subjecting the taxpayer to some sort of penalty or disincentive. These provisions include the following:
  - *Tax favored withdrawals from retirement plans for relief relating to Hurricane Katrina.* Generally, a withdrawal from a qualified retirement plan, a tax-sheltered annuity, an IRA, or an eligible deferred compensation plan maintained by a state or local government is included in taxable income in the year in which it is made. In addition, a distribution that is received before death, disability, or the age of 59 ½ is generally subject to a 10% early withdrawal tax. Some distributions are known as eligible rollover distributions and are not included in taxable income or subject to the 10% penalty tax. These distributions must be rolled over into another qualified retirement account within 60 days. This act provides an exception to the 10% early withdrawal tax in the case of a qualified Hurricane Katrina distribution<sup>4</sup> from a qualified retirement plan, tax-sheltered annuity, or IRA. In addition, any amount required to be included in income as a result of a qualified Hurricane Katrina distribution is included in income in installments over the three-year period beginning with the year in which the distribution is made rather than entirely within the year that the distribution is made. Finally, any amount of a qualified Hurricane Katrina distribution that is recontributed to an eligible retirement account within the three-year period is treated as a roll-over distribution and is not included in income.
  - *Recontribution of withdrawals for home purchases cancelled due to Hurricane Katrina.* There is an exception to the 10% early withdrawal tax discussed above in the case of a qualified first-time homebuyer distribution from an eligible retirement account. A qualified first-time homebuyer distribution is one that does not exceed \$10,000 and that is used within 120 days of the distribution for the purchase or construction of a principal residence of a first-time homebuyer. If the distribution is not used for the purchase of the home within 120 days or is not rolled over into an eligible retirement account within 60 days, the distribution is included in income and is subject to the 10% early withdrawal tax. This act allows a taxpayer who received a qualified distribution from a retirement account to recontribute that amount to an eligible retirement account without penalty. For the purposes of this provision, a 'qualified distribution' is a

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<sup>4</sup> A 'qualified Hurricane Katrina distribution' is a distribution made from an eligible retirement plan on or after August 25, 2005, and before January 1, 2007, to an individual whose primary place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss due to Hurricane Katrina. The total amount of qualified Hurricane Katrina distributions to a taxpayer from all accounts may not exceed \$100,000.

distribution that was received after February 28, 2005, and before August 29, 2005, and that was to be used to purchase or construct a principal residence in the Hurricane Katrina disaster area, but the residence is not purchased or constructed because of Hurricane Katrina. Any portion of a qualified distribution may be contributed to an eligible retirement account and treated as a roll-over if it is recontributed between August 25, 2005, and February 28, 2006. Because it is treated as a roll-over, that portion will not be included in income or subject to the 10% early withdrawal tax.

- *Loans from qualified plans for relief relating to Hurricane Katrina.* An individual is allowed to borrow from a qualified employer plan in which the individual participates provided the loan satisfies certain conditions. Generally, a loan from a qualified employer plan is treated as a taxable distribution of plan benefits. A loan is not treated as a tax distribution of benefits to the extent that the loan, when added to the outstanding balance of all other loans to the individual from all plans maintained by the employer, does not exceed the lesser of 1) \$50,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or 2) the greater of \$10,000 or one half the individual's accrued benefit under the plan. For this exception to apply, the loan must have a repayment period of five years or less, must be amortized in level payments, and must have payments due at least quarterly. This act provides special rules in the case of a loan from a qualified plan to a qualified individual. For the purposes of this provision, a 'qualified individual' is one whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss because of Hurricane Katrina. Under this provision, the loan limit discussed above is increased to the lesser of 1) \$100,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or 2) the greater of \$10,000 or the individual's accrued benefit under the plan. In addition, this act provides that in the case of a qualified individual with an outstanding loan from a qualified plan on or after August 25, 2005, if the due date for any repayment with respect to the loan occurs during the period from August 25, 2005, to December 31, 2006, the due date is delayed for one year.
- *Charitable Giving Incentives.* In the wake of Hurricane Katrina, people from around the nation rushed to the aid of people in the affected areas with unprecedented amounts of charitable giving. As part of this act, Congress further encouraged and rewarded charitable giving.
  - *Temporary suspension of limitations on charitable contributions.* In general, the income tax deduction allowed for charitable contributions is subject to limitations based on the type of taxpayer, the property contributed, and

the donee organization. Subject to certain limitations, discussed further below, the following general rules apply: 1) Contributions of cash are deductible in the amount contributed; 2) Contributions of capital gain property<sup>5</sup> to a qualified charity are deductible at fair market value; 3) Contributions of other appreciated property are deductible at the donor's basis in the property; and 4) Contributions of depreciated property are deductible at the fair market value of the property. Most contributions are subject to percentage limitations. For individuals, the amount deductible is limited to a percentage of the taxpayer's contribution base<sup>6</sup>. The percentage varies depending on the type of donee organization and the type of property contributed. Contributions by an individual of property other than appreciated capital gain property to a charitable organization described in section 170(b)(1)(A) of the Code (public charities, private foundations other than private non-operating foundations, and certain governmental units) are deductible up to 50% of the contribution base. Contributions of this type of property to nonoperating private foundations and certain other organizations are deductible up to 30% of the contribution base. Contributions of appreciated capital gain property to an organization described in section 170(b)(1)(A) of the Code are generally deductible up to 30% of the contribution base. A taxpayer may elect to bring all of these contributions of appreciated capital gain property under the 50% limitation by reducing the amount of the deduction by the amount of the appreciation of the property. Contributions of appreciated capital gains property to a private nonoperating foundation are deductible up to 20% of the contribution base. For corporations, charitable contributions are deductible up to 10% of the corporations taxable income computed without regard to net operating loss or capital loss carrybacks. For both individuals and corporations, excess charitable contributions may be carried forward for up to five years. There is also an overall limitation on most itemized deductions for individuals. The total amount of otherwise allowable itemized deductions is reduced by three percent of the amount of the taxpayer's adjusted gross income in excess of a certain threshold. However, the otherwise allowed deductions may not be reduced by more than 80%. This reduction is reduced to two percent for the 2006 and 2007 taxable years and to one percent for the 2008 and 2009 taxable years, is repealed for the 2010 taxable year, and is reinstated for the 2011 taxable year. This act provides several exceptions to the limitations on charitable contribution deductions. For individuals, the deduction for qualified contributions is allowed up to the amount by which the taxpayer's contribution base exceeds the taxpayer's deductions for other charitable contributions. In most cases, this means that an individual may

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<sup>5</sup> 'Capital gain property' means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in a gain that would have been a long-term capital gain.

<sup>6</sup> The 'contribution base' is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback.

deduct charitable contributions up to 100% of the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. For corporations, the deduction for a qualified contribution is allowed up to the amount by which the corporation's taxable income exceeds the deduction for other charitable contributions. For the purposes of these provisions, a 'qualified contribution' is a cash contribution that is made between August 28, 2005, and December 31, 2005, to an organization described in section 170(b)(1)(A) of the Code. The term does not include a contribution of noncash property or one that is for the establishment or maintenance of a segregated fund or account with respect to which the donor reasonably expects to have advisory privileges with respect to the fund or account because of his status as donor. In the case of a corporation, the contribution must be for relief efforts related to Hurricane Katrina in order to be a qualified contribution. In addition, for individuals the charitable deduction contribution, up to the amount of qualified contributions, is not treated as an itemized deduction and is not subject to the reduction for higher-income taxpayers.

- *Additional exemption for housing Hurricane Katrina displaced individuals.* In the aftermath of Hurricane Katrina, hundreds of thousands of residents of the affected areas were displaced. During this time of displacement, many individuals opened their homes to those who had been displaced. Generally, individuals are allowed personal exemptions in computing taxable income. Personal exemptions are allowed for the taxpayer, the taxpayer's spouse, and the taxpayer's dependents. Personal exemptions are phased out for higher-income taxpayers. This act allowed a taxpayer an additional \$500 exemption for each Hurricane Katrina displaced individual of the taxpayer, up to a maximum additional exemption of \$2,000. The additional exemption is not subject to the phase out for higher-income taxpayers. For the purposes of this provision, a 'Hurricane Katrina displaced individual' is a person 1) whose principal place of abode on August 28, 2005, was in the Hurricane Katrina disaster area, 2) who was displaced from the abode, 3) who is provided housing free of charge in the taxpayer's principal place of residence for a period of 60 consecutive days that ends in the taxable year in which the exemption is claimed, and 4) who is not the spouse or dependent of the taxpayer. For a person whose principal place of abode on August 28, 2005, was outside of the core disaster area, the person's abode must have been damaged by Hurricane Katrina or the person must have been evacuated from the abode by reason of Hurricane Katrina.
- *Increase in standard mileage rate for charitable use of vehicles.* In determining the amount of the charitable contribution deduction when a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer may either deduct actual operating expenditures or use the charitable standard mileage rate. The charitable standard mileage rate, 14 cents per

mile, is significantly less than the business standard mileage rate<sup>7</sup> The charitable rate is less than the business rate because it is meant to offset direct operating expenses only, such as gas, and not other expenses, such as a depreciation, insurance, or general maintenance. This act allows a taxpayer who uses a vehicle in providing donated service to charity for Hurricane Katrina relief only to compute the charitable mileage deduction at a rate equal to 70% of the business standard mileage rate, rounded to the next highest cent, on the date of the contribution. In the alternative, the taxpayer may continue to use actual operating expenditures to determine the amount of the deduction.

- *Mileage reimbursement to charitable volunteers excluded from gross income.* Volunteer drivers who are reimbursed for mileage expenses have taxable income to the extent that the reimbursement exceeds deductible expenses computed using either direct expenses or the charitable standard mileage rate. Under this act, reimbursement for mileage expenses by a charitable organization described in section 170(c) of the Code to a volunteer for the costs of using a passenger vehicle for Hurricane Katrina relief only is not included in income to the extent that the reimbursement does not exceed the amount that would be allowed using the business standard mileage rate. A taxpayer may not claim a deduction or credit for amounts excluded under this provision.
- *Charitable deduction for contribution of food inventories.* A taxpayer's deduction for charitable contributions of inventory is generally limited to the lesser of the taxpayer's basis in the inventory (usually cost) or the fair market value of the inventory. For certain contributions of inventory, a C corporation may claim an enhanced deduction equal to the lesser of 1) basis plus one-half of the item's appreciation or 2) two times basis. To be eligible for the enhanced deduction, the contributed property must generally be inventory of the corporation, contributed to a charitable organization described in section 501(c)(3) of the Code, and the donee must 1) use the property consistent with the donee's exempt purpose only for the care of the ill, the needy, or infants, 2) not transfer the property in exchange for money, other property, or services, and 3) provide the taxpayer with a written statement attesting to the proper use of the property. This act allows the enhanced deduction to any taxpayer engaged in a trade or business that makes a donation of food inventory. For taxpayers other than C corporations, the total deduction for contributions of food inventory may not exceed 10% of the taxpayer's income from all business entities from which a contribution of food inventory is made. The enhanced deduction is available only for food that qualifies as 'apparently wholesome food,' – food intended for human consumption that meets all quality and labeling standards imposed by

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<sup>7</sup> For expenses incurred between January 1, 2005, and September 1, 2005, the standard business mileage rate was 40.5 cents per mile. For expenses incurred between September 1, 2005, and January 1, 2006, the standard business mileage rate was 48.5 cents per mile.

federal, state, and local laws even though the food may not be readily marketable for any number of reasons.

- *Charitable deduction for contribution of book inventories.* As with contributions of food inventories above, this act extends the enhanced deduction for C corporations to qualified book contributions. A 'qualified book contribution' is a charitable contribution of books to a public school that provides elementary education or secondary education, that is an educational organization that normally maintains a regular faculty and curriculum, and that normally has a regularly enrolled body of pupils in attendance at the place where its education activities are regularly conducted.
- *Miscellaneous Provisions.*
  - *Exclusion for certain cancellations of indebtedness by reason of Hurricane Katrina.* Gross income includes income that is realized by a debtor for the discharge of indebtedness, subject to certain exceptions. This act provides that the gross income of a qualified individual does not include any amount which would otherwise be includible in gross income by reason of a discharge of nonbusiness debt if the indebtedness is discharged by an applicable entity. The relief allowed under this provision does not apply to any indebtedness to the extent that real property outside of the Hurricane Katrina disaster area serves as security for the debts. For the purposes of this provision, a 'qualified individual' is any natural person whose principal place of abode on August 25, 2005, was located 1) in the core disaster area or 2) in the Hurricane Katrina disaster area and the person suffered economic loss as a result of Hurricane Katrina. An 'applicable entity' includes the following: a financial institution; a credit union; a corporation that is a direct or indirect subsidiary of a financial institution or credit union and as such is subject to regulation by federal or state agencies; the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the National Credit Union Administration, and certain other federal executive agencies; an executive, judicial, or legislative agency; and any other organization for whom the lending of money is a significant trade or business.
  - *Suspension of certain limitations on personal casualty losses.* A taxpayer may generally claim a deduction for any loss sustained during the taxable year for which he is not compensated by insurance or otherwise. For individuals, the loss must be incurred in a trade or business or consist of property loss attributable to casualty or theft. Losses are deductible only if they exceed \$100 per casualty or theft and total casualty and theft losses exceed 10% of the taxpayer's adjusted gross income. This act removes the \$100 and 10% limitations on casualty and theft losses to the extent those losses are in the Hurricane Katrina disaster area on or after August 25, 2005, and are attributable to Hurricane Katrina.
  - *Required exercise of IRS administrative authority.* In general, the Secretary of the Treasury may grant reasonable extensions of time to taxpayers to

perform certain acts. In addition, for certain military personnel, the time period for performing certain acts (such as filing returns, paying taxes, bringing suit) is automatically suspended. In the case of a Presidentially declared disaster or terroristic or military action, the Secretary has the authority to prescribe a period of up to one year in which the time period for the same actions is suspended. This act requires the Secretary to suspend those time periods at least until February 28, 2006, for taxpayers determined to have been affected by the Presidentially declared disaster relating to Hurricane Katrina. In addition, this act adds employment and excise taxes to the list of taxes for which the Secretary may extend filing and payment time periods.

- *Special rules for mortgage revenue bonds.* A qualified mortgage bond is a type of private activity bond for which interest is excluded from gross income. Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences and to finance qualified home improvement loans. There are several limitations on qualified mortgage bonds, including income limitations for homebuyers, purchase price limitations, and the requirement that the mortgagor be a 'first-time homebuyer' – one that did not have any ownership interest in a primary residence for the previous three years. The first-time home buyer requirement does not apply to targeted area residences – one that is located in an area of chronic economic distress or a census tract in which at least 70% of the families have an income that is 80% or less of the statewide median income. A qualified home improvement loan may not exceed \$15,000. This act eliminates the first-time homebuyer requirement with respect to qualified Hurricane Katrina recovery residences. A 'qualified Hurricane Katrina recovery residence' is one that is financed before January 1, 2008, and is either 1) located in the core disaster area or 2) the mortgagor of which owned a principal residence in the Hurricane Katrina disaster area that was rendered uninhabitable by Hurricane Katrina and the residence financed is in the same state as the previous residence. The act also increases the maximum amount of a qualified home improvement loan to \$150,000 for residences located in the Hurricane Katrina disaster area to the extent that the loan is for repair of damage caused by Hurricane Katrina.
- *Extension of replacement period for nonrecognition of gain.* A taxpayer generally realizes gain to the extent the sales price of property exceeds the taxpayer's basis in the property. The realized gain is subject to taxation unless it is deferred or not recognized under some special provision. Gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer replaces the property within the applicable period. The applicable period begins when property is converted and ends two years after the close of the first taxable year in which the gain is realized. This act extends the applicable period from two years to five years for property that is located within the Hurricane Katrina disaster area that is compulsorily or involuntarily converted after

August 25, 2005, by reason of Hurricane Katrina. Substantially all of the use of the replacement property must be in this area for this provision to apply.

- *Secretarial authority to make adjustments regarding taxpayer and dependency status for taxpayers affected by Hurricane Katrina.* This provision allows the Secretary of the Treasury to make adjustments to the tax laws to ensure that taxpayers do not lose eligibility for credits or deductions or experience a change in filing status due to temporary relocations caused by Hurricane Katrina. An example of such an adjustment would be allowing a parent to claim a personal exemption for a child even if the child did not satisfy the residency requirement as a result of a relocation due to Hurricane Katrina. Any adjustment must ensure that an individual is not taken into account by more than one taxpayer with respect to the same benefit.
- Gulf Opportunity Zone Act of 2005 (P.L. 109-135) (GO Act): The Gulf Opportunity Zone Act of 2005 expanded upon the relief offered in the Katrina Emergency Tax Relief Act of 2005. In some instances, this expansion meant extending the additional benefits allowed under the Katrina Act to taxpayers affected by Hurricanes Rita or Wilma. In other cases, the expansion created new tax benefits for taxpayers in one or more of the disaster areas. The act also made numerous technical corrections.
  - *General Provisions.* First, the GO Zone Act added several new definitions. First, the 'Gulf Opportunity Zone' or 'GO Zone' is a subset of the Hurricane Katrina disaster area that has been determined by the President to warrant individual or individual and public assistance from the federal government and is the same as the 'core disaster area' under the Katrina Act. The 'Hurricane Rita disaster area' means an area with respect to which the President has declared a major disaster before October 6, 2005, with respect to Hurricane Rita. The 'Hurricane Wilma disaster area' means an area with respect to which the President has declared a major disaster before November 14, 2005, with respect to Hurricane Wilma. The 'Rita GO Zone' and 'Wilma GO Zone' are, respectively, the portions of the Hurricane Rita disaster area and Hurricane Wilma disaster area that have been determined by the President to warrant individual or individual and public assistance from the federal government.
  - *Extensions of Hurricane Katrina benefits.* The GO Zone Act extended some of the benefits of the Katrina Act to areas affected by Hurricanes Rita and Wilma. The following changes fall into this category.
    - *Retirement plans.* The specific provisions discussed under the Katrina Act were repealed and replaced with more general provisions relating to all of the hurricanes. The provisions under this act were substantively identical to those discussed under the Katrina Act with some timing differences related to the different dates of the three storms.
    - *Casualty losses.* The specific provisions discussed under the Katrina Act were repealed and replaced with more general provisions relating to all of the hurricanes. The provisions under this act were substantively identical



to that discussed under the Katrina Act with some timing differences related to the different dates of the three storms.

- *Secretarial authority to make adjustments.* The specific provisions discussed under the Katrina Act were repealed and replaced with more general provisions relating to all of the hurricanes. The provisions under this act were substantively identical to those discussed under the Katrina Act with some timing differences related to the different dates of the three storms.
- *Mortgage revenue bonds.* The first-time homebuyer requirement is eliminated for residences in the Rita GO Zone or the Wilma GO Zone. In addition, the increased maximum amount of a qualified home improvement loan is applied to residences in the Rita GO Zone and the Wilma GO Zone.
- *Housing relief for Hurricane Katrina.* As discussed above, the Katrina Act provided some relief to individuals who provided housing for Hurricane Katrina evacuees. In this act, Congress provided further tax relief relating to housing expenditures. Employer-provided housing is generally included in income as a form of compensation. An exception to this general rule exists when an employee is required to accept the lodging on business premises as a condition of employment. This act provides that a qualified employee's gross income does not include the value of any in-kind lodging furnished to the employee, the employee's spouse, or the employee's dependents by or on behalf of the qualified employer. The exclusion applies only to lodging furnished during the six-month period beginning January 1, 2006, and may not exceed \$600 for any month in which lodging is furnished. For the purposes of this provision, a 'qualified employee' is an individual who on August 28, 2005, had a principal residence in the GO Zone and who performs substantially all of his or her employment services in the GO Zone for a qualified employer. For the purposes of this provision, a 'qualified employer' is an employer with a trade or business located in the GO Zone.
- *Depreciation and expensing.*
  - *Bonus depreciation for Gulf Opportunity Zone property.* In 2002 and 2003, Congress acted to allow for bonus depreciation (either 30% or 50% depending on when the property was purchased) for property that was purchased after September 10, 2001. In order to qualify for the bonus depreciation, the property had to have been placed into service before January 1, 2005. For certain transportation property, noncommercial aircraft, or property with a long production period, the property must have been placed into service before January 1, 2006. This act allows a taxpayer to claim an additional first-year depreciation allowance equal to 50% of the adjusted basis of qualified Gulf Opportunity Zone property acquired on or after August 25, 2005, and placed into service before January 1, 2008 (the sunset date is January 1, 2009, for nonresidential real property and residential rental property). 'Qualified Gulf Opportunity Zone' property must satisfy all of the following conditions: 1) It must be depreciable modified accelerated cost recovery systems (MACRS)

recovery property with a recovery period of 20 years or less, MACRS water utility property, qualified leasehold improvement property, off-the-shelf computer software, residential rental property, or nonresidential real property; 2) Substantially all use of the property must be in the active conduct of a trade or business of the taxpayer in the GO Zone; 3) The original use of the property in the GO Zone must commence with the taxpayer on or after August 25, 2005; 4) The property must be purchased on or after August 25, 2005; 5) No written binding contract for the purchase of the property may be in effect before August 25, 2005; and 6) The property must be placed in service before January 1, 2008 (January 1, 2009 for nonresidential real property and residential rental property). The term does not include property that is 1) mandatory alternative depreciation system (ADS) property; 2) tax-exempt bond-financed property; 3) qualified revitalization buildings or rehabilitation expenditures for which a deduction under section 1400I of the Code is claimed; or 4) property used in connection with a private or commercial golf course, a country club, a massage parlor, a hot tub facility, a suntan facility, a liquor store, or a gambling or animal racing property. In addition, this act allows the Secretary to extend the placed-in-service date for noncommercial aircraft and property with longer production periods for up to one year. This extension is granted on a case-by-case basis and may only be granted if the delay in placing the property into service was caused by one of the three hurricanes and the property is placed in service in the GO Zone, the Rita GO Zone, or the Wilma GO Zone.

- *Increase in limits on section 179 deductions.* Certain taxpayers may elect to claim a section 179 expense deduction on the cost of qualifying property rather than depreciating the property over time. For the 2003 through 2007 tax years, the maximum amount of the deduction is limited to \$100,000, indexed for inflation.<sup>8</sup> This limitation is increased by \$35,000 for property that is placed in service in the New York Liberty Zone, an empowerment zone, or a renewal community. The amount of the section 179 deduction is reduced to the extent that the total amount of property placed into service exceeds an investment threshold, currently set at \$400,000, indexed for inflation.<sup>9</sup> The section 179 deduction may not exceed a taxpayer's taxable income from the active conduct of a trade or business. This act increases the maximum section 179 deduction for qualified GO Zone property by the lesser of \$100,000 or the amount of property placed into service in the GO Zone. In addition it increases the total investment limitation by the lesser of \$600,000 or the amount of property placed into service in the GO Zone. The increased amounts apply to property acquired on or after August 25, 2005, and placed into service before January 1, 2008. 'Qualified GO Zone property' must satisfy all of the following conditions: 1) It must be depreciable modified

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<sup>8</sup> The adjusted dollar limitation is \$105,000 for 2005 and \$108,000 for 2006.

<sup>9</sup> The adjusted investment limitation is \$420,000 for 2005 and \$430,000 for 2006.

accelerated cost recovery systems (MACRS) recovery property with a recovery period of 20 years or less; 2) Substantially all use of the property must be in the active conduct of a trade or business of the taxpayer in the GO Zone; 3) The original use of the property in the GO Zone must commence with the taxpayer on or after August 25, 2005; 4) The property must be purchased on or after August 25, 2005; 5) No written binding contract for the purchase of the property may be in effect before August 25, 2005; and 6) The property must be placed in service before January 1, 2008. The term does not include property used in connection with a private or commercial golf course, a country club, a massage parlor, a hot tub facility, a suntan facility, a liquor store, or a gambling or animal racing property.

- *Deduction for demolition and clean-up costs.* Under general law, demolition costs are capitalized and added to the basis of the land on which the demolished building was located. The tax treatment of debris removal costs depends on the nature of the costs incurred. Debris removal costs that are in the nature of replacement must be capitalized and added to the basis of the property damaged. Other times, debris removal costs may be used to show a decrease in the fair market value of property which could be used to determine the amount of a casualty loss. This act allows a taxpayer to claim a current deduction for 50% of any qualified Gulf Opportunity Zone clean-up costs paid between August 25, 2005, and January 1, 2008. For the purposes of this provision, a 'qualified Gulf Opportunity Zone clean-up cost' is an amount paid for the removal of debris, or the demolition of structures, on real property located in the GO Zone if the real property is either held by the taxpayer for use in a trade or business or is inventory in the hands of the taxpayer.
- *Environmental remediation costs.* Under previous law, a taxpayer may elect to deduct, rather than capitalize, certain environmental remediation expenditures incurred in connection with property used in a trade or business for the production of income. This provision expired for expenditures incurred after December 31, 2005. This act extends the expiration date for that provision until December 31, 2007, for qualified environmental remediation expenditures incurred in connection with a qualified site in the GO Zone. In addition, expenditures incurred on or after August 25, 2005, with respect to petroleum products in the GO Zone are included in the deduction.

## Amend Taxation of Logging Machinery.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-19	HB 1938	Rep. Wainwright; Church; McComas; Underhill; (Primary Sponsors)

### **AN ACT TO TREAT COMMERCIAL LOGGING MACHINERY THE SAME AS FARM MACHINERY UNDER THE SALES TAX.**

**OVERVIEW:** This act, which was a recommendation of the Revenue Laws Study Committee, exempts from the 1% privilege tax, with an \$80 maximum tax per article, commercial logging machinery, attachments, repair parts for commercial logging machinery, lubricants applied to commercial logging machinery, and fuel to operate commercial logging machinery for use in commercial logging operations.

**FISCAL IMPACT:** Annual revenue loss is estimated to be \$2.87 million.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** This act became effective when signed into law by the Governor on June 21, 2006, and applies to purchases made on or after July 1, 2006.

**ANALYSIS:** For years, State tax law has provided that the sales and use tax rate on mill machinery is 1%, with an \$80 maximum tax per article. There has never been a specific reference in the sales tax statutes to machinery used in the forestry and logging business; however, based on a long-standing interpretation by the Department of Revenue, logging firms that had contracts with wood product manufacturers to cut timber were deemed entitled to the 1% rate, \$80 cap based on the preferential rate afforded to manufacturing industries and plants.

For several years, North Carolina has worked toward simplifying its sales and use tax statutes in an effort to conform to the Streamlined Sales and Use Tax Agreement. One of the conforming changes the State had to make was to simplify its sales tax rates. Under the Streamlined Sales and Use Tax Agreement, a state must have one rate, with no caps or thresholds, as of January 2006.

Prior to January 1, 2006, North Carolina had several different rates, including this 1% rate with an \$80 cap. To conform to the Streamlined Sales and Use Tax Agreement, the General Assembly changed how the State taxes items previously taxed at the 1% sales tax rate with an \$80 cap:

- In 2001, at the request of North Carolina Citizens for Business and Industry, the General Assembly maintained the preferential tax rate on mill machinery by removing it from the sales tax statutes to the privilege tax statutes. By changing the nature of the tax from a sales tax to a privilege tax, the industry kept its preferential rate and the State conformed to the Streamlined Sales and Use Tax Agreement. The change from a sales tax to a privilege tax means that retailers are not responsible for collecting and remitting the tax. The change in the law, made in 2001, became effective January 1, 2006. Based upon the long-standing

interpretation by the Department, this change encompassed machinery used in the forestry and logging business.

