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REVENUE LAWS STUDY COMMITTEE

REPORT TO THE 2003 GENERAL ASSEMBLY OF NORTH CAROLINA 2003 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*

January 28, 2003

TO THE MEMBERS OF THE 2003 GENERAL ASSEMBLY (2003 Regular Session):

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

Respectfully Submitted,

Rep. Paul Luebke, Co-Chair

Sen. John Kerr, Co-Chair

2001-2002

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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.

In 2002, the General Assembly established a permanent subcommittee under the Revenue Laws Study Committee to study and examine the property tax system.[1] The subcommittee consists of six members, three appointed by the Senate chair of the Revenue Laws Study Committee and three appointed by the House chair of the Committee. The subcommittee may recommend changes in the property tax system to the full Committee for its consideration in its final report to the General Assembly. The chairs to the Revenue Laws Study Committee did not appoint the subcommittee during this interim because of the limited time the Committee had to meet

[1] S.L. 2002-184, s. 8.

before the convening of the 2003 Regular Session of the 2003 General Assembly.

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 after the 2002 Regular Session of the 2001 General Assembly adjourned on October 4, 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 was not able to consider all of them in the limited time available to it. 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 2002 GENERAL ASSEMBLY

The 2002 General Assembly enacted seven of the Revenue Laws Study Committee's eight legislative proposals in whole or in part.[1] Appendix B lists the Committee's recommendations and the action taken on them in 2001. A document entitled "**2002 Tax Law Changes**" summarizes all of the tax legislation enacted in 2002. It is available in the Legislative Library located in the Legislative Office Building.

BUDGET AND REVENUE OUTLOOK

The General Assembly gave the Department of Revenue additional collection tools during the 2001 Session with the expectation that the Department would collect $150 million in back taxes by June 30, 2003. The program for collecting outstanding back taxes became known as "Project Collect Tax". Secretary Tolson informed the Committee that the Department expected to exceed its goal by the end of the 2002-2003 fiscal year. From

[1] The eighth proposal, Disclose Social Security Number to Tax Collector, was not introduced as a piece of legislation for the General Assembly to consider during the 2002 Regular Session.

August 2001 until November 2002, the Department has collected $110 million in back taxes. A copy of the Department's report on the collection of tax debt[2] is included as Appendix C. One of the additional collection tools given to the Department was the authorization to use collection agencies to collect in-State tax debts for two years. This authorization expires July 1, 2003. Legislative Proposal 6, *Revenue Administrative Changes*, contains a provision extending this authorization for an additional two years.

David Crotts, with the Fiscal Research Division, reviewed the State's budget outlook with the Committee. The fiscal analysts estimate that the 2003-04 fiscal year budget gap will be around $2 billion. Little, if any, revenue surplus for the current fiscal year, coupled with subpar revenue growth expected in 2003-04 and the use of one-time revenue sources over the last two years, contributes to the expected budget shortfall. Over the past two years, the General Assembly has enacted several revenue enhancements. The most obvious revenue enhancements available to the General Assembly in 2003 include the continuation of the ½ cent State sales tax that is scheduled to expire on July 1, 2003, the continuation of the 8.25% income tax bracket that is set to expire for taxable years beginning on or after January 1, 2004, and the delay of the 2001 tax cuts for an additional year. Even with these revenue enhancements, the State budget gap exceeds $1.5 billion. Appendix D contains a discussion of the State's budget outlook.

The Honorable Thomas Ross, the chair of the Governor's Commission to Modernize State Finances, presented the Commission's Final Report to the Revenue Laws Study Committee.[3] The Governor created the Commission out of recognition that the State's fiscal system faces long-term challenges. He charged the Commission with the task of modernizing State finances to ensure that the State's revenue system remains stable, fair, and sufficient over the long term. The Commission's recommendations include the following:

- Eliminate the differential rates of taxation of goods and services and remove caps on the sales and use taxes.

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[2] G.S. 105-243.1(f) requires the Department of Revenue to report its progress regarding the collection of tax debt to the General Assembly.

[3] The Commission's Final Report is available on line at http://www.osbm.state.nc.us

- Eliminate sales tax exemptions.
- Consider the expansion of the sales tax base to include more services.
- Adopt changes required to comply with the Streamlined Sales Tax Agreement.
- Simplify the administration of local sales taxes.
- Tie State income tax more closely to the federal tax code.
- Adopt strategies to help low-income taxpayers.
- Eliminate or simplify the use of tax credits.
- Simplify taxation by moving to combined reporting by related entities.
- Modernize the franchise tax.
- Consider the effect of establishing a throw-out provision.
- Conform more closely to the federal definition of corporate income.
- Consider the effects of a move back to the equal weighting of payroll, property, and sales in determining the share of income taxed by the State for multistate corporations.
- Shift Medicaid program costs from counties to State government.
- Establish a new State-Local Relations Commission.
- Review the State unemployment insurance tax laws.

INCOME TAX

The Revenue Laws Study Committee spent considerable time reviewing several different individual and corporate income tax provisions.

The General Assembly enacted the individual income tax credit for premiums paid on long-term care insurance in 1998. The credit amount is equal to 15% of the premium paid each year on long-term care insurance. The credit may not exceed $350 for each policy for which the credit is claimed. The credit became effective for taxable years beginning on or after January 1, 1999. It expires for taxable years beginning on or after January 1, 2004, unless the 2003 General Assembly enacts legislation to extend or repeal the sunset on the credit. The Department of Revenue reported that in examining a sample of returns, it found that 90% of the taxpayers claiming the credit were not in fact eligible for the credit. Appendix E contains a copy of the Department's findings. The Committee did not make any recommendations on this issue.

North Carolina's tax law tracks many provisions of the federal

Internal Revenue Code by reference to the Code.[4] The General Assembly determines each year whether to update its reference to the Internal Revenue Code.[5] Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the State to the extent that State law previously tracked federal law. Legislative Proposal 1, *IRC Update*, changes the statutory reference to the Code from May 1, 2002, to January 1, 2003. Congress enacted one bill between May 1, 2002, and January 1, 2003, that would affect State tax provisions. The Clergy Housing Allowance Clarification Act of 2002, P.L. 107-181, enacted on May 20, 2002, clarifies the amount that may be excluded from gross income by a minister for a rental allowance paid to the minister as part of the minister's compensation.

The issues of the dividend deduction and the banks' expense deduction have long been debated by the North Carolina General Assembly. During the 2001 Session, the General Assembly enacted legislation conforming State law to the federal rules for the deduction of dividends received. This change eliminated the adjustments that had previously been required to reflect differences between the federal and State dividends deduction. Eliminating the adjustments also made the dividends subject to the general State law that expenses related to untaxed income cannot be deducted from taxable income. As a result, expenses related to deductible dividends must be netted from those dividends. During the 2002 Session, the General Assembly changed the expense-netting requirement, as it pertains to subsidiary dividends, by establishing guidelines on how to determine the amount of expenses attributable to dividends and by limiting how much of those attributable expenses must be netted. The 2002 legislation directed the Revenue Laws Study Committee to study the

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

[5] The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation ... shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would ... be invalidated as an unconstitutional delegation of legislative power."

treatment of expenses related to dividends received and other income not taxed, and the taxation of affiliated corporations, of holding companies, and of financial institutions under current law. The Committee's staff presented information on the history of the dividend deduction and the bank expense deduction. A copy of the information the Committee received can be found in Appendices F - H.

In 2001, the General Assembly enacted three separate and distinct corporate income tax changes:

- Income Tax Reporting Option for Royalty Income
- Franchise Tax on Corporate Members of LLCs
- Income Tax of Dividends

The legislation directed the Department of Revenue to report to the Revenue Laws Study Committee on the implementation of these tax law changes and to recommend any changes it thought necessary to the Committee.[6] The Department's third and final report is attached in Appendix I.

The Department raised two issues concerning income derived from intangible property. The Department has seen several cases in which an operating company transferred patents to a holding company that then licensed the patents back to the operating company. This raises the issue of whether the reporting election should be extended to include income from patents or other kinds of intangible property. Second, the Department noted that although the current law is intended to allow only taxpayers who comply with the law to benefit from the royalty filing election but in fact also allows taxpayers who do not report or pay tax on the income to take advantage of the election after the Department discovers the absence of the income. The Department strongly recommended that the Committee consider allowing taxpayers to exercise the royalty reporting option only on a timely filed return. If a timely filed return reporting the royalty income is not filed by the entity receiving the royalty payments, the law should require the royalty payer to forgo its deduction for royalty payments to related members by adding the royalty payments to federal taxable income. The Committee was generally supportive of amending the law to bring it within

[6] S.L. 2001-327, s. 4(a).

the original intent of the 2001 act, so that only taxpayers who comply with the law on a timely basis can benefit from the election, but the Committee did not have time to act on this recommendation.

The Department noted in all three of its reports that tax practitioners have discovered an alternative entity structure to overcome the legislature's attempt to close the franchise tax loophole. The Department suggested consideration be given to extending the franchise tax to LLCs and partnerships. Some Committee members raised a second solution: the repeal of the franchise tax, and consequently an overhaul of the State's corporate income and franchise tax law. The Governor's Commission on the Modernization of State Finances also recommended modernizing the State's franchise tax. The Committee did not have time to develop this issue before the convening of the 2003 General Assembly, but noted that the issue needs to be addressed.

The 2001 legislation amended several sections of the State tax law to generally conform to the federal tax treatment of dividend income. One of the changes was the repeal of G.S. 105-130.7(b), which addressed subsidiary dividends. The Department recommends that G.S. 105-130.7(a), which addresses dividends received from a regulated investment company or a real estate investment trust, be repealed. Legislative Proposal 6, *Revenue Administrative Changes*, contains a section repealing this provision.

Lastly, in the area of income tax law, the Revenue Laws Study Committee considered special apportionment rules for publishing and broadcasting. Corporations doing business in more than one state must allocate and apportion their income among the states in which they do business according the respective states' apportionment formulas. Martha Walston, with the Fiscal Research Division, explained North Carolina's apportionment formulas. She noted that the State has special apportionment formulas for certain types of business, such as railroad companies, telephone companies, motor carriers, public utilities, and air or water transportation companies. Appendix J contains a copy of her remarks. The Department of Revenue recommends changing the apportionment rules for publishing companies and broadcasting companies. The Department recommends that

North Carolina's apportionment rules for these two industries be changed to conform to the model apportionment regulations adopted by the Multistate Tax Commission in 1990 and 1993, and amended in 1996. Appendix K contains a copy of the model regulations adopted by the Multistate Tax Commission and Appendix L contains a list of the states that have adopted all or a portion of the Commission's regulations. The Department's recommendation is included in Appendix M. Legislative Proposal 2, *Update Corporate Tax Apportionment Formula,* contains the Committee's recommendation on this issue. The Committee notes that some of the interested parties have questions about the recommendation and acknowledges that it had insufficient time to answer the questions before the convening of the 2003 General Assembly. The Committee decided to recommend the idea to the 2003 General Assembly where the issue may continue to be addressed.

ESTATE TAX

Until 1999 North Carolina imposed an inheritance tax on property transferred by a decedent. The amount of tax due depended on the relationship of the person transferring the property (the decedent) to the person receiving the property (the beneficiary). This was in contrast to federal law, which has a single rate schedule for estates. State law classified beneficiaries into three classes and set different inheritance tax rates for each class. A Class A beneficiary was a lineal ancestor, a lineal descendant, an adopted child, a stepchild, or a son-in-law or daughter-in-law whose spouse was not entitled to any of the decedent's property. A Class B beneficiary was a sibling, a descendant of a sibling, or an aunt or uncle by blood. A Class C beneficiary was anyone who was not a Class A or Class B beneficiary. Class A beneficiaries had the lowest inheritance rates and a $600,000 inheritance tax exemption. Class B beneficiaries had higher rates and no exemption. Class C beneficiaries had the highest rates and no exemption. Thus, North Carolina's rate structure favored transfers to children and parents by giving those transfers the lowest rates plus an exemption and preferred transfers to other close family members over transfers to more distant relatives or to persons who were not related.

As part of the budget bill in 1998 (S.L. 1998-212) the General Assembly repealed the inheritance tax for decedents dying on or after January 1, 1999, and in its place enacted an estate tax. North Carolina's estate tax is what is commonly known as a "pick-up tax". The amount of state estate tax due is the maximum amount of the federal credit allowed under the Code for federal estate tax purposes.

In 2001 Congress enacted several major changes to the federal estate tax that could have a substantial impact on the North Carolina estate tax. First, Congress gradually increased the amount of the estate that is excluded from taxation.[7] Second, Congress repealed the estate tax effective in 2010.[8] Third, Congress phased out the federal credit over four years.[9]

In 2002 the General Assembly addressed this issue by partially conforming to the federal changes. North Carolina conformed to the increased exclusion amounts. Thus, as under previous law, an estate that is not subject to the federal estate tax will not be subject to the state estate tax. However, North Carolina did not conform to the phase-out of the federal credit. For decedents dying in 2002 and 2003, the amount of the North Carolina estate tax will be computed based on the federal credit without regard to the phase-out. Without further legislative action, North Carolina will conform to the phase out as of January 1, 2004, and the North Carolina estate tax will, for practical purposes, cease to exist beginning in 2005. Finally, North Carolina did conform to the 2010 repeal of the estate tax.

North Carolina was not alone in facing this issue in 2002. At the time of the federal changes in 2001, all 50 states and the District of Columbia had a state estate or inheritance tax that relied on the federal credit to some degree.[10] In 2002, a number of states took legislative action (or declined to

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[7] For 2001, the applicable exclusion amount was $675,000. That amount was increased to $1 million for 2002 and 2003, to $1.5 million for 2004, and 2005, to $2 million for 2006 through 2008, and to $3.5 million for 2009.

[8] However, without further Congressional action, the federal estate tax will be reinstituted automatically in 2011.

[9] The amount of the credit was reduced 25% for 2002, 50% for 2003, 75% for 2004, and eliminated in 2005.

[10] Thirty-eight states, including North Carolina, had a straight pick-up tax. The other 13 states used the state death tax credit as a supplemental tax or as an alternative minimum tax.

take action) to offset the effects of the phase-out. Eleven states, including North Carolina, took affirmative steps to decouple from the phase-out of the federal credit.[11] An additional 6 states and the District of Columbia decided not to update their reference to the Code for purposes of the federal credit. Nebraska enacted a freestanding estate tax that tracks federal definitions and has a rate schedule identical to that of the federal credit as it existed in 2001. On the other hand, New Hampshire repealed its separate inheritance tax effective for 2003. Without further changes to state law, by 2005 30 states will have no estate or inheritance tax, 10 states will have a pick-up tax based on the 2001 credit, and 11 states will have a stand-alone estate or inheritance tax.

The Revenue Laws Study Committee acknowledges that the 2003 General Assembly will need to address this issue and notes that North Carolina has essentially five options in regards to the estate tax:

- North Carolina could extend or remove the sunset on the decoupling from the phase-out of the federal credit. Under current law, North Carolina will conform to the phase-out of the federal credit beginning in 2004. The General Assembly could choose to permanently tie the amount of the state estate tax to the amount of the federal credit that existed in 2001. This would preserve state revenue in the near future, but it would be more difficult administratively for taxpayers. This is only a temporary solution since the federal estate tax is set to be repealed altogether in 2010.
- North Carolina could take no action, thereby conforming to the phase-out of the federal credit beginning in 2004. This option could lead to lower state revenue as early as the 2003-2004 fiscal year and would result in an effective elimination of the state estate tax beginning January 1, 2005.
- North Carolina could move away from the pick-up tax and establish a stand-alone estate or inheritance tax. This tax could be structured to be revenue neutral or to result in a revenue gain or a revenue loss.
- North Carolina could fully conform to the federal changes now. This option could lead to lower state revenues immediately.

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[11] North Carolina decoupled from the federal legislation only temporarily. Under current law, North Carolina is set to conform to the federal legislation as of January 1, 2004. The other ten states that actively decoupled must take further legislative action to conform to the federal legislation.

- North Carolina could repeal the estate tax. This option could lead to lower state revenues immediately.

SALES TAX

The Revenue Laws Study Committee continues to support the efforts of and monitor the progress of the Streamlined Sales Tax Project. The Project is an effort created by state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax administration for both Main Street and remote sellers for all types of commerce. Thirty-nine of the 45 states with a sales and use tax, as well as the District of Columbia, are involved in the Project.

The Project envisions two components to the legislation necessary to accomplish its goals. First, states would adopt enabling legislation referred to as the Uniform Sales and Use Tax Administration Act. The Act allows the state to enter into an agreement with one or more states to simplify and modernize sales and use tax administration in order to reduce the burden of tax compliance for all sellers and all types of commerce. Thirty-five states and the District of Columbia have enacted the Uniform Sales and Use Tax Administration Act. Secondly, states would amend or modify their sales and use tax law to achieve the simplifications and uniformity required by the participating state working together. The Project refers to this legislation as the Streamlined Sales and Use Tax Agreement. A certificate of compliance will document each state's compliance with the provisions of the Agreement.

