REVENUE LAWS STUDY COMMITTEE

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REPORT TO THE 2001
GENERAL ASSEMBLY OF NORTH CAROLINA
2002 SESSION

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REVENUE LAWS STUDY COMMITTEE
State Legislative Building
Raleigh, North Carolina 27603

Senator John H. Kerr, III, Co-Chair
Representative Paul Luebke, Co-Chair

May 28, 2002

TO THE MEMBERS OF THE 2001 GENERAL ASSEMBLY (2002 Regular Session):

The Revenue Laws Study Committee submits to you for your consideration its report pursuant to G.S. 120-70.106.

Respectfully Submitted,

Paul Luebke
Rep. Paul Luebke, Co-Chair

Jn Kerr
Sen. John Kerr, Co-Chair

2001-2002

REVENUE LAWS STUDY COMMITTEE

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PREFACE

The Revenue Laws Study Committee is established in Article 12L of Chapter 120 of the General Statutes, to serve as a permanent legislative commission to review issues relating to taxation and finance. The Committee consists of sixteen members, eight appointed by the President Pro Tempore of the Senate and eight appointed by the Speaker of the House of Representatives. Committee members may be legislators or citizens. Each of the appointing authorities designates one member to serve as co-chair. The co-chairs for 2001-2002 are Senator John Kerr and Representative Paul Luebke.

G.S. 120-70.106 gives the Revenue Law Study Committee's study of the revenue laws a very broad scope, stating that the Committee "may review the State's revenue laws to determine which laws need clarification, technical amendment, repeal, or other change to make the laws concise, intelligible, easy to administer, and equitable." A copy of Article 12L of Chapter 120 of the General Statutes is included in Appendix A. A committee notebook containing the committee minutes and all information presented to the committee is filed in the Legislative Library.

Before it was created as a permanent legislative commission, the Revenue Laws Study Committee was a subcommittee of the Legislative Research Commission. It has studied the revenue laws every year since 1977.

COMMITTEE PROCEEDINGS

The Revenue Laws Study Committee met three times before the convening of the 2002 Regular Session of the 2001 General Assembly on May 28, 2002. Although the Committee received many requests from legislators, taxpayers, the Department of Revenue, and interest groups to study numerous issues of tax policy and tax administration, the Committee chose to consider only those issues that it felt needed to be addressed in the 2002 Regular Session of the 2001 General Assembly. The Committee considered all proposed tax changes in light of general principles of tax policy and as part of an examination of the existing tax structure as a whole.

REVIEW OF THE RECOMMENDATIONS MADE TO THE 2001 GENERAL ASSEMBLY

The 2001 General Assembly enacted 10 of the Revenue Laws Study Committee's 12 legislative proposals in whole or in part. Appendix B lists the Committee's recommendations and the action taken on them in 2001. A document entitled "**2001 Tax Law Changes**" summarizes all of the tax legislation enacted in 2001. It is available in the Legislative Library located in the Legislative Office Building. Appendix C contains a brief summary of the 2001 tax legislation in the form of a slide presentation.

BUDGET AND REVENUE OUTLOOK

At its first meeting on April 11, 2002, the Revenue Laws Study Committee began its work with a briefing on the current year's budget and an overview of the budget outlook for fiscal year 2002-03 from Lynn Muchmore and David Crotts with the Fiscal Research Division. Its review of the current fiscal year's budget assumed a $955 million revenue shortfall. In March 2002, the General Fund revenues were running 6.5% behind the $9.9 billion target. This revenue shortfall becomes part of the $1 billion projected shortfall for fiscal year 2002-03. The Committee understands that the budget outlook has deteriorated since its first meeting in April. The Committee did not have time to revisit the issue before the convening of the 2002 Regular Session of the 2001 General Assembly. Appendix D contains a discussion of the issues and prospects for the General Fund Revenue Outlook for 2001-2003 presented to the Committee at its April meeting.

CONFORMITY TO THE FEDERAL TAX ACTS

The Revenue Laws Study Committee spent a considerable amount of time reviewing the tax law changes enacted by Congress in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Job Creation and Worker Assistance Act of 2002. It also studied the fiscal impact of conformity on North Carolina revenues[1]. The Committee recognized that a sound tax structure is one that is simple and easy for taxpayers to comply with and is inexpensive for the Department of Revenue to administer. The goals of tax simplicity and ease of administration are most readily achieved

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[1] See Appendix I.

with a tax structure that conforms as much as possible to federal laws to which a taxpayer must already comply. However, it is also the responsibility of a sound tax structure to provide the necessary revenues to support the State's budget. In light of the fiscal cost of conformity and the current budget outlook, the Committee did not make any recommendation on this issue.

The Revenue Laws Study Committee began its discussion of the recent federal tax law changes with an explanation of the changes by Professor Walter Nunnallee, a professor of tax law at NC Central University School of Law. The federal Economic Growth and Tax Relief Reconciliation Act of 2001 ('EGTRRA'), was enacted June 7, 2001. It includes numerous changes to rules for pensions and benefits, a repeal of the federal estate tax, a phase-out of the state death tax credit, as well as many other changes to the Internal Revenue Code. Appendix E contains an explanation of EGTRRA. The federal Job Creation and Worker Assistance Act of 2002 ('Economic Stimulus bill'), was enacted March 9, 2002. Among other tax law changes, it includes an accelerated 30% bonus depreciation allowance for certain assets placed in service after September 10, 2001, and before September 11, 2004. Appendix F contains a summary of the Economic Stimulus bill.

The Committee heard from many interested parties on the issue of whether or not the State should conform to the federal changes, especially from people involved in managing pension plans. All of the people interested in pension plans encouraged the Committee members to conform to the federal tax law changes involving pension plan limits and roll-overs. Appendix G contains a summary of the remarks made by one of the interested parties who spoke on this issue. Anne Allen and Brian Usischon, representing TIAA-CREF, spoke of the cost of not conforming to both the State and the State's residents as well as the administrative difficulties and uncertainties created by not conforming.

The Committee collected information on whether other similarly situated states are conforming to the federal tax law changes. It learned that some states are choosing to "decouple" from the federal tax law changes concerning the phase-out of the state death tax credit and the accelerated 30% bonus depreciation allowance. Appendix H contains two charts depicting this information. The charts were updated May 29, 2002.

Both of these federal acts will substantially affect a taxpayer's federal taxable income, and will, to the extent North Carolina conforms to them, have a substantial impact on North Carolina's tax revenues. The fiscal impact on the State's General Fund of fully conforming to both federal acts would be a loss of $258.6 million for the 2002-03 fiscal year. Of this loss to the General Fund, $213.2 million is associated with the 30% accelerated bonus depreciation provision. The pension tax changes would reduce the State's General Fund by approximately $6.1 million for 2002-03 and $14.3 for 2003-04. A chart detailing the fiscal impact of conforming to the federal acts is contained in Appendix I.

In previous years, the State has chosen to conform on most issues where State law tracks federal law. Therefore, the Department of Revenue is administering the State law on the assumption that the General Assembly will choose to conform to most of the changes in the EGTRRA. It will also process current year <u>original</u> returns as if the Code reference date included the provisions in the 2002 Economic Stimulus bill. If the Legislature elects not to conform to the accelerated bonus depreciation provision from the Economic Stimulus bill, taxpayers who claimed the bonus depreciation on their original returns will have to amend their returns and pay any tax and interest due. Taxpayers who have already filed original returns and who now are filing amended federal returns to claim the bonus depreciation should delay filing amended North Carolina returns until the Legislature determines whether it will adopt the bonus depreciation provisions. If a taxpayer files an amended return to claim the bonus depreciation, the Department will not process that amended return until the matter is resolved legislatively. The Department's administration of the federal changes is contained in Appendix J.

PRESENT-USE VALUE CLASSIFICATION

The Revenue Laws Study Committee noted that it is one of three legislative studies concerned with issues surrounding taxation; the other two are the Tax Policy Study Commission and the Property Tax Study Commission. The appointments to the Property Tax Study Commission were not completed before April of 2002. In light of the Property Tax Study Commission's inability to meet, the Revenue Laws Study Committee agreed to hear property tax issues that needed to be addressed by the 2002 Regular Session of the 2001 General Assembly.

The Revenue Laws Study Committee revisited the issue of using cash rents to determine the present-use value of agricultural land and horticultural land instead of the current method, which is based on the price and yield of corn and soybeans. The Revenue Laws Study Committee dealt with this issue extensively in 1997-98 and it recommended legislation to the 1999 General Assembly that is similar to the legislation recommended in Legislative Proposal 6. The Committee continues to believe that the new method of valuation contained in Legislative Proposal 6 would enhance uniformity and fairness by replacing the current method, which yields unrealistically low values, with a method based upon data generated by the farmers themselves. Since 1999, representatives from the Department of Revenue, the NC Farm Bureau, the Association of County Commissioners, and the Association of Assessing Officers have continued to work on the issue of how to improve the present-use value classification and Legislative Proposal 6 is the culmination of that effort.

QUALIFIED BUSINESS VENTURE TAX CREDIT

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

Section 1 of Resolution 2001-36 sets forth the types of legislation that may be considered during the 2002 Regular Session of the 2001 General Assembly. Under Resolution 2001-36, a bill to extend the sunset past the current expiration date of January 1, 2003, would not be eligible for introduction in the 2002 Regular Session. Parties interested in extending the sunset on the tax credit asked the Revenue Laws Study Committee to discuss the tax credit at its last meeting on May 28, 2002, and to consider recommending legislation to extend the sunset.[2]

The Committee agreed to discuss the issue. It heard testimony on the merits of the tax credit from interested parties. It learned about the credit's history, the types of businesses that claim the credit, and the economic impact of the credit. Appendix K contains the information the Committee received on the credit. The Committee also noted with some concern the possible constitutional issue surrounding the definition of "qualified grantee business".[3] After discussing the tax credit, the Committee acknowledged that the issue is one that needs more discussion and study than it could give it at this time. However, it also recognized the desire of taxpayers to know what the tax laws are from year to year and their need to be able to plan accordingly. Therefore the Committee recommends in Legislative Proposal 8 that the credit be extended for one year. The one-year extension will ensure that the matter will be revisited again during the 2003 long session where it can be more fully debated.

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[2] Section 1(3) of Resolution 2001-36 provides that legislation implementing the recommendations of study commissions are eligible for consideration during the 2002 Session of the 2001 General Assembly.

[3] This issue is more fully explained in the summary of Legislative Proposal 8.

TAX COMPLIANCE

One of the principles of tax policy that the Revenue Laws Study Committee has consistently sought to achieve is ease of compliance for both the taxpayer and the tax collector. The Committee recognizes that taxpayers who do not comply with the tax laws create an unfair burden on those taxpayers who do comply. Legislative Proposal 7 would authorize the Division of Motor Vehicles to disclose to a local tax collector the social security number of an applicant for a driver's license to assist the collector in collecting delinquent property taxes due on motor vehicles.[4] Legislative Proposal 4 recommends three changes to the revenue laws to enhance the enforcement abilities of the Criminal Investigations Division of the Department of Revenue.

REVIEW OF VARIOUS STATE REVENUE LAWS

The Revenue Laws Study Committee is charged with reviewing the State's revenue laws to determine which laws need clarification, technical amendment, repeal, or other change to make the laws concise, intelligible, easy to administer, and equitable.[5] Legislative Proposal 1 provides technical, clarifying, and conforming changes to the revenue laws and related statutes. Legislative Proposal 2 enhances uniformity in the taxation of telecommunications by conforming to the federal sourcing rules for mobile telecommunications and codifying the sourcing principles for other telecommunications services. These sourcing principles are the same as the

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[4] This proposal was not introduced as a bill to the 2002 Session of the 2001 General Assembly.
[5] G.S. 120-70.106.

ones adopted by the Streamlined Sales Tax Project and approved by the 27 implementing states in March 2002. Legislative Proposal 3 recommends the following changes to the revenue laws at the request of the Department of Revenue: to codify the Department of Revenue's long-standing use of sales tax exemption certificates, to promote efficiency in the processing of sales tax returns, and to clarify the breadth of the sales tax exemption for certain agricultural substances. Legislative Proposal 5 makes several changes to the property tax laws, as recommended by the Department of Revenue and the North Carolina Association of Assessing Officers, to improve their efficiency and effectiveness.

REPORTS

The General Assembly authorized the Revenue Laws Study Committee to receive certain reports from the Department of Revenue and the Wireless 911 Board. Appendices L through Q contain the reports received by the Committee during this interim.

COMMITTEE RECOMMENDATIONS AND LEGISLATIVE PROPOSALS

The Revenue Laws Study Committee makes the following eight recommendations to the 2002 Regular Session of the 2001 General Assembly. Each proposal is followed by an explanation and, if it has a fiscal impact, a fiscal note or memorandum indicating any anticipated revenue gain or loss resulting from the proposal.

LEGISLATIVE PROPOSAL #1

REVENUE LAWS TECHNICAL CHANGES

LEGISLATIVE PROPOSAL 1:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2002 REGULAR SESSION OF THE
2001 GENERAL ASSEMBLY

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

SHORT TITLE: Revenue Laws Technical Changes.

BRIEF OVERVIEW: It makes technical and clarifying changes to the revenue laws and related statutes.

FISCAL IMPACT: No impact.

EFFECTIVE DATE: This proposal is effective when it becomes law.

A copy of the proposed legislation and bill analysis begin on the next page

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2001

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LEGISLATIVE PROPOSAL 1

SENATE DRS6808-LCxz-202 (04/23)

Short Title:	Revenue Laws Technical Changes.	(Public)
Sponsors:	Senators Hartsell; Clodfelter, Dalton, Hoyle, Kerr, and Webster.	
Referred to:		

A BILL TO BE ENTITLED

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

The General Assembly of North Carolina enacts:

SECTION 1. Section 3 of S.L. 2001-264 reads as rewritten:

"**SECTION 3.** Any provision of a local act that conflicts with G.S. 153A-154.1 or G.S. 160A-214.1 is repealed. Any local meals tax penalty in addition to or greater than the corresponding penalty provided in G.S. 153A-154.1 or G.S. 160A-214.1 is repealed."

SECTION 2. The introductory language of Section 13.(a) of S.L. 2001-427 reads as rewritten:

"**SECTION 13.(a)** G.S. ~~105-472(a)~~ 105-472 reads as rewritten:".

SECTION 3. This act is effective when it becomes law.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 1: REVENUE LAWS TECHNICAL CHANGES

BY: MARTHA HARRIS, BILL DRAFTING DIVISION

SUMMARY: Makes technical and clarifying changes to the Revenue Laws and related statutes, effective when it becomes law.

Each year the Revenue Laws Study Committee recommends numerous technical and clarifying changes. This year, because of the late adjournment of the 2001 Session, electronic copies of the updated statutes are not available to use to draft the bill. Therefore, Legislative Proposal 1 contains only two technical and clarifying changes to the Session Laws. The changes to the statutes can be added in a committee substitute after the bill is introduced.

Section 1 of the bill clarifies S.L. 2001-264, An Act To Provide Uniform Penalties For Local Meals Taxes. That act made all local meals tax penalties uniform by applying the existing State sales and use tax penalty charges to meals taxes. This act was intended to improve tax administration by making the tax penalties for each local meals tax uniform. After the act became law, staff noticed that its language might not be sufficiently clear to assure that the penalties will be uniform in each jurisdiction. Section 1 of this bill adds language to clarify that additional or higher local penalties are repealed.

Section 2 of the act corrects a typographical error. Although Section 3(a) of S.L. 2001-427 purports to amend just subsection (a) of G.S. 105-427, it actually amends the entire statute. Section 2 of this bill conforms the law to accurately state that it amends the entire statute.

LEGISLATIVE PROPOSAL #2

CONFORM MOBILE TELECOMMUNICATIONS SOURCING

LEGISLATIVE PROPOSAL 2:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2002 REGULAR SESSION OF THE
2001 GENERAL ASSEMBLY

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

SHORT TITLE: Conform Mobile Telecommunications Sourcing.

BRIEF OVERVIEW: It conforms North Carolina's sourcing of mobile telecommunications services to the federal Mobile Telecommunications Sourcing Act and it codifies the sourcing rules for other telecommunications services.

FISCAL IMPACT: No fiscal impact.

EFFECTIVE DATE: Two of the sourcing principles become effective January 1, 2004. The remainder of the proposal becomes effective August 1, 2002, and applies to taxable services reflected on bills after August 1, 2002.

A copy of the proposed legislation and bill analysis begin on the next page

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2001

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LEGISLATIVE PROPOSAL 2

HOUSE DRH6393-RBxz-23 (04/29)

Short Title:	Conform Mobile Telecommunications Sourcing.	(Public)
Sponsors:	Representatives Allen; Buchanan, Hill, Holliman, Jarrell, Luebke, McComas, and Wainwright.	
Referred to:		

A BILL TO BE ENTITLED

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

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-164.3 is amended by adding a new subdivision to read:

"**§ 105-164.3. Definitions.**

The following definitions apply in this Article:

…

(26a) Place of primary use. – The street address representative of where the use of a customer's telecommunications service primarily occurs. The street address must be the customer's residential street address or primary business street address. For mobile telecommunications service, the street address must be within the licensed service area of the service provider. If the customer who contracted with the telecommunications provider for the telecommunications service is not the end user of the service, the end user is considered the customer for the purpose of determining the place of primary use."

SECTION 2. G.S. 105-164.3(27) reads as rewritten:

"(27) Prepaid telephone calling ~~arrangement.~~ Service. – A right that meets all of the following requirements:

a. Authorizes the exclusive purchase of telecommunications service.

b. Must be paid for in advance.

c. Enables the origination of calls by means of an access number, authorization code, or another similar means, regardless of whether the access number or authorization code is manually or electronically dialed.

d. Is sold in units or dollars whose number or dollar value declines with use and is known on a continuous basis."

SECTION 3. G.S. 105-164.3(39) is repealed.

SECTION 4. G.S. 105-164.4(a)(4d) reads as rewritten:

"(4d) The sale or recharge of prepaid telephone calling ~~arrangements~~ service is taxable at the general rate of tax. The tax applies regardless of whether tangible personal property, such as a card or a telephone, is transferred. Prepaid telephone calling ~~arrangements~~ service is taxable at the point of sale instead of at the point of use and is sourced in accordance with G.S. 105-164.4B. Prepaid telephone calling service taxed under this subdivision ~~are~~ is not subject to tax as a telecommunications service.

~~Prepaid telephone calling arrangements are taxable at the point of sale instead of at the point of use. If the sale or recharge of a prepaid telephone calling arrangement does not take place at a retailer's place of business, the sale or recharge is considered to have taken place at one of the following:~~

~~a.~~ ~~The customer's shipping address, if an item of tangible personal property is shipped to the customer as part of the transaction.~~

~~b.~~ ~~The customer's billing address or, for mobile telecommunications service, the customer's service address, if no tangible personal property is shipped to the customer as part of the transaction.~~"

SECTION 5. G.S. 105-164.4B(a)(3) reads as rewritten:

"(a) Principles. – The following principles apply in determining where to source the sale of a product. These principles apply regardless of the nature of the product.

…

(3) Delivery address unknown. – When a seller of a product does not know the address where a product is received, the sale is sourced to

the first address or location listed in this ~~subsection~~ subdivision that is known to the seller:

a. The business or home address of the purchaser.

b. The billing address of the ~~purchaser.~~purchaser or, if the product is a prepaid telephone calling service that authorizes the purchase of mobile telecommunications service, the location associated with the mobile telephone number.

c. The address of the seller."

SECTION 6. G.S. 105-164.4C(a) reads as rewritten:

"(a) General. – The gross receipts derived from providing telecommunications service in this State are taxed at the rate set in G.S. 105-164.4(a)(4c). ~~Mobile telecommunications service is provided in this State if the customer's service address is in this State and the call originates or terminates in this State.~~Telecommunications service is provided in this State if the service is sourced to this State under the sourcing principles set out in subsections (a1) and (a2) of this section. The definitions and provisions of the federal Mobile Telecommunications Sourcing Act apply to the sourcing and taxation of mobile telecommunications services."

SECTION 7. G.S. 105-164.4C(b)(1) reads as rewritten:

"(b) Included in Gross Receipts. – Gross receipts derived from telecommunications service include the following:

(1) Receipts from ~~local, intrastate, interstate, toll, private, and mobile telecommunications service.~~flat rate service, service provided on a call-by-call basis, mobile telecommunications service, and private telecommunications service.

…"

SECTION 8. G.S. 105-164.4C(c)(2) reads as rewritten:

"(c) Excluded From Gross Receipts. – Gross receipts derived from telecommunications service do not include any of the following:

…

(2) Telecommunications services that are resold as part of a prepaid telephone calling ~~arrangement.~~service.

…"

SECTION 9. G.S. 105-164.4C is amended by adding two new subsections to read:

"(a1) General Sourcing Principles. – The following general sourcing principles apply to telecommunications services. If a service falls within one of the exceptions set out in subsection (a2) of this section, the service is sourced in accordance with the exception instead of the general principle.

(1) Flat rate. – A telecommunications service that is not sold on a call-by-call basis is sourced to this State if the place of primary use is in this State.

(2) General call-by-call. – A telecommunications service that is sold on a call-by-call basis and is not a postpaid calling service is sourced to this State in the following circumstances:

a. The call both originates and terminates in this State.

b. The call either originates or terminates in this State and the telecommunications equipment from which the call originates or terminates and to which the call is charged is located in this State. This applies regardless of where the call is billed or paid.

(3) Postpaid. – A postpaid calling service is sourced in accordance with either of the following principles, at the election of the seller:

a. The principle set out in subdivision (a1)(2) of this section for call-by-call service.

b. The origination point of the telecommunications signal as first identified by either the seller's telecommunications system or, if the system used to transport the signal is not the seller's system, by information the seller receives from its service provider.

(a2) Sourcing Exceptions. – The following telecommunications services and products are sourced in accordance with the principles set out in this subsection:

(1) Mobile. – Mobile telecommunications service is sourced to the place of primary use, unless the service is authorized by a prepaid telephone calling service or is air-to-ground radiotelephone service. Air-to-ground radiotelephone service is a postpaid calling service that is offered by an aircraft common carrier to passengers on its aircraft and enables a telephone call to be made from the aircraft. The sourcing principle in this subdivision applies to a service provided as an adjunct to mobile telecommunications service if the charge for the service is included within the term 'charges for mobile telecommunications services' under the federal Mobile Telecommunications Sourcing Act.

(2) Prepaid. – Prepaid telephone calling service is sourced in accordance with G.S. 105-164.4B.

(3) Private. – Private telecommunications service is sourced in accordance with subsection (e) of this section."

SECTION 10. G.S. 105-164.4C(e) reads as rewritten:

"(e) ~~Interstate~~ Private Line. – The gross receipts derived from ~~interstate~~ private telecommunications service are ~~taxable~~ sourced as follows:

(1) ~~One hundred percent (100%) of the charge imposed at each channel termination point in this State.~~If all the customer's channel

termination points are located in this State, the service is sourced to this State.

(2) ~~One hundred percent (100%) of the charge imposed for the total channel mileage between each channel termination point in this State.~~If all the customer's channel termination points are not located in this State and the service is billed on the basis of channel termination points, the charge for each channel termination point located in this State is sourced to this State.

(3) ~~Fifty percent (50%) of the charge imposed for the total channel mileage between the first channel termination point in this State and the nearest channel termination point outside this State.~~ If all the customer's channel termination points are not located in this State and the service is billed on the basis of channel mileage, the following applies:

a. A charge for a channel segment between two channel termination points located in this State is sourced to this State.

b. Fifty percent (50%) of a charge for a channel segment between a channel termination point located in this State and a channel termination point located in another state is sourced to this State.

(4) If all the customer's channel termination points are not located in this State and the service is not billed on the basis of channel termination points or channel mileage, a percentage of the charge for the service is sourced to this State. The percentage is determined by dividing the number of channel termination points in this State by the total number of channel termination points."

SECTION 11. G.S. 105-164.4C(h) reads as rewritten:

"(h) Definitions. – The following definitions apply in this section:

~~(1)~~ ~~Call center. – Defined in G.S. 105-164.27A.~~

~~(2)~~ ~~Interstate telecommunications service. – Telecommunications service that originates or terminates in this State, but does not both originate and terminate in this State, and is charged to a service address in this State.~~

~~(3)~~ ~~Intrastate telecommunications service. – Telecommunications service that both originates and terminates in this State.~~

~~(4)~~ ~~Local telecommunications service. – Telecommunications service that provides access to a local telephone network and enables a user to communicate with substantially everyone who has a telephone or radiotelephone station that is part of the local telephone network.~~

~~(5)~~ ~~Mobile telecommunications service. – Defined in G.S. 105-164.3.~~

~~(6) Private telecommunications service. – Telecommunications service that entitles a subscriber of the service to exclusive or priority use of a communications channel or group of channels.~~

~~(7) Service address. – Defined in G.S. 105-164.3.~~

~~(8) Telecommunications service. – Defined in G.S. 105-164.3.~~

~~(9) Toll telecommunications service. – Any of the following:~~

- ~~a. A service for which there is a toll charge that varies in amount with the distance or elapsed transmission time of each individual communication.~~
- ~~b. A service that entitles the subscriber, upon payment of a periodic charge, determined as a flat amount or on the basis of total elapsed transmission time, to an unlimited number of communications to or from all or a substantial portion of those who have a telephone or radiotelephone station in an area outside the local telephone network.~~

(1) Call-by-call basis. – A method of charging for a telecommunications service whereby the price of the service is measured by individual calls.

(2) Call center. – Defined in G.S. 105-164.27A.

(3) Mobile telecommunications service. – Defined in G.S. 105-164.3.

(4) Place of primary use. – Defined in G.S. 105-164.3.

(5) Postpaid calling service. – A telecommunications service that is charged on a call-by-call basis and is obtained by making payment at the time of the call either through the use of a credit or payment mechanism, such as a bank card, travel card, credit card, or debit card, or by charging the call to a telephone number that is not associated with the origination or termination of the telecommunications service. A postpaid calling service includes a service that meets all the requirements of a prepaid telephone calling service, except the exclusive use requirement.

(6) Prepaid telephone calling service. – Defined in G.S. 105-164.3.

(7) Private telecommunications service. – Telecommunications service that entitles a subscriber of the service to exclusive or priority use of a communications channel or group of channels.

(8) Telecommunications service. – Defined in G.S. 105-164.3."

SECTION 12. G.S. 105-467(b)(6) reads as rewritten:

"(6) The sales price of prepaid telephone calling ~~arrangements~~ service taxed as tangible personal property under G.S. 105-164.4(a)(4d)."

SECTION 13. Subdivision (6) of the first paragraph of Section 4 of Chapter 1096 of the 1967 Session Laws reads as rewritten:

"(6) The sales price of prepaid telephone calling ~~arrangements~~ service taxed as tangible personal property under G.S. 105-164.4(a)(4d)."

SECTION 14. G.S. 105-164.4C(a1)(3), as enacted by this act, reads as rewritten:

"(3) ~~Post-paid.~~Postpaid. – A ~~post-paid~~postpaid calling service is sourced ~~in accordance with either of the following principles, at the election of the seller:~~

~~a.~~ ~~The principle set out in subdivision (a1)(2) of this section for call-by-call service.~~

~~b.~~ ~~The~~

to the origination point of the telecommunications signal as first identified by either the seller's telecommunications system or, if the system used to transport the signal is not the seller's system, by information the seller receives from its service provider."

SECTION 15. G.S. 62A-21(4) reads as rewritten:

"(4) "CMRS connection" means each mobile handset telephone number assigned to a CMRS customer with a ~~billing address~~ place of primary use in North Carolina."

SECTION 16. G.S. 105-164.4C(e)(4), as enacted by Section 10 of this act, and Section 14 of this act become effective January 1, 2004, and apply to taxable services reflected on bills dated on or after January 1, 2004. The remainder of this act becomes effective August 1, 2002, and applies to taxable services reflected on bills dated after August 1, 2002.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 2: CONFORM SOURCING OF MOBILE TELECOMMUNICATIONS

BY: CINDY AVRETTE, RESEARCH DIVISION

***SUMMARY:* This draft bill conforms North Carolina's sourcing of mobile telecommunications services to the federal Mobile Telecommunications Sourcing Act. It also codifies the sourcing rules for other telecommunications services. Two of the sourcing principles would become effective January 1, 2004, and apply to taxable services reflected on bills dated on or after that date. The remainder of the bill would become effective August 1, 2002, and apply to taxable services reflected on bills dated after August 1, 2002.**

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

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

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

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

Under the federal legislation, states could furnish service providers with a database[1] matching street addresses with taxing jurisdictions.[2] Service providers would be held harmless for any errors resulting from their use of the database. If a database is not provided for a state, then the service provider may determine the appropriate taxing jurisdiction by using an enhanced zip code[3] to assign each street address to a specific taxing jurisdiction in that state. Service providers would be held harmless from any tax liability that otherwise would be due solely as a result of an assignment of a street address to an incorrect taxing jurisdiction under this method. The accuracy of the method used is important to protect the tax base of local taxing jurisdictions. The hold harmless provision is important to service providers who provide service in a state with multiple taxing jurisdictions.

The Streamlined Sales Tax Project is working with the Telecommunications Industry on uniform provisions for sourcing as well as refund limitation provisions based upon the hold harmless provisions in the federal Mobile Telecommunications Sourcing Act. The Streamlined Sales Tax Project and the implementing states[4] have adopted principles for sourcing. The principles do not differ from North Carolina's current sourcing principles. This bill draft codifies those principles. The Streamlined Sales Tax Project has not yet completed its work on the refund limitation provisions. Since North Carolina does not have multiple taxing jurisdictions[5], the need for these provisions is not imminent. Therefore, this bill draft does not include any provisions on this issue.

6

BILL ANALYSIS: This bill draft conforms North Carolina's sourcing of mobile telecommunications to the federal Mobile Telecommunications Sourcing Act and codifies the sourcing principles adopted by the Streamlined Sales Tax Project and the 27 implementing states. Following is a section-by-section analysis of the draft bill:

Sections 1, 3, and 15::	Replace the term "service address" and "billing address" with the term "place of primary use" because that is the terminology used in the federal Mobile Telecommunications Sourcing Act.
Sections 2, 8, 12, and 13:	Change the term "prepaid telephone calling arrangement" to the term "prepaid telephone calling service" so that the terminology is consistent with the other forms of telecommunication services.

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

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

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

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

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

Sections 4 and 5:	Prepaid telephone calling services are taxed as tangible personal property, not as a telecommunications service. Section 4 removes the sourcing language from the statute that sets the sales tax rates and Section 5 modifies the sourcing principles that apply to tangible personal property to accommodate the taxation of prepaid telephone calling services.
Section 6:	Deletes the sentence that sources mobile telecommunications based on the call originating or terminating in this State because it conflicts with the sourcing principle in the federal Mobile Telecommunications Sourcing Act. It also specifies that mobile telecommunications services be taxed in accordance with federal law. This reference alerts the reader that there is applicable federal law on this issue.
Sections 7 and 11:	Under the federal Mobile Telecommunications Sourcing Act and the Streamlined Sales Tax Project, telecommunications service is sourced based on the type of service provided rather than the type of call. The bill draft defines the different types of services and repeals the terms associated with the types of calls.
Sections 9 and 10:	Set forth the mobile telecommunications sourcing principle in the federal Mobile Telecommunications Sourcing Act and they codify the principles currently used by the State to source other telecommunications services. Section 10 rewrites the sourcing principles for private telecommunications service in a more understandable format and it adds a sourcing principle that is not currently applicable to private lines in the State, but may be applicable in the future. The principles codified in the bill are the same principles adopted by the Streamlined Sales Tax Project and the implementing states in March of 2002. Under the bill draft, at the request of the telecommunications industry, the new sourcing principle applicable to private telecommunications service does not become effective until January 1, 2004.
Sections 9 and 14:	Under the Streamlined Sales Tax Project, postpaid calling service will be sourced based on the origination point of the telecommunications signal as first identified by the seller's telecommunications system. However, not every company in the telecommunications industry has the capability to determine the origination point of the signal. The bill draft gives the seller two options to source postpaid calling service until the year 2004; at which point the seller must source based on the origination point of the telecommunications signal.
Section 16:	At the request of the telecommunications industry, two of the sourcing principles in the bill draft would become effective January 1, 2004, and apply to taxable services reflected on bills dated on or after that date. The remainder of the bill would become effective August 1, 2002, and apply to taxable services reflected on bills dated after that date; the August 1, 2002, effective date corresponds with the effective date of the federal act.

LEGISLATIVE PROPOSAL #3

REVENUE ADMINISTRATIVE CHANGES

LEGISLATIVE PROPOSAL 3:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2002 REGULAR SESSION OF THE
2001 GENERAL ASSEMBLY

AN ACT TO CLARIFY THE SALES AND USE TAX EXEMPTION REGARDING CERTAIN AGRICULTURAL SUBSTANCES AND TO MAKE VARIOUS ADMINISTRATIVE CHANGES IN THE TAX LAWS.

SHORT TITLE: Revenue Administrative Changes.

BRIEF OVERVIEW: This proposal makes the following changes and clarifications in the tax laws:

- It clarifies that the sales and use tax exemption for certain agricultural substances does not include any equipment or devices used to apply those substances.
- It changes the due date of quarterly sales tax returns from the 15th of a month to the last day of a month to enable the Department to spread the processing work more evenly throughout the month.
- It changes the underpayment penalty calculation for semimonthly sales tax payers to conform to the requirements of the Streamlined Sales Tax Project.
- It clarifies the use of sales and use tax exemption certificates.

FISCAL IMPACT: Insignificant.

EFFECTIVE DATE: The change in the due date for quarterly sales tax returns becomes effective October 1, 2002. The changes in the underpayment penalty calculation for semimonthly sales tax payers become effective July 1, 2002. The remainder of this proposal is effective when it becomes law.

A copy of the proposed legislation, bill analysis, and fiscal memorandum begin on the next page

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2001

H **D**

LEGISLATIVE PROPOSAL 3

HOUSE DRH9407-SVz-11 (04/23)

Short Title: Revenue Administrative Changes. (Public)

Sponsors: Representatives Holliman; Allen, Buchanan, Hill, Jarrell, Luebke, and Wainwright.

Referred to:

A BILL TO BE ENTITLED

AN ACT TO CLARIFY THE SALES AND USE TAX EXEMPTION REGARDING CERTAIN AGRICULTURAL SUBSTANCES AND TO MAKE VARIOUS ADMINISTRATIVE CHANGES IN THE TAX LAWS.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-164.13(2a) reads as rewritten:

"(2a) Any of the following substances when purchased for use on animals or plants, as appropriate, held or produced for commercial ~~purposes:~~purposes. This exemption does not apply to any equipment or devices used to administer, release, apply, or otherwise dispense these substances:

a. Remedies, vaccines, medications, litter materials, and feeds for animals.
b. Rodenticides, insecticides, herbicides, fungicides, and pesticides.
c. Defoliants for use on cotton or other crops.
d. Plant growth inhibitors, regulators, or stimulators, including systemic and contact or other sucker control agents for tobacco and other crops."

SECTION 2. G.S. 105-164.16(b) reads as rewritten:

"(b) Quarterly. – A taxpayer who is consistently liable for less than one hundred dollars ($100.00) a month in State and local sales and use taxes must file a return and pay the taxes due on a quarterly basis. A quarterly return covers a calendar quarter and is due by the ~~15th~~last day of the month following the end of the quarter."

SECTION 3. G.S. 105-164.16(b2) reads as rewritten:

"(b2) Semimonthly. – A taxpayer who is consistently liable for at least ten thousand dollars ($10,000) a month in State and local sales and use taxes must pay the tax twice a month and must file a return on a monthly basis. One semimonthly payment covers the period from the first day of the month through the 15th day of the month. The other semimonthly payment covers the period from the 16th day of the month through the last day of the month. The semimonthly payment for the period that ends on the 15th day of the month is due by the 25th day of that month. The semimonthly payment for the period that ends on the last day of the month is due by the 10th day of the following month.

A return covers both semimonthly payment periods. The return is due by the 20th day of the month following the month of the payment periods covered by the return. A taxpayer is not subject to interest on or penalties for an underpayment for a semimonthly payment period if the taxpayer timely pays at least ninety-five percent (95%) of the ~~amount due for each semimonthly payment period~~ lesser of the following and includes the underpayment with the monthly return for those semimonthly payment ~~periods.~~periods:

(1) The amount due for each semimonthly payment period.

(2) The average semimonthly payment for the prior calendar year."

SECTION 4. Part 5 of Article 5 of Chapter 105 is amended by adding a new section to read:

"**§ 105-164.28A. Other exemption certificates.**

(a) Authorization. – The Secretary may require a person who purchases tangible personal property that is exempt from tax or is subject to a preferential rate of tax depending on the status of the purchaser or the intended use of the property to obtain an exemption certificate from the Department to receive the exemption or preferential rate. An exemption certificate authorizes a retailer to sell tangible personal property to the holder of the certificate and either collect tax at a preferential rate or not collect tax on the sale, as appropriate. A person who purchases tangible personal property under an exemption certificate is liable for any tax due on the sale if the Department determines that the person is not eligible for the certificate or the property was not used as intended.

(b) Scope. – This section does not apply to a direct pay permit or a certificate of resale. G.S. 105-164.27A addresses a direct pay permit, and G.S. 105-164.28 addresses a certificate of resale."

SECTION 5. Section 2 of this act becomes effective October 1, 2002, and applies to taxes levied on or after that date. Section 3 of this act becomes effective July 1, 2002, and applies to payments due on or after that date. The remainder of this act is effective when it becomes law.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 3: REVENUE ADMINISTRATIVE CHANGES

BY: TRINA GRIFFIN, RESEARCH DIVISION

SUMMARY: This bill draft makes the following changes and clarifications in the tax laws:

- *It clarifies that the sales and use tax exemption for certain agricultural substances does not include any equipment or devices used to apply those substances.*
- *It changes the due date of quarterly sales tax returns from the 15th of a month to the last day of a month to enable the Department to spread the processing work more evenly throughout the month.*
- *It changes the underpayment penalty calculation for semimonthly sales tax payers to conform to the requirements of the Streamlined Sales Tax Project.*
- *It clarifies the use of sales and use tax exemption certificates.*

CURRENT LAW & ANALYSIS:

I. Clarifying the Exemption for Certain Agricultural Substances

CURRENT LAW: Included among the agricultural group of sales and use tax exemptions is an exemption for plant growth inhibitors, regulators, or stimulators when purchased for use on plants held or produced for commercial purposes. This exemption was at issue in a recent North Carolina Court of Appeals case, American Ripener Company, Inc. v. Secretary of Revenue. In this case, the plaintiff manufactured and sold ethylene concentrate, a plant growth regulator or stimulator that controls the speed of the ripening of fruits and vegetables. The plaintiff also manufactured, sold, and leased generators used to control the release of the ethylene gas. The plaintiff challenged the assessment of sales tax on its sales of ethylene and the assessment of use tax for its generators and replacement parts for its generators. The Department argued that the exemption was not intended to include any hardware or machinery, such as generators, used to apply the exempted substances. Nevertheless, the Court held that since the generators were used to control the release of ethylene gas and to regulate the speed of the ripening of fruits and vegetables, they were plant growth regulators and stimulators and, therefore, exempt from the sales and use tax. The Department's petition for review by the North Carolina Supreme Court was denied. The Department has recommended amending this exemption to clarify that it does not apply to any equipment or devices used to dispense the substances listed in the exemption.

PROPOSAL: G.S. 105-164.13(2a) exempts the following from sales and use tax when purchased for use on animals or plants, as appropriate, held or produced for commercial purposes:

- Remedies, vaccines, medications, litter materials, and feeds for animals.
- Rodenticides, insecticides, herbicides, fungicides, and pesticides.
- Defoliants for use on cotton or other crops.
- Plant growth inhibitors, regulators, or stimulators, including systemic and contact or other sucker control agents for tobacco and other crops.

Section 1 of the proposal clarifies that only these substances, and not any equipment or devices used to administer, release, apply, or otherwise dispense these substances, are exempt from the sales and use tax.

II. Due Date for Quarterly Sales Tax Returns

CURRENT LAW: Quarterly sales tax returns are due on the 15th of a month. In 2001, the General Assembly lowered the threshold for monthly payments of withheld taxes from $500 to $250. Monthly withholding returns are due on the 15th of the month, the same day as monthly and quarterly sales and use tax returns. As a result of the monthly threshold change, approximately 25,000 employers moved from a quarterly to a monthly filing status. The Department now receives 25,000 more returns in eight of the twelve months of the year than it was receiving prior to the change. Therefore, the Department has recommended changing the due date of quarterly sales tax returns from the 15th of a month to the end of the month to enable the Department to spread the work more evenly throughout the month. Currently, there are 91,000 quarterly sales tax filers.

PROPOSAL: Section 2 of the proposal changes the due date for quarterly sales tax returns from the 15th of a month to the end of a month. This change would make the due date for quarterly sales tax returns consistent with the due date for quarterly withholding tax returns. This change would not impact the timing of local sales and use tax distributions, nor would it shift any funds from one fiscal year to the next.

III. Underpayment Penalty Calculation for Semimonthly Sales Tax Payers

CURRENT LAW: A taxpayer who is consistently liable for at least $10,000.00 a month in State and local sales and use taxes must pay the tax twice a month and file a return on a monthly basis. A payment is required for each semimonthly period. The first semimonthly payment covers the period from the first day of the month through the 15th day of the month, and the second semimonthly payment covers the period from the 16th day of the month through the last day of the month. The monthly return covers both semimonthly payment periods with any additional amount due and is due to be filed by the 20th day of the following month. A taxpayer is not subject to interest or penalties for an underpayment for a semimonthly payment period if the taxpayer timely pays at least 95% of the amount due for that payment period and includes the underpayment with the monthly return for both payment periods.

In 2000, the General Assembly enacted legislation to enable North Carolina to participate in the Streamlined Sales Tax Project, which is designed to simplify and modernize sales and use tax administration. There are certain requirements that each state must adopt in order to participate in the project. One requirement with regard to the remittance of funds is that if the State requires more than one remittance per return, the amount of the additional remittance must be determined through a calculation method rather than actual collections. Since semimonthly sales tax payers are required to send two remittances per month with one monthly return, the Department has recommended amending the underpayment penalty calculation for semimonthly sales tax payers which would provide an additional method of calculating their estimated tax liability and thus conform to the requirements of the Streamlined Sales Tax Project.

PROPOSAL: Section 3 of the proposal amends the method for calculating the underpayment penalty for semimonthly sales tax payers. Neither interest nor penalties would apply to the underpayment of sales tax remitted on a semimonthly basis if the taxpayer timely pays at least 95% of the lesser of the following:

- The amount due for the semimonthly payment period; or
- The average semimonthly payment for the prior calendar year.

Just as under the current law, the taxpayer must also include the underpayment with the monthly return for those semimonthly payment periods.

IV. Use of Exemption Certificates

CURRENT LAW: The Department of Revenue administers many of the sales and use tax exemptions and preferential rates targeted at certain industries, such as farming and manufacturing, through the use of an exemption certificate. The statutes do not address exemption certificates, however, except in the penalty provisions in G.S. 105-236(5a), which authorizes the Secretary to assess a penalty for the misuse of an exemption certificate. The Department has recommended that the practice of using exemption certificates be incorporated into the statutes to avoid any questions about the ability of taxpayers to claim exemptions through this method.

PROPOSAL: Section 4 of the proposal would codify a longstanding practice of the Department which requires that a purchaser of tangible personal property that is exempt from tax or subject to a preferential rate of tax obtain an exemption certificate from the Department in order to receive the exemption or preferential rate.

EFFECTIVE DATES: The section changing the due date for quarterly sales tax returns (Section 2) would become effective on October 1, 2002, and would apply to taxes levied on or after that date. The section changing the underpayment penalty calculation for semimonthly sales tax payers (Section 3) would become effective July 1, 2002, and would apply to payments due on or after that date. The remainder of the act would become effective when it becomes law.

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: April 30, 2002

TO: Revenue Laws Study Committee

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: Revenue Administrative Changes

FISCAL IMPACT

Yes ( ) **No ( )** **No Estimate Available (X)**

	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07
REVENUES					
General Fund	Potential Revenue Change – See Assumptions and Methodology				

PRINCIPAL DEPARTMENT(S) &
PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: Section 2 and 3 (quarterly sales tax returns) become effective October 1, 2002 and applies to taxes levied on or after that date. The remainder of the act becomes effective when law.

BILL SUMMARY: This proposal includes several changes recommended by the North Carolina Department of Revenue. Section 1 clarifies that equipment used to dispense plant growth inhibitors is not exempt from sales tax. Section 2 changes the due date for quarterly sales tax returns from the 15th of the month to the last day of the month, following the end of the quarter. Section 3 changes the underpayment penalty calculation for semimonthly taxpayers to conform to the Streamlined Sales Tax Project. Section 4 clarifies the use of sales and use tax exemption certificates.

ASSUMPTIONS AND METHODOLOGY:

Section 1: This proposal is a result of a North Carolina Court of Appeals decision. In American Ripener Co. Inc. v. Muriel K. Offerman, Secretary of Revenue, the court considered the application of state sales taxes to a plant growth regulator or stimulator which controls the ripening of fruits and vegetables (ethylene), as well as the equipment used to deliver that chemical. Tax on replacement parts was also an issue. The court held that all of these items are exempt from sales and use tax under G.S. 105-164.13(2) and G.S. 105-164.13 (2a) which exempts "plant growth inhibitors, regulators, or stimulators for agriculture including systematic and contact or other sucker control agents for tobacco and other crops". The court also ruled that the generators and associate parts are also inhibitors and are therefore exempt from sales tax. The proposal effectively amends G.S. 105-164.13(2a) to make the equipment and parts associated with this gas treatment subject to sales and use taxes. (The Department had previous assumed all these items were taxable). In making its ruling the court effectively reduced sales tax revenue. The bill would restore at least some of that revenue to the General Fund. As such, the bill in and of itself would create a small revenue gain. However, Fiscal Research is unable to create an exact estimate of the value of ethylene delivery parts and equipment. As a result, no estimate is possible on this portion of the proposal.