- In 2005, the General Assembly exempted from tax sales to farmers of machinery, attachments and repair parts for the machinery, and lubricants applied to the machinery. It also expanded the 1% privilege tax with an \$80 cap, originally enacted in 2001, to include manufacturing fuel and major recycling equipment.

Thus, as of January 1, 2006, purchases of mill machinery, which includes commercial logging equipment, and mill machinery parts or accessories and manufacturing fuel, became exempt from sales and use tax, but were subject to the new privilege tax. The privilege tax is imposed on the purchaser of qualifying property, and the purchaser is liable for accruing and remitting the tax to the Department of Revenue. Examples of qualifying commercial logging equipment include log skidders, log carts, tree shears, feller bunchers, winches, chain saws, tractors, axes, and mallets when the items are used to cut and transport timber to a wood products manufacturer.

This act treats commercial logging machinery and related items the same as farm machinery under the current sales tax laws. First, the act exempts commercial logging items from the 1%/\$80 maximum privilege tax, to which they are currently subject. The act also creates a new exemption in the sales and use tax statutes for commercial logging machinery, attachments and repair parts, lubricants, and fuel used to operate commercial logging machinery. The language of the exemption tracks the current exemption for farm machinery, as enacted in S.L. 2005-276.

## Property Tax Changes.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-30	HB 2097	Representative Brubaker

### **AN ACT TO MAKE CLARIFYING CHANGES TO THE PROPERTY TAX LAWS.**

**OVERVIEW:** This act, which was a recommendation of the Revenue Laws Study Committee, makes the following changes to the property tax laws:

- It allows the electronic listing of individual as well as business personal property.
- It clarifies that 60% of only the first month's interest collected on delinquent registered motor vehicle taxes is transferred to the Combined Motor Vehicle and Registration Account, not the total interest collected on the unpaid taxes.
- It gives a county board of equalization and review the authority to approve late applications for present use-value appraisal of property.
- It validates the current practice of allowing tax collectors to receive tax receipts for assessments that have been or are subsequently appealed to the Property Tax Commission and to send the taxpayer an initial bill for those taxes.

**FISCAL IMPACT:** This act does not impact State revenues and does not have a significant impact on local revenues.

(For a more complete fiscal analysis, see Overview: *Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.*)

**EFFECTIVE DATE:** The act became effective when signed into law by the Governor on June 26, 2006.

**ANALYSIS:** This act makes several changes to the property tax statutes.

#### *Electronic Listing*

The General Assembly enacted legislation in 2001 to allow counties to adopt a resolution providing for the electronic listing of business personal property.<sup>10</sup> This act extends a county's authority to provide electronic listing to include individual personal property<sup>11</sup> as well as business personal property. If the county commissioners adopt such a resolution, then the assessor must include information on how to list electronically in the listing notice sent to taxpayers. An abstract submitted by electronic listing is considered filed when received in the office of the assessor.

This act does not extend the listing deadline for individual personal property. The listing period begins on January 1 and ends on January 31. A county may, for good cause, give an individual taxpayer an extension until April 15 to list personal property. Under current law, a county may extend the period for electronic listing of business personal property until June 1.

#### *Clarifying Change*

The act makes a clarifying change to legislation enacted during the 2005 Session. S.L. 2005-294 created a combined system for the registration and taxation of motor vehicles, effective July 1, 2009.<sup>12</sup> Under the new combined system, consumers will receive one statement per registered vehicle containing all the registration fees and property taxes due on the vehicle. The Division of Motor Vehicles, or its agent, will be responsible for collecting the fees and taxes due.

To pay for the new system, the 2005 legislation increased the first month's interest on delinquent registered motor vehicle taxes from 2% to 5%, effective January 1, 2006, and required that 60% of the interest collected on unpaid taxes be transferred on a monthly basis to the Combined Motor Vehicle and Registration Account in the Treasurer's Office. Funds in this Account may only be transferred to the DMV for the purpose of implementing the combined system, at the direction of the North Carolina Association of County Commissioners. The intent of the sponsors of the 2005 legislation was that 60% of only the first month's interest would be transferred to the Account, not the total interest collected on unpaid taxes. This act clarifies this intent.<sup>13</sup>

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<sup>10</sup> S.L. 2001-279.

<sup>11</sup> Examples of individual personal property include automobiles, boats, and mobile homes.

<sup>12</sup> Section 31.5 of S.L. 2006-259 changed this effective date to July 1, 2010.

<sup>13</sup> In December 2005, the North Carolina Department of State Treasurer issued a memorandum directing counties to only remit 60% of the first month's interest to the Treasurer. The memorandum stated that this was the true intent of the legislation and that it anticipated that language clarifying this intent would be enacted during the 2006 Session. The memorandum was sent to all county managers, finance officers, tax administrators, tax assessors, tax collectors, and certified public accountants.

### *Late Application for Present Use-Value*

The act gives a county board of equalization and review the authority to approve a late application for present use-value appraisal of property if the applicant demonstrates good cause for the delay.<sup>14</sup> If the county board of equalization and review is not in session, then the late filing may be approved by the board of county commissioners. Existing law provides for similar approval for late applications for property tax exemptions or exclusions.<sup>15</sup>

### *Tax Receipts for Assessments*

Each year the county board of commissioners or the municipal governing body directs the tax collector to collect taxes charged in the tax records and receipts. The tax receipt sets out the name and address of the taxpayer, the assessment of the taxpayer's property, the rate of tax levied, and the amount of property taxes and any penalties due. Prior law stated that no tax receipts could be delivered to the tax collector for any assessment appealed to the Property Tax Commission until the appeal had been finally adjudicated. In practice, boards of equalization and review often adjourn on June 30, except to hear appeals filed prior to June 30. The tax collector receives the tax receipts by August 1.

This act validates the current practice of allowing tax collectors to receive tax receipts for assessments that have been or are subsequently appealed to the Property Tax Commission, but clarifies that the tax collector may not seek any remedies for collection of the taxes or enforcement of the tax lien pending final adjudication of appeal from the assessment. The tax collector may, however, send an initial bill or notice to the taxpayer pending final adjudication. By providing notice pending appeal, the taxpayer may choose to avoid the amount of interest that accrues while the appeal is pending. If the taxpayer wins on appeal, the taxpayer receives a refund of any taxes paid plus interest. The current practice also puts a potential buyer of property on notice of a tax bill if the property is transferred pending the appeal.

The act also makes a conforming change in the law concerning the annual settlement the tax collector makes with the governing body of its taxing unit. A tax collector is liable for the faithful performance of his or her collection duties. Each year, a tax collector must make a sworn report to the governing body of the taxing unit showing what taxes remain unpaid at the end of the fiscal year. In this final settlement for the preceding fiscal year, a collector is charged with the total amount of taxes for collection, less any amounts that may be credited to the collector in the settlement.<sup>16</sup> This act adds to the list of items that may be credited to the collector the principal amount of taxes for any assessment appealed to the Property Tax Commission when the appeal has not been finally adjudicated.

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<sup>14</sup> Generally, an application for present-use value must be filed during the regular listing period: January 1 through January 31.

<sup>15</sup> G.S. 105-282.1(a1).

<sup>16</sup> Charges include the total amount of all taxes placed in the collector's hands for collection for the year, all late-listing penalties and costs collected by the collector, all interests on taxes collected by the collector, and any other sums collected or received by the tax collector. Credits include all sums deposited by the collector to the credit of the taxing unit, releases allowed by the governing body, discounts allowed for early payment of taxes, the principal amount of taxes constituting liens against real property, the principal amount of taxes determined to be insolvent and to be allowed as credits, and any commission the collector is entitled to deduct from amounts collected.

## SSTA Sales Tax Defn/Sales Tax Payments.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-33	HB 1915	Representative Hill

**AN ACT TO INCORPORATE THE STREAMLINED SALES TAX DEFINITIONS CONCERNING TELECOMMUNICATIONS, TO SIMPLIFY THE TAX PAYMENT REQUIREMENTS FOR SEMIMONTHLY TAXPAYERS, AND TO TREAT TANGIBLE PERSONAL PROPERTY USED IN MODULAR HOMES THE SAME AS TANGIBLE PERSONAL PROPERTY USED IN OTHER HOMES.**

**OVERVIEW:** This act, which was a recommendation of the Revenue Laws Study Committee, does three things:

- Incorporates several definitions from the Streamlined Sales Tax Agreement into North Carolina law.
- Changes the tax payment requirements for semi-monthly sales tax payers.
- Allows a credit for sales tax paid on tangible personal property that is added to a modular home and sold with the modular home.

**FISCAL IMPACT:** The changes made with respect to definitions under the Streamlined Sales Tax Agreement have no fiscal impact on the State, but the changes with respect to sourcing of prepaid wireless may have a minimal impact on local governments. Minimal to no fiscal impact is expected from the changes regarding tax payment schedules.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** Different parts of the act have different effective dates as described below.

**ANALYSIS:** The act makes the following changes to the revenue laws.

### *Streamlined Sales Tax Agreement*

Sections 1 through 8 of the act modify the definitions that apply to telecommunications services for sales and use tax purposes. The changes were made to adopt the definitions in the Streamlined Sales Tax Agreement (hereinafter Streamlined Agreement). These changes become effective January 1, 2007.

Section 1 of the act makes the following changes in G.S. 105-164.3, the definitions section of the sales and use tax laws:

- Adds a definition of the term 'ancillary service' because the definitions in the Streamlined Agreement separate ancillary services from telecommunications services. Previous North Carolina law considered ancillary services to be part of telecommunications services. All of the ancillary services were taxed under previous law and will continue to be taxed.



- Modifies the definition of 'prepaid telephone calling service' to include the newly defined terms for 'prepaid wireless calling service' and 'prepaid wireline calling service'. Previous law did not distinguish between prepaid wireline and prepaid wireless. The definition of prepaid wireless was added to recognize that prepaid wireless includes whatever other services can be obtained with the same card used to obtain wireless telecommunications service. Prepaid cards are taxed at the point of sale rather than as telecommunications service when the minutes are used. Some services that are not within the definition of telecommunications service can be purchased with the card that authorizes prepaid wireless use. The current definition of prepaid telephone calling service has an exclusive use requirement that conflicts with the practice for prepaid wireless.
- Converts the current definition of prepaid telephone calling service into the definition of 'prepaid wireline calling service'. This change is technical.
- Adds a definition for 'prepaid wireless calling service'. This definition does not have an exclusive use requirement, in contrast to prepaid wireline.
- Updates the definition for 'Streamlined Agreement' to include the latest amendments made January 13, 2006.
- Conforms the definition of 'telecommunications service' to the Streamlined definition and incorporates into the definition the appropriate inclusions and exclusions that are now in G.S. 105-164.4C(b) and (c). As changed, the definition is the same as previous law with two exceptions. The first exception relates to Universal Service Fund surcharges. The second exception is related to paging service. With these changes, these charges are part of the sales price and will be subject to tax. Universal Service Fund surcharges could not be 'carved out' and remain as under previous law because there is no Streamlined carve out in sales price or telecommunications service for this surcharge. Paging service may be carved out because there is a Streamlined definition for this, but this act does not include that carve out.

Section 2 of this act changes the tax imposition statute to add the now separate category of 'ancillary service' and to include non-telecommunications services that are sold as part of a prepaid wireless calling service.

Section 3 of this act makes a conforming change to the sourcing statute to apply the new definition of prepaid wireless call service.

Section 4 of this act makes conforming changes to the separate statute on telecommunications to include ancillary service and to apply the new definition of prepaid wireless calling service.

Section 5 of this act moves to the exemption statute the items that were formerly excluded from the definition of telecommunications and are not intended to be taxed. This change maintains the current tax treatment of these services.

Sections 6 through 8 of this act add the now separate category of 'ancillary service' in the exemption statute, in the direct pay permit statute, and in the local distribution statute.

Section 12 of this act repeals the requirement that a certified automated system must be able to determine whether an exemption certificate offered by a purchaser is a valid certificate based upon a State registry because the Streamlined Agreement does not require this determination. The section became effective June 1, 2006, because the first certification of an automated system under the Streamlined Sales Tax Act occurred around that date. Under the Streamlined Sales Tax Act, a seller may collect and remit the sales and use tax due a state through either a certified service provider or it may do it itself through the use of a certified automated system. A certified automated system is a software program certified by the Secretary of Revenue as being able to correctly determine the applicable State and local sales tax rate. G.S. 105-164.44H(a) lists the specific requirements a certified automated system must meet to be certified. This section removes one of the requirements because it is not a requirement under the Agreement.

#### *Sales Tax on Modular Homes*

Previous law stated that the retail sale of a modular home was the sale of the home to a modular homebuilder. It assumed that a manufacturer would sell to a modular homebuilder who would then enter into a performance contract with a customer to construct the home. This assumption was not accurate when the manufacturer sold the modular home directly to the customer who would occupy the home.

Section 13 of the act addresses two issues. First, it clarifies the law concerning a retail sale of a modular home by including within the scope of a retail sale all sales to the customer who will occupy the home. It does this by removing the previous limitation that defined a retail sale as a sale to a modular homebuilder. Second, it allows a credit for sales and use tax paid on materials used in the home. G.S. 105-164.6 allows a credit against this State's sales tax for any sales or use tax paid in another state on the same item. This provision does not apply, however, to taxes paid in another state on materials that are included in a modular home that is taxed when it is sold to a modular homebuilder because the taxes paid to the two states are on different items. This section allows credit for sales tax paid on the items that are included in the home.

This part of the act became effective July 1, 2006, and applies to purchases made on or after that date.

#### *Simplify Semi-Monthly Tax Payments*

Under previous law, taxpayers that were liable for at least \$10,000 a month in sales tax, electric utility tax, or piped natural gas excise tax were required to pay tax twice a month. For these taxpayers, the month was split into two periods – the first day of the month through the 15<sup>th</sup> of the month, and the 16<sup>th</sup> of the month through the end of the month. The tax payment for the 1<sup>st</sup> through 15<sup>th</sup> period was due by the 25<sup>th</sup> of the same month and the tax payment for the 16<sup>th</sup> through the end of the month was due by the 10<sup>th</sup> day of the following month. Therefore, taxpayers had 10 days after the end of a semimonthly period to make a payment. In addition to the payments, these taxpayers also were required to file a return. The sales tax return was due monthly by the 20<sup>th</sup> and the electric utility and piped gas returns were, and remain, due quarterly by the end of the month after the close of the quarter.

Several large retailers in the Streamlined Sales Tax project asked North Carolina to look at its payment schedule to determine if it could require payments to be made only once a month. North Carolina is one of only a few states that require payments twice a month.

Sections 9, 10, and 13 of the act replace the semimonthly payment schedule with a single monthly payment and a prepayment of the next month's liability due on the same day as the monthly payment. The result is that taxpayers will have more time to gather data before filing a return and will make payments on only one day of the month. Under the act, the taxpayer makes one payment on the 20<sup>th</sup> of the month. That payment includes any amount remaining due for the preceding month and 65% of the amount estimated to be due for the current month. The State will experience a slight one-time increase in revenue in the first month that the prepayment schedule takes effect.

The prepayment must equal at least 65% of one of three thresholds:

- The current month's liability.
- The liability for the same month the preceding year.
- The average monthly liability for the past calendar year.

These thresholds are easily determined and eliminate the need for the taxpayer to calculate actual liability for periods of less than a month. The 65% threshold was chosen because it was suggested by the retailers who requested North Carolina to review its law and the prepayment date is about 2/3 of the time in a month. A similar method and threshold are already in place in Florida and Arkansas.

The act eliminates the provisions concerning penalty relief for small underpayments because the relief is no longer needed. The relief was provided under previous law because the law required taxpayers to calculate liability for short periods within 10 days after the end of the period. Under this act, sales tax taxpayers have 20 days after the end of the month to file a return and electric utility and piped gas taxpayers have a full month after the end of a quarter to file a return.

This part of the act becomes effective October 1, 2007.

### **Mill Rehabilitation Tax Credit.**

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-40	HB 474 As amended by S.L. 2006-252 <sup>17</sup>	Rep. Ross, Howard, Brubaker, Goodwin

**AN ACT TO PROVIDE A TAX CREDIT FOR REVITALIZATION OF HISTORIC MILL FACILITIES AND TO PROVIDE AN ENHANCED HISTORIC REHABILITATION CREDIT FOR REHABILITATION EXPENSES WITH RESPECT TO A FACILITY THAT WAS ONCE A STATE-OWNED TRAINING SCHOOL FOR JUVENILE OFFENDERS.**

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<sup>17</sup> S.L. 2006-252 replaced the tax credits under the Bill Lee Act with more narrowly focused credits. The act replaced 'enterprise tiers' with 'development tiers' and reduced the number of tiers from five to three. S.L. 2006-252 made changes to this act to conform to the changes made in it.

**OVERVIEW:** This act does three things:

- It provides an enhanced credit for rehabilitating a facility that at one time was a State-owned training school for juvenile offenders.
- It provides an income tax credit for rehabilitating vacant historic manufacturing sites if the taxpayer spends at least \$3 million to rehabilitate the site. The credit is a percentage of the qualified rehabilitation expenditures or rehabilitation expenses. The percentage amount of the credit varies depending on the development tier location of the site and its eligibility for the federal credit.
- It eliminates the requirement that in order for a project to be eligible for a credit for rehabilitating non-income producing property it must receive the certification of the State Historic Preservation Officer before the commencement of work.

**FISCAL IMPACT:** The act is expected to decrease General Fund revenues \$2.8 million in fiscal year 2006-07. This loss grows to an anticipated \$14.7 million in fiscal year 2008-09 before beginning to decline. Preservation NC estimates there are approximately 30 to 35 mill properties out of more than 200 eligible properties throughout North Carolina likely to be rehabilitated as a result of this tax credit.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** The act is effective for taxable years beginning on or after January 1, 2006, and applies to eligible sites placed into service on or after July 1, 2006. The act expires for qualified rehabilitation expenditures and rehabilitation expenses incurred on or after January 1, 2011.

**ANALYSIS:** North Carolina has two income tax credits for rehabilitating an historic structure. One credit is allowed to taxpayers that qualify for the federal historic rehabilitation credit. The federal tax credit is available for rehabilitating only income-producing historic structures, and is equal to 20% of the rehabilitation expenses. The amount of the North Carolina credit is 20% of the expenses that qualify for the federal credit. The second credit is allowed to taxpayers that rehabilitate an historic structure that is not income producing, and thus not eligible for the federal credit. The credit is equal to 30% of the rehabilitation expenses. To qualify for the credit for rehabilitating a non-income producing historic structure, the taxpayer must spend more than \$25,000 within a 24-month period. The North Carolina credit for both income-producing structures and non-income producing structures must be taken in installments over five years after the structure is placed in service, and any unused portion of the credit may be carried forward for five years. A pass-through entity may allocate the credit to an owner if an owner's adjusted basis in the pass-through entity is at least 40% of the amount allocated to that owner.

#### *Enhanced Credit*

The act amends the tax credit allowed for rehabilitating an historic structure by increasing the credit amount for rehabilitating a facility that was once a State-owned training school for juvenile offenders. The amount of credit such a facility may be eligible to receive is increased to 40% of the qualified rehabilitation expenditures or rehabilitation expenses rather than 20% or 30%, respectively. This provision allows for an enhanced credit for a rehabilitation

of the facilities of the former Stonewall Jackson Manual Training and Industrial School in Cabarrus County.

#### *Mill Rehabilitation Credit*

The act also establishes an enhanced tax credit for rehabilitating vacant historic manufacturing sites. This credit may be taken in place of the existing credit for historic rehabilitation, not in addition to it. The tax credit enacted by this act for rehabilitating historic manufacturing sites differs from the tax credit for historic rehabilitation in several ways. The amount of the credit is larger, the credit may be taken against one of three taxes, in some instances the credit may be taken in the year the property is placed into service, and any unused portion of the credit may be carried forward for nine years.

To be eligible to claim the credit for rehabilitating a vacant historic manufacturing site, a taxpayer must spend at least \$3 million to rehabilitate the site. To qualify for the credit, the site must satisfy all of the following conditions:

- The site was used as a manufacturing facility or for purposes ancillary to manufacturing, as a warehouse for selling agricultural products, or as a public or private utility.
- The site has been at least 80% vacant for a period of at least two years immediately preceding the date the eligibility certification is made.
- The site is a certified historic structure or a State-certified historic structure.

The amount of the credit depends upon the development tier in which the site is located and the eligibility of the site for a federal credit as follows:

- 40% of qualified rehabilitation expenditures or rehabilitation expenses – If the site is located in a development tier one or two, regardless of whether the taxpayer is allowed a federal credit.
- 30% of qualified rehabilitation expenditures – If the site is located in a development tier three and the taxpayer is allowed a federal credit.
- No credit is allowed if the site is located in a development tier three and the taxpayer is not allowed a federal credit.

If the credit is taken for income-producing property, it may be taken in the year the property is placed in service. If the credit is taken for non-income-producing property, the credit must be taken in five equal installments beginning with the taxable year in which the property is placed in service.

The credit allowed may be claimed against the income tax, the franchise tax, or the gross premium tax. The taxpayer must elect the tax against which the credit will be claimed, and this election is binding.

The credit may not exceed the amount of the tax against which the credit is claimed for the taxable year reduced by the sum of all credits allowed, except payment of tax made by the taxpayer. Any unused portion of the credit may be carried forward for nine years.

A pass-through entity may allocate the credit among any of its owners without limitation as long as the owner's adjusted basis in the pass-through entity is at least 40% of the amount of

credit allocated to the owner.<sup>18</sup> An owner of a pass-through entity that qualifies for the credit will forfeit a portion of any credit the owner has received if both of the following conditions are met:

- The owner disposed of the interest within five years from the date the eligible site is placed into service.
- The owner's interest in the pass-through entity is reduced to less than two-thirds of the owner's interest in the pass-through entity at the time the eligible site was placed into service.

The forfeiture of an owner's interest is not required if the change in ownership is the result of the owner's death or the merger, consolidation, or similar transaction requiring approval by the shareholders, partners, or members of the entity, to the extent the entity does not receive cash or tangible property in the transaction. A taxpayer or owner of a pass-through entity that forfeits a credit is liable for all past taxes avoided as a result of the credit plus interest computed from the date the taxes would have been due if the credit had not been allowed.

*Certification by the State Historic Preservation Officer*

To qualify for either the historic rehabilitation tax credit or the mill rehabilitation tax credit, the State Historic Preservation Officer must certify that the facility comprises an eligible site and that the rehabilitation is a certified rehabilitation. A taxpayer must provide the Secretary of Revenue with documents showing that the State Historic Preservation Officer certifies the site and rehabilitation and showing the amount of rehabilitation expenditures or expenses. Under prior law, the certification of the repairs or alterations had to be obtained by the taxpayer from the State Historic Preservation Officer prior to the commencement of the work. This act eliminates the timing of this requirement for both the credit enacted by this act and for the pre-existing credit for rehabilitating an historic structure.<sup>19</sup>

**Modify Appropriations Act of 2005.**

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-66	SB 1741	Senator Garrou

**AN ACT TO MODIFY THE CURRENT OPERATIONS AND CAPITAL APPROPRIATIONS ACT OF 2005, TO INCREASE TEACHER AND STATE EMPLOYEE PAY, TO REDUCE THE SALES TAX RATE AND THE INCOME TAX RATE APPLICABLE TO MOST SMALL BUSINESSES, TO CAP THE VARIABLE WHOLESALE COMPONENT OF THE MOTOR FUEL TAX RATE AT ITS CURRENT RATE, TO ENACT OTHER TAX**

<sup>18</sup> A pass-through entity may also allocate the credit for rehabilitating an historic structure among its owners in the same manner as provided in this provision.

<sup>19</sup> The taxpayer is still required to receive certification from the State Historic Preservation Officer that the repairs or alterations comply with federal standards, but the timing of that certification is immaterial.

## **REDUCTIONS, AND TO PROVIDE FOR THE FINANCING OF HIGHER EDUCATION FACILITIES AND PSYCHIATRIC HOSPITALS AND OTHER CAPITAL PROJECTS.**

**OVERVIEW:** This act is The Current Operations and Capital Improvements Appropriations Act of 2006. In addition to the budget provisions, the act makes many tax law changes and authorizes the issuance of special indebtedness to finance several capital projects across the State. The tax law changes made in this act include the following:

- It reduces the sales tax rate from 4.5% to 4.25%, effective December 1, 2006.
- It reduces the upper individual income tax bracket from 8.25% to 8%, effective for taxable years beginning on or after January 1, 2007, and from 8% to 7.75%, effective for taxable years beginning on or after January 1, 2008.
- It caps the variable wholesale component of the motor fuels tax rate for one year and holds the Highway Fund harmless for any potential revenue loss.
- It creates a new tax credit for small businesses that provide health benefits to their eligible employees, effective for taxable years beginning on or after January 1, 2007, and expiring for taxable years beginning on or after January 1, 2009.
- It extends the sunset for refunds of the State sales and use tax on fuel used by interstate passenger air carriers and on aviation fuel used by a motorsports racing team or a motorsports sanctioning body. The refunds were scheduled to expire for purchases made on or after January 1, 2007; the act extends the date of expiration to January 1, 2009.
- It extends the sunset on the tax credit for constructing renewable fuel production facilities from January 1, 2008, to January 1, 2011, and it creates an enhanced credit if the taxpayer invests at least \$400 million in three separate facilities over a five-year period.
- It creates a tax credit for certain biodiesel providers, effective January 1, 2007, and expiring January 1, 2010.
- It exempts qualifying research and development equipment from State and local sales and use tax and imposes a 1% privilege tax with an \$80 cap, effective July 1, 2007.
- It provides a sales and use tax refund for a professional motorsports racing team for purchases of professional motor racing vehicle component parts other than tires or accessories made by it, effective July 1, 2007.
- It provides a married couple with the option of filing jointly if they file a federal joint return and if one spouse is a nonresident with no income from North Carolina, effective for taxable years beginning on or after January 1, 2006.
- It allows an individual taxpayer to deduct a maximum amount of \$750 contributed by the taxpayer to an account in the Parental Savings Trust Fund. A married couple filing jointly may deduct a maximum of \$1,500. To qualify for the deduction, the adjusted gross income of the individual taxpayer or married

couple filing jointly must not exceed a specified amount. The deduction is effective for taxable years beginning on or after January 1, 2006. The deductible amount increases for taxable years beginning on or after July 1, 2007. The deduction is repealed for taxable years beginning on or after January 1, 2011.

- It provides an exemption from the sales and use tax on sales of tangible personal property and electricity to an eligible Internet data center, effective for sales made on or after October 1, 2006.
- It amends the definition of 'corporation', as it applies to the franchise tax statutes, to include a limited liability company (LLC) that elects to be taxed as a C Corporation for federal income tax purposes. The effect of this change is that the corporate franchise tax will apply to these LLCs. The change is effective for taxable years beginning on or after January 1, 2007.
- It expands the royalty payment reporting option for corporations and their related members to include payments received for use of patents and copyrights, effective for taxable years beginning on or after January 1, 2006.

**FISCAL IMPACT:** The tax changes enacted in this act reduce General Fund revenues by approximately \$193.5 million for fiscal year 2006-2007. The act authorizes approximately \$254 million in special indebtedness for the fiscal year 2006-2007, and another \$419 million in the future.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** The act contains varying effective dates.

**ANALYSIS:** The act makes the following finance law changes.

*Transfer of Tax Proceeds from Highway Trust Fund to General Fund.*

Each fiscal year, a certain sum of highway use tax proceeds is transferred from the Highway Trust Fund to the General Fund. The first amount is equal to \$1.7 million. In 2005, the General Assembly altered that amount for fiscal years 2005-2006 and 2006-2007 by requiring a transfer of \$250 million in each of those fiscal years. Section 2.2(e) of the act reduces the transfer amount to \$55 million for fiscal year 2006-2007 only.