The Revenue Laws Study Committee has recommended, and the General Assembly has enacted, both the Uniform Sales and Use Tax Administration Act and many provisions in the Streamlined Sales and Use Tax Agreement.[12] As of November 12, 2002, representatives of 33 states and the District of Columbia voted to approve the final version of the Streamlined Sales and Use Tax Agreement. The provisions in the Agreement cover many issues, including the following:

- Single tax base

[12] S.L. 2000-120 and S.L. 2001-347.

- Reduction of multiple rates
- Uniform definitions for exemptions
- Uniform sourcing
- Limitations on sales tax holidays
- Elimination of caps and thresholds

The Revenue Laws Study Committee recognizes that some of the issues remaining for the State to address will be difficult ones. For example, the exemption of food from part of the local tax base violates the provision concerning uniform tax bases and the 1%, $80 cap on certain types of equipment violates the provision concerning the elimination of caps and thresholds. The Committee did not have adequate time to devote to these difficult policy decisions. Legislative Proposal 3, *Streamlined Sales and Use Tax Agreement,* includes a few modifications to the State's sales and use tax statutes needed to conform to the Agreement adopted in November 2002. The Committee encourages the General Assembly to give consideration to the other statutory changes that are needed to conform to the Agreement. A copy of the Agreement is contained in the Committee's Notebook and may be found on the Internet at www.geocities.com/streamlined2000.

Currently, all major State agencies except the Department of Transportation[13], are subject to State and local sales taxes. However, the State receives a refund of the local sales taxes paid by its agencies, with the proceeds of the refund going to the General Fund. Refunds for purchases by the constituent institutions of the University of North Carolina are made on an annual basis and refunded directly to the state agency. The current refund process is time-consuming for both the Office of the State Controller, the agencies, and the Department of Revenue. To relieve the agencies of this burden, the Office of the State Controller recommends that the refund process be changed to a sales and use tax exemption for State agencies. Legislative Proposal 4, *State Government Sales Tax Exempt,* allows a sales and use tax exemption for State agencies instead of a sales and use tax refund.

[13] The Department of Transportation is exempt from State and local sales and use tax.

General Tax Law Administration Changes

Legislative Proposal 5, *Uniform Tax Refund Procedure,* is the first step in simplifying the refund procedure for all types of taxes and purposes. Currently, the process differs depending on the reason for which a refund is claimed. The North Carolina Bar Association and the North Carolina Association of CPAs have expressed an interest in a uniform procedure. However, the Committee acknowledges that it did not have time to consult with these interested parties before its final meeting. The Committee recommends Legislative Proposal 5 as the starting point for discussions among the interested parties during the consideration of this issue during the 2003 Session.

The Revenue Laws Study Committee recommends Legislative Proposal 6, *Revenue Administrative Changes.* This proposal incorporates several suggestions from the Department of Revenue and others. Legislative Proposal 7, *Revenue Laws Technical Changes,* makes several technical and clarifying changes to the revenue laws and related statutes.

COMMITTEE RECOMMENDATIONS AND LEGISLATIVE PROPOSALS

The Revenue Laws Study Committee makes the following seven recommendations to the 2003 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.

1. IRC Update
2. Update Corporate Tax Apportionment Formula
3. Streamlined Sales Tax Changes
4. State Government Sales Tax Exemption
5. Uniform Tax Refund Procedure
6. Revenue Administrative Changes
7. Revenue Laws Technical Changes

LEGISLATIVE PROPOSAL #1

IRC UPDATE

LEGISLATIVE PROPOSAL 1:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2003 GENERAL ASSEMBLY, 2003 SESSION

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

SHORT TITLE: IRC Update.

SPONSORS: **Rep. McComas**, Allen, Hill, Holliman, Luebke, Wainwright
Sen. Dalton, Clodfelter, Hartsell, Hoyle, Kerr

BRIEF OVERVIEW: This proposal updates to January 1, 2003, the reference to the Internal Revenue Code used in defining and determining certain State tax provisions.

FISCAL IMPACT: The State's General Fund may realize a gain of less than $30,000 annually.

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

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

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2003

S D

BILL DRAFT 2003-LYxz-7 [v.4] (1/9)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/21/2003 11:38:17 AM

Short Title: IRC Update. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

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

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-228.90(b)(1b) reads as rewritten:

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

...

(1b) Code. – The Internal Revenue Code as enacted as of ~~May 1, 2002~~,January 1, 2003, including any provisions enacted as of that date which become effective either before or after that date."

SECTION 2. Notwithstanding Section 1 of this bill, any amendments to the Internal Revenue Code enacted in 2002 that increase North Carolina taxable income for the 2002 taxable year become effective for taxable years beginning on or after January 1, 2003.

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

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 1: IRC UPDATE

BY: CANAAN HUIE, BILL DRAFTING DIVISION

SUMMARY: This bill updates to January 1, 2003 the reference to the Internal Revenue Code used in defining and determining certain state tax provisions. This bill is effective when it becomes law.

ANALYSIS: North Carolina's tax law tracks many provisions of the federal Internal Revenue Code, by reference to the Code.[1] The General Assembly determines each year whether to update its reference to the Internal Revenue Code.[2] Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the State to the extent that State law previously tracked federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. Under current law, the reference date to the Code is May 1, 2002.

This bill would update the reference to the Code to January 1, 2003. Congress enacted one bill between May 1, 2002, and January 1, 2003 that would affect State tax provisions. The Clergy Housing Allowance Clarification Act of 2002, P.L. 107-181, enacted on May 20, 2002, clarifies the amount that may be excluded from gross income by a minister for a rental allowance paid to the minister as part of the minister's compensation. Under previous federal law, the rental allowance was excluded to the extent that the allowance was used to rent or provide a home for the minister. Under current federal law, the rental allowance is excluded to the extent that it is used to rent or provide a home for the minister and to the extent that it does not exceed the fair market value of the rental.

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

[2] The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation ... shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would ... be invalidated as an unconstitutional delegation of legislative power."

This change could have the effect of increasing taxable income for some taxpayers and is therefore required to be roll-called on separate days pursuant to Section 23 of Article II of the North Carolina Constitution.

The federal change became effective for taxable years beginning on or after January 1, 2002. Since this change could have the effect of increasing taxable income for some taxpayers, it could not become effective for taxable years that have already ended. Section 2 of this bill ensures that this change will not increase North Carolina taxable income for any person for the 2002 taxable year.

FISCAL ANALYSIS MEMORANDUM

[This 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: January 17, 2003

TO: Revenue Laws Study Committee

FROM: Richard Bostic
Fiscal Research Division

RE: IRC Update

FISCAL IMPACT

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

	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08
REVENUES					
General Fund	Gain of < $30,000 each year				
EXPENDITURES					

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

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

BILL SUMMARY: This bill updates the statutory reference to the Internal Revenue Code used in defining and determining certain state income tax provisions. The referenced date is changed from May 1, 2002 to January 1, 2003.

BACKGROUND: Ordained ministers, rabbis, and cantors do not pay income tax on housing allowances received as part of their compensation for ministerial duties. However, the housing allowance is subject to Social Security and Medicare taxes under the Self-Employment Contributions Act. To remain tax free, the housing allowance must be used to pay rent, to make a down payment on a house, to pay mortgage installments, or to pay utilities, interest, tax, and house repair expenses. The church or local congregation must designate the part of the minister's compensation that is a housing allowance. This designation of the allowance amount must be made in advance of any payments.

The housing allowance is also given to ministers working as teachers or administrators for a parochial school, college, or theological seminary, to retired ministers if furnished in recognition of past services, and to traveling evangelists to maintain a permanent home. Ordained ministers that work as executives of nonreligious organizations are generally barred from using the allowance. Non-ordained church officers such as minister of music and minister of education do not qualify for a housing allowance.

ASSUMPTIONS AND METHODOLOGY: The effect of this bill is to conform to a change approved by Congress on May 20, 2002 in the Clergy Housing Allowance Act of 2002 (PL 107-181). This law clarified that the clergy housing allowance is excluded from income tax to the extent that it does not exceed the fair market value of the housing unit. For those that had been claiming housing allowances greater than the fair market value for their property, their taxable income will increase in 2003. The Bureau of Labor Statistics in the US Department of Labor reports 450 clergy in North Carolina making an average salary of $36,640 and 100 directors of religious activities and education making an average salary of $27,910. However, there is no data on housing allowances claimed by North Carolina clergy.

The Congressional Joint Committee on Taxation estimated that clergy nationwide would pay an additional $1million in federal income tax each year beginning in 2004 due to the law change. The amount of additional tax would increase to $2 million in 2006, $3 million in 2007, and $4 million in 2008. Since North Carolina taxable income is based on the federal taxable income, North Carolina will gain a small amount of revenue from this change. State income tax collections divided by national tax collections equals approximately .723%. Using this percentage times the national estimate for the tax change equals the following North Carolina General Fund revenue increase:

FY 2003-04	$7,230
FY 2004-05	$7,230
FY 2005-06	$14,460
FY 2006-07	$21,690
FY 2007-08	$28,920

SOURCES OF DATA: Congressional Joint Committee on Taxation; Bureau of Labor Statistics

TECHNICAL CONSIDERATIONS:

LEGISLATIVE PROPOSAL #2

UPDATE CORPORATE APPORTIONMENT FORMULA

LEGISLATIVE PROPOSAL #2

UPDATE CORPORATE APPORTIONMENT FORMULA

LEGISLATIVE PROPOSAL 2:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2003 GENERAL ASSEMBLY, 2003 SESSION

AN ACT TO ADJUST THE APPORTIONMENT FORMULA SALES FACTOR FOR BROADCASTERS AND PUBLISHERS AND TO UPDATE THE APPORTIONMENT FORMULA PROPERTY FACTOR FOR ALL CORPORATIONS BY EXCLUDING OUTER-JURISDICTIONAL PROPERTY FROM THAT FACTOR.

SHORT TITLE: Update Corporate Tax Apportionment Formula.

SPONSORS: **Sen. Clodfelter**, Dalton, Hartsell, Hoyle, Kerr

BRIEF OVERVIEW: This proposal makes the following three changes to the apportionment formula for corporate income tax:

1. Amends the property factor so that outer-jurisdictional property is excluded from the numerator and denominator of the property factor.
2. Adds an alternative formula for corporations engaged in the business of broadcasting radio or television programming.
3. Adds an alternative formula for corporations engaged in the business of publishing, selling, licensing, or distributing newspapers, magazines, trade journals, books, or other publications.

FISCAL IMPACT: See Appendix N for an analysis of the revenue changes, prepared by the Tax Research Division of the Department of Revenue.

EFFECTIVE DATE: This proposal is effective for taxable years beginning on or after January 1, 2003.

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

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2003

S D

BILL DRAFT 2003-LAzx-1 [v.15] (12/16)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/29/2003 10:39:31 AM

Short Title: Update Corporate Tax Apportionment Formula. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO ADJUST THE APPORTIONMENT FORMULA SALES FACTOR FOR BROADCASTERS AND PUBLISHERS AND TO UPDATE THE APPORTIONMENT FORMULA PROPERTY FACTOR FOR ALL CORPORATIONS BY EXCLUDING OUTER-JURISDICTIONAL PROPERTY FROM THAT FACTOR.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-130.4 reads as rewritten:

"**§ 105-130.4. Allocation and apportionment of income for corporations.**

(a) As used in this section, unless the context otherwise requires:

(1) "Business income" means all income that is apportionable under the United States Constitution.

(1a) Broadcasting. -- Transmitting radio or television programming to viewers or listeners by an electronic or other signal conducted by radio waves, microwaves, wires, coaxial cables, fiber optics, satellite transmissions, or any other means of communication.

(2) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(3) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(4) "Excluded corporation" means any corporation engaged in business as a building or construction contractor, a securities dealer, or a loan company or a corporation that receives more than fifty percent (50%) of its ordinary gross income from intangible property.

(4a) General formula. – A fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four. If the sales factor does not exist, the denominator of the fraction is the number of existing factors. If the sales factor exists but the payroll factor or the property factor does not exist, the denominator of the fraction is the number of existing factors plus one.

(5) "Nonbusiness income" means all income other than business income.

(5a) Outer-jurisdictional property. -- Tangible personal property that is not physically located in any state. The term includes orbiting satellites and undersea transmission cables.

(6) "Public utility" means any corporation that is subject to control of one of more of the following entities: the North Carolina Utilities Commission, the Federal Communications Commission, the Interstate Commerce Commission, the Federal Power Commission, or the Federal Aviation Agency; and that owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, the transportation of goods or persons, or the production, storage, transmission, sale, delivery or furnishing of electricity, water, steam, oil, oil products, or gas. The term also includes a motor carrier of property whose principal business activity is transporting property by motor vehicle for hire over the public highways of this State. The term does not include a corporation engaged in the business of broadcasting radio or television programming.

(6a) Radio programming. – Any performance, event, or production broadcast on radio, including news, sporting events, plays, stories, and other literary, commercial, educational, or artistic works, through the use of an audio tape, disk, or any other format or medium. Each episode of a series is considered separately.

(7) "Sales" means all gross receipts of the corporation except for the following receipts:

a. Receipts from a casual sale of property.

b. Receipts allocated under subsections (c) through (h) of this section.

c. Receipts exempt from taxation.

d. The portion of receipts realized from the sale or maturity of securities or other obligations that represents a return of principal.

(8) "Casual sale of property" means the sale of any property which was not purchased, produced or acquired primarily for sale in the corporation's regular trade or business.

(9) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

(9a) Television programming.. -- Any performance, event, or production broadcast on television, including news, sporting events, plays, stories, and other literary, commercial, educational, or artistic works, through the use of video tape, disk, or any other format or medium. Each episode of a series is considered separately.

(b) A corporation having income from business activity which is taxable both within and without this State shall allocate and apportion its net income or net loss as provided in this section. For purposes of allocation and apportionment, a corporation is taxable in another state if (i) the corporation's business activity in that state subjects it to a net income tax or a tax measured by net income, or (ii) that state has jurisdiction based on the corporation's business activity in that state to subject the corporation to a tax measured by net income regardless whether that state exercises its jurisdiction. For purposes of this section, "business activity" includes any activity by a corporation that would establish a taxable nexus pursuant to 15 United States Code section 381.

(c) Rents and royalties from real or tangible personal property, gains and losses, interest, dividends less the portion deductible under G.S. 105-130.7, patent and copyright royalties and other kinds of income, to the extent that they constitute nonbusiness income, less related expenses shall be allocated as provided in subsections (d) through (h) of this section.

(d) (1) Net rents and royalties from real property located in this State are allocable to this State.

(2) Net rents and royalties from tangible personal property are allocable to this State:

a. If and to the extent that the property is utilized in this State, or

b. In their entirety if the corporation's commercial domicile is in this State and the corporation is not organized under the laws of, or is not taxable in, the state in which the property is utilized.

(3) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the

income year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the income year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the corporation, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession.

(e) (1) Gains and losses from sales or other disposition of real property located in this State are allocable to this State.

(2) Gains and losses from sales or other disposition of tangible personal property are allocable to this State if

a. The property had a situs in this State at the time of the sale, or

b. The corporation's commercial domicile is in this State and the corporation is not taxable in the state in which the property has a situs.

(3) Gains and losses from sales or other disposition of intangible personal property are allocable to this State if the corporation's commercial domicile is in this State.

(f) Interest and net dividends are allocable to this State if the corporation's commercial domicile is in this State. For purposes of this section, the term "net dividends" means gross dividend income received less related expenses and less that portion of the dividends deductible under G.S. 105-130.7.

(g) (1) Royalties or similar income received from the use of patents, copyrights, secret processes and other similar intangible property are allocable to this State:

a. If and to the extent that the patent, copyright, secret process or other similar intangible property is utilized in this State, or

b. If and to the extent that the patent, copyright, secret process or other similar intangible property is utilized in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this State.

(2) A patent, secret process or other similar intangible property is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, processing, or other use in the state or to the extent that a patented product is produced in the state. If the basis of receipts from such intangible property does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the intangible property is utilized in the state in which the taxpayer's commercial domicile is located.

(3) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

(h) The income less related expenses from any other nonbusiness activities or investments not otherwise specified in this section is allocable to this State if the business situs of the activities or investments are located in this State.

(i) Most Corporations. --All business income of ~~corporations other than public utilities and excluded corporations shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four. Provided, that where the sales factor does not exist, the denominator of the fraction shall be the number of existing factors and where the sales factor exists but the payroll factor or the property factor does not exist, the denominator of the fraction shall be the number of existing factors plus one.~~corporations, other than those corporations that are required to apportion business income under one of the special formulas provided in subsections (m) through (s2) of this section, is apportioned to this State by multiplying the income by the general formula.

(j) (1) The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned or rented and used in this State during the income year and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used during the income year. Neither the numerator nor the denominator includes outer-jurisdictional property.