Section 2: Currently the Department of Revenue receives monthly withholding returns, monthly sales tax returns, and quarterly sales tax returns on the 15th of the month. On the 15th of March, April, September, and October income tax returns are due as well. Shifting the due date of quarterly sales and use tax returns from the 15th of the month to the end of the month will create a more even distribution of work in the Department. Because the payments are due in the month following the end of the quarter (October, February, April, and July) the shift will not move any revenue from one fiscal year to the next. Some loss of interest on the payments or "float" will occur. However, because of the relatively small sums of money involved, the Department expects the loss to be minimal.

Section 3: This section changes the calculation of penalty for underpayment by semimonthly sales tax payers. Under current law the taxpayer must remit at least 95% of the amount due for each semimonthly payment period. This proposal allows the taxpayer to remit the lesser of this amount or the average semimonthly payment for the prior calendar year. Clearly this proposal will result in some loss of penalty revenue. However, no data is available to determine the magnitude of the loss. The Department expects the loss to be slight.

Section 4: Historically the Department of Revenue has issued exemption certificates to taxpayers in certain exempted industries to facilitate tax administration. However, there is no reference to exemption certificates in the statutes, except as it relates to penalties for misuse of such a certificate. This proposal would codify the practice of issuing exemption certificates. Since the proposal is only codifying the existing practice of the Department, no fiscal impact is expected.

LEGISLATIVE PROPOSAL #4

REVENUE LAWS ENFORCEMENT ENHANCEMENTS

LEGISLATIVE PROPOSAL 4:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2002 REGULAR SESSION OF THE
2001 GENERAL ASSEMBLY

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

SHORT TITLE: Revenue Laws Enforcement Enhancements.

BRIEF OVERVIEW: This proposal makes three substantive changes to the revenue laws:

- It allows for enhanced punishment when an income tax retum preparer aids or assists I the filing of false or fraudulent documents with the Department of Revenue.
- It creates an offense for fleecing taxpayers.
- It allows the Department of Revenue to share information concerning the commission of an offense with appropriate state or federal law enforcement agencies.

FISCAL IMPACT: No fiscal impact.

EFFECTIVE DATE: The criminal offenses created by this proposal become effective December 1, 2002, and apply to actions that are committed on or after that date. The remainder of this proposal is effective when it becomes law.

A copy of the proposed legislation and bill analysis begin on the next page

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2001

S **D**

LEGISLATIVE PROPOSAL 4

SENATE DRS8708-LYz-165A (04/16)

Short Title:	Revenue Laws Enforcement Enhancements.	(Public)
Sponsors:	Senators Clodfelter, Dalton, Hartsell, Hoyle, and Kerr.	
Referred to:		

A BILL TO BE ENTITLED

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

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-228.90(b) is amended by adding a new subdivision to read:

"(b) Definitions. – The following definitions apply in this Article:

…

(4) Income Tax Return Preparer. – Any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by Article 4 of this Chapter or any claim for refund of tax imposed by Article 4 of this Chapter. For purposes of this definition, the completion of a substantial portion of a return or claim for refund is treated as the preparation of the return or claim for refund. The term does not include a person merely because the person (i) furnishes typing, reproducing, or other mechanical assistance, (ii) prepares a return or claim for refund of the employer, or an officer or employee of the employer, by whom the person is regularly and continuously employed, (iii) prepares as a fiduciary a return or claim for refund

for any person, or (iv) represents a taxpayer in a hearing regarding a proposed assessment."

SECTION 2. G.S. 105-236(9a) reads as rewritten:

"(9a) Aid or Assistance. – Any person, pursuant to or in connection with the revenue laws, who willfully aids, assists in, procures, counsels, or advises the preparation, presentation, or filing of a return, affidavit, claim, or any other document that the person knows is fraudulent or false as to any material matter, whether or not the falsity or fraud is with the knowledge or consent of the person authorized or required to present or file the return, affidavit, claim, or other document, ~~shall be~~is guilty of a ~~Class H felony.~~felony as follows:

a. If the person who commits an offense under this subdivision is an income tax return preparer and the amount of all taxes fraudulently evaded on returns filed in one taxable year is one hundred thousand dollars ($100,000) or more, the person is guilty of a Class C felony.

b. If the person who commits an offense under this subdivision is an income tax return preparer and the amount of all taxes fraudulently evaded on returns filed in one taxable year is less than one hundred thousand dollars ($100,000), the person is guilty of a Class F felony.

c. If the person who commits an offense under this subdivision is not covered under sub-subdivision a. or b. of this subdivision, the person is guilty of a Class H felony."

SECTION 3. G.S. 105-159.1(e) reads as rewritten:

"(e) ~~A~~ An ~~paid preparer of tax returns~~income tax return preparer may not designate on a return that the taxpayer does or does not desire to make the political contribution authorized in this section unless the taxpayer or the taxpayer's spouse has consented to the designation."

SECTION 4. G.S. 105-236 is amended by adding a new subdivision to read:

"**§ 105-236. Penalties.**

Penalties assessed by the Secretary under this Subchapter are assessed as an additional tax. Except as otherwise provided by law, and subject to the provisions of G.S. 105-237, the following penalties shall be applicable:

…

(10b) Misrepresentation Concerning Payment. – A person who receives money from a taxpayer with the understanding that the money is to be remitted to the Secretary for application to the taxpayer's tax liability and who willfully fails to remit the money to the Secretary is guilty of a Class F felony."

SECTION 5. G.S. 105-259(b) is amended by adding a new subdivision to read:

"(b) Disclosure Prohibited. – An officer, an employee, or an agent of the State who has access to tax information in the course of service to or employment by the State may not disclose the information to any other person unless the disclosure is made for one of the following purposes:

…

"(15a)To furnish to the head of the appropriate State or federal law enforcement agency information concerning the commission of an offense under the jurisdiction of that agency discovered by the Department during a criminal investigation of the taxpayer."

SECTION 6. Sections 1 through 4 of this act become effective December 1, 2002, and apply to actions that are committed on or after that date. The remainder of this act is effective when it becomes law.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 4: REVENUE LAWS ENFORCEMENT ENHANCEMENTS

BY: CANAAN HUIE, BILL DRAFTING DIVISION

SUMMARY: This draft makes three substantive changes to the revenue laws. First, it allows for enhanced punishment when an income tax return preparer aids or assists in the filing of false or fraudulent documents with the Department of Revenue. Second, it creates an offense for fleecing taxpayers. Third, it allows the Department of Revenue to share information concerning the commission of an offense with appropriate state or federal law enforcement agencies.

CURRENT LAW AND BILL ANALYSIS:

Sections 1-3. This draft provides for enhanced punishment when an income tax return preparer aids or assists in the filing of false or fraudulent documents with the Department of Revenue. Under current law, it is a Class H felony to aid, assist, procure, counsel, or advise the preparation, presentation, or filing of a return, affidavit, claim, or other document that is fraudulent or false as to any material matter. Over the past few years, the Department has noticed an increase in the number of fraudulent return cases involving an income tax return preparer. According to the Department, these cases generally involve income tax return preparers that intentionally inflate the itemized deductions claimed on a return or include fictitious business losses on the return. This fraud is carried out in order to reduce taxable income, thereby reducing tax liability. The Department has also noticed an increase in the number of fictitious returns. These are returns that are based on fictitious wage and tax statements.

Under this draft, an income tax return preparer who aids or assists in the filing of false or fraudulent documents would be guilty of a Class F felony. If the total amount of tax fraudulently avoided in one taxable year on all returns exceeds one hundred thousand dollars ($100,000), the income tax return preparer would be guilty of a Class felony. These punishments are the same as the punishments for embezzlement under Article 18 of Chapter 14 of the General Statutes.

This draft incorporates the definition of income tax return preparer used under the Code. In addition, this draft makes a conforming change in G.S. 105-159.1(e) to incorporate this definition.

These sections would become effective December 1, 2002, and would apply to criminal offenses committed on or after that date.

Section 4. This provision would make it a Class F felony for a person to receive money from a taxpayer with the understanding that the person would remit the money to the Secretary for application on a tax liability and then willfully fail to remit the money to the Secretary. The Department reports that several times a year they will have a situation where an accountant receives money from a taxpayer to satisfy a sales or withholding tax liability. The accountant then files a fraudulent return showing reduced or zero tax due and then pockets the taxpayer's money. Although the Department can and does bring charges against the account for filing a fraudulent return, the taxpayer still owes the money that he or she has lost. The taxpayer must then get the local district attorney to file embezzlement charges. The Department reports that the district attorneys would prefer that the Department handle this since it involves taxes and since the Department is already involved. The penalty is the same as for embezzlement totaling less than one hundred thousand dollars ($100,000).

This section would become effective December 1, 2002, and would apply to criminal offenses committed on or after that date.

<u>Section 5.</u> This provision would allow the Department of Revenue to share information it discovers during a criminal investigation of a taxpayer with appropriate state or federal law enforcement agencies. Under current law, the Department may provide information concerning a tax imposed by Article 2A, 2C, or 2D[1] to law enforcement agencies. However, the Criminal Investigation Division of the Department occasionally discovers evidence of criminal activity unrelated to the taxes imposed in those Articles. Under current law, the Department is not allowed to disclose that information to law enforcement.

This provision has been changed since the May 2 meeting of the Revenue Laws Study Committee. In response to concerns raised by Senator Webster, the Department of Revenue requested that disclosure only be allowed when the information is discovered during a criminal investigation of the taxpayer. This significantly limits the situations in which the Department could share information to those in which there is real evidence obtained by a trained law enforcement officer conducting an independent investigation.

This section would become effective when it becomes law.

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[1] These Articles deal with the tobacco products tax, alcoholic beverage license and excise taxes, and unauthorized substances taxes.

LEGISLATIVE PROPOSAL #5

AMEND PROPERTY TAX LAWS

LEGISLATIVE PROPOSAL 5:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2002 REGULAR SESSION OF THE
2001 GENERAL ASSEMBLY

AN ACT TO AMEND VARIOUS PROPERTY TAX LAWS.

SHORT TITLE: Amend Property Tax Laws.

BRIEF OVERVIEW: This proposal makes the following changes to the property tax laws:

- It authorizes tax collectors to impose a $25 returned check fee or 10% of the amount of the check, whichever is greater, subject to a maximum of $1,000.
- It sets out the procedure and time limit for appeals of personal property value, situs, or taxability.
- It clarifies that the board of equalization and review may continue to meet after it adjourns to hear and decide appeals relating to personal property.
- It changes the effective date of the change in the definition of "real property" as amended in S.L. 2001-506 (HB 253).
- It allows local agencies to impose a $15 local collection assistance fee on each local agency debt collected through setoff.

FISCAL IMPACT: No General Fund impact. Insignificant local revenue impact.

EFFECTIVE DATE: The establishment of a $15 local collection assistance fee becomes effective January 1, 2003. The remainder of this proposal becomes effective for taxes imposed for taxable years beginning on or after July 1, 2002.

A copy of the proposed legislation, bill analysis, and fiscal memorandum begin on the next page

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2001

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LEGISLATIVE PROPOSAL 5

HOUSE DRH1242-LAfz-6 (04/23)

Short Title: Amend Property Tax Laws. (Public)

Sponsors: Representatives Hill; Allen, Buchanan, Holliman, Jarrell, Luebke, and Wainwright.

Referred to:

A BILL TO BE ENTITLED

AN ACT TO AMEND VARIOUS PROPERTY TAX LAWS.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-357(b)(2) reads as rewritten:

"(2) Penalty. – In addition to interest for nonpayment of taxes provided by G.S. 105-360 and in addition to any criminal penalties provided by law for the giving of worthless checks, the penalty for giving in payment of taxes a check that is returned because of insufficient funds or nonexistence of an account of the drawer is twenty-five dollars ($25.00) or ten percent (10%) of the amount of the check, whichever is greater, subject to a ~~minimum of one dollar ($1.00) and a~~ maximum of one thousand dollars ($1,000). This penalty does not apply if the tax collector finds that, when the check was presented for payment, the drawer of the check had sufficient funds in an account at a financial institution in this State to pay the check and, by inadvertence, the drawer of the check failed to draw the check on the account that had sufficient funds. This penalty shall be added to and collected in the same manner as the taxes for which the check was given."

SECTION 2. G.S. 105-317.1 is amended by adding a new subsection to read:

"(c) A taxpayer who owns personal property taxable in the county may appeal the value, situs, or taxability of the property within 30 days after the date of the initial notice of value. If the assessor does not give separate written notice of the value to the taxpayer at the taxpayer's last known address, then the tax bill serves as notice of the value of the personal property. The notice must contain a statement that the taxpayer may appeal the value, situs, or taxability of the property within 30 days after the date of the notice. Upon receipt of a timely appeal, the assessor must arrange a conference with the taxpayer to afford the taxpayer the opportunity to present any evidence or argument regarding the value, situs, or taxability of the property. Within 30 days after the conference, the assessor must give written notice to the taxpayer of the assessor's final decision. Written notice of the decision is not required if the taxpayer signs an agreement accepting the value, situs, or taxability of the property. If an agreement is not reached, the taxpayer has 30 days from the date of the notice of the assessor's final decision to request review of that decision by the board of equalization and review or, if that board is not in session, by the board of county commissioners. Unless the request for review is given at the conference, it must be made in writing to the assessor. Upon receipt of a timely request for review, the provisions of G.S. 105-322 or G.S. 105-325, as appropriate, must be followed."

SECTION 3. G.S. 105-322(g)(5) reads as rewritten:

"(5) Duty to Change Abstracts and Records After Adjournment. – Following adjournment upon completion of its duties under subdivisions (g)(1) and (g)(2) of this subsection, the board may continue to meet to carry out the following duties:

a. To hear and decide all appeals relating to discovered property under G.S. 105-312(d) and (k).

b. To hear and decide all appeals relating to the appraisal, situs, and taxability of classified motor vehicles under G.S. 105-330.2(b).

c. To hear and decide all appeals relating to audits conducted under G.S. 105-296(j) and relating to audits conducted under G.S. 105-296(j) and (l) of property classified at present-use value and property exempted or excluded from taxation.

d. To hear and decide all appeals relating to personal property under G.S. 105-317.1(c)."

SECTION 4. Section 4 of S.L. 2001-506 reads as rewritten:

"**SECTION 4.** Section 1 of this act is effective for taxes imposed for taxable years beginning on or after July 1, ~~2002.~~2004. Sections 2 and 3 of this act become effective January 1, 2002, and apply to manufactured home title cancellations and to declarations of intent, deeds, deeds of trust, and other instruments recorded after that date. The remainder of this act is effective when it becomes law."

SECTION 5.(a) G.S. 105A-2 reads as rewritten:

"**§ 105A-2. Definitions.**

The following definitions apply in this Chapter:

(1) Claimant agency. – Either of the following:
  - a. A State agency.
  - b. A local agency acting through a clearinghouse or an organization pursuant to G.S. 105A-3(b1).

(2) Debt. – Any of the following:
  - a. A sum owed to a claimant agency that has accrued through contract, subrogation, tort, operation of law, or any other legal theory regardless of whether there is an outstanding judgment for the sum.
  - b. A sum a claimant agency is authorized or required by law to collect, such as child support payments collectible under Title IV, Part D of the Social Security Act.
  - c. A sum owed as a result of an intentional program violation or a violation due to inadvertent household error under the Food Stamp Program enabled by Chapter 108A, Article 2, Part 5.
  - d. Reserved for future codification purposes.
  - e. A sum owed as a result of having obtained public assistance payments under any of the following programs through an intentional false statement, intentional misrepresentation, intentional failure to disclose a material fact, or inadvertent household error:
    - 1. The Work First Program provided in Article 2 of Chapter 108A of the General Statutes.
    - 2. The State-County Special Assistance for Adults Program enabled by Part 3 of Article 2 of Chapter 108A of the General Statutes.
    - 3. A successor program of one of these programs.

(3) Debtor. – An individual who owes a debt.

(4) Department. – The Department of Revenue.

(5) Reserved.

(6) Local agency. – A county, to the extent it is not considered a State agency, or a municipality.

(7) Net proceeds collected. – Gross proceeds collected through setoff against a debtor's refund minus the collection assistance ~~fee retained by the Department.~~fees provided in G.S. 105A-13.

(8) Refund. – An individual's North Carolina income tax refund.

(9) State agency. – Any of the following:
  - a. A unit of the executive, legislative, or judicial branch of State government.
  - b. A county, to the extent it administers a program supervised by the Department of Health and Human Services or it

operates a Child Support Enforcement Program, enabled by Chapter 110, Article 9, and Title IV, Part D of the Social Security Act."

SECTION 5.(b) G.S. 105A-5 reads as rewritten:

"**§ 105A-5. Local agency notice, hearing, and decision.**

(a) Prerequisite. – A local agency may not submit a debt for collection under this Chapter until it has given the notice required by this section and the claim has been finally determined as provided in this section.

(b) Notice. – A local agency must send written notice to a debtor that the agency intends to submit the debt owed by the debtor for collection by setoff. The notice must explain the basis for the agency's claim to the debt and that the agency intends to apply the debtor's refund against the debt. The notice must also inform the debtor that the debtor has the right to contest the matter by filing a request for a hearing with the local agency, must state the time limits and procedure for requesting the hearing, and must state that failure to request a hearing within the required time will result in setoff of the debt.

(c) Administrative Review. – A debtor who decides to contest a proposed setoff must file a written request for a hearing with the local agency within 30 days after the date the local agency mails a notice of the proposed action to the debtor. A request for a hearing is considered to be filed when it is delivered for mailing with postage prepaid and properly addressed. The governing body of the local agency or a person designated by the governing body must hold the hearing.

If the debtor disagrees with the decision of the governing body or the person designated by the governing body, the debtor may file a petition for a contested case under Article 3 of Chapter 150B of the General Statutes. The petition must be filed within 30 days after the debtor receives a copy of the local decision. Notwithstanding the provisions of G.S. 150B-2, a local agency is considered an agency for purposes of contested cases and appeals under this Chapter.

In a hearing under this section, an issue that has previously been litigated in a court proceeding cannot be considered.

(d) Decision. – A decision made after a hearing under this section must determine whether a debt is owed to the local agency and the amount of the debt.

(e) Return of Amount Set Off. – If a local agency submits a debt for collection under this Chapter without sending the notice required by subsection (b) of this section, the agency must send the taxpayer the entire amount set off plus the collection assistance ~~fee~~ fees ~~retained by the Department.~~provided in G.S. 105A-13. Similarly, if a local agency submits a debt for collection under this Chapter after sending the required notice but before final determination of the debt and a decision finds that the local agency is not entitled to any part of the amount set off, the agency must send the taxpayer the entire amount set off plus the collection assistance ~~fee~~ fees ~~retained by the Department.~~provided in G.S. 105A-13. That portion of the amount returned that reflects the collection assistance ~~fee~~ fees must be paid from the local agency's funds.

If a local agency submits a debt for collection under this Chapter after sending the required notice and the net proceeds collected that are credited to the local agency for the debt exceed the amount of the debt, the local agency must send the balance to the debtor. No part of the collection assistance ~~fee~~ fees ~~retained by the Department~~provided in G.S. 105A-13 may be returned when a notice was sent and a debt is owed but the debt is less than the amount set off.

Interest accrues on the amount of a refund returned to a taxpayer under this subsection in accordance with G.S. 105-266. A local agency that returns a refund to a taxpayer under this subsection must pay from the local agency's funds any interest that has accrued since the fifth day after the Department mailed the notice of setoff to the taxpayer."

SECTION 5.(c) G.S. 105A-13 reads as rewritten:

"**§ 105A-13. Collection assistance fees.**

(a) State Setoff. – To recover the costs incurred by the Department in collecting debts under this Chapter, a collection assistance fee of no more than fifteen dollars ($15.00) is imposed on each debt collected through setoff. The Department must collect this fee as part of the debt and retain it. The Department must set the amount of the collection assistance fee based on its actual cost of collection under this Chapter for the immediately preceding year.~~ If the Department is able to collect only part of a debt through setoff, the collection assistance fee has priority over the remainder of the debt.~~ The collection assistance fee shall not be added to child support debts or collected as part of child support debts. Instead, the Department shall retain from collections under Division II of Article 4 of Chapter 105 of the General Statutes the cost of collecting child support debts under this Chapter.

(b) Repealed.

(c) Local Debts. – To recover the costs incurred by local agencies in submitting debts for collection under this Chapter, a local collection assistance fee of fifteen dollars ($15.00) is imposed on each local agency debt submitted under G.S. 105A-3(b1) and collected through setoff. The Department must collect this fee as part of the debt and remit it to the clearinghouse that submitted the debt. The local collection assistance fee does not apply to child support debts.

(d) Priority. – If the Department is able to collect only part of a debt through setoff, the collection assistance fee provided in subsection (a) of this section has priority over the local collection assistance fee and over the remainder of the debt. The local collection assistance fee has priority over the remainder of the debt."

SECTION 6. Sections 1 and 4 of the act are effective when they become law. Sections 5(a), 5(b), and 5(c) become effective January 1, 2003. The remaining sections are effective for taxes imposed for taxable years beginning on or after July 1, 2002.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 5: AMEND PROPERTY TAX LAWS

BY: MARTHA WALSTON, FISCAL RESEARCH DIVISION

SUMMARY: The Proposal makes several changes to the property tax laws as recommended by the North Carolina Association of Assessing Officers and the Department of Revenue:

- *Authorizes tax collectors to impose a $25 returned check fee or 10% of the amount of the check, whichever is greater, subject to a maximum of $1,000.*
- *Sets out the procedure and time limit for appeals of personal property value, situs, or taxability.*
- *Clarifies that the board of equalization and review may continue to meet after it adjourns to hear and decide appeals relating to personal property.*
- *Changes the effective date of the definition of "real property" as amended in S.L. 2001-506 (HB 253).*
- *Amends the Setoff Debt Collection Act in Chapter 105A of the General Statutes to allow local agencies to impose a $15 local collection assistance fee on each local agency debt collected through setoff.*

BILL ANALYSIS: Section 1 of the Proposal amends G.S. 105-357(b) regarding the penalty imposed on a worthless check given to pay taxes. Current law authorizes the tax collector to impose 10% of the amount of the check, subject to a minimum of $1 and maximum of $1,000. The proposal authorizes the tax collector to impose $25 or 10% of the amount of the check, whichever is greater, subject to a maximum of $1,000.

Section 2 of the Proposal sets out the procedure and time limit for appeals of the value, situs, or taxability of personal property. The current statutory framework is oriented toward appeals of real estate tax values and does not specifically address appeals of personal property. Consequently, counties use different procedures and time limits for appeals of personal property. The proposal amends G.S. 105-317.1 to include the following:

- The appeal must be within 30 days after the date of the initial notice of value of the personal property. The tax bill will serve as notice of value if a separate written notice of value is not sent. The notice must set out the 30-day limit.
- Upon receipt of a timely appeal, the assessor must arrange a conference with the taxpayer and allow the taxpayer to present evidence or argument.

- Within 30 days after the conference, the assessor must give written notice of the assessor's decision. Notice is not required if the taxpayer accepts the value, situs, or taxability of the property.
- Within 30 days of notice of the assessor's final decision, the taxpayer may request review by the board of equalization and review or the board of county commissioners.[1]

Section 3 of the Proposal authorizes a county board of equalization and review to meet after its adjournment to hear appeals relating to personal property. Last session, the Revenue Laws Study Committee recommended that a county board of equalization and review be given the authority to meet after its adjournment date to hear appeals relating to motor vehicle property taxes, discoveries, and property reviewed annually to determine its continued qualification for exemption or exclusion. Cabarrus, Lincoln, and Stokes Counties already had this authority under local acts. The recommendation was enacted in S.L. 2001-139.

Section 4 of the Proposal changes an effective date in S.L. 2001-506. Last session, the General Assembly made several changes to the laws regarding the classification of a manufactured home as real property. One of these changes was to amend the definition of "real property" in G.S. 105-273(13) of the property tax laws, by removing the requirement that a manufactured home have multiple sections to be considered real property. The amendment also clarified that a manufactured home would be considered personal property if it did not meet the following statutory conditions: has the moving hitch, wheels, and axles removed, and is placed upon a permanent foundation on land owned by the owner of the manufactured home. This definition change became effective for taxable years beginning on or after July 1, 2002. The Proposal moves the effective date to taxable years beginning on or after July 1, 2004. The assessors have not been able to determine whether the manufactured homes in their county meet this definition and have requested an extension of the effective date.

Section 5 of the Proposal amends the Setoff Debt Collection Act in Chapter 105A of the General Statutes to authorize the charge of a $15 collection assistance fee on each local agency debt collected through setoff. The Act currently authorizes the Department of Revenue to impose a collection assistance fee of no more than $15 on overdue tax debts collected through setoff against the debtor's refund. The Act also provides for optional usage of the Act by a local agency (county) that is owed a debt. The local agency must submit the debt through one of the following:

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[1] The original draft gave the assessor 15 days to give written notice of the assessor's decision and gave the taxpayer 15 days to request review of this decision by the board of equalization and review. Mike Pate, a member of the Revenue Laws Study Committee, has raised concerns that 15 days may not be sufficient time to give notice in some cases. The North Carolina Association of Assessing Officers and the Property Tax Division of the Department of Revenue have agreed to increase the period for notice from 15 to 30 days.

1. A clearinghouse that is established pursuant to an interlocal agreement and has agreed to submit debts on behalf of any requesting local agency.
2. The North Carolina League of Municipalities.
3. The North Carolina Association of County Commissioners.

The Proposal amends the Setoff Debt Collection Act to require the Department of Revenue to collect a $15 collection assistance fee on each local agency debt collected through setoff. The fee must be remitted by the Department to the clearinghouse that submitted the debt. Last year the N.C. Association of County Commissioners and the League of Municipalities entered into an interlocal agreement to establish a clearinghouse for local debt collection. The clearinghouse is registered with the Department of Revenue as the North Carolina Local Government Debt Setoff Clearinghouse. The Association and League have also contracted with a third party to process and compile the local debts. The $15 collection assistance fee will be used to pay for the costs of collecting these debts.

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: May 13, 2002

TO: Revenue Laws Study Committee

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: Amend Property Tax Laws

FISCAL IMPACT

Yes ( ) **No ( )** **No Estimate Available (X)**

	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07
REVENUES					
General Fund	No General Fund Impact				
Local Governments	Potential Revenue Increase – See Assumptions and Methodology				
Setoff Debt Collection Clearinghouse	Potential Revenue Increase – See Assumptions and Methodology				
EXPENDITURES					
Local Governments	Potential Cost Savings – See Assumptions and Methodology				

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Local Governments, North Carolina Department of Revenue, Property Tax Division.

EFFECTIVE DATE: Sections 1 (worthless checks) and 4 (manufactured homes) are effective when they become law. The remainder becomes effective for taxes imposed on taxable years beginning on or after July 1, 2002.

BILL SUMMARY: This proposal makes several changes to the property tax law and is recommended by the Revenue Laws Study Committee, the North Carolina Association of Assessing Officers and the North Carolina Department of Revenue.
Section 1 addresses the returned check fee charged by tax collectors. Under current statute the collector can impose a 10% fee for returned checks, with a minimum of $1.00 and a maximum of $1,000. The proposal increases the minimum fee to $25.00. The 10% rate and the $1,000 maximum provisions are retained. Section 2 defines the procedures and time limits surrounding a property tax appeal of personal property taxes. Section 3 authorizes local boards of equalization and review to meet after their adjournment date to hear personal property appeals. Section 4 changes the effective date of several property tax changes made last session in regards to manufactured homes. Section 5 authorizes the Department of Revenue to collect a $15 collection assistance fee on each local debt collected through the Setoff Debt Collection program. The funds are to be forwarded to the North Carolina Local Government Debt Setoff Clearinghouse.

ASSUMPTIONS AND METHODOLOGY:

Section 1: Because the proposal increases the minimum amount charged by tax collectors for returned checks, local fee revenues will increase. Fiscal Research is unable to offer an exact estimate of the increase, although it is expected to be relatively small.

Section 2: The statutory procedure for property tax appeals is oriented towards real estate and does not specifically address how to handle motor vehicle appeals. As a result, counties use a variety of procedures and timelines. Because the bill only clarifies procedure, it is not expected to have a fiscal impact.

Section 3: This section is not expected to have a fiscal impact as it merely extends the time limit for appeals.

Section 4: During the 2001 session several changes were made regarding the classification of manufactured homes for property tax purposes. In particular, the statute laid out specific qualifications for a manufactured home to be considered real property. This included having multiple sections, being placed on a permanent foundation, and having several items (hitch, wheels, axles) removed from the home. The effective date for the changes was July 1, 2002. Since the legislation passed, many assessors have been unable to determine if all the manufactured homes in the county meet the new criteria. As a result, they are asking that the current effective date be delayed until July 1, 2004. Because some properties would continue to be valued as personal property for two extra years, some impact is expected on property taxes. However, Fiscal Research is unable to make a reliable estimate of the impact during that period.

Section 5: Under current law, counties and cities can submit debts for collection to the Department of Revenue as long as the request is forwarded through the League of Municipalities, the County Commissioners Association, or a clearinghouse established through interlocal agreement. However, when the government submits the debt for collection, they must absorb the $15 fee themselves. The proposal authorizes the Department of Revenue to collect the $15 fee from the delinquent payer. This fee does not apply to child support. The proposal will reduce the cost of debt collection for local governments, and will likely increase program usage. However, no firm estimate is available on the total financial impact for local governments.

LEGISLATIVE PROPOSAL #6

AMEND USE VALUE STATUTES

LEGISLATIVE PROPOSAL 6:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2002 REGULAR SESSION OF THE
2001 GENERAL ASSEMBLY

AN ACT TO AMEND THE PRESENT-USE VALUE STATUTES.

SHORT TITLE: Amend Use Value Statutes.

BRIEF OVERVIEW: This proposal makes the following changes to the present-use value statutes:

- It changes the method of determining the present use-value for agricultural land and horticultural land to one based on cash rents. The current method is based on the price and yield of corn and soybeans.
- It authorizes the Use-Value Advisory Board to set the capitalization rate within a range of 6 to 7%. Current law sets the rate at 9%.
- It adds four new members to the Use-Value Advisory Board.
- It makes changes to the definitions that apply to the use-value statutes.
- It requires a new owner to file an application within 60 days of the property's transfer and certify that the owner intends to continue the present use and accepts liability for deferred taxes on the property.

FISCAL IMPACT: No General Fund impact. Potential local revenue change.

EFFECTIVE DATE: The proposal becomes effective for taxes imposed for taxable years beginning on or after July 1, 2003.

A copy of the proposed legislation, bill analysis, and fiscal memorandum begin on the next page

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2001

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LEGISLATIVE PROPOSAL 6

SENATE DRS8712-LAxz-5 (04/17)

Short Title: Amend Use Value Statutes. (Public)

Sponsors: Senators Hartsell; Dalton, Hoyle, Kerr, and Webster.

Referred to:

A BILL TO BE ENTITLED

AN ACT TO AMEND THE PRESENT-USE VALUE STATUTES.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-277.2 reads as rewritten:

"**§ 105-277.2. Agricultural, horticultural, and forestland – Definitions.**

The following definitions apply in G.S. 105-277.3 through G.S. 105-277.7:

(1) Agricultural land. – Land that is a part of a farm unit that is actively engaged in the commercial production or growing of crops, plants, or animals under a sound management program. Agricultural land includes woodland and wasteland that is a part of the farm unit, but the woodland and wasteland included in the unit ~~shall~~ must be appraised under the use-value schedules as woodland or wasteland. A farm unit may consist of more than one tract of agricultural land, but at least one of the tracts must meet the requirements in G.S. 105-277.3(a)(1), and each tract must be under a sound management program. If the agricultural land includes less than 20 acres of woodland, then the woodland portion is not required to be under a sound management program.

(1a) Business entity. – A corporation, a general partnership, a limited partnership, or a limited liability company.

(2) Forestland. – Land that is a part of a forest unit that is actively engaged in the commercial growing of trees under a sound management program. Forestland includes wasteland that is a part of the forest unit, but the wasteland included in the unit ~~shall~~ must

be appraised under the use-value schedules as wasteland. A forest unit may consist of more than one tract of forestland, but at least one of the tracts must meet the requirements in G.S. 105-277.3(a)(3), and each tract must be under a sound management program. Forestland is not required to be under a sound management program if it is determined that the highest and best use of the forestland is to diminish wind erosion, protect water quality, or serve as buffers for livestock or poultry operations. The term 'forestland' includes timberland and woodland.

(3) Horticultural land. – Land that is a part of a horticultural unit that is actively engaged in the commercial production or growing of fruits or vegetables or nursery or floral products under a sound management program. Horticultural land includes woodland and wasteland that is a part of the horticultural unit, but the woodland and wasteland included in the unit ~~shall~~ must be appraised under the use-value schedules as woodland or wasteland. A horticultural unit may consist of more than one tract of horticultural land, but at least one of the tracts must meet the requirements in G.S. 105-277.3(a)(2), and each tract must be under a sound management program. If the horticultural land includes less than 20 acres of woodland, then the woodland portion is not required to be under a sound management program.

(4) Individually owned. – Owned by one of the following:

a. A natural person. For the purpose of this section, a natural person who is an income beneficiary of a trust that owns land may elect to treat the person's beneficial share of the land as owned by that person. If the person's beneficial interest is not an identifiable share of land but can be established as a proportional interest in the trust income, the person's beneficial share of land is a percentage of the land owned by the trust that corresponds to the beneficiary's proportional interest in the trust income. For the purpose of this section, a natural person who is a member of a business entity, other than a corporation, that owns land may elect to treat the person's share of the land as owned by that person. The person's share is a percentage of the land owned by the business entity that corresponds to the person's percentage of ownership in the entity.

b. A business entity having as its principal business one of the activities described in subdivisions (1), (2), and (3) and whose members are all natural persons who meet one or more of the following conditions:

1. The member is actively engaged in the business of the entity.
2. The member is a relative of a member who is actively engaged in the business of the entity.
3. The member is a relative of, and inherited the membership interest from, a decedent who met one or both of the preceding conditions after the land qualified for classification in the hands of the business entity.

c. A trust that was created by a natural person who transferred the land to the trust and each of whose beneficiaries who is currently entitled to receive income or principal meets one of the following conditions:

1. Is the creator of the trust or the creator's relative.
2. Is a second trust whose beneficiaries who are currently entitled to receive income or principal are all either the creator of the first trust or the creator's relatives.

d. A testamentary trust that meets all of the following conditions:

1. It was created by a natural person who transferred to the trust land that qualified in that person's hands for classification under G.S. 105-277.3.
2. At the time of the creator's death, the creator had no relatives as defined in this section as of the date of death.
3. The trust income, less reasonable administrative expenses, is used exclusively for educational, scientific, literary, cultural, charitable, or religious purposes as defined in G.S. 105-278.3(d).

e. Tenants in common, if each tenant is either a natural person or a business entity described in sub-subdivision b. of this subdivision. Tenants in common may elect to treat their individual shares as owned by them individually in accordance with G.S. 105-302(c)(9). The ownership requirements of G.S. 105-277.3(b) apply to each tenant in common who is a natural person and the ownership requirements of G.S. 105-277.3(b1) apply to each tenant in common who is a business entity.

(4a) Member. – A shareholder of a corporation, a partner of a general or limited partnership, or a member of a limited liability company.

(5) Present-use value. – The value of land in its current use as agricultural land, horticultural land, or forestland, based solely on its ability to produce ~~income, using a rate of nine percent (9%) to capitalize the expected net income of the property and assuming an average level of management.~~ income and assuming an average level of management. A rate of nine percent (9%) shall be used to capitalize the expected net income of forestland. The capitalization rate for agricultural land and horticultural land is to be determined by the Use-Value Advisory Board as provided in G.S. 105-277.7.

(5a) Relative. – Any of the following:

a. A spouse or the spouse's lineal ancestor or descendant.

b. A lineal ancestor or a lineal descendant.

c. A brother or sister, or the lineal descendant of a brother or sister. For the purposes of this sub-subdivision, the term brother or sister includes stepbrother or stepsister.

d. An aunt or an uncle.

e. A spouse of a person listed in paragraphs a. through d.

For the purpose of this subdivision, an adoptive or adopted relative is a relative and the term "spouse" includes a surviving spouse.

(6) Sound management program. – A program of production designed to obtain the greatest net return from the land consistent with its conservation and long-term improvement.

(7) Unit. – One or more tracts of agricultural land, horticultural land, or forestland. Multiple tracts must be under the same ownership. If the multiple tracts are located within different counties, they must be within 50 miles of a tract qualifying under G.S. 105-277.3(a) and share one of the following characteristics:

a. Type of classification.

b. Use of the same equipment or labor force."

SECTION 2. G.S. 105-277.3 reads as rewritten:

"**§ 105-277.3. Agricultural, horticultural, and forestland – Classifications.**

(a) Classes Defined. – The following classes of property are designated special classes of property under authority of Section 2(2) of Article V of the North Carolina Constitution and ~~shall~~ must be appraised, assessed, and taxed as provided in G.S. 105-277.2 through G.S. 105-277.7.

(1) Agricultural land. – Individually owned agricultural land consisting of one or more tracts, one of which consists of at least 10 acres that are in actual production and that, for the three years preceding

January 1 of the year for which the benefit of this section is claimed, have produced an average gross income of at least one thousand dollars ($1,000). Gross income includes income from the sale of the agricultural products produced from the land and any payments received under a governmental soil conservation or land retirement program. Land in actual production includes land under improvements used in the commercial production or growing of crops, plants, or animals.

(2) Horticultural land. – Individually owned horticultural land consisting of one or more tracts, one of which consists of at least five acres that are in actual production and that, for the three years preceding January 1 of the year for which the benefit of this section is claimed, have met the applicable minimum gross income requirement. Land in actual production includes land under improvements used in the commercial production or growing of fruits or vegetables or nursery or floral products. Land that has been used to produce evergreens intended for use as Christmas trees must have met the minimum gross income requirements established by the Department of Revenue for the land. All other horticultural land must have produced an average gross income of at least one thousand dollars ($1,000). Gross income includes income from the sale of the horticultural products produced from the land and any payments received under a governmental soil conservation or land retirement program.

(3) Forestland. – Individually owned forestland consisting of one or more tracts, one of which consists of at least 20 acres that are in actual production and are not included in a farm unit.

(b) Natural Person Ownership Requirements. – In order to come within a classification described in subsection (a) of this section, the land must, if owned by a natural person, also satisfy one of the following conditions:

(1) It is the owner's place of residence.

(2) It has been owned by the current owner or a relative of the current owner for the four years preceding January 1 of the year for which the benefit of this section is claimed.

(3) At the time of transfer to the current owner, it qualified for classification in the hands of a business entity or trust that transferred the land to the current owner who was a member of the business entity or a beneficiary of the trust, as appropriate.

(b1) Entity Ownership Requirements. – In order to come within a classification described in subsection (a) of this section, the land must, if owned by a business entity or trust, have been owned by the business entity or trust or by one or more of its members or creators, respectively, for the four years immediately preceding January 1 of the year for which the benefit of this section is claimed.

(b2) Exception to Ownership Requirements. – ~~G.S. 105-277.4(c) provides that deferred taxes are payable if land fails to meet any condition or requirement for classification. Accordingly, if land fails to meet an ownership requirement due to a change of ownership, G.S. 105-277.4(c) applies. Despite this failure and the resulting liability for taxes under G.S. 105-277.4(c), the~~Notwithstanding the provisions of subsections (b) and (b1) of this section, land may qualify for classification in the hands of the new owner if ~~both~~ all of the conditions listed in this subsection are met, even if the new owner does not meet all of the ownership requirements of subsections (b) and (b1) of this section with respect to the land. If the land qualifies for classification in the hands of the new owner under the provisions of this subsection, then the deferred taxes remain a lien on the land under G.S. 105-277.4(c). the new owner becomes liable for the deferred taxes, and the deferred taxes become payable if the land fails to meet any other condition or requirement for classification.

(1) The land was appraised at its present use value or was eligible for appraisal at its present use value at the time title to the land passed to the new owner.

(2) At the time title to the land passed to the new owner, the new owner acquires the land for the purposes of and continues to use the land for the purposes it was classified under subsection (a) of this section while under previous ownership.

(3) The new owner has timely filed an application as required by G.S. 105-277.4(a) and has certified that the new owner accepts liability for the deferred taxes and intends to continue the present use of the land.

(c) Repealed by Session Laws 1995, c. 454, s. 2.

(d) Exception for Conservation Reserve Program. – Land enrolled in the federal Conservation Reserve Program authorized by 16 U.S.C. ~~§ 1381~~Chapter 58 is considered to be in actual production, and income derived from participation in the federal Conservation Reserve Program may be used in meeting the minimum gross income requirements of this section either separately or in combination with income from actual production. Land enrolled in the federal Conservation Reserve Program ~~shall~~ must be assessed as agricultural land if it is planted in vegetation other than trees, or as forestland if it is planted in trees. Land that is voluntarily removed from production due to participation in any other program is not considered to be in actual production.

(e) Exception for Turkey Disease. – Agricultural land that meets all of the following conditions is considered to be in actual production and to meet the minimum gross income requirements:

(1) The land was in actual production in turkey growing within the preceding two years and qualified for present use value treatment while it was in actual production.

(2) The land was taken out of actual production in turkey growing solely for health and safety considerations due to the presence of Poult Enteritis Mortality Syndrome among turkeys in the same county or a neighboring county.

(3) The land is otherwise eligible for present use value treatment.

(f) Sound Management Program. – If the property owner demonstrates any one of the following factors with respect to property, then the property is operated under a sound management program:

(1) Enrollment in and compliance with an agency-administered and approved farm management plan.

(2) Compliance with a set of best management practices.

(3) Compliance with a written sound forest management plan for the production and sale of forest products.

(4) Compliance with a minimum gross income per acre test.

(5) Evidence of net income from the farm operation.

(6) Evidence that farming is the farm operator's principal source of income.

(7) Certification by a recognized agricultural, forestry, or horticultural agency within the county that the land is operated under a sound management program.

Operation under a sound management program may also be demonstrated by evidence of other similar factors. As long as a farm operator meets the sound management requirements, it is irrelevant whether the property owner received income or rent from the farm operator."

SECTION 3. G.S. 105-277.4 reads as rewritten:

"**§ 105-277.4. Agricultural, horticultural and forestland – Application; appraisal at use value; appeal; deferred taxes.**

(a) Application. – Property coming within one of the classes defined in G.S. 105-277.3 ~~shall be~~ is eligible for taxation on the basis of the value of the property in its present use if a timely and proper application is filed with the assessor of the county in which the property is located. The application ~~shall~~ must clearly show that the property comes within one of the classes and ~~shall~~ must also contain any other relevant information required by the assessor to properly appraise the property at its present-use value. An initial application ~~shall~~ must be filed during the regular listing period of the year for which the benefit of this classification is first claimed, or within 30 days of the date shown on a notice of a change in valuation made pursuant to G.S. 105-286 or G.S. 105-287. A new application is not required to be submitted unless the property is transferred or becomes ineligible for use-value appraisal because of a change in use or acreage. An application required due to transfer of the land may be submitted at any time during the calendar year but must be submitted within 60 days of the date of the property's transfer.

(b) Appraisal at Present-use Value. – Upon receipt of a properly executed application, the assessor ~~shall~~ must appraise the property at its present-use value as established in the schedule prepared pursuant to G.S. 105-317. In appraising the property at its present-use value, the assessor ~~shall~~ must appraise the improvements located on qualifying land according to the schedules and standards used in appraising other similar improvements in the county. If all or any part of a qualifying tract of land is located within the limits of an incorporated city or town, or is property annexed subject to G.S. 160A-37(f1) or G.S. 160A-49(f1), the assessor ~~shall~~ must furnish a copy of the property record showing both the present-use appraisal and the valuation upon which the property would have been taxed in the absence of this classification to the collector of the city or town. ~~He shall~~The assessor must also notify the tax collector of any changes in the appraisals or in the eligibility of the property for the benefit of this classification. Upon a request for a certification pursuant to G.S. 160A-37(f1) or G.S.160A-49(f1), or any change in the certification, the assessor for the county where the land subject to the annexation is located ~~shall,~~ must, within 30 days, determine if the land meets the requirements of G.S. 160A-37(f1)(2) or G.S. 160A-49(f1)(2) and report the results of its findings to the city.

(b1) Appeal. – Decisions of the assessor regarding the qualification or appraisal of property under this section may be appealed to the county board of equalization and review or, if that board is not in session, to the board of county commissioners. Decisions of the county board may be appealed to the Property Tax Commission.