The second amount required to be transferred annually from the Highway Trust Fund to the General Fund is determined by a formula. The formula is determined by adjusting the amount distributed in the previous fiscal year, which began as a base of \$2.4 million in fiscal year 2002-2003, plus or minus a percentage of this sum equal to the percentage by which tax collections have increased or decreased for the most recent 12-month period for which data is available. Using this formula, the second amount transferred to the General Fund for fiscal year 2006-2007 is \$2,486,602.

*Consultation Not Required Prior to Establishing or Increasing Fees pursuant to the Executive Budget Act*

Section 6.3 of the act provides that an agency is not required to consult with the Joint Legislative Commission on Governmental Operations pursuant to G.S. 12-3.1<sup>20</sup> prior to

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<sup>20</sup> G.S. 12-3.1 provides that before an agency's rule to establish or increase a fee can become effective, the agency must consult with the Joint Legislative Commission on Governmental Operations on the amount and



establishing or increasing a fee authorized or anticipated in the Current Operations and Capital Improvements Appropriations Act of 2006, or in the Senate and House of Representatives Appropriations Committee Reports on the Continuation, Expansion and Capital Budgets, that were distributed in the Appropriations and Base Budget Committees and used to explain this act. The statutory consultation requirement is unnecessary since the General Assembly already considered these fees in the Appropriation Act of 2006 and Committee Reports.

*No Increases that the General Assembly has Rejected*

Section 6.4 of the act amends the Executive Budget Act by adding a statute prohibiting a fee increase if the General Assembly has rejected an increase in that fee for the current fiscal period. For purposes of this section, the General Assembly has rejected a fee increase when that fee is included in a bill which fails a reading or is in a version of a bill that passes one house but is enacted without the fee increase.

*Refund of Local Sales and Use Taxes to a Local School Administrative Unit*

Prior to the 2006-2007 fiscal year, local school administrative units were eligible for an annual refund of sales and use taxes paid by the unit. In 2005, the General Assembly repealed the provision which authorized the refund for local school administrative units in an attempt to redirect estimated State sales tax revenues refundable to LEAs to the State Public School Fund for allotment through State position, dollar, and categorical allotments. However, the amount that was transferred to the State Public School Fund was sufficient to offset only the State portion of the taxes that were previously refunded. The effect of this was to reduce the amount going to the public schools. Section 7.20 of the act maintains the repeal of the refund of the State taxes, but allows local school administrative units to apply for a refund of the local sales and use taxes paid by the unit. As before, the refund applies to sales and use taxes paid on direct purchases of tangible personal property, other than telecommunications and electricity, and indirect purchases of building materials. Also as before, the request for a refund must be in writing and is due within six months after the end of the entity's fiscal year. This is the only instance in which a taxpayer is eligible for a refund of local sales and use taxes when the taxpayer is not also eligible for a refund of State sales and use taxes. This change is effective retroactive for purchases made on or after July 1, 2005.

*Revised Maximums for Collection Assistance Fees*

Section 19.2 of the act increases the maximum amount of collection assistance fee proceeds that the Department of Revenue may apply to taxpayer locator services from \$100,000 to \$150,000 per year and adds a yearly limit of \$353,000 to the amount of the fees that may be applied towards postage or other delivery charges for correspondence related to collecting overdue tax debts. In 2001, the General Assembly established a system under which the cost of collecting overdue tax debts is to be borne by the delinquent taxpayers, not by the taxpayers who pay their taxes on time. The collection assistance fee is 20% of the overdue tax debt and is a receipt of the Department.<sup>21</sup> The proceeds of the fee are credited to a

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purpose of the fee to be established or increased. If the Commission does not hold a meeting to hear the consultation request within a specified time, then the consultation requirement is deemed satisfied.

<sup>21</sup> Section 22.6 of S.L. 2005-276 amended the law to provide that the amount of the collection assistance fee would be the actual cost of collection, not to exceed 20% of the amount of the overdue tax debt. However,

special, non-reverting account to be used only for collecting overdue tax debts. The Department of Revenue may apply the fee proceeds for the following purposes:

- To pay contractors for collecting tax debts.
- To pay the fee charged by the federal government for collecting tax debts by offset.
- To pay for taxpayer locator services. Section 19.2 increases the dollar amount that may be used to pay for these services from a maximum of \$100,000 a year to a maximum of \$150,000 a year.
- To pay for postage or other delivery charges for correspondence relating to collecting overdue tax debts. Section 19.2 sets a dollar limit of \$353,000 a year on the amount that may be used to pay for postage and delivery charges.
- To pay operating expenses for Project Collection Tax and the Taxpayer Assistance Call Center.
- To pay the expenses of the Examination and Collection Division related to collecting overdue tax debts.

#### *Consolidate Tax Project Reports*

Section 19.3 of the act moves the statutory requirement that the Department of Revenue report on its efforts to collect tax debts and on its use of the proceeds of the collection assistance fee from G.S. 105-243.1 to G.S. 105-256. G.S. 105-256(a) contains a list of the reports the Department must provide. This section adds the report of its collection efforts to this list.

#### *Special Indebtedness Projects*

Section 23.12 of the act authorizes the issuance of special indebtedness to finance the capital facility costs, including construction or renovation, of the following projects and in the following amounts:

- North Carolina Museum of Art - \$40 million.
- Central Regional Psychiatric Hospital for the Department of Health and Human Services - \$20 million.
- A new Secondary State Data Center - \$24,841,300.
- A new Center City Classroom Building at the University of North Carolina-Charlotte - \$45,827,400.
- The Department of Health and Human Services Public Health Laboratory and Office of Chief Medical Examiner - \$101 million.
- The Eastern Regional Psychiatric Hospital for the Department of Health and Human Services - \$145 million. The indebtedness must be incurred over a period

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Section 37 of S.L. 2005-345 subsequently repealed this section, leaving the amount of the collection assistance fee at 20% of the amount of the overdue debt.

of time: no more than \$20 million may be incurred prior to July 1, 2007; and no more than \$100 million may be incurred prior to July 1, 2008.

- The Regional Medical Center and Mental Health Center of the Department of Correction - \$132,200,000. The indebtedness must be incurred over a period of time: no more than \$8.2 million may be incurred prior to July 1, 2007; no more than \$58.2 million may be incurred prior to July 1, 2008; and no more than \$98.2 million may be incurred prior to July 1, 2009.
- The Western Regional Psychiatric Hospital for the Department of Health and Human Services - \$162.8 million. However, no indebtedness may be incurred prior to July 1, 2008.

*Reduce Sales Tax Rate Early*

Section 24.1 of the act provides for an earlier reduction of the State sales tax rate from 4.5% to 4.25%, effective December 1, 2006. Prior to October 16, 2001, the general rate of State sales tax was 4%. Effective October 16, 2001, the general rate was raised to 4.5%. The general rate was set for reduction back to 4% on July 1, 2007. This section moved up the date of reduction of the State sales tax to 4.25% from July 1, 2007, to December 1, 2006. The remaining quarter-cent will expire as scheduled on July 1, 2007. The cost of the early sales tax reduction is estimated at \$140.1 million for 2006-07.

*Reduce Income Tax Rate Applicable to Most Small Businesses Early*

Section 24.2 of the act provides for an earlier reduction in the upper-income individual tax bracket rate than provided under previous law. The rate will be reduced from 8.25% to 8%, effective for taxable years beginning on or after January 1, 2007.<sup>22</sup> The rate will then be further reduced to 7.75% in 2008 as provided under previous law. In 2001, the General Assembly added a new tax bracket that imposed an additional one-half percent income tax (a total rate of 8.25%) on certain North Carolina taxable income for three years. In 2003 the General Assembly extended the rate to 2006<sup>23</sup> and in 2005 the General Assembly extended the rate until 2008.<sup>24</sup> The change was estimated to affect approximately 2% of North Carolina taxpayers. The anticipated impact of this change on General Fund revenues is a one-time reduction of \$28.6 million in non-recurring revenues in FY 2006-07.

Prior to 2001, tax was imposed at the following rates on individuals' North Carolina taxable income:

Tax Rate	Married filing jointly	Heads of household	Single filers	Married filing separately
6%	Up to \$21,250	Up to \$17,000	Up to \$12,750	Up to \$10,625
7%	Over \$21,250 and up to \$100,000	Over \$17,000 and up to \$80,000	Over \$12,750 and up to \$60,000	Over \$10,625 and up to \$50,000
7.75%	Over \$100,000	Over \$80,000	Over \$60,000	Over \$50,000

<sup>22</sup> The Governor's budget recommended a phase down of the upper income tax rate to 8% in 2006 and the elimination of this bracket in 2007.

<sup>23</sup> S.L. 2003-284, Section 39.1.

<sup>24</sup> S.L. 2005-276, Section 36.1.

The 2001 law created a fourth tax bracket for North Carolina taxable income as follows:

Tax Rate	Married filing jointly	Heads of household	Single filers	Married filing separately
8.25%	Over \$200,000	Over \$160,000	Over \$120,000	Over \$100,000

*Cap Variable Wholesale Component of Motor Fuels Tax Rate and Hold Highway Fund Harmless*

A motor fuel excise tax is imposed on all motor fuel sold, distributed, or used in the State. The rate of tax consists of a flat rate of 17.5¢ per gallon plus a variable wholesale component equal to the greater of 7% of the average wholesale price of motor fuel during a base six-month base period or 3.5¢ per gallon. The variable wholesale rate for the period of January 1, 2006, through June 30, 2006 was 12.4¢ per gallon, and the total rate was 29.9¢ per gallon. One-half cent per gallon of the excise tax is allocated to various environmental funds. Of the remaining excise tax revenue, 75% goes to the Highway Fund and 25% goes to the Highway Trust Fund.

Section 24.3 of the act caps the variable wholesale component of the motor fuel excise tax rate at its current rate of 12.4¢ per gallon for the period of July 1, 2006, through June 30, 2007. In addition, Section 2.2(g) of the act provides a reserve in the General Fund for the purpose of holding harmless the Highway Fund and the Highway Trust Fund in the event that the variable wholesale component of the excise tax would have exceeded 12.4¢ per gallon, if it were not capped.<sup>25</sup> If the calculated variable component of the motor fuel excise tax rate exceeds the cap, the State Treasurer is directed to transfer funds, on a monthly basis, from the reserve account to the Highway Fund and the Highway Trust Fund. The amount transferred is the difference between the amount of motor fuel excise tax revenue allocated to each of those funds for a month and the amount that would have been allocated to it if the variable wholesale component were not capped at 12.4¢ per gallon. The total amounts that may be transferred to the Highway Fund and the Highway Trust Fund are limited to \$17.6 million and \$5.7 million, respectively. Funds remaining in the Reserve for Motor Fuels Tax Ceiling on June 30, 2007 revert to the Savings Reserve Account within the General Fund on that date.

These two sections became effective July 1, 2006.

*Small Business Health Insurance Tax Credit*

Section 24.4 of the act creates a new tax credit for small businesses that provide health benefits to their eligible employees. A 'small business' is defined as a taxpayer that employs no more than 25 full-time employees. An 'eligible employee' is one that works a normal workweek of 30 or more hours. In order to be eligible for the credit, either (1) the business must pay at least 50% of the premiums for health insurance coverage that equals or exceeds the minimum provisions of the basic health care plan of coverage recommended by the Small Employer Carrier Committee, or (2) the employee has existing coverage under one or more of the following: Medicare; Medicaid; a government funded program; or a health insurance or benefit arrangement that provides benefits similar to or in excess of benefits provided under the basic health care plan.

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<sup>25</sup> The amount allocated to the environmental funds is not affected because that amount depends on the number of gallons sold.

The credit amount is equal to \$250 per employee whose total wages or salary received from the business does not exceed \$40,000 annually, not to exceed the taxpayer's cost of providing the health insurance benefit. The taxpayer may use the credit against either its income tax or its franchise tax liability. The credit may not exceed 50% of the taxpayer's tax liability. Any unused portions of the credit may be carried forward for five years. The credit is effective for taxable years beginning on or after January 1, 2007, and it expires for taxable years beginning on or after January 1, 2009.

Under the Internal Revenue Code, an employer may deduct premiums paid for health insurance cost of its employees as a business expense. This credit would be in addition to any expense deduction the taxpayer claimed on its income tax return for health insurance costs.

#### *Expand Definition of Development Zone*

Section 24.5 of the act expands the definition of a development zone to include an economic development and training district. Location in a development zone leads to more favorable treatment for the taxpayer under the Bill Lee Act with respect to the wage standard, the credit for creating new jobs, the credit for investing in machinery and equipment, and the credit for worker training and could result in extending the availability of the credits if certain other criteria are met with respect to a project. The effective date of this change is retroactive for taxable years beginning on or after January 1, 2004.

The General Assembly provided for the creation of economic development and training districts in 2003.<sup>26</sup> An economic development and training district may be created for the purpose of providing a skills training center to prepare county residents to perform manufacturing, research and development, and related service and support jobs in the pharmaceutical, biotech, life science, chemical, telecommunications, and electronics industries. A county may levy property taxes within a district, in addition to those levied throughout the county, in order to finance the skills training center. A municipality cannot annex property within a district. The 2003 legislation provided that if the Board of Commissioners of Johnston County elected to establish an economic development and training district, then the district as initially established would consist of certain described real property owned by Bayer Corporation, Novo Nordisk Pharmaceutical Industries, Inc., Fresenius Kabi Clayton, L.P., and the Johnston County Airport Authority. The Johnston County commissioners created such a district.

The companies expanding in that economic development and training district understood they would be eligible for the Bill Lee tax credits applicable to a development zone. In retrospect, the property included in the district did not meet the requirements of a development zone. This act expands the definition of a development zone to include this property.

#### *Extend Sunsets on Sales and Use Tax Refunds for Aviation Fuel*

Section 24.6 of the act extends the sunset for refunds of the State sales and use tax on fuel used by interstate passenger air carriers and on aviation fuel used by a professional motorsports racing team or a motorsports sanctioning body from January 1, 2007, to January 1, 2009. This section became effective when the Governor signed it into law on July 10,

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<sup>26</sup> S.L. 2003-418.

2006. The extension of the sunset is expected to reduce General Fund revenues by \$90,000 in fiscal year 2006-2007.

In 2005, the General Assembly added a new refund allowable to interstate passenger air carriers for the net amount of sales and use tax paid by them on fuel during a calendar year in excess of \$2,500,000. That same year, the General Assembly enacted a refund for motorsports racing teams and motorsports sanctioning bodies of the sales and use tax paid by them on aviation fuel used to travel to/from a motorsports event in this State, to travel to a motorsports event in another state from a location in this State, or to travel to this State from a motorsports event in another state. Those refunds became effective on January 1, 2005, and applied to purchases made on or after that date; they were scheduled to expire for purchases made on or after January 1, 2007. Section 24.6 of the act extends the date of expiration to January 1, 2009.

#### *Ethyl Alcohol Tax Credit*

Although the title of this section refers to ethyl alcohol, the credit itself applies to either ethyl alcohol or biodiesel. In 2004, the General Assembly created a credit for constructing renewable fuel production facilities. The credit is equal to 25% of the costs of constructing the facility. The credit may be claimed against income tax or franchise tax, is limited to 50% of the amount of tax liability against which it is claimed, and has a carryforward period of five years. That credit was set to sunset for taxable years beginning on or after January 1, 2008.

Section 24.7 of the act does two things. First, it extends the sunset on the credit for constructing renewable fuel production facilities and a related credit for constructing a renewable fuel dispensing facility until 2011. Second, it creates an enhanced credit if the taxpayer invests at least \$400 million in three separate facilities over a five-year period. As with the current credit, the enhanced credit cannot exceed 50% of the amount of tax liability. Unlike the current credit, the enhanced credit may be claimed only against the income tax, but has a carryforward period of 10 years. A taxpayer may not claim both credits with respect to the same facility.

#### *Tax Credit for Biodiesel Producer*

Section 24.8 of the act provides for a tax credit for certain biodiesel providers. In order to qualify for the credit, the provider must be a producer of biodiesel<sup>27</sup> (as opposed to an importer) that produces at least 100,000 gallons of biodiesel during the taxable year. The amount of the credit is equal to the per gallon excise tax (currently 29.9 cents per gallon) paid by the producer on the biodiesel. The credit may be claimed against income tax or franchise tax, is limited to 50% of the amount of tax liability against which it is claimed, and has a carryforward period of five years. The credit is repealed for taxable years beginning on or after January 1, 2010.

#### *Research and Development Sales Tax Changes*

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<sup>27</sup> For the purposes of this provision, biodiesel is liquid fuel derived in whole from agricultural products, animal fats, or wastes of agricultural products or animal fats. This differs from the definition of biodiesel for motor fuels excise tax purposes in that for motor fuel excise tax purposes the fuel may be derived in part from one of those substances.

Mill machinery is taxed at a 1% rate with an \$80 cap per article.<sup>28</sup> Research and development equipment is subject to the 7% State and local sales tax rate. Section 24.9 of this act, as amended by Section 12 of S.L. 2006-196, exempts research and development equipment from State and local sales and use tax and imposes a 1% privilege tax with an \$80 cap, thus affording this type of equipment the same tax treatment as mill machinery. In order to qualify, the equipment must meet all of the following requirements:

- Purchased by a research and development company in the physical, engineering, and life sciences that is included in industry 54171 of NAICS.<sup>29</sup>
- Capitalized by the taxpayer for tax purposes under the Code.
- Used by the taxpayer in the research and development of tangible personal property.
- Would be considered mill machinery if it were purchased by a manufacturing industry and is used in the research and development of tangible personal property manufactured by the industry.

This section becomes effective July 1, 2007.

#### *Sales and Use Tax Refund for Motorsports Racing Teams*

Section 24.10 of the act provides a sales and use tax refund for a professional motorsports racing team for purchases of professional motor racing vehicle component parts other than tires or accessories. The amount of the refund is equal to 50% of the sales and use tax paid. This section becomes effective July 1, 2007, and applies to purchases made on or after that date. A professional motorsports racing team is a racing team (1) operated for profit (2) that obtains the majority of its revenue from sponsorship of the racing team and prize money and (3) that competes in at least 66% of the races per season sponsored by a motorsports sanctioning body. In 2005, the General Assembly enacted a refund for motorsports racing teams<sup>30</sup> and motorsports sanctioning bodies of the sales and use tax paid by them on aviation fuel used to travel to or from a motorsports event in this State, to travel to a motorsports event in another state from a location in this State, or to travel to this State from a motorsports event in another state.

#### *Joint Filing Options*

Prior to this act, a married couple who filed a federal joint return was required to file a North Carolina joint return if each spouse was either a resident or had North Carolina income. If one spouse was a nonresident and had no North Carolina income, that spouse was not subject to North Carolina income tax and the other spouse was required to file a separate return. This requirement is based on the fact that North Carolina has no jurisdiction to tax a person who is not a resident and does not have income from North Carolina sources. However, this approach can be burdensome and complicated because the couple must recompute their income separately in order to file a North Carolina return.

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<sup>28</sup> Prior to January 1, 2006, mill machinery was subject to a 1% State sales tax with an \$80 cap per article. Last session, to comply with the uniform rate requirements of the Streamlined Sales and Use Tax Agreement, the General Assembly exempted mill machinery from the sales tax and began imposing a 1% privilege tax with an \$80 cap.

<sup>29</sup> 'NAICS' is the North American Industrial Classification System. It divides businesses into categories based on the primary activity that occurs at an establishment.

<sup>30</sup> Section 24.6 of this act inserts the defined term 'professional motorsports racing team' in the refund provisions for aviation fuel.

Section 24.11 of the act, which originated as a Revenue Laws recommendation<sup>31</sup> provides a married couple with the option of filing jointly if they file a federal joint return and if one spouse is a nonresident with no income from North Carolina. Because North Carolina does not have jurisdiction over the nonresident spouse, the act permits, but does not require, a joint return.<sup>32</sup> This option would also allow North Carolina residents to file jointly in Georgia and South Carolina. Currently, these two states do not allow nonresident joint filing for residents of states that do not allow joint filings for Georgia and South Carolina residents.

This provision is effective for taxable years beginning on or after January 1, 2006.

#### *Parental Savings Trust Fund Tax Deduction*

Section 24.12 of the act allows an individual taxpayer to deduct from the taxpayer's taxable income a maximum amount of \$750 contributed by the taxpayer to an account in the Parental Savings Trust Fund. A married couple filing jointly may deduct a maximum of \$1,500. To qualify for the deduction, the adjusted gross income of the individual taxpayer or married couple filing jointly must not exceed a specified amount.<sup>33</sup> The deduction is effective for taxable years beginning on or after January 1, 2006, and is repealed for taxable years beginning on or after January 1, 2011. For taxable years beginning on or after January 1, 2007, the deduction for an individual taxpayer is increased to a maximum of \$2,000 and the deduction for a married couple filing jointly is increased to a maximum of \$4,000.<sup>34</sup> The Parental Savings Trust Fund Tax deduction is repealed for taxable years beginning on or after January 1, 2011.

In 1996, the General Assembly established the Parental Savings Trust Fund. The Fund is maintained by the State Education Assistance Authority, a political subdivision of the State, and is administered by the College Foundation of North Carolina as agent of the Authority. The Fund was established to enable qualified parents to save funds to meet the costs of the postsecondary education expenses of eligible students. Anyone may contribute to the Fund. Because the Fund meets the qualifications of a qualified tuition program under Section 529 of the Internal Revenue Code, distributions from the Fund are excludable from taxable income to the extent the distributions are used to pay for qualified higher education expenses.<sup>35</sup> Interest earned on the Fund is also tax exempt. Currently every state offers a state Section 529 plan, and twenty-five states allow for a full or partial income tax deduction for contributions to the state's own plan.

The Parental Savings Trust Fund deduction allowed by Section 24.12 of this act must be added back to taxable income if the amount withdrawn from the Fund was not used to pay

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<sup>31</sup> Senate Bill 1552, 2006 Regular Session of the 2005 General Assembly.

<sup>32</sup> A New York court found that a provision, which required married nonresidents to file a joint nonresident tax return in New York if they filed a joint federal return, was unconstitutional. The court explained that the provision exposed a nonresident spouse with no New York connections to civil and criminal liability in New York by virtue of that spouse's signature on the State tax return.

<sup>33</sup> The deduction from taxable income is allowed for taxpayers with adjusted gross income below the following amounts: \$60,000 for a single taxpayer, \$100,000 for married, filing jointly, \$80,000 for head of household, or \$50,000 for married, filing separately.

<sup>34</sup> Section 27 of S.L. 2006-198.

<sup>35</sup> Qualified higher education expenses are: (1) tuition fees, books, supplies, equipment required for the enrollment or attendance of a beneficiary at an eligible educational institution, and expenses for special needs services; and (2) room and board costs.



for qualified higher education expenses of the designated beneficiary. An exception is made if the withdrawal was made due to the death or permanent disability of the beneficiary.

The Parental Savings Trust Fund deduction is estimated to reduce General Fund revenues by \$1 million in fiscal year 2006-2007, and \$1.6 million in fiscal year 2007-2008.

#### *Sales Tax on Railroad Cars*

Section 24.13(a) of the act provides that when a lease or rental agreement requires periodic payments for a railway car that is leased by a utility company and the railway car would be considered transportation equipment if it were in interstate commerce, the periodic payments are sourced according to the following general sourcing principles set out in G.S. 105-164.4B(a) for sales tax purposes:

- When a purchaser receives the product at the business location of the seller, the sale is sourced to that business location.
- When the product is delivered to an address specified by the purchaser, the sale is sourced to the location where the purchaser received the product.
- When the delivery address is unknown, the sale is sourced to the first address or location listed below that is known to the seller:
  - The business or home address of the purchaser.
  - The billing address of the purchaser.
  - The address from which tangible personal property was shipped.

Section 24.13(a) became effective July 1, 2006, and applies to lease or rental payments made on or after that date.

Section 24.13.(b) of the act provides utility companies with the same refund for a portion of sales and uses taxes paid on purchases of railway cars and accessories that is currently available to interstate carriers for those same purchases.<sup>36</sup> The formula for calculating the refund is based on the number of miles that the applicant operated the railway cars in the State as compared to the total miles, both inside and outside the State, multiplied by the purchase price. The product is then multiplied by the tax rate that would have applied if all of the items had been purchased in this State. The formula for calculating the refund and the procedures for claiming the refund are identical to the formula and procedures set out for interstate carriers in the current law. Section 24.13(b) became effective July 1, 2006, and applies to purchases made on or after that date.

Section 24.13 is estimated to reduce General Fund revenue by \$370,000 in fiscal year 2006-2007.

During the 2005 Session, the General Assembly increased the sales and use tax rate of railway cars and locomotives from a 3% rate, with a cap of \$1,500 per item, to the 7% general rate in order to comply with the Streamlined Sales Tax Agreement. At the same time the General Assembly authorized interstate carriers to receive a refund of a portion of the sales and use taxes paid on purchases of railway cars and locomotives, as well as fuel, lubricants, repair parts, and accessories for these vehicles. Prior to Section 24.13 of this act,

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<sup>36</sup> G.S. 105-164.14 defines an 'interstate carrier' as a person who is engaged in transporting persons or property in interstate commerce for compensation.

utility companies were not considered interstate carriers for purposes of this refund, even though utility companies often purchase railway cars to transport coal used to generate electricity.

#### *Wage Standards – Certain Manufacturers*

Section 24.14 of the act alters the definition of 'location' with respect to certain manufacturers for the purpose of meeting the wage standard under the Bill Lee Act. This change is effective retroactively for taxable years beginning on or after January 1, 1996.

A taxpayer is eligible for a credit under the Bill Lee Act only if the jobs provided by the taxpayer meet a wage standard.<sup>37</sup> For the credit for job creation, the average weekly wage of the jobs for which the credit is claimed and the average weekly wage of all jobs at the location with respect to which the credit is claimed must meet the relevant wage standard. For the other credits, the average weekly wage of all jobs at the location with respect to which the credit is claimed must meet the relevant wage standard. The term 'location' is not defined in the statute, but the Department of Revenue has interpreted 'location' to be synonymous with 'establishment' for the purpose of applying the wage standard.

This section modifies the definition of 'location' with respect to certain manufacturers. For a fiber, yarn, or thread mill that uses a sequential manufacturing process, the term could mean either a single facility or all facilities located within a single county that were part of the sequential manufacturing process. At least one taxpayer that qualifies as a fiber, yarn, or thread mill that uses a sequential process would become eligible for credits under the Bill Lee Act based on this change. American & Efir, located in Gaston County, undertook activities for which it would have been eligible for credits during the 1996 tax year if it had met the wage standard. The company failed to satisfy the wage standard at each individual facility, but would have satisfied the standard if all the facilities were treated as one location. There are no other known taxpayers that will benefit from this change.