(2) Property owned by the corporation is valued at its original cost. Property rented by the corporation is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the corporation less any annual rental rate received by the corporation from subrentals except that subrentals shall not be deducted when they constitute business income. Any property under construction and any property the income from which constitutes nonbusiness income shall be excluded in the computation of the property factor.

(3) The average value of property shall be determined by averaging the values at the beginning and end of the income year, but in all cases the Secretary of Revenue may require the averaging of monthly or other periodic values during the income year if reasonably required to reflect properly the average value of the corporation's property. A

corporation that ceases its operations in this State before the end of its income year because of its intention to dissolve or to relinquish its certificate of authority, or because of a merger, conversion, or consolidation, or for any other reason whatsoever shall use the real estate and tangible personal property values as of the first day of the income year and the last day of its operations in this State in determining the average value of property, but the Secretary may require averaging of monthly or other periodic values during the income year if reasonably required to reflect properly the average value of the corporation's property.

(k) (1) The payroll factor is a fraction, the numerator of which is the total amount paid in this State during the income year by the corporation as compensation, and the denominator of which is the total compensation paid everywhere during the income year. All compensation paid to general executive officers and all compensation paid in connection with nonbusiness income shall be excluded in computing the payroll factor. General executive officers shall include the chairman of the board, president, vice-presidents, secretary, treasurer, comptroller, and any other officers serving in similar capacities.

(2) Compensation is paid in this State if:

a. The individual's service is performed entirely within the State; or

b. The individual's service is performed both within and without the State, but the service performed without the State is incidental to the individual's service within the State; or

c. Some of the service is performed in this State and (i) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in this State, or (ii) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this State.

(l) (1) The sales factor is a fraction, the numerator of which is the total sales of the corporation in this State during the income year, and the denominator of which is the total sales of the corporation everywhere during the income year. Notwithstanding any other provision under this Part, the receipts from any casual sale of property shall be excluded from both the numerator and the denominator of the sales factor. Where a corporation is not taxable in another state on its business income but is taxable in another state

only because of nonbusiness income, all sales shall be treated as having been made in this State.

(2) Sales of tangible personal property are in this State if the property is received in this State by the purchaser. In the case of delivery of goods by common carrier or by other means of transportation, including transportation by the purchaser, the place at which the goods are ultimately received after all transportation has been completed shall be considered as the place at which the goods are received by the purchaser. Direct delivery into this State by the taxpayer to a person or firm designated by a purchaser from within or without the State shall constitute delivery to the purchaser in this State.

(3) Other sales are in this State if:

a. The receipts are from real or tangible personal property located in this State; or

b. The receipts are from intangible property and are received from sources within this State; or

c. The receipts are from services and the income-producing activities are in this State.

(m) All business income of a railroad company shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the "railway operating revenue" from business done within this State and the denominator of which is the "total railway operating revenue" from all business done by the company as shown by its records kept in accordance with the standard classification of accounts prescribed by the Interstate Commerce Commission.

"Railway operating revenue" from business done within this State shall mean "railway operating revenue" from business wholly within this State, plus the equal mileage proportion within this State of each item of "railway operating revenue" received from the interstate business of the company. "Equal mileage proportion" shall mean the proportion which the distance of movement of property and passengers over lines in this State bears to the total distance of movement of property and passengers over lines of the company receiving such revenue. "Interstate business" shall mean "railway operating revenue" from the interstate transportation of persons or property into, out of, or through this State. If the Secretary of Revenue shall find, with respect to any particular company, that its accounting records are not kept so as to reflect with exact accuracy such division of revenue by State lines as to each transaction involving interstate revenue, the Secretary of Revenue may adopt such regulations, based upon averages, as will approximate with reasonable accuracy the proportion of interstate revenue actually earned upon lines in this State. Provided, that where a railroad is being operated by a partnership which is treated as a corporation for income tax purposes and pays a net income tax to this State, or if

located in another state would be so treated and so pay as if located in this State, each partner's share of the net profits shall be considered as dividends paid by a corporation for purposes of this Part and shall be so treated for inclusion in gross income, deductibility, and separate allocation of dividend income.

(n) All business income of a telephone company shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is gross operating revenue from local service in this State plus gross operating revenue from toll services performed wholly within this State plus the proportion of revenue from interstate toll services attributable to this State as shown by the records of the company plus the gross operating revenue in North Carolina from other service less the uncollectible revenue in this State, and the denominator of which is the total gross operating revenue from all business done by the company everywhere less total uncollectible revenue. Provided, that where a telephone company is required to keep its records in accordance with the standard classification of accounts prescribed by the Federal Communications Commission the amounts in such accounts shall be used in computing the apportionment fraction as provided in this subsection.

(o) All business income of a motor carrier of property shall be apportioned by multiplying the income by a fraction, the numerator of which is the number of vehicle miles in this State and the denominator of which is the total number of vehicle miles of the company everywhere. The words "vehicle miles" shall mean miles traveled by vehicles owned or operated by the company hauling property for a charge or traveling on a scheduled route.

(p) All business income of a motor carrier of passengers shall be apportioned by multiplying the income by a fraction, the numerator of which is the number of vehicle miles in this State and the denominator of which is the total number of vehicle miles of the company everywhere. The words "vehicle miles" shall mean miles traveled by vehicles owned or operated by the company carrying passengers for a fare or traveling on a scheduled route.

(q) All business income of a telegraph company shall be apportioned by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor and the denominator of which is three.

The property factor shall be as defined in subsection (j) of this section, the payroll factor shall be as defined in subsection (k) of this section, and the sales factor shall be as defined in subsection (l) of this section.

(r) All business income of an excluded corporation and of all other public utilities shall be apportioned by multiplying the income by the sales factor as determined under subsection (l) of this section.

(s) All business income of an air or water transportation corporation shall be apportioned by a fraction, the numerator of which is the corporation's revenue ton miles in this State and the denominator of which is the corporation's revenue ton miles everywhere. The term "revenue ton mile" means one ton of passengers, freight,

mail, or other cargo carried one mile. In making this computation, a passenger is considered to weigh two hundred pounds.

(s1) Broadcasters. -- All business income of a corporation engaged in the business of broadcasting radio or television programming is apportioned by multiplying the income by the general formula, after modifying the numerator of the sales factor in accordance with this section. The numerator includes all receipts from broadcasting radio and television programming multiplied by an audience factor. For radio broadcasts and for television broadcasts by a television station, the audience factor is the ratio of the corporation's North Carolina listening or viewing audience to the corporation's total listening or viewing audience. For television broadcasts by a cable television system, the audience factor is the ratio of the cable television system's subscribers located in this State to all the cable television system's subscribers. A corporation may use published rating or subscription statistics, as appropriate, to determine its audience factor.

(s2) Publishers. -- All business income of a corporation engaged in the business of publishing, selling, licensing, or distributing newspapers, magazines, trade journals, books, or other publications is apportioned by multiplying the income by the general formula, after modifying the numerator of the sales factor in accordance with this section. The numerator includes all the corporation's receipts from advertising and from the sale, rental, or other use of its customer lists multiplied by a circulation factor. The circulation factor is the ratio of the corporation's North Carolina purchasers and subscribers of a publication to the corporation's total purchasers and subscribers of the publication. A purchaser or subscriber of a publication is the final recipient of the publication. A separate circulation factor applies to each publication. If advertising in a publication is included only in copies of the publication distributed to a limited geographic area, the circulation factor is determined on the basis of the circulation within the limited geographic area. A corporation may use rating statistics published by the Audit Bureau of Circulations or other comparable statistics to determine the circulation factor for a publication.

(t) (1) If any corporation believes that the method of allocation or apportionment as administered by the Secretary has operated or will so operate as to subject it to taxation on a greater portion of its income than is reasonably attributable to business or earnings within the State, it may file with the Tax Review Board a petition setting forth the facts upon which its belief is based and its argument with respect to the application of the allocation formula. This petition shall be filed in such form and within such time as the Tax Review Board may prescribe. The Board shall grant a hearing on the petition. The time limitations set in G.S. 105-241.2 for the date of the hearing, notification to the taxpayer, and a decision following the hearing apply to a hearing held pursuant to this subsection. At

least three members of the Tax Review Board shall attend any hearing pursuant to such petition. In such cases, the Tax Review Board's membership shall be augmented by the addition of the Secretary, who shall sit as a member of the Board with full power to participate in its deliberations and decisions with respect to petitions filed under the provisions of this subsection. An informal record containing in substance the evidence, contentions and arguments presented at the hearing shall be made. All members of the augmented Tax Review Board shall consider such evidence, contentions and arguments and the decisions thereon shall be made by a majority vote of the augmented Board.

(2) If the corporation employs in its books of account a detailed allocation of receipts and expenditures which reflects more clearly than the applicable allocation formula prescribed by this section the income attributable to the business within this State, application for permission to base the return upon the taxpayer's books of account shall be considered by the Tax Review Board. The Board may permit such separate accounting method in lieu of applying the applicable allocation formula if the Board finds that method best reflects the income and earnings attributable to this State.

(3) If the corporation shows that any other method of allocation than the applicable allocation formula prescribed by this section reflects more clearly the income attributable to the business within this State, application for permission to base the return upon such other method shall be considered by the Tax Review Board. The application shall be accompanied by a statement setting forth in detail, with full explanations, the method the corporation believes will more nearly reflect its income from business within this State. If the Board concludes that the allocation formula prescribed by this section allocates to this State a greater portion of the net income of the corporation than is reasonably attributable to business or earnings within this State, it shall determine the allocable net income by such other method as it finds best calculated to assign to this State for taxation the portion of the corporation's net income reasonably attributable to its business or earnings within this State.

(4) There shall be a presumption that the appropriate allocation formula reasonably attributes to this State the portion of the corporation's income earned in this State, and the burden shall rest upon the corporation to show the contrary. The relief herein authorized shall be granted by the Board only in cases of clear, cogent and convincing proof that the petitioning corporation is entitled thereto.

No corporation shall use any alternative formula or method other than the applicable allocation formula provided by statute in making a report or return of its income to this State except upon order in writing of the Board, and any return in which any alternative formula or other method, other than the applicable allocation formula prescribed by statute, is used without permission of the Board shall not be a lawful return.

When the Board determines, pursuant to the provisions of this subsection, that an alternative formula or other method more accurately reflects the income allocable to North Carolina and renders its decision with regard thereto, the corporation shall allocate its net income for future years in accordance with such determination and decision of the Board so long as the conditions constituting the basis upon which the decision was made remain unchanged or until such time as the business method of operation of the corporation changes. Provided, however, that the Secretary may, with respect to any subsequent year, require the corporation to furnish information relating to its property, operations, and activities.

(5) A corporation which proposes to do business in this State may file a petition with the Board setting forth the facts upon which it contends that the applicable allocation formula will allocate a greater portion of the corporation's future income to North Carolina than will be reasonably attributable to its proposed business or contemplated earnings within the State. Upon a proper showing in accordance with the procedure described above for determinations by the Board, the Board may authorize such corporation to allocate income from its future business to North Carolina on the basis prescribed by the Board under the provisions of this section for such future years if the conditions constituting the basis upon which the Board's decision is made remain unchanged and the business operations of the corporation continue to conform to the statement of proposed methods of business operation presented by the corporation to the Board.

(6) When the Secretary asserts liability under the formula adjustment decision of the Tax Review Board, an aggrieved corporation may pay the tax and bring a civil action for recovery under the provisions of Article 9."

SECTION 2. This act is effective for taxable years beginning on or after January 1, 2003.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 2: UPDATE CORPORATE TAX APPORTIONMENT FORMULA

BY: MARTHA WALSTON, FISCAL RESEARCH DIVISION

SUMMARY: This proposal is a Department of Revenue recommendation to amend the allocation and apportionment of income for corporations set out in G.S. 105-130.4 by making the following three changes:

1. *Amend the property factor so that outer-jurisdictional property is excluded from the numerator and denominator of the property factor. Outer-jurisdictional property is defined as "tangible personal property that is not physically located in any state." Examples of "outer-jurisdictional property" include orbiting satellites and undersea transmission cables.*
2. *Add an alternative formula for corporations engaged in the business of broadcasting radio or television programming. The sales factor is amended so that gross receipts, including advertising revenue, are sourced by an audience factor*
3. *Add an alternative formula for corporations engaged in the business of publishing, selling, licensing, or distributing newspapers, magazines, trade journals, books, or other publications. The sales factor is amended so that gross receipts from advertising and from the sales, rental, or other use of the corporation's customer lists are sourced by a circulation factor.*

ANALYSIS: Below is a more detailed description of the changes to G.S. 105-130. 4:
The proposal amends subsection (a). This subsection sets out the definitions used in this statute. The proposal adds the following new definitions: "broadcasting", "general formula", "outer-jurisdictional property", "radio programming", and "television programming". The current definition of "public utility" is amended so that the term does not include a corporation engaged in the business of broadcasting radio or television programming.

The proposal amends subsection (i). This subsection sets out the apportionment formula applicable to most corporations. The proposal refers to the special formulas and new definition for "general formula".

The proposal amends subsection (j). This subsection describes the property factor used in the general formula for allocation and apportionment of income for corporations. The proposal amends the subsection by excluding outer-jurisdictional property from the numerator and denominator of the property factor.

The proposal adds a new subsection (s1). This new subsection provides an alternative apportionment formula for corporations engaged in the business of broadcasting radio or television programming. The new formula modifies the standard sales factor based on a model regulation adopted by the Multistate Tax Commission on August 31, 1990, and amended on April 25, 1996. The new sales factor is calculated using an audience factor:

Gross receipts from broadcasting, including advertising revenue, X audience factor plus other gross receipts

Total gross receipts of the corporation everywhere in income year

The audience factor, for radio broadcasts and television broadcasts, is the ratio of the corporation's NC viewing or listening audience to the corporation's total viewing or listening audience. The audience factor, for television broadcasts by a cable television system, is the ratio of the cable television system's subscribers located in this State to all the cable television system's subscribers.

The Department of Revenue gives the following example of how the audience factor would affect taxpayers:

> A national broadcasting company with nexus in NC and several other states owns a television station in Charlotte and generates advertising revenue from Charlotte-area merchants. Twenty percent of the television station's audience is in South Carolina. All of the income producing activities with respect to the advertising is conducted in NC. Under current law, all of the advertising revenue is included in the numerator of the NC sales factor fraction. Under the audience factor provision, twenty percent of the advertising revenue would be excluded from the numerator of the NC sales factor fraction.

The proposal adds a new subsection (s2). This new subsection provides an alternative apportionment formula for corporations engaged in the business of publishing, selling, licensing or distributing newspapers, magazines, periodicals, trade journals, or other publications. The new formula modifies the standard sales factor based on a model regulation adopted by the Multistate Tax Commission on July 30, 1993. The following new sales factor is calculated using a circulation factor:

gross receipts from sales of publications to NC purchaser or subscriber + circulation factor X gross receipts from advertising and from sale or use of the corporation's customer list

total gross receipts of corporation everywhere during income year

The circulation factor equals the ratio of the corporation's NC purchasers and subscribers of a publication to the corporation's total purchasers and subscribers of the publication. A separate circulation factor applies to each publication.

The Department of Revenue gives the following example of how the circulation factor would affect taxpayers:

> A national publishing company with nexus in NC and several other states generates advertising revenue from one of its magazines. Ten percent of the magazine's subscribers are in NC. All of the income producing activities with respect to the advertising is conducted outside of NC. Under current law, none of the advertising revenue is included in the numerator of the NC sales factor fraction. Under the circulation factor provision, ten percent of the advertising revenue would be included in the numerator of the NC sales factor fraction.

The above changes to G.S. 105-130.4 will also affect the way a corporation apportions its capital stock, surplus, and undivided profits for franchise tax purposes. G.S. 105-122(c)(1) provides that a corporation must apportion its capital stock, surplus, and undivided profits to NC by using the apportionment formula in G.S. 105-130.4. The franchise tax, one of the oldest NC taxes, is a tax on S corporations and C corporations for the privilege of doing business in the State. The tax rate is $1.50 per $1,000 of value of the largest of (1) the amount of capital stock, surplus, and undivided profits apportionable to the State, (2) 55% of the appraised value of all real and tangible personal property in the State that is subject to local property taxation, or (3) the total actual investment in tangible property in the State.

LEGISLATIVE PROPOSAL #3

STREAMLINED SALES TAX CHANGES

LEGISLATIVE PROPOSAL 3:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2003 GENERAL ASSEMBLY, 2003 SESSION

AN ACT TO ADOPT THE STREAMLINED SALES TAX CHANGES.

SHORT TITLE: Streamlined Sales Tax Changes.

SPONSORS: **Rep. Luebke**, Allen, Hill, Holliman, Wainwright
Sen. Kerr, Clodfelter, Dalton, Hartsell, Hoyle

BRIEF OVERVIEW: This proposal adopts the uniform definition of "drug", "prescription", and "over-the-counter drug" contained in the Streamlined Sales and Use Tax Agreement. The change in the definition does not change the taxability of drugs for North Carolina sales and use tax purposes. Prescription drugs and over-the-counter drugs issued on a prescription continue to be exempt from North Carolina sales and use tax.