(c) Deferred Taxes. – Land meeting the conditions for classification under G.S. 105-277.3 ~~shall~~ must be taxed on the basis of the value of the land for its present use. The difference between the taxes due on the present-use basis and the taxes that would have been payable in the absence of this classification, together with any interest, penalties, or costs that may accrue thereon, are a lien on the real property of the taxpayer as provided in G.S. 105-355(a). The difference in taxes ~~shall~~ must be carried forward in the records of the taxing unit or units as deferred taxes. The taxes become due and payable when the land fails to meet any condition or requirement for classification. Failure to have an application approved is ground for disqualification. The tax for the fiscal year that opens in the calendar year in which deferred taxes become due is computed as if the land had not been classified for that year, and taxes for the preceding three fiscal years that have been deferred are immediately payable, together with interest as provided in G.S. 105-360 for unpaid taxes. Interest accrues on the deferred taxes due as if they had been payable on the dates on which they originally became due. If only a part of the qualifying tract of land fails to meet a condition or requirement for classification, ~~a determination shall be made of~~ the assessor must determine the amount of deferred taxes applicable to that part and that amount becomes payable with interest as provided above. Upon the payment of any taxes deferred in accordance with this section for the three years immediately preceding a disqualification, all liens arising under this subsection are extinguished. The deferred taxes for any given year may be paid in that year without the qualifying tract of land becoming ineligible for deferred status.

(d) Exceptions. – Notwithstanding the provisions of subsection (c) of this section, if property loses its eligibility for present use value classification solely due to one of the following reasons, no deferred taxes are due and the lien for the deferred taxes is extinguished:

(1) There is a change in income caused by enrollment of the property in the federal conservation reserve program established under 16 U.S.C. Chapter 58.

(2) The property is conveyed by gift to a nonprofit organization and qualifies for exclusion from the tax base pursuant to G.S. 105-275(12) or G.S. 105-275(29).

(3) The property is conveyed by gift to the State, a political subdivision of the State, or the United States.

(e) Repealed by Session Laws 1997-270, s. 3, effective July 3, 1997."

SECTION 4. G.S. 105-277.7 reads as rewritten:

"§ 105-277.7. Use-Value Advisory Board.

(a) Creation and Membership. – The Use-Value Advisory Board is established under the supervision of the Agricultural Extension Service of North Carolina State University. The ~~Board shall annually submit to the Department of Revenue a recommended use-value manual developed in accordance with the guidelines in G.S. 105-289(a)(5). In developing the manual, the Board may consult with federal and State agencies as needed. The Board shall submit to the Department of Revenue recommendations concerning requirements for horticultural land used to produce evergreens intended for use as Christmas trees when requested to do so by the Department.~~

~~The Board shall be chaired by the~~ Director of the Agricultural Extension Service of North Carolina State University shall serve as the chair of the Board. The Board ~~and~~ shall consist of the following additional ~~members:~~members, to serve ex officio:

(1) A ~~a~~ representative of the Department of Agriculture and Consumer Services, designated by the Commissioner of ~~Agriculture;~~Agriculture.

(2) A ~~a~~ representative of the Forest Resources Division of the Department of Environment and Natural Resources, designated by the Director of that ~~Division; and a~~Division.

(3) A representative of the Agricultural Extension Service at North Carolina Agricultural and Technical State University, designated by the Director of the Extension Service.

(4) A representative of the North Carolina Farm Bureau, designated by the President of the Bureau.

(5) A representative of the North Carolina Association of Assessing Officers, designated by the President of the Association.

(6) The Director of the Property Tax Division of the North Carolina Department of Revenue or the Director's designee.

(7) A representative of the North Carolina Association of County Commissioners, designated by the President of the Association.

(b) Staff. ~~– All members shall serve ex officio.~~ The Agricultural Extension Service at North Carolina State University ~~shall~~ must provide clerical assistance to the Board.

(c) Duties. – The Board must annually submit to the Department of Revenue a recommended use-value manual. In developing the manual, the Board may consult with federal and State agencies as needed. The manual must contain all of the following:

(1) The estimated cash rental rates for agricultural lands and horticultural lands for the various classes of soils found in the State. The rental rates must recognize the productivity levels by class of soil or geographic area. The rental rates must be based on the rental value of the land to be used for agricultural or horticultural purposes when those uses are presumed to be the highest and best use of the land. The recommended rental rates may be established from individual county studies or from contracts with federal or State agencies as needed.

(2) The recommended net income ranges for forestland furnished to the Board by the Forestry Section of the North Carolina Cooperative Extension Service. These net income ranges may be based on up to six classes of land within each Major Land Resource Area designated by the United States Soil Conservation Service. In developing these ranges, the Forestry Section must consider the soil productivity and indicator tree species or stand type, the average stand establishment and annual management costs, the average rotation length and timber yield, and the average timber stumpage prices.

(3) The capitalization rates adopted by the Board prior to February 1 for use in capitalizing incomes into values. The capitalization rate for forestland shall be nine percent (9%). The capitalization rate for agricultural land and horticultural land must be no less than six

percent (6%) and no more than seven percent (7%). The incomes must be in the form of cash rents for agricultural lands and horticultural lands and net incomes for forestlands.

(4) The value per acre adopted by the Board for the best agricultural land. The value may not exceed one thousand two hundred dollars ($1,200).

(5) Recommendations concerning any changes to the capitalization rate for agricultural land and horticultural land and to the maximum value per acre for the best agricultural land based on a calculation to be determined by the Board. The Board shall annually report these recommendations to the Revenue Laws Study Committee and to the President Pro Tempore of the Senate and the Speaker of the House of Representatives.

(6) Recommendations concerning requirements for horticultural land used to produce evergreens intended for use as Christmas trees when requested to do so by the Department."

SECTION 5. G.S. 105-289(a) reads as rewritten.

"(a) It ~~shall be~~is the duty of the Department of Revenue:

(1) To discharge the duties prescribed by law and to enforce the provisions of this Subchapter.

(2) To exercise general and specific supervision over the valuation and taxation of property by taxing units throughout the State.

(3) To appraise the property of public service companies.

(4) To keep full and accurate records of the Commission's official proceedings.

(5) To prepare and distribute annually to each assessor ~~a~~ the manual developed by the Use-Value Advisory Board under G.S. 105-277.7 that establishes ~~five expected net income per acre ranges for agricultural land, horticultural land, and forestland, and establishes a method for appraising nonproductive land as a percentage of the lowest use-value established for productive land. The high and low net income amount in each range may differ by no more than fifteen dollars ($15.00). The basis for establishing each range shall be soil productivity.~~

~~For agricultural land, the expected net income per acre ranges shall be based on the actual yields and prices of corn and soybeans over a period of at least the five previous years, and the actual fixed and variable costs, including an imputed management cost, incurred in growing corn and soybeans over the same period of time. The manual shall contain recommended adjustments to the net income~~

~~per acre ranges for the growing of crops subject to acreage or poundage allotments.~~

~~Expected net income per acre ranges shall be similarly established for horticultural land and forestland, using typical horticultural or forest products in various growing regions of the State instead of corn and soybeans.~~ the cash rental rates for agricultural lands and horticultural lands and the net income ranges for forestland.

(6) To establish requirements for horticultural land, used to produce evergreens intended for use as Christmas trees, in lieu of a gross income requirement until evergreens are harvested from the land, and to establish a gross income requirement for this type horticultural land, that differs from the income requirement for other horticultural land, when evergreens are harvested from the land.

(7) To conduct studies of the cash rents for agricultural lands on a county or a regional basis, such as the Major Land Resource Area map designated and developed by the U.S. Department of Agriculture. The results of the studies must be furnished to the North Carolina Use-Value Advisory Board. The studies may be conducted on any reasonable basis and timetable that will be reflective of rents and values for each local area based on the productivity of the land."

SECTION 6. G.S. 105-296(j) reads as rewritten:

"(j) The assessor ~~shall~~ must annually review one eighth of the parcels in the county classified for taxation at present-use value to verify that these parcels qualify for the classification. By this method, the assessor ~~shall~~ must review the eligibility of all parcels classified for taxation at present-use value in an eight-year period. The period of the review process is based on the average of the preceding three years' data. The assessor may request assistance from the Farm Service Agency, the Cooperative Extension Service, the Forest Resources Division of the Department of Environment and Natural Resources, or other similar organizations.

The assessor may require the owner of classified property to submit any ~~information~~ information, including sound management plans for forestland, needed by the assessor to verify that the property continues to qualify for present-use value taxation. The owner has 60 days from the date a written request for the information is made to submit the information to the assessor. If the assessor determines the owner failed to make the information requested available in the time required without good cause, the property loses its present-use value classification and the property's deferred taxes become due and payable as provided in G.S. 105-277.4(c). The assessor must reinstate the property's use-value classification when the owner submits the requested information unless the information discloses that the property no longer qualifies for present-use value classification. When a property's present-use value classification is reinstated, it is reinstated retroactive to the date the classification was revoked and any deferred taxes that were paid as a result of the revocation must be refunded to the property owner.

In determining whether property is operating under a sound management program, the assessor must consider any weather conditions or other acts of nature that prevent the growing or harvesting of crops or the realization of income from cattle, swine, or poultry operations. The assessor must also allow the property owner to submit additional information before making this determination."

SECTION 7. G.S. 105-299 reads as rewritten:

"§ 105-299. Employment of experts.

The board of county commissioners may employ appraisal firms, mapping firms or other persons or firms having expertise in one or more of the duties of the assessor to assist ~~him or her~~ the assessor in the performance of ~~such~~ these duties. The county may also assign to county agencies, or contract with State or federal agencies, for any duties involved with the approval or auditing of use-value accounts. The county may make available to ~~such~~ these persons any information it has that will facilitate the performance of a contract entered into pursuant to this section. Persons receiving ~~such~~ this information ~~shall be~~are subject to the provisions of G.S. 105-289(e) and G.S. 105-259 regarding the use and disclosure of information provided to them by the county. Any person employed by an appraisal firm whose duties include the appraisal of property for the county ~~shall~~ must be required to demonstrate that he or she is qualified to carry out ~~such~~ these duties by achieving a passing grade on a comprehensive examination in the appraisal of property administered by the Department of Revenue. In the employment of ~~such~~ these firms, primary consideration ~~shall~~ must be given to the firms registered with the Department of Revenue pursuant to ~~the provisions of~~ G.S. 105-289(i). A copy of the specifications to be submitted to potential bidders and a copy of the proposed contract may be sent by the board to the Department of Revenue for review before the invitation or acceptance of any bids. Contracts for the employment of these ~~such~~ firms or persons ~~shall be deemed to be~~ are contracts for personal services and ~~shall not be~~are not subject to the provisions of Article 8, Chapter 143, of the General Statutes."

SECTION 8. This act is effective for taxes imposed for taxable years beginning on or after July 1, 2003.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 6: AMEND USE VALUE STATUTES

BY: MARTHA WALSTON, FISCAL RESEARCH DIVISION

SUMMARY: This Proposal is a joint effort of representatives from the Department of Revenue, the Farm Bureau, the Association of County Commissioners, and the Association of Assessing Officers to amend the present-use value statutes to more accurately determine the realistic present-use value of agricultural land, horticultural land, and forestland. The Proposal does the following:

- *Changes the method of determining the present use-value for agricultural land and horticultural land to one based on cash rents. The current method is based on the price and yield of corn and soybeans.*
- *Lists factors that demonstrate property is operated under a sound management plan.*
- *Authorizes the Use-Value Advisory Board to set the capitalization rate within a range of 6 to 7% for agricultural land and horticultural land. Forestland remains at 9%.*
- *Adds four new members to the Use-Value Advisory Board.*
- *Makes changes to the definitions that apply to the use-value statutes.*
- *Requires a new owner to file an application within 60 days of the property's transfer and certify that the owner intends to continue the present use and accepts liability for deferred taxes on the property.*
- *Requires the Use-Value Advisory Board to report annually to the Revenue Laws Study Committee and to the President Pro Tempore of the Senate and the Speaker of the House of Representatives on any recommended changes to (1) the capitalization rate for agricultural land and horticultural land, and (2) the maximum value per acre for the best agricultural land.*

BACKGROUND: In 1973, the General Assembly designated three classes of property as special classes of property under Article V, Sec. 2(2) of the North Carolina Constitution: agricultural land, horticultural land, and forestland. At that time, eligible property began to be appraised, assessed, and taxed at its present-use value, as opposed to its fair market value. The present-use value classification helps preserve farmland by insulating it from the rising property tax values caused by competing market pressures to develop farmland for commercial and residential purposes.

In 1985, the General Assembly enacted the current methodology for calculating present-use value. It directed the Department of Revenue to prepare and distribute annually to each tax assessor a present-use value manual to assist in appraising and assessing farmland. A four-member Use-Value Advisory Board, under the supervision of the Agricultural Extension Service of North Carolina State University, submits a recommended manual to the Department each year. The present-use value manual is advisory only, and each county remains free to develop its own present-use value schedules. Until several years ago, all counties used the manual. Today, an increasing number of counties do not use the manual because the present-use values in the manual cannot be supported by credible market evidence. For example, the values determined for agricultural land are based on yields and prices of corn and soybeans using a capitalization rate of 9%. Corn and soybeans no longer represent the typical crops grown in the State and are not the major money crops. This current method erodes the intent to foster uniformity and creates equity problems between similar types of properties.

In 1999, the Revenue Laws Study Committee recommended to change the method for determining the present-use value of agricultural land and horticultural land. The Committee based the value of such land upon its cash rents using a capitalization rate of 5%. The proposal was introduced during the 1999 session, but was never discussed in committee.

BILL ANALYSIS: Section 1 of the proposal makes the following changes to the definitions that apply in the use-value statutes:

- To qualify for use-value treatment the agricultural land, forestland land, and horticultural land must be actively engaged in commercial production under a sound management program. A "sound management program" is defined as "a program of production designed to obtain the greatest net return from the land consistent with its conservation and long-term improvement." The proposal exempts certain agricultural land, forestland, and horticultural land from a sound management program:
    1. If the agricultural land includes less than 20 acres of woodland, then the woodland portion is not required to be under a sound management program.
    2. Forestland is exempt if it is determined that the highest and best use of the forestland is to diminish wind erosion, protect water quality, or serve as buffers for livestock or poultry operations. The proposal also clarifies that the term "forestland" includes timberland and woodland.
    3. If the horticultural land includes less than 20 acres of woodland, then the woodland portion is not required to be under a sound management program.

- To qualify for use-value treatment, agricultural land, forestland, and horticultural land must be individually owned. The term "individually owned" means:

    1. a natural person who (a) lives on the land, (b) has owned the land in their family for at least four years, or (c) received the land when it was eligible for use-value treatment in the prior owner's hands.
    2. a business entity if farming, horticulture, or forestry is its principal business and whose members are all natural persons who are actively engaged in the business, are related to a member actually engaged in the business, or have inherited the property from one of these members.
    3. a family or charitable testamentary trust that meets certain conditions. The family trust must be created by a natural person and the beneficiaries must be the creator of the trust, the creator's relatives, or a second trust whose beneficiaries are the creator of the first trust or the creator's relatives.
    4. The proposal adds "tenants in common" within the term "individually-owned". Each tenant in common must either be a natural person or a business entity.

- The current definition of "present-use value" bases the value of agricultural land, horticultural land, or forestland on its ability to produce income, using a capitalization rate of 9%. The proposal provides that the capitalization rate for agricultural land and horticultural land is to be determined by the Use-Value Advisory Board pursuant to statutory guidelines defining the duties of the Board. The capitalization rate for forestland will remain at 9%.
- The proposal creates a definition for "unit". Current law requires agricultural land, horticultural land, and forestland to be part of a unit, but does not define the term.

Section 2 of the proposal does the following:

- Under current law, the property must be the owner's residence or have been owned by the person for four years before the property can be classified in the use-value program. Prior to 2002, there was an exception to the four-year ownership requirement, if the new owner owned other property classified in the use-value program. S.L. 2001-499 removed the requirement that the new owner have other property classified in the use-value program. However, the new owner must acquire the land for the purposes of and continue to use the land for the purposes it was classified under the use-value program. Also, the new owner is liable for the deferred taxes. The proposal clarifies that when the land is transferred to a new owner who intends to continue its use-value purpose, the deferred taxes remain a lien on the land. The proposal also requires the new owner to file an application for use-value within 60 days of the date of the property's transfer and certify that the new owner intends to continue the present use of the land and accepts liability for the deferred taxes. Under current law, the deferred taxes for the preceding three years become payable whenever the property loses its eligibility for the benefit of the present-use value.

- Under current law, land enrolled in the federal Conservation Reserve Program is considered to be in actual production for use-value determination, and income derived from participation in the federal program may be used to meet the gross income requirements for use-value classification. The proposal corrects an incorrect cite to this federal program, and clarifies that land voluntarily removed from production due to participation in any other program WILL NOT be considered to be in actual production. (Under the federal Conservation Reserve Program, owners are paid for agreeing to refrain from farming their property in order to conserve and improve the soil and water resources of the land.)
- The proposal sets out a list of factors that the property owner may demonstrate in order to show that the property is operated under a sound management program. Only one of these factors must be demonstrated in order to meet the sound management requirement.

Section 3 of the proposal does the following:

- G.S. 105-277.4 sets out the requirements for a timely and proper application for present-use value classification, the duties of the assessor when appraising at present-use value, and the determination and payment of deferred taxes. An initial application for present-use value is required to be filed during the regular listing period or within 30 days of the date shown on a notice of change in valuation. A new application is required when the property is transferred or becomes ineligible because of a change in use or acreage. The proposal allows a taxpayer to file an application any time during the calendar year if the application is required because of a transfer of the land. However, the new application must be submitted within 60 days of the date of the property's transfer.
- The proposal clarifies that failure to have an application approved is ground for disqualification as classified property. This means that if classified property is transferred to a new owner who intends to continue the present use of the property and the new owner does not apply for and receive approval for present-use value classification, then the new owner becomes liable for the deferred taxes.

Section 4 of the proposal does the following:

- Changes the make-up and duties of the Use-Value Advisory Board. Under current law, the Use-Value Advisory Board is established under the supervision of the Agricultural Extension Service of NC State University.

The Board annually submits a recommended manual to the Department of Revenue. The Department of Revenue annually prepares and distributes this manual to each assessor.

The proposal adds four new members to the current make-up of the Board:

1. The Director of the Agricultural Extension Service of NCSU, serves as chair.
2. A representative of the Department of Agriculture and Consumer Services, designated by the Commissioner of Agriculture.
3. A representative of the Forest Resources Division of DENR, designated by the Director of that Division.
4. A representative of the Agricultural Extension Service at NC Agricultural and Technical State University, designated by the Director of the Extension Service.
5. A representative of the NC Farm Bureau, designated by the President of the Bureau.
6. A representative of the NC Association of Assessing Officers, designated by the President of the Association.
7. The Director of the Property Tax Division of the NC Department of Revenue or the Director's designee.
8. A representative of the NC Association of County Commissioners, designated by the President of the Association.

The proposal makes substantive changes to the duties of the Use-Value Advisory Board. Under current law, the required contents of the manual are set out in the statutory duties of the Department of Revenue. The proposal changes some of these requirements and moves them to the statute setting out the duties of the Use Value-Advisory Board. The Board must set out the following in the manual:

- The expected net income per acre ranges of agricultural land. These are to be based on the estimated cash rental rates for agricultural lands for the various classes of soil in the State, instead of the actual yields and prices of corn and soybeans over a period of at least the five previous years.

- The expected net income per acre ranges for horticultural land. These are to be based on the estimated cash rental rates for horticultural lands for the various classes of soil in the State, instead of typical horticultural products in various growing regions in the State.

- The rental rates for both agricultural land and horticultural land are to be used when agricultural or horticultural purposes are presumed to be the highest and best use of the land. These rates may be established from individual county studies or contracts with federal or State agencies.

- The expected net income per acre ranges for forestland. These are to be furnished by the Forestry Section of the NC Cooperative Extension Service and are to be based on six Major Land Resource Areas in the State. These areas are geographic regions designated by the US Soil Conservation Service. The proposal sets out in the statute a list of factors that the Forestry Section must consider when developing the income ranges. These same factors are currently listed in the Use-Value Manual.
- The capitalization rates adopted by the Board prior to February 1. The rate for forestland remains at 9%. The rate for agricultural land and horticultural land is changed from 9% to a rate of no less than 6% and no more than 7%. The rate is used to capitalize incomes into values.
- The value per acre for the best agricultural land, not to exceed $1,200.
- Recommendation of any changes to the capitalization rate for agricultural land and horticultural land and to the maximum value per acre for the best agricultural land. These recommendations must be annually reported to the Revenue Laws Study Committee and to the President Pro Tem and Speaker.

Section 5 of the proposal changes the duties of the Department of Revenue as follows:

- Moves the required contents of the Use-Value Manual to the Use-Value Advisory Board statute.
- Requires the Department to conduct studies of the cash rents for agricultural lands.

Section 6 of the proposal amends G.S. 105-296, which sets out the powers and duties of the assessor. This section requires the assessor to annually review one eighth of the parcels in the county classified at present-use value and authorizes the assessor to require an owner to submit information needed by the assessor to verify that the property continues to qualify. The proposal (1) authorizes the assessor to request assistance in carrying out the review, (2) clarifies that the assessor may require the owner to submit information of a sound management plan when verifying the classification of forestland, (3) clarifies that the period of the review process is based on the average of the preceding three years' data, (4) requires the assessor to consider acts of nature that may prevent the growing of crops or the realization of income when determining whether the property is operated under a sound management program, and (5) requires the assessor to allow the property owner to submit additional information before determining that the property is not operated under a sound management program.

Section 7 of the proposal amends G.S. 105-299, which authorizes the board of county commissioners to employ experts. The proposal authorizes the county to assign to county agencies or contract with State or federal agencies, for any duties involved with the approval or auditing of use-value accounts.

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: **May 13, 2002**

TO: Revenue Laws Study Committee

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: Amend Use Value Statutes

FISCAL IMPACT

Yes ( ) **No ( )** **No Estimate Available (X)**

	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07
REVENUES					
General Fund			No General Fund Impact		
Local Revenue			Potential Local Revenue Change		

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Local Governments, N.C. Department of Revenue, Ad Valorem Tax Division.

EFFECTIVE DATE: July 1, 2003 and applies to taxes imposed for taxable years beginning on or after that date.

BILL SUMMARY: Under current law farmers are charged property taxes based on the land value for agricultural and horticultural purposes, rather than the full market price. In general, this value is lower than the market price because it does not reflect any potential alternative uses for the property (i.e. new homes, commercial development, or industrial facilities). Under the current system the adjusted value for agriculture is based on the market price for corn and soybeans, as well as the cost of producing corn and soybeans. A Use Value Advisory Board is charged with determining the basis for horticultural land. The Use Value Advisory Board has generally created a manual each year. County tax assessors can use this manual to determine values under the use value program, or can include their own values in line with the county's schedule of values. This bill changes the current program in several ways. In Section 1 the proposal exempts certain agricultural, forestland, and horticultural land from the existing sound management program requirement, primarily if the "highest and best use" of the forestland is to serve as a buffer, or a small portion of the agricultural or horticultural unit is actually woodland. Second, it clarifies that the term "tenants in common" is a form of individually owned property for use value participation purposes. It also clarifies that each beneficiary of a family trust must be a natural person to meet the individually owned requirements. This section also provides that the Use Value Advisory Board determines the appropriate income and capitalization rates to be used to determine use value. Section 2 clarifies that when land under the use value program is transferred to a new owner who intends to continue under the program, the deferred taxes remain a lien on the property. It also requires that the new owner file an application for use value within 60 days of the transfer, certify that they intend to continue to use the property for an allowable activity under the use value program, and accept liability for the deferred taxes if the requirements are not met. This section also clarifies that land voluntarily removed from production due to participation in certain federal programs will not be considered in actual production for use value purposes. Section 3 modifies existing law to allow a taxpayer to file an application at any time during the calendar year if such an application is required due to a land transfer. It also clarifies that failure to have an application approved is grounds for disqualification from the program.

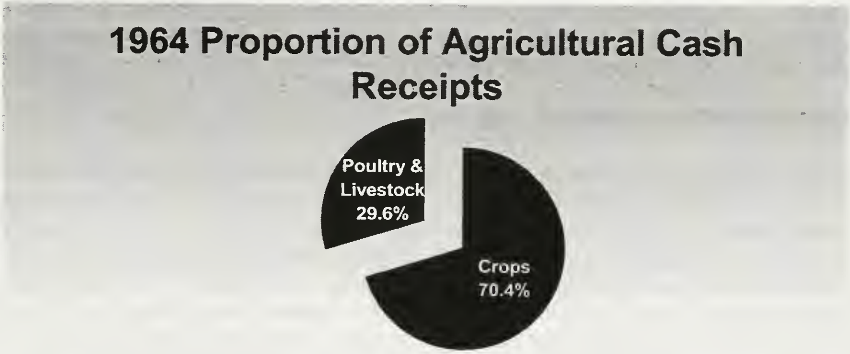
Section 4 makes the most significant changes to current law. It modifies both the membership and duties of the Use Value Advisory Board. The new members include a representative of the Farm Bureau, a representative of the NC Association of Assessing Officers, the Director of the Property Tax Division of the Department of Revenue, and a representative of the NC Association of County Commissioners. The Board is now charged with determining expected net incomes per acre for agricultural and horticultural land on the basis of cash rental rates. (Currently yields and prices of corn, soybeans, and various horticultural products are used as the base). Thus, this section of the bill changes the tax basis for both types of land to cash rents. Section 4 also requires that the Use Value Advisory Board annually select a capitalization rate for converting incomes into values. This capitalization rate must be between 6% and 7%.

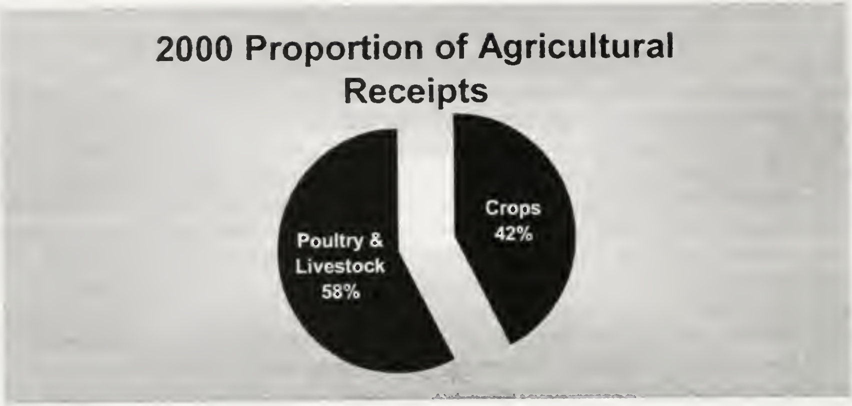
Section 5 requires the Department of Revenue to study cash rents for agricultural lands, and moves some existing language to a different section of the Machinery Act. Section 6 authorizes the assessor to request assistance in the review and clarifies that the assessor may require the owner to submit evidence of the existence of a sound management plan. Section 7 gives county commissions the authority to assign county agents or contract with other state and federal agencies to assist with the use valuation process.

BACKGROUND:

Under G.S. 105-289(a)5 the Department of Revenue and the Use Value Advisory Committee are instructed to develop a manual to assist county assessors in determining the use-value of agricultural, horticultural, and forest land. The law states that the use value should be based on expected net income from the property. The expected net income for agricultural land is based on actual yields, the price of corn and soybeans for the past five years, and the actual cost of growing corn and soybeans during that same period. The law allows the committee to set a method for determining the income potential of horticultural land. At the time this law was adopted, crops represented 52.8% of agricultural cash receipts.

In 1996, 1997, and 1999 the Revenue Laws Study Committee was informed that corn and soybean prices might no longer be the most appropriate method for determining the expected income for farmland, as crops were no longer the primary agricultural product of the state, and corn and soybeans represent an extremely small subset of crop receipts. As noted in the charts below, the proportion of agricultural cash receipts that come from crops has declined from 70.4% in 1964 to 42.4% in 2000. In 2000 corn and soybeans are only 3.8% of the total farm cash receipts, suggesting that those two items were approximately 8.9% of the crop total.





SOURCES OF DATA: North Carolina Department of Agriculture and Consumer Services, Agriculture Statistics Section.

In 1996 Revenue Laws was also informed that cost of production data for corn and soybeans was also no longer available, as the federal government no longer created that database. As a result of these two factors, limited data and shifts in agricultural production, Revenue Laws directed the Use Value Advisory Board to study the issue and return to Revenue Laws with their recommendation for a new system.

ASSUMPTIONS AND METHODOLOGY:

In May 1998 researchers from the North Carolina Cooperative Extension Service conducted a statewide survey to determine the appropriateness of cash rent as a new basis for the use value system. The survey asked Extension Directors, Tax Assessors, Farm Credit Service Appraisers, and farmers to provide estimates of agricultural land values (when sold as agricultural land) and agricultural cash rents. Estimates were given for low, medium, and high productivity land. The data was sorted by region (referred to as a Major Land Resource Area or MLRA). Allowances were also made for quota crops. The Extension Service received responses from 98 County Extension Directors and 98 County Tax Assessors. Farm Credit also gave estimates for all 100 counties. They received at least one farmer response from 75 counties.

When the Use Value Advisory Board compared the sale price of farmland sold as farmland to the cash rent derived from that land, it found the average rent to value ratio to be 2% in most of the MLRAs. The notable exception is the Tidewater region where the average rent to value ratio is 4.5%. This ratio most closely reflects the true rent to value ratio because the agricultural use of the property in that region is often its highest and best use since there are not many competing pressures to increase the value of the property. For this reason, the Use Value Advisory Board recommended using a 5% capitalization rate. Also, 5% is the nationwide average capitalization rate for farmland.

Since that time the Department of Revenue and the Extension Service have attempted to update their findings. This new survey indicates that only 57 counties are currently using the Use Value Advisory Board manual, while 39 are not (4 counties did not report or did not have agriculture acres in the use value program). The data also showed that at a 6% cap rate under a cash rent system, 64 counties would gain revenue, while 32 would lose. At 7% the numbers move to 40 counties that will gain and 55 that will lose revenue. (The Use Value Advisory Board is charged with choosing a rate between 6% and 7%). The average rent to value ratio in this survey was 7.57%. A review of the newer revaluations suggests an average rent to value ratio of 6% or less.

At this time no data is available on the number of acres in the program in each county. Therefore, no overall estimate of the fiscal impact of this portion of the bill is possible. Additionally, no good data is available on the impact of the other changes in the bill, although the overall statewide impact is expected to be fairly small.

LEGISLATIVE PROPOSAL #7

DISCLOSE SOCIAL SECURITY # TO TAX COLLECTOR

LEGISLATIVE PROPOSAL 7:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2002 REGULAR SESSION OF THE
2001 GENERAL ASSEMBLY

AN ACT TO AUTHORIZE DMV TO DISCLOSE SOCIAL SECURITY NUMBERS TO LOCAL TAX COLLECTORS.

SHORT TITLE: Disclose Social Security # to Tax Collector.

BRIEF OVERVIEW: This proposal authorizes DMV to disclose to a local tax collector the social security number of an applicant for a driver's license to assist counties in collecting unpaid taxes, especially delinquent property taxes due on motor vehicles.

FISCAL IMPACT: No impact on the General Fund. Potential revenue gain for local governments.

EFFECTIVE DATE: The proposal is effective when it becomes law.

A copy of the proposed legislation, bill analysis, and fiscal memorandum begin on the next page

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2001

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LEGISLATIVE PROPOSAL 7

2001-LAz-7 [v.7] (04/29)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
5/14/2002 12:32:40 PM

Short Title: Disclose Social Security # to Tax Collector. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO AUTHORIZE DMV TO DISCLOSE SOCIAL SECURITY NUMBERS TO LOCAL TAX COLLECTORS.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 20-7(b2) reads as rewritten:

"(b2) Disclosure of Social Security Number. – The social security number of an applicant is not a public record. The Division may not disclose an applicant's social security number except as allowed under federal law. A violation of the disclosure restrictions is punishable as provided in 42 U.S.C. § 408, and amendments to that law.

In accordance with 42 U.S.C. 405 and 42 U.S.C. 666, and amendments thereto, the Division may disclose a social security number obtained under subsection (b1) of this section only as follows:

(1) For the purpose of administering the drivers license laws.
(2) To the Department of Health and Human Services, Child Support Enforcement Program for the purpose of establishing paternity or child support or enforcing a child support order.
(3) To the Department of Revenue for the purpose of verifying taxpayer identity.
(4) To a tax collector for the purpose of verifying the identity of a delinquent taxpayer."

SECTION 2. G.S. 105-350 reads as rewritten:

"**§ 105-350. General duties of tax collectors.**

It shall be the duty of each tax collector:

(1) To employ all lawful means to collect all property, dog, license, privilege, and franchise taxes with which he is charged by the governing body.

(2) To give such bond as may be required of him by the governing body under the provisions of G.S. 105-349.

(3) To perform such duties in connection with the preparation of the tax records and tax receipts as the governing body may direct under the provisions of G.S. 105-319 and 105-320.

(4) To keep adequate records of all collections he makes.

(5) To account for all moneys coming into his hands in such form and detail as may be required by the chief accounting officer of the taxing unit.

(6) To make settlement at the times required by G.S. 105-373 and at any other time the governing body may require him to do so.

(7) To submit to the governing body at each of its regular meetings a report of the amount he has collected on each year's taxes with which he is charged, the amount remaining uncollected, and the steps he is taking to encourage or enforce payment of uncollected taxes.

(8) To send bills or notices of taxes due to taxpayers if instructed to do so by the governing body.

(9) To visit delinquent taxpayers to encourage payment of taxes if instructed to do so by the governing body.

(10) To use social security numbers obtained from the Division of Motor Vehicles under G.S. 20-70(b2) solely for the purposes of securing complete tax listings, appraising or assessing taxable property, and collecting taxes. The tax collector may not disclose the numbers to any other person except to comply with a court order or a law. A collector who violates this subdivision is punishable as provided in G.S. 153A-148.1 or G.S. 160A-208.1, as appropriate."

SECTION 3. This act is effective when it becomes law.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 7: DISCLOSE SOCIAL SECURITY # TO TAX COLLECTOR

BY: MARTHA WALSTON, FISCAL RESEARCH DIVISION

SUMMARY: The proposal authorizes the Division of Motor Vehicles to disclose to a local tax collector the social security number of an applicant for a driver's license who is delinquent in paying property taxes on a motor vehicle. This would assist counties in collecting delinquent property taxes due on motor vehicles. The proposal also amends the statutory duties of a tax collector to include the duty to use the social security numbers obtained from the Division only for specified purposes. Violation of this duty is a misdemeanor.

BACKGROUND: Until several years ago, the Department of Revenue and the local tax collectors had access to a Division of Motor Vehicles (DMV) computer screen that included the social security numbers of applicants for driver's licenses. This exchange of information was not addressed by statute. In 1997, the DMV changed to a new computer system that did not show social security numbers. That year, the General Assembly also amended the driver's license law to require all applicants for a driver's license to provide their social security numbers and gave specific authority to the DMV to provide social security numbers to the Child Support Enforcement Program.[1] The law did not address disclosure of the numbers to the Department of Revenue. As a result, the practice between the DMV and the Department ceased.

In 1999, the Revenue Laws Study Committee recommended that the DMV be given authority to disclose a social security number to the Department of Revenue for the purpose of taxpayer identification. This legislation was enacted in S.L. 2000-120. The disclosure of numbers for tax purposes is authorized by Federal law, 42 U.S.C. 405(c)(2)(C)(i). This federal statute provides that any State **or political subdivision thereof** may, in the administration of any tax, within its jurisdiction, utilize the social security account numbers for the purpose of establishing the identification of individuals affected by such law.

For several years, local tax collectors, the DMV, and the Department of Revenue have been meeting to solve the access problem without legislation, but have reached no solution.

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[1] 42 U.S.C. 666 requires each State to have statutorily prescribed procedures to improve effectiveness of child support enforcement. One of these procedures is the recording of the social security number of any applicant for a driver's license.

BILL ANALYSIS: The **Proposal** amends G.S. 20-7(b2) to add tax collectors to the list of persons authorized to receive social security numbers from the DMV. This statute authorizes the DMV to disclose the social security number of a driver's license applicant only if disclosure is allowed under federal law. 42 U.S. C. 405 appears to support disclosure to local tax collectors. The proposal only authorizes the disclosure of social security numbers of delinquent taxpayers. It does not authorize the DMV to disclose social security numbers of taxpayers who are in compliance. Pursuant to G.S. 105-330.4, the taxes on motor vehicles up for registration renewal become due on the first day of the fourth month following the date registration expired. The taxes become delinquent in the fifth month. If the taxes on a registered vehicle are not paid within four months after they become due, then on the tenth of each month the collector must send a list containing the names, addresses, and vehicle identification numbers of these delinquent taxpayers to the DMV pursuant to G.S. 105-330.7. The list shows those taxpayers that have been delinquent for four months. Once receiving this list the DMV places a block on the vehicle's registration for the following year. Registration is renewed only when the taxpayer obtains a receipt showing that the previous year's taxes have been paid (G.S. 20-50.4).

The **Proposal** authorizes the DMV to disclose the social security numbers of these delinquent taxpayers to the tax collector. The tax collectors would like to receive these numbers as soon as possible once the taxpayer is delinquent (the fifth month after expiration of the registration date). The interested parties plan to work together in developing appropriate procedures for sharing social security numbers. Access to social security numbers will assist the tax collectors in collecting delinquent property taxes, especially taxes due on motor vehicles, and will also make it easier for collectors to garnish wages of non-payers.

The **Proposal** also amends the statutory duties of tax collectors by directing that the collector use the social security numbers obtained from the DMV solely for the purposes of securing complete tax listings, appraising or assessing taxable property, and collecting taxes. The tax collector may not disclose the numbers to any other person except to comply with a court order or a law. A violation of this duty is a Class 1 misdemeanor and subjects the violator to dismissal from public office or public employment and inability to hold public office or public employment in the State for five years after the violation. This is the same punishment given to a local tax official who divulges confidential information obtained from the Department of Revenue under G.S. 105-289.

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: **May 13, 2002**

TO: Revenue Laws Study Committee

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: Disclose Social Security # to Tax Collector

FISCAL IMPACT

Yes ( ) **No ( )** **No Estimate Available (X)**

	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07
REVENUES					
General Fund	No General Fund Impact				
Local Governments	Potential Revenue Gain – See Assumptions and Methodology				
EXPENDITURES					
Highway Fund	$26,400-$29,840				

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Local Governments, the Property Tax Division of the Department of Revenue, Division of Motor Vehicles.

EFFECTIVE DATE: When it becomes law.

BILL SUMMARY: The proposal authorizes the Division of Motor Vehicles (DMV) to disclose social security numbers to local tax collectors for the purposes of verifying taxpayer identity and collecting delinquent property taxes, primarily those due on motor vehicles. The social security numbers will only be disclosed if a block is placed on the vehicle for non-payment. (Social security numbers of non-delinquent taxpayers will not be released). The bill also includes penalties for improper use of a taxpayer's social security number.

ASSUMPTIONS AND METHODOLOGY: In 1993 the General Assembly approved a new method of collecting motor vehicle property taxes. Under this structure county tax assessors are to report the non-payment of property taxes on a motor vehicle to the Division of Motor Vehicles. Once this information is received, neither the DMV or tag agents should renew that vehicle's registration because of outstanding tax liabilities. As such, the vehicle registration is "blocked" until the local property taxes are paid. Despite this system, local tax collectors report that some vehicle owners continue to avoid paying local property taxes on motor vehicles.

As the chart below indicates, the collection rate for motor vehicles is consistently lower than that of real property.

	Fiscal Year Ending June 30,			
Municipalities	2001	2000	1999	1998
Property Tax Collection % all Property	97.04	97.07	97.23	97.02
Property Tax Collection % all except Motor Vehicles	98.18	98.17	98.45	98.17
Property Tax Collection % Motor Vehicles	86.97	86.38	86.63	86.65
Counties				
Property Tax Collection % all Property	96.46	96.53	96.53	96.59
Property Tax Collection % all except Motor Vehicles	97.67	97.81	97.9	97.79
Property Tax Collection % Motor Vehicles	86.95	87.22	87.67	87.41

Local government experts indicate that this lower collection rate is the result of a number of factors, including tax avoidance.

By releasing the social security numbers of delinquent taxpayers to local tax officials, the proposal provides local governments with one more tool to collect delinquent taxes. If the legislation were approved, tax collectors would be able to pursue collection through wage garnishment. (This method is currently employed to collect delinquent taxes on real property). Social security numbers are already used by the Department of Revenue and DHHS to collect back taxes and delinquent child support payments.

Because it is unclear to Fiscal Research how often tax collectors would use this information, how successful they will be in receiving payment through garnishment, and what proportion of the motor vehicle collection issue is attributable to tax avoidance, no fiscal estimate of the revenue gain is possible on the bill.

One the expenditures side, the Division of Motor Vehicles believes two different methods could be employed to transfer the social security numbers of delinquent taxpayers to county assessors and tax collectors. One option is to provide this information to county tax collectors through the County Tax Menu on the DMV system. Under this option, appropriate officials in all 100 counties would be able to view social security information for a tax stop placed on a vehicle. Only the vehicle's primary owner would have their social security number disclosed. This is DMV's preferred method, and is estimated to cost approximately $26,400 in FY 2002-03. The funds would be used primarily to cover 300 hours of programming. A second option is to provide the same information to county tax officers through a batch processing system. Under this option, only counties that submit tax blocks would receive a FTP file with appropriate data. The system would be updated nightly. This option would cost approximately $29,840 to cover 340 hours of programming time.

SOURCES OF DATA: Local Government Commission, Office of the State Treasurer.

LEGISLATIVE PROPOSAL #8

EXTEND QUALIFIED BUSINESS VENTURE TAX CREDIT

LEGISLATIVE PROPOSAL 8:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2002 REGULAR SESSION OF THE
2001 GENERAL ASSEMBLY

AN ACT TO EXTEND THE SUNSET ON TAX CREDITS FOR QUALIFIED BUSINESS INVESTMENTS.

SHORT TITLE: Extend Qualified Business Venture Tax Credit.

BRIEF OVERVIEW: The proposal extends the sunset for the tax credit for qualified business investments for one year. Without this bill, that tax credit would expire for investments made on or after January 1, 2003.

FISCAL IMPACT: The proposal could decrease General Fund revenues by $6 million in fiscal year 2003-04

EFFECTIVE DATE: The proposal is effective when it becomes law.

A copy of the proposed legislation, bill analysis, and fiscal memorandum begin on the next page

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2001

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LEGISLATIVE PROPOSAL 8

SENATE DRS8709-LYz-174B* (04/22)

Short Title: Extend Qualified Business Venture Tax Credit. (Public)

Sponsors: Senators Hoyle, Clodfelter, Dalton, Hartsell, and Kerr.

Referred to:

A BILL TO BE ENTITLED

AN ACT TO EXTEND THE SUNSET ON TAX CREDITS FOR QUALIFIED BUSINESS INVESTMENTS.

The General Assembly of North Carolina enacts:

SECTION 1. Section 7 of Chapter 443 of the 1993 Session Laws, as amended by Section 29A.15 of S.L. 1998-212, is repealed.

SECTION 2. Section 10 of Chapter 443 of the 1993 Session Laws, as amended by Section 29A.15 of S.L. 1998-212, reads as rewritten:

"Sec. 10. Section 6 of this act is effective upon ratification. ~~Section 7 of this act becomes effective for investments made on or after January 1, 2003.~~ The remainder of this act becomes effective for taxable years beginning on or after January 1, 1994.

A business registered as a qualified business venture or a qualified grantee business before January 1, 1994, retains its registration until the renewal date for the registration of that business under Part 5 of Article 4 of Chapter 105 of the General Statutes as in effect before January 1, 1994. The Secretary of State shall not grant renewal of a registration as a qualified business venture or a qualified grantee business unless at the time of filing the renewal application, the business meets the requirements then in effect for a new registration.

Notwithstanding the provisions of G.S. 105-163.014(a), as amended by this act, a credit under Part 5 of Article 4 of Chapter 105 of the General Statutes for an investment made before January 1, 1994, is not forfeited solely on the grounds that a sibling of the taxpayer provides services for compensation to the business in which the taxpayer invested.

Notwithstanding the provisions of G.S. 105-163.014(d), as amended by this act, a credit under Part 5 of Article 4 of Chapter 105 of the General Statutes for an investment made before January 1, 1994, is not forfeited solely on the grounds that a redemption of the securities received in the investment is made within five years after the investment was made.

The Secretary of State may require a qualified business venture or a qualified grantee business that is unable to renew its registration after January 1, 1994, to file reports the Secretary of State considers appropriate to determine the location of the headquarters and principal business operations of the business until three years after the date of the last investment in the business that qualified for the tax credit allowed under Part 5 of Article 4 of Chapter 105 of the General Statutes."

SECTION 3. Part 5 of Article 4 of Chapter 105 of the General Statutes is amended by adding a new section to read:

"**§ 105-163.015. Sunset.**

This Article is repealed effective for investments made on or after January 1, 2004."

SECTION 4. This act is effective when it becomes law.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 8:
EXTEND QUALIFIED BUSINESS VENTURE TAX CREDIT

BY: CANAAN HUIE, BILL DRAFTING DIVISION

SUMMARY: This proposal extends the sunset for the tax credit for qualified business investments one year. Without this proposal, the tax credit would expire for investments made on or after January 1, 2003. This bill is effective when it becomes law.