#### *Real Property Tax Donation Credit*

In 2001, the General Assembly moved to conform North Carolina law to federal law regarding a partnership's eligibility for certain tax credits. Now, North Carolina law states that a dollar amount limitation on a tax credit applies to a partnership as a whole as well as to each individual partner. When this change was made, the General Assembly voted to delay its imposition of the dollar amount limitation on the credit allowed for real property donations. The credit for real property donations is allowed when a person makes a qualified donation of an interest in real property that is useful for public beach access, public access to public waters or trails, fish and wildlife conservation, or other similar land conservation purposes. The credit is equal to 25% of the fair market value of the donated property interest. To be eligible for the credit, the interest in property must be donated to and accepted by the State, a local government, or a body that is both organized to receive and administer lands for conservation purposes and qualified to receive charitable contributions under the Internal Revenue Code. The credit amount may not exceed \$250,000. Originally, that delay was set to expire in 2005. In 2004, the time period for that delay was extended by one year. Section 24.15 of the act extends that delay another year until 2007. This act also

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<sup>37</sup> Legislation in 2002 eliminated the wage standard in enterprise tier one and two areas. Because the wage standard for a business located in a development zone is the same as for tier one counties, that legislation also eliminated the wage standard for a development zone area.

directs the Revenue Laws Study Committee to study this issue before the 2007 General Assembly.

#### *Agrarian Growth Zones – Bill Lee*

Section 24.16 of the act authorizes the creation of agrarian growth (AG) zones and provides for favorable treatment of the zones under the Bill Lee Act. This section is effective for taxable years beginning on or after January 1, 2006, and applies to business activities occurring on or after that date.

An AG zone must satisfy the following conditions: it must be composed of contiguous census tracts or block groups located within a single county that does not have any municipality with a population in excess of 10,000; each census tract or block group in the zone must have more than 20% of its population below the poverty level; the area of the zone, less its smallest census tract, may not exceed 5% of the total area of the county. The Department of Commerce must designate an area as an AG zone upon the request of a local government.

For the most part, the benefits of an AG zone are the same as the benefits of a development zone. For activities that are performed in an AG zone, the taxpayer does not have to meet the wage standard requirement, receives an additional credit of \$4,000 per job created, and is treated as an enterprise tier one area for purposes of the credit for investing in machinery and equipment and the credit for worker training. There are several provisions of the Bill Lee Act which refer to development zones that were put into place for specific projects; those provisions are not repeated for AG zones.<sup>38</sup>

#### *Internet Data Center Facilities – Tax Exemption*

Section 24.17 of the act provides an exemption from the sales and use tax on sales of tangible personal property and electricity to an eligible Internet data center. The section is effective for sales made on or after October 1, 2006.<sup>39</sup>

Generally, sales of tangible personal property are taxed at a State rate of 4.5% and the applicable county rate (generally 2.5%, but 3.0% in Mecklenburg County). Sales of electricity are taxed at rates varying from 0.17% to 3.0% depending on the purchaser of the electricity. Sales of electricity to an Internet data center would be taxed at 3.0%.

This section allows for an exemption from the sales and use tax for sales of electricity and eligible business property to an eligible Internet data center. For the purposes of this exemption, 'eligible business property' is property that is capitalized for tax purposes under the Internal Revenue Code and is used for one or more of the following:

- The provision of Internet service or Web search portal services, including equipment cooling systems for managing the performance of the property.
- The generation, transformation, transmission, distribution, or management of electricity.

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<sup>38</sup> AG zones are included in the replacement of the Bill Lee Act but the incentives offered under it differ from the incentives available under the current Bill Lee Act. The replacement of the Bill Lee Act becomes effective for taxable years beginning on or after January 1, 2007. See the summary of S.L. 2006-252 for an explanation of how AG zones will be treated under the new law.

<sup>39</sup> S.L. 2006-168 made technical changes to this section of the act.

- To support related computer engineering or computer science research.

In order to qualify as an eligible Internet data center, a facility must satisfy each of the following conditions:

- The facility is used primarily by a business engaged in Internet service providers and Web search portals industry 51811 as defined by NAICS.<sup>40</sup> Under NAICS, establishments in this industry provide clients access to the Internet or operate Web sites that use a search engine to provide Internet search services. These establishments generally provide related services such as Web hosting, Web page design, and additional Internet services such as email, connections to other Web sites, auctions, news, and other limited content.
- The facility is comprised of a structure or series of structures on a single parcel of land or on contiguous parcels of land owned by the operator of the facility.
- The facility is located in an enterprise tier one, two, or three area at the time of the application for the required determination by the Department of Commerce.<sup>41</sup>
- The Department of Commerce has made a written determination that at least \$250 million in private funds has been or will be invested in real property, eligible business property, or both at the facility within five years after the commencement of construction of the facility.

A taxpayer that fails to make the level of investment required for qualification forfeits the exemption and is required to repay all taxes, with interest, avoided as a result of the forfeited exemption. Similarly, a taxpayer that does satisfy the investment amount, but fails to use the property or electricity at the eligible facility forfeits the exemption with respect to that particular property or electricity. The past taxes and interest are due 30 days after the date of the forfeiture.

#### *Oyster Shell Tax Credit*

Currently, there is a voluntary oyster shell donation program operated by the Division of Marine Fisheries of the Department of Environment and Natural Resources. The Division of Marine Fisheries purchases oyster shells in very large quantities from shucking houses at a negotiated price of 50¢ per bushel. Recycled oyster shells offer the following value: (1) their placement in sanctuaries and/or estuaries aid in the restoration of oyster populations; (2) landscaping purposes; and (3) nutritional supplements. Beginning October 1, 2009, oyster shells may not be disposed in landfills.

Section 24.18 of the act provides for a nonrefundable income tax credit of one dollar for each bushel<sup>42</sup> of oyster shells that a taxpayer donates to the Division of Marine Fisheries of the Department of Environment and Natural Resources. To be eligible for the credit, the

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<sup>40</sup> NAICS is the North American Industrial Classification System and divides businesses into categories based on the primary activity that occurs at an establishment.

<sup>41</sup> Effective January 1, 2007, S.L. 2006-252 changes the references to enterprise tiers one, two, or three areas to development tier one and two areas.

<sup>42</sup> The Division of Marine Fisheries has determined that the average weight of a bushel of oyster shells is 55 pounds. The net weight of a load of shells is divided by 55, which provides the number of bushels contained in the load.

taxpayer must provide the Department of Revenue with documentation, supplied by the Division of Marine Fisheries, verifying the donation and the number of bushels donated. The credit may be carried forward for five years. The taxpayer may not claim a deduction for any oyster shells for which a credit is claimed.

#### *Reduce Sales Tax on Electricity Sold to Manufacturers*

Effective for sales made on or after July 1, 2007, Section 24.19 of the act replaces the current sales tax rate of 2.83% on sales of electricity to manufacturing industries and manufacturing plants for use in connection with their operation, with a sales tax rate of 2.6%. As under current law, the reduced rate will be applied to the sales price of electricity that is measured by a separate meter or another separate device.

Under current law, the following sales of electricity are subject to a sales and use tax rate of 2.83%:

- Sales to farmers to be used for any farm purposes other than preparing food, heating dwellings, and other household purposes.
- Sales to manufacturing industries and manufacturing plants for use in connection with their operation.
- Sales to commercial laundries or to pressing and dry-cleaning establishments for use in machinery used in the direct performance of their service.

Sales of electricity to an aluminum smelting facility are taxed at the rate of 1%, but this rate expires for sales made on or after October 1, 2007.

#### *No Sales Tax Refund for Alcohol Purchases*

Section 24A.1 of the act disallows sales and use tax refunds for purchases of alcoholic beverages, effective July 1, 2006. The impact on General Fund revenues is expected to be negligible. North Carolina has authorized certain sales and use tax refunds if qualifying requirements are met. These refunds are codified in G.S. 105-164.14. This section of the act removes purchases of alcoholic beverages from those purchases that qualify for a refund. An alcoholic beverage is one that contains at least one-half of 1% alcohol by volume, including malt beverages, unfortified wine, fortified wine, spirituous liquor, and mixed beverages.

#### *Franchise Tax Loophole Closing*

Section 24A.2 of the act adds language to the revenue statutes to close another franchise tax loophole.<sup>43</sup> Subsection (a) of Section 24A.2 amends the definition of 'corporation', as it applies to the franchise tax statutes, to include a limited liability company<sup>44</sup> (LLC) that elects to be taxed as a C Corporation for federal income tax purposes. The effect of this change is that the corporate franchise tax will apply to these LLCs.<sup>45</sup> Subsection (b) makes conforming

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<sup>43</sup> The North Carolina franchise tax is among the oldest taxes in North Carolina. It is a tax on S Corporations and C Corporations for the privilege of doing business in the State. The tax rate is \$1.50 per \$1,000 of value of the greatest of (1) apportioned net book value of the corporation; (2) 55% of appraised value of real and tangible personal property in the State; or (3) total actual investment in tangible property in the State.

<sup>44</sup> A limited liability company is a business entity that is essentially a hybrid of a partnership and a corporation. Like a corporation, an LLC limits the liability of its owners. Like a partnership, an LLC is usually not subject to entity-level taxation.

<sup>45</sup> Section 9 of S.L. 2006-196 makes a conforming change to the definition of 'holding company' to recognize that LLCs do not have voting stock but capital interests. Prior to this change, a holding company was defined

changes to the LLC statute, G.S. 105-114.1, to provide that LLCs that do not elect to be taxed as a C Corporation will be considered 'noncorporate LLCs' and will be subject to the attribution rules in this statute for franchise tax purposes. Subsection (c) provides LLCs that elect to be taxed as a C Corporation a nonrefundable credit for the difference between the annual report fee for corporations, which is \$20, and the annual report fee for LLCs, which is \$200.

The above changes were a recommendation of the Revenue Laws Study Committee and originated as the result of at least one request for a private ruling from a major accounting firm. Based on this request, the Department of Revenue identified another scenario that could result in a corporation's avoidance of paying franchise tax. This scenario would involve a corporation headquartered in North Carolina, but whose parent company is domiciled outside the State. In addition, the parent's only contact with North Carolina is its ownership of the corporation. This corporation, which already files as a C Corporation for federal tax purposes, could convert to an LLC but make an election to continue being taxed as a C Corporation and avoid franchise tax because the parent has no nexus with this State and thus the 'constructive ownership' attribution rules do not apply.<sup>46</sup>

Previous law provided that an LLC could be disregarded and treated as a division of its parent. The parent company was then considered to own property in this State and therefore had nexus, making it subject to income and franchise tax. The constructive ownership rules, therefore, applied for attributing the LLC's assets to the parent's franchise tax calculation. However, when an LLC elects to be taxed as a C Corporation, nexus is not conferred on the parent, and the attributes of the LLC do not flow to the parent. Prior to this act, companies operating in this State as C Corporations could convert to an LLC, make an election to file as a C Corporation, as they always have, and eliminate their North Carolina franchise tax obligations.

This section is effective for taxable years beginning on or after January 1, 2007. The fiscal impact cannot be determined.

#### *Expansion of Royalty Reporting Option*

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as a corporation that receives during its taxable year more than 80% of its gross income from corporations in which it owns more than 50% of the outstanding stock. Section 9 adds language to the definition to include a corporation that receives more than 50% of the outstanding voting capital interests, since the holding company cap was intended to apply to LLCs that elect to be treated as C Corporations.

<sup>46</sup> Under current law, the franchise tax extends to all LLC assets that a corporation controls through trusts and other entities, with some limitation. Specifically, a corporation (or an affiliated group of corporations) must own more than 50% of the capital interest in an LLC for the attribution rules to apply, and LLCs whose assets do not exceed \$150,000 are exempt. The concept of control is determined by tracing ownership of the capital interests in the LLCs assets. A capital interest is the right to receive some or all of the assets under the LLC's governing law if the LLC was dissolved. Ownership of the capital interests in an LLC is traced, using the principles of constructive ownership, through any noncorporate entities. The chain of constructive ownership can run through layers of noncorporate entities but not through individuals. The franchise tax is payable by corporation or affiliated group of corporations to which ownership of the capital interests is traced. Ownership of capital interests in an LLC is determined as of the last day of the LLC's tax year. If an LLC and a corporation engage in a pattern of trading assets back and forth so that neither owns them on the respective trigger date, the Secretary may require the determination to be made as of the last day of the corporation's tax year. If the capital interests in an LLC are owned by an affiliated group of corporations, the value of the assets is allocated among the members of the group for franchise tax purposes so that there will not be double taxation of any assets. The allocation is in proportion to each affiliate's ownership interest.

In 2001, the General Assembly enacted G.S. 105-130.7A to enhance corporate compliance with taxes on trademark income. This statute did not change what was already considered taxable but merely enhanced compliance with the State tax on income generated from using trademarks and added a reporting option to the income tax statute. Specifically, G.S. 105-130.7A restates that a company's receipts from royalty payments for the use of trademarks in North Carolina are income from doing business in North Carolina. It provides adjustments to assure full and fair accountability of this income in relationship to where it is actually earned. In cases where the recipient of the North Carolina royalty income is unrelated to the payer, the recipient is required to pay tax on the income to North Carolina. In cases where the recipient and the payer are related, they have an option on how the income is reported to North Carolina. Either the payer can deduct the North Carolina royalty payments on its North Carolina return and the recipient can include them on its North Carolina return, or the payer can add them to its North Carolina income and the recipient can deduct them on its North Carolina return.

This provision solved the problem as it relates to trademarks and trade names, but it did not address other types of intellectual property, such as patents<sup>47</sup> and copyrights.<sup>48</sup> Section 24A.3 of the act expands the royalty payment reporting option for corporations and their related members to include payments received for use of patents and copyrights. As with the changes that occurred in 2001, this provision does not subject any income to tax that was not already taxable, it gives taxpayers an option of how to pay the tax. This provision is effective for taxable years beginning on or after January 1, 2006.

## Franchise Tax Base Calculation.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-95	SB 1283	Senator Hartsell

### **AN ACT TO CLARIFY THE TREATMENT OF DEFERRED TAX ASSETS IN THE COMPUTATION OF THE FRANCHISE TAX CAPITAL BASE AND TO INCREASE THE ADMINISTRATIVE EFFICIENCY OF THE UNIVERSITY OF NORTH CAROLINA BY EXEMPTING IT FROM LAWS GOVERNING CONSULTANT SERVICES, ALLOWING THE BOARD OF GOVERNORS TO DELEGATE MORE AUTHORITY TO THE PRESIDENT OF THE UNIVERSITY OF NORTH CAROLINA, AND CHANGING ITS REPORTING DATES.**

**OVERVIEW:** This act seeks to clarify the treatment of deferred tax assets in the computation of the franchise tax capital base. It also increases the efficiency of The

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<sup>47</sup>A patent for an invention is the grant of a property right to the inventor that gives the inventor the right to exclude others from making, using, offering for sale, selling or importing the invention for a specified period of time.

<sup>48</sup> Copyright is a form of protection provided under federal law to the authors of original works of authorship, including literary, dramatic, musical, artistic, and certain other intellectual works, both published and unpublished.

University of North Carolina by exempting it from laws relating to consultant services and allowing the Board of Governors to delegate more authority to the President of The University of North Carolina.

**FISCAL IMPACT:** Discussions with the Department of Revenue indicate that the impact of this act will be minimal.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** This act became effective when signed into law by the Governor on July 10, 2006. The portions of this act relating to the franchise are effective for taxable years beginning on or after January 1, 2007.

**ANALYSIS:** The act clarifies the franchise tax base calculation, based upon a recommendation of the Revenue Laws Study Committee. The act also seeks to increase the administrative efficiency of The University of North Carolina, at the request of the University system.

#### *Franchise Tax Base Calculation*

A corporation's determination of its capital base for purposes of the franchise tax is not the same as the calculation of its capital base for financial reporting purposes. Most public corporations compute their capital base for financial reporting purposes. Public corporations must comply with the requirements of the Financial Accounting Standards Board (FASB) when reporting the results of their operations and financial positions. Under FASB, corporations are required to accrue certain liabilities and the related deferred tax assets<sup>49</sup> which are applicable to those accrued liabilities in order to accurately reflect the financial position of the corporation.

The calculation of a corporation's capital base for franchise tax purposes is determined by G.S. 105-122(b), not by the requirements of FASB. The statute refers to book value as 'issued and outstanding capital stock, surplus, and undivided profits'<sup>50</sup> This is similar to net book value, which is used in computing the capital base under FASB, with certain adjustments. The principal adjustment is for contingent or deferred liabilities.

Under FASB, deferred tax liabilities are recognized as liabilities for accounting purposes. However, deferred liabilities are not recognized for franchise tax purposes because they are not 'definite and accrued'. Therefore, deferred tax liabilities must be added back to a corporation's capital base for franchise tax purposes.

Frequently, a taxpayer that has a deferred liability will also have a deferred tax asset. The issue is whether the deferred liability that must be added-back can be reduced by the amount of the deferred tax asset. In 1996, the Department of Revenue issued a TAM (technical advice memorandum) that permitted the netting of deferred liability accounts and deferred

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<sup>49</sup> Deferred tax assets and deferred tax liabilities are accounts carried on the books of a corporation for financial reporting purposes. They represent timing differences in the recognition of income and deductions for income tax purposes and for financial accounting purposes. Deferred tax liability typically arises where income has been recognized on the corporation's books but not for tax purposes. For example, where a gain is reflected on the books but reported for tax purposes on the installment basis.

<sup>50</sup> In addition, for franchise tax purposes, the corporation's capital base may not be less than 55% of the appraised value of all the real and tangible personal property owned by the corporation in the State nor less than its total actual investment in tangible property in the State.



tax asset accounts. The TAM provided that the deferred tax asset account had to be clearly identified with the deferred tax liability account and the deferred tax asset could not reduce the related deferred liability below zero.

The statute, the 1996 TAM, and generally accepted accounting principles differ on how to account for deferred tax assets as follows:

- The franchise tax statute began the calculation of a corporation's franchise tax capital base with the 'total amount of its issued stock, surplus, and undivided profit'. The statute provided that "no reservation or allocation from surplus or undivided profits shall be allowed other than for definite and accrued legal liabilities, except as herein provided: taxes accrued, dividends declared and reserves for depreciation of tangible assets as permitted for income tax purposes shall be treated as deductible liabilities."
- In 1992, FASB Statement No. 109 established financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. The statement resulted in deferred tax assets being separately stated from deferred tax liabilities. When the two accounts were netted, a smaller net tax liability account was added back to the franchise tax base. When the accounts had to be separately stated, the Department did not permit the netting of the two accounts. This resulted in the add-back of the deferred tax liability unreduced by the amount of the deferred tax asset.
- Taxpayers having deferred tax asset accounts contended that they should be allowed to reduce their capital stock bases by the balances in those accounts. Since the asset and liability accounts are reciprocal concepts, they argued that it was inequitable to include a deferred tax liability in the capital stock base without decreasing it by the deferred tax asset.
- The TAM appears to contradict the plain meaning of the statute because it permits the deferred liability accounts to be reduced by deferred tax asset accounts.<sup>51</sup> In explaining the change, the TAM states that a more equitable and consistent position is to recognize that net worth is incorrectly stated when the total amount of a deferred liability is included without a netting adjustment for the deferred tax benefit resulting directly from such liability. The TAM provides that the inclusion of a deferred liability in the computation of the net worth base should permit an offset or adjustment for the deferred tax asset required to be computed under the accounting standards without regard to how the deferred tax asset is reflected on the financial statement.

The FASB change in 1992 concerned the accounting for income taxes. Arguably, the TAM written in 1996 attempted to address the accounting changes precipitated by that FASB change. The wording of the TAM, however, refers to deferred liabilities as a whole instead of just deferred tax liabilities. Any deferred liability may create a corresponding deferred tax asset. Taxpayers contend that the TAM permits them to reduce the amount of any deferred liability required to be added back to its net book value for franchise tax purposes by the amount of a deferred tax asset. Examples of the types of contingent and deferred liabilities

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<sup>51</sup> In response to taxpayer concerns, the Department of Revenue issued TAM-CF-96-1 in August of 1996. The TAM became effective for tax years ending on or after July 1, 1996.

that have been reduced include post retirement benefits, loan loss reserves, credit card reserves, and litigation reserves.

This act changes the law to allow deferred tax liabilities to be reduced by their corresponding deferred tax assets. This clarification adopts the policy of the Department of Revenue set out in the TAM in 1996.

*Increase Administrative Efficiency of The University of North Carolina*

The changes in this part of the act do the following:

- Exempt The University of North Carolina from the statutes governing contracts for consultant services. The Board of Governors will now be required to establish its own rules governing these contracts.
- Allow the Board of Governors to delegate more authority to the President of The University of North Carolina.
- Change the reporting date of several studies that must be submitted to the Joint Legislative Oversight Committee from March 1 to December 1.

**Delinquent Property Tax/Inventory/Study.**

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-106	SB 1451	Senator Hartsell

**AN ACT TO ENFORCE COLLECTION OF PROPERTY TAXES ON REAL PROPERTY AGAINST THE RECORD OWNER AS OF THE DATE THE TAXES BECOME DELINQUENT, TO CODIFY THE PRORATION OF TAXES ON REAL PROPERTY, TO REQUIRE A TAX COLLECTOR TO TAKE REASONABLE ADDITIONAL STEPS TO NOTIFY A PROPERTY OWNER OF A TAX SALE UNLESS THE TAX COLLECTOR HAS AFFIRMATIVE KNOWLEDGE THAT THE MAILED NOTICE REACHED THE RECIPIENT, TO AMEND THE DEFINITION OF INVENTORIES TO INCLUDE DISPLAY MODULAR HOMES, AND TO STUDY THE VALUATION OF PROPERTY AT ITS PRESENT-USE VALUE FOR PROPERTY TAX PURPOSES.**

**OVERVIEW:** This act, part of which was a recommendation of the Revenue Laws Study Committee, makes several changes to the property tax laws to facilitate the collection of delinquent property taxes, to provide a standard for prorating property taxes in real estate closings, and to clarify that certain modular homes qualify as inventory and are, therefore, not subject to tax as real estate. In addition, this act directs the Revenue Laws Study Committee to study issues related to the present-use value property tax system.

**FISCAL IMPACT:** The act is expected to have minimal to no impact on local revenues and no impact on State revenues.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** In general, this act is effective for taxes imposed for taxable years beginning on or after July 1, 2006, except that Section 7 of this act is effective for contracts entered into on or after October 1, 2006, and Section 9 of this act became effective when signed into law by the Governor on July 12, 2006.

**ANALYSIS:** Under North Carolina property tax laws, January 1 is the applicable date for each of the following events: determination of the value of real property for tax purposes, listing of the property in the name of the owner on that date, and attachment of a tax lien to the real property.

The owner of property as of January 1 generally receives a property tax bill in July or August for property taxes due on the property for the fiscal year that runs from July 1 of the year the property is required to be listed to the following June 30. Taxes become due and payable on September 1, and are payable at face amount if paid before January 6 following the due date. Taxes are delinquent if paid on or after January 6 following the due date and are subject to interest charges.<sup>52</sup> For example, if a taxpayer lists his or her property on January 1, 2006, then taxes on the property become due on September 1, 2006, for the fiscal year beginning July 1, 2006, and ending June 30, 2007. Taxes on the property are delinquent beginning January 6, 2007.<sup>53</sup>

In February of each year, the tax collector must report to the governing body the total amount of unpaid taxes for the current fiscal year that are liens on real property. After the governing body orders the tax collector to advertise tax liens, the tax collector must send a notice to the record owner of each affected parcel as determined as of December 31 of the fiscal year for which taxes are due. If the property was transferred during the one-year period beginning on the listing date preceding the fiscal year in which the taxes become due, then the notice of tax lien on the property must be sent to each listing owner and to each record owner of the parcel as determined as of December 31 of the fiscal year for which taxes are due. The notice must inform the owners that their names will appear in a newspaper advertisement of delinquent taxes if the taxes are not paid before the publication date. If the listing owner transferred the property after the listing date, the advertisement will state the record owner's name followed by a notation that the property was transferred to the record owner and a notation of the name of the listing owner.

In addition to the remedy of foreclosing on the real property, the taxing unit may also attach and garnish the wages and other compensation, rents, bank deposits, and other intangible personal property of the listing owner of the property. Attachment and garnishment may only be enforced against the listing owner because the pertinent statutes provide that the remedy may be enforced against the taxpayer. Taxpayer is defined in G.S. 105-273(17) as the person whose property is subject to property tax by a county or municipality and any person who has a duty to list property for taxation.

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<sup>52</sup> For the period January 6 to February 1, interest rate accrues at 2%. For the period February 1 until the date the principal amount of taxes, the accrued interest, and any penalties are paid, interest accrues at the rate of  $\frac{3}{4}\%$  a month or fraction thereof.

<sup>53</sup> When real property is acquired after January 1, but prior to July 1, and the property was not subject to taxation on January 1 on account of its exempt status, it is listed for tax by the transferee as of the date of acquisition and is appraised at its true value as of January 1 preceding the date of acquisition. The property is taxed for the fiscal year of the taxing unit beginning on July 1 of the year in which it is acquired.

Section 1 of the act amends the definition of 'taxpayer' in the property tax laws so that for purposes of collecting delinquent property taxes assessed on real property, the remedies against personal property may be enforced only against the record owner of the real property on the date the taxes become delinquent and against any subsequent record owner of the real property if conveyed after the delinquent date. This change means that the tax collector would have the authority to garnish the wages, bank account, or other intangible property of the owner of the property at the time the taxes on that property become delinquent and any subsequent record owner instead of the listing owner of the property.

Section 2 of the act provides that the notice of the tax lien be sent to the record owner of the real property as of the date the taxes became delinquent instead of the listing owner. The advertisement of the tax lien would not set out the name of the listing owner, unless the listing owner and owner of record on the delinquent date is the same person.

Sections 3 and 4 of the act make conforming changes to the statutes regarding the change in definition of 'taxpayer' for collection purposes.

Sections 5 and 6 of the act add language to the notice requirements for a tax lien foreclosure and execution sale of property in order to comply with the notice requirements of *Jones v. Flowers*, decided by the U.S. Supreme Court in April, 2006. In that case, mailed notice of a tax sale was returned unclaimed. The Government then published a notice of public sale in the newspaper. The U.S. Supreme Court held that when the government becomes aware prior to selling the property that its notice attempt has failed, then it must take additional reasonable steps to attempt to provide notice to the property owner before selling his property, if it is practicable to do so. The Court suggested that the Government could have mailed the notice by regular mail or posted notice on the property. Sections 5 and 6 of this act require the tax collector to take additional reasonable steps to notify a taxpayer of a pending tax lien foreclosure if the tax collector is aware that the previous notice attempt failed.

Section 7 of the act codifies the practice of prorating property taxes between the seller and buyer of real property on a calendar-year basis, unless the contract states otherwise. It has become common practice in real estate closings to prorate taxes on a calendar year basis rather than a fiscal year basis despite the fact that the taxes are imposed on a fiscal year basis.

Section 8 of the act amends the definition of inventory to include a modular home that is used exclusively as a display model and held for eventual sale at the retail merchant's place of business. 'Modular home' is defined as a factory-built structure that is designed to be used as a dwelling, is manufactured in accordance with the specifications for modular homes under the North Carolina State Residential Building Code, and bears a seal or label issued by the Department of Insurance pursuant to G.S. 143-139.1. This language clarifies that a modular home satisfying the proposed language will be classified as inventory and not taxed as real property.

Section 9 of the act directs the Revenue Laws Study Committee to study the present-use value system. Specifically, this section directs the Committee to study the issue of adding new types of property to the present-use value system and adding additional requirements relating to sound management for property enrolled in the present-use value system.

## Video Service Competition Act.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-151	HB 2047	Rep. Carney, Luebke, McComas, Wainwright

### **AN ACT TO PROMOTE CONSUMER CHOICE IN VIDEO SERVICE PROVIDERS AND TO ESTABLISH UNIFORM TAXES FOR VIDEO PROGRAMMING SERVICES.**

**OVERVIEW:** This act, which was a recommendation of the Revenue Laws Study Committee, provides for equal taxation of video programming services regardless of how the service is delivered and it replaces locally negotiated franchises of cable service provided over a cable system with a State-issued franchise.