FISCAL IMPACT: No impact.

EFFECTIVE DATE: This proposal becomes effective July 1, 2003.

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

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2003

S D

BILL DRAFT 2003-SCz-2 [v.3] (1/24)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/24/2003 1:33:49 PM

Short Title: Streamlined Sales Tax Changes. (Public)

Sponsors:

Referred to:

A BILL TO BE ENTITLED

AN ACT TO ADOPT THE STREAMLINED SALES TAX CHANGES.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-163.3 is amended by adding the following new subsections to read:

"(8a) Drug. – A compound, substance or preparation or a component of one of these that meets any of the following descriptions and is not food, a dietary supplement, or an alcoholic beverage:

a. Is recognized in the United States Pharmacopoeia, Homeopathic Pharmacopoeia of the United States, or National Formulary.

b. Is intended for use in the diagnosis, cure, mitigation, treatment, or prevention of disease.

c. Is intended to affect the structure of the body.

...

(25a) Over-the-counter-drug. – A drug that can be dispensed under federal law without a prescription and is required by 21 C.F.R. section 210.66 to have a label containing a "Drug Facts" panel and a statement of its active ingredients."

SECTION 2. G.S. 106-164.3(29) reads as rewritten:

"(29) ~~Prescription drug. – A drug that under federal law is required, prior to being dispensed or delivered, to be labeled with the following statement: "Caution: Federal law prohibits dispensing without prescription".~~ Prescription. – An order, formula, or recipe issued orally, in writing, electronically, or by another

means of transmission by a physician, dentist, veterinarian, or another person licensed to prescribe drugs."

SECTION 3. G.S. 105-164.13(13) reads as rewritten:

"(13) All of the following drugs, including ~~the constituent elements and ingredients used to produce the drugs, the~~ their packaging ~~materials,~~ materials and any instructions or information about the ~~product~~ drugs included in the package with ~~the drugs:~~ them:

a. ~~Prescription drugs.~~ Drugs required by federal law to be dispensed only on prescription.

b. ~~Nonprescription drugs sold on prescription of physicians, dentists, or veterinarians.~~ Over-the-counter drugs sold on prescription.

c. Insulin."

SECTION 4. This act is effective July 1, 2003.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 3: STREAMLINED SALES TAX CHANGES

BY: CINDY AVRETTE, RESEARCH DIVISION

SUMMARY: Legislative Proposal 3 adopts the uniform definition of "drug", "prescription", and "over-the-counter drug" contained in the Streamlined Sales and Use Tax Agreement. The change in definition does not change the taxability of drugs for North Carolina sales and use tax purposes. Prescription drugs and over-the-counter drugs issued on a prescription continue to be exempt from North Carolina sales and use tax.

BACKGROUND: The Streamlined Sales Tax Project is an effort created by state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax administration for both Main Street and remote sellers for all types of commerce. Thirty-nine of the forty-five states with a sales and use tax, as well as the District of Columbia, are involved in the Project.

The Project envisions two components to the legislation necessary to accomplish its goals. First, states would adopt enabling legislation referred to as the Uniform Sales and Use Tax Administration Act. The Act allows the state to enter into an agreement with one or more states to simplify and modernize sales and use tax administration in order to reduce the burden of tax compliance for all sellers and all types of commerce. Thirty-five states and the District of Columbia have enacted the Uniform Sales and Use Tax Administration Act. Secondly, states would amend or modify their sales and use tax law to achieve the simplifications and uniformity required by the participating state working together. The Project refers to this legislation as the Streamlined Sales and Use Tax Agreement. A certificate of compliance will document each state's compliance with the provisions of the Agreement. The Agreement takes effect when at least 10 states comprising at least 20 percent of the total population of all states imposing a state sales tax have petitioned for membership and have been found to be in compliance with the requirements of the Agreement. The Agreement will take effect on the first day of a calendar quarter at least 60 days after the tenth state is found in compliance, but cannot take effect prior to July 1, 2003.

The Revenue Laws Study Committee has recommended, and the General Assembly has enacted, both the Uniform Sales and Use Tax Administration Act and many provisions in the Streamlined Sales and Use Tax Agreement.[1] As of

[1] S.L. 2000-120 and S.L. 2001-347.

November 12, 2002, representatives of 33 states and the District of Columbia voted to approve the final version of the Streamlined Sales and Use Tax Agreement. The provisions in the Agreement cover many issues, including the following:

- Single tax base
- Reduction of multiple rates
- Uniform definitions for exemptions
- Uniform sourcing
- Limitations on sales tax holidays
- Elimination of caps and thresholds

BILL ANALYSIS: Legislative Proposal 3 adopts only one change necessitated by the Agreement: it adopts the uniform definitions for the terms "drug", "prescription", and "over-the-counter drug". The proposal does not change the taxability of drugs for North Carolina sales and use tax purposes.

Although North Carolina has adopted many of the provisions in the Agreement, it will need to address several others before it can be found to be in compliance with the Agreement adopted in November 2002. Some of the issues remaining for the State to address include:

- The exemption of food from part, but not all, of the local tax base.
- The 1%, $80 cap on certain types of equipment.
- The uniform definition of computer software.

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: **February 7, 2003**

TO: Revenue Laws Study Committee

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: Legislative Proposal 3: Streamlined Sales Tax Changes

FISCAL IMPACT

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

	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08
REVENUES					
	See Assumptions and Methodology				
EXPENDITURES					
POSITIONS:					

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

EFFECTIVE DATE:

BILL SUMMARY: Under the U.S. Supreme Court decision in Belle Hess and Quill states cannot require out of state retailers to collect sales tax on purchases delivered into their state, as it was determined to create an undo burden on those out of state businesses. In an attempt

reduced the potential burden on out of state retailers and capture this potential revenue stream the states are in the process of developing a uniform streamlined sales agreement with common definitions, terms and processes. North Carolina has been involved in the Streamlined Sales Tax Project for several years and has been a signatory of the agreement since 2000. This bill incorporates some of the newest changes to that agreement proposed by the multi-state Streamlined Sales Tax Project participants. Specifically, it provides definitions of the terms "drug", "prescription", and "over-the-counter drug".

ASSUMPTIONS AND METHODOLOGY: Because the proposal does not change the taxability of drugs in North Carolina for sales and use tax purposes, no significant sales tax revenue change is expected. There may be some small shift if the new definitions change the taxability of particular subsets of these categories, such as shampoos purchased under prescription, but since it is unclear to Fiscal Research what, if any, products might change categories, no specific fiscal estimate is possible. The Department of Revenue expects whatever shift occurs to be extremely small.

SOURCES OF DATA: North Carolina Department of Revenue.

LEGISLATIVE PROPOSAL #4

STATE GOVERNMENT SALES TAX EXEMPTION

LEGISLATIVE PROPOSAL 4:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2003 GENERAL ASSEMBLY, 2003 SESSION

AN ACT TO PROMOTE EFFICIENCY IN STATE GOVERNMENT BY ALLOWING A SALES AND USE TAX EXEMPTION FOR STATE AGENCIES INSTEAD OF A SALES AND USE TAX REFUND TO STATE AGENCIES.

SHORT TITLE: State Government Sales Tax Exemption.

SPONSORS: **Rep. Allen**, Hill, Holliman, Luebke, McComas, Wainwright
Sen. Kerr, Clodfelter, Dalton, Hartsell, Hoyle

BRIEF OVERVIEW: This proposal exempts direct purchases by State agencies from the State and local sales tax. State agencies must currently apply for a refund of local sales taxes.

FISCAL IMPACT: The loss to the General Fund of sales tax monies paid by State agencies on direct purchases of tangible personal property would be offset by the reduction in State expenditures needed to pay the sales taxes.

EFFECTIVE DATE: The sales and use tax exemption would become effective July 1, 2004, and apply to sales made on or after that date.

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

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2003

S D

BILL DRAFT 2003-SCz-1 [v.6] (1/24)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
2/12/2003 4:04:48 PM

Short Title: State Govt. Sales Tax Exempt. (Public)

Sponsors:

Referred to:

A BILL TO BE ENTITLED

AN ACT TO PROMOTE EFFICIENCY IN STATE GOVERNMENT BY ALLOWING A SALES AND USE TAX EXEMPTION FOR STATE AGENCIES INSTEAD OF A SALES AND USE TAX REFUND TO STATE AGENCIES.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-164.13 is amended by adding a new subdivision to read:

"**§ 105-164.13. Retail sales and use tax.**

The sale at retail, the use, storage or consumption in this State of the following tangible personal property is specifically exempted from the tax imposed by this Article:

...

(51) Items subject to sales and use tax under G.S. 105-164.4, other than electricity and telecommunications service, if all of the following conditions are met:

a. The items are purchased by a State agency.

b. The items purchased are paid for by a check, credit card, procurement card, or credit account of the State agency.

c. The items are purchased pursuant to a purchase order of the State agency signed by the person authorized to sign checks for the agency that contains the exemption number of the agency and a description of the property purchased."

SECTION 2. G.S. 105-164.14(c) reads as rewritten:

"(c) Certain Governmental Entities. – A governmental entity listed in this subsection is allowed an annual refund of sales and use taxes paid by it under this ~~Article, except under G.S. 105-164.4(a)(4a) and G.S. 105-164.4(a)(4c),~~ Article on direct purchases of tangible personal ~~property.~~ property and services, other than electricity and telecommunications service. Sales and use tax liability indirectly incurred by a governmental entity on building materials, supplies, fixtures, and equipment that become a part of or annexed to any building or structure that is owned or leased by the governmental entity and is being erected, altered, or repaired for use by the governmental entity is considered a sales or use tax liability incurred on direct purchases by the governmental entity for the purpose of this subsection. A request for a refund must be in writing and must include any information and documentation required by the Secretary. A request for a refund is due within six months after the end of the governmental entity's fiscal year.

This subsection applies only to the following governmental entities:

(1) A county.

(2) A city as defined in G.S. 160A-1.

(2a) A consolidated city-county as defined in G.S. 160B-2.

(2b) A local school administrative unit.

(3) A metropolitan sewerage district or a metropolitan water district in this State.

(4) A water and sewer authority created under Chapter 162A of the General Statutes.

(5) A lake authority created by a board of county commissioners pursuant to an act of the General Assembly.

(6) A sanitary district.

(7) A regional solid waste management authority created pursuant to G.S. 153A-421.

(8) An area mental health, developmental disabilities, and substance abuse authority, other than a single-county area authority, established pursuant to Article 4 of Chapter 122C of the General Statutes.

(9) A district health department, or a public health authority created pursuant to Part 1A of Article 2 of Chapter 130A of the General Statutes.

(10) A regional council of governments created pursuant to G.S. 160A-470.

(11) A regional planning and economic development commission or a regional economic development commission created pursuant to Chapter 158 of the General Statutes.

(12) A regional planning commission created pursuant to G.S. 153A-391.

(13) A regional sports authority created pursuant to G.S. 160A-479.
(14) A public transportation authority created pursuant to Article 25 of Chapter 160A of the General Statutes.
(14a) A facility authority created pursuant to Part 4 of Article 20 of Chapter 160A of the General Statutes.
(15) A regional public transportation authority created pursuant to Article 26 of Chapter 160A of the General Statutes, or a regional transportation authority created pursuant to Article 27 of Chapter 160A of the General Statutes.
(16) A local airport authority that was created pursuant to a local act of the General Assembly.
(17) A joint agency created by interlocal agreement pursuant to G.S. 160A-462 to operate a public broadcasting television station.
(18) Repealed by Session Laws 2001-474, s. 7.
(19) Repealed by Session Laws 2001-474, s. 7.
~~(20) A constituent institution of The University of North Carolina, but only with respect to sales and use tax paid by it for tangible personal property acquired by it through the expenditure of contract and grant funds.~~
~~(21) The University of North Carolina Hospitals at Chapel Hill.~~
(22) A regional natural gas district created pursuant to Article 28 of Chapter 160A of the General Statutes."

SECTION 3. G.S. 105-164.14(e) reads as rewritten:

"(e) State Agencies. – The State is allowed quarterly refunds of local sales and use taxes paid ~~by a State agency on direct purchases of tangible personal property and local sales and use taxes paid~~ indirectly by the State agency on building materials, supplies, fixtures, and equipment that become a part of or annexed to a building or structure that is owned or leased by the State agency and is being erected, altered, or repaired for use by the State agency. ~~This subsection does not apply to purchases for which a State agency is allowed a refund under subsection (c) of this section.~~

A person who pays local sales and use taxes on building materials or other tangible personal property for a State building project shall give the State agency for whose project the property was purchased a signed statement containing all of the following information:

(1) The date the property was purchased.
(2) The type of property purchased.
(3) The project for which the property was used.
(4) If the property was purchased in this State, the county in which it was purchased.

(5) If the property was not purchased in this State, the county in which the property was used.

(6) The amount of sales and use taxes paid.

If the property was purchased in this State, the person shall attach a copy of the sales receipt to the statement. A State agency to whom a statement is submitted shall verify the accuracy of the statement.

Within 15 days after the end of each calendar quarter, every State agency shall file with the Secretary a written application for a refund of taxes to which this subsection applies paid by the agency during the quarter. The application shall contain all information required by the Secretary. The Secretary shall credit the local sales and use tax refunds directly to the General Fund."

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

"**§ 105-164.29A. State government exemption process.**

(a) Application. – To be eligible for the exemption provided in G.S. 105-164.13(47), a State agency must obtain from the Department of Revenue a sales tax exemption number. The application for exemption must be in the form required by the Secretary, be signed by the State agency's head, and contain any information required by the Secretary. The Secretary must assign a sales tax exemption number to a State agency that submits a proper application.

(b) Liability. – A State agency that does not use the items purchased with its exemption number must pay the tax that should have been paid on the items purchased, plus interest calculated from the date the tax would otherwise have been paid."

SECTION 5. The Office of State Budget and Management must reduce each State agency's certified budget for fiscal years 2003-04 and 2004-05 by an appropriate amount to reflect the tax savings generated by the sales and use tax exemption for State agencies allowed under this act.

SECTION 6. Section 4 of this act becomes effective January 1, 2004. The remainder of this act becomes effective July 1, 2004, and applies to sales made on or after that date.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 4: STATE GOVERNMENT SALES TAX EXEMPTION

BY: CINDY AVRETTE, RESEARCH DIVISION

SUMMARY: Legislative Proposal 4 exempts purchases by State agencies from the State and local sales tax. State agencies must currently apply for a refund of local sales taxes. The exemption, versus the refund, would become effective July 1, 2004.

CURRENT LAW: Currently, all major State agencies except the Department of Transportation[1], is subject to State and local sales taxes. However, the State receives a refund of the local sales taxes paid by its agencies, with the proceeds of the refund going to the General Fund. Refunds for purchases by the constituent institutions of the University of North Carolina, the North Carolina Low Level Radioactive Waste Management Authority, the North Carolina Hazardous Waste Management Commission, and the University of North Carolina Hospitals at Chapel Hill are made on an annual basis and refunded directly to the state agency.

BILL ANALYSIS: The current refund process is time-consuming for both the Office of the State Controller, the agencies, and the Department of Revenue. To relieve the agencies of this burden, the Office of the State Controller recommends that the refund process be changed to a sales and use tax exemption for State agencies.

Legislative Proposal 4 changes the current refund process to an exemption. To qualify for the exemption, the following conditions must be met:

- The items must be purchased by a State agency.
- The items purchased must be paid for by a check, credit card, procurement care, or credit account of a State agency.
- The items must be purchased pursuant to a purchase order of the State agency signed by the person authorized to sign checks for the agency. The purchase order must contain the exemption number of the agency and a description of the items purchased. To receive an exemption number, the State agency must apply for one from the Department of Revenue. The application must be signed by the State agency's head and contain any information required by the Secretary.

[1] The Department of Transportation is exempt from State and local sales and use tax.

The sales tax exemption would apply only to direct purchases of tangible personal property. State agencies would continue to apply for refunds of local taxes paid on indirect purchases of building materials, supplies, fixtures, and equipment that become a part of a structure owned or leased by the State.

A state agency would be liable for items purchased with its exemption number that it does not use. The liability would include not only the tax that should have been paid on the items purchased, but also interest calculated fro the date the tax would otherwise have been paid.

The term "State agency" is currently defined for sales and use tax purposes as a unit of the executive, legislative, or judicial branch of State government, such as a department, commission, board, council, or The University of North Carolina. The term does not include local boards of education.

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: **January 27, 2003**

TO: Revenue Laws Study Committee

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: State Agency Sales Tax Exemption

FISCAL IMPACT

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

	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08
REVENUES					
General Fund	(33.5)	(34.6)	(35.9)	(37.1)	(38.4)
EXPENDITURES					
State Agencies	(25.2)	(25.7)	(26.3)	(26.8)	(27.3)
UNC Hospitals	(8.3)	(8.9)	(9.6)	(10.3)	(11.1)
TOTAL	(33.5)	(34.6)	(35.9)	(37.1)	(38.4)

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: State agencies, UNC Constituent Institutions, UNC Hospitals.