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

The credit is allowed for an individual taxpayer who purchases the equity securities or subordinated debt of a qualified business venture or a qualified grantee business directly from that business. The credit is equal to 25% of the amount invested and may not exceed $50,000 per individual in a single taxable year. An individual investor may also claim the allocable share of credits obtained by "pass-through entities" of which the investor is an owner. Pass-through entities include limited partnerships, general partnerships, S corporations, and limited liability companies. The credit may not be taken in the year the investment is made. Instead, the credit is taken in the year following the calendar year in which the investment was made, but only if the taxpayer filed an application with the Secretary of State. The unused credit may be carried forward for the next five years. The total amount of credits allowed to all taxpayers for investments made in a calendar year may not exceed $6 million. The Secretary of Revenue calculates the total amount of tax credits claimed from applications filed with the Secretary of State. If the amount exceeds the cap, then the Secretary allows a portion of the tax credits claimed by allocating the total of $6 million in tax credits in proportion to the size of the credit claimed by each taxpayer. In general, a taxpayer forfeits the credit if the taxpayer transfers the securities within one year or the qualified business redeems the securities purchased by the taxpayer within five years after the investment was made.[1]

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

There may be a constitutional concern with the provision of the credit regarding "qualified grantee businesses". In order to be a business in which investments are eligible for a credit, the business must be either a "qualified business venture" or a "qualified grantee business". Both types of businesses must be registered with the Secretary of State. The definition of "qualified business venture" includes several general requirements related to the line of business, gross revenues of the business, and the organization date of the business. The definition of "qualified grantee business" includes a requirement that the business have received a grant in at least one of the three previous years from one of several named entities. One could argue that this provision violates the rule of uniformity since a credit is allowed only for investments in business that have received a grant from one of several specifically named organizations, and not for investments in similar businesses that have received grants from similar organizations. However, to date this issue has not been raised in litigation and is therefore not settled.

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[1] There are two exceptions to this forfeiture provision. First, if the transfer occurs as a result of the death of the taxpayer, the liquidation of the taxpayer, or certain reorganizations of the qualified business, within the one-year period, the transfer does not require forfeiture. Second, the 1998 legislation created an exception to this forfeiture provision for projects in the film industry. It is unusual for a project in that industry in which a person might invest to last for more than 5 years.

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: June 6, 2002

TO: Revenue Laws Study Committee

FROM: Richard Bostic
Fiscal Research Division

RE: Extend Qualified Business Venture Tax Credit

FISCAL IMPACT

Yes (X) No ( ) No Estimate Available ( )

	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07
REVENUES					
General Fund		($6,000,000)			
EXPENDITURES					
POSITIONS:					

**PRINCIPAL DEPARTMENT(S) &
PROGRAM(S) AFFECTED:** Department of Revenue, Department of the Secretary of State

EFFECTIVE DATE: The act is effective when it becomes law.

BILL SUMMARY: The bill extends the individual income tax credit for Qualified Business investments from January 1, 2003 to January 1, 2004.

ASSUMPTIONS AND METHODOLOGY: The amount of Qualified Business credits given each year is capped at $6 million. Requests for credits have exceeded the $6 million cap for four out of the last five years. In fact, the amount of credit requested ($19 million) in 2001 was approximately three times the amount of credit available. Given the recent investor interest in the credit program, it is likely that the $6 million annual cost of the program will continue until its sunset in 2004. The General Fund fiscal impact occurs in FY 2003-04 because the investments made in 2003 will be awarded credits on returns filed in the spring of 2004.

SOURCES OF DATA: Department of Revenue

TECHNICAL CONSIDERATIONS:

APPENDIX A

AUTHORIZING LEGISLATION

ARTICLE 12L
Revenue Laws Study Committee.

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§ 120-70.105. Creation and membership of the Revenue Laws Study Committee.

(a) Membership. -- The Revenue Laws Study Committee is established. The Committee consists of 16 members as follows:

(1) Eight members appointed by the President Pro Tempore of the Senate; the persons appointed may be members of the Senate or public members.
(2) Eight members appointed by the Speaker of the House of Representatives; the persons appointed may be members of the House of Representatives or public members.

(b) Terms. -- Terms on the Committee are for two years and begin on January 15 of each odd-numbered year, except the terms of the initial members, which begin on appointment. Legislative members may complete a term of service on the Committee even if they do not seek reelection or are not reelected to the General Assembly, but resignation or removal from service in the General Assembly constitutes resignation or removal from service on the Committee. A member continues to serve until a successor is appointed. A vacancy shall be filled within 30 days by the officer who made the original appointment. (1997-483, s. 14.1; 1998-98, s. 39.)

§ 120-70.106. Purpose and powers of Committee.

(a) The Revenue Laws Study Committee may:

(1) Study the revenue laws of North Carolina and the administration of those laws.
(2) Review the State's revenue laws to determine which laws need clarification, technical amendment, repeal, or other change to make the laws concise, intelligible, easy to administer, and equitable.
(3) Call upon the Department of Revenue to cooperate with it in the study of the revenue laws.
(4) Report to the General Assembly at the beginning of each regular session concerning its determinations of needed changes in the State's revenue laws.

These powers, which are enumerated by way of illustration, shall be liberally construed to provide for the maximum review by the Committee of all revenue law matters in this State.

(b) The Committee may make interim reports to the General Assembly on matters for which it may report to a regular session of the General Assembly. A report to the General Assembly may contain any legislation needed to implement a recommendation of the Committee. When a recommendation of the Committee, if enacted, would result in an increase or decrease in State revenues, the report of the Committee must include an estimate of the amount of the increase or decrease. (1997-483, s. 14.1.)

§ 120-70.107. Organization of Committee.

(a) The President Pro Tempore of the Senate and the Speaker of the House of Representatives shall each designate a cochair of the Revenue Laws Study Committee. The Committee shall meet upon the joint call of the cochairs.

(b) A quorum of the Committee is nine members. No action may be taken except by a majority vote at a meeting at which a quorum is present. While in the discharge of its official duties, the Committee has the powers of a joint committee under G.S. 120-19 and G.S. 120-19.1 through G.S. 120-19.4.

(c) The Committee shall be funded by the Legislative Services Commission from appropriations made to the General Assembly for that purpose. Members of the Committee receive subsistence and travel expenses as provided in G.S. 120-3.1 and G.S. 138-5. The Committee may contract for consultants or hire employees in accordance with G.S. 120-32.02. Upon approval of the Legislative Services Commission, the Legislative Services Officer shall assign professional staff to assist the Committee in its work. Upon the direction of the Legislative Services Commission, the Supervisors of Clerks of the Senate and of the House of Representatives shall assign clerical staff to the Committee. The expenses for clerical employees shall be borne by the Committee. (1997-483, s. 14.1.)

APPENDIX B

FINAL DISPOSITION OF BILLS RECOMMENDED BY THE REVENUE LAWS STUDY COMMITTEE TO THE 2002 REGULAR SESSION OF THE 2001 GENERAL ASSEMBLY

FINAL DISPOSITION OF BILLS RECOMMENDED BY THE REVENUE LAWS STUDY COMMITTEE – 2001 REGULAR SESSION

Short Title	Senate Sponsors	House Sponsors	Bill #	Final Status*
CCRC – Retirement Home Tax Change	Hoyle,	Jarrell,	S142 H193	HB 193 Enacted SL 2001-17
Property Tax Homestead Exclusion		Hill,	H102	SL 2001-308 [HB 42, Property Tax Homestead Exemption] contains similar provisions
Property Tax Amendments	Hartsell,		S162	Enacted SL 2001-139
Wetlands Reimbursement/Local Tax Base		Tucker	H143	S Finance
Extend Tax Deadline		Allen,	H150	Enacted SL 2001-87
Fund DOR Audit Recommendations	Kerr	Allen	H459 S335	SL 2001-424 [SB 1005, Appropriations Act] provided funding & equipment necessary for Project Collect Tax
Modify Partnership Tax Credit		Luebke	H146	Enacted SL 2001-335
Make Franchise Tax More Equitable	Dalton		S242	SL 2001-327, Sec. 2, [HB 1157, Enforce Tax Compliance & Equity] contains similar provisions
Equalize Sales Tax on Software		Allen	H231	Original bill was not enacted. HB 231 [SL 2001-513] was enacted as Budget Technical Corrections
Streamlined Sales and Use Tax Agreement	Kerr,		S144	Enacted SL 2001-347
Revenue Laws Technical Changes	Hartsell		S165	Enacted SL 2001-414
Simplify Taxes on Telecommunications	Hoyle	Allen	H571, S268	H571 Enacted SL 2001-430 *[SL 2001-424, Appropriations Act, increased the rate from 4.5% to 6%]*
IRC Update	Kerr		S143	SL 2001-427, [HB 232, Budget Revenue Provisions], contains this provision.

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* Bills were modified prior to enactment.

APPENDIX C

SUMMARY OF TAX LEGISLATION ENACTED IN 2001

The TaX Files

An Overview of the 2001
Tax Law Changes

By: Cindy Avrette
February 28, 2001

THE TAX FILES

- Budget Revenue Provisions
- Significant Tax Legislation
- Sales Tax Legislation
- Property Tax Legislation
- Income Tax Legislation

Budget Revenue Provisions

- **Closure of Tax Loopholes – HB 1157**
- **DOR Debt Collection Changes – SB 353**
- **Budget Revenue Provisions – HB 232**
- **The Appropriations Act of 2001 – SB 1005**

BUDGET REVENUE AMOUNTS

REVENUE PROVISION	FY 2001-02	FY 2002-03
Closure of Tax Loopholes	$61.3	$64.3
Project Collect Tax	$50	$50
Budget Revenue Provisions	$112.1	$6.0
Appropriations Act Revenues	$435.3	$614.3

Enforce Tax Compliance & Equality

S.L. 2001-327 (HB 1157)

- Royalty Reporting Options
- Equalize Franchise Tax on Corporate Affiliated LLCs
- Conform North Carolina's Subsidiary Dividend Deduction to the Generally Accepted Treatment Used in Other States

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Enforce Tax Compliance & Equality

Royalty Reporting Option

Clarified that income from using trademarks in NC is taxable to this State

SB 1158 Governor's Study SB 1005

"The General Assembly finds that most corporations ... comply with the State tax on income generated from using trademarks ... Taxpayers who do not comply ... create unfair burden... intent ... to reward taxpayers who comply, by giving them an option on how to file tax returns involving royalty income."

Enforce Tax Compliance & Equality
Equalize Franchise Tax on Corporate Affiliated LLCs

Provides that franchise tax applies equally to corporate assets held by an affiliated LLC

SB 242 Governor's Study SB 1005

"The General Assembly finds that most corporations comply with the State franchise tax on corporate assets .. Some taxpayers, however, take advantage of an unintended loophole ...creates an unfair burden on corporate citizens that pay ... intent .. apply the franchise tax equally ... criminal penalty applies to taxpayers who fraudulently evade the tax."

Enforce Tax Compliance & Equality
Conform NC's Subsidiary Dividend Deduction

It piggybacks the federal dividends received deduction for State corporate income tax purposes

Governor's Study SB 1005

✓Under this act, some parent companies will gain and some should lose.

✓S.L. 2001-427 amended this Act so that foreign source dividends would be treated the same as domestic source dividends.

DOR Debt Collection Changes
S.L. 2001-380 (SB 353)
"Project Collect Tax"

- Use collection agencies
- Impose collection assistance fee
- 52 new positions and 12 contract positions (S.L. 2001-424)

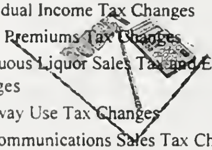
Budget Revenue Provisions
S.L. 2001-427 (HB 232)

- Accelerates Payment of Withholding Taxes, January 1, 2002
- Accelerates Payment of Sales and Utility Taxes, January 1, 2002
- Accelerates Payment of Local Sales and Use Tax Revenue, July 1, 2003
- Accelerates Payment of Excise Tax on Conveyances, July 1, 2003

Budget Revenue Provisions
S.L. 2001-427 (HB 232)

- **General Assembly Oversight of Agency Fees**
- General Assembly set fee OR
- Agency consult with Joint Legislative Commission on Governmental Operations before setting fee

The Appropriations Act of 2001
S.L. 2001-424 (SB 1005)

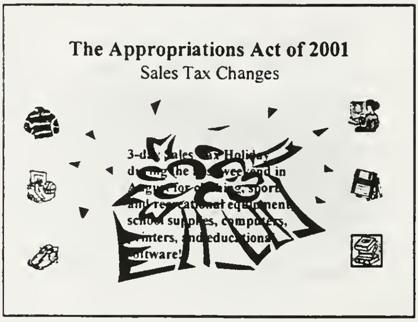


- Sales Tax Changes
- Individual Income Tax Changes
- Gross Premiums Tax Changes
- Spirituous Liquor Sales Tax and Excise Tax Changes
- Highway Use Tax Changes
- Telecommunications Sales Tax Changes

The Appropriations Act of 2001

Sales Tax Changes

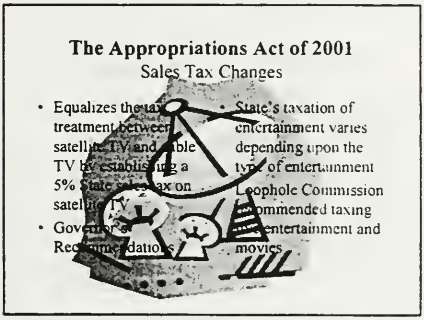
- Increased the State sales tax ½ %, for the period October 16, 2001, to July 1, 2003.
- Authorizes an additional ½ % local sales tax, effective July 1, 2003.
- Repeals the State reimbursements to local governments -- $333.4 million a year.
- Provides hold harmless payments to those local governments whose gain from a ½ % local sales tax increase less than 100% of their loss from the repealed State tax reimbursements.



The Appropriations Act of 2001

Sales Tax Changes

3-day Sales Tax Holiday during the first weekend in August for clothing, sports and recreational equipment, school supplies, computers, printers, and educational software!



The Appropriations Act of 2001

Sales Tax Changes

- Equalizes the tax treatment between satellite TV and cable TV by establishing a 5% State sales tax on satellite TV
- Governor's Recommendations
- State's taxation of entertainment varies depending upon the type of entertainment Loophole Commission recommended taxing entertainment and movies

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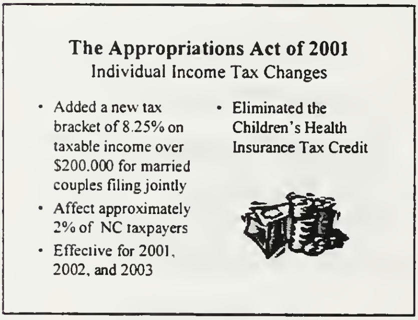


The Appropriations Act of 2001

Individual Income Tax Changes

- Added a new tax bracket of 8.25% on taxable income over $200,000 for married couples filing jointly
- Affect approximately 2% of NC taxpayers
- Effective for 2001, 2002, and 2003
- Eliminated the Children's Health Insurance Tax Credit

The Appropriations Act of 2001

Individual Income Tax Changes

Eliminate Marriage Tax Penalty for Standard Deduction

Increases standard deduction for married couples to an amount that is twice that of a single taxpayer over two years, 2002 and 2003

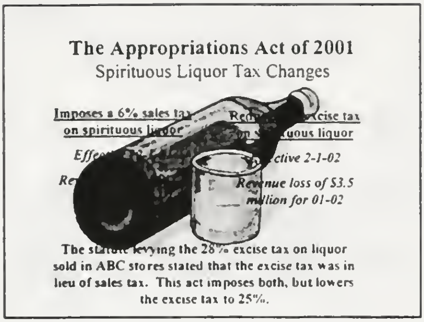
Increase Tax Credit for Children

Increase the per child tax credit from $60 to $75 in 2002 and to $100 in 2003

The Appropriations Act of 2001

Gross Premiums Tax Changes

- Imposes a gross premiums tax on HMOs and Medical Service Corporations
- Rate is 1.1% for 2003 and 1% for taxable years beginning on or after 2004 (S.L. 2001-489)
- Both the Loophole Commission and the Governor Recommended this change at 1.9%



The Appropriations Act of 2001
Spirituous Liquor Tax Changes

Imposes a 6% sales ta on spirituous li

Effe

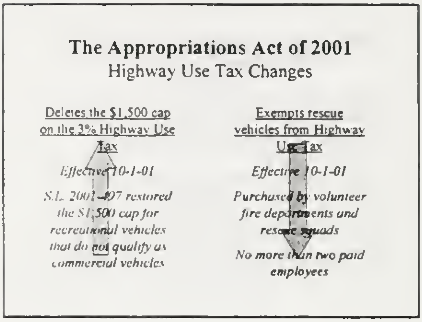
Re

Re cise tax on s uous liquor

ctive 2-1-02

Revenue loss of $3.5 million for 01-02

The statute levying the 28% excise tax on liquor sold in ABC stores stated that the excise tax was in lieu of sales tax. This act imposes both, but lowers the excise tax to 25%.



The Appropriations Act of 2001
Highway Use Tax Changes

Deletes the $1,500 cap on the 3% Highway Use Tax

Effective 10-1-01

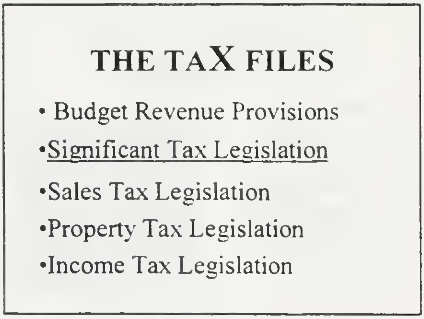
S.L. 2001-497 restored the $1,500 cap for recreational vehicles that do not qualify as commercial vehicles

Exempts rescue vehicles from Highway Use Tax

Effective 10-1-01

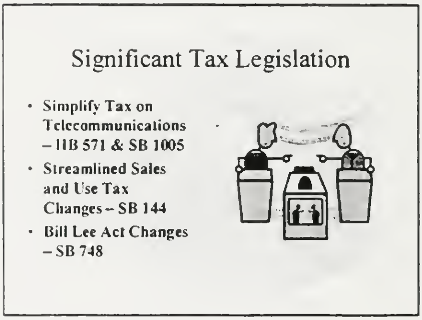
Purchased by volunteer fire departments and rescue squads

No more than two paid employees



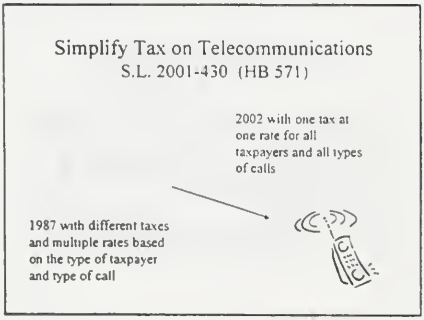
THE TAX FILES

- Budget Revenue Provisions
- Significant Tax Legislation
- Sales Tax Legislation
- Property Tax Legislation
- Income Tax Legislation



Significant Tax Legislation

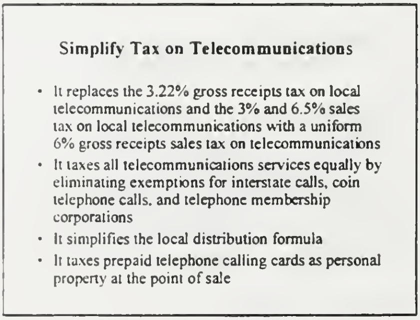
- **Simplify Tax on Telecommunications – HB 571 & SB 1005**
- **Streamlined Sales and Use Tax Changes – SB 144**
- **Bill Lee Act Changes – SB 748**



Simplify Tax on Telecommunications
S.L. 2001-430 (HB 571)

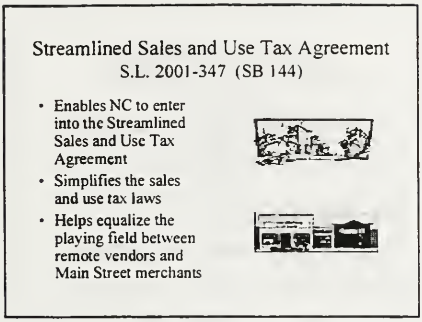
2002 with one tax at one rate for all taxpayers and all types of calls

1987 with different taxes and multiple rates based on the type of taxpayer and type of call



Simplify Tax on Telecommunications

- It replaces the 3.22% gross receipts tax on local telecommunications and the 3% and 6.5% sales tax on local telecommunications with a uniform 6% gross receipts sales tax on telecommunications
- It taxes all telecommunications services equally by eliminating exemptions for interstate calls, coin telephone calls, and telephone membership corporations
- It simplifies the local distribution formula
- It taxes prepaid telephone calling cards as personal property at the point of sale



Streamlined Sales and Use Tax Agreement
S.L. 2001-347 (SB 144)

- Enables NC to enter into the Streamlined Sales and Use Tax Agreement
- Simplifies the sales and use tax laws
- Helps equalize the playing field between remote vendors and Main Street merchants

Bill Lee Act Changes
S.L. 2001-476 (SB 748)

- **First enacted in 1996 and modified annually**
- **Tax credits for investment in machinery and equipment and real property, for job creation, for worker training, and for research and development**
- **Counties are divided into 5 tiers; the lower the tier, the more favorable the incentive**
- **Sunset 2006**

Five economic distress tiers are based on the unemployment rate, per capita income, and population growth of the county.

<u>**Exceptions to county tier designations:**</u>

1. **Population less than 12,000 (10,000) and more than 16% of its population below the federal poverty level = TIER 1 Alleghany and Jones Counties**
2. **Population less than 35,000 (50,000) and more than 18% of its population below the federal poverty level = A TIER DESIGNATION ONE LEVEL LOWER THAN OTHERWISE WOULD BE Alexander, Dare, Davie, Macon, and Transylvania Counties**
3. **Population less than 25,000 CANNOT be designated higher than a TIER 3**

Clarifies that a taxpayer is eligible for a credit ONLY IF the primary business of the taxpayer is an eligible business

THEN it relaxes the eligible business requirement for warehousing. A taxpayer can qualify if it has an establishment whose primary activity is warehousing so long as the establishment is located in a tier 1. 2. or 3 area; separate site; and serves at least 25 establishments in at least 5 different counties in one or more states. (Lowe's)

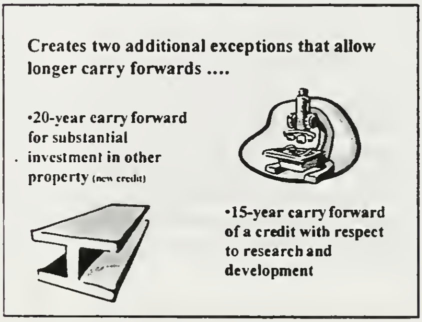
Substantial Investment in other Real Property

Invest at least $10 million in real property within 3 years

Create at least 200 new jobs within 2 years of the time the property is first used

Credit = 30% of the eligible investment (no cap). taken over a 7-year period

20-year carry forward



Creates two additional exceptions that allow longer carry forwards ....

- **20-year carry forward for substantial investment in other property** (new credit)
- **15-year carry forward of a credit with respect to research and development**

Misc. Bill Lee Act Changes

- Establishes statute of limitations – credit cannot be taken more than 6 months after the deadline for filing the return on which it would be claimed
- Eliminates the requirement that taxpayer receive a certification from Commerce; may seek advisory ruling from Revenue
- Equity and impact studies must be updated every 2 years

Sales Tax on Electricity

Reduces the sales tax on electricity sold to manufacturers

Megawatt-hours used annually	Rate January 1, 2002, until July 1, 2005	Rate on and after July 1, 2005
5,000 or less	2.83%	2.83%
Over 5,000 and up to 250,000	2.83%	2.25%
Over 250,000 and up to 900,000	2.83%	2.0%
Over 900,000	.17%	.17%

THE TAX FILES

- Budget Revenue Provisions
- Significant Tax Legislation
- <u>Sales Tax Legislation</u>
- Property Tax Legislation
- Income Tax Legislation

Sales Tax Changes:
Tax Revenue for Turfgrass

S.L. 2001-514 (HB 688)

- Imposes 6.5% State and local sales tax on fertilizers and seeds sold to consumers <u>other than</u> farmers
- $700,000 appropriated for turfgrass research in 2001-02 and 2002-03
- $750,000 credited to the Savings Reserve Account for 2001-02
- Effective February 1, 2002

Sales Tax Changes:
Grape Growers Council Fund

S.L. 2001-475 (SB 970)

- Increases earmarking to 100% of the excise tax on unfortified and fortified wine bottled in NC
- Raises the cap from $175,000 to $350,000
- Revenue used by Council to promote the NC wine and grape industry and to contract for research and development services to improve viticultural practices in NC

Sales Tax Changes:
No Tax on Newspapers sold in Vending Machines

S.L. 2001-509 (SB 400)

- Current exemption for newspapers sold by street vendors
- Is a vending machine a "street vendor"?
- Ends confusion about the taxation of newspapers sold through vending machines
- The act does NOT exempt free circulation publications from the sales tax

THE TAX FILES

- Budget Revenue Provisions
- Significant Tax Legislation
- Sales Tax Legislation
- Property Tax Legislation
- Income Tax Legislation

Property Tax Homestead Exclusion

S.L. 2001-308

- **Increases the homestead exclusion amount from $20,000 to the greater of $20,000 or 50% of the tax value of the home**
- **Increases the income eligibility amount from $15,000 to $18,000. Indexes this amount annually by a percentage = COLA used to increase SSI the preceding year**
- **No local government reimbursement**
- **Last increased in 1996**

Retirement Home Tax Change

S.L. 2001-17

- Creates a permanent exclusion for CCRCs that provide minimum amounts of charity care and/or community benefits
- The exclusion may be complete or partial, dependent upon the percentage of the facility's resident revenue that is provided in charity care and community benefit

Present-Use Value Changes

S.L. 2001-139; S.L. 2001-499

- Annual Review of Property with Preferential Tax Treatment
- Expand Use-Value for Farmer to Farmer Transfers
- Creates a Property Tax Study Commission

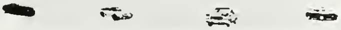
Property Tax on Motor Vehicles

✓S.L. 2001-139 gives all boards of E&R the authority to meet after its adjournment date for motor vehicle cases

✓S.L. 2001-139 conforms the interest rate on unpaid motor vehicle taxes to the interest rate due on other unpaid property taxes

✓S.L. 2001-406 prevents double taxation of motor vehicles whose tax year changes due to a change in registration

✓S.L. 2001-497 extends from 120 days to one year the time to request a refund for taxes paid on a vehicle for which the registration plate has been surrendered



Misc. Property Tax Changes

- **S.L. 2001-308 allowed local governments to lower property tax rates in response to Governor's unexpected release of the reimbursement monies** Anson County lowered its rate from 90 cents to 87 cents
- **S.L. 2001-464 and S.L. 2001-513 give 35 counties the authority to require payment of delinquent taxes before recordation of deeds**

THE TAX FILES

- Budget Revenue Provisions
- Significant Tax Legislation
- Sales Tax Legislation
- Property Tax Legislation
- Income Tax Legislation

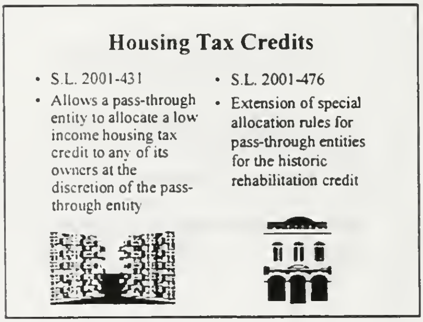
Income Tax Changes

- Extend Tax Deadline
- S.L. 2001-87
- Waives penalties for failure to meet certain tax-related deadlines because of a Presidentially declared disaster

- Support Troops
- S.L. 2001-508
- Waives penalties and deadlines and allows refunds of tuition grants to those deployed in Operations Enduring Freedom and Noble Eagle

Modify Partnership Tax Credit
S.L. 2001-335 (HB 146)

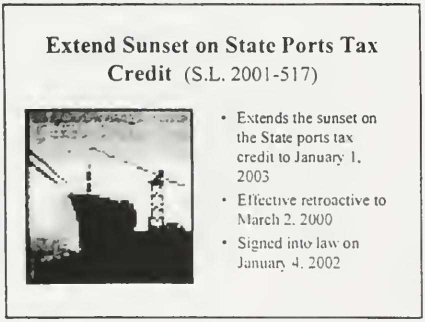
- Clarifies that any dollar amount limitation on a credit allowed to a partnership applies to the total credit
- Consistent with federal tax treatment of partnerships and with State tax treatment of Subchapter S Corporations
- Delays until 2005 the imposition of the limitation on the credit allowed for donations of real property for public beach access, fish and wildlife conservation, and other land conservation purposes



Housing Tax Credits

- S.L. 2001-431
- Allows a pass-through entity to allocate a low income housing tax credit to any of its owners at the discretion of the pass-through entity

- S.L. 2001-476
- Extension of special allocation rules for pass-through entities for the historic rehabilitation credit



Extend Sunset on State Ports Tax Credit (S.L. 2001-517)

- Extends the sunset on the State ports tax credit to January 1, 2003
- Effective retroactive to March 2, 2000
- Signed into law on January 4, 2002

Sunsets the 2001 Episode of ......

APPENDIX D

GENERAL FUND REVENUE OUTLOOK: ISSUES AND PROSPECTS

GENERAL FUND REVENUE OUTLOOK: ISSUES AND PROSPECTS

FISCAL RESEARCH DIVISION
APRIL 11, 2002

A CAUTIOUS OUTLOOK IS REQUIRED FOR 2002-03 FISCAL YEAR

- ✓ When adopting the budget for the first year of a biennium, a tentative second-year revenue estimate is adopted with to the understanding that a full-scale revision will take place the next year. The August 2001 projection of 4.9% General Fund revenue growth needs to be adjusted downward for the following reasons:
  - ✓ The impact of lower inflation in taxable sales and wages.
  - ✓ The economic consulting firm used by Fiscal Research is projecting a 67% drop in capital gains realizations (from stock and bond sales) between the 2000 tax year and 2002.
  - ✓ Many economists expect a sluggish economic recovery, at least for 2002, due to high consumer debt levels and the lack of pent-up demand. In addition, it normally takes 3-12 months for employers to begin re-hiring after a recession ends.
  - ✓ Middle-East hostilities could lead to higher energy prices.
  - ✓ The Federal Reserve could prematurely raise interest rates.
  - ✓ The state's budget reserves are very limited.
  - ✓ The phased-in impact of mergers and acquisitions activity in banking and health-care could dampen employment growth.

OUTLOOK THEME: IT MAY BE TOO LATE TO SEE MUCH IMPROVEMENT FOR CURRENT YEAR

- ✓ Through March, General Fund revenues are running $647.2 million behind schedule, or 6.5% of $9.9 billion target. More importantly, since essentially all of this damage has occurred since September, the shortfall for the affected 7 month period has been 8.2%

- ✓ The "final" revenue update normally occurs about three weeks from today, after the tabulation of "tax due" payments by individuals and first-quarter estimated tax payments by high-income individuals and corporations. To date, the national economic recovery that began in November has not had a significant impact on withholding or sales tax receipts (down 1.9% for January-March).

- ✓ In addition, the 19% decline in fourth quarter estimated tax payments for the 2001 tax year could lead to a $314 million shortfall for the combination of "tax due" payments in April and the first two estimated tax payments for the 2002 tax year. This adjustment alone would bring the total shortfall for the year to about $950 million. In addition, there will be a continued erosion of economy-based tax collections (withholding, sales, corporate) during the remaining months. Finally, the impact of the recession and September 11 on the economic base and equity prices means that some of the 2001 tax increases will not produce the anticipated yield.

- ✓ For these reasons, it is likely that the General Fund revenue shortfall will be close to the top end of the $.9-1.2 billion range the Governor has been using since January. This recurring revenue shortfall becomes part of the 2002-03 budget gap, because of the flow-through to the 2002-03 revenue base.

- Over -

CAUTIOUS OUTLOOK REQUIRED FOR 2002-03 FISCAL YEAR
(Continued)

- ✓ For these reasons, we are using a 1.8% revenue growth assumption for 2002-03. This is tied to a "pessimistic" alternative economic scenario developed by our economic consultant and one provided by the firm used by State Budget Office. This forecast increases the budget gap for 2002-03 by over $425 million.

- ✓ The Governor and State Treasurer are suggesting the use of a zero growth assumption for 2002-03 revenues. This could have a $280 million impact.

- ✓ Even if the economic recovery is stronger than we anticipate, the strength will not be clear until well after the May, 2002 revenue forecast. This is why time is running out for an improving revenue outlook.

APPENDIX E

Summary of the Economic Growth and Tax Reconciliation Act of 2001

THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

Tax Changes Affecting Individuals

Reduction in Income Tax Rates. (This does not impact NC Taxable Income)

- ✓ It creates a new fixed tax bracket; as under current law, the remaining five tax brackets are indexed annually for inflation. The bracket is the first $6,000 for single taxpayers; the first $12,000 for married taxpayers filing jointly; the first $10,000 for heads of households; and the first $6,000 for married taxpayers filing separately. The bracket increases to $7,000 in 2007 (the other tax filing status are changed accordingly).
- ✓ A new rate of 10% is applicable for the first tax bracket. This rate reduction became effective retroactively to January 1, 2001. The tax savings from the lower rate will be realized for the 2001 tax year by a rate reduction credit. Taxpayers received an advance refund check in the late summer/early fall of 2001. This refund check will be subtracted from the credit. Beginning in tax year 2002, the 10% rate will be shown as a 6th tax bracket.
- ✓ The lowest current rate of 15% remains unchanged. The new 10% tax bracket is carved from the 15% bracket. The 15% bracket is not expanded. The remaining four tax rates will be lowered over time. The rates are lowered 1%, effective June 30, 2001. This means an effective reduction for 2001 of ½ percent. For the 2002 tax year, the rates will be reduced the full 1%. The rates will continue to decrease until 2006 when the six effective tax rates will be as follows: 10%, 15%, 25% (formerly 28%), 28% (formerly 31%); 33% (formerly 36%), 35% (formerly 39.6%).

Repeal of Itemized Deduction Limit. (May affect NC taxable income because deducted from Adjusted Gross Income (AGI) to arrive at federal taxable income; but provisions do not become effective until 2006.)

- ✓ Currently, certain itemized deductions available on individual returns are reduced by the lesser of 3% of AGI in excess of $132,950 ($66,475 for Married Filing Separately) or 80% of the itemized deductions otherwise allowable.[1]
- ✓ Currently, personal exemptions[2] are also reduced once AGI exceeds the inflation-adjusted threshold of $199,450 (Married Filing Jointly), $166,200 (Head of Household); $132,950 (Single), and $99,725 (Married Filing Separately). Under the

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[1] The threshold amount is $100,000 for most taxpayers and $50,000 for married taxpayers filing separately. The threshold amounts are increased annually for inflation. The numbers used here are the inflation-adjusted threshold amounts for the 2001 tax year.

[2] The exemption amount is adjusted annually for inflation. The inflation-adjusted exemption amount for 2001 is $2,900.

phaseout, the exemption amount is reduced by 2% for each $2,500 by which the taxpayer's AGI exceeds the applicable threshold amount. The points at which a taxpayer's exemptions would be completely phased out in 2001 are $321,950 (Married Filing Jointly), $288,700 (Head of Household), $255,450 (Single), and $160,975 (Married Filing Separately).

- ✓ Effective for taxable years beginning on or after 2006, these reductions are phased out over four years. For tax years beginning on or after 2010, there will no longer be any phase-out for high-income taxpayers.

Marriage Penalty Relief. (The first three points do not impact NC taxable income; the fourth one may.)

- ✓ The Act increases the standard deduction for married couples filing jointly until, by the tax year 2009, it is double the standard deduction for singles.[3] The increase does not become effective until the 2005 tax year. Under current law, the standard deduction for a joint return is approximately 167% of the standard deduction for a single taxpayer. Beginning in 2005, the standard deduction for married taxpayers filing separately will be the same as the standard deduction for single persons. This means that for tax years 2005-2008, two married persons filing a separate return will have a greater combined standard deduction than if they filed jointly.
- ✓ Effective in 2005, the Act gradually expands the starting taxable income amount for the 15% rate bracket for married filing jointly until, by the tax year 2008, it is double the income amount for the 15% rate bracket for singles. This expansion means that more of the taxpayer's income is taxed at the lower 15% bracket.
- ✓ The Act increases the phaseout point for the earned income credit over seven years, starting in 2002.
- ✓ The Act increases the income phaseout point for contributions to education IRAs starting in 2002.

Tax Credits. (The changes to the dependent care credit may affect NC's dependent care credit amount. The credits do not impact NC taxable income.)

- ✓ Effective 2002, the act simplifies the **earned income tax credit** by changing the definition of "earned income" to exclude nontaxable employee compensation, by calculating the credit on AGI instead of modified AGI, by modifying the relationship test, by repealing the provision that reduces the credit by any alternative minimum tax, and by establishing new "tie-breaking" rules.

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[3] Section 34.19 of S.L. 2001-424 increases the NC standard deduction for married couples filing jointly over a two-year period so that by the 2003 tax year the amount is twice that of a single taxpayer. The Act increased the standard deduction from $5,000 to $5,500 for the 2002 tax year and to $6,000 for the 2003 tax year. The standard deduction for married persons filing separately is one-half that for a married couple filing jointly.

- ✓ Effective 2001, the Act increases the **child tax credit** from $500 to $600 per child.[4] This amount is increased over 10 years so that by the tax year 2010, the credit amount will be $1,000 per child.[5]
- ✓ Effective 2002, the Act liberalizes the **dependent care credit** in three ways: it increases the amount of the credit from 30% of eligible expenses to 35%; it changes the AGI phase-out point from $10,000 to $15,000[6]; and it increase the amount of eligible dependent care expenses taken into account in figuring the credit from $2,400 to $3,000 for one dependent and from $4,800 to $6,000 for two or more dependents.[7]
- ✓ Effective 2002, the Act expands the **adoption credit** by increasing the amount of the credit to $10,000 per adoption. The current credit amount is $5,000 per adoption and $6,000 per adoption of a special-needs child. The Act also increases the income phase-out range from $75,000 to $115,000 MAGI to $150,000 to $190,000 MAGI. The Act makes the credit permanent for all adoptions.[8] Both the dollar limitation and the income limitation amounts are subject to COLA in tax years beginning after 2002. Also, effective for tax years beginning on or after 2003, the $10,000 adoption credit for a special-needs child is allowed in the year the adoption is finalized, regardless of whether the taxpayer has qualified adoption expenses.

Tax Exclusions. (May affect NC taxable income)

- ✓ Effective 2002, the income exclusion for **employer-provided adoption assistance** is made permanent and it is increased to $10,000 per eligible child. The Act also increases the income phase-out range from $75,000 - $115,000 modified AGI to $150,000 - $190,000 modified AGI. Both the dollar limitation and the income limitation amounts are subject to COLA in tax years beginning after 2002. A taxpayer may be eligible for both the adoption credit and the exclusion, so long as they apply to different qualified adoption expenses.
- ✓ Individuals, as well as their heirs or estates, can exclude from income payments received as **restitution for being a Holocaust victim.** This provision applies to amounts received on or after January 1, 2000.
- ✓ The Act gives the IRS authority to expand the time for certain tax deadlines from 90 days to 120 days for **Presidentially-declared disasters.**[9]

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[4] North Carolina increased its child tax credit in S.L. 2001-424. For the 2002 tax year, the credit amount is increased from $60 per child to $75 per child and in 2003 the amount is increased to $100 per child. To qualify for the credit, the taxpayer's AGI for married filing jointly must be below $100,000.

[5] The credit amount is reduced if MAGI on a joint return exceed $110,000. The credit amount is reduced by $50 for each $1,000 of MAGI over the threshold amount.

[6] The credit percentage cannot be reduced below 20%. Therefore, for taxpayers with an AGI over $43,000, the credit is equal to 20% of eligible expenses.

[7] NC's dependent care credit is a specified percentage of the expenses eligible for the credit under the Code. NCGA 105-151.11.

[8] The adoption credit for children other than special-needs children was set to expire December 31, 2001.

[9] S.L. 2001-87 provides that State tax deadlines are extended to the same extent as the federal tax deadlines for Presidentially-declared disaster areas.

- ✓ Effective 2002, the Act provides that employer-provided qualified retirement planning services are excludable from employees' incomes.

IRAs. (May affect NC taxable income)

- ✓ The Act increases the amounts that may be contributed to both traditional IRAs (deductible from income at time of deferral) and Roth IRAs (tax-free distributions and earnings in the future) from $2,000 for 2001 to $3,000 for 2002-2004. This amount increases to $4,000 for 2005-2007 and to $5,000 for 2008. After 2008, this amount will be indexed annually for inflation in $500 increments. The Act does NOT change the income eligibility limits or the phase-out rules.
- ✓ The Act allows an additional contribution of $500 (2002-2005) to an IRA or a Roth IRA by a person age 50 or older. This "catch-up contribution" increases to $1,000 for tax years beginning on or after 2006.
- ✓ Effective 2002, the Act allows employers to set up traditional or Roth IRAs on behalf of their employees without impacting any other qualified plan of the employer. The provision allows an employer to assume the burden of setting up IRAs that was previously on the employee. With the IRA already set up, it is hoped that employees will be more likely to make contributions, through payroll deductions, toward retirement.
- ✓ Effective 2006, 401(k) and 403(b) plans may treat elective deferrals as Roth contributions. These are non-excludable (currently taxable) from the participant's gross income and are called Roth 401(k)s or QRCP – qualified Roth contribution programs. The annual dollar limit on a participant's designated Roth contributions is the annual limit on elective deferrals (which is $15,000 for 2006[10]); not the maximum Roth contribution limit (which is $4,000 in 2006 for individuals under 50). Unlike Roth IRAs, QRCPs will be available to everyone who is a participant in a 401(k) or 403(b) plan, which allows such contributions. Distributions from Roth 401(k)s will be excludable from gross income if made after a non-exclusion period and on account of the participant reaching age 59½, the participant's death, or the participant's disability.[11] From a sponsoring employer's perspective, the adoption of a QRCP will result in substantial administrative complexity since separate accounting will be required between pre-tax and designated Roth accounts; however, the potential benefit to employees from tax-free buildup in their accounts may leave employers little choice but to offer the plan.
- ✓ Effective for tax years beginning after December 31, 2001, and before January 1, 2007, an eligible taxpayer may claim a tax credit for elective deferrals to 401(k)

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[10] A participant's total amount of elective deferrals cannot exceed the dollar limit (which is $15,000 in 2006). Therefore, if the person contributes $7,000 to a pre-tax plan, the person cannot contribute more than $8,000 to a QRCP. Roth contributions that exceed the applicable limit will subject the participant to double tax (subject to tax in the year of deferral as well as the year of distribution) unless the excess deferrals and any earnings thereon are returned to the person on or before April 15 of the year following the tax year in which the excess deferral was made.

[11] The Roth 401(k) distribution does not include the tax-free distribution to pay first-time home buying expenses as in the case of Roth IRAs.

plans, 403(b) annuities, SIMPLEs, 457 plans, salary reduction SEPs and IRA contributions – traditional or Roth. The credit is in addition to any exclusion or deduction that may apply. To qualify for the credit, a married taxpayer filing jointly' s AGI (MFJ) must not exceed $50,000. The credit amount varies from 50% of the amount of the contribution to 10%, depending on the taxpayer's AGI.

Tax Changes Affecting Pension Contributions and Funding

Recognizes that Americans will not have financially secure retirements unless they and their employers save for retirement in tax-advantaged savings plans. The tax law changes discussed below liberalize contribution and benefit limits as well as funding rules. Although the tax law changes increase the limits, the plans do not have to provide for the maximum contributions allowed.

New Contribution and Benefit Limits. (May affect NC taxable income)

- ✓ Under current law, the amount that may be contributed to a defined contribution plan is limited to the lesser of the base amount[12] or 25% of compensation. Effective 2002, the Act increases the amount that may be contributed to the lesser of the base amount or 100% of compensation. The Act also increases the base amount to $40,000, indexed annually for COLA in $1,000 increments.
- ✓ Effective 2002, the Act increases the annual benefit limit under a defined benefit plan from $140,000[13] in 2001 to $160,000. This amount will be indexed for inflation in $5,000 increments starting in 2003.
- ✓ For purposes of figuring contributions and benefits, the maximum amount of compensation is limited to a statutory amount. For 2001, that amount is $170,000. The Act increases the base amount to $200,000 for 2002 and provides that this amount will be indexed for inflation in $5,000 increments.
- ✓ The Act increases the dollar limit on annual elective deferrals to 401(k) plans, 403(b) annuities, and salary reduction SEPs from $10,500 in 2001 to $11,000 in 2002.[14] The dollar limit increases by $1,000 for each year thereafter until it reaches $15,000 in 2006. Starting in 2007, the limit will be indexed for inflation in $500 increments.
- ✓ The Act increases the maximum annual elective deferrals that may be made to a SIMPLE plan from $6,500 in 2001 to $7,000 in 2002 and in $1,000 annual increments until the limit reaches $10,000 in 2005. Starting in 2006, the limit will be indexed for inflation in $500 increments.
- ✓ The Act increases the dollar limit on deferrals under a 457 plan to the same deferral limits for 401(k) plans.

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[12] The current base amount is $30,000, indexed annually for COLA in $5,000 increments. The 2001 limit is $35,000.

[13] The current base amount is $90,000. It has been indexed over time in $5,000 increments to the $140,000 amount in 2001. The Act changes the base amount to $160,000.

[14] Under 2001 Code, the amount that could be deferred through a 401(k) plan would have been $11,000 in 2002 without this change because of the $500 inflationary indexing.