**FISCAL IMPACT:** This legislation does not change the amount of tax assessed on telecommunications, cable, or satellite television services. All these services remain subject to the sales tax at the combined general rate, which is currently 7%. However, this act significantly alters the calculation of the local share of shared sales tax and creates an entirely new distribution method for the local share of shared sales tax collections.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** This act becomes effective January 1, 2007.

**ANALYSIS:** North Carolina began taxing communication services when the technologies enabling the services were separate and distinct technologies and the providers of the services were separate and distinct taxpayers. Over the past several years, the technology used to provide these services has converged so that the line between the services is no longer separate and distinct. The Current Operations and Capital Improvements Appropriations Act of 2005 directed the Revenue Laws Study Committee to study the equity of taxation of providers of cable service, direct-to-home satellite service, satellite digital audio radio service, video programming service, and data service.

The Revenue Laws Study Committee spent a considerable amount of time on this issue.<sup>54</sup> The Committee found that the State taxes these services based upon who provides the service rather than the service itself. Despite the General Assembly's repeated attempts to provide tax equity among these providers, it is debatable whether that has been accomplished. Prior to this act, the following describes how the State taxed various types of communications.

- The State imposes a 7% State sales tax on telecommunication services and it earmarks a percentage of the revenues to cities. The amount each city receives is

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<sup>54</sup> The Revenue Laws Study Committee staff met separately with representatives of the cable industry, the telephone industry, the cable administrators, and the counties and cities. It also held a series of four meetings with all the affected parties and solicited comments from the parties on numerous occasions. The staff prepared a survey given to all the local governments in the State to determine their franchise fee collections and other nonmonetary contributions received in accordance with their cable franchise agreements.

based upon a per capita statutory formula. State law prohibits counties and cities from imposing local taxes on this service.

- The State imposes a 7% State sales tax on direct-to-home satellite service. Federal law prohibits a local tax on this service and it prohibits local regulation of this service. The tax revenue is not shared with local governments.
- The State imposes a 4.5% State sales tax and a 2.5% local sales tax on digital audio radio service.
- The State imposes a 7% State sales tax on cable service, with a credit equal to the amount of local franchise tax paid on the service. Counties and cities may impose a local franchise tax on this service; the tax may not exceed 5% of gross receipts. Cable service has been subject to local regulation since 1973. The local regulation of cable service varies from county to county and from city to city, depending on the terms of the locally negotiated agreements. The definition of 'gross receipts' may also vary from agreement to agreement. The cable boxes rented to customers are subject to the State and local sales tax. The gross receipts from the rental of these boxes may also be included in the company's gross receipts for local franchise tax purposes, depending upon how the term is defined in the local agreement.

The Revenue Laws Study Committee acknowledged that the method of taxation should not provide one provider of a service with a competitive advantage over another. The Committee expressed a goal to establish a method of taxation that applies equally to the same service, regardless of who provides it, based on the following principles:

- Equal taxation of the same service.
- A tax system that is easy to administer.
- A tax and regulatory system that does not impede competition.
- Equal compensation to cities for the use of their public rights-of-way.
- Support of PEG (Public access, Education, and Government) channels as a public purpose.

Based upon those principles, it desired a bill that met the following goals:

- Applies the principles stated above.
- Contains no tax or fee increase.
- Preserves local government revenue streams.
- Promotes competition in the marketplace.
- Promotes deployment of broadband as a basic communication tool.

North Carolina is not alone in grappling with the issue of how to tax and regulate telecommunications and video programming services. Congress and other states are considering legislation on this issue. At this time, at least four states have enacted legislation changing the regulation and taxation of telecommunications and video programming services and at least eight other states have legislation pending on the issue.

This act establishes uniform taxes for video programming services and seeks to promote consumer choice. It establishes equal taxation of the same service by applying a State sales tax at the combined general rate to all video programming services, repealing the local authority to impose a local franchise tax, and repealing the sales tax credit allowed to cable companies for local franchise tax paid. It preserves the local government revenue stream by distributing part of the sales tax revenues from telecommunications and video programming services to the counties and cities. The distribution formula is based upon the amount of cable franchise tax imposed during the first six months of fiscal year 2006-2007 plus any subscriber fees imposed during that same period.

The act promotes competition by providing a State franchise process, in lieu of the current locally negotiated franchise agreements. It seeks to ensure competitive neutrality by allowing cable providers to opt-out of existing local agreements when one or more households in the franchise area may be served by both the existing provider and the holder of a State-issued franchise. The act specifically prohibits discrimination in the provision of video programming services and declares a violation of this law to be an unfair or deceptive trade practice. The holder of a State-issued franchise must comply with customer service and emergency alert requirements established by the Federal Communications Commission. The act designates the Consumer Protection Division of the Attorney General's Office as the State agency to receive customer complaints regarding video programming services.

The act preserves local regulation of public rights-of-way and provides for PEG channel support and growth. The act requires local governments that imposed subscriber fees to use a portion of the amount of revenue distributed to it for PEG channel operation and support and it requires local governments that appropriated money for PEG channels in fiscal year 2005-2006 to continue appropriating that amount of money for PEG channel support. In addition to this mandated funding, the act provides \$2 million for supplemental PEG support through direct appropriation for PEG channel support and operation and through grants. The act provides that existing franchise agreements will determine the number, service tier placement, and transmission quality required of PEG channels under a State-issued franchise. In the absence of an existing agreement, the number of PEG channels a county or city may have is determined by the area's population. A local entity may acquire additional PEG channels, with the maximum number of channels set at seven. The act also requires cable service providers to provide free basic service to local public buildings.

*State issued franchise.* – Section 1 of the act replaces the authorization to counties and cities to award a franchise for cable service with a State franchising authority, effective January 1, 2007. The act provides that a county or city may not award or renew a franchise for cable service after this date. The act designates the Secretary of State as the exclusive franchising authority in the State for cable service provided over a cable system. The terms 'cable service' and 'cable system' track the definitions in federal law. The act requires the franchising of cable service that is required to be franchised under federal law. The act does not expand the services that need to be franchised beyond those currently required to be franchised under federal law.

The State franchise process is one of notice, not regulation. To receive a State-issued franchise, a person must file a notice of franchise with the Secretary of State and pay a fee of

\$125.<sup>55</sup> A person who files a notice of franchise with the Secretary must begin providing cable service within 120 days after the notice is filed. If service is not provided within this period, the notice of franchise terminates 130 days after it was filed. The notice of franchise must include all of the following:

- The applicant's name, principal place of business, mailing address, physical address, telephone number, and e-mail address.
- A description and map of the area to be served.
- A list of each county and city in which the described service area is located.
- A schedule indicating when service is expected to be offered in the service area.

Notice of Service. – Once cable service is provided, the holder of a State-issued franchise must file a notice of service with the Secretary within 10 days after the cable service begins. The notice of service must include the effective date of the notice of franchise for that area, a description and map of the service area, and a statement that cable service has begun in the service area.

Annual Service Report. – The holder of a State-issued franchise must also file an annual service report on or before July 31 of each year and pay a fee of \$200.<sup>56</sup> The annual service report must include all of the following:

- The effective date of a notice of franchise for that area.
- A description and map of the service area.
- The approximate number of households in the service area.
- A description and map of the households passed<sup>57</sup> in the service area as of July 1.
- The percentage of households passed in the service area as of July 1.
- The percentage of households passed in the service area as of July 1 of any preceding year for which a report was required.
- A report indicating the extent to which the holder has met the customer service requirements.
- A schedule indicating when service is expected to be offered in the service area, to the extent the schedule differs from one included in the notice of franchise or in a report previously submitted, and an explanation of the reason for the new schedule.

General filing and reporting requirements. – A person who files a notice of franchise or an annual service report with the Secretary of State must send a copy of the document to any county or city included in the service area described in the document as well as to the registered agent

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<sup>55</sup> Fee amount is the same as the filing fee for articles of organization of a limited liability company under G.S. 57C-1-22.

<sup>56</sup> Fee amount is the same as the filing fee for an annual report of a limited liability company under G.S. 57C-1-22.

<sup>57</sup> A household is 'passed' if service is available to that household, regardless of whether the household subscribes to the service.



of any cable service provider that is providing cable service under an existing agreement in the service area. The provisions of Article 2 of Chapter 55D of the General Statutes apply to the submission of documents.<sup>58</sup> The Secretary must either post to its Internet Web site the document filed or indicate on its Internet Web site that the document has been filed and is available for inspection.

A person who offers cable service over a cable system without filing a notice of franchise or a notice of service is subject to forfeiture of the revenue received from subscribers to the cable service during the period of noncompliance. A cable service provider whose area includes the area in which a person is providing cable service without complying with the notice requirements may bring a civil action for forfeiture.

*Existing agreements.* – An existing agreement is defined as a local franchise agreement that is in effect on January 1, 2007, or as one that expired before January 1, 2007, and the cable service provider under the agreement provides cable service to subscribers in the franchise area on January 1, 2007. The State franchising authority does not affect an existing agreement, except as follows:

- Effective January 1, 2007, gross revenue used to calculate the payment of a local franchise tax does not include gross receipts from cable service subject to the State sales tax.
- A local franchise agreement may be terminated in any one of the following circumstances:
  - When a notice of service indicates that one or more households in the franchise area of the existing agreement are passed by both the cable provider under the existing agreement and the holder of a State-issued franchise.
  - As of January 1, 2007, a county or city has an existing agreement with more than one cable service provider and at least 25% of the households in the franchise areas of the existing agreements are passed by more than one cable service provider.
  - A person provides wireline competition in the franchise area of the existing agreement by offering video programming, as defined in G.S. 105-164.3, over wireline facilities by a method that does not require a State-issued franchise. To terminate an existing agreement under this circumstance, a cable service provider must include evidence of the competition. A county or city is allowed 60 days to review the evidence. The termination becomes effective at the end of this 60-day period unless the county or city brings an action to stay the termination.

*Termination of existing agreements.* – To terminate an existing agreement, a cable service provider must file a notice of termination with the affected county or city and file a notice of franchise with the Secretary of State. A notice of termination becomes effective at the end of

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<sup>58</sup> This Article contains several provisions: To be filed, a document must contain all the required information and be accompanied by the filing fee. The Secretary of State's filing of a document does not relate to the veracity of the document. A person who knowingly signs a false document filed with the Secretary is guilty of a Class 1 misdemeanor.

a month. A termination of an existing agreement ends the obligations under the agreement and under any local cable regulatory ordinance as of the effective date of the termination.

Service standards and requirements. – The act specifically prohibits discrimination in the provision of the cable service. A violation of the law is an unfair and deceptive trade practice under G.S. 75-1.1. In determining whether a cable service provider has violated the law, the following factors may be considered: the length of time since the provider filed the notice of service for the area, the cost of providing service to an area, technological impediments to providing service to an area, the inability to obtain access to property required to provide service to an area, and competitive pressure to respond to service offered by another cable provider. The information in the annual service reports may be used to help determine whether a violation of the law has occurred.

A cable service provider must comply with the customer service requirements and emergency alert requirements established by the Federal Communications Commission. The Consumer Protection Division of the Attorney General's Office is designated as the State agency to receive and respond to consumer complaints. In addition to any other authority the Attorney General has to respond to consumer complaints, the act provides that persistent or repeated violations of the federal customer service requirements or the terms and conditions of the cable service provider's agreement with customers is an unfair and deceptive trade practice under G.S. 75-1.1. Each individual violation of the federal requirements or the provider's agreement constitutes a separate violation. In a suit instituted by the Attorney General's office, the court may impose a civil penalty of up to \$5,000 a day for each violation if it finds the cable service provider violated G.S. 75-1.1. In a suit instituted by a person where the cable service provider is found to have violated G.S. 75-1.1, the person is entitled to treble the amount of damages fixed by the verdict.

PEG channels. – The act requires a cable service provider operating under a State-issued franchise to include the transmission of PEG channels. A county or city may make a written request for PEG channel capacity and the cable service provider must provide the requested capacity within 120 days after it receives the request. A city with a population of at least 50,000 is allowed a minimum of three PEG channels and a city with a population of less than 50,000 is allowed a minimum of two PEG channels. A county is allowed a minimum of two PEG channels. This minimum number of initial PEG channels may be increased by the number of channels in excess of this minimum that are activated as of July 1, 2006, under the terms of an existing agreement whose franchise area includes the city or county.

The maximum number of PEG channels a cable service provider must provide to a county or city is seven. If a county or city does not have seven PEG channels, including the initial PEG channels, it may request additional channels. The additional channels may be provided on any service tier and the transmission quality of the additional channels must be at least equivalent to the transmission quality of the other channels provided. The PEG channels operated by a county or city must meet the following programming requirements in order for the county or city to obtain additional channels:

- All of the PEG channels must have scheduled programming for at least 8 hours a day.
- The programming content of each PEG channel must not repeat more than 15% of the programming content on any of the other PEG channels.

- No more than 15% of the programming content on any PEG channel may be character-generated programming.<sup>59</sup>

A cable service provider is responsible only for the transmission of a PEG channel. A county or city to which the PEG channel is provided is responsible for the operation and content of the channel.

*PEG channel grants.* – The act establishes the PEG Channel Fund as an interest-bearing special revenue fund. The purpose of the Fund is to provide matching grants to counties and cities for PEG channel support. The e-NC Authority administers the Fund.<sup>60</sup> A grant may only be used for capital expenditures necessary to provide PEG channels. The size of a grant may not exceed \$25,000 and an applicant may receive no more than one grant per fiscal year. The applicant must match the grant on a dollar-for-dollar basis. The Authority must publish an annual report on the grants awarded from the Fund.

*Service to public buildings.* – At the written request of a county or city, a cable service provider operating under a State-issued franchise must provide cable service without charge to a public building located within 125 feet of the provider's cable system. The required service is the basic, or lowest-priced, service the provider offers to customers. Only one service outlet is required for a building. A public building is a building used as a public school, a charter school, a library, or for a function of the county or city. A cable provider is not required to provide service that conflicts with restrictions that apply in a program licensing agreement or another contract.

*State sales tax.* – Sections 2 and 3 of the act apply the State sales tax equal to the combined general rate<sup>61</sup> equally to all video programming services, regardless of who provides the service. Section 2 defines the term 'video programming' to be programming provided by, or generally considered comparable to programming provided by, a television broadcast station, regardless of the method of delivery. The term is broader than 'cable service provided over a cable system'. It would include cable services offered over private rights-of-way as well as those offered over public rights-of-way. Section 3 imposes a State sales tax at the combined general rate on the gross receipts derived from providing video programming to a subscriber in this State.<sup>62</sup>

*Local distribution.* – Sections 7 and 8 of the act distribute a share of the sales tax revenues imposed on video programming to counties and cities. The legislature finds that the revenue distributed is local revenue, not a State expenditure. Thus, the Governor may not reduce or withhold the distribution.<sup>63</sup>

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<sup>59</sup> 'Character-generated programming' is programming that consists of text messages. Examples of character-generated programming include menus and bulletin boards.

<sup>60</sup> The e-NC Authority is charged with managing and promoting high-speed broadband Internet access.

<sup>61</sup> The combined general rate is the State sales tax rate set in G.S. 105-164.4(a) plus the sum of the rates of the local sales and use taxes.

<sup>62</sup> Although the term video programming includes broadcast services, the provision of these services would not be taxed unless the provider sells the service to subscribers and thus realizes gross receipts from the provision of the services.

<sup>63</sup> It is debatable whether a legislative finding that the revenue is a local revenue rather than a State expenditure would be adopted by a court if challenged. However, such a finding is not unprecedented as the legislature enacted several such findings in 2002 after the Governor withheld certain funds generally distributed to local governments.

Section 7 increases the amount of the sales tax revenue derived from telecommunication services distributed to cities and counties. Section 8 distributes the following portion of the gross receipts derived from video programming to counties and cities: 22.61% of the net proceeds collected on video programming, other than on direct-to-home services and 37% of the net proceeds collected on direct-to-home satellite service.<sup>64</sup> The distributions will be made quarterly.

The amount distributed will be allocated as follows:

- Two million dollars (\$2,000,000) a year will be distributed as supplemental PEG channel support. A portion of this amount will be distributed to counties and cities with qualifying PEG channels.<sup>65</sup> The amount per qualifying PEG channel is \$25,000. A county or city can not receive supplemental PEG channel support for more than three PEG channels. The amount distributed to a county or city as supplemental PEG channel support must be used by it for the operation and support of PEG channels. If the amount to be distributed for qualifying PEG channels in a fiscal year is less than \$2,000,000, the Secretary must credit the excess amount to the PEG Channel Fund to be used for matching local grants for PEG channel support.
- The remainder of the revenues to be distributed will be allocated between the counties and cities on a proportional basis. The proportionate share of a county or city is the base amount for the county or city compared to the base amount for all counties and cities. The base amount for a county or city that did not impose a cable franchise tax before July 1, 2006, is two dollars (\$2) times the most recent annual population estimate for that county or city. The population of the county is the population of its unincorporated areas plus the population of an ineligible city in the county. The base amount for a county or city that imposed a cable franchise tax before July 1, 2006, is the amount of cable franchise tax and subscriber fee revenue the county or city certifies to the Secretary it imposed during the first six months of fiscal year 2006-2007. For subsequent fiscal years, the amount each county or city receives will be adjusted based upon its percentage change in population.

A county or city that imposed subscriber fee revenue must use a portion of the amount distributed to it for PEG channel operation and support. The amount it must use for this purpose is two times the amount of revenue it certified to the Secretary it imposed as subscriber fees during the first six months of fiscal year 2006-2007. A county or city that appropriated funds for PEG channel operation and support during fiscal year 2005-2006 must continue appropriating that amount of funding for PEG channels. The remainder of the money distributed to counties and cities may be used for any public purpose.

Conforming and technical provisions. – Sections 4 through 6 of the act make technical and conforming changes to the provisions governing bundled transactions.

Section 9 repeals the credit against the State sales tax on cable services for local franchise tax paid because the local franchise tax is repealed in Section 13.

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<sup>64</sup> This percentage distribution from satellite TV services mirrors the 2.5% local sales tax on satellite radio services.

<sup>65</sup> A "qualifying PEG channel" is a channel that meets the programming requirements under G.S. 66-357(d).

Section 10 repeals the county's authority to franchise cable television services.

Section 11 repeals the county's authority to impose a franchise tax on cable services. Unlike a city, a county may only levy a privilege tax to the extent it is authorized by law. This section repeals the county's authorization.

Section 12 specifically prohibits a city from imposing a tax on video programming services under the statute that gives cities the general authority to levy a privilege license tax on businesses and franchises unless prohibited from doing so by law. This section contains such a prohibition.

Section 13 repeals the city's specific statutory authority to impose a franchise tax on cable services.

Section 14 clarifies that a city may not impose a fee or charge for use of the public right-of-way unless the fee or charge applies uniformly to all non-municipal users of the public right-of-way.

Section 15 repeals the city's authority to franchise cable television services.

Section 16 requires a county or city desiring to receive a distribution for supplemental PEG channel support under G.S. 105-164.44I(b) to certify to the Secretary of Revenue by March 15, 2007, the number of qualifying PEG channels it operates.

*Studies.* – Section 17 recognizes that the staffing needs of the Consumer Protection Division of the Attorney General's Office may change with the passage of this act. However, the section also finds that the impact of this act on the staffing needs of the Division is not clear. This section requests the Office of the Attorney General to monitor the number and type of cable service complaints it receives from customers and to determine whether the Division needs additional staff to fulfill the duty imposed by this act on it. The Office of the Attorney General must make a report concerning its staffing needs to the Fiscal Research Division by April 1, 2007.

Section 18 directs the Consumer Protection Division of the Attorney General's Office to report to the Revenue Laws Study Committee on or before April 1 of each year, beginning April 1, 2008, on the number of customer complaints it has received regarding cable service, the types of complaints, and the different means it has used to resolve those complaints.

Section 21 directs the Revenue Laws Study Committee to review the effects of this act on competition in video programming services, the number of cable service subscribers, the price of cable service by service tier, the technology used to deliver the service, and the deployment of broadband in the State. The Committee may recommend any changes to the law it believes are necessary to the North Carolina General Assembly.

*Severability.* – Section 19 provides that an award of a State-issued franchise does not affect a determination of whether video programming provided by the holder of the franchise is considered cable service provided over a cable system under federal law.

Section 20 provides that the provisions of this act are severable.

## Revenue Laws Tech. & Motor Fuel Tax Changes.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-162	HB 1963	Representative Luebke

**AN ACT TO MAKE TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES TO THE REVENUE LAWS AND RELATED STATUTES, TO IMPROVE THE COLLECTION AND ADMINISTRATION OF THE MOTOR FUEL TAX, AND TO AUTHORIZE A COUNTY THAT IMPOSES A SALES TAX FOR PUBLIC TRANSPORTATION TO LEVY A VEHICLE RENTAL TAX.**

**OVERVIEW:** This act makes technical, clarifying, and administrative changes to the revenue laws and related statutes and to the motor fuel tax laws to improve collection and administration. These changes were a recommendation of the Revenue Laws Study Committee. The act also authorizes counties that impose an additional one-half cent sales and use tax for public transit to also levy a vehicle rental tax.

**FISCAL IMPACT:** Parts I. through IV. of this act have no fiscal impact. Part V. has no fiscal impact on the General Fund, and the impact to local government revenue cannot be determined.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** Except as otherwise specified, this act became effective when signed into law by the Governor on July 24, 2006.

**ANALYSIS:**

*Part I: Technical Changes.*

Section	Explanation
1	Corrects a departmental reference since S.L. 2005-380 transferred the NC Grape Growers Council from the Department of Agriculture and Consumer Services to the Department of Commerce.
2	Removes obsolete language and makes other stylistic changes. This statutory subsection makes two obsolete references to the appraised value of intangible property in the appraised value base. This language became obsolete with the repeal of the intangibles tax effective for tax years beginning on or after January 1, 1995. The Department of Revenue does not require intangible property to be included in the appraised value base.
7	Makes a grammatical change to the statute.
19	Amends the caption of the statute to reflect what the statute actually provides.

21	Corrects an incorrect statutory reference.
22	Corrects an incorrect statutory reference.
23	Corrects introductory language from a 2005 session law.
24	Corrects an incorrect statutory reference within a local session law.
27	Repeals a reporting requirement related to sales and use tax refunds allowed to local school administrative units. This reporting requirement is unnecessary since the General Assembly changed the law in 2005 to redirect State sales and use tax revenues refundable to LEAs to the State Public School Fund.
28	Corrects an incorrect statutory reference.
31	Corrects an incorrect statutory reference.

*Part II: Clarifying Changes*

Section	Explanation
3(a) & (b)	Defines the term 'gross income' in the corporate income tax law by reference to Section 61 of the Internal Revenue Code, which is the same definition that is currently found in the individual income tax law. Section 3(b) is a conforming change.
5(a) & (b)	In 2005, the General Assembly made the use tax applicable to services sourced to this State. Section 5(a) is a conforming change which amends the definition of 'use' to include services. Section 5(b) is a conforming change to the statute regarding use tax returns.
6	Corrects an inadvertent omission. In the 2005 budget bill, there was a rewrite of this statutory section on use tax. A credit should be allowed for both sales and use tax paid to another state, but the revised statute only provided a credit for sales tax paid. There was no intent to change the application of the tax, so this section adds the phrase 'or use' back into the statute.
8(a) & (b)	Clarifies that the exemption from sales tax for sales of grain, feed, or soybean storage facilities and accessories only applies to sales made to farmers. This was one of the items previously subject to the 1%, \$80 maximum rate of tax. The 1% rate was imposed on sales to farmers of grain, feed, or soybean storage facilities and accessories. In 2005, in order to conform to the Streamlined Agreement, the General Assembly exempted these items from sales tax. However, the new exemption did not limit the exemption to farmers.