EFFECTIVE DATE: July 1, 2003

BILL SUMMARY: Under current law purchases by all major state agencies but one are subject to state and local sales taxes, unless the item purchased is exempt from tax for all

purchasers. (The Department of Transportation is exempt from all local and state tax). However, the State receives a refund of the local sales taxes paid by its agencies, with the proceeds of this refund going to the general fund. Most state agencies file on a quarterly basis. Refunds of state and local taxes on purchases by the North Carolina Low Level Radioactive Waste Management Authority, the North Carolina Hazardous Waste Management Commission, constituent institutions of the University of North Carolina, and the University of North Carolina Hospitals at Chapel Hill are made on an annual basis and are refunded directly to the state agency. This bill exempts all state agencies from state and local sales tax. In order to qualify for the exemption a state agency must obtain a sales tax exemption number from the Department of Revenue. If the state agency does not use the items purchased with its number it is liable for the tax on that item. State agencies will continue to file quarterly for a refund of local sales taxes on indirect purchases. The Office of Management and Budget is charged with reducing 2003-04 agency allocations to reflect this change.

ASSUMPTIONS AND METHODOLOGY: This legislation will affect both revenues and expenditures.

REVENUES: According to the Department of Revenue, for FY 1999-00 state agency refunds of local taxes (excluding the UNC Hospitals) to the General Fund totaled $14.2 million. Based that refund data, Tax Research estimates that state agencies paid $42.6 million in state and local sales taxes in 1999-00. Due to continuing budget and agency allocation reductions, actual refunds for local sales taxes paid on agency direct purchases in 2001-02 dropped to approximately $8.5 million, suggesting that state agencies (excluding UNC Hospitals) paid a total of approximately $27.3 million in state and local sales taxes on direct purchases ($8.5 million in local taxes, $18.6 million in state taxes, $0.2 million in Mecklenburg additional ½ cent taxes). Given the current budget situation, it is assumed that agency purchases decline again in 2002-03 and 2003-04 and then slowly increase in the out years. Estimated potential state agency refunds for sales that occur in a given fiscal year are as follows:

	State	Local	Mecklenburg	TOTAL
2001-02	18,607,329	8,546,907	181,346	27,335,581
2002-03	18,269,013	9,134,507	172,279	27,575,799
2003-04	15,427,167	9,641,979	163,665	25,232,811
2004-05	15,735,710	9,834,819	166,938	25,737,467
2005-06	16,050,424	10,031,515	170,277	26,252,216
2006-07	16,371,433	10,232,146	173,682	26,777,261
2007-08	16,698,862	10,436,789	177,156	27,312,806

The amounts for 2003-04 and 2004-05 are the amounts that are anticipated to be backed out of individual agencies by the Office of State Budget and Management in their budget certification process.

The above analysis does not include the UNC Hospitals, although they will be affected by the legislation. According to returns filed with the Department of Revenue, UNC Hospitals paid $7,043,970 in sales tax in 2001-02 on direct purchases. Under the legislation, these sales would now become tax-exempt. Historic data on sales tax refund claims filed by UNC Hospitals indicates that over the past three years claim amounts have grown by an average of 7.6%. Using this historic rate to estimate future potential claims suggests the following potential UNC Hospital refunds for sales that occur in a given fiscal year:

2002-03	7,691,674
2003-04	8,276,241
2004-05	8,905,236
2005-06	9,582,034
2006-07	10,310,268
2007-08	11,093,849

The amounts for 2003-04 and 2004-05 are the amounts that are anticipated to be backed out of individual agencies by the Office of State Budget and Management in their budget certification process.

NOTE: Indirect purchases are not included in these estimates, as they are not affected by the legislation.

EXPENDITURES:

The primary impact of the legislation on expenditures is the reduction in agency budgets to reflect the sales tax exemption. Under the bill the Office of Management and Budget is directed to determine the amount of sales tax each agency would have spent and reduce their funding allocation by the amount. After the first year, this process will become unnecessary. This fiscal note assumes that the Office of Management and Budget will be able to back out the sales tax numbers and that 2003-04 and 2004-05 allocations will be reduced to reflect the reduced cost of doing business.

SOURCES OF DATA: NC Department of Revenue, Office of State Budget and Management, and the constituent institutions of the University of North Carolina.

LEGISLATIVE PROPOSAL #5

UNIFORM TAX REFUND PROCEDURE

LEGISLATIVE PROPOSAL 5:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2003 GENERAL ASSEMBLY, 2003 SESSION

AN ACT TO ESTABLISH A UNIFORM PROCEDURE FOR TAX REFUND CLAIMS.

SHORT TITLE: Uniform Tax Refund Procedure.

SPONSORS: **Sen. Hartsell,** Clodfelter, Dalton, Hoyle, Kerr

BRIEF OVERVIEW: This proposal establishes a uniform tax refund procedure by repealing the "protest rule" and revising the statute governing refunds for overpayment of taxes to address all refund claims. Under this proposal, a taxpayer seeking a refund for any reason would be required to make a written request to the Secretary explaining why the refund is due. The Secretary would then have 90 days to review the request and issue a decision. Upon receiving notice of the Secretary's decision, a taxpayer who disagrees with the decision has 90 days to either request a hearing or file a civil action.

FISCAL IMPACT: No impact.

EFFECTIVE DATE: The proposal would become effective January 1, 2004, and apply to taxes paid on or after that date.

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

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2003

H D

BILL DRAFT 2003-SVz-1A [v.12] (12/16)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/30/2003 1:00:13 PM

Short Title: Uniform Tax Refund Procedure. (Public)

Sponsors:

Referred to:

A BILL TO BE ENTITLED

AN ACT TO ESTABLISH A UNIFORM PROCEDURE FOR TAX REFUND CLAIMS.

The General Assembly of North Carolina enacts:

SECTION 1. The first sentence of G.S. 105-267 is recodified as the first sentence of G.S. 105-266.1(a). The remainder of G.S. 105-267 is repealed.

SECTION 2. G.S. 105-266.1, as amended by Section 1 of this act, reads as rewritten:

"§ 105-266.1. Contesting a tax; ~~Refunds~~refunds of overpayment of taxes.

(a) Contesting a tax. – No court of this State shall entertain a suit of any kind brought for the purpose of preventing the collection of any tax imposed in this Subchapter.

(a1) Request for Refund. – A taxpayer may request a refund of tax paid by the taxpayer by making a written request to the Secretary for a refund. The refund request must explain why the refund is due and must be submitted within the period of the statute of limitations established in G.S. 105-266. The Secretary must review a request for refund within 90 days after it is received and determine whether the refund is due. If the Secretary requests the taxpayer to provide additional information needed to make a determination, the time allowed for making the determination is extended until 30 days after the Secretary received the information. The Secretary must notify the taxpayer of a determination and adjust the refund, if needed, in accordance with the determination. A taxpayer who disagrees with the Secretary's determination may request a hearing under subsection (a2) of this section or bring a civil action under subsection (c) of this section.~~If a taxpayer claims that a tax or an~~

~~additional tax paid by the taxpayer was excessive or incorrect, the taxpayer may apply to the Secretary for refund of the tax or additional tax at any time within the period set by the statute of limitations in G.S. 105-266.~~

(a2) Hearing. – A taxpayer may obtain a hearing on a refund determination by filing a written request for a hearing within 90 days after notification of the determination. ~~The Secretary shall grant a hearing on each timely request for a refund.~~ Within 60 days after a timely request for a ~~refund~~ hearing has been filed and at least 10 days before the date set for the hearing, the Secretary shall notify the taxpayer in writing of the time and place at which the hearing will be conducted. The date set for the hearing shall be within 90 days after the timely request for a hearing was filed or at a later date mutually agreed upon by the taxpayer and the Secretary. The date set for the hearing may be postponed once, at the request of the taxpayer or the Secretary, for a period of up to 90 days or for a longer period mutually agreed upon by the taxpayer and the Secretary.

Within 90 days after conducting a hearing under this subsection, the Secretary shall make a decision on the requested refund, notify the taxpayer of the decision, and adjust the computation of the tax in accordance with the decision. ~~The Secretary shall refund to the taxpayer in accordance with G.S. 105-266 the amount of any tax the Secretary finds was paid incorrectly or paid in excess of the tax due.~~

(b) Procedure. – The rules of evidence do not apply in a hearing before the Secretary of Revenue under this section. G.S. 105-241.2, 105-241.3, and 105-241.4 apply to a tax or additional tax assessed under this section. G.S. 105-266 governs a refund issued under this section.

(c) Civil Action. – A taxpayer may bring a civil action against the Secretary to recover the amount a taxpayer claims is an overpayment as a result of the determination denying the request for refund. The taxpayer must bring the civil action within 90 days after notification of the determination. ~~Within 90 days after notification of the Secretary's decision with respect to a demand for refund of any tax or additional tax under this section, an aggrieved taxpayer may, instead of petitioning for administrative review by the Tax Review Board under G.S. 105-241.2, bring a civil action against the Secretary for recovery of the alleged overpayment.~~ If the alleged overpayment is more than two hundred dollars ($200.00), the taxpayer may bring the action either in the Superior Court of Wake County or in the superior court of the county in which the taxpayer resides; if the alleged overpayment is two hundred dollars ($200.00) or less, the taxpayer may bring the action in any State court of competent jurisdiction in Wake County. If upon trial it is determined that ~~there has been an overpayment of tax or additional tax,~~ the taxpayer is entitled to a refund of tax or an additional tax paid by the taxpayer, judgment shall be rendered therefor, with interest, and the State shall refund the amount due.

(d) Appeal. – Either party may appeal to the appellate division from the judgment of the superior court under the rules and regulations prescribed by law for

appeals, except that ~~the Secretary, if he should appeal, shall not be~~ if the Secretary appeals, the Secretary is not required to give any undertaking or make any deposit to secure the cost of ~~such~~ the appeal.

(e) Alternative Procedure. – Nothing in this section shall be construed to conflict with or supersede the provisions of G.S. ~~105-241.2, and, with respect to tax paid to the Secretary of Revenue, the rights granted by this section are in addition to the rights provided by G.S. 105-267.~~105-241.2."

SECTION 3. G.S. 105-113.113(a) reads as rewritten:

"(a) Special Account. – The Secretary shall credit the proceeds of the tax levied by this Article to a special nonreverting account, to be called the State Unauthorized Substances Tax Account, until the tax proceeds are unencumbered. The Secretary shall remit the unencumbered tax proceeds as provided in this section on a quarterly or more frequent basis. Tax proceeds are unencumbered when either of the following occurs:

(1) The tax has been fully paid and the taxpayer has no current right under ~~G.S. 105-267~~Article 9 of this Chapter to seek a refund.

(2) The taxpayer has been notified of the final assessment of the tax under G.S. 105-241.1 and has neither fully paid nor timely contested the tax under ~~G.S. 105-241.1 through G.S. 105-241.4 or G.S. 105-267.~~Article 9 of this Chapter."

SECTION 4. G.S. 105-239.1(c) reads as rewritten:

"(c) The provisions of G.S. 105-241.1, 105-241.2, 105-241.3, 105-241.4, ~~105-266.1 and 105-267~~and 105-266.1 with respect to assessment procedure, demand for refund, review, and appeal ~~shall~~ apply to the liability of any transferee assessed under this section or of any property subject to the liability imposed by this section and to the assertion of a lien upon property in the hands of the transferee."

SECTION 5. G.S. 105-241.4 reads as rewritten:

"**§ 105-241.4. Action to recover tax paid.**

Within 30 days after notification of the Secretary's decision with respect to liability under this Subchapter or Subchapter V, any taxpayer aggrieved ~~thereby,~~ by the decision, in lieu of petitioning for administrative review thereof by the Tax Review Board under G.S. 105-241.2, may pay the tax and bring a civil action for its recovery as provided in G.S. ~~105-267.~~105-266.1.

Any taxpayer who has obtained an administrative review by the Tax Review Board as provided by G.S. 105-241.2 and who is aggrieved by the decision of the Board may, in lieu of appealing pursuant to the provisions of G.S. 105-241.3, within 30 days after notification of the Board's decision with respect to liability pay the tax and bring a civil action for its recovery as provided in G.S. ~~105-267.~~105-266.1.

Either party may appeal to the appellate division from the judgment of the superior court under the rules and regulations prescribed by law for appeals, except

that if the Secretary appeals, the Secretary is not required to give any undertaking or make any deposit to secure the cost of the appeal.

Any taxes, interest or penalties paid and found by the court to be in excess of those which can be properly assessed shall be ordered refunded to the taxpayer with interest from time of payment."

SECTION 6. G.S. 105-266(e) reads as rewritten:

"(e) Scope. ~~This section does not apply to interest required under G.S. 105-267.~~ This section applies to a refund payable to a husband and wife who filed a joint return."

SECTION 7. G.S. 105-266.1(e) reads as rewritten:

"(e) Nothing in this section shall be construed to conflict with or supersede the provisions of ~~G.S. 105-241.2, and, with respect to tax paid to the Secretary of Revenue, the rights granted by this section are in addition to the rights provided by G.S. 105-267.~~G.S. 105-241.2."

SECTION 8. G.S. 1-52(15) reads as rewritten:

"(15) For the recovery of taxes paid as provided in ~~G.S. 105-267 and~~ G.S. 105-381."

SECTION 9. G.S. 20-99(b)(3) reads as rewritten:

"(3) Shall be accompanied by a copy of this subsection, and thereupon the procedure shall be as follows:

If the garnishee has no defense to offer or no setoff against the taxpayer, he shall, within 10 days after service of said notice, answer the same by sending to the Commissioner of Motor Vehicles by registered mail a statement to that effect, and if the amount due or belonging to the taxpayer is then due or subject to his demand, it shall be remitted to the Commissioner with said statement, but if said amount is to mature in the future, the statement shall set forth that fact and the same shall be paid to the Commissioner upon maturity, and any payment by the garnishee hereunder shall be a complete extinguishment of any liability therefor on his part to the taxpayer. If the garnishee has any defense or setoff, he shall state the same in writing under oath, and, within 10 days after service of said notice, shall send two copies of said statement to the Commissioner by registered mail; if the Commissioner admits such defense or setoff, he shall so advise the garnishee in writing within 10 days after receipt of such statement and the attachment or garnishment shall thereupon be discharged to the amount required by such defense or setoff, and any amount attached or garnished hereunder which is not affected by such defense or setoff shall be remitted to the Commissioner as above provided in cases where the garnishee has no defense or setoff, and with like effect. If the

Commissioner shall not admit the defense or setoff, he shall set forth in writing his objections thereto and shall send a copy thereof to the garnishee within 10 days after receipt of the garnishee's statement, or within such further time as may be agreed on by the garnishee, and at the same time he shall file a copy of said notice, a copy of the garnishee's statement, and a copy of his objections thereto in the superior court of the county where the garnishee resides or does business where the issues made shall be tried as in civil actions.

If judgment is entered in favor of the Commissioner of Motor Vehicles by default or after hearing, the garnishee shall become liable for the taxes, interest and penalties due by the taxpayer to the extent of the amount over and above any defense or setoff of the garnishee belonging, owing, or to become due to the taxpayer, but payments shall not be required from amounts which are to become due to the taxpayer until the maturity thereof, nor shall more than ten percent (10%) of any taxpayer's salary or wages be required to be paid hereunder in any one month. The garnishee may satisfy said judgment upon paying said amount, and if he fails to do so, execution may issue as provided by law. From any judgment or order entered upon such hearing either the Commissioner of Motor Vehicles or the garnishee may appeal as provided by law. If, before or after judgment, adequate security is filed for the payment of said taxes, interest, penalties, and costs, the attachment or garnishment may be released or execution stayed pending appeal, but the final judgment shall be paid or enforced as above provided. The taxpayer's sole remedies to question his liability for said taxes, interest, and penalties shall be those provided in ~~G.S. 105-267, as now or hereafter amended or supplemented.~~ Article 9 of Chapter 105 of the General Statutes. If any third person claims any intangible attached or garnished hereunder and his lawful right thereto, or to any part thereof, is shown to the Commissioner, he shall discharge the attachment or garnishment to the extent necessary to protect such right, and if such right is asserted after the filing of said copies as aforesaid, it may be established by interpleader as now or hereafter provided by the General Statutes in cases of attachment and garnishment. In case such third party has no notice of proceedings hereunder, he shall have the right to file his petition under oath with the Commissioner at any time within 12 months after said intangible is paid to him and if the Commissioner finds that such party is lawfully entitled thereto or to any part

thereof, he shall pay the same to such party as provided for refunds by G.S. 105-407 and if such payment is denied, said party may appeal from the determination of the Commissioner to the Superior Court of Wake County or to the superior court of the county wherein he resides or does business. The intangibles of a taxpayer shall be paid or collected hereunder only to the extent necessary to satisfy said taxes, interest, penalties, and costs. Except as hereinafter set forth, the remedy provided in this section shall not be resorted to unless a warrant for collection or execution against the taxpayer has been returned unsatisfied: Provided, however, if the Commissioner is of opinion that the only effective remedy is that herein provided, it shall not be necessary that a warrant for collection or execution shall be first returned unsatisfied, and in no case shall it be a defense to the remedy herein provided that a warrant for collection or execution has not been first returned unsatisfied: Provided, however, that no salary or wage at the rate of less than two hundred dollars ($200.00) per month, whether paid weekly or monthly, shall be attached or garnished under the provisions of this section."