- ✓ Effective 2002, individuals who participate in a 457 plan are no longer required to coordinate the maximum annual deferral amount for the 457 plan with contributions made to other types of retirement plans, such as a 40(k) plan, 403(b) plan, SEP, or SIMPLE. Under prior law, the maximum deferral amount for a 457 plan was reduced dollar for dollar by any contribution made to other types of retirement plans.
- ✓ Effective 2002, the exclusion allowance limitation for 403(b) annuities is repealed so that the limit is the same as applies to defined contribution plans – 100% of compensation. Likewise, for 457 plans, the 33 1/3% limitation on deferrals is raised to 100%.

Catch-up Provisions. (May affect NC taxable income.)

- ✓ Effective 2002, the Act increases the additional elective deferral limits employees age 50 or older may make to 401(k) plans, 403(b) annuities, salary reduction SEPs, 457 plans[15], and SIMPLEs. The catch-up deferral is the lesser of the applicable dollar amount or the participant's compensation for the year, reduced by any regular elective deferrals for the year.[16] The applicable dollar amount varies depending on the type of plan. The maximum catch-up contribution amounts are phased-in until 2006; after 2006, they will be adjusted for inflation in increments of $500.

New Benefit Limits under Qualified Plans. (May NC affect taxable income)

- ✓ Effective for years ending after 2001, the dollar limit on annual benefits is reduced if benefits under the plan begin before the social security retirement age and is increased if benefits begin after that age. Currently, the social security retirement age is 65; however, it is increasing to 67. Under the Act, effective in 2002, the dollar limit is reduced for benefits' beginning before age 62 and the dollar limit is increased for benefits beginning after age 65.

Faster Vesting of Employer Matching Contributions.

- ✓ If a plan has employer matching, it must adopt one of two alternative vesting schedules: 100% vesting after 3 years of service or 20% vesting for each year of service, starting with the second year of service and ending with 100% after 6 years of service. This provision is effective for plan years beginning after December 31, 2001. Under prior law, the vesting period was 100% after 5 years of service or 20% for each year of service, starting with the third year of service.[17]
- ✓ The change in vesting makes retirement packages more portable. It recognizes that workers stay with employers for fewer years.

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[15] This catch-up rule does NOT apply during the participant's last three years before retirement. In those years, the regularly applicable dollar limit is doubled as provided under current law.

[16] Most 401(k) plan participants do not make the maximum allowable deferral under the regular limits – so it is unlikely that many will take advantage of the additional deferral option.

[17] More rapid vesting is intended to support portability of benefits by plan participants who change jobs.

Deductions of Qualified Plan Contributions. (May affect NC taxable income because greater employer deductions possible)

- ✓ Generally, employers are permitted to deduct their contributions to qualified retirement plans. The amount of the deduction is based on the type of plan. Contributions to a defined benefit plan are deductible to the extent that they are necessary to satisfy the minimum funding standard. Contributions to a defined contribution plan are limited to 15% of compensation. If an employer sponsors both types of plans, the total deduction for all the plans may not exceed the greater of 25% of compensation or the contribution necessary to meet the minimum funding standard for the defined benefit plan. Employee elective deferral contributions to 401(k) plans are considered employer contributions for purposes of the deduction limits.
- ✓ Effective 2002, the annual limitation on contributions to defined contribution plans is increased from 15% of compensation to 25% of compensation.
- ✓ Effective 2002, the definition of compensation is modified so that it is larger. The compensation limit is increased from $170,000 in 2001 to $200,000 in 2002 and elective deferrals are no longer considered employer contributions.

Contributions on Behalf of Domestic Workers.

- ✓ Employers of domestic workers can set up SIMPLE plans. However, since they are not in business, they cannot deduct the contributions. Also, because the contributions are not deductible, they are subject to a 10% excise tax. Effective for tax years beginning after December 31, 2001, the Act eliminates the 10% excise tax that applies to these non-deductible contributions.

Pension Funding Rules. (May affect NC taxable income)

- ✓ Defined benefit plans are subject to minimum funding requirements that are designed to ensure that pension plans have a sufficient amount of assets for them to pay benefits. Employers that sponsor plans may deduct amounts contributed to satisfy the minimum-funding standard. Plan contributions that exceed the full funding limit are generally non-deductible and subject to a 10% excise tax. Pursuant to a special rule, employer-sponsors of defined benefit plans with more than 100 participants are permitted to deduct a maximum amount that is not less than the plan's unfunded current liability.
- ✓ The full funding limit is defined as the excess of (1) the lesser of (a) the *accrued* liability under the plan or (b) 160% of the plan's *current* liability, over (2) the value of the plan's assets. In an effort to strengthen pension security, EGTRRA increases the applicable percentage of *current* full-funding liability to 165% in 2002 and 170% in 2003. The *current* full-funding liability provision is repealed for plan years beginning in 2004 so that the applicable limit will be the excess, if any, of the *accrued* liability under the plan over the value of the plan's assets. Companies that want to provide a safety net for their funding obligation against business downturns

will be able to take advantage of the additional funding opportunity in prosperous times.

- ✓ Effective 2002, the 10% excise tax will not apply to employer contributions in excess of the current liability full funding limit. It will continue to apply to contributions that exceed the accrued liability full funding limit.
- ✓ Effective 2002, the special rule allowing a deduction for amounts contributed of up to 100% of a plan's unfounded current liability has been extended to all defined benefit pension plans. Expansion of the special deduction rule should give more plan sponsors incentives to adequately fund their plans.

Tax Changes Affecting Pension Distributions and Rollovers

Recognizing that Americans typically change jobs frequently, the Act contains provisions strengthening the portability of retirement plan benefits.

- ✓ In figuring required minimum distributions, the Treasury is directed to revise the life expectancy tables to reflect current life expectancy.
- ✓ Effective 2002, if a participant receives a hardship withdrawal he or she is barred from making additional deferral contributions to the plan for six months – was 12 months.
- ✓ Effective 2002, plan loans may be made to Subchapter S shareholders, partners in partnerships, and sole proprietors of unincorporated businesses. The maximum allowable borrowing amount is the lesser of 50% of the vested account balance or $50,000. Loans in excess of the dollar limit are treated as taxable distributions. This plan loan rule erases all of the distinctions between corporate and self-employed retirement plans. This is one less reason for professionals to form professional corporations instead of organizing as LLCs.
- ✓ Effective 2002, the Act provides greater latitude for plans that are merged or changed as a result of company acquisitions or similar transactions. If benefits are transferred to a defined contribution plan, the plan will not be treated as reducing the participant's benefits merely because the plan does not provide all of the same forms of distribution available under the prior plan so long as certain conditions are met.
- ✓ Effective 2002, the types of eligible tax-free rollover distributions are expanded to include distributions from qualified plans, 403(b) annuities, and 457 plans to other such plans and distributions from IRAs to qualified plans, 403(b) annuities, and 457 plans.
- ✓ Effective 2002, rollovers are permitted to be made with after-tax contributions to qualified plans or IRAs. In order to make a rollover of after-tax contributions, the plan must be set up to provide separate accounting for such contributions and the earnings on after-tax contributions. After-tax contributions to an IRA may not be rolled over to a qualified plan, 403(b) annuity, or a 457 plan.
- ✓ Effective 2002, surviving spouses may roll over distributions to qualified plans, 403(b) annuities, or 457 plans in which they participate. Prior to this change, the

surviving spouse was not entitled to make a tax-free rollover to another qualified plan or a 403(b) annuity; the tax-free rollover had to be made to an IRA.

- ✓ Effective 2002, a direct rollover will be the default option for involuntary distributions that exceed $1,000 when the qualified retirement plan provides that nonforfeitable accrued benefits which do not exceed $5,000 must be distributed immediately. This change is meant to preserve retirement savings.
- ✓ Amounts received from a qualified plan or IRA may be rolled over tax free if the rollover is make within 60 days from the date of distribution. If the rollover is not made, the distribution is taxable to the recipient. The IRS cannot waive the 60-day rule. Effective 2002, the Act permits the IRS to waive the 60-day rollover period if the failure to meet the deadline would be against equity or good conscience to extend it; i.e. when the failure is out of the taxpayer's control the deadline may be extended.

Tax Changes Affecting Education Incentives

Exclusions. (May affect NC taxable income)

- ✓ Educational expenses paid by an employer for its employees are generally deductible. **Employer-paid education assistance** can be excluded from the gross income of the employee if provided under an educational assistance plan or if the expenses qualify as a working condition fringe benefit. The Code provides an exclusion of $5,250 for employer-provided educational assistance.[18] However, the exclusion did not apply to graduate level courses beginning after June 30, 1996 and it was set to expire December 31, 2001. The Act makes the exclusion permanent and extends it to graduate level courses.
- ✓ The Act liberalizes the rules for **qualified tuition programs,** effective 2002:
    - o It expands the definition of "qualified tuition program" to include programs established by private institutions as well as state institutions.[19]
    - o It excludes distributions from state qualified tuition programs to pay for higher education costs from gross income; it allows the same exclusion for distributions from private qualified tuition programs in 2004.[20]
    - o The maximum allowance for room and board has been expanded.
    - o The term "family member" has been expanded to include first cousins of the original beneficiary.
    - o A 10% penalty is imposed on distributions included in gross income.[21] Generally, distributions would only be included in gross income if the funds

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[18] Employer-paid educational assistance is excludable, without any dollar limit, if the courses are taken to maintain or improve job skills – a tax-free working condition fringe benefit.

[19] The expansion applies only to prepaid tuition plans; private institutions may still not set up qualified tuition savings programs.

[20] Formerly, distributions were taxable at the beneficiary's rate.

  were used for a purpose other than qualified higher education costs. Prior to this change, states were required to impose a penalty and that penalty was often 15%.

  - Prepaid tuition credits or amounts in savings-type programs can be rolled over to other programs tax-free for the benefit of the same beneficiary.[22]

- ✓ The Act expands and modifies **education IRAs** to make them more attractive vehicles for accumulating savings for education:
  - It increases the annual maximum contribution from $500 to $2,000.
  - It allows the accounts to be used for elementary and secondary expenses.
  - It increases the MAGI phase-out range for married taxpayers filing jointly to twice the amounts applicable for single filers -- $190,000 to $220,000.
  - It provides that a beneficiary is no longer required to waive the tax-free treatment for distributions from an education IRA in order for the education credits[23] to be claimed during the same year, so long as the distributions are not used to pay the same expenses taken into account in figuring the credit. This allows the credits to be claimed for tuition and the education IRA to be used to pay for room and board, which are expenses for which the credits may not be claimed.
  - It repeals the 6% excise tax on contributions made by any person to an education IRA on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a QTP on behalf of the same beneficiary.[24]
  - It allows contributions for special needs beneficiaries above age 18 and allows accounts to continue for special needs beneficiaries above age 30.
  - It extends the time for making contributions until the return due date and it extends the time for returning excess contributions.

- ✓ Awards under the **National Health Services Corps and the Armed Forces Scholarship program** are excludable from gross income, effective 2002. As with other tax-free scholarships, the exclusion does not apply to amounts for room and board.

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[21] The penalty does not apply to distributions from private qualified tuition programs for qualified higher education costs before 2004; in 2004, these distributions will be excluded from gross income.

[22] Such rollovers are limited to one transfer within any 12-month period.

[23] The HOPE credit is limited to the first two years of higher education and is 100 of expenses plus 50% of the next $1,000 for a top credit of $1,500. The lifetime learning credit is 205 of qualified higher education costs up to $5,000 ($10,000 starting in 2003) for a top credit of $1,000 ($2,000 starting in 2003). Taxpayers with MAGI over $100,000 on a joint return do not qualify for either the HOPE or the lifetime learning credit.

[24] If distributions from education IRAs and QTP exceed the beneficiary's QHEE for the year, the beneficiary is required to allocate the expenses between the distributions to determine the amounts includible in income.

Deductions. (May affect NC taxable income)

- ✓ Effective 2002, the above-the-line **student loan deduction** is no longer restricted to payments made in the first 60 months in which interest is required and the deduction applies to voluntary payments, such as interest-only payments. Lastly, the AGI limits on claiming the deduction are increased and will be indexed annually for inflation.[25]
- ✓ The Act creates a **new deduction for qualified higher education expenses**. For payments made in tax years beginning after 2001 and before 2006, the Act permits an above-the-line deduction for QHEE (tuition and fees). In 2002 and 2003, taxpayers with MAGI that does not exceed $130,000 for married couples filing jointly are entitled to a maximum deduction of $3,000. In 2004 and 2005, these same taxpayers are entitled to a maximum deduction of $4,000 and taxpayer with MAGI in excess of these limits but that does not exceed $160,000 for married couples filing jointly are entitled to a maximum deduction of $2,000. Taxpayers may not claim the deduction and a HOPE or Lifetime Learning Credit in the same year with respect to the same student. A taxpayer may not claim a deduction for amounts distributed from education IRAs and may not claim a deduction for the earnings portion of distributions from QTP.

Tax Changes Affecting the Estate and Gift Taxes

Estate and gift taxes, which have been unified since 1976, will start to operate on different platforms as the estate tax is phased out starting in 2002. The same tax rates will apply, but different exemption amounts will apply to each for these taxes after 2003 when the estate tax exemption increases to $1.5 million while the gift tax exemption amount stays at $1 million. The estate tax is scheduled to expire in 2010; however, it is scheduled to reapply in 2011 unless a future Congress makes the repeal permanent.

Phase Out of State Death Tax Credit. (Will affect NC tax revenues)

- ✓ Decedents' estates are entitled to a federal credit for state death taxes paid. This is commonly referred to as the "pick-up tax". The amount of the credit is based on the decedent's "adjusted taxable estate", which is defined as the taxable estate less $60,000. The credit is allowed only for the portion of the adjusted taxable estate that exceeds $40,000.
- ✓ The state death tax credit available will be reduced by 25% in 2002, 50% in 2003, 75% in 2004, and will be repealed entirely in 2005. Beginning in 2005, the credit for state death taxes will be replaced by a deduction equal to the amount of any estate, inheritance, or succession taxes actually paid to a state with respect to property included in the decedent's gross estate.
- ✓ As of July 1, 2001, 37 states and the District of Columbia impose only a "pick-up tax", which is designed to pick up no more state death tax from a decedent's estate than would be allowed by the federal credit. The loss of revenue at the state level from the eventual repeal of the federal estate tax is accelerated by the reduction of the credit beginning in 2002.

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[25] The $2,500 dollar limit on the deduction for student loan interest stays the same. The limit is not adjusted for inflation.

Repeal of the Federal Estate Tax (May affect NC tax revenues)

- ✓ The top federal estate tax rate drops from 55% in 2001 to 50% in 2002. It continues to drop by 1% each year until the tax is repealed in 2010. In 2011, if the tax is reinstated, the rate will again be 55%.
- ✓ Effective for decedents dying after 2001, the 5% surtax on very large estates is repealed. Therefore, after 2001, very large estates can enjoy the benefit of the graduated rates since the surtax no longer applies.
- ✓ The exemption amount increases from $675,000 in 2001 to $1 million in 2002-03, $1.5 million in 2004-05, $2 million in 2006-08, and $3.5 million in 2009. There is no need for an exemption amount after 2009 since the tax is repealed in 2010. However, if the tax is reinstated in 2011, the exemption amount would be $1 million.[26]
- ✓ The current deduction for family-owned business interests of up to $675,000 is repealed, effective for the estates of decedents dying after December 31, 2003.

Change in Gift Tax Rules.

- ✓ The same graduated tax rates for estates apply to taxable gifts until the estate tax is repealed. When the estate tax is repealed, gifts in excess of the exemption amounts will become taxable at the highest individual income tax rate.
- ✓ The lifetime exemption amount for gifts remains at $1 million.
- ✓ The $10,000 annual exclusion amount ($20,000 for joint gifts) has not changed. These figures are adjusted for inflation. The exclusion for direct payments of tuition or medical expenses continues to apply. Gifts to a spouse or charity continue to be fully gift-tax free.

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[26] There continues to be an unlimited marital deduction and charitable contribution deduction.

APPENDIX F

SUMMARY OF THE JOB CREATION AND WORKER ASSISTANCE ACT OF 2002

JOB CREATION AND WORK ASSISTANCE ACT OF 2002

I. INTRODUCTION

After months of political debate, Congress finally passed the "Job Creation and Worker Assistance Act of 2002" - - its long-awaited economic stimulus legislation. President Bush signed the bill on March 9, 2002. Although the final bill does not contain earlier proposals to repeal the corporate alternative minimum tax or to accelerate individual income tax cuts, it does retain many tax incentives for large and small businesses.

For example, there is a new 30% first year depreciation deduction for qualifying property purchased and placed into service after September 10, 2001. In addition, there is a temporary increase in the net operating loss carryback period from 2 to 5 years, effective for net operating losses generated for tax years ending in 2001 and 2002. The tax bill also contains many other changes, including: the extension of a host of tax credits that would have otherwise expired in 2001; tax incentives for property located in the "New York Liberty Zone"; new restrictions on the "nonaccrual experience method of accounting"; an increase in the deduction limit for SEP IRAs; new rules for the tax treatment of cancellation of debt income by S corporations; a 13-week extension of unemployment benefits; and technical corrections to previous tax legislation.

Several of these provisions may impact your 2001 tax return. If you have already filed your return for 2001, an amended return must be filed to take advantage of these new tax provisions.

Also, there is a new "deemed-sale election" for capital gain property which can only be made with your 2001 tax return. This election could possibly save you taxes down the road. There are many complicated factors to consider in deciding if you should make this election. This outline includes a segment that will help you evaluate those factors to determine whether this deemed-sale election is prudent.

Caution. As you read this outline, please pay special attention to the effective dates, which change from one provision to another. We have highlighted the effective date of each provision discussed. This portion of the outline is intended to be a summary of the 2002 Act provisions that the author believes affect the largest number of taxpayers. Accordingly, the summary does not address every change made by the Act. Also, most states have not yet adopted the provisions of the Job Creation and Work Assistance Act of 2002. So the state income tax implications of these changes are uncertain at this time.

II. HIGHLIGHTS OF CHANGES IMPACTING PRIMARILY BUSINESSES

1. Additional 30% First Year Depreciation for Qualified Property

Under current rules, your business may generally depreciate its tangible business property under the so-called modified accelerated cost recovery system ("MACRS"). Under MACRS, the depreciation period for most of your tangible personal property ranges from 3 to 25 years. Generally, your depreciation method for this property is either 200% or 150% declining balance, switching to the straight-line method when it is most tax advantageous to your business.

In order to stimulate the purchases of depreciable tangible property, the new legislation allows your business an immediate 30% deduction of the cost of "qualified property." **To qualify, the property generally must be purchased after September 10, 2001 and before September 11, 2004, and must be placed into service before January 1, 2005.** You will be allowed this deduction **for both regular and alternative minimum tax purposes.** **Tax Tip**. If you have already filed your 2001 return, you may obtain the benefit of this deduction by filing an amended return. **Planning Alert!** To qualify for this deduction, you must satisfy a long list of requirements summarized below.

a. **Qualifying Property.** The new 30% deduction generally applies only to MACRS property that has a statutory depreciation period of 20 years or less. The following is a partial list of the types of property that could qualify for this deduction:

- **3-year property** includes (but is not limited to): tractor units for use over the road; breeding hogs; any race horse over 2 years old when placed in service; and qualified rent-to-own property.

- **5-year property** includes (but is not limited to): cars and light general purpose trucks; taxis and buses; airplanes not used in commercial or contract carrying of passengers or freight; data handling equipment other than computers (e.g., typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment); computer-based telephone central office switching equipment; computers and peripheral equipment; breeding cattle; and dairy cattle.

- **7-year property** includes (but is not limited to): office furniture and fixtures (e.g., desks, files, safes, overhead projectors, cell phones, fax machines); certain livestock 12 years old or less when placed into service; and fishing vessels.

- **10-year property** includes (but is not limited to): vessels; barges; tugs; and single purpose agriculture or horticultural structures.

- **15-year property** includes (but is not limited to): municipal waste water treatment plants; assets used in producing cement; qualified retail motor fuel outlets; car wash buildings and related land improvements; billboards; and certain land improvements (e.g., sidewalks, drainage facilities, sewers, fences, landscaping, shrubbery, radio and television towers).

- **20-year property** includes (but is not limited to) certain farm buildings.

- **Qualified Water Utility Property**, which generally has a 25-year depreciation period, also qualifies for the immediate 30% deduction.

- **Computer Software** generally qualifies for the 30% immediate deduction. **Planning Alert!** If your business purchases the software as part of its purchase of all or a substantial part of an entire business, the software will generally not qualify for the 30% immediate deduction. Instead, the software must be amortized straight line over a 15-year period.

- **Certain Leasehold Improvements** may also qualify for the immediate 30% deduction. To qualify, the leasehold improvement must be made to the interior portion of a commercial building (i.e., nonresidential real property) pursuant to a lease (or a binding commitment to enter a lease). Your business will qualify whether it is the lessor, lessee, or the sublessee, provided the leasehold improvement is placed into service **more than 3 years after** the building was first placed into service, and that portion of the building is occupied exclusively by the lessee (or any sublessee). **Planning Alert!** The following leasehold improvements will not qualify: improvements that enlarge the building; any elevator or escalator; any structural component benefitting a common area; and any cost relating to the internal structural framework of the building. Furthermore, improvements under a lease between "related persons" will also fail to qualify. The definition of a related person is quite technical. Please consult the Tax Act for further information on this term.

b. The Qualified Property's "Original Use" Must Commence after September 10, 2001. You will qualify for the additional 30% depreciation deduction only if your business is the first taxpayer to actually use the qualified property in business. If your business purchases "used property" after September 10, 2001, it will generally not qualify for the 30% deduction. Moreover, even if you buy "factory reconditioned" or "rebuilt" machinery or equipment, your business will not qualify for the new deduction. **Tax Tip.** If your business incurs capital expenditures to recondition, rebuild, or refurbish property you acquire (or you already own), the capital expenditures will qualify for the new 30% deduction. **Example.** Let's say that on February 1, 2002, your business purchased $20,000 of used equipment. You then incur a $5,000 capitalized expenditure to recondition the equipment. The original $20,000 purchase price would not qualify for the new additional first year depreciation, but the $5,000 capitalized expenditure would qualify. **Planning Alert!** Special rules apply if your business participates in certain sale-leaseback arrangements of otherwise qualified property.

- Your Business Must Purchase Qualified Property Within the "Applicable Time Period." To qualify for the new 30% deduction, your business must generally acquire the qualified property after September 10, 2001 and before September 11, 2004. **Planning Alert!** Even if you acquire the property after September 10, 2001, it will not qualify if the purchase was pursuant to a binding written contract in effect before September 11, 2001. **Tax Tip.** If your business purchases qualifying property after September 10, 2004, pursuant to a binding written contract that was entered into after September 10, 2001 and before September 11, 2004, the property will still qualify for the additional first year depreciation **if it is placed in service before January 1, 2005.** There is a special rule for businesses that are manufacturing, constructing, or producing the qualified property for their own use. To qualify for the additional 30% first-year depreciation, these businesses must begin the manufacture, construction, or production **after September 10, 2001 and before September 11, 2004** and the property must generally be placed in service **before January 1, 2005.** However, certain property with a longer construction period must be placed in service by January 1, 2006.

- You May "Elect Out" of the 30% First Year Depreciation. If your business purchases qualifying property, it has the option to elect out of the additional 30% first year depreciation for any class of property for any taxable year. **Tax Tip.** In certain situations, you might decide to elect out of this 30% deduction if you determine you will get a greater tax benefit by deferring depreciation deductions to later years using regular MACRS depreciation. For example, your business might anticipate paying tax at a much higher rate in later years and decide to defer the depreciation deductions by forgoing the additional first year depreciation.

2. No Change to the §179 Expense Deduction **Except for New York Liberty Zone Property**

Under current law, your business may generally deduct up to $24,000 in 2001 and 2002 ($25,000 thereafter) of the cost of qualifying depreciable, tangible, personal property. This is commonly referred to as the §179 deduction. Although the tax stimulus bill as originally proposed would have significantly increased the §179 deduction for all businesses, this proposal was dropped from the final legislation except for qualifying New York Liberty Zone property. Consequently, the §179 deduction remains at $24,000 in 2001 and 2002, and will increase to $25,000 thereafter. **Planning Alert!** If your company's total equipment purchases for a tax year exceed $200,000, the amount it can immediately deduct as a §179 deduction will be reduced, and possibly eliminated. Also, your company's immediate write off cannot exceed the company's business income, computed without regard to the §179 deduction. **Tax Tip.** Since you select the property for which you are taking the §179 deduction on Form 4562, you will generally save taxes by selecting the assets with the longest depreciable lives.

The §179 Deduction is Taken Before the 30% Deduction. For example, assume that on December 1, 2001, your calendar year business purchases $200,000 of computer equipment (5-year property), which represents the only §179 property your company purchased in 2001. Assume further that the computer purchases qualify for the maximum §179 deduction, the new 30% additional first year depreciation, and the normal MACRS depreciation. The total deductions in 2001 on the computer purchases would be $101,440, computed as follows: **(i)** a §179 deduction of $24,000, plus **(ii)** additional 30% first year depreciation of $52,800 on the remaining basis ([$200,000 - $24,000] x 30%), plus **(iii)** $24,640 of MACRS depreciation ([$176,000 - $52,800] x 20% [using mid-year convention and 200% declining balance]). **Tax Tip.** Generally, if your business purchases more than 40% of its equipment in the last 3 months of its tax year, it may only take 1½ months of depreciation (instead of 6 months of depreciation) for the property acquired in the last 3 months. This is commonly referred to as the "mid-quarter convention." The IRS has waived the "mid-quarter convention" for any business where the 3rd or 4th quarter of its tax year includes September 11, 2001. Therefore, businesses qualifying for this waiver may take 6 months of depreciation for all assets placed in service during the qualifying year. **Planning Alert!** Like any other depreciation, the 30% additional depreciation will be subject to the ordinary income recapture provisions if the property is sold.

3. Additional First Year Depreciation on Passenger Automobiles

The maximum annual depreciation for passenger automobiles used in a business is capped at certain dollar amounts. For example, for 2001 and 2002, the maximum first year depreciation on a passenger automobile is $3,060. Under the new law, for passenger automobiles purchased **after September 10, 2001 and before September 11, 2004,** the first year depreciation cap is increased by $4,600 if the additional 30% depreciation is taken for the auto. Consequently, the maximum first year depreciation on a qualifying passenger automobile placed in service after September 10, 2001 will be $7,660 ($3,060 plus $4,600). **Tax Tip.** Trucks and vans are exempt from these depreciation limitations if the vehicle's "gross vehicle weight" exceeds 6,000 pounds (e.g., Expedition, Range Rover, Tahoe, Durango, Suburban). These vehicles may qualify for the full §179 deduction, the new 30% first year depreciation deduction, and the regular MACRS depreciation deduction.

4. Net Operating Loss Carryback Period Temporarily Increased from 2 Years to 5 Years

Businesses can generally carry back net operating losses ("NOLs") 2 years, and carry them forward 20 years to offset taxable income in the carryback and carryforward years. The NOL deduction cannot offset more than 90% of a business' alternative minimum taxable income. **For NOLs arising in taxable years ending in 2001 and 2002,** the new law temporarily extends the general NOL carryback period from 2 years to 5 years. The new law also allows a NOL deduction attributable to loss carrybacks arising **in taxable years ending in 2001 and 2002** to offset 100% (instead of 90%) of a business' AMTI. In addition, any prior year NOL that is being carried forward into taxable years ending in 2001 and 2002 will likewise offset 100% (instead of 90%) of AMTI. **Planning Alert!** You can elect to forgo the 5-year carryback period by making a qualifying election by the due date of your tax return (including extensions) for the year of the loss. This election is irrevocable and, if made, will not qualify for any of the relief provisions under the new law. **Caution!** Electing to waive the 5-year carryback rule can make sense if it allows you to carry the NOL to a year you were (or will be) in a higher tax bracket. However, detailed computations generally should be made before you elect this waiver.

5. New Law Reverses Supreme Court Decision on S Corporation's Discharge of Indebtedness

If you own stock in an S corporation, you are required to pay taxes on any taxable income generated by the S corporation, and you are also allowed to deduct the S corporation losses on your individual tax return. However, you cannot deduct S corporation losses in excess of your tax basis in your S corporation stock, plus any money you have personally loaned to the corporation.

Generally, an S corporation will have taxable income if it owes money to a creditor but the debt is forgiven (e.g., in bankruptcy). However, this so-called "discharge of indebtedness" income is generally exempt from tax if the S corporation is in bankruptcy or is insolvent when the discharge occurs.

In an unexpected taxpayer victory, the Supreme Court held in 2001 that an S corporation's tax exempt discharge of indebtedness income increased the stockholders' bases in their stock. In the case before the court, the increased basis permitted the stockholders to take losses that would otherwise be unavailable. Unfortunately, the new law reverses this result.

Effective for discharges of indebtedness after October 11, 2001, the new law provides that an S corporation's tax exempt discharge of indebtedness income will not increase the basis of any shareholder's stock in the corporation. **Planning Alert!** This new provision does not apply to any discharge of indebtedness **before October 12, 2001, or a discharge before March 1, 2002,** which is **under a plan of reorganization filed with a bankruptcy court before October 12,**

2001. **Tax Tip**. If you own stock in an S corporation that incurred a discharge of indebtedness before October 12, 2001, you may be entitled to a loss deduction for the 2001 tax year (or for a previous "open" year).

6. New Law Limits the Use of Non-Accrual Experience Method of Accounting

If your business is an accrual method taxpayer, it must generally accrue income for tax purposes in the tax year all events have occurred establishing the right to the income (this is commonly referred to as the "all events" test). Generally, once the "all events" test is satisfied, income must be accrued even though the chances of collecting the income are in doubt. Under current rules, if your business primarily performs services, it is not required to accrue income (even if the "all events" test is satisfied), if it anticipates the income will not be collected in the future. This is known as the "non-accrual experience method" of accounting. Furthermore, this special rule for service providers is available only if your business does not charge interest or impose a penalty for failure to timely pay the amount charged.

Effective for taxable years ending after March 9, 2002, this non-accrual experience method of accounting will be available only if your business is a "qualified small business" or it operates in the service fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. If your business does not provide the previously-listed services, it will still qualify if it is a "qualified small business" (i.e., any business with "average annual gross receipts" of $5,000,000 or less). **Tax Tip.** If this change impacts your business, you will generally be given approval by the IRS for an automatic accounting method change.

7. Technical Correction Increases Contributions to SEP

Last year Congress generally increased allowable contributions to defined contribution retirement plans from 15% of compensation to 25% of compensation. However, Congress inadvertently failed to change the law so that participants of a simplified employee pension ("SEP") would get the full benefit of the new 25% limit. The new law corrects this inadvertent mistake and, **starting in 2002,** you will be able to contribute and deduct up to 25% of compensation to your SEP (not to exceed $40,000). **Tax Tip.** This is indeed good news for many small businesses. Unlike most retirement plans, your business can establish a new SEP for its employees after the close of the tax year. However, the plan must be established by the due date of the business' tax return.

8. Technical Correction to New Retirement Plan Credit

Last year, Congress created a new tax credit for qualifying small businesses that set up a new qualified retirement plan after December 31, 2001 (provided that the business did not have a qualified plan within the prior three years). The new credit is generally available to businesses who employ no more than 100 employees and establish a retirement plan that covers at least one non-highly compensated employee. The credit equals 50% of the plan's first $1,000 of administrative costs for each of the first 3 years.

The new law now clarifies that this credit is available for qualifying retirement expenses for plans first effective after December 31, 2001, **even if the plan was adopted on or before that date.** **Tax Tip.** For determination letter requests made after 2001, last year's legislation also eliminated the IRS user fee (which can range from $125 to $1,250) for obtaining a determination letter for a retirement plan of a "qualified small business." **Planning.** These new credits reduce the after-tax costs of individually designed plans.

III. HIGHLIGHTS OF NEW TARGETED TAX BENEFITS FOR NEW YORK CITY

1. Background.

The tax bill contains several tax benefits for businesses located in the "New York Liberty Zone." The New York Liberty Zone is located in Southern Manhattan. More specifically, it includes the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan, New York, New York. The new tax benefits for the New York Liberty Zone are much too lengthy to cover in detail in this summary. The following highlights the more important provisions:

a. **Expanded Work Opportunity Tax Credit.** A tax credit of up to $2,400 per employee is allowed for Liberty Zone employers with an average of 200 or fewer employees who are: (1) individuals performing substantially all their services in the Liberty Zone, or (2) individuals substantially performing all their services in New York City for a business relocated from the Liberty Zone to some place else within New York City due to the terrorist attacks. This expanded credit is **effective** for wages paid or incurred to qualified individuals **for work after December 31, 2001 and before January 1, 2004.**

b. **Expanded 30% Additional First Year Depreciation.** In addition to the assets normally qualifying for the 30% additional first year depreciation deduction, the new law expands the 30% depreciation deduction to qualifying "nonresidential real property" and "residential rental property," to the extent the property rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of the terrorist attacks of September 11, 2001. Furthermore, the sunset dates for the 30% additional first year depreciation are generally extended for property used in the New York Liberty Zone.

c. **Increased §179 Deduction.** The new law generally allows an additional §179 deduction of up to $35,000 for qualifying property placed in service in the New

York Liberty Zone **after September 10, 2001 and before January 1, 2007.** For example, for 2001 and 2002, a business with at least $35,000 of qualifying New York Liberty Zone property would have a maximum §179 deduction of $59,000, rather than $24,000. **Planning Alert!** The §179 deduction is subject to phase-out rules.

d. **Expanded Rules for Tax-Free Involuntary Conversions.** If you receive insurance proceeds or other compensation for property lost by fire, theft, or condemnation, ordinarily you must report as income any excess of the compensation received over the adjusted basis of the property lost. But you can elect not to report this gain to the extent that you reinvest the amount received in similar property. Generally, you have 2 years to replace the converted property. The new law extends the replacement period to 5 years for a taxpayer to replace property that was involuntarily converted within the New York Liberty Zone as a result of the terrorist attacks that occurred on September 11, 2001. However, the 5-year period is available only if substantially all of the use of the replacement property is in New York City.

e. **Shorter Depreciable Lives for Qualified Leasehold Improvements.** Generally, leasehold improvements to commercial real property are depreciated using the straight-line method over 39 years. **Effective for property placed in service after September 10, 2001 and before January 1, 2007**, leasehold improvements to "qualified New York Liberty Zone leasehold improvement property" may be depreciated using the straight-line method over 5 years. Qualified New York Liberty Zone leasehold improvement property is generally qualifying leasehold improvements to commercial real property located in the New York Liberty Zone.

IV. HIGHLIGHTS OF CHANGES IMPACTING PRIMARILY INDIVIDUALS

1. Changes to Adoption Tax Credit

Last year, Congress enacted legislation that increased the adoption tax credit from $5,000 per child to $10,000 per child, effective after 2001. Under that legislation, it appeared that if you finalized the adoption in 2002, you could get the new $10,000 credit even for qualified adoption expenses that were paid in 2001.

The new legislation changes this result. The new law says that any qualifying adoption expenses paid or incurred during taxable years **beginning before January 1, 2002,** will be subject to the $5,000 cap ($6,000 for special needs children), even if the credit is allowed in a tax year beginning after December 31, 2001.

2. Expansion of Tax-Free Foster Care Payments

If you are receiving payments for providing foster care, and you meet certain requirements, you are entitled to exclude the payments from your taxable income. **Effective for taxable years beginning after 2001,** the new legislation expands the definition of qualified foster care payments to include payments by a placement agency that is licensed or certified by a state or local government, or by an entity designated by a state or local government to make payments to providers of foster care. Thus, payments made by for-profit agencies contracting with State and local governments to provide foster home placements will now be excludable from gross income by foster care providers. Also, the new law allows foster care providers to exclude payments made by tax-exempt and for-profit placement agencies with respect to foster care individuals who are over age 18 at the time of placement.

3. New "Above-the-Line" Deduction for Teachers Who Provide Classroom Materials

If you or your spouse teach kindergarten through 12th grade, you are going to like this new provision. **For 2002 and 2003,** if you are an "eligible educator" you will be able to fully deduct as an "above-the-line" deduction up to $250 of your qualified teaching expenses. Your qualified expenses include books, supplies (other than non-athletic supplies for courses in health or physical education), computer equipment (including software and services), other equipment, and supplementary materials. **Planning Alert!** To be an "eligible educator" you must be a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide working at least 900 hours during the school year.

4. Technical Corrections to Catch-up Contributions to Retirement Plans

A law change in 2001 increased the amount you may contribute to IRAs, 401(k) plans, and other retirement plans if you are age 50 by year end. The new law makes it clear that if your 50th birthday occurs during a year, you will be eligible for this additional contribution as of the beginning of that tax year, rather than on your 50th birthday. **This increased contribution is effective for 2002**.

5. New Law Extends Application of Personal Tax Credits to AMT

Under current law, the following non-refundable personal tax credits would not have been available to reduce the alternative minimum tax after 2001: dependent care credit; credit for the elderly and disabled; credit for interest on certain home mortgages; HOPE and Lifetime Learning credits; and D.C. home buyer's credit. **The new law will allow these credits to offset the alternative minimum tax liability through 2003. Tax Tip.** The adoption credit, child credit, and other credits were already available to offset the alternative minimum tax.

V. EXTENSION OF EXPIRING PROVISIONS

The new law extends credits and other tax provisions that would have otherwise expired or started phasing out by the end of 2001. The following are some of the items extended:

- the 10% credit (maximum $4,000) for electric vehicles will not be reduced until 2004 (rather than 2002)
- the credit for the production of electricity from wind, closed loop biomass, and poultry litter is extended for two additional years (2002 and 2003)
- the work opportunity tax credit is extended for two years (2002 and 2003)
- the welfare-to-work credit is extended for two years (2002 and 2003)
- the deduction for clean-fuel vehicles and for clean-fuel vehicle refueling property will not be reduced until 2004 (rather than 2002)
- the 100% net-income limitation on percentage depletion for independent producers and royalty owners will not be effective until 2004 (rather than 2002)
- those who did not establish a Medical Savings Account by the end of 2001 may establish a MSA in 2002 or 2003 (rather than by the end of 2002)

VI. NEW DEEMED SALE ELECTION FOR CAPITAL GAIN PROPERTY

1. Background.

2001 is the first year you may be entitled to a new capital gains tax rate. **For property sold after Dec. 31, 2000,** capital gains that would otherwise be taxed at a 10% capital gain rate (because an individual is in the 15% ordinary income tax bracket) will be taxed at 8% if the property is owned for more than 5 years. The 8% rate applies to property held for more than 5 years even if the holding period begins before 2001. For property **acquired and sold** after Dec. 31, 2000, the 20% capital gain rate is reduced to 18% if the property is owned for more than 5 years. To qualify for the 18% rate, the 5-year holding period must begin after 2000. **Planning Alert!** Because the 5-year holding period must begin after 2000, the 18% rate won't be available for gains realized before 2006.

2. Deemed-Sale Election. Since the holding period must begin after 2000 to qualify for the 18% rate, assets acquired before January 1, 2001 will not qualify regardless of how long the taxpayer holds them. However, you are permitted to make an election to treat such property as having been sold and repurchased at the beginning of 2001. If the election is made, the asset is deemed acquired after 2000. Under the deemed-sale-and-repurchase election, a taxpayer that is not a regular C corporation may elect to treat any readily tradable stock (which is a capital asset) held on January 1, 2001 as having been sold and reacquired on January 2, 2001 for its closing market price on January 2, 2001. The taxpayer may also elect to treat any other capital asset or property used in a trade or business and held by the taxpayer on January 1, 2001 as having been sold and reacquired on January 1, 2001 for its fair market value on that date. Any gain on the "deemed" sale is recognized, but any loss is permanently disallowed. **Planning Alert!** You cannot make the deemed-sale-election for an asset you dispose of within one year after the effective date of

the election (January 1, 2001 or January 2, 2001).

Caution! The benefits of this election cannot be realized until after 2005 and then the maximum benefit is a 2-percentage point reduction in the capital gains rate from 20% to 18%. Therefore, it may be difficult for you to decide if you should make the election. The election must be made with your 2001 return. **Obviously, in most cases, an informed decision cannot be made without detailed calculations.**

3. Who is Eligible to Make the Deemed-Sale Election? The election may be made by individual taxpayers or by pass-through entities. The term "pass-through entities" includes S corporations, partnerships, estates, trusts, mutual funds (or other regulated investment companies), real estate investment trusts, and common trust funds. For grantor trusts, the grantor of the trust must make the election. **The election can, apparently, be made on an asset-by-asset basis. So, you can make the election for some assets and not for others.**

4. Effect of Election. The deemed reacquisition resulting from the election starts a new, post-2000 holding period for the property. The new holding period begins on the date of the deemed sale. As a result, any gain on the actual sale of the property after 2005 will qualify for the reduced 18% maximum capital gains rate (if all other requirements for application of the 18% rate are met). **Tax Tip!** You may also start a new holding period by actually selling the property and then reacquiring it. However, making the election avoids the transaction costs that would be incurred if you actually sold and repurchased assets in order to qualify them for the 18% maximum capital gains rate.

   Any gain resulting from the election is treated as received or accrued on the date the asset is deemed to have been sold. **The gain is recognized notwithstanding any other Code provision.** However, any **loss from the deemed-sale election is not recognized** even though the basis for the asset is reduced to the fair market value on the date of the deemed sale. **Tax Tip.** It appears that you may use net operating losses or capital losses to offset gain from the deemed-sale election. **Planning Alert!** The 2002 tax legislation clarified that if the deemed-sale election is made for your principal residence, the $250,000 or $500,000 exclusion **may not be used** to eliminate the gain. The 2002 legislation also clarified that the deemed-sale election for a **passive activity** will not be treated as a complete disposition of the passive activity releasing all suspended losses associated with the activity. However, any gain from the passive activity resulting from the election should be treated as a passive gain.

5. Selected Situations Where Election May Be Advisable

   - **Property With Little Gain or Loss.** You might want to make the election with respect to property that, as of January 1, 2001 or January 2, 2001, hasn't appreciated substantially or that has a small loss (so that no gain or only a small amount of gain will be recognized) but which you expect to hold until after 2005 and anticipate substantial appreciation. You should use caution, however, in making the election for property with a significant loss, since the loss is not allowed in 2001 or any other year if the election is made.

- **Property That Will Appreciate Substantially and Will be Sold After 2005.** You should consider making the deemed-sale election for stock and other qualifying assets that you expect to appreciate substantially in the future and that you expect to sell after 2005. However, the deemed-sale election only reduces the capital gain rate by two percentage points (from 20% to 18%). So, for the election to be advantageous, the present value of the 2% rate savings after 2005 must be compared with the additional tax due with the 2001 return because of the election. **Planning Alert!** The problem with this calculation is predicting what the actual gain on the sale will be and whether or not the present capital gain rate structure will be in effect when the asset is sold.

- **Net Operating Loss Carryovers.** Making the election might also be a good move if you have net operating loss carryovers to 2001 (that will otherwise expire) to offset any gain resulting from the election.

- **Capital Loss Carryovers.** If you have capital loss carryovers, you may wish to make the deemed-sale election if there are capital losses sufficient to eliminate the gain triggered by the election. This could be beneficial where you hold depreciable real estate that has appreciated in value. Making the election for the depreciable real estate could result in additional depreciation at no current tax cost. Also, if you have both capital loss carryovers and passive activity loss carryovers, capital losses and passive activity losses may both be allowed in 2001 to the extent of any gain resulting from making the deemed-sale election for a qualifying passive activity asset.

- **Nonrefundable Credits.** It could be beneficial to make the election for qualifying appreciated assets where there are unused nonrefundable credits for 2001. In this situation, the tax created by the deemed-sale would be offset by credits that will otherwise be lost.

- **Spreading 2002 Gain over 2 Years.** Making the election may enable you to spread the gain on property with respect to which the election is made over 2 tax years (even if you don't get the lower 18% rate because you do not wait 5 years to sell). For example, assume you own stock that was worth $10,000 more than your cost on January 2, 2001 and you have an actual gain on the sale of the stock on October 1, 2002 of $25,000. If you do not make the deemed-sale election, the entire $25,000 gain will be reported in your 2002 return. However, if the deemed-sale election is made for 2001 (IRS says the election can be made as late as October 15,th 2002 for individuals), then $10,000 of the gain is included in your 2001 return and $15,000 is included in your 2002 return.

Whether or not moving gain from 2002 into 2001 will save you money can only be determined by performing calculations to determine the tax savings, if any. Also, if $10,000 of the gain is included in the 2001 return and additional income tax is generated, you will have paid tax a year early on the $10,000.

6. Where Election May Not Be Advisable

   - Savings Do Not Exceed Additional 2001 Tax and Lost Earnings on Additional Tax. In general, you should not make the election if the election creates substantial additional tax for 2001 and the tax savings upon the sale of the asset does not justify this early payment of tax. **Planning Alert!** The practical problem here is predicting with reasonable accuracy the amount of future appreciation, when the property will be sold, and what the capital gains rate will be in the year of sale. Also, the deemed-sale election could backfire if you pay a 20% capital gains tax for 2001 on the gain triggered by the election and your capital gain rate for the year of the sale is 8% or there is no capital gain tax in the year of sale because you have capital losses to offset the gains. Under these facts, the election will actually cost you money.

7. The Election Is Irrevocable. The election, once made with respect to an asset, is irrevocable. Consequently, you should not make the election without careful consideration of all the tax ramifications. Also, you should use caution in making the election for property other than marketable stock since the IRS may challenge the value used for computing the gain resulting from the election. If the IRS increases the value significantly upon audit, you could be faced with a tax liability larger than you expected with no way to revoke the election.