12	<p>Section 12(a) makes changes to various penalty statutes. Section 12(a) repeals two misdemeanor statutes relating to the willful failure to comply with the tax laws and aiding and abetting in the violation of the tax laws. These violations are covered by G.S. 105-236(9), so the two statutes are unnecessary.</p> <p>Section 12(b) reorganizes the penalties statute and makes some technical and clarifying changes. It divides the former statutory section into three subsections: subsection (a) lists the various penalties available to the Department of Revenue for violations of the tax laws; subsection (b) is a recodification of the principle previously set out in subdivision (11), which states that a violation of a tax law is considered an act committed in part at the office of the Secretary in Raleigh; and subsection (c) restates language previously found at the beginning of the statute directing the disposition of the penalty proceeds to the Civil Penalty and Forfeiture Fund. Subsection (c) also deletes an obsolete requirement to avoid the penalty for a bad check, which states that a person had sufficient funds in a bank account 'in this State'. Since the Department does not follow this requirement, it is deleted.</p> <p>Section 12(c) repeals G.S. 105-449.127, which provides that civil penalties assessed for violation of the motor fuels tax laws be credited to the Highway Fund. Section 12(c ) also repeals G.S. 105-449.48, which provides that fees collected for the issuance of temporary permits for motor carriers and all civil penalties collected for violations of the motor carrier laws be credited to the Highway Fund. Section 12(d) moves the fee disposition language in repealed G.S. 105-449.48 to G.S. 105-449.49.</p> <p>The repeal of these two statutes redirects from the Highway Fund to the Civil Penalty and Forfeiture Fund any civil penalty proceeds collected under these two statutes as required by <i>North Carolina School Boards Assn. v. Moore</i>. In July of 2005, the North Carolina Supreme Court in the above referenced case held that the penalties assessed under Chapter 105 are imposed as a monetary payment for a taxpayer's noncompliance with a mandate of the Revenue Act, that they are punitive in nature, and, as such, they are subject to Article IX, Section 7 of the North Carolina Constitution requiring these funds be remitted to the Civil Penalty and Forfeiture Fund for use by the schools.</p>
18	<p>Amends the caption of G.S. 105-249.2 by replacing the word 'individuals' with the word 'persons'. This statute provides, in part, that no penalties may be assessed for any period in which the time for filing a federal return or for paying a federal tax is extended because of a presidentially declared disaster. The relief provided by this statute is applied by the Department of Revenue equally to all tax entities, including businesses, and not just individuals.</p>



26	Amends the State estate tax statute by clarifying that State estate tax liability may not exceed federal estate tax liability determined without regard to the deduction for State death taxes or certain federal credits. Prior to this act the Department of Revenue interpreted the statute as limiting the State estate tax in this way, but the Estate Planning Section of the NC Bar Association requested that clarifying language be put in the statute. This change does not change the way in which estate tax is calculated.
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*Part III: Administrative Changes*

<b>Section</b>	<b>Explanation</b>
4	<p>Section 4 relates to the new film incentives tax credit enacted in 2005.</p> <p>Subsections (a) and (b) make clarifying changes to the film incentives in both the corporate and individual provisions. First, the term 'highly compensated individual' is limited to individuals who are compensated for services and does not include individuals who may sell goods in excess of the one-million-dollar limitation. Second, the exclusion of amounts paid to highly compensated individuals is clarified so that it is clear that the exclusion applies whether the individual is paid directly by the production company or by an unrelated third-party. It is not uncommon for a production company to contract with a separate entity for the services of actors or other professionals involved in a production. Third, the statutes are amended so that withholdings must be remitted in order for compensation to qualify as a qualifying expense, but that withholding does not necessarily have to be performed by the production company.</p> <p>Subsection (c) makes changes to G.S. 105-259(b) of the confidentiality statute, one of which is related to the film incentives tax credit. It adds a new subdivision (36), which allows the Department of Revenue to provide to a production company claiming a film production credit information used by the Department to adjust the amount of the credit claimed by the production company.</p> <p>It also repeals subdivision (32), which allows the Department of Revenue to provide to the Department of Public Instruction and the Fiscal Research Division reports regarding sales and use tax refunds received by school administrative units. This provision was enacted last year. However, Section 32(b) of S.L. 2005-435 amended the definition of tax information to exclude governmental agency refunds. Therefore, an exception is not needed in the confidentiality statute since the information is no longer confidential tax information.</p> <p>It also rewrites subdivision (27) to create a generic exception to allow disclosure of reports required by law rather than listing out specific statutes and makes conforming changes.</p> <p>This section became effective for taxable years beginning on or after January 1, 2006.</p>

9	In 2005, the General Assembly authorized a sales and use tax refund for the purchase of fuel by interstate passenger air carriers and by motor sports racing teams or sanctioning bodies. Under current law, the Department of Revenue is required annually to publish the number of taxpayers claiming certain sales and use tax refunds. This section adds these categories of refunds to the reporting requirement.
10	Clarifies the effective date for a rate increase with regard to prepayments of service. In 2005, the General Assembly enacted G.S. 105-164.15A, which addresses the effective date for rate increases and decreases to taxable services, but the statute does not specifically address prepayments of service.
11	Provides a credit against the privilege tax for sales and use tax, or a similar type of tax, paid to another state. Under prior law, there was no specific provision for credits in the newly enacted Article 5F. <i>Manufacturing Fuel and Certain Machinery and Equipment</i> .
20	Section 20(a) and (b) conform the date an occupancy tax return is due to the date that the occupancy taxes are due.
25	Allows a municipality to create a municipal service district effective upon the adoption of the resolution creating it, rather than waiting for the first day of the next fiscal year, if general obligation bonds are anticipated to be authorized for the project. However, it provides that no ad valorem tax may be levied for the partial year.
29	Repeals G.S. 106-452, which sets the maximum charges for handling and selling tobacco on the floor of tobacco warehouses.
32	Conforms the language in G.S. 105-467(b) to changes made by S.L. 2006-33, that exclude ancillary service from the refund of sales and use taxes paid by certain local school administrative units for tangible personal property and services. Effective January 1, 2007

*Part IV. Motor Fuel Tax Changes*

Section	Explanation
13(a) & (b)	<p>Section 13 gives the Department of Revenue the ability to cross match all motor fuel to ensure compliance with the motor fuel tax laws. Under current law, the Department may cross-match information regarding fuel entering the State and fuel leaving the State, but it cannot cross-match information regarding the intrastate movement of motor fuel. The Department has a new fuel tracking system that will better enable it to monitor the movement of fuel. The Department expects the system to be operational by the last quarter of this fiscal year. Section 13 makes the statutory changes necessary to enable the Department to review intrastate movements of fuel by providing that anyone who transports fuel must be licensed as a transporter and that all transporters must file informational returns on all movements of motor fuel.</p> <p>Section 13(a) provides that all people who transport motor fuel will be licensed as a motor fuel transporter. Under current law, a person licensed as</p>

	<p>a distributor or blender is considered to be licensed as a motor fuel transporter if the person transports the fuel for others for hire. This section removes the exception for persons who transport their own fuel so that any distributor or blender who transports fuel – whether for hire or for their own use – would also be considered licensed as a transporter.</p> <p>Section 13(b) provides that a transporter must file an informational return showing deliveries of motor fuel. Under current law, only interstate movements of fuel must be reported on a monthly informational return. The change in this section of the bill will require such a return for all deliveries of fuel.</p> <p>Section 13 becomes effective July 1, 2007, and applies to motor fuel transported on or after that date.</p>
14	<p>Section 14 provides that all motor fuel leaving the terminal rack is subject to the motor fuel excise tax. The Department requested this change to reduce the areas of evasion and inadvertent duplicate refunds. Under current law, a licensed distributor or importer may remove fuel from a terminal without paying the tax if the person has an exempt card issued by the supplier. This section removes the ability of distributors and importers to use exempt cards at the terminal rack. Instead, they will be able to obtain a monthly refund on any sales of fuel to exempt entities.<sup>66</sup> This change conforms North Carolina's law to the laws of the surrounding states who do not allow untaxed gasoline or undyed fuel to leave their terminals without the imposition of the tax.</p> <p>Section 14(a) puts the definition of 'exempt card or code' in the definitional statute for the motor fuel article. Section 14(b) repeals the portion of the statute that allows fuel to be removed from the terminal without paying the tax. Section 14(c) repeals the requirement of a quarterly return and makes conforming changes. Section 14(d) removes the deduction a licensed distributor or importer may make for tax exempt fuel taken from the terminal rack because the ability to obtain the fuel without paying the tax is repealed in section 14(b). Section 14(e) repeals the statute requiring a licensed distributor or importer who obtains fuel at the terminal rack with an exempt card to file a quarterly reconciling return. Section 14(f) makes conforming changes. Section 14(g) provides a monthly refund procedure for a distributor who sells diesel fuel to an airport. A refund procedure already exists for sales of motor fuel to the other listed exempt entities.</p> <p>Section 14 becomes effective January 1, 2007, and applies to motor fuel purchased on or after that date. An exempt card or code will not be valid for sales of motor fuel at the terminal rack on or after January 1, 2007.</p>
15	<p>Section 15 establishes a common due date for all motor fuel tax and informational returns. Under current law, most of the monthly tax returns are due on the 22<sup>nd</sup> day of the month following the month covered by the</p>

<sup>66</sup> G.S. 105-449.88 exempts the following entities from the motor fuel excise tax if it is sold to them for their use: the federal government, the State, local boards of education, charter schools, community colleges, counties, municipalities, and airports.

	<p>return. Informational returns are due on the 25<sup>th</sup> day of the month following the month covered by the return. These sections provide that all monthly returns are due on the 22<sup>nd</sup> day of the month following the month covered by the return.</p> <p>Section 15 becomes effective January 1, 2007, and applies to motor fuel purchased on or after that date.</p>
16	<p>Section 16 adds a reference to the privilege tax imposed under Article 5F, which was enacted last year, with respect to refunds of motor fuels tax allowed for nonhighway use of a vehicle.</p> <p>A refund of motor fuels tax allowed for the nonhighway use of a vehicle is to be reduced by the amount of sales and use tax owed based on the method set out in G.S. 105-449.107. Prior to January 1, 2006, the amount of sales tax due was based on either the general State and local rates of tax or the 1% rate imposed on sales of fuel to farmers and manufacturers. Effective January 1, 2006, sales of fuel to farmers and manufacturers are subject to the new 1% privilege tax. Currently, these two statutes refer only to the sales and use taxes levied in Article 5.</p>
17	<p>Section 17 removes the misdemeanor for taxpayers failing to pay the destination state taxes collected to that state. This provision was put into the law when North Carolina first moved to tax-at-the-rack. Today, all of the surrounding states have destination state tax laws. North Carolina does not collect and remit the taxes to those states, therefore this misdemeanor is no longer needed.</p> <p>Section 17 becomes effective January 1, 2007, and applies to motor fuel purchased on or after that date.</p>

*Part V: Expansion of Tax Authority for Certain Counties.*

Section	Explanation
30	<p>Section 30 authorizes a county that imposes an additional ½ cent sales and use tax for public transportation to also levy a vehicle rental tax. In 1997, the General Assembly authorized a regional public transportation authority to levy a gross receipts tax of up to 5% on retailers within the region engaged in the business of renting private passenger vehicles and motorcycles. The tax applies only to short-term rentals which are rentals for a period of less than one year. Each authority may use the proceeds of the tax for its public transportation purposes</p> <p>Section 30 provides that a county that imposes the additional ½ cent sales and use tax is considered an authority under the 1997 legislation and may also levy a vehicle rental tax. The county must allocate the proceeds of any vehicle rental tax it imposes to the largest city in the county that operates a public transportation system. The city must use the money to finance, construct, operate, and maintain local public transportation systems. However, unlike the tax proceeds from a vehicle tax levied by a public transportation authority, the proceeds of a vehicle tax levied by a county</p>

	<p>may be used to supplant and replace existing general fund revenues allocated for a public transportation system. Under current law, this section applies only to Mecklenburg County, since that county is the only one that imposes an additional ½ cent sales and use tax for public transportation.</p> <p>If the Mecklenburg County Board of Commissioners decides to levy a vehicle rental tax of 5%, then the annual proceeds generated from the tax are estimated to be \$7.4 million.</p>
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## Economic Development Program Modifications.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-168	HB 2744	Rep. Owens, Daughtridge

### AN ACT TO MAKE MODIFICATIONS TO THE JOB DEVELOPMENT INVESTMENT GRANT PROGRAM, TO EXTEND THE WILLIAM S. LEE QUALITY JOBS AND BUSINESS EXPANSION ACT FOR CERTAIN TAXPAYERS, AND TO EXTEND CERTAIN SALES AND USE TAX REFUNDS.

**OVERVIEW:** This act makes numerous changes to the Job Development Investment Grant Program, it extends by two years the time period in which eligible major industries can qualify for the extension of the Bill Lee Act, and adds financial services, securities operations, and related systems development as an industry that is eligible for the sales and use tax refund related to certain building materials.

**FISCAL IMPACT:** The act could reduce General Fund revenues by as much as \$570,000,000 over a 12-year period.

*(For a more complete fiscal analysis, see Overview: [Fiscal and Budgetary Actions](#), 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** Except as otherwise noted, this act became effective when signed into law by the Governor on July 27, 2006.

**ANALYSIS:**

#### *Part I: JDIG Changes*

The Job Development Investment Grant (JDIG) Program was created in 2002 as a new economic development tool for new and expanding businesses in North Carolina. JDIG is used to attract businesses to the State by allowing a five-member committee to award grants to businesses. The amounts of the grants are based on income tax withholdings from new jobs created by the businesses.

This act makes numerous changes to the JDIG program. Some of these changes significantly expand or extend the program, whereas other changes are intended to streamline the administration of the program, clarify certain aspects of the program, or reduce penalties for failure to comply with agreements under the program.

There are two changes in the act that may significantly add to the cost of the program over the next 12-13 years. First, the act increases the maximum amount of total annual liability for agreements entered into during the 2006 calendar year from \$15 million to \$30 million. This change is effective for agreements entered into during 2006 only; for agreements entered into in later years, the maximum amount of the total annual liability returns to \$15 million. Under the JDIG program, agreements entered into in one calendar year may result in annual grant payments for the succeeding 12 years. Therefore, an increase in the maximum amount of the total annual liability of \$15 million for one year may have a fiscal impact of up to \$180 million over a 12-year period. Second, the act extends the sunset on the JDIG program by an additional two years, through the end of the 2009 calendar year. As with the increase discussed above, this two-year extension of the program could have a significant fiscal impact stretching out for a dozen years or more.

The act makes significant changes to the clawback provisions under the JDIG program. Under the JDIG program, the Economic Investment Committee (EIC), the entity that administers the JDIG program, 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 comply with any term of the agreement or with criteria developed by the EIC, the EIC 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 comply with any term of the agreement or with criteria developed by the EIC for two consecutive years, the EIC must terminate the agreement. In addition, in each agreement the EIC must include a provision describing the conditions that will lead to recapture of a grant made in an earlier year.

Under this act, the provisions relating to failure to comply with the agreement for two consecutive years are changed so that termination of the agreement is not required in all cases. Under this act, if the business is still in the base period established by the EIC, the EIC may withhold the grant for any consecutive year remaining in the base period in which the business fails to comply with the agreement. The EIC also has the option of extending the base period by up to 24 months over the amount specified in the original agreement in these cases. If the business does not come into compliance by the end of the base period, the agreement must be terminated. If the business is no longer in the base period established by the EIC, the EIC must terminate the agreement. The effect of these changes is to allow a company more leeway in meeting the terms of an agreement in the early years of the agreement.

This act also expands the types of entities that are eligible to enter into agreements under the program. When the JDIG program was originally created, all but two specific industries were eligible for grants under the program. Those two industries were retail operations and professional and semiprofessional sports teams and clubs. The exclusion of professional sports was put into place, in part, due to concerns that the intent behind the program was to attract one or more major league sports teams to the State. This act provides an exception to that exclusion by allowing professional motorsports racing teams to be eligible for grants under the program.

The act also makes the following changes:

- Changes references to 'base years' to 'base period' and allows the EIC to set the base period. Under current law, the base years are the first two years, unless the EIC decides on a different period. This clarifies that the EIC has authority to set that base period. The base period may not contain more than 5 years in which grant payments are to be made.
- Changes the definition of 'new employee.' Under prior law, a 'new employee' could include an employee that was originally hired in the base period, was subsequently laid off, and then was subsequently rehired by the company during the term of the agreement. The act changes the law to exclude these rehires from the definition of new employee.
- Clarifies that the \$6,500 cap per new employee and the 75% cap on the amount of a grant apply to the total amounts and not just the amount that flows to the business. This is important because the amount of a grant is reduced by 25% for a position located in a development tier three area<sup>67</sup> with that portion instead being directed to the Utility Account of the Industrial Development Fund. This clarifies that the two caps apply to both the amount that flows to the business and the amount that flows to the Utility Account.
- Clarifies that social security numbers related to the positions on which a grant is based must be included with annual reports to the EIC. The change further clarifies that the social security numbers and State and federal tax returns are tax information, which is protected from disclosure under general laws related to public records.
- Removes the State Controller from the disbursement process. In 2004, a JDIG Reserve was created within the Department of Commerce. Due to the manner in which that Reserve was established, the State Controller is not directly involved with disbursements to businesses from the JDIG Reserve. This act relieves the State Controller of certain duties related to certification of grant amounts and remittance of payments to grantees and transfers those duties to the Department of Commerce.
- Clarifies that the tier designation that determines whether a grant payment is subject to reduction is the designation that is in effect in the year in which the application is filed. Under prior law, the amount of a grant was reduced by 25% if the position with respect to which the grant was awarded was located in an enterprise tier four or five area. Under that law, it was not clear when that determination was supposed to be made – at the time the business applied for a grant, at the time a grant agreement was entered into, or at the time the grant payment was made.

Lastly, this part of the act directs the Department of Commerce to conduct a comprehensive study of the costs of the JDIG Program in relation to other State economic development incentive programs. The study should also include information on the use of the program in urban, suburban, and rural areas throughout the various geographic regions of the State. The

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<sup>67</sup> See S.L. 2006-252, Section 2.9(b).

Department must submit the report to the chairs of the House and Senate Finance Committees by February 1, 2007.

*Part II: Bill Lee Act Changes*

The William S. Lee Quality Jobs and Business Expansion Act (hereinafter 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, and for worker training. In 2000, the General Assembly extended the sunset on the Act until January 1, 2006. During the 2005 Regular Session, the General Assembly further extended the Act until January 1, 2008. However, the General Assembly changed the effective date from January 1, 2008, to January 1, 2007, in Section 1.3 of S.L. 2006-252.

There are several exceptions to the sunset date, one of which involves eligible major industries. Eligible major industries that qualify as such before January 1, 2006, are allowed to claim credits for business activity that occurs on or before January 1, 2010. A taxpayer is an eligible major industry if it will invest at least \$100 million in acquiring, constructing, and equipping a facility and it is engaged in bioprocessing, the manufacture or distribution of pharmaceuticals or medicines, aircraft manufacturing, computer manufacturing, motor vehicle manufacturing, or semiconductor manufacturing.

The definition of eligible major industries for the purposes of the Bill Lee Act largely conforms to the list of taxpayers who are eligible for a refund on the sales and use taxes paid by the taxpayer on building materials for construction of a new facility in this State. Taxpayers that are eligible for the refund of sales and use taxes are not required to qualify as such by a specific date, but the refund provision does expire for purchases made on or after January 1, 2010.

Part II of this act extends by two years the time period in which eligible major industries may qualify for the extension of the Bill Lee Act. This provision allows for an extension of the Bill Lee Act to the taxpayers that qualify as an eligible major industry by January 1, 2008, rather than 2006.

*Part III: Sales Tax Refund Changes*

Part III of this act adds financial services, securities operations, and related systems development as an industry that is eligible for the sales and use tax refund related to certain building materials, effective July 1, 2006. The effect of this change is to make these types of taxpayers eligible for the extension of the Bill Lee Act discussed in Part II above. In addition, this part extends the sunset on the sales and use tax refund for all eligible industries by three years, until January 1, 2013.

*Part IV: Internet Data Center Tax Exemption Changes.*

Part IV of the act makes technical changes to the sales and use tax exemption for Internet data center facilities enacted as part of the 2006 Appropriations Act (S 1741, S.L. 2006). The changes were requested by the industry whose recruitment was the catalyst for the exemption.



## Simplify Fire Tax Rate/Other Tax Changes.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-196	HB 1891	Rep. Wainwright, Luebke, Church, Hill

### **AN ACT TO CLARIFY AND SIMPLIFY THE APPLICATION OF THE ADDITIONAL GROSS PREMIUMS TAXES ON FIRE AND LIGHTNING COVERAGE AND TO MAKE TECHNICAL AND CLARIFYING TAX LAW CHANGES.**

**OVERVIEW:** This act does the following:

- Clarifies and simplifies the application of the additional gross premiums taxes on fire and lightning coverage. This part of the act was a recommendation of the Revenue Laws Study Committee.
- Makes a conforming change to the definition of 'holding company' for purposes of the franchise tax.
- Clarifies the application of the royalty reporting option when one of the related members is in a foreign country.
- Allows the Department of Revenue to share information with a county or city on a room occupancy tax to the same extent as a prepared food and beverage tax.
- Directs the Revenue Laws Study Committee to study various issues.

**FISCAL IMPACT:** Effective January 1, 2008, the act combines the statewide and local rates for insurance policies providing fire and lightning coverage and establishes a new statewide rate of 0.85% for the supplemental tax. The tax will apply to 100% of premiums for property coverage and 10% of premiums for automobile physical damage. Because the new statewide rate is calculated to be revenue neutral, it is estimated that the rate change will have no fiscal impact. The remaining sections of the act also have no fiscal impact.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** There are various effective dates.

**ANALYSIS:** This act makes several changes to the State and local tax laws.

#### *Additional Gross Premiums Taxes on Fire and Lightning Coverage*

North Carolina imposes a 1.9% tax rate on the gross premiums of most insurance policies.<sup>68</sup> In addition to the general rate, there is a 1.33% rate applied to the gross premiums on insurance policies that provide fire and lightning coverage. The statute specifically excludes marine and automobile policies from this additional tax. Twenty-five percent of the net

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<sup>68</sup> Workers' compensation policies are taxed at 2.5%. HMO policies are currently taxed at a rate of 1%; however, effective January 1, 2007, these policies will be taxed at the general rate of 1.9%.

proceeds of this additional tax are credited to the Volunteer Fire Department Fund,<sup>69</sup> and the remainder is credited to the General Fund. There is also a 0.5% rate applied to gross premiums on insurance policies that provide fire and lightning coverage within fire districts. The statute authorizing the 0.5% rate does not provide any exceptions from this tax. The net proceeds of this tax are credited to the Department of Insurance.<sup>70</sup>

The General Assembly enacted the additional statewide fire and lightning tax in 1959. Although the statute does not provide that the tax will apply differently to different types of policies, the Department of Revenue has administered the tax this way. The additional tax has been imposed on 100% of premiums from insurance that covers only fire losses and on a percentage of premiums from insurance that covers multiple risks. The percentages applied are neither statutory nor imposed by administrative rule. Within the past few years, the Department has been informally advised by both the Department of Insurance and the Attorney General's Office that the statute as written does not provide for assessing the tax against only a percentage of a policy's premium. Rather, without a statutory change, it is their opinion that the tax should be applied to 100% of the premiums of any policy that includes fire and lightning coverage.

Section 1 of this act codifies the current administrative practice of the Department by setting in statute the percentage of an insurance policy's gross premiums to which the additional tax applies. It provides that policies covering fire loss would be taxable at 100%. It sets by statute the taxable percentages for the following types of policies:

<u>Type of Insurance Policy</u>	<u>Taxable Percentage</u>
Non-liability portion of a Commercial Multiple Peril policy	100%
Homeowner's Policy	50%
Farm Owner's Policy	30%

Section 3 of the act also establishes a new method of taxing insurance policies that provide property coverage, effective for taxable years beginning on or after January 1, 2008. The act broadens the base and lowers the rate applicable to insurance contracts that provide property coverage. The revenue-neutral tax rate is 0.85%. The revenue generated by the tax is distributed in the same proportion as the current State and local fire and lightning tax revenue is distributed. Under the current method of taxation, the local tax is applied to contracts of insurance applicable to fire and lightning coverage within fire districts. A portion of the revenue from this tax is distributed to these fire districts. The act does not limit the application of the tax to fire districts. It also does not require the accounting by insurance companies of the amount of premiums written in fire districts. Section 7 of the act

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<sup>69</sup> Funds in the Volunteer Fire Department Fund provide matching grants to volunteer fire departments to purchase equipment and make capital improvements. In 2005, the Department received 567 applications for grants requesting matching funds of \$6,577,455. The available monies in the Fund totaled only \$4,369,976. The Department approved 500 applications totaling \$4,365,489.

<sup>70</sup> Three percent (3%) of the tax proceeds are credited to the State Firemen's Association for general purposes. Two percent (2%) of the proceeds are used by the Department of Insurance for the purpose of administering the disbursement. The remaining funds are allocated among the fire districts in proportion to the amount of business done in the district and used by the local district for firemen's local relief purposes. See *Article 84 of Chapter 58 of the General Statutes*.

establishes a new method of distribution based upon a per capita allocation among fire districts, effective January 1, 2008. However, this new method of distribution needs further review. Given that, the act directs the Revenue Laws Study Committee to study the new method of taxation as well as the distribution of the revenues.

#### *'Holding Company' Definition*

Section 9 of this act makes a technical change to the definition of a 'holding company' for franchise tax purposes. This change corresponds with a substantive provision in the budget which eliminates a franchise tax loophole that existed for LLCs that elect to be taxed as C Corporations. This section is effective for taxable years beginning on or after January 1, 2007. For a more detailed explanation of this provision and the corresponding technical change, see the analysis of Section 24A.2 of S.L. 2006-66.

#### *Royalty Reporting Option*

Section 10 of this act clarifies the application of the royalty reporting option when one of its related members is in a foreign country. This change corresponds to a substantive provision enacted in the budget expanding the scope of the royalty reporting option. This section is effective for taxable years beginning on or after January 1, 2006. For a more detailed explanation, see the analysis of Section 24A.3 of S.L. 2006-66.

#### *Tax Sharing*

Current law allows the Department of Revenue to share tax information with a county or city if the information is relevant to the administration of the county's or city's food and beverage tax. Section 11 of this act expands the provision to include the administration of a county's or city's room occupancy tax. This section became effective when the act became law on August 3, 2006.

#### *Effective Date Correction of Research & Development Sales Tax Changes*

Section 12 of this act changes the effective date of a budget provision exempting research and development equipment from State and local sales tax and imposing a 1% privilege tax, with an \$80 cap from January 1, 2007, to July 1, 2007,. For a more detailed explanation, see the analysis of Section 24.9 of S.L. 2006-66.

#### *Revenue Laws Study*

Effective when the act became law on August 3, 2006, Section 13 of this act directs the Revenue Laws Study Committee to study the following issues:

- Distribution of the additional gross premiums tax on property coverage.
- Use of consolidated corporate returns.
- Replacement of the corporate income and franchise tax with a commercial activity tax.
- Revision of the administrative process for the review of disputed tax matters.

## Local Government Debt Revisions.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-211	SB 1436	Senator Garrou

### **AN ACT TO ALLOW REGIONAL COUNCILS OF GOVERNMENT TO FINANCE REAL PROPERTY ACQUISITIONS AND IMPROVEMENTS AND TO MAKE REVISIONS RELATED TO TAX INCREMENT FINANCING.**

**OVERVIEW:** This act does three things:

- It gives regional planning commissions the same authority to acquire real property for office space that the General Assembly gave regional councils of government last session.
- It authorizes regional councils of government and regional planning commissions to finance real property purchases or improvements by pledging the real property as security for the debt, subject to approval by the Local Government Commission.
- It exempts a private agency that enters into a contract with a local government unit for the implementation of a development financing plan from the statutes governing government contracts to the extent specified in the contract.

**FISCAL IMPACT:** The act does not affect the General Fund.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** The act became effective when signed into law by the Governor on August 8, 2006.

**ANALYSIS:** Last session, the General Assembly gave regional councils of government the power to acquire real property by purchase, gift, or otherwise, and to improve that property for the purposes of meeting a council's office space and program needs.<sup>71</sup> A regional planning commission is very similar to a regional council of government. Both may be formed by a concurrent resolution adopted by one or more units of local government and both study regional problems and develop coordinated plans to address those problems. This act gives regional planning commissions the same authority to acquire real property as regional councils of governments.

The authority given to regional councils of government last year to own property did not include the authority to finance the purchase of the property. This act gives both regional councils of government and regional planning commissions the authority to pledge the real property as security in order to purchase the property or to make improvements to the property, subject to approval by the Local Government Commission.<sup>72</sup>

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<sup>71</sup> S.L. 2005-290.

<sup>72</sup> The incurrence of indebtedness by an entity created by any action of a unit of local government must be approved by the Local Government Commission under G.S. 159-153.

Project development financing, also known as tax increment financing, allows a local government to issue bonds to finance the public portion of certain economic development projects. The bonds are secured by the incremental property tax increase generated by the development financed. This type of financing can be used for airports, auditoriums and arenas, hospitals, museums, parking facilities, sewer systems, storm sewers and flood control facilities, water systems, street improvements, public transportation facilities, railroads, affordable housings, land development for industrial or commercial purposes, utilities, and redevelopment.

The Local Government Commission must approve the issuance of project development financing debt instruments. Before it can approve an issuance requested by a city, the governing body of the city must adopt a development financing plan. In implementing the plan, a city may act directly, through a redevelopment commission, through one or more contracts with private agencies, or by any combination of these. A city is subject to the public contract provisions of Article 8 of Chapter 143. This act provides that a private agency that enters into a contract with a city for the implementation of a development financing plan is subject to the statutory provisions governing public contracts ONLY to the extent specified in the contract.<sup>73</sup>

## **Exempt Agri-Tourism From Privilege Tax.**

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-216	HB 143	Representative Coates

### **AN ACT TO EXEMPT AGRITOURISM ACTIVITIES FROM THE PRIVILEGE TAX ON AMUSEMENTS.**

**OVERVIEW:** This act exempts from the 3% gross receipts privilege tax all farm-related exhibitions, shows, attractions, or amusements offered on land used for farm purposes, including hayrides, animal exhibitions, and farm pond fishing.

**FISCAL IMPACT:** According to the Department of Revenue, a State privilege tax is not collected for activities such as hayrides and farm pond fishing because these activities are participatory in nature as opposed to other types of amusements subject to the tax. Animal exhibitions are considered to be taxable under current law. The Department is aware of only two instances in which current taxpayers would be affected by the act. It is unclear whether other businesses would be affected by the exemption. Because the act is retroactive to January 1, 1999, the first-year impact of the act would include any refunds to qualifying businesses that have paid the tax since that date.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** This act is effective retroactively to January 1, 1999, and applies to agri-tourism activities occurring on or after that date.

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<sup>73</sup> The City of Kannapolis plans to use project development financing to convert old Pillowtex factory buildings into research labs. It plans to enter into a contract with a private entity to implement its development financing plan.