SECTION 10. This act becomes effective January 1, 2004, and applies to taxes paid on or after that date.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 5: UNIFORM TAX REFUND PROCEDURE

BY: TRINA GRIFFIN, RESEARCH DIVISION

SUMMARY: Legislative Proposal 5 establishes a uniform tax refund procedure by repealing the "protest rule" and revising the statute governing refunds for overpayment of taxes to address all refund claims. Under this proposal, a taxpayer seeking a refund for any reason would be required to make a written request to the Secretary explaining why the refund is due. The Secretary would then have 90 days to review the request and issue a decision. Upon receiving notice of the Secretary's decision, a taxpayer who disagrees with the decision has 90 days to either request a hearing or file a civil action.

The proposal would become effective January 1, 2004, and apply to taxes paid on or after date.

CURRENT LAW: The refund procedure for a tax paid by a taxpayer depends on the nature of the claim.[1] If the taxpayer is challenging the constitutionality of a tax, then the taxpayer must follow the procedure set out in G.S. 105-267, known as the "payment under protest rule." If the taxpayer claims that the tax paid was incorrect or excessive, then G.S. 105-266.1 governs the refund procedure. Under both statutes, the taxpayer is required to apply to the Secretary in writing for a refund. Under G.S. 105-267, the refund request must be made within three years after payment.[2] Under G.S. 105-266.1, the refund request must be made within three years after the date for filing of the return or within 6 months after payment of the tax, whichever is later.[3] At this stage, the procedure varies as follows:

Payment under protest (G.S. 105-267). – Once the refund request has been made, the Secretary has 90 days to issue a decision and refund the tax in accordance with the decision. If the tax is not refunded within 90 days, the taxpayer may file a civil

[1] This summary addresses the two main refund statutes, G.S. 105-266.1 and G.S. 105-267, which have varying statutes of limitation periods for filing suit among their procedural differences. G.S. 105-241.4 is another statute that authorizes a taxpayer to recover a tax paid by filing suit and has yet another statute of limitations period. This statute may be invoked after the Secretary has conducted a hearing and issued a decision on a proposed assessment. The hearing is distinguished from the hearing authorized by G.S. 105-266.1 in that the taxpayer is not required to pay the tax prior to the hearing. Within 30 days after the Secretary's decision is issued, the taxpayer may pay the tax and file a civil action. The total timeframe from the notice of the proposed assessment to the filing of a lawsuit under this statute is less than one year.

[2] The protest period for taxes paid on alcoholic beverages, tobacco products, and controlled substances is 30 days after payment.

[3] The statute of limitations period varies for overpayments associated with worthless debts or securities, capital losses and net operating losses, and returns reflecting a federal determination.

action at any time within three years after the expiration of the 90-day period allowed for making the refund. Thus, a taxpayer has a maximum of 6 years and 90 days from payment of the tax to bring a civil action. If upon trial it is determined that all or part of the tax was levied for an illegal or unauthorized purpose, judgment shall be rendered for the taxpayer, and the amount of the judgment shall be refunded by the State.

Refunds for overpayment (G.S. 105-266.1). - Once the refund request has been made, the Secretary is required to schedule a hearing to be held within 90 days, unless the taxpayer and the Secretary agree to a later date. Within 90 days of the hearing, the Secretary must make a decision, notify the taxpayer, and adjust the tax in accordance with the decision. A taxpayer aggrieved by the Secretary's decision may, within 90 days after notification of the decision, either:

1. Petition for administrative review before the Tax Review Board under G.S. 105-241.2[4]; or
2. Bring a civil action against the Secretary for recovery of the alleged overpayment.[5]

BILL ANALYSIS: Section 1 of the proposal repeals G.S. 105-267, with the exception of the first sentence, which is recodified as the first sentence of G.S. 105-266.1. The recodification of the first sentence preserves the case law upholding the constitutionality of the statutory requirement that a taxpayer pay the tax prior to challenging the legality of the tax in court.

Section 2 of the proposal sets out the procedure for requesting a refund for a tax paid regardless of the nature of the claim. In order to obtain a refund, a taxpayer must first make a written request to the Secretary explaining why the refund is due. The request must be made within three years after the date for filing of the return or within 6 months after payment of the tax, whichever is later. Within 90 days, the Secretary must review the request, determine whether a refund is due, notify the taxpayer of the decision, and adjust the refund, if needed, in accordance with the decision. A taxpayer who disagrees with the Secretary's determination may, within 90 days after notification, request a hearing or bring a civil action.

The main differences between the current law and the bill draft with regard to refunds based on the unconstitutionality of a tax are as follows:

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[4] Either party may appeal a decision of the Tax Review Board to superior court, then to the North Carolina Court of Appeals, and then to the North Carolina Supreme Court.

[5] Either party may appeal to the appellate division from the judgment of the superior court.

Current Law	Bill Draft
• Refund request must be made within 3 years after payment. • Civil action may be brought within 3 years after the 90-day period allowed for making a refund. • The suit may be brought in the Superior Court of Wake County or in the county in which the taxpayer resides.	• Refund request must be made within 3 years after the date for filing of the return or within 6 months after payment of the tax, whichever is later. • Civil action may be brought within 90 days after notification of the refund decision. • The suit may be brought in either the Superior Court of Wake County or in the county in which the taxpayer resides if the amount of the refund demand is more than $200. If the refund demand is less than $200, the suit may be brought in any State court of competent jurisdiction in Wake County.

The main differences between the current law and the bill draft with regard to refunds based on payment of an incorrect or excessive tax are:

Current Law	Bill Draft
• Secretary is required to schedule a hearing on each refund request. The hearing must be scheduled within 90 days of the refund request. • The Secretary must issue a decision within 90 days of the hearing. • Within 90 days after notification of the Secretary's decision, the taxpayer may either petition for administrative review or file a civil action.	• No hearing required to be scheduled upon receipt of refund request. • The Secretary must issue decision within 90 days of receipt of refund request. • Within 90 days after notification of the Secretary's decision, the taxpayer may either request a hearing before the Secretary or file a civil action.

Sections 3 through 9 of the bill are technical and conforming changes.

BACKGROUND:

LEGISLATIVE HISTORY OF THE STATUTE OF LIMITATIONS PERIOD

For well over 50 years, the statute of limitations in North Carolina for requesting a refund under G.S. 105-267 was 30 days after payment of the tax.[6] Then in 1996, the General Assembly extended the period to one year for all taxes except for the taxes on alcoholic beverages, tobacco products, and controlled substances, which remained at 30 days. In 1999, the General Assembly extended the protest period from one to three years.[7] Under current law, a person may demand a refund in writing at any time within three years after making payment. If the tax is not refunded within 90 days, the taxpayer may file suit against the Secretary of the Department of Revenue at any time within three years after the expiration of the 90-day period.

Judicial Interpretation of Protest Rule

The protest rule has proven problematic for both the Department and tax practitioners. The statute's vagueness has raised issues with regard to what constitutes a valid protest, whether all similarly situated taxpayers must file a protest, and when a protest should be filed to best serve the taxpayer. The North Carolina Supreme Court further muddied the waters in 1998 when it held in Bailey II[8] that all taxpayers who wrongfully had their benefit contracts impaired by the State, not just those who complied with G.S. 105-267, were entitled to refunds. The Court found that G.S. 105-267 was simply a procedural requirement designed to give the State notice of potential liabilities and allow it to budget accordingly. In addition to finding that the State did have sufficient notice of its potential liability for all taxpayers involved, the Court also seemed to be influenced by the fact that North Carolina does not provide taxpayers with any predeprivation procedures for determining the legality of a tax. Thus, after Bailey II, it appears that if a taxpayer pays under protest and initiates litigation, then all other similarly situated taxpayers stand to benefit from the protest if the litigation succeeds.

The broad fiscal implications of the Bailey II Court's statutory interpretation have already been felt in a subsequent lawsuit against the State. In Smith v. State, 349 N.C. 332, 341, 507 S.E.2d 28, 33 (1998), the North Carolina Supreme Court held that the State owed hundreds of millions of dollars in additional refunds to all taxpayers who paid unconstitutional intangibles taxes, including those taxpayers who did not

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[6] Most states that utilize a protest rule have a statute of limitations longer than 30 days.

[7] Under current law, the statute of limitations for requesting a refund for taxes paid on alcoholic beverages, tobacco products, and controlled substances is still 30 days.

[8] In Bailey v. State of North Carolina, 348 N.C. 130, 500 S.E.2d 54 (1998), the Court found unconstitutional legislation that placed a cap on a tax exemption for state and local government employees' retirement benefits.

protest payment. However, the Court made clear that its decision was controlled, not by an interpretation of G.S. 105-267, but rather by the constitutional uniformity requirement.

LEGISLATIVE PROPOSAL #6

REVENUE ADMINISTRATIVE CHANGES

LEGISLATIVE PROPOSAL 6:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2003 GENERAL ASSEMBLY, 2003 SESSION

AN ACT TO MODIFY THE DIVIDENDS RECEIVED DEDUCTION FOR REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS TO ENSURE THAT ALL DIVIDENDS ARE TREATED UNIFORMLY, TO EXTEND FOR TWO YEARS THE DEPARTMENT OF REVENUE'S AUTHORITY TO OUTSOURCE THE COLLECTION OF IN-STATE TAX DEBTS, AND TO MAKE VARIOUS ADMINISTRATIVE CHANGES IN THE TAX LAWS.

SHORT TITLE: Revenue Administrative Changes.

SPONSORS: **Rep. Allen**, Hill, Holliman, Luebke, Wainwright
Sen. Kerr, Clodfelter, Dalton, Hartsell, Hoyle

BRIEF OVERVIEW: This proposal makes the following changes with regard to the administration of the tax laws:

- It modifies the dividends received deduction for regulated investment companies and real estate investment trusts to ensure that all dividends are treated uniformly, effective for taxable years beginning on or after January 1, 2003.
- It amends the reporting requirements regarding sales of seized property by the Secretary of Revenue to avoid duplicative filing of reports.
- It extends until October 1, 2005 the Department of Revenue's authority to continue using outside collection agencies for the collection of in-state tax debts.
- It revises the secrecy provision regarding the disclosure of tax information to reflect the transfer of the Division of Motor Vehicles to the Division of the State Highway Patrol of the Department of Crime Control and Public Safety.

- It ensures that the monthly distribution of local sales and use tax proceeds is based on taxpayer data from filed returns, effective July 1, 2003.
- It simplifies the process for making the hold harmless calculation by requiring the Department of Revenue, rather than the Office of State Budget and Management, to make the required projection of estimated tax proceeds.
- It clarifies that the $20 filing fee for annual reports is nonrefundable.

FISCAL IMPACT: Insignificant.

EFFECTIVE DATE: See the explanation.

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

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2003

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BILL DRAFT 2003-SVxfz-2 [v.11] (01/13)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/30/2003 12:34:56 PM

Short Title: Revenue Administrative Changes. (Public)

Sponsors:

Referred to:

A BILL TO BE ENTITLED

AN ACT TO MODIFY THE DIVIDENDS RECEIVED DEDUCTION FOR REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS TO ENSURE THAT ALL DIVIDENDS ARE TREATED UNIFORMLY, TO EXTEND FOR TWO YEARS THE DEPARTMENT OF REVENUE'S AUTHORITY TO OUTSOURCE THE COLLECTION OF IN-STATE TAX DEBTS, AND TO MAKE VARIOUS ADMINISTRATIVE CHANGES IN THE TAX LAWS.

The General Assembly of North Carolina enacts:

MODIFY DIVIDENDS RECEIVED DEDUCTION FOR RICs AND REITs.

SECTION 1. G.S. 105-130.7 and G.S. 105-130.5(b)(3) are repealed.

SECTION 2. G.S. 105-130.4(c) reads as rewritten:

"(c) Rents and royalties from real or tangible personal property, gains and losses, interest, ~~dividends less the portion deductible under G.S. 105-130.7,~~dividends, patent and copyright royalties and other kinds of income, to the extent that they constitute nonbusiness income, less related expenses shall be allocated as provided in subsections (d) through (h) of this section."

SECTION 3. G.S. 105-130.4(f) reads as rewritten:

"(f) Interest and net dividends are allocable to this State if the corporation's commercial domicile is in this State. For purposes of this section, the term "net dividends" means gross dividend income received less related ~~expenses and less that portion of the dividends deductible under G.S. 105-130.7.~~expenses."

AVOID DUPLICATIVE REPORTING REQUIREMENTS REGARDING SALES OF SEIZED PROPERTY.

SECTION 4. G.S. 105-242(a)(2) reads as rewritten:

(2) The Secretary may issue a warrant or order under the Secretary's hand and seal to any revenue officer or other employee of the Department of Revenue charged with the duty to collect taxes, commanding the officer or employee to levy upon and sell the taxpayer's personal property, including that described in G.S. 105-366(d), found within the State for the payment of the tax, including penalties and interest. Except as otherwise provided in this subdivision, the levy upon the sale of personal property shall be governed by the laws regulating levy and sale under execution. The person to whom the warrant is directed shall proceed to levy upon and sell the personal property subject to levy in the same manner and with the same powers and authority normally exercised by sheriffs in levying upon and selling personal property under execution, except that the property may be sold in any county, in the discretion of the Secretary. In addition to the notice of sale required by the laws governing sale of property levied upon under execution, the Secretary may advertise the sale in any reasonable manner and for any reasonable period of time to produce an adequate bid for the property. Levy and sale fees, plus actual advertising costs, shall be added to and collected in the same manner as taxes. The Secretary is not required to file a report of sale with the clerk of superior court, as required by the laws governing sale of property levied upon under execution, if the sale is otherwise publicly reported."

EXTEND AUTHORITY TO CONTINUE USING OUTSIDE COLLECTION AGENCIES.

SECTION 5. Section 9 of S.L. 2001-380 reads as rewritten:

"**SECTION 9.** Section 3 of this act becomes effective November 1, 2001. Section 6 of this act is effective on and after July 1, 2001. Section 8 of this act becomes effective ~~October 1, 2003.~~ October 1, 2005. The remainder of this act is effective when it becomes law and applies to tax debts that remain unpaid on or after that date."

REVISE SECRECY PROVISION TO REFLECT TRANSFER OF DMV ENFORCEMENT TO THE DIVISION OF THE STATE HIGHWAY PATROL.

SECTION 6. G.S. 105-259(b)(7) reads as rewritten:

"(7) To exchange information with the ~~Division of Motor Vehicles of the Department of Transportation~~ Division of the State Highway Patrol of the Department of Crime Control and Public Safety or the International Fuel Tax Association, Inc., when the information is needed to fulfill a duty imposed on the Department of Revenue or

the ~~Division of Motor Vehicles.~~Division of the State Highway Patrol of the Department of Crime Control and Public Safety."

BASE LOCAL SALES TAX DISTRIBUTIONS ON TAXPAYER DATA.

SECTION 7. G.S. 105-472(a) reads as rewritten:

"(a) County Allocation. – The Secretary shall, on a monthly basis, allocate to each taxing county for which the Secretary collects the tax the net proceeds of the tax collected in that county under this Article. For the purpose of this section, "net proceeds" means the gross proceeds of the tax collected in each county under this Article less taxes refunded, the cost to the State of collecting and administering the tax in the county as determined by the Secretary, and other deductions that may be charged to the county. If the Secretary collects local sales or use taxes in a month and the taxes cannot be identified as being attributable to a particular taxing county, the Secretary shall allocate the taxes among the taxing counties in proportion to the amount of taxes collected in each county under this Article during that month and shall include them in the monthly distribution. Amounts collected by electronic funds transfer payments are included in the distribution for the month in which the return that applies to the payment is due."

SIMPLIFY PROCEDURE FOR HOLD HARMLESS CALCULATION.

SECTION 8. G.S. 105-521(b) reads as rewritten:

"(b) Distributions. – On or before May 1 of each year, the Department of Revenue and the Fiscal Research Division of the General Assembly must each submit to the Secretary and to the General Assembly a final projection of the estimated amount that all local governments would be expected to receive during the upcoming fiscal year under G.S. 105-520 if every county levied the tax under this Article for the fiscal year. If the Secretary does not use the lower of the two final projections to make the calculation required by this subsection, the Secretary must report the reasons for this decision to the Joint Legislative Commission on Governmental Operations within 60 days after receiving the projections.