8. Making the Election. The election is made on an asset-by-asset basis by reporting the deemed sale(s) on the timely filed return (including extensions) for the tax year that includes the date of the deemed sale (calendar year taxpayers make the election on their 2001 tax returns). If the deemed sale results in a loss, IRS says we should enter zero on the return instead of the amount of the loss (because the deemed sale can't result in a loss). We must attach a statement to your return stating that you are making the deemed-sale election and we must list the assets for which you are making the election. The IRS says we can also make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). In other words, calendar-year individuals may make the deemed-sale election as late as October 15, 2002.

APPENDIX G

STATEMENT OF TIAA-CREF ON STATE CONFORMITY TO FEDERAL TAX LAW CHANGES

STATEMENT OF TIAA-CREF

BEFORE THE

NORTH CAROLINA REVENUE LAWS STUDY COMMITTEE

MAY 28, 2002

NORTH CAROLINA AND EGTRRA CONFORMITY: A SUMMARY

Conforming states

Of the eighteen states not conforming to EGTRRA as of January 2002, eleven states have enacted conformity legislation this year.

EGTRRA Non-Conforming States as of May 2002:
Alabama (administrative guidelines issued), Arizona, Arkansas (administrative guidelines issued), Hawaii (bill with governor), Massachusetts, New Jersey, North Carolina (administrative guidelines issued), Pennsylvania, Wisconsin (bill in conference committee)

States Enacting EGTRRA Conformity in 2002 (budget deficit information in parenthesis):
California* - ($23.6 billion est.)
Georgia
Idaho ($36.7 million est.)
Indiana ($1 billion est.)
Iowa ($212.5 million est.)
Kentucky (shortfall to be reported 6-30-02)
Maine ($180 million est.)
Minnesota ($200 - $400 million est.)
South Carolina ($320 million)
West Virginia ($100 million est.)

* California enacted partial conformity

EGGTRA Nonconformity Issues:

Rollovers, Aggregation Rules / Contribution Limits, Compensation Limits and Elective Deferral Limits / Tax Deferred Annuity Calculations, Hardship Distributions, Distribution Rules

NC Department of Revenue Guidelines

- Creates additional cost of monitoring for enforcement of state laws vs. federal law
- Does not resolve participant and institution uncertainty surrounding EGTRRA non-conformity
- Does not discuss changes with regard to rollovers and new calculations as a result of EGTRRA,
- Still subjects employees to the old federal Maximum Exclusion Allowance
- Does not provide for catch-up contributions

Potential problems for the state

- Cost of noncompliance vs. compliance.
- State as an employer will also have to create dual accounting mechanisms and separate enforcement procedures.
- Does not eliminate the need for NC to amend tax forms and publications.
- Residents of North Carolina will not be able to take advantage of higher savings limits and catch-up contribution provisions. Retirement savings will be discouraged.

Benefits of enacting a bill:

- Administrative remedies cannot go as far as a legislative change.
- Enacting EGTRRA's rollover provisions will have no cost to the state.
- EGTRRA's provision allowing employees to use 403(b) money to purchase service credit in various state retirement plans could translate into more money for the state to manage.
- Enacting pension conformity will allow North Carolina to ease into the cost of total EGTRRA conformity.
- Will relieve employers - including the state - of administrative uncertainty.

STATEMENT OF BRIAN USISCHON, TIAA-CREF

Revenue Laws Study Committee, May 28, 2002

My name is Brian Usischon. I am a Consulting Officer with TIAA-CREF and I provide pension plan consulting to colleges, universities and other non-profit organizations in the analysis, development, design and installation of employee benefit plans. I have been a resident of North Carolina for ten years, having worked as the Director of Benefits for Wake Forest University School of Medicine in Winston-Salem from 1992 through 2000. In addition, I have served on the board of trustees of the Work Family Resource Center in Winston-Salem, a non-profit Child Care Resource and Referral Program that has administered grant funds for the Smart Start Program.

I am here to provide you with some brief comments from the input I have received from employers around the state, including the University of North Carolina, Wake Forest University and Duke University.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) includes a substantial array of reforms related to retirement savings—66 provisions in all. The benefits of these reforms to academic faculty and staff will improve over the 10-year life of the law, as contributions and other ceilings increase. Taken together, all these changes will increase the amount that can be saved for retirement and greatly simplify the calculations for determining employer and employee plan contributions. In addition, the record-keeping required to correctly administer pension and tax deferred annuity plans has been considerably reduced by EGTRRA, except in states that have not passed conforming legislation.

Human Resource professionals who have become familiar with the provisions of EGTRRA are anxious to see the state pass conforming legislation so that they can make changes to comply with the new law and introduce innovations to their retirement programs that will capture the full benefits of the new law.

Here are some examples of the EGTRRA issues that employers in North Carolina are faced with:

Rollovers

EGTRRA created new opportunities for employees to roll over money between different types of retirement plans, particularly with regard to supplemental retirement plans. Under EGTRRA, such rollovers would not be subject to tax on the federal level, however, in nonconforming states such rollovers to other retirement vehicles would subject a taxpayer to state personal income tax. Enacting EGTRRA's rollover provisions will have no cost to the state because such transfers were not allowed previously and they were not a source of revenue for the state. EGTRRA also allows employees to purchase service credit in state retirement plans using 403(b) money. Adopting EGTRRA's rollover provisions could increase the amount of 403(b) money available for such state service credit purchases and could result in more money coming to the state.

Example: An employee decides to rollover his account balance of $200,000 in a 403(b) plan to a governmental 457(b) plan. Before EGTRRA this could not be done and if the state does not conform its laws to EGTRRA, the rollover will be treated as a taxable distribution under state law and plans receiving such rollovers may become disqualified under state law. This topic was not covered in the release issued by the Department of Revenue.

Aggregation Rules

EGTRRA repeals the complex contribution aggregation requirements of 403(b), 401(k) and 457(b) plans, thus encouraging employees to save for retirement. Employers are concerned that with the state not conforming to EGTRRA, employers and providers will be faced with a larger burden to track and report non-excludable contributions for state tax.

Contribution Limits

Employees are limited as to how much they may contribute annually to a defined contribution plan by IRC Section 415. Under EGTRRA, the limit is the lesser of $40,000 or 100% of compensation, and will be increased periodically in $1000 increments based on the cost of living. Under the old Section 415, the total limit was the lesser of $35,000 or 25% of compensation. It is unclear which limit will apply for North Carolina employees.

Additionally, before EGTRRA, contributions to 403(b) plans were subject to the Maximum Exclusion Allowance (MEA) Calculation (a complex calculation that includes multiple variables of data including salary, years of service, any breaks in service, and prior employer & employee contributions), which ensured that when the total amount of contributions that could be excluded from taxable income had been made, the overage of retirement contributions in a given year was subject to taxation as income. The MEA calculation was repealed under EGTRRA but would still be required for state purposes.

Elective Deferral Limits

It is difficult to maintain two separate systems for elective deferrals to Tax Deferred Annuity (TDA) Plans. Under EGTRRA's revision of IRC Section 402(g), employees may make an annual elective deferral to a 401(k) or 403 (b) plan of up to $11,000 (rising to $15,000 by 2006). Under the old version of section 402(g), employee elective deferrals were limited to $10,500 and were subject to the MEA calculation (see above). The MEA calculation would apply to elective deferrals to 403(b) plans.

Example: An employee makes an elective deferral of $11,000 in 2002 to her 403(b) plan, which is allowable on the federal level under post-EGTRRA rules. Since the state does not conform to EGTRRA and imposes either the MEA limit or the previous IRC 402(g) limit of $10,500. Five hundred dollars (or more if using the MEA calculation) of the contribution is not excluded from salary for state tax purposes.

Employers are concerned that if an employee achieves the higher EGTRRA limit, how are earnings on contributions, not excluded from salary for state tax purposes treated? Where will the burden fall with respect to record-keeping these amounts: to employers, providers or to employees?

Employers are concerned that contribution amounts not excluded from salary for state tax purposes will be even greater for employees who attempt to reach the limits allowed by the new catch-up provision of EGTRRA.

Compensation Limits

The IRC 401(a)(17) limit on compensation that can be taken into account under a plan increased under EGTRRA from $170,000 to $200,000. Employers are concerned as to how contributions will be treated if they use the higher limits for calculating employer contributions.

EGTRRA Technical corrections were included in the Job Creation Act of 2002. Under this Act, the definition of compensation for a 457(b) plan was changed to be the same definition as is used for qualified plans and 403(b) plans. Prior to this Act, the 457(b) definition of compensation excluded items such as elective deferrals to 403(b) plans, 401(k) plans, SEPs, Simple IRAs and 457 plans, cafeteria plans (IRC Section 125) and transportation benefits (IRS Section 132).

Hardship Distributions

Employers are concerned about the new hardship distributions rules approved under EGTRRA. Prior to EGTRRA, if an employee requested a hardship withdrawal, elective deferrals were suspended for a twelve-month period and the amount of the distribution reduced the elective deferral limit in the year contributions resumed. EGTRRA allows elective deferral contributions to resume after six months and the amount of the hardship withdrawal does not reduce the limit on elective deferrals.

Distribution Rules
Providers like TIAA-CREF must report distributions from a governmental 457(b) plan on IRS Form 1099-R under EGTRRA, rather than as wages on W-2 as under prior federal law. Such distributions to participants in non-conforming states would, it appears, have to be reported on a Form W-2, in which case the amount of wages reported for federal and state tax purposes on the individual's W-2 will not match and will have to be tracked and reported correctly. Employers are concerned that this could have an impact on an employee's decision to participate in a 457(b) plan.

Beyond the short-term benefits of EGTRRA lies an important and attractive opportunity for saving for retirement over the next ten years. Over the next few years, as recruitment, retention, and retirement patterns and needs continue to change at colleges and universities, employers will need to evaluate the programs they are offering and the potential benefits available under such programs to their employees. Passing EGTRRA conforming legislation will give North Carolina employers the opportunity to keep their benefit programs competitive and at the same time reduce significantly the record-keeping burdens that would be required to administer these programs.

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APPENDIX H

CHARTS ON STATES' CONFORMITY WITH THE FEDERAL ACTS

State Conformity to the Temporary Increase in the Depreciation Allowance Provided in the Job Creation and Worker Assistance Act of 2002

Automatically Conforming	Conforming Legislation Introduced	Conforming Legislation Passed	Automatically Decoupled	Decoupling Legislation Introduced	Decoupling Legislation Passed
Alabama		Maine[4]	Arizona	Connecticut	Maryland[8]
Alaska		West Virginia	Arkansas[1]	Illinois[7]	Virginia
Colorado			Florida	Kansas	Nebraska
Delaware			Georgia[5]	Massachusetts	District of Columbia
Louisiana			Hawaii	Rhode Island	
Michigan			Idaho[6]	Wisconsin	
Missouri			Indiana[6]		
Montana[1]			Iowa		
New Jersey			Kentucky		
New Mexico			Minnesota		
New York			Mississippi		
North Dakota			Nevada[1]		
Ohio			New Hampshire		
Oklahoma			North Carolina		
Oregon[1]			South Carolina		
Pennsylvania[2]			South Dakota[1]		
Tennessee			Texas[1]		
Utah			Wyoming		
Vermont[3]					

In addition: California uses its own depreciation schedule, and Washington has no income or business tax that provides a depreciation allowance.

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[1] No regular session in 2002.

[2] Secretary of Revenue has proposed decoupling.

[3] The Vermont Legislature is reviewing alternatives to the federal provisions that would affect 2001 Vermont corporate and personal income tax calculations retroactively. One recommended alternative is to exclude the temporary 30% depreciation bonus that applies retroactively to affect 2001 tax returns.

[4] Contingent upon balance in special fund.

[5] For purposes of Georgia corporate income and personal income taxes, any reference to the Internal Revenue Code refers to the IRC of 1986 as it existed on January 1, 2002 (previously, January 1, 2001), effective for tax years beginning after 2001. Since the JCWAA was enacted on March 9, 2002, Georgia does not adopt these provisions.

[6] This state has updated its tax code reference to conform to the changes made by EGTRRA but chose not to conform to the bonus depreciation provisions in JCWAA.

[7] The Illinois House of Representatives amended S.B. 1543 on May 1, 2002, to provide that, for taxable years 2001 and thereafter, to determine base income for Illinois corporate and personal income tax purposes, taxpayers must add to their federal adjusted gross income an amount equal to the bonus depreciation deduction (30% of the adjusted basis of qualified property) taken on the taxpayer's federal income tax return.

[8] S323 passed April 4, 2002.

State Conformity with the Estate Tax Provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001

Automatically Conforming		Conforming Legislation Introduced	Conforming Legislation Passed	Automatically Decoupled	Decoupling Legislation Introduced	Decoupling Legislation Passed
Alabama[1]	Nevada[1]	Arizona[2]	Georgia[4]	Arkansas[11]	Illinois	Minnesota
Alaska	New Hampshire	California	Indiana[5]	District of Columbia	Maine[15]	Rhode Island[17]
Colorado	New Jersey	Hawaii[3]	Idaho[6]	Kansas[12]	Vermont	Washington[18]
Delaware	New Mexico		Iowa[7]	New York[13]	Connecticut[16]	Wisconsin[19]
Florida[1]	North Dakota		Kentucky[8]	North Carolina		Maryland
Massachusetts	Ohio		South Carolina[9]	Oregon		
Michigan	Pennsylvania		West Virginia[10]	Virginia[14]		
Mississippi	Tennessee					
Missouri	Texas					
Montana	Utah					
Nebraska	Wyoming					

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[1] The state constitution prohibits an estate tax greater than the federal pickup, so once the credit is completely phased out, the state could not continue collecting an estate tax unless it amended its constitution.

[2] SB 1071

[3] HB 2566 and SB 2824

[4] HB 1026

[5] P.L. 177 (HB 1195); for purposes of adjusted gross income and supplemental net income taxes, references to the IRC are updated to refer to the version in effect as of January 1, 2002. In addition, the Indiana estate tax and generation skipping tax will be phased out and repealed in concert with the federal taxes.

6 Amendments to the Internal Revenue Code made by EGTRRA have been adopted, ensuring that the changes made to the federal estate tax apply to Idaho estate tax. (Ch. 59 (H.B. 492), Laws 2002, effective January 1, 2002.)

The legislation provides that the state estate tax credit will be computed under the federal estate tax law in effect on January 1, 2002.

[7] HF 2116

[8] HB 457 has passed both houses and has been presented to the Governor.

[9] H4695 signed by the Governor on April 22, 2002.

[10] SB 661

[11] The state estate tax credit is computed under the federal estate tax law in effect on January 1, 1999. The state legislature is not expected to meet again until 2003.

[12] The state estate tax credit is computed under the federal estate tax law in effect on December 31, 1997.

[13] The state estate tax credit is computed under the federal estate tax law in effect as of July 22, 1998.

[14] The state estate tax credit shall not be less than allowable under the federal estate tax law in effect on January 1, 1978.

[15] While the Governor has proposed decoupling from the federal estate tax provisions, conforming legislation for the retirement portions of EGTRRA is expected.

16 The Connecticut Joint Finance, Revenue, and Bonding Committee has approved Substitute S.B. 611, which includes a freeze on state estate taxes at the federal tax rates that applied on January 1, 2001. The freeze would become effective on July 1, 2002, and would apply to any transfer occurring, or estate commencing, on or after that date.

[17] The state estate tax credit is computed under the federal estate tax law in effect on January 1, 2001 (passed on July 5, 2001).

[18] The state estate tax credit is computed under the federal estate tax law in effect on January 1, 2001 (passed on July 1, 2001).

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[19] "Federal credit" means, for deaths occurring after September 30, 2002, and before January 1, 2008, the federal estate tax credit allowed for state death taxes as computed under the federal estate tax law in effect on December 31, 2000, and for deaths occurring after December 31, 2007, the federal estate tax credit allowed for state death taxes as computed under the federal estate tax law in effect on the day of the decedent's death.

APPENDIX I

FISCAL SUMMARY OF INTERNAL REVENUE CODE UPDATE

INTERNAL REVENUE CODE UPDATE SUMMARY

Conformity Category	Conformity Status	North Carolina Conformity Cost ($ Million)						
		01-02	02-03	03-04	04-05	05-06	06-07	
Economic Growth and Tax Relief Reconciliation Act of 2001 (June 2001)								
Education	Tentative conformity by Revenue Department (DOR), subject to legislative action		(14.6)	(20.5)	(25.3)	(27.8)	(15.8)	
Pensions, IRA's	Tentative conformity by DOR, subject to legislative action		(6.1)	(14.3)	(18.5)	(24.7)	(29.4)	
Estate Tax	No conformity at present due to the way the state tax law is worded		(28.5)	(49.4)	(72.2)	(83.6)	(87.4)	
Other	Tentative conformity by DOR, subject to legislative action						(12.8)	
Job Creation and Worker Assistance Act of 2002 (March 2002)								
Bonus Depreciation	DOR is tentatively allowing conformity on 2001 final returns but asking taxpayers to delay filing amended returns until legislative action takes place. It is unclear whether taxpayers will adjust their 2002 estimated tax payments for April and June.	(90.3)	(213.2)	(152.2)	(83.1)	0.0	89.2	(See Notes)
Net operating losses	Tentative conformity by DOR, subject to legislative action		(4.7)	(3.9)	2.5	1.7	1.1	
Other	Tentative conformity by DOR, subject to legislative action		8.5	13.2	(8.4)	(26.1)	(20.3)	
	Total Cost of All Conformity Items	**(90.3)**	**(258.6)**	**(227.1)**	**(205.0)**	**(160.5)**	**(75.5)**	

NOTES: A review of specific estimates of other states and outside groups shows a wide range of results. The estimates shown are tentative, subject to later modifications. A particular concern is the difficulty of estimating the timing of the relief for the 2001 and 2002 tax years. It is possible that some of the 2001-02 fiscal year cost will be shifted to 2002-03.

ESTIMATED STATE REVENUE EFFECTS OF H.R. 1836 -
The Economic Growth and Tax Relief Reconciliation Act of 2001

[Millions of Dollars]

	Effective	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
[1]							
Marginal Rate Reduction Provisions (Sunset 12/31/10)							
1. Phase-in repeal of Pease cutback of itemized deductions over 5 years.	tyba 12/31/05					(9.30)	(18.86)
2. Phase-in repeal of the personal exemption phaseout over 5 years.	tyba 12/31/05					(3.48)	(7.02)
Total of Marginal Rate Reductions Provisions (Sunset 12/31/10)						**(12.78)**	**(25.88)**
Education Provisions (Sunset 12/31/10)							
1. Education IRAs - increase the annual contribution limit to $2,000; allow education IRA contributions for special needs beneficiaries above the age of 18; allow corporations and other entities to contribute to education IRAs; allow contributions until April 15 of the following year; allow a taxpayer to exclude Ed IRA distributions from gross income and claim the HOPE or Liretime Learning credits as long as they are not used for the same expenses; repeal excise tax on contributions made to education IRA when contribution made by anyone on behalf of same beneficiary to QTP; modify phaseout range for married taxpayers; allow tax-free expenditures for elementary and secondary school expenses; expand							

the definition of qualified expenses to include certain computers and related items. [3]	tyba 12/31/01	(1.23)	(2.21)	(2.79)	(3.39)	(4.03)	(4.70)
2. Qualified Tuition Plans - tax-free distributions from State plans; allow private institutions to offer prepaid tuition plans, tax-deferred in 2002, with tax-free distributions beginning in 2004; allow a taxpayer to exclude QTP distributions from gross income and claim the HOPE or Lifetime Learning credits as long as they are not used for the same expenses; expand definition of family member to include cousins; allow tax-free distributions for actual living expenses; ease rollover limitations; clarify coordination with the deduction for high education expenses. [3]	tyba 12/31/01	(0.15)	(0.32)	(0.49)	(0.67)	(0.85)	(1.03)
3. Employer Provided Assistance - permanently extend the exclusion for undergraduate courses and graduate level courses. [3]	cba 12/31/01	(3.14)	(4.35)	(4.59)	(4.86)	(5.15)	(5.46)
4. Student loan interest - eliminate the 60-month rule; increase phaseout ranges to $50,000-$65,000 single/$100,000-$130,000 joint; indexed for inflation after 2002. [2]	ipa 12/31/01	(0.81)	(1.17)	(1.25)	(1.32)	(1.38)	(1.46)
5. Eliminate the tax on awards under the National Health Corps Scholarship program and F. Edward Hebert Armed Forces Health Professions Scholarship program.	tyba 12/31/01	No significant state fiscal impact					
6. Above-the-line deduction for qualified higher education expenses in 2002 through 2005. [3]	tyba 12/31/01	(9.27)	(12.46)	(16.21)	(17.59)	(4.41)	--
Total of Education Provisions (Sunset 12/31/10)		**(14.60)**	**(20.51)**	**(25.33)**	**(27.83)**	**(15.82)**	**(12.65)**

Pension and IRA Provisions (Generally Sunset 12/31/10)							
Individual Retirement Arrangement Provisions							
1. Modification of IRA Contribution Limits - increase the maximum contribution limit for traditional and Roth IRAs to: $3,000 in 2002 through 2004, $4,000 in 2005 through 2007, and $5,000 in 2008; index in years thereafter.	tyba 12/31/01	(2.70)	(6.23)	(7.75)	(12.44)	(17.24)	(18.98)
2. IRA Catch-Up Contributions - increase maximum contribution limits for traditional and Roth IRAs for individuals age 50 and above by $500 in 2002 and $1,000 in 2006.	tyba 12/31/01	(0.51)	(1.11)	(1.28)	(1.29)	(1.65)	(2.15)
3. Deemed IRAs under employee plans.	pyba 12/31/02	No significant state fiscal impact					
Total of Individual Retirement Arrangement Provisions		**(3.21)**	**(7.34)**	**(9.03)**	**(13.73)**	**(18.89)**	**(21.13)**
Provisions for Expanding Coverage							
1. Increase contribution and benefit limits:							
a. Increase limitation on exclusion for elective deferrals to: $11,000 in 2002, $12,000 in 2003, $13,000 in 2004, $14,000 in 2005, and $15,000 in 2006; index thereafter [4][5].	yba 12/31/01	--	(0.74)	(2.41)	(3.68)	(4.67)	(5.20)
b. Increase limitation on SIMPLE elective contributions to: $7,000 in 2002, $8,000 in 2003, $9,000 in 2004, and $10,000 in 2005; index therafter [4][5].	yba 12/31/01	(0.07)	(0.22)	(0.31)	(0.37)	(0.40)	(0.43)
c. Increase defined benefit dollar limit to $160,000	yba 12/31/01	(0.17)	(0.31)	(0.34)	(0.35)	(0.35)	(0.36)
d. Lower early retirement age to 62; lower normal retirement age to 65.	yba 12/31/01	(0.02)	(0.03)	(0.03)	(0.04)	(0.04)	(0.04)
e. Increase annual addition limitation for defined contribution plans to $40,000 with indexing in							

$1,000 increments [4].	yba 12/31/01	(0.05)	(0.11)	(0.14)	(0.15)	(0.12)	(0.12)
f. Increase qualified plan compensation limit to $200,000 with indexing in $5,000 increments [4] and expand availablity of qualified plans to self-employed individuals who are exempt from the self-employment tax by reason of their religious beliefs.	yba 12/31/01 & tyba 12/31/01	(0.40)	(0.87)	(0.92)	(1.05)	(1.04)	(1.15)
g. Increase limits on deferrals under deferred compensation plans of State and local governments and tax-exempt organizations to: $11,000 in 2002, $12,000 in 2003, $13,000 in 2004, $14,000 in 2005, and $15,000 in 2006; index thereafter [4][5].	yba 12/31/01	(0.21)	(0.45)	(0.64)	(0.79)	(0.93)	(1.01)
2. Plan loans for S corporation owners, partners, and sole proprietors.	yba 12/31/01	(0.15)	(0.24)	(0.25)	(0.26)	(0.29)	(0.30)
3. Modification of top-heavy rules.	yba 12/31/01	(0.02)	(0.05)	(0.06)	(0.06)	(0.08)	(0.08)
4. Elective deferrals not taken into account for purposes of deduction limits.	yba 12/31/01	(0.35)	(0.65)	(0.76)	(0.82)	(0.87)	(0.93)
5. Repeal of coordination requirements for deferred compensation plans of State and local governments and tax-exempt organizations [4].	yba 12/31/01	(0.12)	(0.20)	(0.20)	(0.18)	(0.17)	(0.18)
6. Definition of compensation for purposes of deduction limits [4].	yba 12/31/01	(0.01)	(0.02)	(0.02)	(0.02)	(0.02)	(0.02)
7. Increase stock bonus and profit sharing plan deduction limit from 15% to 25% [4].	tyba 12/31/01	(0.04)	(0.08)	(0.09)	(0.11)	(0.11)	(0.12)
8. Option to treat elective deferrals as after-tax							

Roth contributions.	yba 12/31/05	--	--	--	--	1.36	1.73
9. Small business (100 or fewer employees) tax credit for new retirement plan expenses - first 3 years of the plan.	[6]	No estimate available - could deduct expenses if credit not used.					
10. Treatment of nonresident aliens engaged in international transportation services.	tyba 12/31/01	(0.01)	(0.05)	(0.05)	(0.05)	(0.06)	(0.06)
Total of Provisions for Expanding Coverage		**(1.62)**	**(4.02)**	**(6.22)**	**(7.93)**	**(7.79)**	**(8.27)**
Provisions for Enhancing Fairness for Women							
1. Additional catch-up contributions for individuals age 50 and above - increase the otherwise applicable contribution limit for all plans other than SIMPLE by $1,000 in 2002, $2,000 in 2003, $3,000 in 2004, $4,000 in 2005, and $5,000 in 2006 and thereafter; index in $500 increments after 2006; SIMPLE plan catch-ups would be 50% of that applicable to other plans; (nondiscrimination rules would not apply)[4].	tyba 12/31/01	(0.91)	(1.79)	(1.72)	(1.21)	(0.74)	(0.62)
2. Equitable treatment for contributions of employees to defined contribution plans [4].	yba 12/31/01	(0.33)	(0.62)	(0.72)	(0.78)	(0.83)	(0.89)
3. Faster vesting of certain employer matching contributions.	cf pyba 12/31/01	No significant state fiscal impact					
4. Simplify and update the minimum distribution rules by modifying post-death distribution rules.	yba 12/31/01	--	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
5. Clarification of tax treatment of division of section							

457 plan benefits upon divorce.	tdapma 12/31/01	No significant state fiscal impact					
6. Modification of safe harbor relief for hardship withdrawals from 401(k) plans.	yba 12/31/01	No significant state fiscal impact					
7. Waiver of tax on nondeductible contributions for domestic or similar workers.	tyba 12/31/01			(0.01)	(0.01)	(0.03)	(0.04)
Total or Provisions for Enhancing Fairness for Women		**(1.24)**	**(2.42)**	**(2.46)**	**(2.01)**	**(1.61)**	**(1.56)**
Provisions for increasing Portability for Participants							
1. Rollovers allowed among governmental section 457 plans, section 403(b) plans, and qualified plans.	da 12/31/01	0.20	(0.03)	(0.03)	(0.04)	(0.04)	(0.04)
2. Rollovers of IRAs to workplace retirement plans.	da 12/31/01	No significant state fiscal impact					
3. Rollovers of after-tax retirement plan contributions.	dma 12/31/01	No significant state fiscal impact					
4. Waiver of 60-day rule.	da 12/31/01	No significant state fiscal impact					
5. Treatment of forms of qualified plan distributions.	yba 12/31/01	No significant state fiscal impact					
6. Rationalization of restrictions on distributions.	da 12/31/01	No significant state fiscal impact					
7. Purchase of service credit in governmental defined benefit plans.	ta 12/31/01	No significant state fiscal impact					
8. Employers may disregard rollovers for cash-out amounts.	da 12/31/01	No significant state fiscal impact					
Total of Provisions for Increasing Portability for Participants		**0.20**	**(0.03)**	**(0.03)**	**(0.04)**	**(0.04)**	**(0.04)**

Provisions for Strengthening Pension Security and Enforcement							
1. Phase-in repeal of 160% of current liability funding limit; extend maximum deduction rule.	pyba 12/31/01	(0.08)	(0.12)	(0.21)	(0.21)	(0.22)	(0.22)
2. Notice of significant reduction in plan benefit accruals.	pateo/a DOE	No significant state fiscal impact					
3. Repeal 100% of compensation limit for multi-employer plans.	yba 12/31/01	(0.01)	(0.03)	(0.03)	(0.03)	(0.03)	(0.04)
4. Modification of section 415 aggregation rules for multiemployer plans.	tyba 12/31/01	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
5. Investment of employee contributions in 401(k) plans.	aiii TRA '97	No significant state fiscal impact					
6. Prohibited allocations of stock in an ESOP S corporation.	[7]	0.02	0.04	0.04	0.06	0.06	0.07
7. Automatic rollovers of certain mandatory distributions.	dma frap	--	--	(0.05)	(0.21)	(0.22)	(0.24)
8. Clarification of treatment of contributions to multiemployer plans.	yea DOE	--	(0.08)	(0.14)	(0.24)	(0.28)	(0.26)
Total of Provisions for Strengthening Pension Security and Enforcement		**(0.08)**	**(0.20)**	**(0.40)**	**(0.64)**	**(0.70)**	**(0.70)**
Provisions for Reducing Regulatory Burdens							
1. Modification of timing of plan valuations.	pyba 12/31/01	No significant state fiscal impact					
2. ESOP dividends may be reinvested without loss of dividend deduction.	tyba 12/31/01	(0.12)	(0.29)	(0.35)	(0.37)	(0.39)	(0.41)

3. Repeal transition rule relating to certain highly compensated employees.	pyba 12/31/01	(0.01)	(0.02)	(0.02)	(0.02)	(0.02)	(0.03)
4. Employees of tax-exempt entities [8].	DOE	No significant state fiscal impact					
5. Treatment of employer-provided retirement advice.	yba 12/31/01	No significant state fiscal impact					
Total of Provisions for Reducing Regulatory Burdens		**(0.13)**	**(0.31)**	**(0.37)**	**(0.39)**	**(0.41)**	**(0.44)**
Miscellaneous Provisions (Generally Sunset 12/31/10)							
1. Adoption credit - increase the expense limit and the exclusion to $10,000 for both non-special needs and special needs adoptions, and beginning in 2003, make the credit independent of expenses for special needs adoptions, permanently extend the credit and the exclusion, increase the phase-out start point to $150,000, index for inflation the expenses limit and the phase-out start point for both the credit and the exclusion, and allow the credit to apply to the AMT [9]	generally tyba 12/31/01	No significant state fiscal impact					
2. Exclude from gross income certain payments made to Holocaust survivors or their heirs. [10]	aro/a 1/1/00	No significant state fiscal impact					
Total		**(20.68)**	**(34.83)**	**(43.84)**	**(52.57)**	**(58.04)**	**(70.67)**

Legend for "Effective" column:
aiii TRA'97 = as if included in the Taxpayer Relief Act of 1997
aro/a = amounts received on or after
bia = bonds issued after
cba = courses beginning after
cf = contributions for
da = distributions after
doa = disasters occurring after
pea = plans established after
pyba = plan years beginning after
rma = requests made after
ta = transfers after
tdapma = transfers, distributions, and payments made after
tyba = taxable years beginning after
yba = years beginning after
yea = years ending after

[1] The estimates presented in this table are based on the fiscal analysis of the Congressional Joint Committee on Taxation. The federal analysis includes the effects of certain behavioral responses to tax proposals, including shifts between nontaxable and taxable sources of income, changes in amounts of charitable giving, and changes in the timing of realization of some sources of income. To derive an estimate for North Carolina for individual income tax changes, the federal income tax receipts for the U.S. were compared to the North Carolina General Fund income tax receipts for the July 2000 to July 1 2001 period (with adjustments for earmarks and refunds). The resulting percentage was .735%. For corporate income tax, a .59% rate was derived using the 1997 US Economic Census on Manufacturing.

[2] According to the State Education Assistance Authority, North Carolina average indebtedness in the 1990's was 65% of national indebtedness.

[3] Based on 1999-2000 tuition,fee, room and board data from the National Center for Education Statistics and enrollment figures from the Abstract of Higher Education in NC 1999-2000, the higher education costs of in-state students is 82.2% of the national average.

[4] Provision includes interaction with other provisions in provisions for Expanding Coverage.

[5] Provision includes interaction with the Individual Retirement Arrangement Provisions.

[6] Effective for costs paid or incurred in taxable years beginning after December 31, 2001, with respect to qualified employer plans established after such date.

[7] Generally effective with respect to years beginning after December 31, 2004. In the case of an ESOP established after March 14, 2001, or an ESOP established on or before such date if the employer maintaining the plan was not an S corporation on such date, the proposal would be effective with respect to plan years ending after March 14, 2001.

[8] Directs the Secretary of the Treasury to modify rules through regulations.

[9] 97% of the federal estimated loss is from the tax credit.

[10] In July 1999, NC had .3% of US Jewish population according to the American Jewish Year Book printed by the American Jewish Committee in 2000. The NC population is 2.86% of the US population according to the US Census.

ESTIMATED STATE REVENUE EFFECTS OF HR 3090 - JOB CREATION AND WORKER ASSISTANCE ACT OF 2002

			[Millions of Dollars]						
	Provision	Effective	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
	Business Provisions [1]								
1.	Special depreciation allowance for certain property - 30% expensing of the value of capital assets with MACRS lives of 20 years or less, leasehold improvements, and purchased software with one-year placed in service extension for certain property subject to a long production period; conform AMT depreciation allowance (sunset after 36 months). Estimated loss of $90.3 million in 2001-02. [2]	ppisa 9/10/01	(213.20)	(152.20)	(83.10)	0.00	89.20	86.00	82.30
2.	5-year carryback of net operating losses and waive the AMT 90% limitation on the allowance of losses (including losses carried forward into tax years ending in 2001 and 2002) (sunset after 24 months). [3]	NOLs gi tyea 12/31/00	(4.68)	(3.91)	2.48	1.69	1.12	0.74	0.50
	Total of Business Provisions		**(217.88)**	**(156.11)**	**(80.62)**	**1.69**	**90.32**	**86.74**	**82.80**
	Tax Benefits for Area of New York City Damaged in Terrorist Attacks on September 11, 2001 [4]								
1.	30% bonus depreciation for property placed in service in the Liberty Zone				no estimate available on impact on NC firms				

2.	Increase in section 179 expensing by $35,000; only half the cost of section 179 Liberty Zone property taken into account when apply the phaseout threshold (sunset 12/31/06)		no estimate available on impact on NC firms						
3.	Extension of replacement period to 5 years for certain property involuntarily converted in the New York Liberty Zone on 9/11/01, and substantially all of the use of the replacement property is in New York City.		no estimate available on impact on NC firms						
	Miscellaneous and Technical Provisions								
1.	Reverse the Supreme Court's decision in Gitlitz v. Commissioner (relating to subchapter S corporations)	[5]	0.25	0.56	0.63	0.65	0.67	0.69	0.71
2.	Limit use of non-accrual experience method of accounting to amount to be received for the performance of qualified professional services.	tyea DOE	0.03	0.33	0.28	0.17	0.09	0.05	0.06
3.	Exclusion for foster care payments to apply to payments by qualified placement agencies.	tyba 12/31/01	(0.12)	(0.21)	(0.26)	(0.32)	(0.38)	(0.45)	(0.51)
4.	Temporary increase in the highest specified percentage applied to the interest rate used in determining additional required contributions to defined benefit pension plans and PBGC variable rate premiums (sunset 12/31/03)	[6]	11.52	23.48	2.04	(14.62)	(7.76)	(9.58)	(10.41)
5.	Above-the-line deduction for teacher classroom expenses capped at $250 annually for 2002 and 2003. [7]	tyba 12/31/01	(1.93)	(1.96)		-	-	-	-
	Total of Miscellaneous and								

	Technical Provisions		**9.75**	**22.19**	**2.69**	**(14.13)**	**(7.38)**	**(9.29)**	**(10.15)**
	Technical Corrections to Previously Enacted Legislation	**DOE**	No significant state fiscal impact						
	Extensions of Certain Expiring Provisions								
1.	Deductions for qualified clean-fuel vehicles property and qualified clean-fuel refueling property (sunset after 24 months).	ppisa 12/31/01 [8]	(0.19)	(0.68)	(0.75)	(0.64)	(0.27)	0.37	0.47
2.	Suspension of 100 percent-of-net-income limitation on percentage depletion for oil and gas from marginal wells (sunset 12/31/03)	tyba 12/31/01	No significant state fiscal impact						
3.	Authority to issue qualified zone academy bonds (sunset 12/31/03)	oia DOE	-	-	-	(0.08)	(0.11)	(0.12)	(0.12)
4.	Extension of Archer medical savings accounts ("MSAs") (sunset 12/31/03)	1/1/2002	No significant state fiscal impact						
5.	Extension of accelerated depreciation and employment tax credit for incentives on tribal lands (through 12/31/04) [9]	DOE	-	0.00	(0.01)	(0.02)	(0.01)	0.00	0.00
6.	Extension of exceptions under Subpart F for active financing income (allow use of foreign statement of insurance reserves pursuant to guidance) (sunset 12/31/06)	tyba 12/31/01	(1.86)	(8.79)	(9.94)	(11.23)	(12.56)	(8.97)	-
7.	Permanent suspension of requirement that terminals selling diesel fuel and kerosene must sell both dyed and undyed fuel.	1/1/2002	No significant state fiscal impact						
	Total of Extensions of Certain Expiring Provisions		**(2.05)**	**(9.47)**	**(10.69)**	**(11.97)**	**(12.95)**	**(8.72)**	**0.35**
	NET TOTAL		**(210.18)**	**(143.39)**	**(88.63)**	**(24.40)**	**69.98**	**68.73**	**73.00**

Legend for "Effective" column:

DOE = date of enactment
gi = generated in
NOLs = net operating losses
oia = obligations issued after
ppisa = property placed in service after
pyba = plan years beginning after
tyba = taxable years beginning after
tyea = taxable years ending after

[1] The estimates presented in this table are based on the fiscal analysis of the Congressional Joint Committee on Taxation. The federal analysis includes the effects of certain behavioral responses to tax proposals, including shifts between nontaxable and taxable sources of income, changes in amounts of charitable giving, and changes in the timing of realization of some sources of income. To derive an estimate for North Carolina for individual income tax changes, the federal income tax receipts for the U.S. were compared to the North Carolina General Fund income tax receipts for the July 2000 to July 1 2001 period (with adjustments for earmarks and refunds). The resulting percentage was .735%. For corporate income tax, a .59% rate was derived using the 1997 US Economic Census on Manufacturing.

[2] A binding contract placed-in-service extension would apply in certain cases.

[3] Since North Carolina has its own statutes covering net economic losses, this federal change only applies to individuals. The Joint Committee on Taxation estimates that 90% of the federal loss is for corporations and 10% individuals.

[4] The New York City Liberty Zone is defined as all business addresses located on or south of Canal Street, East Broadway, or Grand Street in the Borough of Manhattan, New York, NY.

[5] The provision generally applies to discharges of indebtedness after October 11, 2001. The provision does not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganziation field with a bankruptcy court on or before October 11, 2001.

[6] Effective with respect to plan contributions and PBGC variable rate premiums for plan years beginning after December 31, 2001, and before January 1, 2004.

[7] 100,397 public school teachers, guidance counselors, principals and other instructional support personnel projected in 2002-03 and 101,847 projected in 2003-04. Private school staff estimated to be 11,025 in 2002-03 and 11,104 in 2003-04. Assume all will use the deduction and assume 7% tax bracket.

[8] The deduction phases down for vehicles placed in service after 12/31/03. The deductible amount is reduced by 25 percent in 2004, 50 percent in 2005, and 75 percent in 2006. No expensing is available after 2006.

[9] The Cherokee reservation has .936% of the nation's reservation housing units based on the 2000 Census. This percentage is applied to the total estimated federal loss.

APPENDIX J

DEPARTMENT OF REVENUE'S ADMINISTRATION OF FEDERAL ACTS

Administration of EGTRRA's Pension and Retirement Provisions
North Carolina Department of Revenue

The federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), signed by President Bush on June 7, 2001, made numerous changes to the pension and retirement provisions of the Internal Revenue Code. Some of these changes affect contribution amounts to various retirement plans and portability options for these plans. The changes begin to take effect for federal law in 2002.

EGTRRA changed federal law on these matters, but it did not change North Carolina law. North Carolina's individual income tax law is tied to the Internal Revenue Code as it exists on a certain date. That date is set in G.S. 105-228.90(b)(1b), and the date is currently January 1, 2001. Chapter 427 (House Bill 232) of the 2001 Session Laws sets the date at January 1, 2001. This date does not include the changes made by EGTRRA.

North Carolina's individual income tax law was revised in 1989 to use federal taxable income, as defined in the Internal Revenue Code as of the date set in G.S. 105-228.90, as the starting point for calculating State taxable income. Since 1989, the North Carolina General Assembly has reviewed the changes made to the Internal Revenue Code each year by federal legislation and has always changed the date set in G.S. 105-228.90 to a date that includes the federal changes.

North Carolina uses a fixed date as the reference date to the Internal Revenue Code for two reasons. One is a policy reason and one is a legal constraint. The policy reason for specifying a particular date is that, due to the many changes made to federal tax law from year to year, the State may not want to adopt all federal changes automatically, particularly when the changes result in large State revenue increases or decreases. More importantly, however, the North Carolina Constitution imposes a legal constraint. Section 2(1) of Article V of the North Carolina Constitution prohibits a delegation of the taxing power. The Attorney General's Office has advised that an automatic adoption of future federal tax changes would be invalidated as an unconstitutional delegation of legislative power.

As a result of the need for the General Assembly to review federal tax changes before adopting them for North Carolina purposes, the reference date of the Internal Revenue Code in G.S. 105-228.90 is almost always out of alignment with the most recent federal changes. This poses administrative problems of varying degrees for taxpayers as well as for the Department of Revenue. For example, tax returns for a tax year are sometimes due before the General Assembly has had a chance to review federal changes that affect the returns filed. The Department has always handled the federal and State income tax alignment problem by allowing taxpayers to file returns as if the State's reference date to the Internal Revenue Code included the most recent federal changes.

The dilemma posed by the lack of alignment in the EGTRRA retirement and pension provisions is substantial. If North Carolina law is not aligned with the federal on these matters, plan participants can make contributions under federal law that will have different consequences for federal tax purposes than for State tax purposes. For taxpayers to report the proper amount of State tax, the North Carolina individual income tax return would need to be revised to reflect these differences. Various add-backs would be needed to account for the differences on the "front end" when contributions are made and various deductions would be needed to account for the differences on the "back end" when contributions are withdrawn. Plan administrators would need to track the differences and tax practitioners would need to explain the differences to taxpayers who are likely to be totally confused.

The Department will recommend to the 2002 General Assembly that the State conform to these changes for both practical and policy reasons. The Department is quite mindful, however, of the problems created by a loss of revenue and recognizes that other changes may need to be made in the tax laws to avoid a revenue loss.

If the General Assembly chooses not to conform, the Department will modify its tax forms accordingly and will waive certain penalties. It will waive all penalties that might otherwise apply to plan administrators for failure to withhold tax on contributions that are exempt from federal tax but are subject to State tax. It will also waive estimated tax penalties that might otherwise apply to individuals who have more taxable income under State law than under federal because their contributions are subject to State tax. These waivers will apply for the 2002 tax year.

Administration of EGTRRA's Estate Tax Provisions
North Carolina Department of Revenue

The federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), signed by President Bush on June 7, 2001, made significant changes to the estate tax provisions of the Internal Revenue Code. The changes increase the amount excluded from federal estate tax and phase out the state death tax credit. The changes begin to take effect for decedents dying on or after January 1, 2002.

EGTRRA changed federal law on these matters, but it did not change North Carolina law. North Carolina's estate tax law is tied to the Internal Revenue Code as it exists on a certain date. That date is set in G.S. 105-32.1(1) and G.S. 105-228.90(b)(1b), and the date is currently January 1, 2001. Chapter 427 (House Bill 232) of the 2001 Session Laws sets the date at January 1, 2001. This date does not include the changes made by EGTRRA.

Until the General Assembly changes the law, the amount of estate tax imposed under North Carolina law will continue to be the maximum credit for state death taxes allowed under section 2011 of the Code as of January 1, 2001. Similarly, the amount excluded from tax will continue to be the amount set in the Code as of January 1, 2001.

This lack of conformity poses practical problems for taxpayers as well as for the Department of Revenue. For example, a decedent who dies in 2002 with a gross estate of $800,000 is not required to file a federal estate tax return. The estate, however, exceeds the filing threshold of $700,000 applicable under the Code as of January 1, 2001, and a State estate tax return must be filed. The tax due is the amount that equals the federal state death tax credit calculated under the Code as of January 1, 2001. To file the North Carolina return, the taxpayer must complete a federal estate tax return under the law as of January 1, 2001, even though no federal tax is due.

An estate tax return is due nine months after the decedent's date of death. The General Assembly meets in short session starting in May, 2002. The General Assembly may address this issue in the short session. Given this possibility, the Department advises taxpayers to wait to file returns for decedents dying in 2002 until after the General Assembly adjourns in 2002.