**ANALYSIS:** Under North Carolina law, amusements are generally subject to a privilege tax equal to 3%. Certain amusements are exempt from the imposition of a privilege tax. This act adds 'all farm-related exhibitions, shows, attractions, or amusements offered on land used for bona fide farm purposes as defined in G.S. 153A-340' to the list of exemptions from the privilege tax on amusements. The exemption would apply to hayrides, animal exhibitions, farm pond fishing, corn mazes, and other such attractions. The term 'bona fide farm purposes', as defined in G.S. 153A-340, includes the production of and activities relating or incidental to the production of crops, fruits, vegetables, ornamental and flowering plants, dairy, livestock, poultry, and all other forms of agricultural products having a domestic or foreign market.

## **Film Incentive Changes.**

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-220	HB 1522	Representative McComas

### **AN ACT TO CONFORM THE TAX CREDIT FOR PRODUCTION COMPANIES TO THE STANDARD TAX TREATMENT WITH RESPECT TO THE DEDUCTION OF BUSINESS EXPENSES.**

**OVERVIEW:** This act eliminates the prohibition against claiming both an income tax deduction and an income tax credit for the same qualifying expenses spent by a production company with regard to the film incentives tax credit.

**FISCAL IMPACT:** The act is estimated to reduce General Fund revenues by \$8.1 million in FY 2007-2008, \$8.5 million in FY 2008-2009, \$9.0 million in FY 2009-2010, and \$9.5 million in FY 2010-2011.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** This act is effective for taxable years beginning on or after January 1, 2007.

**ANALYSIS:** This act repeals the sections of the State's tax laws that prohibit a film and television production company from claiming both an income tax credit and deduction with respect to the same qualifying expenses. This means that a company claiming the film incentives tax credit no longer has to add back the qualifying expenses that form the basis of the credit to its taxable income, to the extent these expenses were not included in taxable income.

During the 2005 Session, the General Assembly replaced the film industry development grant program with a refundable income tax credit equal to 15% of the qualifying expenses spent by a production company in connection with a production.<sup>74</sup> A production company is defined as a person engaged in the business of making original motion picture, television, or radio images for theatrical, commercial, advertising, or educational purposes. In order to qualify for the credit, the production company must have qualifying expenses of at least

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<sup>74</sup> S.L. 2005-276.

\$250,000 with respect to the production.<sup>75</sup> The credit expires for qualifying expenses occurring on or after January 1, 2010. This tax incentive benefits feature films, episodic television series, and commercial advertising. Qualifying expenses are the total amount spent in North Carolina for the following:

- Goods and services purchased by a production company in connection with a production. For goods with a purchase price of \$25,000 or more, the amount included in qualifying expenses is the purchase price less the fair market value of the goods at the time the production is completed.
- Compensation and wages paid by a production company on which it remitted withholding payments to the Department of Revenue. Any amounts paid to an individual whose compensation is in excess of \$1 million with respect to a single production cannot be included as a qualifying expense.

In order to claim the credit, the taxpayer must provide on its return a detailed accounting of the qualifying expenses. The credit may be claimed for the taxable year in which the production activities are completed. The credit is computed based on all of the taxpayer's qualifying expenses incurred with respect to the production, not just the qualifying expenses incurred during the taxable year. If the credit exceeds the amount of tax imposed for the taxable year reduced by the sum of all credits allowable, the Secretary of Revenue must refund the excess to the taxpayer. A pass-through entity is considered a taxpayer for purposes of claiming this credit; therefore, it does not distribute the credit among its owners.

As indicated, this act repeals the prohibition against claiming both a deduction and a credit for the same qualifying expenses, but the following limitations on the credit will continue. First, the amount of the credit with respect to a feature film production is capped at \$7.5 million. Second, the production may not be any of the following: political advertising, television production of a news program or live sporting event, a radio production, or a production containing obscene material.<sup>76</sup>

### **Various ABC Law Changes.**

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-227	HB 1025	Representative Luebke

### **AN ACT TO MAKE VARIOUS CHANGES TO THE ALCOHOL BEVERAGE CONTROL LAWS.**

<sup>75</sup> In the case of an episodic television series, an entire season of episodes is considered one production.

<sup>76</sup> G.S. 14-190.1 defines "obscene material" as material that meets all of the following conditions: the material depicts or describes in a patently offensive way sexual conduct; the average person applying contemporary community standards relating to the depiction or description of sexual matters would find that the material taken as a whole appeals to the prurient interest in sex; the material lacks serious literary, artistic, political, or scientific value; and the material as used is not protected or privileged under the Constitution of the United States or the Constitution of North Carolina.

**OVERVIEW:** Section 14 of this act requires the Secretary of Revenue to credit the Department of Commerce \$200,000 quarterly from the net proceeds of the excise tax collected on unfortified wine.

**FISCAL IMPACT:** The impact on General Fund revenues is negligible.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** Section 14 of this act is effective July 1, 2007.

**ANALYSIS:** Under current law, the Secretary of Revenue is directed to credit, on a quarterly basis, the total of the net proceeds of the excise tax collected on unfortified wine bottled in North Carolina during the previous quarter to the Department of Commerce for use by the North Carolina Wine and Grape Council. The amount to be credited is capped at \$500,000 per fiscal year. Under this act, the cap is removed and the source of the funds is changed to unfortified wine without regard to where it was bottled. Accordingly, the Secretary is directed to credit a flat amount of \$200,000 per quarter, derived from the net proceeds of the excise tax collected on unfortified wine, to the Department of Commerce.

## Special Indebtedness Projects.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-231	SB 1621	Senator Hoyle

### AN ACT TO AUTHORIZE ADDITIONAL SPECIAL INDEBTEDNESS FOR THE CONSTRUCTION OF UP TO FIVE YOUTH DEVELOPMENT CENTERS; TO AUTHORIZE SPECIAL INDEBTEDNESS FOR THE PURCHASE OF STATE GAME LANDS; TO AUTHORIZE SPECIAL INDEBTEDNESS FOR A PARKING FACILITY IN DOWNTOWN RALEIGH; AND TO EXEMPT SALES OF TIMBER FROM THE SERVICE CHARGE IMPOSED BY THE DEPARTMENT OF ADMINISTRATION.

**OVERVIEW:** This act authorizes an additional \$7 million in special indebtedness to complete five youth development centers for which special indebtedness was originally authorized in 2004. It authorizes the issuance of \$20 million in special indebtedness to finance the purchase of land by the Wildlife Resources Commission to be used as State game lands. To assist with the repayment of this indebtedness, the act also exempts sales of timber on land owned by the Wildlife Resources Commission from the service charge imposed by the Department of Administration. Lastly, it authorizes the issuance of \$20 million in special indebtedness to finance the construction of a new parking deck in downtown Raleigh.

**FISCAL IMPACT:** (For a complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)

**EFFECTIVE DATE:** The authorization of additional special indebtedness for the construction of youth development centers is effective January 1, 2007. The remainder of this act became effective August 10, 2006.



**ANALYSIS:** This act authorizes the issuance of special indebtedness for various projects. Commonly referred to as 'certificates of participation', special indebtedness is nonvoted debt that is typically secured only by an interest in State property being acquired or improved. The term 'special indebtedness' covers the various forms this type of debt can take: installment purchase (with or without certificates of participation), lease-purchase (with or without certificates of participation), or bonds.

Before any type of special indebtedness may be issued or incurred, the State Treasurer must certify that debt financing may be desirable for a specific project presented to it by the Department of Administration. Next, the Council of State must give preliminary approval. If preliminary approval is obtained, the Council of State must give final approval, setting out details such as the maximum amount to be financed, the maximum maturity, and the maximum interest rates. The maximum maturity may not exceed 40 years. The State Treasurer must approve the details of the financing, finding that the amount to be borrowed is adequate and not excessive and will not require an excessive increase in any State revenues to provide for repayment, and that the special indebtedness can be incurred or issued on terms favorable to the State. Finally, the State Treasurer must report to the Joint Legislative Commission on Governmental Operations at least five days before any special indebtedness is issued or incurred.

In 2004, the General Assembly authorized the State to issue or incur up to \$35 million of special indebtedness for five youth development centers with a total of 224 beds to be operated by the Department of Juvenile Justice. This act authorizes an additional \$7 million of special indebtedness to complete the construction of five youth development centers for which special indebtedness was originally authorized in 2004. The increase in the amount of the authorization is due to bids on the projects coming in higher than anticipated in 2004.

This act also authorizes the issuance of up to \$20 million of special indebtedness to finance the purchase of land by the Wildlife Resources Commission to be used as State game lands.

The proposed land acquisition involves a total of 77,090 acres currently owned by the International Paper Corporation and located in four separate tracts. The total estimated cost for purchasing the lands is \$80 million, and the Nature Conservancy has approached the State to fund the purchase in the following manner:

- \$45 million from the Clean Water Management Trust Fund
- \$10 million from the Natural Heritage Trust Fund
- \$5 million from the Parks and Recreation Trust Fund
- \$20 million from the Wildlife Resources Commission

With the authorization provided by this act, the Wildlife Resources Commission would purchase roughly 66,000 acres of International Paper lands through a land deal brokered by the Nature Conservancy. The purchase of all 77,090 acres would occur over three years. It is anticipated that timber receipts from the land will be sufficient to repay the indebtedness.

The Department of Administration may assess and collect a service charge when a State agency transfers or sells any State surplus property or recyclable material. This act creates an exception to the service charge for sales of timber on land owned by the Wildlife Resources Commission. The effect of this would be to free up resources to repay the indebtedness.

Finally, this act authorizes the issuance of \$20 million of special indebtedness to construct a parking deck in downtown Raleigh. The act does not, however, specify where in downtown Raleigh the deck will be located. The deck is expected to serve State employees and visitors to the State government complex. The act also requires the Department of Administration to report to the Joint Legislative Commission on Governmental Operations by September 1, 2006, on how this parking deck fits with the Green Square Project. The Green Square Project, authorized by S.L. 2005-255, is a proposal involving the sale by the State to the State Employees' Credit Union of land on which the credit union is currently situated. The property is located on the corner of Jones and Salisbury Streets, next to the Museum of Natural Sciences across from the Department of Administration. The State Employees' Credit Union intends to use the land to construct a building and parking deck for various uses.

## Public-Private Partnerships for Schools.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-232, as amended by S.L. 2006-259	SB 2009	Senator Malone

### **AN ACT TO ALLOW CAPITAL LEASE FINANCING FOR PUBLIC SCHOOLS.**

**OVERVIEW:** This act allows local school administrative units to enter into capital leases for school facilities and allows for those leases to contain an agreement relating to construction, repairs, or renovations.

**FISCAL IMPACT:** No fiscal impact.

**EFFECTIVE DATE:** This act became effective when signed into law by the Governor on August 12, 2006, and will be repealed on July 1, 2011.

**ANALYSIS:** Local school administrative units are responsible for providing for adequate public school facilities. Local governments have several options for financing the provision of public school facilities, including direct appropriations for construction, the issuance of special indebtedness or general obligation indebtedness (provided that the general obligation indebtedness is approved by a voter referendum), and the use of operating leases. Under prior law, a local board of education was prohibited from contracting for the erection of a school facility unless the property on which the building was to be located was owned in fee simple by the local unit. In addition, all construction and repairs were required to be performed under the control and direction of the local board of education.

This act expands the financing authority of local school administrative units by allowing them to enter into capital leases for school facilities. The lease may relate to an existing building or new construction. The lease may also contain an agreement relating to construction, repairs, or renovations. Under a capital lease, the local school board is not required to own the property and the lease may provide that the lessor is responsible for repairs and renovations.

Capital leases differ from operating leases in several respects. In general, a capital lease is one that is considered to have the economic characteristics of ownership. To determine whether a lease is a capital lease or an operating lease, one must look at a number of different provisions in the lease. Under generally accepted accounting principles, a capital lease is a non-cancelable contract satisfying one or more of the following conditions:

- Legal title to the property is transferred to the lessee.
- The lease contains bargain or nominal purchase options.
- The lease term equals or exceeds 75% of the asset's useful life.
- The present value of the minimum lease payments equals or exceeds 90% of the asset's fair market value.

Under this act, all capital leases are subject to the following limitations:

- The lease cannot contain a clause that restricts the right of the local board to continue to provide a service or activity or to replace or provide a substitute for any property financed or purchased by a capital lease.
- Each capital lease is required to contain a clause specifying that it does not constitute a pledge of the taxing power or full faith and credit of the local board of education or board of county commissioners. This provision clarifies that a capital lease is not a general obligation of the local unit. Further, the act provides that no deficiency judgment can be rendered against a local board of education or other local government unit under the lease.
- A capital lease is considered a continuing capital outlay and is subject to the provisions of G.S. 115C-441(c1). That statute generally allows a local board of education to enter into a contract for continuing capital outlay provided that the budget resolution includes an appropriation for the current fiscal year, an unencumbered balance remains in the appropriation sufficient to pay in the current fiscal year the sums authorized under the contract, and the contracts are approved by the board of county commissioners in a resolution that binds the board to appropriate sufficient sums in later fiscal years. For capital leases, however, the resolution by the board of county commissioners requires only that the board make appropriations in later years in the board's discretion.
- A capital lease is subject to approval by the Local Government Commission (LGC) to the extent that the lease satisfies one or more of the conditions relating to financing agreements requiring approval by the LGC. These conditions are:
  - The agreement extends for at least five years.
  - The agreement obligates the unit to pay sums of money to another, regardless of whether the other is a payee, or the agreement obligates the unit to payments of over \$500,000.
- A capital lease cannot contain any agreement with respect to student assignment.
- The property subject to a capital lease is subject to all laws relating to liens on private property.

In addition to the general provisions listed above, numerous additional provisions apply to a 'build-to-suit capital lease.' A build-to-suit capital lease is defined as a lease that provides for construction or renovation, the cost of which is estimated to exceed \$300,000. The following provisions apply to build-to-suit capital leases.

- Before entering into a build-to-suit capital lease, the local board of education is required to adopt a resolution approving the lease. The board is required to provide at least 10 days' notice of the meeting at which the board plans to adopt the resolution approving the lease. The notice is required to include a brief description of the lease and the name of the other party to the lease. The resolution adopted by the board must include a finding that the capital lease is in the best interests of the unit and that the private developer (the lessor) is qualified to provide the products and services called for under the lease.
- All architectural, engineering, and survey services must be procured in accordance with the provisions of Article 3D of Chapter 143 of the General Statutes. Article 3D provides requirements to ensure that public entities procure qualified professionals when contracting for architectural, engineering, or surveying services.
- Private developers are required to seek competition and minority business participation in connection with the construction work. The private developer is required to conduct a competitive bidding process which could include prequalification of subcontractors. The private developer is required to comply with general law regarding minority business participation in public projects, and is required to adopt the minority business participation goals of the local board of education. The local board of education is required to approve of the private developer's plan for compliance with minority business participation prior to the private developer seeking bids.
- The board of education may require the private developer to provide performance or payment bonds in accordance with the provisions of Article 3 of Chapter 44A of the General Statutes. That Article provides for model provisions for performance bonds related to public construction contracts.
- A local board of education may enter into a predevelopment agreement with a private developer. Predevelopment agreements are required to be approved by the board of county commissioners and may involve such areas as site selection or building design.
- A local government unit is authorized to sell, lease, or otherwise transfer real property to a private developer for construction, repair, or renovation of a school facility under a capital lease without following general procedures related to the disposition of property.
- Each capital lease requires that the private developer provide an irrevocable letter of credit of not less than 5% of the total costs of the improvements for the benefit of laborers and materialmen.

## Bill Lee Changes.

<i>Session Law</i>	<i>Bill #</i>	<i>Sponsor</i>
S.L. 2006-252	HB 2170	Rep. Harrell, Daughtridge, Gibson, Owens

### **AN ACT TO REPLACE THE TAX CREDITS GENERALLY AVAILABLE UNDER THE WILLIAM S. LEE QUALITY JOBS AND BUSINESS EXPANSION ACT WITH MORE NARROWLY FOCUSED CREDITS FOR JOB CREATION AND BUSINESS INVESTMENT.**

**OVERVIEW:** This act creates a new Article under Chapter 105 to provide tax credits to new and expanding businesses, effective for taxable years beginning on or after January 1, 2007; sunsets the Bill Lee Act for activities occurring on or after January 1, 2007, rather than January 1, 2008; and makes conforming changes to other statutes that refer to provisions of the Bill Lee Act.

**FISCAL IMPACT:** The act does not have a fiscal impact in fiscal year 2006-2007, and a minimal impact on the State's General Fund in fiscal year 2007-08.

*(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2006 Session. Available in the Legislative Library.)*

**EFFECTIVE DATE:** The new tax credits and the sunset of the existing Bill Lee Act become effective January 1, 2007.

**ANALYSIS:** The William S. Lee Quality Jobs and Business Expansion 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, and for worker training. Counties are divided into five enterprise 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 2000, the General Assembly extended the sunset on the Act until January 1, 2006. In 2005, the General Assembly approved a two-year extension of the Act, until January 1, 2008, in order to provide additional time to study

alternatives to the Act. This act changes the sunset for the Bill Lee Act from January 1, 2008, to January 1, 2007.<sup>77</sup>

*Part 1: Tax Credits for Growing Businesses*

This act creates a new package of State tax incentives to replace the Bill Lee Act for most taxpayers. These incentives become effective January 1, 2007, and expire January 1, 2011. Taxpayers that are eligible for the later repeal date of the Bill Lee Act may choose to take credits under the current Act or under the new provisions of Article 3J of Chapter 105<sup>78</sup> Many of the provisions of Article 3J are similar or identical to the provisions of the Bill Lee Act. There are some significant differences however.

General administration. – By November 30 of each year, the Department of Commerce must assign a tier designation to each of the 100 counties in the State. In order to make these assignments, the Department must give each county a 'development factor'. A county's development factor is determined by ranking all counties based on the following factors: unemployment, median household income, percentage population growth, and per capita adjusted assessed property value. Regardless of the development factor, any county with a population of less than 12,000 is automatically included in the counties with the 40 highest rankings, any county with a population of less than 50,000 is automatically included in the counties with the 80 highest rankings, and any county with a population of less than 50,000 and more than 19% of its population below the federal poverty level is automatically included in the counties with the 40 highest rankings. Regardless of the development factor, a county first designated as a tier one area in one of the two previous years is included in the counties with the 40 highest rankings. The 40 counties with the highest ranking will be designated as development tier one,<sup>79</sup> the next 40 highest counties will be designated as development tier two, and the remaining counties will be designated as development tier three.

This tier designation differs in several keys ways from the Bill Lee Act. First, under the Bill Lee Act, counties are divided into five tiers rather than three. Second, in order to make the Bill Lee Act tier designations, the Department of Commerce ranks all 100 counties based on the following three factors: unemployment, average per capita income, and percentage growth in population. The tier designation under the new Article substitutes median

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<sup>77</sup> There are several exceptions to the 2007 sunset date. Interstate air couriers are eligible to claim the credits for business activity that occurs on or before January 1, 2010, provided that the interstate air courier entered into a real estate lease on or before January 1, 2006, with an airport authority that provides for the lease of at least 100 acres of land for a term of at least 15 years. 'Eligible major industries' that qualify as such before January 1, 2008, are also allowed to claim credits for business activity that occurs on or before January 1, 2010. A taxpayer is an eligible major industry if it will invest at least \$100 million in acquiring, constructing, and equipping a facility and it is engaged in bioprocessing, the manufacture or distribution of pharmaceuticals or medicines, aircraft manufacturing, computer manufacturing, motor vehicle manufacturing, semiconductor manufacturing, or financial services, securities operation, or related systems of development. (See Part III of S.L. 2006-168) In addition, projects that are located in development zones are eligible for credits for business activities occurring before January 1, 2010, if all of the following conditions are met: before January 1, 2006, the taxpayer signs a letter of commitment with the Department of Commerce; the Secretary of Commerce makes a written determination that the taxpayer will invest \$10 million and create at least 300 new jobs at the facility within a three-year period; and the taxpayer invests at least \$4 million and creates at least 20 new jobs at the facility before January 1, 2006.

<sup>78</sup> The legislation created a new Article 3I. However, the codifier codified the new Article as 3J to avoid any potential confusion since the Article could easily be misinterpreted as Article 31.

<sup>79</sup> For the 2007 and 2008 taxable years, there will be 41 counties in development tier one.

household income for per capita income and adds the new factor related to adjusted assessed property value per capita. Third, under the new Article, the number of counties in a tier would be fixed. If one county received a lower tier designation because of the population or low-tier status exception, another county would be moved to a higher tier. Under the Bill Lee Act, the adjustments may move a county to a lower tier, but they do not result in any county being assigned to a higher tier. And last, the tier designation is made by November 30 of each year as opposed to December 31.

The Bill Lee Act also contains exceptions to the tier designation structure for certain multi-jurisdictional industrial parks. Under those exceptions, taxpayers located in certain industrial parks that are owned by multiple jurisdictions are eligible for credits as if they were located in the lower-tiered jurisdiction. The new Article retains these exceptions.

Development zones are another key feature of the Bill Lee Act.<sup>80</sup> Development zones were intended to be areas of high poverty within cities. Over the years, it has become clear that the development zones often include areas that are neither high-poverty nor particularly urban. The new Article replaces development zones with urban progress (UP) zones. UP zones are more narrowly focused than development zones. First, an UP zone must be entirely within the corporate limits of a municipality with a population of at least 10,000. Development zones are located, at least partially, in a municipality with a population of at least 5,000. Second, UP zones must meet more stringent guidelines with respect to poverty within the zone. Third, the total area of all UP zones in a municipality may comprise no more than 15% of the area of a municipality. There is no similar restriction on development zones.

The new Article also creates a new type of zone in which the credits are enhanced. The Article authorizes the creation of agrarian growth (AG) zones and provides those areas with the same benefits provided to UP zones. An AG zone must satisfy the following conditions: it must be composed of contiguous census tracts or block groups located within a single county that does not have any municipality with a population in excess of 10,000; each census tract or block group in the zone must have more than 20% of its population below the poverty level; and the area of the zone, less its smallest census tract, may not exceed 5% of the total area of the county. The Department of Commerce shall designate an area as an AG zone upon the request of a local government.<sup>81</sup>

Under the new Article, all of the credits may be taken against the franchise tax levied in Article 3 of Chapter 105, the income taxes levied in Article 4 of Chapter 105, the gross

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<sup>80</sup> Under the Bill Lee Act, the Department of Commerce is also responsible for designating development zones. Development zones were intended to be areas of higher poverty within urban centers. In order to be designated as a development zone, the area must satisfy all of the following conditions: every census tract or block group in the zone is located in a city with a population of at least 5,000, the zone has a population of at least 1,000, more than 20% of the population of the zone is below the poverty level, every census track or block group in the zone has more than 10% of its population below the poverty level or is immediately adjacent to a census tract or block group that has more than 20% of its population below the poverty level, and no census tract or block group in the zone is located in another development zone. Designation as a development zone is effective for two years. Location in a development zone leads to more favorable treatment for the taxpayer with respect to the wage standard, the credit for creating new jobs, the credit for investing in machinery and equipment, and the credit for worker training.

<sup>81</sup> S.L. 2006-66, Section 24.16, created AG zones under the Bill Lee Act. The AG zones under S.L. 2006-66 became eligible for Bill Lee credits in taxable year 2006. Under this act, the Bill Lee Act expires for taxable years beginning on or after January 1, 2007.

premiums tax levied in Article 8B of Chapter 105, or a combination of these taxes. The credits allowed under the Bill Lee Act are also allowed against these taxes; however, unlike this new Article, under the Bill Lee Act, a taxpayer may take a credit against only one of the three taxes.

Under the new Article created by this act, the total amount of credits allowed may not exceed 50% of the amount of the taxpayer's combined tax liability for franchise, income, and gross premiums taxes. Under the Bill Lee Act, the credits are limited to 50% of the taxpayer's tax liability for the one tax against which the taxpayer chooses to apply it. As with the Bill Lee Act, this cap applies to the cumulative amount of credits for the current year and carryforwards of credits from previous years. Under the new Article, any unused portion of a credit with respect to the credit for creating jobs or investing in business property may be carried forward for the succeeding five years. This is also the standard carryforward period for the Bill Lee Act. Any unused portion of a credit with respect to the credit for investing in real property may be carried forward for the succeeding 15 years, as compared to the succeeding 20 years under the Bill Lee Act. Finally, as with the Bill Lee Act, credits with respect to a large investment (at least \$150 million) may be carried forward for 20 years. The new Article shortens the carryforward period for some credits and eliminates some enhanced carryforward provisions altogether.

When filing a return for a taxable year in which the taxpayer engaged in activity for which the taxpayer is eligible for a credit, the taxpayer is required to submit a fee of \$500 for each type of credit the taxpayer intended to claim with respect to an establishment.<sup>82</sup> The Bill Lee Act contains a similar fee requirement. Under the Bill Lee Act, there is a maximum fee of \$1,500 per taxable year. Article 3J does not have a maximum fee amount.

As under the Bill Lee Act, each taxpayer claiming a credit under the new Article must provide any information required by the Secretary of Revenue to evaluate the eligibility of the taxpayer for the credit claimed.

As under the Bill Lee Act, the Department of Revenue and the Department of Commerce must report on various facets of the business tax incentives allowed under this new Article. By each May 1, the Department of Revenue must publish information itemized by credit and by taxpayer relating to the amount and tier designation of new jobs, new real property investment, and new business property. The Department of Commerce is required to make biennial reports on tax equity and the effectiveness of the tax incentives provided under this new Article. In addition to these periodic reports, the Department of Commerce, in consultation with the North Carolina Rural Center, Inc. and the lower-tiered counties, must develop additional strategies to enhance economic growth and development in enterprise tier one areas. The Department must report on the results of this study to the Joint Legislative Economic Development Oversight Committee by January 1, 2007.

As with the Bill Lee Act, credits under the new Article may not be taken more than six months after the deadline for filing the tax return (including extensions) on which they were claimed. This is more restrictive than is generally the case under North Carolina law. In

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<sup>82</sup> The fee revenue is credited to the General Fund. Under the Bill Lee Act, three-fourths of the fees collected are retained by the Department of Revenue to administer and audit the credits and the remaining fee amounts are retained as departmental receipts by the Department of Commerce to administer the act. This act recognizes that the cost of administering the act extends years beyond the filing of the actual tax return and that the costs of adequately administering and auditing the credits exceeds the amount of fee revenue.



general, an overpayment may be refunded only if the discovery is made or the written request for a refund made within 3 years of the date set by statutes for filing the return or within 6 months of the date of the overpayment, whichever is later.

*Basic eligibility.* – To be eligible for a credit under this new Article, a taxpayer must meet eligibility requirements with respect to type of business as well as established standards with respect to wages, health insurance, environmental impact, and health and safety programs. A taxpayer cannot claim the credit if the taxpayer has an overdue tax debt.

A business type generally is determined solely by reference to the primary activity of the particular establishment.<sup>83</sup> The following types of businesses are eligible for credits under the new Article:

- Aircraft maintenance and repair.
- Air courier services hub.
- Corporate headquarters, but only if additional eligibility requirements related to job creation are satisfied.
- Customer service call centers.
- Electronic shopping and mail order houses.
- Information technology and services.
- Manufacturing.
- Motorsports facilities.
- Motorsports racing teams.
- Research and development.
- Warehousing.
- Wholesale trade.