On or before September ~~15, 2003, and each September 15 thereafter,~~15 of each year, the Secretary must multiply each local government's local sales tax share by the estimated amount that all local governments would be expected to receive during the current fiscal year under G.S. 105-520 if every county levied the tax under this Article for the year. If the resulting amount is less than one hundred percent (100%) of the local government's repealed reimbursement amount, the Secretary must pay the local government the difference, but not less than one hundred dollars ($100.00).

~~On or before May 1, 2003, and each May 1 thereafter, the Office of State Budget and Management and the Fiscal Research Division of the General Assembly must each submit to the Secretary and to the General Assembly a final projection of the estimated amount that all local governments would be expected to receive during the upcoming fiscal year under G.S. 105-520 if every county levied the tax under this Article for the fiscal year. If the Secretary does not use the lower of the two final~~

~~projections to make the calculation required by this subsection, the Secretary must report the reasons for this decision to the Joint Legislative Commission on Governmental Operations within 60 days after receiving the projections.~~"

CLARIFY THAT THE FILING FEE FOR AN ANNUAL REPORT IS NONREFUNDABLE.

SECTION 9. G.S. 55-1-22 is amended by adding a new subsection to read:

"(d) The fee for the annual report in subdivision (23) of this section is nonrefundable."

EFFECTIVE DATE.

SECTION 10. Sections 1, 2, and 3 are effective for taxable years beginning on or after January 1, 2003. Section 7 becomes effective July 1, 2003. The remainder of this act is effective when it becomes law.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 6: REVENUE ADMINISTRATIVE CHANGES

BY: TRINA GRIFFIN, RESEARCH DIVISION

SUMMARY: Legislative Proposal 6 makes the following changes with regard to the administration of the tax laws:

- *It modifies the dividends received deduction for regulated investment companies and real estate investment trusts to ensure that all dividends are treated uniformly, effective for taxable years beginning on or after January 1, 2003.*
- *It amends the reporting requirements regarding sales of seized property by the Secretary of Revenue to avoid duplicative filing of reports.*
- *It extends until October 1, 2005 the Department of Revenue's authority to continue using outside collection agencies for the collection of in-state tax debts.*
- *It revises the secrecy provision regarding the disclosure of tax information to reflect the transfer of the Division of Motor Vehicles to the Division of the State Highway Patrol of the Department of Crime Control and Public Safety.*
- *It ensures that the monthly distribution of local sales and use tax proceeds is based on taxpayer data from filed returns, effective July 1, 2003.*
- *It simplifies the process for making the hold harmless calculation by requiring the Department of Revenue, rather than the Office of State Budget and Management, to make the required projection of estimated tax proceeds.*
- *It clarifies that the $20 filing fee for annual reports is nonrefundable.*

SECTION-BY-SECTION BILL ANALYSIS:

Sections 1, 2, and 3: Modify dividends received deduction for RICs and REITs

CURRENT LAW: G.S. 105-130.7(a) provides that a corporation may deduct the proportionate part of dividends received by it from a regulated investment company (RIC) or a real estate investment trust (REIT) as corresponds to income received by the company or trust that would not be taxed by North Carolina if received directly by the corporation. In other words, dividends received by a corporation from a RIC or REIT are deductible only to the extent that income received by that corporation from a RIC or a REIT is taxable by North Carolina.

BILL ANALYSIS: Section 1 of the proposal repeals G.S. 105-130.7. The repeal of G.S. 105-130.5(b)(3) and the changes in Sections 2 and 3 of the proposal are conforming changes.

Dividends received from a RIC qualify for the federal dividends received deduction. Therefore, the repeal of G.S. 105-130.7(a) is a technical change with regard to RICs because dividends received from those companies will continue to receive the same tax treatment under the proposal as under current law. The repeal of G.S. 105-130.7 also ensures that dividends received from a RIC are subject to the same rules concerning attribution of expenses as dividends received from other corporations.

Dividends from REITs do not qualify for the federal dividends received deduction. Therefore, under current law, dividends from REITs are taxed more favorably for State tax purposes than under federal law. The repeal of G.S. 105-130.7 would ensure that the State category of dividends with respect to REITs is the same as under federal law.

FEDERAL LAW:

Dividends received deduction.[1] – The dividends received deduction is meant to reduce the negative effects of the double tax on C corporation profits distributed to corporation shareholders as dividends. Subject to certain exceptions and limitations, corporations may deduct 70% of the dividends received from another domestic corporation if the receiving corporation owns less than 20% of the distributing corporation. The deduction rises to 80% of dividends if the corporation owns 20% or more of the corporation paying the dividends, and to 100% of the corporations are "affiliated" under the Code.

Regulated investment companies (RICs). – Certain investment companies, including mutual funds, may elect to be taxed as regulated investment companies. There are several conditions that must be satisfied to qualify for the election, of which the salient features are that ninety percent of gross income must be derived from dividends, interest, and gains on the sale of stock or securities, and that the corporation's investments must be diversified as prescribed by Section 851 of the Code. A qualified RIC is taxed only on its undistributed income and is treated as a partial conduit for the income it earns. The fundamental premise of conduit treatment is that the RIC's income should be taxed only once, at the shareholder level, rather than to the RIC. Dividends received from RICs are eligible for the federal deduction, subject to additional limitations.[2]

Real estate investment trusts (REITs). – A real estate investment trust is a corporation or trust that uses the pooled capital of many investors to purchase and manage income property and/or mortgage loans. REITs are traded on major exchanges just like stocks. They are also granted special tax considerations. They pay yields in the

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[1] 26 U.S.C. 243.

[2] Capital gain dividends received from a regulated investment company do not qualify for the deduction.

form of dividends. However, REITs are not eligible for the federal dividends received deduction.

BACKGROUND: In 2001, the General Assembly repealed G.S. 105-130.7(b) and G.S. 105-130.5(a)(7), which provided corporations with an income tax deduction for dividends received by their subsidiaries. As a result of the repeal, North Carolina law now piggybacks the federal law with regard to the dividends received deduction for subsidiary dividends. Adopting the federal approach simplifies tax administration and compliance because the taxpayer is required to make fewer adjustments to taxable income in order to calculate State net income. The repeal under Section 1 of this proposal would be consistent with this approach.

Section 4: Avoid duplicative reporting requirements regarding sales of seized property

CURRENT LAW: If any tax levied by the State and payable to the Secretary of Revenue has not been paid within 30 days after the taxpayer was given a notice of final assessment of the tax, the Secretary is authorized to collect the tax through the levy upon and sale of real or personal property of the taxpayer. The Secretary may either direct the sheriff to levy upon and sell property, or it may levy upon the property itself through one of the Department's employees.

Most personal property seized by the Department of Revenue is for the payment of unauthorized substance taxes. When the Department levies upon the property itself without the use of the sheriff, the actual sale of the property is conducted by the Department of Administration's State Surplus Property section in accordance with the same notice and bidding procedures that apply to surplus property. The State Surplus Property section posts information related to bids and sales of seized property both online and in written format, which is available to the public.

The laws in Article 29B of Chapter 1 of the General Statutes, which apply to the sheriff when conducting the levy and sale of property, also apply to the Department of Revenue when conducting the levy and sale of property. Among those provisions is G.S. 1-339.63, which states that the sheriff must file a report of sale with the clerk of superior court. Since the Department is subject to the same laws governing execution sales, it has construed this provision to mean that the Department must file a report of all sales of seized property with the clerk of superior court.

BILL ANALYSIS: Section 4 of the proposal amends G.S. 105-242 such that the Department of Revenue is not required to file a report of sale of seized property with the clerk of superior court as long as the sale is otherwise publicly reported.

Since the Department of Administration makes a report of all property sold through the surplus property sales, the Department of Revenue does not see a need to file a report of sale with the clerk of court as well. In addition to improving efficiency by

avoiding duplicative reporting, this change should also reduce costs since several clerks of court have begun charging a fee for filing these reports.

Section 5: Extend authority to use outside collection agencies

CURRENT LAW: The Department of Revenue has permanent authority to outsource out-of-state tax debts and temporary authority to outsource in-state tax debts. This temporary authority is scheduled to expire on October 1, 2003.

BILL ANALYSIS: Section 5 of the proposal extends the authority of the Department of Revenue to outsource in-state tax debts for an additional two years.

BACKGROUND: In 1999, the General Assembly authorized the Department of Revenue to initiate a pilot program whereby the Department would contract for the collection of tax debts[3] owed by nonresidents and foreign entities. In September 2000, the Department, in conjunction with the Office of the State Auditor, began outsourcing some of its out-of-state tax debts. Between September 2000 and May 2001, it collected in excess of $12 million in out-of-state receivables using a combination of outsourcing and in-house collection techniques.

In 2001, the General Assembly enacted legislation that substituted a broader debt collection program for the pilot program. Under this program, the Department of Revenue was authorized to outsource out-of-state tax debts permanently and to outsource in-state tax debts for two years. When outsourcing tax debts, the Department is required to notify the taxpayer prior to submitting the debt to a collection agency. The taxpayer has 30 days after the notice is sent to pay the tax debt. If the debt remains unpaid at the end of the 30 days, then the debt may be outsourced to a collection agency. The collection agencies that contract to collect tax debts are prohibited from revealing confidential tax information. If a contractor reveals tax information, it is subject to a misdemeanor penalty, its contract is terminated, and it is barred from contracting again for five years.

Section 6: Revise secrecy provision to reflect transfer of DMV to the State Highway Patrol

CURRENT LAW: Under G.S. 105-259(b), an officer, employee, or agent of the State who has access to tax information in the course of service or employment by the State may not disclose the information to any other person unless authorized to do by statute. There are several exceptions to this rule, one of which is that tax information may be disclosed for the purpose of exchanging information with the Division of Motor Vehicles of the Department of Transportation when the information is needed to fulfill a duty imposed on the Department of Revenue of the Division of Motor Vehicles.

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[3] A tax debt is the amount of tax, interest, and penalties due for which a final notice of assessment has been mailed to the taxpayer after the taxpayer no longer has the right to contest the debt.

BILL ANALYSIS: Section 6 of the proposal replaces the phrase "Division of Motor Vehicles of the Department of Transportation" with the phrase "Division of the State Highway Patrol of the Department of Crime Control and Public Safety" to reflect departmental changes made last year.

BACKGROUND: In 2002, the General Assembly enacted legislation[4] that transferred the personnel and functions of the Department of Transportation Division of Motor Vehicles Enforcement Section for the regulation and enforcement of commercial motor vehicles, oversize and overweight vehicles, motor carrier safety, and mobile and manufactured housing to the Department of Crime Control and Public Safety, effective January 1, 2003. Consequently, the reference to the "Division of Motor Vehicles of the Department of Transportation" in G.S. 105-259(b)(7) needs to be amended to reflect this transfer to preserve the secrecy provision currently in place. Specifically, the State Highway Patrol will be performing the functions of the prior DMV Enforcement Section.

Section 7: Base local sales tax distributions on taxpayer data

CURRENT LAW: Pursuant to G.S. 105-472, the Secretary of Revenue makes quarterly distributions of local sales and use tax proceeds to cities and counties. In 2001, the General Assembly accelerated the payment of local sales and use tax revenues by requiring that the distribution be made on a monthly basis, effective beginning July 1, 2003.

In addition, as of January 1, 2002, the threshold for taxpayers required to make semimonthly payments of sales and use tax was lowered from $20,000 to $10,000, substantially increasing the total amount of revenues received for processing by the Department on a monthly basis. Sales and use tax revenues received between the 1st and 15th of the month must be paid by the 25th of the same month, while sales and use tax revenues from the remainder of the month must be paid by the 10th of the next month. The return for the semimonthly period is due 10 days later, on the 20th of the month. Consequently, there is no return accompanying the revenues received for the first half of each month to indicate where the funds should be distributed.

BILL ANALYSIS: Section 7 of the proposal amends the local government sales and use tax distribution statute by stating that amounts collected by electronic funds transfer payments are included in the distribution for the month in which the return that applies to the payment is due. Since semimonthly taxpayers are required to pay by electronic funds transfer, this amendment will ensure that the Department of Revenue is distributing local sales and use tax proceeds based on known information obtained from the semimonthly return rather than a speculative estimate.

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[4] S.L. 2002-190 (HB 314), as amended by S.L. 2002-159, Sec. 31.5 (SB 1217, Sec. 31.5).

Section 8: Simplify the procedure for hold harmless calculation

CURRENT LAW: G.S. 105-521(b) directs the Office of State Budget and Management (OSBM) and the Fiscal Research Division of the General Assembly to each submit to the Secretary of Revenue and the General Assembly, by May 1 of each year, a projection of the estimated amount that local governments are expected to receive from the levy of the third one-half cent local sales and use tax during the upcoming fiscal year. Then, by September 15 of each year, the Secretary of Revenue is required to calculate the hold harmless distribution amounts[5], if any, based on the projections and distribute the funds. If the Secretary does not use the lower of the two projections when making the calculation, the Secretary must report the reasons for this decision to the Joint Legislative Commission on Governmental Operations within 60 days after receiving the projections.

BILL ANALYSIS: Section 8 of the proposal would require the Department of Revenue, rather than the OSBM, to project the estimated amount that all local governments would be expected to receive during the upcoming fiscal year from levying the third one-half cent local sales and use tax, assuming that every county levied the tax. From a practical standpoint, the data needed to make the projections are housed within the Department of Revenue. By making this change, it simplifies the process by eliminating the need for the OSBM to first obtain the data from Revenue and then make the necessary projection. Section 8 also makes a technical change by reversing the two paragraphs in G.S. 105-521(b) so that the statutory requirements appear chronologically.

BACKGROUND: In 2001, the General Assembly authorized all counties of the State to levy a third one-half cent sales tax.[6] In that same legislation, local governments were also provided with an annual hold harmless distribution from the State's General Fund to ensure that none of them would lose money when the local government reimbursements are repealed. The hold harmless distribution provides that if a county or city's estimated proceeds from the third half-cent tax would be less than 100%of the amount it would have gotten under the repealed reimbursements, it will receive a reimbursement for the difference. If a county or city's estimated gain from the third half-cent tax exceeds 100% of its repealed reimbursements amount, it does not receive a hold harmless payment from the State. The hold harmless payment is the same whether or not the new tax is levied in the county.

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[5] The hold harmless distribution amount is obtained by multiplying the each local government's sales tax share by the estimated amount that all local government are expected to receive from levying the third one-half cent local sales and use tax; if the amount is less than 100%of the local government's repealed reimbursement amount, the Secretary must pay the local government the difference, but not less than $100.00.

[6] To date, nearly 90 counties have adopted the local option third one-half cent sales tax authorized by Section 34.14 of S.L. 2001-424.

Section 9: Clarify that the filing fee for an annual report is nonrefundable

CURRENT LAW: G.S. 55-1-22 sets out the fees for filing certain documents with the Secretary of State, including documents such as articles of incorporation, articles of dissolution, designation of a registered agent, etc. Included on the list is a $20.00 fee for filing an annual report. Each corporation[7] authorized to do business in this State is required to file an annual report, which unlike the other documents in G.S. 55-1-22, must be delivered to the Secretary of Revenue. The annual report contains the name of the corporation, its address, the name and address of its registered agent, the names and addresses of its principal officers, and a brief description of the nature of its business. Annual reports are due by the due date for the filing the corporation's income and franchise tax return. As a practical matter, the annual reports are typically attached to the return along with a check for the filing fee.

BILL ANALYSIS: Section 9 of the proposal amends G.S. 55-1-22 by adding a new subsection stating that the annual report fee of $20.00 is nonrefundable. The purpose of this change is to codify the Department of Revenue's existing policy that annual report fees are not refundable.

BACKGROUND: G.S. 55-1-22 does not address whether or under what circumstances the filing fees are refundable. However, it is the policy and practice of the Secretary of State to issue refunds for those fees, if requested and depending on the circumstances. Specifically, if the Secretary of State's office has not begun to process or review the document for which the refund is requested, then it will usually refund the filing fee at the filer's request, regardless of whether the fee has been deposited. The Department of Revenue's policy with regard to the annual report is that the fee is nonrefundable.

Section 10: Effective date

The repeal of the dividends received deduction is effective for taxable years beginning on or after January 1, 2003. The section regarding the local sales tax distribution is effective July 1, 2003. The remainder of the act is effective when it becomes law.

[7] Nonprofit corporations are exempt from this requirement and insurance companies are required to deliver their annual reports to the Secretary of State.

LEGISLATIVE PROPOSAL #7

REVENUE LAWS TECHNICAL CHANGES

LEGISLATIVE PROPOSAL 7:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2003 GENERAL ASSEMBLY, 2003 SESSION

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

SHORT TITLE: Revenue Laws Technical Changes.

SPONSORS: **Rep. Holliman**, Allen, Hill, Luebke, Wainwright
Sen. Hartsell, Clodfelter, Dalton, Hoyle, Kerr

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

FISCAL IMPACT: No impact.