FROM DOR WEB SITE

Job Creation and Worker Assistance Act of 2002 - Impact on North Carolina Income Tax Returns

On March 9, 2002, President Bush signed the Job Creation and Worker Assistance Act of 2002. The Act contains several income tax provisions. The Department of Revenue has received several inquiries as to the impact of the Act on North Carolina income tax returns since the State's current statutory reference to the Internal Revenue Code is to the Code as enacted as of January 1, 2001. Each year the Legislature considers updating the reference to the Internal Revenue Code to adopt the changes enacted by Congress to the Code since the last update. Until the Legislature takes action this summer, it is uncertain whether the Act's income tax provisions will be adopted for North Carolina income tax purposes. The two provisions included in the Act that will impact the most North Carolina taxpayers are the 30 percent bonus depreciation allowance and the extension of the net operating loss carryback period from two to five years. The **additional 30 percent bonus depreciation allowance** is available for certain assets placed in service after September 10, 2001, and before September 11, 2004. Taxpayers are still entitled to the normal first-year depreciation on the remaining basis of the asset after reducing the basis by the bonus depreciation. This provision affects both corporate and individual income taxpayers. Because North Carolina's income tax returns do not provide instructions on how to report depreciation in a manner different than that reported on the federal return, the Department will process current year original returns as if the Code reference date included the provisions in the Job Creation and Worker Assistance Act. If the Legislature elects not to adopt the bonus depreciation provision, taxpayers who claimed the bonus depreciation on their original returns must amend their returns and pay any tax and interest due. Taxpayers who have already filed original returns and who now are filing amended federal returns to claim the bonus depreciation should delay filing amended North Carolina returns until the Legislature determines whether it will adopt the bonus depreciation provision. If a taxpayer files an amended return to claim the bonus depreciation, the Department will not process that amended return until the matter is resolved legislatively. The **carryback period for net operating losses occurring in tax years ending in 2001 and 2002** is extended from two to five years for federal income tax purposes. For State income tax purposes, this change affects only individual income taxpayers because North Carolina does not follow the net operating loss provisions for corporate income tax purposes. Individuals filing amended federal returns to carry back a 2001 or 2002 net operating loss should delay filing amended North Carolina returns until the Legislature determines whether it will adopt the additional carryback period provision. If a taxpayer files an amended return to claim a carryback of a 2001 or 2002 net operating loss, the Department will not process that amended return until the matter is resolved legislatively. *Last modified on: 03/19/02 09:57:13 AM.*

APPENDIX K

QUALIFIED BUSINESS VENTURE TAX CREDIT

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May 27, 2002

MEMORANDUM

TO: Revenue Laws Study Committee

FROM: Richard Bostic

SUBJECT: Qualified Business Tax Credit Program

Credit Outline

The bullets below briefly describe the Qualified Business Tax Credit Program. A more detailed program description has been prepared by Committee Counsel and included in the committee handouts.

- This individual income tax credit is for the direct purchase of equity securities or subordinated debt of a Qualified Business Venture (QBV) or a Qualified Grantee Business. The Department of Secretary of State registers companies as QBVs.
- The tax credit is taken in the tax year after the calendar year of investment and any unused credit may be carried forward 5 years.
- The credit is administered by Department of Revenue and limited to $6 million in total credits each tax year.
- The credit sunsets January 1, 2003.

QBV & QGB

Businesses seeking Qualified Business Venture (QBV) or a Qualified Grantee Business (QGB) status apply to the Securities Division of the Department of the Secretary of State. GS 105-163.013 requires QBV firms to be engaged primarily in manufacturing, processing, warehousing, wholesaling, research and development, and services. QGB firms qualify by virtue of receiving a grant from the NC Technological Development Authority, NC First Flight, Inc., the NC Biotechnology Center, the Microelectronics Center of NC, the Kenan Institute for Engineering, Technology, and Science, or the Federal Small Business Innovation Research Program. Based on business descriptions of 539 current and former QBVs provided to the Fiscal Research Division by the Department of the Secretary of State, the qualified firms can be broken down as follows:

	# of Firms
Service Related	246
Research and Development	202
Manufacturing	73
Wholesaling	13
Processing	3
Warehousing	2
	539

The broad definition of QBV has allowed a wide range of companies to qualify for the investor credit. As expected in 1990's, a major sub-category of these firms were software developers (92) and providers of services over the internet (94). Many of the research and development firms were associated with the Research Triangle Park or directly with the state's major universities. However, one may not have expected state tax credit investment into beer microbreweries (4), an ACC sports magazine (1), a day care center (1), assisted living facilities (2), golf course developers (2), a dry cleaner (1), and a bowling center (1). If North Carolina wanted to narrow the focus of its investment credit it might look to New York state. New York provides a Qualified Emerging Technologies Companies Capital Tax Credit to encourage investment in emerging technology companies. Investments in a qualifying company held for 4 years earns the investor a tax credit equal to 10% of the investment up to $150,000. Hold the investment for nine or more years and you earn a credit equal to 20% of the investment up to $300,000.

Credit History

The $57.5 million in investment tax credits awarded from 1989 to 2001 were for reported investments of $350.1 million. Approximately 70% of the investment came from individuals and 30% from LLCs, partnerships, or other pass through entities.

Year Credit Claimed	Individuals	Corporations/ Pass-Throughs	Total
1989	$1,028,882		$1,028,882
1990	784,235	564,345	1,348,580
1991	2,270,392	624,425	2,894,817
1992	3,327,527	606,805	3,934,332
1993	4,122,857	589,056	4,711,913
1994	6,005,769	5,744	6,011,513
1995	2,285,551	1,238,343	3,523,894
1996	2,583,748	2,093,473	4,677,221
1997	2,322,317	3,677,683	6,000,000*
1998	4,235,771	1,108,870	5,344,641
1999	4,714,892	1,285,108	6,000,000*
2000	4,221,732	1,778,268	6,000,000*
2001	3,612,777	2,387,223	6,000,000*
	$41,516,450	**$15,959,343**	**$57,475,793**

*In these years, total credits requested exceeded $6 million. Actual requests were as follows:

1997	$9,250,000
1999	6,450,000
2000	7,000,000
2001	19,000,000

What companies have received investments that qualify for the credit? Individuals or pass-through entities that apply for the Qualified Business Investment tax credit must file a form D-499 with their income tax returns. A taxpayer must list the name and amount invested in a Qualified Business Venture or a Qualified Grantee Business. The Personal Taxes Division of the Department of Revenue compiles information from the D-499. In the last five years, 270 firms received investments of $209.9 million and their investors received approximately $28.9 million in tax credits. Approximately 25% of the credits ($7.3 million) have been taken by 18 venture capital funds. Five of the top ten recipients of credits are venture capital firms.

	1997 through 2001 Returns	
Business	**Investment**	**Credit**
Tristate Investment Group III LLC	$8,692,811	$1,472,703
Heartland Outdoor Brands Inc	5,866,366	1,127,801
Piedmont Venture Management Inc.	6,050,000	930,955
Aurora Ventures II LLC	4,623,669	910,871
Intersouth Partners IV LP	5,529,620	791,405
Southeast Interactive Technology Fund II LLC	4,482,515	771,528
Xanthon Inc.	5,081,999	674,131
Raindrop Geomagic Inc	5,500,000	632,972
Volumetrics Medical Imaging (3D Ultrasound)	2,612,352	631,911
Lambda Technologies	3,875,883	594,703

State of Incorporation

Of the 270 firms receiving investment tax credits, 98 (36.3%) are incorporated outside the state of North Carolina. Of these 98 firms, 95 are incorporated in Delaware. Five of the top 10 tax credit recipients have Delaware incorporations. Why incorporate in Delaware when all company assets are in North Carolina? It is argued that corporations choose Delaware because it has the most advanced and flexible corporate statutes in America, it has a long history of corporate case law, and it has a Secretary of State very effective in working with corporations. However Michael Mazerov of Washington, D.C.'s Center on Budget and Policy Priorities might argue that firms move to Delaware to avoid taxation of income derived from their patents, trademarks, or other intangible property. (HB 1157 in the 2001 Session closed a tax loophole involving royalties from trademarks.) Delaware has a special income tax exemption for corporations whose activities are limited to owning and collecting income from intangible assets. To avoid tax, a company will transfer ownership of patents and other intangible property to subsidiary corporations called passive investment companies (PIC) that are located in states such as Delaware. These PICs charge a royalty to the main corporation for use of the patent. The royalty then becomes a deductible expense for the main corporation and thus reduces its profit. Sometimes the profit from the PIC is loaned back to the main corporation and the interest from that loan also becomes a deductible expense. Without an audit or review from the Department of Revenue, it is not known if the out of state firms taking the investment credit are using this tax avoidance strategy.

Economic Impact

Based on a survey of companies with investors that utilized the qualified business tax credit program, tax credit proponents project that 2,811 full time jobs have been created with a payroll of $160.37 million. The survey estimates that $295.5 million of private funds were invested into these companies and that $11.22 million in state income taxes were paid.

The estimated number of jobs created by QBVs may be too high. The Employment Security Commission (ESC) was asked to provide the Fiscal Research Division with the number of jobs reported by current and former QBVs and QGBs. The ESC found 109 firms with 1,574 jobs in their database. While the ESC had some trouble matching company names to their database, their figure is actual not estimated. One reason the actual is lower than estimated is that some firms have dissolved since they received investments. In a search of the Secretary of State's corporations database, 74 QBVs have formally discontinued business in NC since 1994. Of that number, 22 had received investment from 1997 to 2001 that resulted in $1.8 million in tax credits. Other QBVs have reported significant layoffs or have been reported as closed in the past two years. Sciquest reported personnel layoffs of 40 in November 2000 due to restructuring and 105 in March 2001 due to realignment of software sales and service. NxView had staffing as high as 60, but had reduced that number to 4 by September 2001 due to financial difficulties. Worknet went from a staff of 230 to a staff of 40 by late 2001. Paradigm Genetics laid off 20 people in February 2002. Business journals have reported that Zingbill, Vios, Thinksource, and Johnson Beer Company have closed their businesses.

The Department of Revenue has not substantiated the estimate of state income taxes paid by QBVs. Nor has the Department compiled data on the compliance of investors with GS 105-163.012(d) that states that "The taxpayer's basis in the equity securities or subordinated debt acquired as a result of an investment in a qualified grantee business shall be reduced for the purposes of this Article by the amount of the allowable credit." The Department relies on voluntary compliance with this provision and admits it does not have the resources to track these investments to determine when they are disposed of.

The question for any tax credit is would the investment have been made without the incentive. The tax credit does reduce the risk of investing in start up businesses, but venture capitalists are willing to take high risk in order to receive high returns at a later date. Venture capitalists carefully screen the technical and business merits of potential companies. For the most promising ideas the investment would have been made without the tax credit. Perhaps the credit allows investors to gamble on firms that do not meet venture capital fund standards and have a higher likelihood of failure had the public subsidy not been available. This memo cannot answer this question without more indepth study.

Administration

QBVs and QGBs pay a $100 filing fee for initial application for registration with the Secretary of State and pay a $50 annual renewal fee. The revenue from this fee is deposited into the General Fund and benefits neither the Secretary of State nor the Department of Revenue. The qualified business investment program is an unfunded mandate for both departments. Until recently, the Secretary of State had assigned one person to administer the program. However, that person has been reassigned and his replacement has not been named. The Secretary of State has not provided an estimate of what it needs to run the program. The Department of Revenue estimates that it spends between $7,500 and $10,000 managing the applications for tax credit from investors. The Department estimates it would need $52,000 to fund an auditor to examine businesses that seek QBV qualification and investors who claim the credits.

In renewing the tax credit, the General Assembly might consider transferring all authority for the program to the Department of Revenue. The registration and renewal fee could be increased to a level high enough to cover the administrative and audit costs of the tax credit program. For example, if the 185 current qualified businesses paid $500 each year, the resulting $92,500 in revenue might be sufficient to cover the Department's cost. An alternative funding method would be to allow the Department of Revenue to deduct its administrative costs from the $6 million earmarked from the General Fund each year before the credit is allocated to investors.

Testimony before the Revenue Laws Study Committee
May 28, 2002
Monica Doss - President
Council for Entrepreneurial Development

Good morning Mr. Chairman and members of the Revenue Laws Study Committee. My name is Monica Doss and I currently serve as the president of the Council for Entrepreneurial Development, also known as CED – the largest and one of the oldest member-based entrepreneurial support organizations in the nation. Located in the Research Triangle Park, we serve greater than 5000 individual members, representing more than 1200 entrepreneurial companies, financiers and professional firms. Formed in 1984 to stimulate the creation and growth of high-impact companies in the greater Research Triangle region, CED provides education, mentoring and capital formation resources to new and existing high-growth entrepreneurs.

This morning, I would like to ask you to support extension of the Qualified Business Venture tax credit, also known as the QBV Credit. The QBV Credit is a mainstay of North Carolina's small business financing infrastructure, allowing individual investors up to a 25% tax credit for investments in qualified small companies. The Credit is North Carolina's only tax incentive specifically targeted to small business startups and is an essential element in the initial financing of many early-stage high-growth companies. Most claimants are so-called "angel investors" who typically provide the critical first few hundred thousand dollars of capital for startup businesses.

Currently, 153 companies are registered as QBV qualified through the Office of the Secretary of State. Among 52 QBV companies that responded to a recent survey, the average company employed a total of 23 full-time workers with a payroll of $1.57 million. Using the figures from the survey respondents to project results for all of the QBV qualified companies, collectively we estimate the companies employ as many as 2800 people, have likely raised as much as $295 million in private equity investments, and potentially paid as much as $11 million in payroll taxes last year alone.

While I understand and empathize with the dire financial challenges you face in such a difficult economic budgeting cycle, the Credit may only be claimed in the tax year after a qualifying investment is made. Therefore, extending the Credit will not affect State revenue collections until the 2003-2004 fiscal year and will have no impact on the current State budget.

QBV Companies are important to North Carolina because they create large numbers of high-paying jobs; attract – and spend – large amounts of capital investments; create a large demand for goods and services in the community; and provide tax revenue to the state that more than pays for the cost of the credit in terms of payroll taxes, corporate taxes on earnings, capital gains on investment returns and other revenues. In the end, the growth of these companies resonates throughout our entire economy.

I respectfully urge your favorable consideration of extending this QBV Credit.

Monica Doss
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Testimony in Support of Extension of the Qualified Business Venture Tax Credit

Thank you Mr. Chairman and members of the Revenue Laws Study Committee for this opportunity to testify in support of extension of the Qualified Business Venture Tax Credit ("QBV Credit"). My name is Donovan Moxey and I am one of the founders of LIPSinc., a company based in the Research Triangle Park that produces animation software for use in television production and interactive gaming. I am a graduate of both NC A&T and NC State University.

My company grew out of NC State's Technology, Education and Commercialization Program ("TEC Program"). The TEC Program, sponsored by NCSU's College of Management teaches students about building business and commercialization cases for technology companies, and allows them access to original technology at NCSU. During my last semester at NC State, while finishing my PhD, I spun my animation software company out of the TEC Program, joined the Council for Entrepreneurial Development ("CED"), and wrote a formal business plan. The CED connected me to potential angel investors.

One of the first questions that I was asked by potential investors was whether I was a "qualified business venture". Being able to show potential angel investors that my company was qualified for the QBV Credit gave my company a degree of credibility that helped me to attract the investment that I needed to get my company off of the ground. During the first round of funding, my company was able to attract $1.3 million from 26 angel investors – 22 based in North Carolina. In the second round, my company raised $9.5 million from 42 investors – 38 from North Carolina. $6 million of that sum came from venture capital investors and $3.5 million was additional angel investor funding. Today, LIPSinc has 15 employees and the average salary is $55,000.

Qualifying under the QBV Credit was a stamp of approval that attracted the investment that led to the success of my company. North Carolina reaps many rewards from such investments – including increased revenue to the state and the creation of good paying jobs. I urge the North Carolina General Assembly to continue this Credit.

Testimony to the Revenue Laws Study Committee
May 28, 2002
Respectfully submitted by: Donovan Moxey

Testimony Supporting Extension of the Qualified Business Venture Tax Credit, Revenue Laws Study Committee, May 28, 2002

My name is Peter Young and I am President and CEO of AlphaVax, Inc, a company located in Research Triangle Park. Thank you for this opportunity to testify in support of extension of the Qualified Business Venture Tax Credit.

AlphaVax develops vaccines. More specifically, we provide a broad vaccine technology platform that can be used to prevent a wide variety of infectious diseases and cancers. Our lead program is a vaccine to prevent HIV infection, focused on Africa. We are pursuing this vaccine in conjunction with the International AIDS Vaccine Initiative, the National Institutes of Health, and the Republic of South Africa.

Our vaccine technology originated from North Carolina State University, the University of North Carolina at Chapel Hill and the US Army Medical Research Institute for Infectious Disease, with whom we are also exploring applications for vaccines against military and bio-terrorist threats.

AlphaVax was incorporated in 1997. We received a license from UNC in early 1998 and started to raise our first equity investment later that year. Our first round of investments raised $511,000 in June 1999. The Tax Credit was an important incentive and motivation for those investors and played a direct role giving AlphaVax its first equity platform in our earliest formative stages. It helped put us in a position to begin hiring a management team and staff to build an organization. It provided a true springboard for the company.

Today, AlphaVax has 40 employees. We have an average salary of $80,000 and a total annual payroll of $3 million.

From the start that the Tax Credit helped to provide, we have gone on to attract over $10 million worth of out-of-state sponsored research funding and raise over $20 million in equity investment from outside North Carolina. We are spending the great majority of these funds in North Carolina, where we have established a state of the art laboratory and contracted with Greer Laboratories in Lenoir, North Carolina to begin producing small quantities of our first vaccine.

We hope to initiate our first clinical trials with this technology by the end of this year. Those first trials – in HIV – will likely attract global attention that projects North Carolina science and this state's support for cutting edge technology on a worldwide stage. The Tax Credit has helped make this possible and I sincerely hope that you will support its extension. Thank you for your time and for allowing me to testify before the Study Committee.

Support Extension of the Qualified Business Venture Tax Credit

What is the Credit?

The Qualified Business Venture Tax Credit ("Credit") (codified at G.S. 105-163.010 et. seq.) is a mainstay of North Carolina's small business financing infrastructure, allowing individuals up to a 25% tax credit for investments in qualified small companies. Individual credits are capped at $50,000 per year. Total credits awarded to all taxpayers cannot exceed $6 million per year. In years when claims exceed $6 million, available funds are distributed *pro rata* among qualified applicants.

Extending the Credit will not impact the 2002-03 State Budget.

The Credit is currently scheduled to expire January 1, 2003. However, the Credit may only be claimed in the tax year after a qualifying investment is made, so extending the Credit will not affect State revenue collections until the 2003-04 fiscal year. Extending the Credit will therefore have no impact on the current State budget.

The Credit helps small businesses.

The Credit is North Carolina's only tax incentive specifically targeted to small business startups and is an essential element in the initial financing of many early-stage technology companies. Most claimants are so-called "angel investors" who typically provide the first few hundred thousand dollars of capital for startup businesses.

The Credit is working to help start and expand businesses.

Approximately 95 percent of the companies that have pre-qualified as eligible for the Credit have received equity investments from individual investors or angel investment groups. The average individual/angel investment per company was $2.5 million.

Approximately 32 percent of the companies that have applied to be pre-qualified for the Credit also have received equity investment from professional venture capital funds. Because of limitations on the Credit, venture capital firms typically are not eligible to receive the Credit for investments they make in such companies.

The Credit creates jobs and expands the tax base.

A recent survey completed by 52 companies qualified for the Credit showed an average employment of 23 full-time workers and an average annual payroll of $1.3 million.
In all but one year of the period (1998), total claims for the Credit exceeded the $6 million cap, resulting in partial credits to all claimants.

Many North Carolina organizations support extending the Credit.

Supporters of the Credit include:
Council for Entrepreneurial Development (CED)
NC Biosciences Organization (NCBIO)
NC Electronic and Information Technology Association (NCEITA)
NC Venture Capital Association (NCVCA)
National Federation of Independent Business (NFIB)
Tri-State Investment Group (TIG)

For more information, please contact Harry Kaplan at (919) 870-8186 or Sam Taylor at (919) 212-0543.

SURVEY OF STATE INVESTMENT TAX CREDITS

Introduction

North Carolina offers the Qualified Business Tax Credit ("QB Tax Credit") to taxpayers who invest in qualifying businesses. Taxpayers who invest in qualifying businesses may earn a QB Tax Credit that equals up to 25% of that investment. The QB Tax Credit is specifically designed to give taxpayers an incentive to invest in small businesses.

We have reviewed a number of states' tax laws to determine whether they offer similar tax incentives. The states we reviewed were Alabama, Florida, Georgia, Mississippi, New York, South Carolina, Tennessee, Virginia, and West Virginia. The review included a detailed search of the states' governmental web sites as well as conversations with the states' revenue officers.

The Survey's Findings

A vast majority of the states we reviewed offer some sort of tax credits designed to attract businesses to that state and reward businesses for expansion within that state. The following states have tax credits similar to North Carolina's QB Tax Credit: New York, South Carolina, Virginia, and West Virginia.

The Survey's Structure

The Survey is divided by state. Within each state's section there are three subsections. The first subsection addresses the issue whether that state has a tax credit similar to North Carolina's QB Tax Credit. The second subsection provides an outline of the state's other business tax credits. The third subsection details the state's business tax credits. At the end of the sections on certain states are links to particularly useful web sites.

The Survey's Limitations

The survey is not comprehensive. We excluded certain state tax credits that narrowly focused on a particular industry. We primarily gathered the information for our survey from each state's governmental web site and we relied on the validity of those web sites. We did not undertake a through examination of each states' statutes nor did we consult third party legal research tools.

Conclusion

North Carolina's QB Tax Credit is an important tax incentive designed to support small businesses in North Carolina. Other states have similar tax incentives. In order to sustain and nurture a friendly business environment, we recommend that the North Carolina legislature extend the QB Tax Credit.

Alabama

I. Alabama currently does not have an investment tax credit for taxpayers investing in small businesses. The Birmingham Area Technology Task Force ("BATT Force") has written an article concerning BATT Force's proposals to the state legislature to create investment tax credits targeted to attract technology businesses.
(http://www.alatechtoday.com/Jan02/techlaw.html)

II. Other Business Tax Incentives

A. Capital Investment Tax Credit
B. State Enterprise Zone Incentives

III. Description of Business Tax Incentives

A. Capital Investment Tax Credit

The Capital Investment Tax Credit allows qualifying companies to claim a tax credit against their Alabama income tax liability generated by a qualifying capital investment. The amount of the tax credit is 5% of total capital investment each year for 20 years, beginning in the year the project is placed into service.

In order to qualify, small businesses must have one hundred or fewer full-time employees in Alabama prior to the date the capital improvement project is commenced. Also the minimum capital investment must be $1,000,000 and the project must create fifteen new full-time jobs. Finally, there is a minimum average hourly wage requirement. There is no carry forward, carry back, or retroactivity of the tax credit.

B. State Enterprise Zone Incentives

The Alabama Enterprise Zone Program is another tax incentive to help attract new businesses to Alabama. Businesses can accumulate tax credits for creating new jobs in certain geographic areas designated as "Enterprise Zones," for investing in an Enterprise Zone or for improving existing facilities in an Enterprise Zone.

A business's maximum tax credit for operations in the enterprise zone cannot exceed $2,500 per new permanent employee hired. A business also can receive a tax credit of $1,000 per new permanent employee for expenses of training those employees in new skills. Additionally, if a business can certify that at least 30% of new permanent employees hired were formerly unemployed for at least 90 days prior to this employment, then the business qualifies for a tax credit equal to 80% of the 1st year wages; 60% of the 2nd year wages, 40% of the 3rd year wages and 20% of the 4th and 5th years wages.

Businesses that invest in improvements to physical facilities or build new physical facilities can receive a tax credit of 10% on first $10,000 invested, 5% on next $90,000 invested, and 2% on remaining investment

Additionally, businesses may receive an exemption from Alabama sales and use tax on the purchases of the materials used in the construction of a building, or any addition or improvement for housing any legitimate zone business and on machinery and equipment used in an Enterprise Zone.

Finally, businesses may receive certain exemptions from Alabama income and corporate franchise taxes for a period of five years. In order to receive an exemption from income and corporate franchise taxes, the business must: 1) be located in the boundaries of an Enterprise Zone; 2) generally fall into Standard Industrial Classification (SIC) Codes 20-42 or 44-49 or consist of major warehousing, distribution centers, or such other activities having a prospect of significant economic impact without threatening the well-being of existing industries located within the county hosting the Enterprise Zone; 3) expand its labor force, make new capital investment or prevent loss of employment; 4) have not closed or reduced employment elsewhere in Alabama in order to expand into the Enterprise Zone; and 5) obtain an endorsement resolution approved by the appropriate local governing authority.

Florida

Florida does not have a personal income tax. All efforts to attract businesses to Florida are at the business level. The Florida Venture Forum advocates for small businesses; its web site is http://www.flvencap.org/.

Georgia

I. Georgia does not have an investment tax credit for taxpayers investing in small businesses.

II. Other Business Tax Incentives

A. Job Tax Credit
B. Small Business Growth Tax Credit
C. Investment Tax Credit
D. Optional Investment Tax Credit
E. Employee Retraining Tax Credit
F. Tax Credit for Increasing Research Activities

III. Description of Business Tax Incentives

A. Job Tax Credit

The Job Tax Credit encourages economic development in Georgia by providing qualified businesses tax incentives to locate and expand in the state. The job tax credit is available for any business engaged in manufacturing, warehousing and distribution, processing, telecommunications, tourism or research and development. The requirements concerning the number of jobs created and the amount of tax credit depends on the location of the job creation.

The Department of Community Affairs classifies each county into Tiers depending on the level of economic development; Tier 1 is the least developed, Tier 2 is more developed and Tier 3 is the most developed. In order to qualify for the job tax credit of $2,500 for Tier 1, businesses must create an average of 5 or more full-time job. Businesses must create an average of 15 or more full-time jobs to qualify for Tier 2's $1,500 job tax credit. Finally, to qualify for Tier 3's job tax credit of $500, businesses must create an average of 25 or more full-time jobs.

Businesses that use the entire job tax credits can carry forward the tax credit for 10 years. Businesses may not claim both the job tax credit and the investment tax credit, described below, for a given project.

B. Small Company Business Growth Tax Credit

The Small Company Business Growth Tax Credit is a credit for businesses that have significantly increased their net Georgia taxable income over a three-year period. The credit can only be claimed by businesses engaged in manufacturing, warehousing and distribution, processing, telecommunications, tourism, and research and development industries. Retail businesses are specifically excluded.

The credit is "... the excess over 20% of the percentage growth in the business enterprise's Georgia net taxable income in the current taxable year ... ." The credit is limited to 50% of the business's Georgia tax liability after all other tax credits have been applied. There is no provision for any carryover to another tax year.

In each of the two preceding years, the Georgia taxable income of the business must have increased by at least 20% over the Georgia taxable income to the respective immediately preceding taxable year. In the third year (i.e., the year for which the credit is calculated), the growth in Georgia taxable income must be more than 20% over the preceding year. No credits are allowed if the Georgia tax liability of the business is over $1.5 million before application of the credit.

C. Investment Tax Credit

The Investment Tax Credit is available for taxpayers that have operated a manufacturing or telecommunications facility in Georgia for the past three years and invest in new or expanded facilities within Georgia. The amount of credit varies according to the county where an expansion project is located. For purposes of the investment credit, counties in the state are ranked into three tiers in the same manner as they are for the Job Tax Credit. The Investment Tax Credit may be taken beginning in the year following the tax year in which the project is purchased or acquired by the taxpayer. The planned investment must have an aggregate cost in excess of $50,000.00

The amount of the Investment Tax Credit for Tier 1 counties is equal to 5% of the cost of all qualified investment property purchased or acquired for the project in that taxable year. The investment tax credit amount for Tier 2 counties equals 3% of the cost of all qualified investment property purchased and Tier 3 counties rate for investment tax credits is 1%. The investment tax credit taken may not exceed 50% of the taxpayer's Georgia income tax liability for that taxable year. An investment tax credit that is claimed but not used in a taxable year may be carried forward for ten years in which the qualified investment property was acquired.

D. Optional Investment Tax Credit

The Optional Investment Tax Credit operates in the same manner as the Investment Tax Credit except that in order to qualify businesses are required to make a higher aggregate investment and the tax credit percentages are higher. For Tier 1 counties, businesses must purchase qualified investment property with an aggregate cost of at least $5,000,000 and they will receive a tax credit equal to 10% of the cost of all qualified investment property purchased or acquired for the project in that taxable year. For Tier 2 counties, businesses must purchase $10,000,000 of qualified investment property and the Optional Investment Tax Credit equals 8 % of the cost of all qualified investment property purchased. For Tier 3 counties, businesses must purchase $20,000,000 of qualified investment property and the rate for the Optional Investment Tax Credits is 6%.

E. Employee Retraining Tax Credit

The Employee Retraining Tax Credit is for businesses that provide retraining for employees. Businesses can earn a tax credit against their income taxes equal to one-half of the direct cost of retraining full-time employee up to $500 per employee. The Employee Tax Credit cannot exceed 50% of the amount of a business's tax liability. Businesses can carry forward the tax credit for 10 years.

F. Tax Credit for Increasing Research Activities

The Tax Credit for Increasing Research Activities allows businesses to claim a research tax credit, similar to the Federal research credit, for research conducted in Georgia. The amount of the credit is based on a complicated formula that takes into consideration a number of factors. The credit is limited to 50% of the business's Georgia tax liability for the year after all other credits have been deducted. Unused credits maybe carried forward for ten years.

http://www.legis.state.ga.us/departments/dor/inctax/infotaxcr_1197.pdf

Mississippi

I. Mississippi does not have an investment tax credit for taxpayers investing in small businesses.

II. Other Tax Incentives

A. Ad Valorem Credit
B. Rural Economic Development (RED) Credit
C. Jobs Tax Credit

D. National or Regional Headquarters Credit
E. Research and Development Skills Credit
F. Basic Skills Training or Retraining Tax Credit

III. Description of Other Tax Incentives

A. Ad Valorem Credit

An income tax credit is available for ad valorem tax paid on commodities, goods, wares and merchandise held for resale by manufacturers, distributors, and wholesale or retail merchants. The credit is limited to the lesser of $5,000 per location or the income tax attributable to the location. For the credit to be taken, the ad valorem tax must be determined by specific location. The credit may be claimed only in the tax year in which the ad valorem taxes are paid. A carry forward is not available.

The credit cannot be used by any business enterprise or corporation other than the business enterprise actually qualifying for the credits. The credit is not refundable. An expense cannot be used both as a credit and a deduction. If a credit is based on an expense, then the amount of the credit taken must be added back to Mississippi taxable income in the year the credit is used.

B. Rural Economic Development (RED) Credit

An income tax credit is available for debt service on certain bonds issued by the Mississippi Business Finance Corporation. Debt service may include the total amount paid to service the debt. Only debt service paid on revenue bonds issued by the Mississippi Business Finance Corporation to finance economic development projects to induce the location of manufacturing facilities within this state can be taken as a credit. This credit can be used against the taxes due from the income generated by or arising out of an economic development project.

This credit has been amended several times and the applicable credit carry forward periods vary. Currently, excess credits may be carried forward to the three (3) years following the year in which the credit was earned. The credit is limited to 80% of the income tax due on income generated by the economic development project that gave rise to the credit. This income is determined by a formula adopted by the Mississippi Business Finance Corporation. It may be used in combination with any of the other credits. The credit is not refundable. An expense cannot be used both as a credit and a deduction. If a credit is based on an expense, then the amount of the credit taken must be added back to Mississippi taxable income in the year the credit is used.

C. Jobs Tax Credit

Income tax credits are available for: 1) Permanent business enterprises that are primarily engaged in manufacturing, processing, distribution, wholesaling, research and development and warehousing; 2) Permanent business enterprises designated by rule or regulation of the Department of Economic and Community Development as air transportation and maintenance facilities, final destination or resort hotels having a minimum of 150 guest rooms, recreational facilities that impact tourism, movie industry studios or telecommunication enterprises. For the purposes of this credit, the counties in Mississippi are classified as less developed, moderately developed and developed. They are then divided into the three previously mentioned groups with one-third of the counties in each group. The classification for a specific county can change from year to year based on the evaluation. This classification is used to determine the minimum number of jobs a business enterprise must create in a given year before it qualifies for the credit. It is also used to determine the amount of credit per job created.

The jobs tax credit was instituted to encourage construction or expansion of facilities in Mississippi in order to increase employment. The credit is for each net new full time job created as long as the minimum increase has been achieved and maintained. The credit is allowed each year for 5 years beginning in years 2 through 6 after the creation of the job. The unused portions can be carried forward for up to 5 years from the original year in which the excess credit could not be used, but a business must use the oldest year's unexpired credit first. The credits may be used in combination with any of the other credits.

To determine whether a taxpayer with an existing facility, including an expansion at an existing facility, has created the minimum number of jobs to qualify for the credit, the taxpayer must compare the average annual employment level for the previous year with the average annual employment in the current year. If the amount of the increase exceeds the minimum required, then the employer would qualify for the credit. This allows the credit to employers who have not constructed a new facility, but have substantially increased employment at an existing facility. To determine whether a taxpayer with a new facility qualifies for the credit, the average employment for the portion of the year after production was started should be compared with the same period for the previous year. If the increase exceeds the minimum, then the taxpayer would qualify for the credit.

The total of the Jobs Tax Credit, the Headquarters Credit and the Research & Development Skills Credit is limited to 50% of a business's Mississippi income tax liability. The credit is not refundable.

D. National or Regional Headquarters Credit

A credit is available to any company transferring or establishing a national or regional headquarters from within or outside the State of Mississippi and creating a minimum of thirty-five (35) jobs at the headquarters. The amount of the credit is $500.00 for each net new full time employee for the first five (5) years. The minimum increase of thirty-five (35) jobs must occur within one (1) year. Any type of business may qualify for the credit as long as the other criteria are met, but a national or regional sales office does not qualify for the credit. A national headquarters is that office or location of a multi-state business, where managerial, professional, technical and administrative personnel are domiciled and employed. It is the location where the centralized functions such as financial, legal, technical and personnel functions are performed. The function and purpose of the national headquarters is to plan, direct and control all aspects of the organization's operations and it has final authority over all regional offices, operating facilities or any other offices of the business enterprise.

Before the credit is granted, the taxpayer must show that the headquarters will have officers and other high level employees with the support staff normally associated with a headquarters. The support staff for the headquarters is also included in the computation of the credit. The support staff are those full time employees required to assist management and other headquarters personnel to perform functions that are unique to, or required by, the headquarter's operation. Companies that transfer full time headquarter employees into the state that are employed in Mississippi for less than twelve (12) months will be allowed a pro-rated portion of the $500.00 yearly credit in the first and last years. To be used in the credit computation, the employee must be located in Mississippi and subject to withholding tax.

The total of the Jobs Tax Credit, the Headquarters Credit, and the Research & Development Skills Credit is limited to 50% of a business's Mississippi Income Tax liability. The unused portions can be carried forward for up to 5 years from the original year in which the excess credit could not be used, but a business must use the oldest year's unexpired credit first. They may be used in combination with any of the other credits.

E. Research and Development Skills Credit

A credit of $500.00 is available for each net new full time employee in any job requiring research and development skills for the first five (5) years of the employees employment. This credit is available to any company regardless of the business in which it engages. The applicant will be notified on approval of the application for credit. Credit should not be taken until approval is received by the taxpayer. If the employee is employed in Mississippi for less than twelve (12) months, credit will be allowed for a pro-rated portion of the $500.00 yearly credit in the first and last years. To be used in the credit computation, the employee must be located in Mississippi and subject to withholding tax.

The total of the Jobs Tax Credit, the Headquarters Credit, and the Research & Development Skills Credit is limited to 50% of a business's Mississippi Income Tax liability. The unused portions can be carried forward for up to 5 years from the original year in which the excess credit could not be used, but a business must use the oldest year's unexpired credit first. The credit may be used in combination with any of the other credits. The credit is not refundable.

F. Basic Skills Training or Retraining Tax Credit

An income tax credit for expenses related to training or retraining employees is available for businesses that are manufacturers, warehousers, distributors, processors or refiners, or telecommunication enterprises meeting certain minimum criteria established by the Department of Economic and Community Development. The credit allowed is 25% of qualified expenses not to exceed 50% of the income tax liability. Any excess credit will not be refunded, but may be carried forward for up to 5 years. For training to qualify for the credit, it must be both job-related, and for either basic skills training or basic skills retraining. Basic skills are reading, writing and math skills up to the twelfth grade level. The training must be provided by a

Mississippi community college and must be designed to increase opportunities for employee advancement with the employer.

The Basic Skills Training or Retraining Tax Credit may also offset up to 50% of the income tax due. It may be used in combination with any of the other credits. The credit is not refundable. An expense cannot be used both as a credit and a deduction. If a credit is based on an expense, then the amount of the credit taken must be added back to Mississippi taxable income in the year the credit is used.

http://www.mstc.state.ms.us/revenue/incentive/income.pdf

New York

I. Qualified Emerging Technologies Companies Capital Tax Credit

New York State provides a Qualified Emerging Technologies Companies Capital Tax Credit (QETC Capital Tax Credit) to encourage investment in emerging technology companies in the State. For investments in a qualifying companies held for at least four years, taxpayers may claim a credit of 10% of the investment (up to $150,000). If the taxpayer holds the investment for nine or more years, 20% may be taken as a credit (up to a cap of $300,000). Investments made by or on behalf of an owner of the business are ineligible.

The amount of the credit, including carry-overs of the credit, deducted from the tax otherwise due may not, in the aggregate, exceed 50% of the tax imposed (before credits). The credit is not refundable; however any unused credit may be carried over indefinitely. If a taxpayer disposes of or recovers a qualified investment before expiration of the required holding period, a recapture of some or all of the credit is required.

II. Other Business Tax Incentives

A. Investment Tax Credit for Manufacturers
B. Additional Investment Tax Credit & Employment Incentive Credit
C. Industrial or Manufacturing Business (IMB) Credit
D. Empire Zone (EZ) Wage Tax Credit
E. Zone Equivalent Areas (ZEA) Wage Tax Credit
F. EZ Investment Tax Credit (EZ-ITC) & Employment Incentive Credit (EZ-EIC)
G. EZ Capital Tax Credit
H. Enhanced Benefits for Qualified Empire Zone Enterprises (QEZEs)

III. Description of Business Tax Incentives

A. Investment Tax Credit for Manufacturers

General business corporation taxpayers or personal income taxpayers may claim an investment tax credit (ITC) for equipment or buildings used in the production of goods. Corporation franchise taxpayers may claim the ITC for the cost of qualified investment expenditures, including buildings and structural components of buildings that are depreciable, have a useful life of four years or more, are located within the State, and are used principally for the production of goods.

The credit is 5% of up to $350,000,000 of such expenditures and 4% for such expenditures in excess of $350,000,000. Certified pollution control, industrial waste treatment, and acid rain control facilities also qualify for this credit. Eligible costs also include those associated with retail enterprises' investments in qualified rehabilitated buildings. Research and development (R&D) property may qualify for an optional rate of 9%.

B. Additional Investment Tax Credit & Employment Incentive Credit

A business that qualifies for an ITC and increase employment by at least 1% above its employment in the year before it made the investment (base year) may claim an employment incentive credit (EIC) for the next two succeeding years. The EIC rate ranges from 1.5% of the investment tax credit base to 2.5%, depending on the level of increased employment over the base year. General business corporations may claim this credit but banking corporations may not.

C. Industrial or Manufacturing Business (IMB) Credit

Industrial or manufacturing businesses (IMBs) or sole proprietors of IMBs or partners in an IMB are allowed a credit to be taken against taxes. The credit is the sum, or pro-rata share of such, of taxes paid or passed through to the IMB, during the taxable year for gas, electricity, steam, water or refrigeration; or the services of providing such, where they are used or consumed in New York.

Businesses qualifying under the Investment Tax Credit will also qualify for the IMB. That is, any business which during the taxable year is principally engaged in: manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture, commercial fishing or research and development; or is an industrial waste treatment facility or an air pollution control facility; or is principally engaged in a combination of such activities.

D. Empire Zone (EZ) Wage Tax Credit

A business may claim a wage tax credit for doing business and creating jobs in geographic areas designated as Empire Zones (EZs). The credit equals the product of the average number of newly hired EZ employees and the credit amount and may be taken for 5 years. Corporation franchise taxpayers, banks, insurance companies, and personal income taxpayers may claim this credit.

E. Zone Equivalent Areas (ZEA) Wage Tax Credit

Businesses employing individuals in areas eligible to become Empire Zones (EZs) but not so designated (Zone Equivalent Areas or ZEAs), may take a two-year credit for EZ wages paid for full-time employment in jobs created in the ZEA. Businesses must take the credit during the five-year period following designation as a ZEA. The two-year credit equals $3,000 multiplied by the average number of targeted employees and $1,500 multiplied by the average number nontargeted employees hired during the first year. Also, taxpayers may take the credit during a ten-year period following designation as a ZEA. The total wage tax credit cannot exceed 50% of tax due before credits. Corporation franchise taxpayers, banks, insurance companies, and personal income taxpayers may claim this credit.

F. EZ Investment Tax Credit (EZ-ITC) & Employment Incentive Credit (EZ-EIC)

Businesses may also qualify for an investment tax credit of either 8 or 10% of the cost or other federal basis of tangible personal property, including buildings and structural components of buildings located within a designated Empire Zone (EZ). The 8% rate applies to personal income taxpayers; the 10% rate applies to corporations. Also, an employment incentive credit applies in addition to the regular EZ-ITC for businesses that increase their average number of employees by at least one percentage point over the preceding base year. Generally, this credit is 50% refundable to new businesses.

G. EZ Capital Tax Credit

Taxpayers may qualify for credit for investments in zone capital corporations, direct equity investments in certified zone businesses, and contributions to community development projects. The credit equals 25% of the sum of the investments and contributions. The maximum credit per taxpayer is $300,000 and cannot exceed one half of the taxpayer's pre-credit tax. Corporate franchise taxpayers, banks, insurance companies, and personal income taxpayers may claim this credit.

H. Enhanced Benefits for Qualified Empire Zone Enterprises (QEZEs)

Empire Zone businesses that meet an annual test demonstrating job creation can become certified as a QEZE, resulting in benefits that could potentially reduce their tax liability to zero. QEZEs can receive a credit against their income tax for the cost of eligible real property taxes imposed on property owned by the business and located within the Empire Zone. The credit is available for up to 14 years. Any credit not deducted in the current tax year may be refunded. QEZEs are allowed to take a credit against tax equal to a percentage of taxes attributable to the zone enterprise. The credit is available for up to 14 years. This credit is not refundable and any unused credit may not be carried forward to future years. In addition, QEZEs are granted a 10 year exemption from State sales tax on purchases of goods and services (including utility services) used predominantly in such zones.

http://www.tax.state.ny.us/statistics/Tax_Incentives/Default.htm

South Carolina

I. South Carolina has an investment tax credit available to taxpayers that invest in certain types of business. The Economic Impact Zone Stock Deduction is an individual income tax credit equal to 20% of the purchase price (paid in cash) of "economic impact zone stock." Economic impact zone stock is original issue stock of a small "C" corporation that conducts an active trade or business in a designated economic impact zone. At least one-third of the employees must reside in the economic impact zone. The corporation must use the proceeds from the sale of the stock during the following 12 month period to purchase "qualified impact zone property." The maximum amount that a taxpayer may claim as a deduction is $10,000 per year and $100,000 for all tax years.

II. Other Business Tax Incentives

A. Job Tax Credit
B. Job Development and Job Retraining Credits
C. Research and Development Credit
D. Credit for Investing in an Economic Impart Zone
E. Corporate Headquarters Credit

III. Description of Business Tax Incentives

A. Job Tax Credit

South Carolina Code law provides a tax credit against South Carolina income tax or insurance premium tax for a business creating new jobs in the State. To qualify for the job tax credit, a business must: (1) be a certain type of business and (2) create and maintain a required minimum number of "new, full time jobs" at the time a new facility or expansion is initially staffed. The amount of the credit for each new job is $1,500 to $5,500 per year depending, in part, on where a taxpayer's facility is located. The credit is available for 5 years and is adjusted for job increases or decreases.

To obtain the tax credit, a business must be engaged in manufacturing, processing, tourism, warehousing, distribution, or research and development, or must be a qualifying service-related facility or a corporate office facility. A retail facility or service-related industry located in a least developed county may also qualify for the credit. Further, effective for tax years beginning after June 30, 2001, a technology intensive facility is a qualifying business.

In general, a business must increase employment by a monthly average of 10 new full time jobs to qualify for the credit, regardless of the county in which the employer is located. The amount of credit that a business may receive for each job created is determined by the county where the business's facility is located. The 46 counties in South Carolina are ranked and designated as "least developed," "under developed," "moderately developed," or "developed."

B. Job Development and Job Retraining Credits

To qualify for the job development and retraining credits, a business must be located in South Carolina must meet the following criteria:

1. The business must be primarily in the type of business required for the job tax credit, such as manufacturing, tourism, processing, distribution, or research and development.

2. The business must provide a benefits package, including health care, to full time employees at the project site where the investment is made.

3. The business must enter into a revitalization agreement with the Advisory Coordinating Council for Economic Development ("Council") at the Department of Commerce.

4. The Council must determine that the available incentives are appropriate for the project, and the Council must certify to the Department that the total benefits of the proposed project exceed the total costs to the public, and that the qualifying business otherwise fulfills the requirements.

A qualifying business may negotiate with the Council to claim a job retraining credit equal to $500 a year for each production employee being retrained. Qualifying business may not, however, claim a job retraining credit in excess of $2,000 over a 5 year period for any single employee being retrained. Further, a business may not claim the job retraining credit and the job development credit on the same employee.