Business-type eligibility under the new Article is substantially different than under the Bill Lee Act. Under the Bill Lee Act, business type eligibility depends on several factors including the primary business of the taxpayer as a whole, the primary activity of the particular establishment, the location of the establishment, and the number of new jobs created. The following types of business are eligible under the Bill Lee Act:

- Air courier services, if the primary business of the taxpayer is air courier services.
- Data processing, if the primary business of the taxpayer is data processing.
- Manufacturing, if the primary business of the taxpayer is manufacturing, warehousing, or wholesale trade and the primary activity of the establishment is manufacturing.
- Warehousing, if the primary business of the taxpayer is manufacturing, warehousing, or wholesale trade and the primary activity of the establishment is warehousing, or if the primary activity of an establishment is warehousing, the

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<sup>83</sup> The definition of 'establishment' under the new Article is different from the definition of 'establishment' under the Bill Lee Act. Generally, under the new Article, an establishment means a single physical location. Under the Bill Lee Act, an 'establishment' is defined by NAICS (North American Industry Classification System) as the smallest operating entity for which records provide information on the cost of resources – materials, labor, and capital – employed to produce the units of output. Under NAICS, an establishment is generally a single physical location; although there are many exceptions to this generality.

establishment is located in an enterprise tier 1-3 area, and the establishment serves 25 or more establishments of the taxpayer.

- Wholesale trade, if the primary business of the taxpayer is manufacturing, warehousing, or wholesale trade and the primary activity of the establishment is wholesale trade.
- Computer services, if the primary activity of the establishment is computer services.
- Electronic mail order house, if the primary activity of the establishment is an electronic mail order house and the electronic mail order house is located in an enterprise tier one through three area and creates at least 250 new jobs.
- Customer service center, if the primary business of the taxpayer is financial services or telecommunications, the primary activity of the establishment is a customer service center, and the center is located in an enterprise tier 1-3 area.
- Central office or aircraft facility, if the primary activity of the establishment is a central administrative office or a training or maintenance center for an interstate air passenger carrier and the establishment creates at least 40 new jobs.

Under Article 3J, motorsports facilities and motorsports racing teams are eligible for credits whereas they are not currently eligible under the Bill Lee Act. A larger group of manufacturers, warehouseers, wholesale traders, electronic mail order houses, and customer service centers are eligible for credits under the new Article than under the Bill Lee Act. Under the new Article, credits for central administrative office facilities are restricted to those facilities that are corporate headquarters, and the credit for information technology and services replaces the Bill Lee Act credits for data processing and computer services.

In order for a corporate headquarters to qualify for credits under the new Article, the establishment must create at least 75 new jobs within a 24-month period. A taxpayer that satisfies this job creation requirement is eligible for credits in the year in which the requirement is satisfied and the two succeeding years. A taxpayer that later creates an additional 75 new jobs in a 24-month period may be eligible for an additional three-year period of eligibility, but only if the job creation occurred outside of any other period of eligibility.

A taxpayer is eligible for a credit under the new Article 3J only if the jobs provided by the taxpayer meet a wage standard. As with the Bill Lee Act, no wage standard applies in the lower-tiered areas.<sup>84</sup> For development tiers two and three, the jobs provided by the taxpayer must pay at least the lower of 90% of the average county wage or 110% of the average State wage to qualify for a tax incentive. This differs significantly from the manner in which the wage standard is calculated under the Bill Lee Act. Under the Bill Lee Act, for enterprise tier areas three through five, the jobs provided by the taxpayer must pay at least 110% of the applicable average weekly wage. The applicable average weekly wage of the county is the lowest of the following: the average weekly wage for all insured private employers in the county, the average weekly wage for all insured private employers in the State, and the average weekly wage for all insured private employers in the county multiplied by the county

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<sup>84</sup> Legislation enacted in 2002 eliminated the wage standard in enterprise tiers one and two under the Bill Lee Act. Under the new Article, no wage standard applies in development tier one. Development tier one under the new Article is roughly equivalent to enterprise tiers one and two under the Bill Lee Act.

income/wage adjustment factor.<sup>85</sup> Under the new Article, for activities that occur in UP zones or AG zones, the wage standard is lower than for activities that occur in development tiers two and three outside of UP zones or AG zones. For UP zones or AG zones, the wage standard is 90% of the lesser of the average county wage and the average State wage. Under the Bill Lee Act, there is no wage standard for activities occurring in development zones.

Under the new Article, the wage standard is calculated in different ways for the credit for creating jobs and the credit for investing in business property. For the credit for creating jobs, the average weekly wage of the jobs for which the credit is claimed and the average weekly wage of all jobs at the establishment with respect to which the credit is claimed will be required to meet the relevant wage standard. For the credit for investing in business property, the average weekly wage of all jobs at the establishment with respect to which the credit is claimed must meet the relevant wage standard. This is equivalent to how the wage standard is applied under the Bill Lee Act for the credits for creating jobs and for investing in machinery and equipment. As with the Bill Lee Act, there is no wage standard for the credit for investing in real property because that credit is available only in the lower-tiered counties where the wage standard requirement does not apply.

Under the Bill Lee Act, all jobs, including part-time jobs, must be included in the wage standard calculation. However, part-time jobs that also provide health insurance are considered to have an average weekly wage at least equal to the relevant wage standard. For the purpose of calculating the wage standard, the weekly wage of a part-time job is converted to a full-time equivalency. Under the new Article, part-time jobs are not included in the calculation of the wage standard. As under the Bill Lee Act, all jobs that were filled for at least 1600 hours during the year in which the taxpayer engaged in the activity for which a credit was claimed would be included in the wage standard calculation under the new Article even if those jobs were not filled at the time the taxpayer claimed the credit.

As under the Bill Lee Act, a taxpayer is required to provide health insurance for all full-time jobs at the establishment in order to be eligible for a credit under the new Article. The taxpayer must pay at least 50% of the premiums for health insurance that met at least the minimum provisions of the basic health care plan of coverage recommended by the Small Employer Carrier Committee. Each year that a taxpayer claims an installment or carryforward of a credit, the taxpayer must provide certification that it continues to provide health insurance for all full-time employees. If the taxpayer ceases to provide health insurance, the credit expires and the taxpayer is not allowed to take any remaining installment or carryforward of the credit.

As under the Bill Lee Act, a taxpayer is ineligible for a credit under the new Article if the taxpayer has any pending administrative, civil, or criminal enforcement action based on alleged significant violation of any program implemented by an agency of the Department of Environment and Natural Resources or if the taxpayer has had any final determination of responsibility for any significant administrative, civil, or criminal violation of any program implemented by an agency of the Department of Environment and Natural Resources in the last five years. The Secretary of Environment and Natural Resources is required to notify the

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<sup>85</sup> The county income/wage adjustment factor is the county income/wage ratio divided by the State income/wage ratio. The income/wage ratio is determined by dividing the average per capita income in the relevant jurisdiction by the annualized average wage for all insured private employers in the jurisdiction.

Department of Revenue of all persons who currently have any of these pending actions or who have had any of these final determinations in the past five years.

As under the Bill Lee Act, a taxpayer is ineligible for a credit under the new Article if the taxpayer had any outstanding violations under the Occupational Safety and Health Act that had become a final order for 'willful serious' or 'failure to abate serious' violations within the past three years. The Department of Labor must notify the Department of Revenue of all employers who have had these citations become final orders in the past three years.

As under the Bill Lee Act, a taxpayer is ineligible for a credit under the new Article if the taxpayer has any overdue tax debts. An overdue tax debt is any part of a tax debt that remains unpaid 90 days or more after a notice of final assessment was mailed to the taxpayer. A tax debt is a final assessment after all possibilities for appeal have been exhausted.

Expiration. – Under the Bill Lee Act, credits may expire for several reasons. If the taxpayer is no longer engaged in an eligible type of business or if the number of jobs of an eligible business falls below the minimum number required, the credit expires. Generally, if a credit expires, the taxpayer may not continue to take installments of the credit, but may continue to take carryforwards of installments that accrued in previous years.<sup>86</sup> The credit for creating jobs and the credit for investing in machinery and equipment expire if the jobs are no longer filled or if the machinery and equipment are taken out of service used in an eligible business. The credit does not expire if the enterprise tier designation of an eligible taxpayer changes after the credit is first claimed. The credits under the new Article retain these expiration provisions.

Forfeiture. – Under the Bill Lee Act, a taxpayer forfeits a credit if the taxpayer was not eligible for the credit in the year in which the taxpayer engaged in the activity for which the credit was claimed. A taxpayer that forfeits a credit is liable for all past taxes avoided as a result of the credit plus interest. The past taxes and interest are due 30 days after the date the credit is forfeited. The credits under the new Article retain these forfeiture provisions.

Credit for creating jobs. – A taxpayer is allowed a credit for creating new full-time jobs. In order to be eligible for this credit, the taxpayer must meet a job creation threshold based on the development tier designation of the location where the jobs are created.<sup>87</sup> If the taxpayer creates jobs in more than one county during a year, the threshold applies separately to each county. If the taxpayer creates jobs at more than one establishment in a single county during a year, the threshold applies jointly to all establishments within the county. In addition, the amount of the credit varies depending on the development tier designation of the area in which the job is located. A job is located in an area if 50% or more of the employee's duties are performed in the area. The full amount of the credit cannot be taken in the first year, but instead must be taken in four equal installments beginning with the taxable year following the year in which the employee was hired. Jobs transferred from one part of the State to another do not qualify for the credit. In addition, jobs transferred within the State from a related member of the taxpayer to the taxpayer do not qualify for the credit. The amount of the credit and the job creation threshold are equal to the amounts in the following table based on the development tier area in which the job is located. In addition, a job created in

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<sup>86</sup> Expiration of a credit because the taxpayer ceases to provide health insurance is an exception to this general rule. In that case, the taxpayer may not claim installments or carryforwards after the credit expires.

<sup>87</sup> For jobs created in an UP zone or an AG zone, the threshold applicable to development tier one would apply.

an UP zone or an AG zone is eligible for an additional credit of \$1,000 and if that job is filled by a resident of the zone or a long-term unemployed worker,<sup>88</sup> it would be further increased by an additional \$2,000.

<u>Area Development Tier</u>	<u>Amount of Credit</u>	<u>Threshold</u>
Tier One	\$12,500	5
Tier Two	5,000	10
Tier Three	750	15

Under the new Article, if in one of the four years in which the installment of a credit accrues, the jobs with respect to which the credit was taken were unfilled, the credit related to those specific jobs would expire and the taxpayer would not be allowed to take any remaining installments of the credit. If, in one of the four years in which the installment of a credit accrues, the total number of jobs fell below the sum of the applicable job creation threshold and the number of jobs existing in the year before the new jobs were created, the credits with respect to all the new jobs would expire and the taxpayer would not be allowed to take any remaining installments of the credits. If, in one of the four years in which an installment of the credit accrued, a job that qualified for the credit was subsequently transferred to another area, the remaining installments of the credit would be calculated as if the job had been initially located in the later area.

Under the new Article, a taxpayer that plans to create new jobs in a specific area during the next two years may sign a letter of commitment with the Department of Commerce in order to lock-in the current year's development tier designations for the purposes of this credit. If the taxpayer created the jobs within the next two years, the taxpayer would be allowed to compute the amount of the credit based on the designations in effect in either the year in which the letter of commitment was signed or the year in which the jobs were created. If the taxpayer did not create the jobs in the next two years, the taxpayer could still claim a credit under the existing tier designation if the jobs were later created.

A taxpayer cannot claim a credit under the new Article and under the Bill Lee Act with respect to the same job. This restriction is important because the Bill Lee Act will remain in effect for a limited group of taxpayers until 2010.

There are several significant differences between the new credit for creating jobs and the credit that currently exists under the Bill Lee Act. First, the Bill Lee Act credit does not require the taxpayer to meet a job creation threshold whereas the new credit does. Second, the amount of the credit per job is more generous for some taxpayers under the new credit than under the existing Bill Lee Act credit. And third, the credit is based on the average number of jobs filled during the year rather than the year-end total.

Credit for investing in machinery and equipment.— Under this act, a taxpayer is allowed a credit for the amount by which the cost of the eligible investment amount of business property placed into service during a taxable year exceeds a threshold. The eligible investment amount is the lesser of (i) the cost of the eligible business property and (ii) the net increase in eligible business property over the base year (the year of the preceding three years in which the taxpayer had the largest amount of business property in service in the State). In order to be eligible for the credit, the taxpayer must place new business property into service in excess of

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<sup>88</sup> A 'long-term unemployed worker' is defined as an individual that has been totally unemployed for at least the preceding 26 consecutive weeks.

a threshold based on the development tier designation. The credit is taken in four equal installments, beginning the year after the equipment is placed in service. The amount of the credit is equal to a percentage of the eligible investment amount of the business property. If the taxpayer places eligible business property into service in more than one county during a year, the threshold applies separately to each county. If the taxpayer places eligible business property into service at more than one establishment in a single county during a year, the threshold applies jointly to all establishments within the county. The following table sets out the relevant percentage and threshold for each development tier area:

<u>Area Development Tier</u>	<u>Threshold</u>	<u>Credit Percentage</u>
Tier One <sup>89</sup>	\$ -0-	7%
Tier Two	1,000,000	5%
Tier Three	2,000,000	3.5%

If in one of the four years in which the installment of a credit accrues, the business property with respect to which the credit was taken is disposed of, moved out of State, or taken out of service, the credit expires and the taxpayer may not take any remaining installments of the credit unless the cost of that business property is offset in the same taxable year by the taxpayer's new investment in business property. If eligible business property that qualifies for a credit is subsequently transferred to another area, the remaining installments of the credit are calculated as if the business property had been initially located in the later area.

A taxpayer that plans to place specific business property in service at a specific location within the next two years may sign a letter of commitment with the Department of Commerce in order to lock-in the current year's development tier designation for the purposes of this credit. If the taxpayer places the eligible business property in service within the next two years, the taxpayer may compute the amount of the credit based on the designations in effect in either the year in which the letter of commitment was signed or the year in which the business property is placed in service. If the taxpayer does not place the business property in service in the next two years, the taxpayer may still claim a credit under the existing tier designation if the business property is later placed in service.

A taxpayer cannot claim a credit under the new Article 3J and under the Bill Lee Act with respect to the same business property. This restriction is important because the Bill Lee Act will remain in effect for a limited group of taxpayers until 2010.

There are significant differences between the new credit for investing in business property and the credit currently allowed under the Bill Lee Act for investing in machinery and equipment. First, the thresholds under the new credit differ from the thresholds under the existing credit. Second, the definition of 'business property' under the new credit is broader than the definition of 'machinery and equipment' under the existing credit. Third, the percentage that determines the amount of the credit under the new credit differs from the percentage for the existing credit for some taxpayers. And lastly, the new credit is taken in equal installments over four years rather than seven.

Credit for substantial investment in other property. – Under this act, a taxpayer that is located in a development tier one area is eligible for a credit for investment in real property. In order for the taxpayer to claim this credit, the Secretary of Commerce must make a written

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<sup>89</sup> For the purposes of this credit, investment that occurs in an UP zone or an AG zone is subject to the threshold and percentage applicable to activity that occurs in a development tier one area.

determination that the taxpayer is expected to invest at least \$10 million in real property at a location within a three-year period and that the taxpayer will create at least 200 new jobs at the location within two years of the time that the property is first used in an eligible business. The taxpayer may begin to claim the credit once the property is first used in an eligible business. The amount of the credit is equal to 30% of the eligible investment amount and must be taken in installments over a seven-year period. The new credit does not have a ceiling on the amount of credit that may be taken. The credit for investment in real property expires if the number of people employed at the location falls below 200.

A taxpayer cannot claim both the new credit for investment in real property and either of the existing Bill Lee Act credits for investment in real property with respect to the same property. This restriction is important because the Bill Lee Act will remain in effect for a limited group of taxpayers until 2010.

The only significant difference between the new credit for investment in real property and the Bill Lee Act credit for substantial investment in other property is the carryforward period. Under the Bill Lee Act, unused portions of the credit can be carried forward for up to 20 years. Under the new Article, unused portions of the credit may be carried forward for up to 15 years.

Expiring credits. – The Bill Lee Act contains five credits that do not have a counterpart in this new Article. Those credits are as follows:

- Technology commercialization credit. The technology commercialization credit is essentially an enhanced version of the credit for investing in machinery and equipment for taxpayers that are making significant investments in certain types of machinery and equipment. There is no similar enhancement in the new Article; however, the technology commercialization credit was designed with a specific project in mind that never came to fruition and, therefore, the credit has never been claimed.
- Credit for research and development. The Bill Lee Act contained a credit for research and development expenditures. In 2004, the General Assembly created a new, stand-alone credit for research and development (See Article 3G of Chapter 105 of the General Statutes). Therefore, no similar credit is included in the new Article.
- Credit for worker training. The Bill Lee Act contains a credit with which a taxpayer could offset certain worker training expenses. There is no similar credit in the new Article.
- Credit for investing in central office or aircraft facility property. The Bill Lee Act contains a credit for investing in central office or aircraft facility property. The credit is equal to 7% of the eligible investment amount and is capped at \$500,000. There is no similar credit in the new Article though a business that would have been eligible for this credit under the Bill Lee Act is eligible for the credit for investing in real property under the new Article if the requirements of that credit are satisfied.
- Credit for development zone projects. This credit allows a taxpayer to claim a credit equal to 25% of a donation to a development zone agency for an

improvement project in a development zone. There is no similar credit in the new Article.

Extension of Bill Lee Act for taxpayers signing a letter of commitment. – This act allows certain taxpayers to claim credits under the Bill Lee Act rather than the new Article in certain circumstances. There are any number of companies that are currently considering expanding in or relocating to North Carolina. Many of the expansions or relocations have been considered assuming that the credits allowed under the Bill Lee Act would be available through at least its current repeal date, 2008. For some taxpayers, the Bill Lee Act would allow for more generous credits, whereas for other taxpayers the credits under the new Article 3J would be more generous. The act allows taxpayers that sign a letter of commitment with the Department of Commerce on or before December 31, 2006, that describes the specific project to claim credits under the Bill Lee Act for the 2007 taxable year rather than under the new Article. The legislation clarifies that if a taxpayer elects to take any credit under the Bill Lee Act during the 2007 taxable year, the taxpayer may not take any credit under the new Article with respect to the same establishment for that taxable year. This restriction prevents a taxpayer from picking and choosing which Article would be more beneficial for each particular credit.

#### *Part 2: Conforming Changes*

Part II of the act makes a number of conforming changes. Since the creation of the Bill Lee Act in 1996, many other programs have adopted the enterprise tier designation as a proxy for the economic viability or the available resources of a county. Many of these programs deal with economic development, but the tier structure has also been adopted as a proxy in areas such as animal control and wetlands mitigation. In addition, some programs refer to other aspects of the Bill Lee Act such as development zones or the wage standard. Because the Article created in Part I of this act largely replaces the Bill Lee Act, the changes in Part II of this act should help to lessen confusion that would be inherent in the use of two different tier systems. Because the tier structures are not equivalent, the changes in this Part will benefit some areas while reducing benefits to other areas. The changes are briefly summarized below.

Research & development expenses. – Section 2.1 conforms the credit for research and development expenses to the new tier structure. Under current law, the credit for research and development expenses is more generous if the research is conducted in an enterprise tier one, two, or three area. Under this act, research conducted in a development tier one area will be eligible for the more generous credit. Because development tier one will contain fewer counties than enterprise tiers one, two, and three combined, this change could result in some taxpayers being eligible for a smaller credit.

Section 2.20 conforms eligibility requirements for the credit for research and development to the new Article. Under current law, in order to be eligible for that credit the taxpayer must satisfy the wage standard, health insurance, environmental impact and safety and health record requirements under the Bill Lee Act. This section changes the reference to those requirements under the new Article. This change could have the effect of making more taxpayers eligible for the credit because the wage standard requirement under the new Article is less strenuous than the requirement under the Bill Lee Act.

Sales & use tax refund for low enterprise tier machinery and equipment. – Section 2.2 conforms the sales and use tax refund for low enterprise tier machinery and equipment to the new tier



structure. Under current law, a taxpayer is eligible for a refund of sales and use tax paid at the general rate on machinery and equipment put into service in enterprise tier one and two areas. This section adds a reference to development tier one. Because development tier one is expected to be roughly equivalent to, though including more counties than, enterprise tiers one and two combined, this change should have limited effect.

Sales & use tax refund on building materials for major eligible industrial facilities. – Section 2.3 conforms the sales and use tax refund on building materials for major eligible industrial facilities to the new tier structure. Under current law, a taxpayer must invest at least \$50 million in an eligible facility in an enterprise tier one, two, or three area or \$100 million in an eligible facility in an enterprise tier four or five area to be eligible for the refund. This section changes the requirement so that the \$50 million threshold applies to facilities in development tier one and the \$100 million threshold applies to facilities in tiers two and three. Because development tier one will contain fewer counties than enterprise tiers one, two, and three combined, this change could result in some taxpayers being ineligible for a refund.

Industrial Development Fund. – Section 2.4 makes changes to the Industrial Development Fund to conform to the tier designation changes. Local government units in enterprise tiers one, two, and three are eligible for grants from the Fund to help create jobs. The grant funds may be used in limited ways mostly related to the provision of infrastructure, equipment, or building repairs. Generally, a local match is required unless the local government unit is in an enterprise tier one area. This provision would make the counties that have the 65 highest rankings (development tier one and slightly more than half of development tier two) eligible for grants from the Fund. In addition, no local match could be required for the counties that have the 25 highest rankings (slightly more than half of development tier one). The intent was to maintain the status quo with respect to the Industrial Development Fund.

Community Development Block Grant funds. – Section 2.4 conforms the guidelines adopted by the Department of Commerce relating to community development block grant funds to the new tier structure. Under current law, those guidelines must ensure that grants awarded in enterprise tier one areas do not require a local match and that priority is given to projects in enterprise tier one areas and development zones. This section changes those references. The reference to enterprise tier one is changed to the counties that have the 25 highest rankings (slightly more than half of development tier one) and the reference to development zones is changed to UP zones. Because the counties that have the 25 highest rankings would be roughly equal to enterprise tier one, this change should maintain the status quo with respect to enterprise tier one areas. On the other hand, because UP zones are more restrictive than development zones, this change could have the effect of eliminating some projects from priority consideration.

Jobs Development Incentive grants. – Section 2.6 changes a definitional reference under the JDIG statutes.

Section 2.7 conforms the JDIG job creation requirements to the new tier structure. Under current law, a business must create at least 10 new jobs in an enterprise tier one, two, or three area or 20 new jobs in an enterprise tier four or five area to be eligible for consideration for JDIG. This section changes those requirements so that a business must create at least 10 new jobs in a development tier one area or 20 new jobs in a development tier two or three area to be eligible for consideration. Because development tier one will contain fewer counties than enterprise tiers one, two, and three combined, this change could

result in some taxpayers being ineligible for consideration for JDIG. However, all businesses that have received JDIG grants have created far more jobs than the minimum required; therefore, this change will not likely have any practical effect.

Section 2.8 conforms a reference to tiers under the JDIG reporting requirements.

Section 2.9 conforms the JDIG grant reduction requirements to the new tier structure. Under current law, a business that is located in an enterprise tier four or five area when the grant is awarded would have the amount of a grant reduced by 25%, with that reduction flowing to the Utility Account of the Industrial Development Fund rather than to the business. This section changes that reference. Under this provision, for development tier three, the amount of the reduction remains at 25% and for development tier two, the reduction is equal to 15%. This section roughly maintains the status quo in enterprise tier five, provides a benefit to enterprise tier four, and lessens the amount of the grant for enterprise tier three.

Tax increment financing. – Section 2.10 conforms a provision relating to tax increment financing to the new tier structure. This section expands an exception created for financing districts related to tourism-related economic development projects. Under current law, this exception is allowed only in an enterprise tier one area. This section allows that exception in a development tier one area. Because development tier one would contain more counties than enterprise tier one, this change expands the exception.

Spay/Neuter Account. – Section 2.11 conforms provisions dealing with the Spay/Neuter Account to the new tier structure. Under existing law, there is an account that helps offset the cost incurred by cities and counties for the spaying and neutering of animals. Fifty percent of the funds in the account are reserved for cities and counties in enterprise tiers one, two, and three. The remaining 50% is reserved for cities and counties in enterprise tiers four and five. If there are excess funds after all needs have been met in enterprise tier one, two and three areas, those funds are transferred and used in enterprise tier four and five areas. The funds designated for a group of tier areas are then allocated based on population. This section changes this breakdown so that the division is between development tier one areas and development tier two and three areas. Because development tier one will contain fewer counties than enterprise tiers one, two, and three combined, this change could result in some cities and counties getting more assistance and some cities and counties getting less assistance.

Farmland Preservation Trust Fund. – Section 2.12 conforms a provision relating to agricultural easements and the Farmland Preservation Trust Fund to the new tier structure. Under current law, enterprise tier one, two, and three counties that have prepared countywide farmland protection plans are not required to match funds from the Farmland Preservation Trust Fund used to purchase agricultural easements. This section changes that reference to development tier one. Because development tier one will contain fewer counties than enterprise tiers one, two, and three combined, this change could result in some counties being newly subject to the match requirement.

Clean Water Management Trust Fund. – Section 2.13 corrects a definition relating to the Clean Water Management Trust Fund. The Article establishing the Fund refers to an "economically distressed county as defined by G.S. 105-129.3". Although G.S. 105-129.3 is the statute that specifies tier designation under the Bill Lee Act, there is no definition in that statute of an 'economically distressed county'. There is, however, a definition of an

economically distressed county under the statute dealing with the Industrial Development Fund. This provision corrects that statutory reference. As discussed above, the definition under the Industrial Development Fund was changed in section 2.4 of this act, but that change roughly maintained the status quo.

Wetlands mitigation. – Sections 2.14 through 2.17 conform provisions dealing with wetlands mitigation to the new tier structure. Under current law, when the State purchases land for wetlands mitigation it is required to make a payment in lieu of taxes to the county in which the land is located if the county is an enterprise tier one or two area. These sections change those references to development tier one area. Because development tier one would have slightly more counties than enterprise tiers one and two combined, this change would require the State to make these payments in more instances.

Condemnation of unsafe buildings. – Sections 2.18 and 2.19 conform provisions dealing with condemnation of unsafe buildings to the new tier structure. Under current law, cities have more flexibility in condemning nonresidential buildings as unsafe if the building is located in a 'community development target area'. A community development target area is one that has characteristics of a development zone or similar characteristics. These sections change the references from development zone to UP zone. Because of the amorphous nature of the definition of 'community development target area', this change should not have any impact.

Tax secrecy statute. – Section 2.21 amends the statutes relating to tax secrecy to ensure that the Department of Revenue may share information that is needed to administer the new Article with the Department of Commerce.

Mill rehabilitation tax credit. – Sections 2.22 through 2.24 amend the statutes relating to the mill rehabilitation tax credit passed earlier this year by the General Assembly in S.L. 2006-40. The mill rehabilitation tax credit is larger if the eligible site is located in an enterprise tier one, two, or three area. These sections change those references to development tiers one and two. Because development tiers one and two include more counties than enterprise tiers one, two, and three, these sections effectively allow for more generous credits at more sites.

Internet data centers. – Section 2.25 conforms the provisions of the sales and use tax exemption for eligible Internet data centers to the new tier structure. S.L. 2006-66, the 2006 Appropriations Act, created a sales and use tax exemption for certain Internet data service centers. In order to be eligible for that exemption, the center has to be located in an enterprise tier one, two, or three area. This section changes that reference to development tiers one and two, thereby enlarging the number of counties in which the center could be located and remain eligible for the exemption. In addition, this section makes technical changes requested by the industry for which the exemption was requested.

Definition of NAICS. – Section 2.26 cross references the definition of NAICS for sales and use tax purposes to the definition used under the Article created by this act.



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