C. Research and Development Credit

South Carolina law allows a corporation a credit against corporate income tax or corporate license fees imposed under South Carolina Code §12-20-50 equal to 5% of its qualified research and development expenditures made in South Carolina. The credit is limited to 50% of the taxpayer's tax liability remaining after all other credits have been applied. Any unused credit can be carried forward, but must be used before a taxable year beginning 10 years or after from the date of the qualified expenditure. For a corporation to qualify for the credit, the corporation must claim a federal income tax credit pursuant to Internal Revenue Code §41 for increasing research activities for the taxable year.

D. Credit for Investing in an Economic Impart Zone

South Carolina law allows a taxpayer an "economic impact zone investment tax credit" for qualified manufacturing and productive equipment properties that are placed in service during the taxable year in a designated economic impact zone. The credit claimed is limited to $5 million for a business subject to the license tax (including utilities and electric cooperatives). This credit does not apply to any property to which other tax credits apply, unless the qualifying business waives such credits. Any unused credit may be carried forward for 10 years.

E. Corporate Headquarters Credit

South Carolina law grants corporations credits against corporate income tax or corporate license fees for establishing a corporate headquarters in South Carolina, or expanding or adding to an existing corporate headquarters.

The credit is equal to 20% of:

1. Qualifying real property costs incurred in the design, preparation, and development of establishing, expanding, or adding a corporate headquarters, and

2. Direct construction costs or, with respect to leased facilities, direct lease costs for the first 5 years of operations for the headquarters.

The qualifying real property costs involved must be at least $50,000 in order to qualify for the credit. Additionally, the establishment of the headquarters, or addition or expansion, must result in the creation of at least 40 new headquarters related function and service jobs or research and development related function and service jobs. At least 20 of these jobs must be executive, administrative, or professional workers performing headquarters related functions and services. An additional credit equal to 20% of the cost of tangible personal property is also available if the personal property is capitalized under the Internal Revenue Code, purchased for the establishment, expansion, or addition of a corporate headquarters, and is used for headquarters related services or research and development.

If a business claims the headquarters credit, the basis of any property used to calculate the credit must be reduced by the amount of the credit claimed. Any unused credit may be carried forward for 10 years. If, however, certain criteria are met, the credit can be carried forward for 15 years.

http://www.sctax.org/frames/frametaxin.html

Tennessee

I. Tennessee does not have an investment tax credit for taxpayers investing in small businesses.

II. Other Business Tax Incentives

A. Qualified Industrial Machinery Exemption
B. Equipment Sales Tax Exemption
C. Excise Tax Credit
D. Jobs Tax Credit
E. Investment Tax Credit

III. Description of Business Tax Incentives

A. Qualified Industrial Machinery Exemption

A business that sells Qualified Industrial Machinery is exempt from sales tax for such machinery.

B. Equipment Sales Tax Exemption

Tennessee law provides that there is no sales tax on purchases of equipment associated with the required capital investment by a distribution or warehouse facility.

C. Excise tax credit

Excise tax credit equal to 1% of the purchase price of qualified industrial machinery. Also there is an excise tax credit equal to 1% of the purchase price of equipment associated with the required capital investment by a distribution or warehouse facility.

D. Jobs tax credit

Tennessee grants jobs tax credits of $2,000 or $3,000 per new full-time employee for eligible businesses that meet requirement of increased employment and additional capital investment.

E. Investment Tax Credit

Manufacturers are allowed a tax credit of 1% of the cost of industrial machinery.

Virginia

I. The Qualified Equity and Subordinated Debt Investments Credit is Virginia's investment tax credit. The Qualified Equity and Subordinated Debt Investments Credit is available to individual taxpayers making a qualified investment in the form of "equity" or "subordinated debt" in a pre-qualified small business venture.

The credit is equal to 50% of the qualified business investments made during the taxable year. If total annual requests for the credit exceed $5,000,000, the Department of Taxation will pro-rate the credit for each taxpayer. The total amount of credit a taxpayer may claim per taxable year may not exceed their authorized credit, $50,000 or the tax liability, whichever is less. The credit is nonrefundable. Unused credit may be carried forward up to 15 years.

II. Other Business Tax Incentives

A. Enterprise Zone Act Credit
B. Major Business Facility Job Tax Credit
C. Worker Retraining Tax Credit

III. Description of Business Tax Incentives

A. Enterprise Zone Act Credit

Qualified businesses are given a credit against the tax due on their taxable income and may be eligible for real property improvement tax credit and an investment tax credit. The credit is a percentage of the tax due on taxable income from within designated Enterprise Zones. In addition, a credit for percent of unemployment tax due on zone employees may be claimed.

B. Major Business Facility Job Tax Credit

A company engaged in any business in Virginia, except for retail trade business, may claim a Virginia tax credit if the company creates at least 100 new full-time jobs in connection with the establishment or expansion of a major business facility. If a business is located in an Enterprise Zone or in an economically distressed area (as defined by the Virginia Department of Economic Development), the threshold is reduced from 100 new full time jobs to 50.

The credit is equal to $1,000 per qualified full-time employee (in excess of the 100/50 threshold) who was employed during the credit year. The allowable credit may not exceed a business's tax liability. Unused credits may be carried forward for ten years.

C. Worker Retraining Tax Credit

This credit allows a business to claim a tax credit for the training costs of providing eligible worker retraining to qualified employees for taxable years beginning on or after January 1, 1999. The credit may be applied against individual income tax, estate and trust tax, corporate income tax, bank franchise tax, and taxes imposed on insurance companies and utility companies.

Generally, the credit is 30% of all class room training costs or up to $100 annual credit per student if the course work is incurred at a private school. The Department of Taxation is authorized to issue up to $2,500,000 of retraining credits annually. If total requested credits exceed this amount, the Department of Taxation will pro-rate the authorized credits. Credits taken may not exceed a business's tax liability in any one year. Unused credits may be carried over for three years.

http://www.tax.state.va.us/it_credit_pg3.htm - worker

West Virginia

I. The West Virginia Capital Company Credit is available to taxpayers who make a qualified investment.in a qualified West Virginia capital company. The following are among the characteristics required to qualify as a West Virginia capital company: 1) the company must have a reasonably accessible business office in West Virginia that has a listed telephone number and is open to the public during normal business hours; 2) the company must maintain all of its capital base, except that which has been invested in "qualified investments", in bank accounts at financial institutions in West Virginia; and 3) the company must have a capital base of at least $1,000,000 but not more than $4,000,000.

A "qualified investment" is a debt or equity investment in a West Virginia business engaged in one or more of the following activities: manufacturing, agricultural production or processing, forestry production, mineral production, tourism, wholesale or retail distribution, services industries and computer software development.

The credit is for 50% of the amount invested. The total amount of tax credits authorized for a single qualified capital company may not exceed $2,000,000, and the total credits authorized by West Virginia for all capital companies generally may not exceed a total of $10,000,000 per fiscal year. If the amount of tax credit exceeds the taxpayer's liability for the taxable year, the amount of the credit which exceeds the tax liability may be carried forward for up to fifteen years.

II. Other Business Tax Incentives

A. Business Investment and Jobs Expansion Credit
B. Industrial Expansion and Revitalization Credit
C. Research and Development Projects Credit

III. Description of Business Tax Incentives

A. Business Investment and Jobs Expansion Credit

The Business Investment and Jobs Expansion Credit (Super Credit) is available for businesses engaged in the primary activities of manufacturing, information processing, warehousing, goods distribution and destination-oriented recreation and tourism. The types of Super Credit and the general qualifications include the following:

1. Regular credit--A firm that creates at least fifty new jobs within the State over a three-year period as the result of making a capital investment is entitled to this credit.

2. Corporate headquarters relocation credit--Credit is also available to a business that moves its corporate headquarters to West Virginia from a location outside the State. The amount of credit allowed depends on the number of new jobs created in West Virginia by the relocation.

3. Small business credit--A small business may qualify for Super Credit if it creates at least ten new jobs and if it meets the size criteria as defined within the law.

B. Industrial Expansion and Revitalization Credit

The purpose of the Credit for Industrial Expansion and Revitalization is to encourage the establishment of new industry, the expansion of existing industry, and the growth and revitalization of industrial facilities in West Virginia. 10% of the cost of any qualified industrial expansion or revitalization may be claimed as a credit by a business and can be applied against Business and Occupation Tax, Severance Tax or Business Franchise Tax liability or purchases directly used in the investment activity over a ten-year period by three types of taxpayers:

1. manufacturers who produce their own goods,
2. service manufacturers who produce goods that they do not own, and
3. firms that generate electric power.

To qualify for this credit, property must be placed in service or use in this State by the business. In addition, the property involved must be real property, improvements thereto, or tangible personal property. To qualify as an industrial expansion investment, the property must be constructed, leased or purchased as a component part of a new or expanded business facility of an industrial taxpayer. To qualify as an industrial revitalization investment, the property must be constructed, leased, or purchased for use as a component part of an on-going industrial facility.

C. Research and Development Projects Credit

The purpose of this credit is to encourage qualified research and development projects in West Virginia. Qualified research and development projects are those conducted for purposes relating to the technical, economic, financial, engineering or marketing aspects of expanding markets for and increasing sales of West Virginia's natural resources and industrial products. 10% of the qualified investment may be claimed as a credit by a business and can be applied against Business and Occupation Tax, Business Franchise Tax, or Severance Tax over a ten-year period at the rate of 10% per year.

For tax years beginning after December 31, 1988, the Research and Development Project Credit may also be utilized to offset up to 50% of a business's adjusted Corporation Net Income Tax liability. A business electing to use this credit is required to add back 10% of the qualified investment expenses, attributable to the credit, to its federal taxable income in calculating the taxpayer's West Virginia taxable income for West Virginia Corporation Net Income Tax purposes. The sum of the applicable percentage of investment in land and depreciable property placed in service or use during the tax year and the amount of the qualified research expenses deducted by the taxpayer for federal income tax purposes for the tax year shall be considered the qualified investment.

By: Stillman Hanson
April 26, 2002

Snapshot of Companies Who Have Used the North Carolina Qualified Business Venture Tax Credit

Based on responses to date 4/30/02 from 52 companies who have used the QBV Tax Credit.

Average size	23 Full Time Employees
Average age	3.5 Years
Average salary	$57,038
Average payroll	$1.57 million

	Actual aggregated from 52 respondents:	***Projected for all QBV qualifying companies:***
➢ Total Employment:	1209	2811
➢ Total Payroll:	$ 68.95 million	$160.37 million
➢ Most Jobs Created:	PeopleClick, RTP (380)	
➢ Total Private Investment (raised to date):	$127.07 million	$295.52 million
➢ Estimated 2000 earnings:	$39.58 million	$92.05 million
➢ Estimated state income taxes paid in 2001:	$ 4.8 million	$11.22 million

Recent QBV success examples:

Company	Type	Initial Market Value
Paradigm Genetics, Inc.	IPO	$42M
Extensibility	Acquisition	$100M
SciQuest.com	IPO	$120M

QBV Companies are important to North Carolina because they:

- Create large numbers of high-paying jobs
- Attract – and spend – large amounts of capital
- Create a large demand for goods and services in the community
- Provide tax revenue to the state that more than pays for the cost of the credit (payroll taxes, corporate taxes on earnings, capital gains on investment returns)
- Their growth resonates throughout the economy

For more information, please contact Harry Kaplan at (919) 870-8186 or Sam Taylor at (919) 212-0543.

(over)

Comments made about the Credit:

- "This Business Venture tax credit program is absolutely important for growing a start-up company in NC. The state has received more tax from our employees than the credit to investors. The state should continue this program because it is extremely important for North Carolina economic development in the future." – *Ken Chang, Ardent Pharmaceuticals, Durham.*

- "The QBV tax credit is crucial to raising money on the local and regional level." – *Bill Ward, BUILDERadius, Inc., Asheville.*

- "Invaluable. Progressive. Extremely effective. An excellent return on investment for the state. Besides my own sweat and talent, it has been the single most important element in raising venture/angel capital. We have just closed a major deal with Warner Bros. Without this tax credit, I doubt that would have been possible." – *Duncan Brantley, Eat A Peach Pictures, Wilmington.*

- "It was a critical element in us raising equity from North Carolina private investors. In some cases, it was this benefit that swung an investor to invest." – *Gene Pease, Hospitality Partners Inc., Chapel Hill.*

- "Valuable to our investors – helped attract new investors." – *Michael Norris, Invencom, Charlotte.*

- "It is of great value. To end it would be very short-sighted." – *Bill Zahn, Medascope, Inc., Cary.*

- "The lifeblood of this company has been angel investors. It is imperative to keep the QBV tax credit." – *Jeff Reedy, Overture Networks, Research Triangle Park.*

- "Helps raise critical angel round before venture capitalists are interested. Very important." – *David Gardner, PeopleClick, Raleigh.*

- "Invaluable in attracting our initial group of investors." – *Joe Dowd, Piedmont Pharmaceuticals, High Point.*

- "The QBV credit is an invaluable program to help start up businesses secure necessary investments from Angel investors. The credit helps to offset some of the risk involved in investing in start up businesses." – *Warren Grimes, Reedy Creek Technologies, Inc., Four Oaks.*

- "In addition to the contribution that our company makes to the tax base in North Carolina, we also purchase hundreds of thousands of dollars annually from other North Carolina-based companies which allows them to further contribute to the tax base of our great state." – *Van D. Stamey, Salon Dynamics, Kannapolis.*

APPENDIX L

REPORT ON IMPLEMENTATION OF TAX LAW CHANGES
11/30/01

North Carolina Department of Revenue

Michael F. Easley
Governor

E. Norris Tolson
Secretary

November 30, 2001

Report on Implementation of Tax Law Changes

TO: Senator John H. Kerr, III
Representative Paul Luebke,
Co-Chairs, Revenue Laws Study Committee

FROM: Sabra J. Faires
Department of Revenue

This memorandum reports on the Department of Revenue's plans and actions to implement the provisions of Session Law 2001-327 (House Bill 1157). This report is required by section 4(a) of that act. The purpose of the act is to combat tax fraud, enhance corporate compliance with taxes on trademark income, assure that franchise tax applies equally to corporate assets, and conform corporate dividend treatment to the generally accepted formula used in other states. The bill consists of three separate and distinct changes.

Summary of the Law Changes

Income Tax on Royalty Income: Section 1 of the bill addresses the issue of royalty income. A new section, G.S. 105-130.7A, is enacted to specifically state in the law that royalty payments received for the use of trademarks in this State are income derived from doing business in this State. If the royalty income recipient and the payer are related members, the taxpayers have an option concerning the method by which the royalties can be reported for taxation. The royalty payments can be either (i) deducted by the payer and included in the income of the recipient, or (ii) added back to the income of the payer and excluded from the income of the recipient. This section is effective for taxable years beginning on or after January 1, 2001.

Franchise Tax on Corporate Members of LLCs: Section 2 addresses the issue of franchise tax on corporations that are controlling owners of limited liability companies. The intent of the section is to close a loophole that existed in the law because limited liability companies are not subject to franchise tax. A corporation could avoid franchise tax on its assets by transferring the assets to a controlled limited liability company. The new law requires a corporation that is entitled to receive 70% or more of the limited liability company's assets upon the limited liability company's dissolution to include its percentage ownership share of the limited liability company's income, assets, liabilities, and equity in the corporation's calculation of its franchise tax. The new law also emphasizes the application of criminal sanctions against a taxpayer that underpays the franchise tax on assets attributable to it under this provision as the result of fraud with intent to evade the tax. These changes are effective January 1, 2002, for taxes due on or after that date.

Income Tax on Dividends: Section 3 repeals various sections of the law to generally conform to the federal tax treatment of dividend income. This change also conforms to the treatment of dividend income by most other states. As part of the changes, two new deductions were enacted to exclude certain foreign dividends from North Carolina income tax although they are taxed for federal purposes. Under prior law, dividend income was fully taxable if received from a corporation of which the recipient corporation owned 50% or less of the voting stock, and dividend income was nontaxable if received from a corporation of which the recipient corporation owned more than 50% of the voting stock. These changes are effective for taxable years beginning on or after January 1, 2001.

General Actions Taken by the Department

The Department of Revenue has taken the following actions to implement the provisions of the act:

- The three changes are explained in a block of text titled Important Legislative Changes Affecting 2001 Returns in the corporate income tax forms and instructions booklet. The changes are also addressed on the tax forms and in the applicable line instructions within the booklet.

- The three changes are explained in the North Carolina 2001 Tax Law Changes booklet. The booklet is published annually after the General Assembly adjourns. This publication is available upon request and at the Department's website, www.dor.state.nc.us.

- The three changes are explained in various speeches and presentations the Department makes to taxpayers, tax practitioners, lawyers, and other professional groups. By January 1, 2002, the Department will have made presentations to about 500 individuals at various forums and will continue to explain law changes to various groups after that date.

- The three changes are included in the Corporate, Excise, and Insurance Tax Division Rules and Bulletins booklet. This booklet is published every two years and is available to the public upon request and at the Department's website.

- The Department's existing administrative rules will be reviewed and changed, as needed, to incorporate or explain the three law changes.

Actions Specific to the Royalty Income Provisions

Form Changes: The Department made changes to the CD-401S, S Corporation Tax Return, and the CD-405, C Corporation Tax Return. Schedule H, Adjustments to Federal Taxable Income, is revised to reflect the changes. If the election is made for the payer to forgo the deduction for royalty expense and the recipient to exclude the royalty income in North Carolina taxable income, the payer reports an addition on Schedule H, line 1d for the amount of royalty expenses deducted on the federal return and the recipient claims a deduction on Schedule H, line 3d.

Schedule F, line 9 instructs a corporation that is related to another corporation as a parent, subsidiary, or affiliate to identify the relationship and attach a copy of the appropriate federal income tax schedule reflecting the relationship. To ensure compliance with the law, the Department of Revenue can either review the Schedule F information provided by the corporation or request additional information from the corporation to support the adjustment to federal taxable income.

Technical Advice Directive: The Department is in the process of writing a Technical Advice Directive that will be issued to address technical questions and to clarify the Department's administrative position with respect to the royalty income issue. The Directive will include examples that explain when royalty income is taxable in North Carolina. The Directive is expected to be completed by January 15, 2002. When issued, the Directive will be available to the public upon request and at the Department's website.

Actions Specific to the Franchise Tax Provisions

Form Changes: The franchise tax change did not require a change in the tax forms; however, the general instructions for LLCs on page 4 of the instruction booklet was rewritten to explain the law change.

Technical Advice Directive: The Department is in the process of writing a Technical Advice Directive that will be issued to address technical questions and clarify the Department's administrative position with respect to the franchise tax issue. The Directive is expected to be completed by January 15, 2002. When issued, the Directive will be available to the public upon request and at the Department's website.

Actions Specific to the Dividend Provisions

Law Change: The Department recognized that, under HB 1157 as enacted, it is not clear whether the new deductions for foreign dividends are net of related expenses. Under general taxation principles, expenses incurred in earning taxable income are deductible and expenses incurred in earning income that is exempt from tax are not deductible. The Department suggested a clarifying change to the General Assembly. This change was enacted in Section 10 of House Bill 232, Session Law 2001-427.

Form Changes: This change required significant changes to the corporate tax forms. With the change, North Carolina generally follows the federal tax treatment of dividends. This changes the starting point for calculating the North Carolina income tax liability. Previously, the taxpayer began with federal taxable income before the special deductions (dividends received deduction) and any net operating loss. The taxpayer now begins with federal taxable income before any net operating loss. Schedule H is revised to address the foreign dividends that are now deductible.

Future Reports

In addition to this report, Chapter 327 requires the Department of Revenue to report to the Revenue Laws Study Committee by May 1, 2002, and December 1, 2002, on the effects of the act. The report is to include any recommendations the Department has for changes to the act or to other similar provisions of the tax laws.

As a matter of information, we note that we have already held preliminary discussions with General Assembly staff regarding another kind of loophole with respect to the franchise tax. Tax practitioners have pointed out to us that placing a partnership between the corporation and limited liability company will result in the assets transferred to the limited liability company being excluded from franchise tax as before. This is because corporations are not required to include their percentage ownership of a partnership's assets in their calculation of franchise tax and partnerships, like limited liability companies, are not subject to franchise tax.

cc: Secretary Tolson

APPENDIX M

REPORT OF EFFECT OF TAX LAW CHANGES
5/1/02

North Carolina Department of Revenue

Michael F. Easley
Governor

E. Norris Tolson
Secretary

May 1, 2002

Report on Effect of Tax Law Changes

TO: Senator John H. Kerr, III
Representative Paul Luebke
Co-Chairs, Revenue Laws Study Committee

FROM: Sabra J. Faires
Department of Revenue

This memorandum reports on the effects of Chapter 327 of the 2001 Session Laws (House Bill 1157), and includes issues identified by the Department of Revenue concerning changes to that act or to other similar provisions of the tax laws. This report is required by section 4(a) of Chapter 327. This is the second of three reports required by the act. The first report was dated November 30, 2001. That report summarizes the law changes and identifies the actions taken by the Department to implement the act. The final report is due by December 1, 2002.

Effects of the Law Changes

Session Law 2001-327 consisted of three separate and distinct changes. Those changes are:

- Income Tax Reporting Option for Royalty Income
- Franchise Tax on Corporate Members of LLCs
- Income Tax on Dividends

Because the changes were effective for tax returns that were due to be filed on March 15, 2002, or later, it is premature to offer an opinion as to whether the changes will accomplish the act's stated purposes. The purposes of the act, as stated in the act's title, are to combat tax fraud, enhance corporate compliance with taxes on trademark income, assure that franchise tax applies equally to corporate assets, and conform corporate dividend treatment to the generally accepted formula used in other states.

The changes with respect to the income tax on royalty income and the franchise tax on corporate members of LLCs have generated significant interest and numerous questions from taxpayers and tax practitioners. Other states have also expressed interest in North Carolina's manner of addressing the income tax treatment of royalty income as those states consider how to address this problem. Questions that have been raised include:

Income Tax on Royalty Income

- Does the recipient of the royalty income have to file a North Carolina return if the payer of the royalties elects to eliminate its deduction of the royalty expense?
- How does a taxpayer make the election permitted under G. S. 105-130.7A?
- In an unrelated entity situation, when does the trademark holder have nexus in North Carolina and how does it determine its sales factor?
- Can North Carolina impose income tax on a foreign trademark holding company?

Franchise Tax on Corporate Members of LLCS

- Is the new law applicable to franchise tax due on March 15, 2002?
- What effect does being a member of an LLC have on a corporation's computation of its North Carolina franchise tax?
- Does a corporation have nexus in North Carolina by virtue of being a member of an LLC doing business in North Carolina?
- If so, does the corporation have to file a North Carolina corporate income and franchise tax return?

The Department plans to issue Directives to answer these questions. The Directive on the income tax treatment of royalty income will be issued by the end of May. There will be two Directives regarding corporate members of LLCs. One will address whether a corporate member of an LLC has nexus in North Carolina and when the corporate member of an LLC is required to file a North Carolina return. The other Directive will address the provisions of Chapter 327 and explain how the corporate member of an LLC computes its franchise tax. These Directives will be issued by May 10, 2002.

Issues

The Department of Revenue recommends that the General Assembly consider the following issues related to the law changes included in Chapter 327:

- The law changes specifically addresses royalty income from the use of trademarks. How should income from royalties other than trademarks be taxed? For example, should royalty income from patents be taxed based on the location where the product is manufactured or the location where the product is sold?

- As mentioned in the Department's November 30, 2001 report, tax practitioners have already discovered an alternative entity structure to overcome the legislature's attempt to close the franchise tax loophole. Instead of having the corporation transfer its assets directly to an LLC, the corporation transfers the assets to a partnership. The partnership, in turn, transfers the assets to the LLC. A partnership, like the LLC, is not subject to franchise tax. Corporations are not required to include their percentage ownership of a partnership's assets in their calculation of the tangible property base for franchise tax purposes. The new 70% test also does not apply to partnerships that are members of LLCs. Consideration should be given to subjecting LLCs to the franchise tax as recommended by the North Carolina Efficiency and Loophole-Closing Commission.

cc: Secretary Tolson

APPENDIX N

REPORT ON PROJECT COLLECT TAX
11/1/01

North Carolina Department of Revenue

Michael F. Easley
Governor

E. Norris Tolson
Secretary

November 1, 2001

REPORT ON COLLECTION OF TAX DEBT

TO: The Honorable Marc Basnight
President Pro Tempore

TO: The Honorable James B. Black
Speaker of the House

From: E. Norris Tolson
Secretary of Revenue

Norris Tolson

Subject: Project Collect Tax – Collection of Tax Debt

Section 2, Article 9 of Chapter 105 of the 2001 Session Laws requires the Department of Revenue to submit quarterly reports, beginning November 1, 2001 through November 1, 2002 and semiannually thereafter, to the entities listed above on the Department's progress regarding the collection of tax debt. This Section permits the Department of Revenue to outsource tax debt to collection agencies and to impose a 20% collection assistance fee on overdue tax debt. The 20% collection assistance fee is applied to overdue tax debt 30 days after a fee notice is mailed to the taxpayer.

The Department has mailed 232,110 notices informing individuals and businesses owing tax debt that the fee would be added unless the tax was paid or an installment payment plan was agreed upon within 30 days. As a result of these notices, $5,849,630 in tax debt was collected and 3,123 installment payment agreements were established involving $11,351,691 of tax debt.

Collections by Age and Amount

The report must include detail as to the amount and age of three categories of tax debt:

- Collections by Collection Agencies

P.O. Box 25000, Raleigh, North Carolina 27640
State Courier 51-71-00
An Equal Opportunity Employer

- Collections by the Department of Revenue through Warning Letters
- Other Collections by Department Personnel

For the quarter ending September 30, 2001, tax debt collected by the contract **collection agency** was $2,770,184, from collection fee **warning letters** $5,849,630 and $27,790,496 of tax debt **otherwise collected by Department personnel.** In addition, tax collected from **non-filers** totaled $1,703,300. Total tax debt and tax collected from non-filers for the quarter totaled **$38,113,610** (Exhibits I & II).

Collection Plan and Timeline

We have developed several key initiatives that are part of our long-term collection plan, including **Project Collect Tax**. As a result of these initiatives, the agency will become **more aggressive** in collecting overdue tax debts. The initiatives and target implementation dates are as follows:

- **Post Delinquent Taxpayers on the Agency Website - www.dor.state.nc.us**

11-15-01	Mail notice to taxpayers advising on action to be taken
12-01-01	Press release regarding website postings
01-01-02	Delinquent taxpayers are posted on website

- **Hire 44 New Collection Division Employees**

10-15-01	Hire 15 new employees (completed 10-15-01)
11-01-01	Hire 13 new employees (completed 11-01-01)
12-01-01	Hire 16 new employees for the central collection unit

- **Hire 10 Contract Employees For the Collection Division**

10-15-01	Hire 10 former DOR employees on contract (completed 10-15-01)

- **Civil Enforcement Team - Eight (8) Senior Revenue Officers (Purpose of team is to conduct concentrated collection operations)**

7-23-01	Deployed team to Mecklenburg County Collected 2.2 million
11-5-01	Deploy team to Forsyth and Guilford Counties
1-15-02	Deploy team to Wake, Durham and Orange Counties

- **Bankruptcy Collections**

A review of policies and procedures within the Bankruptcy Unit has just been finalized. The enhancements implemented as a result of that study will allow a more timely filing of "proofs of claim" in Chapter 13 cases and a more aggressive monitoring of taxpayers reorganizing under provisions of Chapter 11. It is estimated these enhancements will cause revenues collected by this Unit to increase from $4 million to $7 million annually.

- **Develop Request for Proposal for Outsourcing Collection of In-State Tax Debt**

12-15-01	RFP finalized to solicit additional bids from collection agencies, including in-state collection agencies.
01-01-02	RFP issued
03-01-02	Bid closing
04-01-02	Contract awarded

- **Prior to Awarding Contract Mentioned in the Previous Initiative, the Agency's Timeline for Outsourcing In-State Accounts is as Follows**:

11-26-01	Begin outsourcing accounts under $500
12-10-01	Exchange of Information with Contractor (payments made to Agency by Contractor for debts collected. Additional accounts transferred to Collection Agency)
12-31-01	On a going forward basis, Agency will continue to exchange Information with contractor every two weeks.

- **Develop Request for Proposal for a Performance-Based Contract to Collect Overdue Tax Debt**

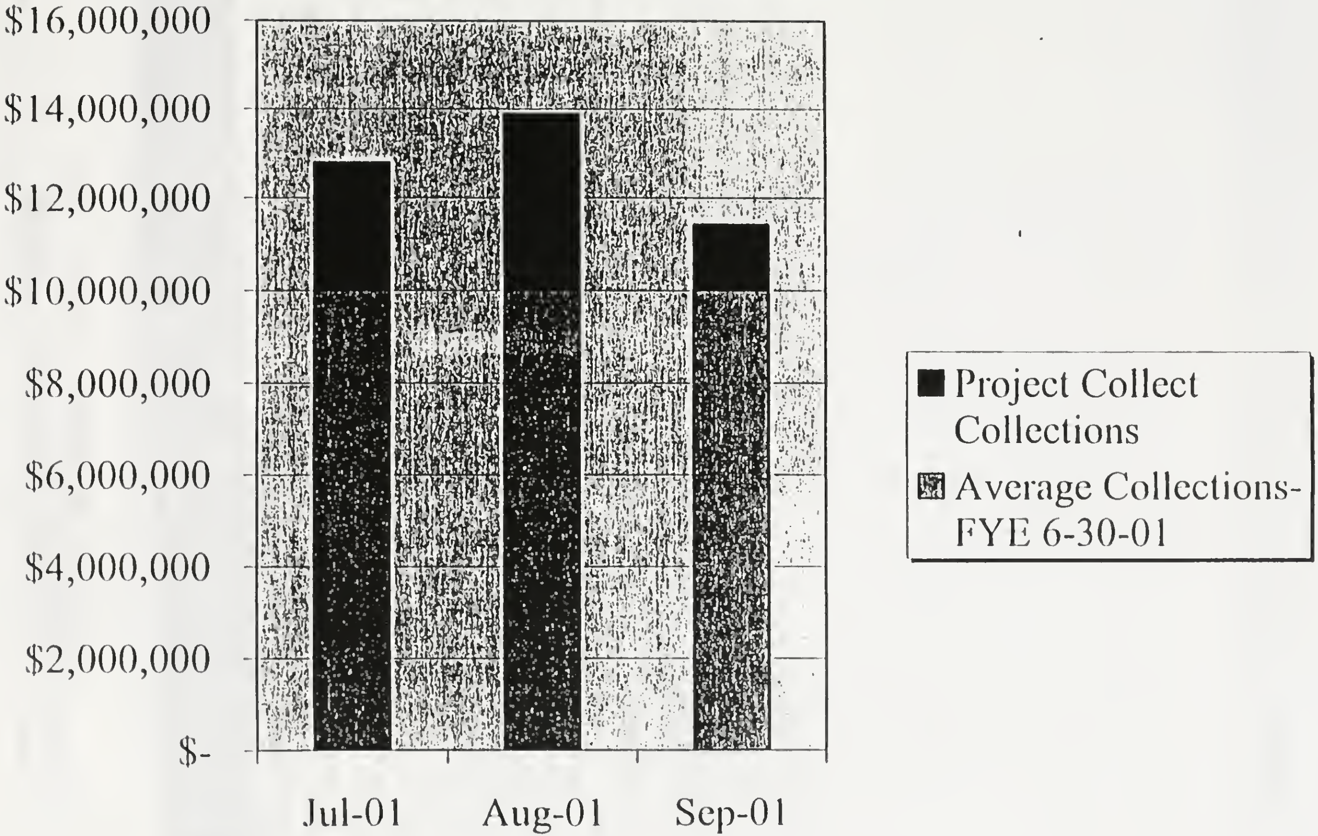
11-14-01	RFP submitted to Joint Legislative Commission on Governmental Operation and Resource Management Commission
01-14-02	RFP issued
03-15-02	Bid closing
04-03-02	Contract awarded

Exhibit 1 - Tax Debt Collections
July 1, 2001 – September 30, 2001

Age of Assessments	20% Fee Warning Letters*	Collection Agencies	Other DOR Collection Efforts	20% Fee Collections	Totals
0-30 days	-0-	-0-	$3,016,595.56	-0-	$3,016,595.56
31-60 days	-0-	-0-	$6,814,970.16	-0-	$6,814,970.16
61-90 days	$373,887.76	$11,464.41	$1,422,755.86	-0-	$1,808,108.03
90-120 days	$886,529.83	$207,049.59	$3,478,032.90	-0-	$4,571,612.32
121-180 days	$1,201,523.65	$837,071.80	$2,416,674.74	-0-	$4,455,270.19
181-365 days	$1,404,687.30	$718,095.55	$5,383,583.34	-0-	$7,506,366.19
366-730 days	$1,101,381.48	$530,383.72	$3,007,222.10	-0-	$4,638,987.30
Older than 730 days	$881,622.05	$466,119.19	$2,250,658.88	-0-	$3,598,400.12
Totals	$5,849,632.07	$2,770,184.26	$27,790,493.54	-0-	$36,410,309.87

Additional tax collections from non-filers	$1,703,300.13
Grand Total- Tax Debt and Non-Filer Collections	$38,113,610.00

Exhibit 2 - Past-Due Tax Collections
North Carolina Department of Revenue



APPENDIX O

REPORT ON COLLECTION OF TAX DEBTS

1/9/02

North Carolina Department of Revenue

Michael F. Easley
Governor

E. Norris Tolson
Secretary

January 9, 2002

Report on Collection of Tax Debt

TO: Joint Legislative Commission on Governmental Operations
Revenue Laws Study Committee

FROM: E. Norris Tolson
Secretary of Revenue

General Statute 105-241.3(f) requires the Department to submit a quarterly report, beginning November 1, 2001 through November 1, 2002 and semiannually thereafter, to the entities listed above on the Department's progress regarding the collection of tax debt. The report must detail the amount and age of tax debt in three categories, including tax debt collected by collection agencies, tax debt collected as a result of the 20% collection assistance fee notice, and all other collections of tax debt by Departmental personnel. The report must also include a long-term collection plan, a timeline for implementing each step of the plan, a summary of steps taken since the last report and their results, and any other data requested by the Commission or the Committee.

The first quarterly report for the quarter ending September 30, 2001 was previously submitted on November 1, 2001. This report provides an update through December 31, 2001.

Tax Debt Collections for the Six-Month Period July 1, 2001 Through December 31, 2001

• Tax Debt Collected by Collection Agency	$ 3,210,906.
• Tax Debt Collected From Fee Warning Letters	24,497,253.
• Other Tax Debt Collected by Departmental Personnel	61,568,939.
Total Tax Debt Collected For Six-Month Period	$89,277,098.
• Total Collections From Non-Filers	16,069,902.
• Total Collections For Six-Month Period **(Exhibit 1)**	$ 105,347,000.

- Less Baseline Collections (Debt Collections 7-1-00/12-31-00) 74,639,045.
- Total Tax Debt and Non-Filer Collections from Project Collect $ 30,707,955.

Long Term Collection Plan

In July 2001, the Department implemented an agency-wide initiative called "Project Collect Tax." Through this project, the Department has committed to achieving two primary goals: reduce accounts receivable and collect $150,000,000 in tax debt over and above normal revenue collections by implementing best practices for collecting tax debt.

Reduce Accounts Receivable For Accounts 120 Days or Older:

Accounts Receivable – July 1, 2001	$359 M
Accounts Collected Older than 120 Days	37 M
Balance of 7-01-01 Accounts Receivable	$322 M

We anticipate accounts receivable to decline further as the full impact of Project Collect Tax activities is realized.

Generating $150,000,000 of New Revenue

To achieve our $150,000,000 goal, several initiatives are being used. The primary initiatives are as follows:

- Warning Letters – On August 21, 2001, the Department began sending 20% fee warning letters to taxpayers. Over a six-week period, approximately 250,000 notices were mailed. For the period ending 12-31-01, tax debt collected from these notices totaled $24.5 million.

- Listing Delinquent Taxpayers on the Internet – On January 7, 2002, sixty-nine (69) taxpayers were listed on the Department's Website with tax liabilities totaling $2.7 million. Approximately 8600 accounts with a value of $179 million have been identified each with tax debt greater than $5,000. Each month we will add 100 accounts to our website until we collect our money or exhaust the entire list.

- Hire 44 New Collection Division Employees – All have been hired and received initial training in mid December. They are currently working in Raleigh and various field offices. Preliminary collection figures are not yet available. However, these new employees will have a substantial impact on generating new revenue.

- Hire Former Employees as Contract Workers – Ten former revenue officers were hired effective October 15, 2001. As of December 31, 2001, these employees had collected $550,000.

- Civil Enforcement Team – Eight senior revenue officers have conducted operations in Charlotte and Greensboro. As of December 31, 2001, this team had collected $3.7 million.

- Enhance Bankruptcy Collections – This initiative was listed in the first quarterly report. As of this reporting, no collection information is available to report.

- Develop an RFP for Outsourcing In-State Tax debt – The timelines originally reported for the first quarter remain the same.

- Outsource In-State Debt Prior to Completion of RFP – On December 26, 2001, 57,371 in-state accounts were out-sourced to a collection agency. These accounts had a dollar value of $6,420,414.

- Develop an RFP for a Performance-Based Contract to Collect Tax Debt – The timelines originally reported for the first quarter remain the same. A separate report on this initiative is submitted.

- Redirect of Existing Personnel - Support personnel from the Documents and Payments Processing Division were temporarily diverted to duties including the issuing of garnishments on individuals owing past due taxes. During the quarter ending 12-31-01, these individuals processed 38,000 accounts and issued 18,000 garnishments.

- The Examination Division identified 20,000 non-filers from a potential pool of 500,000 cases using Federal abstract information. These non-filers include individuals who filed Federal tax returns but failed to file state tax returns. Total collections from this initiative as of December 31, 2001 totaled $4,115,238.

- Federal Offset Initiative – North Carolina and other states are now authorized to offset Federal tax refunds for state individual income tax debt. As of December 31, 2001, this initiative resulted in state tax debt collections totaling $1,410,138.

Total new revenue generated from all "Project Collect Tax" initiatives for the six-month period ending 12-31-01 totaled $30,707,955. This total includes collections from the initiatives previously mentioned and from a more aggressive collection and enforcement effort.

APPENDIX P

REPORT ON ACCELERATED WITHHOLDING PAYMENT THRESHOLD

4/1/02

North Carolina Department of Revenue

Michael F. Easley
Governor

E. Norris Tolson
Secretary

April 1, 2002

Report on Accelerated Withholding Payment Threshold

TO: Revenue Laws Study Committee

FROM: Sabra J. Faires
Department of Revenue

This report is submitted in accordance with Section 6(g) of Chapter 427 of the 2001 Session Laws. That act directs the Department of Revenue to review the thresholds set for accelerated payment of withheld income taxes "to evaluate the efficiency, burden, and level of compliance under the current law" and to report the results of this review to the Revenue Laws Study Committee by April 1, 2002. The report is to include any recommendations on the subject.

Accelerated Payment Threshold

G.S. 105-163.6 requires employers to pay withheld individual income taxes to the Department on a semiweekly (accelerated), monthly, or quarterly basis depending on the average amount of taxes withheld by the employer during a month. The thresholds for each payment frequency are as follows:

Frequency	Average Amount of Tax Withheld
Accelerated	At least $2,000 a month
Monthly	At least $250 but less than $2,000 a month
Quarterly	Less than $250 a month

The 2001 General Assembly changed the threshold that divides employers who pay quarterly from those who pay monthly. Prior to the change, which became effective January 1, 2002, employers who withheld an average of less than $500 a month were required to pay quarterly rather than monthly. The change lowered the monthly threshold to $250, so that employers who withhold an average of at least $250 a month are required to pay monthly. This change does not affect the accelerated payment threshold but does increase the compliance burden for the taxpayer as well as the administrative burden on the Department.

Action by Department

The Department developed a program to analyze payments of withheld taxes received by taxpayers and used the program to determine if taxpayers were paying in accordance with the frequencies set in G.S. 105-163.6. Based on the program, the Department determined that many taxpayers were making payments on the wrong frequency.

The Department put taxpayers on the correct frequency and informed them of the requirements of the law by the methods listed below. Copies of this information are attached to this report.

1. Sending a notice to all employers in November, 2001.
2. Including the information in the revised NC-30, Income Tax Withholding Tables and Instructions for Employers.
3. Posting the information on the Department's website, www.dor.state.nc.us.
4. Sending employers the appropriate forms booklets to use in 2002 based on their correct frequency and alerting employers of the thresholds on the cover of the booklets.

To ensure continued compliance with the proper frequencies, the Department plans to run the program that analyzes payment history each year and notify affected employers of changes in their payment frequencies. The Department will run the program in the fall before printing and mailing the forms booklets.

Effect of Action

Placing taxpayers on the correct frequency resulted in switching about 7,500 employers from a monthly basis to an accelerated basis. This change, coupled with normal changes and additions occurring throughout a year, resulted in increasing the number of accelerated taxpayers from about 32,000 as of January 1, 2001, to about 41,000 as of January 1, 2002.

The fiscal impact to the State of the change is the receipt of tax payments sooner than would otherwise have occurred. Collections for the month of February, 2002 show that receipts from employers paying on an accelerated basis increased by $8.4 million when compared to the same month of 2001. This occurred despite a decrease of $7 million for February, 2002 in the receipts from employers paying on a monthly basis when compared to the same month for 2001. The number of payments received in February, 2002 from accelerated payers increased by about 16,500 when compared to the same month of 2001.

Efficiency, Burden, and Level of Compliance

Placing employers on an accelerated payment frequency rather than a monthly payment frequency increases the number of payments employers must make and the Department must process. Because most employers that pay on an accelerated basis make their payments by electronic funds transfer (EFT) even though the law does not require them to do so, the increased burden on the

Department is minimal. The burden to the employer is the time involved in determining the proper payment to make and then transmitting the payment.

The Department can require payment by EFT only if the employer withholds an average of $20,000 per month. About 52,700 employers voluntarily pay by EFT because it is easier for them to do so than to send a paper return and check. When an employer pays by EFT, the employer sends no paper return to the Department until the quarterly return.

The Department is primarily responsible for ensuring that employers pay withheld taxes on the correct frequency. With the programming changes that have been made, the Department can annually review employers' payment histories to ensure continued compliance.

Recommendation: Make the due date of the quarterly sales tax return the same as the due date for the quarterly withholding tax return.

The 2001 General Assembly lowered the threshold for monthly payments of withheld taxes from $500 to $250. Monthly withholding returns are due on the 15th of the month, the same day as monthly and quarterly sales and use tax returns. In March, April, September, and October, in particular, the 15th of the month is the same day that income tax returns are due.

The monthly threshold change moved about 25,000 employers from a quarterly to a monthly basis. The Department now receives 25,000 more returns in eight of the twelve months of the year than it was receiving prior to the change. This has compacted the processing work of the Department into a shorter time frame and is straining the Department's ability to process all payments received in a timely manner.

The Department recommends that the General Assembly change the due date of quarterly sales tax returns from the 15th of a month to the end of the month to enable the Department to spread the work more evenly throughout the month. There are 91,000 quarterly sales tax filers, so this would greatly reduce the peaks on the 15th. This change would also make the due date for quarterly sales tax returns consistent with the due date for quarterly withholding tax returns. This change would not impact the timing of local sales and use tax distributions. Nor would it shift any funds from one fiscal year to the next.

To make this change, G.S. 105-164.16 needs to be amended. The change should become effective October 1, 2002.

APPENDIX Q

REPORT BY THE WIRELESS 911 BOARD ON REVENUES AND EXPENDITURES FOR 2000-2001

2/15/02

North Carolina
WIRELESS 911 BOARD

Ronald P. Hawley, Chair
Carolyn H. Carter, Vice Chair

-Executive Summary-

February 15, 2002

On September 25, 1998, the 1998 Session of the General Assembly of North Carolina approved Senate Bill 1242, G.S. 62a, Enhanced 911 Wireless Fund. The objectives of the act include providing for a wireless enhanced 911 system for the use of wireless telephone customers. The act provides for a service charge of $ .80 per month on each commercial mobile radio service (CMRS) connection. These funds are disbursed as provided by statute to CMRS providers and public safety answering points (PSAPs) in North Carolina.

The Board is staffed by an Executive Director and an accountant under the Office of Information Technology Services. The Board consists of 13 members and meets monthly to indentify, discuss and act upon those issues concerning the Wireless 911 Fund. (See attachment for a list of the Board members and staff)

For the reporting period of 2000 and 2001, the total revenues collected by the CMRS providers are:

2000 - $ 21,325,662.33
2001 - $ 13,386,215.30
Total Revenues -$ 34,711,877.63

For the reporting period of 2000 and 2001, the total expenditures are:

2000	CMRS Providers	- $ 1,339,263.64	2001	CMRS Providers	- $ 4,063,937.50
	PSAPs	- 14,463,757.79		PSAPs	- $ 4,807,429.38
	Administration	- 96,807.26		Administration	- $ 44,553.83
	Total Expenditures	- $ 15,899,828.69		Total Expenditures	- $ 8,915,920.71

The fund balance as of December 31, 2001, including interest, is $ 37,599,321.94.

As of December 31, 2001, 117 PSAPs have been certified as being capable of receiving and utilizing Phase I data from the CMRS providers. 53% of the state had Phase I coverage deployed by the wireless carriers.

www.wireless911.its.state.nc.us
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NC Sheriff's Association
Wilkes County

Frank Thomason
National Association of Communications Officers
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Toby Turner
CMRS Provider
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