EFFECTIVE DATE: The proposal becomes 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 2003

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BILL DRAFT 2003-LCx-2 [v.14] (11/12)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/30/2003 11:59:03 AM

Short Title: Revenue Laws Technical Changes. (Public)

Sponsors:

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 10 of S.L. 2002-87 reads as rewritten:

"**SECTION 10.** Section 9 of this act is effective on and after January 1, 2002, and applies to the estates of decedents dying on or after that ~~date.~~date, except that if the amendments made by Section 9 would create an increase in tax for a decedent dying before August 22, 2002, then the tax may be calculated under the prior law. The remainder of this act is effective when it becomes law. Section 2 of this act applies to credits for buildings ~~that are awarded a federal credit allocation before January 1, 2003, and~~ for which a federal tax credit is first claimed for a taxable year beginning on or after January 1, 2002."

SECTION 2. S.L. 2002-172 is reenacted.

SECTION 3. G.S. 105-129.40 reads as rewritten:

"**§ 105-129.40. (See Editor's note for repeal) ~~Definitions applicable to Article.~~Scope and definitions.**

(a) Scope. – G.S. 105-129.41 applies to buildings that are awarded a federal credit allocation before January 1, 2003. G.S. 105-129.42 applies to buildings that are awarded a federal credit allocation on or after January 1, 2003.

(b) Definitions. – The definitions in section 42 of the Code and the following definitions apply in this Article:

(1) Housing Finance Agency. – The North Carolina Housing Finance Agency established in G.S. 122A-4.

(2) Pass-Through ~~Entity.~~entity. – Defined in G.S. ~~105-129.35.~~ 105-228.90."

SECTION 4. (a) G.S. 105-163.010(7) reads as rewritten:

"(7) Pass-through entity. – Defined in G.S. 105-228.90. ~~An entity or business, including a limited partnership, a general partnership, a joint venture, a Subchapter S Corporation, or a limited liability company, all of which is treated as owned by individuals or other entities under the federal tax laws, in which the owners report their share of the income, losses, and credits from the entity or business on their income tax returns filed with this State. For the purpose of this Part, an owner of a pass-through entity is an individual or entity who is treated as an owner under the federal tax laws.~~"

SECTION 4.(b) G.S. 105-163.1(9) reads as rewritten:

"(9) Pass-through entity. – Defined in G.S. ~~105-163.010.~~ G.S. 105-228.90."

SECTION 4.(c) G.S. 105-129.35(c) reads as rewritten:

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

(1) Certified historic structure. – Defined in section 47 of the Code.

(2) Pass-through entity. – Defined in G.S. 105-228.90. ~~An entity or business, including a limited partnership, a general partnership, a joint venture, a Subchapter S Corporation, or a limited liability company, all of which is treated as owned by individuals or other entities under the federal tax laws, in which the owners report their share of the income, losses, and credits from the entity or business on their income tax returns filed with this State. For the purpose of this section, an owner of a pass-through entity is an individual or entity who is treated as an owner under the federal tax laws.~~

(3) Qualified rehabilitation expenditures. – Defined in section 47 of the Code."

SECTION 4.(d) G.S. 105-228.90(b) is amended by adding a new subdivision to read:

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

…

(4d) Pass-through entity. – An entity or business, including a limited partnership, a general partnership, a joint venture, a Subchapter S Corporation, or a limited liability company, all of which is treated as owned by individuals or other entities under the federal tax laws, in which the owners report their share of the income, losses, and credits from the entity or business on their income tax returns filed with this State. For the purpose of this section, an owner of a

pass-through entity is an individual or entity who is treated as an owner under the federal tax laws."

SECTION 5.(a) G.S. 105-130.4(a)(1) reads as rewritten:

"(1) ~~'Business'~~ 'Apportionable income' means all income that is apportionable under the United States Constitution."

SECTION 5.(b) G.S. 105-130.4(a)(5) reads as rewritten:

"(5) ~~'Nonbusiness'~~ 'Nonapportionable income' means all income other than ~~business~~ apportionable income."

SECTION 5.(c) G.S. 105-130.4(c) reads as rewritten:

"(c) Rents and royalties from real or tangible personal property, gains and losses, interest, dividends less the portion deductible under G.S. 105-130.7, patent and copyright royalties and other kinds of income, to the extent that they constitute ~~nonbusiness~~ nonapportionable income, less related expenses shall be allocated as provided in subsections (d) through (h) of this section."

SECTION 5.(d) G.S. 105-130.4(i) reads as rewritten:

"(i) All ~~business~~ apportionable income of corporations other than public utilities and excluded corporations shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four. Provided, that where the sales factor does not exist, the denominator of the fraction shall be the number of existing factors and where the sales factor exists but the payroll factor or the property factor does not exist, the denominator of the fraction shall be the number of existing factors plus one."

SECTION 5.(e) G.S. 105-130.4(j)(2) reads as rewritten:

"(2) Property owned by the corporation is valued at its original cost. Property rented by the corporation is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the corporation less any annual rental rate received by the corporation from subrentals except that subrentals shall not be deducted when they constitute ~~business~~ apportionable income. Any property under construction and any property the income from which constitutes ~~nonbusiness~~ nonapportionable income shall be excluded in the computation of the property factor.

SECTION 5.(f) G.S. 105-130.4(k)(1) reads as rewritten:

"(k) (1) The payroll factor is a fraction, the numerator of which is the total amount paid in this State during the income year by the corporation as compensation, and the denominator of which is the total compensation paid everywhere during the income year. All compensation paid to general executive officers and all compensation paid in connection with ~~nonbusiness~~ nonapportionable income shall be excluded in computing the

payroll factor. General executive officers shall include the chairman of the board, president, vice-presidents, secretary, treasurer, comptroller, and any other officers serving in similar capacities."

SECTION 5.(g) G.S. 105-130.4(l)(1) reads as rewritten:

(l) (1) The sales factor is a fraction, the numerator of which is the total sales of the corporation in this State during the income year, and the denominator of which is the total sales of the corporation everywhere during the income year. Notwithstanding any other provision under this Part, the receipts from any casual sale of property shall be excluded from both the numerator and the denominator of the sales factor. Where a corporation is not taxable in another state on its ~~business~~ apportionable income but is taxable in another state only because of ~~nonbusiness~~ nonapportionable income, all sales shall be treated as having been made in this State."

SECTION 5.(h) G.S. 105-130.4(m) through (s) read as rewritten:

"(m) All ~~business~~ apportionable income of a railroad company shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the "railway operating revenue" from business done within this State and the denominator of which is the "total railway operating revenue" from all business done by the company as shown by its records kept in accordance with the standard classification of accounts prescribed by the Interstate Commerce Commission.

"Railway operating revenue" from business done within this State shall mean "railway operating revenue" from business wholly within this State, plus the equal mileage proportion within this State of each item of "railway operating revenue" received from the interstate business of the company. "Equal mileage proportion" shall mean the proportion which the distance of movement of property and passengers over lines in this State bears to the total distance of movement of property and passengers over lines of the company receiving such revenue. "Interstate business" shall mean "railway operating revenue" from the interstate transportation of persons or property into, out of, or through this State. If the Secretary of Revenue ~~shall find,~~ finds, with respect to any particular company, that its accounting records are not kept so as to reflect with exact accuracy such division of revenue by State lines as to each transaction involving interstate revenue, the Secretary of Revenue may adopt such regulations, based upon averages, as will approximate with reasonable accuracy the proportion of interstate revenue actually earned upon lines in this State. Provided, that where a railroad is being operated by a partnership which is treated as a corporation for income tax purposes and pays a net income tax to this State, or if located in another state would be so treated and so pay as if located in this State, each partner's share of the net profits shall be considered as dividends paid by a corporation for purposes of this Part and shall be so treated for inclusion in gross income, deductibility, and separate allocation of dividend income.

(n) All ~~business~~ apportionable income of a telephone company shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is gross operating revenue from local service in this State plus gross operating revenue from toll services performed wholly within this State plus the proportion of revenue from interstate toll services attributable to this State as shown by the records of the company plus the gross operating revenue in North Carolina from other service less the uncollectible revenue in this State, and the denominator of which is the total gross operating revenue from all business done by the company everywhere less total uncollectible revenue. Provided, that where a telephone company is required to keep its records in accordance with the standard classification of accounts prescribed by the Federal Communications Commission the amounts in such accounts shall be used in computing the apportionment fraction as provided in this subsection.

(o) All ~~business~~ apportionable income of a motor carrier of property shall be apportioned by multiplying the income by a fraction, the numerator of which is the number of vehicle miles in this State and the denominator of which is the total number of vehicle miles of the company everywhere. The words "vehicle miles" shall mean miles traveled by vehicles owned or operated by the company hauling property for a charge or traveling on a scheduled route.

(p) All ~~business~~ apportionable income of a motor carrier of passengers shall be apportioned by multiplying the income by a fraction, the numerator of which is the number of vehicle miles in this State and the denominator of which is the total number of vehicle miles of the company everywhere. The words "vehicle miles" shall mean miles traveled by vehicles owned or operated by the company carrying passengers for a fare or traveling on a scheduled route.

(q) All ~~business~~ apportionable income of a telegraph company shall be apportioned by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor and the denominator of which is three.

The property factor shall be as defined in subsection (j) of this section, the payroll factor shall be as defined in subsection (k) of this section, and the sales factor shall be as defined in subsection (l) of this section.

(r) All ~~business~~ apportionable income of an excluded corporation and of all other public utilities shall be apportioned by multiplying the income by the sales factor as determined under subsection (l) of this section.

(s) All ~~business~~ apportionable income of an air or water transportation corporation shall be apportioned by a fraction, the numerator of which is the corporation's revenue ton miles in this State and the denominator of which is the corporation's revenue ton miles everywhere. The term "revenue ton mile" means one ton of passengers, freight, mail, or other cargo carried one mile. In making this computation, a passenger is considered to weigh two hundred pounds."

SECTION 5.(i) G.S. 105-130.8(a)(5) reads as rewritten:

"(5) For purposes of this section, any income item deductible in determining State net income under the provisions of G.S. 105-130.5 and any ~~nonbusiness~~ nonapportionable income not allocable to this State under the provisions of G.S. 105-130.4 shall be considered as income not taxable under this Part. The amount of the income item considered income not taxable under this Part is determined after subtracting related expenses for which a deduction was allowed under this Part."

SECTION 5.(j) G.S. 105-122(c)(1) reads as rewritten:

"(c) (1) After ascertaining and determining the amount of its capital stock, surplus and undivided profits, as provided herein, every corporation permitted to allocate and apportion its net income for income tax purposes under the provisions of Article 4 of this Chapter shall apportion ~~said~~ its capital stock, surplus and undivided profits to this State through use of the fraction computed for apportionment of its ~~business~~ apportionable income under ~~said~~ that Article. A corporation that is subject to franchise tax under this Article but is not subject to income tax under Article 4 of this Chapter must apportion its capital stock, surplus, and undivided profits to this State by using the apportionment formula that would apply to the corporation if it were subject to Article 4.

~~Provided, that although~~ Notwithstanding the foregoing, if a corporation is authorized by the Tax Review Board to apportion its ~~business~~ apportionable income by use of an alternative formula or method, the corporation may not use ~~such~~ this alternative formula or method for apportioning its capital stock, surplus and undivided profits unless specifically authorized to do so by order of the Tax Review Board.

~~Provided, further, that a~~ A corporation ~~which~~ that is required to pay an income tax to this State on its entire net income shall apportion its entire capital stock, surplus and undivided profits to this State."

SECTION 6. G.S. 105-129.42(a)(3) reads as rewritten:

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

. . .

(3) Qualified residential unit. ~~Residential Unit.~~ – A housing unit that meets the requirements of section 42 of the Code."

SECTION 7. G.S. 105-129.42(g) reads as rewritten:

"(g) Return and Payment. – A taxpayer may claim the credit allowed by this section on a return filed for the taxable year in which the taxpayer receives a carryover allocation of a federal low-income housing credit. The return must state the

name and location of the qualified low-income housing development for which the credit is claimed.

If a taxpayer chooses the loan method for receiving the credit allowed under this section, the Secretary must transfer to the Housing Finance Agency the amount of credit allowed the taxpayer. The Agency must loan the taxpayer the amount of the credit on terms consistent with the Qualified Allocation Plan. The Housing Finance Agency is not required to make a loan to a qualified North Carolina low-income housing development until the Secretary transfers the credit amount to the Agency.

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

(1) The Agency determines that the taxpayer has complied with the Qualified Allocation Plan and has completed at least fifty percent (50%) of the activities included in the development's eligible basis.

(2) Within 30 days after the date the development is placed in service ~~date~~."

SECTION 8. G.S. 105-129.42(i) reads as rewritten:

(i) Liability From Forfeiture. – A taxpayer that forfeits all or part of the credit allowed under this section is liable for all past taxes avoided and any refund claimed as a result of the credit plus interest at the rate established under G.S. 105-241.1(i). The interest ~~rate~~ is computed from the date the Secretary transferred the credit amount to the Housing Finance Agency. The past taxes, refund, and interest are due 30 days after the date the credit is forfeited. A taxpayer that fails to pay the taxes, refund, and interest by the due date is subject to the penalties provided in G.S. 105-236."

SECTION 9. G.S. 105-299 reads as rewritten:

"**§ 105-299. (Effective for taxes imposed for taxable years beginning on or after July 1, 2003) 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 the assessor in the performance of these duties. The county may also assign to county agencies, or contract with State or federal ~~agencies, for~~ agencies for, any duties involved with the approval or auditing of use-value accounts. The county may make available to these persons any information it has that will facilitate the performance of a contract entered into pursuant to this section. Persons receiving this information 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 must be required to demonstrate that he or she is qualified to carry out 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 these firms, primary consideration must be given to the firms registered with the Department of Revenue pursuant to 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 firms or persons are contracts for personal services and are not subject to the provisions of Article 8, Chapter 143, of the General Statutes".

SECTION 10. G.S. 105-358(a) reads as rewritten:

"(a) Waiver. – A tax collector may, upon making a record of the reasons therefor, reduce or waive the ~~ten percent (10%)~~ penalty imposed on giving a worthless check under G.S. 105-357(b)(2)."

SECTION 11 . G.S. 20-305.2(a)(7) reads as rewritten:

"**§ 20-305.2. Unfair methods of competition.**

(a) It is unlawful for any motor vehicle manufacturer, factory branch, distributor, distributor branch, or subsidiary thereof, to directly or indirectly through any subsidiary or affiliated entity, own any ownership interest in, operate, or control any motor vehicle dealership in this State, provided that this section shall not be construed to prohibit:

...

(7) The ownership, operation, or control of a dealership that sells primarily recreational vehicles as defined in ~~[G.S.]~~ G.S. 20-4.01 by a manufacturer, factory branch, distributor, or distributor branch, or subsidiary thereof, if the manufacturer, factory branch, distributor, or distributor branch, or subsidiary thereof, owned, operated, or controlled the dealership as of October 1, 2001.

(b) This section does not apply to manufacturers or distributors of trailers or semitrailers that are not recreational vehicles as defined in G.S. 20-4.01."

SECTION 12. Subchapter I of Chapter 105 of the General Statutes is amended by adding a new section to read:

"**§ 105-1.1. Supremacy of State Constitution.**

The State's power of taxation is vested in the General Assembly. Under Article V, Section 2(1), of the North Carolina Constitution, this power cannot be surrendered, suspended, or contracted away. In the exercise of this power, the General Assembly may amend or repeal any provision of this Subchapter in its discretion. No provision of this Subchapter constitutes a contract that the provision will remain in effect in future years, and any representation made to the contrary is of no effect."

SECTION 13. This act is effective when it becomes law.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL 7: REVENUE LAWS TECHNICAL CHANGES

BY: MARY SHUPING, RESEARCH DIVISION AND
MARTHA H. HARRIS, BILL DRAFTING DIVISION

SUMMARY: This draft makes technical and clarifying changes to the Revenue and related statutes.

Sections 1 & 3	Section 1 clarifies that the 2002 law modifying the estate tax formula for estates with property in more than one state does not apply to the extent it would create a retroactive increase for estates of decedents dying between January 1, 2002, and the date the act became law. Sections 1 and 3 clarify the effective date of the Low-Income Housing Tax Credit.
Section 2	Re-enacts a session law that did not receive three roll-call readings on adoption of the conference report.
Section 4	Moves the definition of "pass through entity" to the general definitions section and makes appropriate cross-reference changes.
Section 5	Modernizes terminology by changing the word "business" to "apportionable" as it relates to the apportionment of corporate income tax.
Section 6	Correct capitalization.
Section 7	Makes a grammatical change.
Section 8	Clarifies that interest, not the interest rate, for the low income housing tax credit is computed from the date the Secretary transferred the credit amount to the Housing Finance Agency.
Section 9	Makes a punctuation change.
Section 10	Clarifies that the entire penalty may be waived for the nonpayment of taxes. G.S. 105-357(b)(2) imposes a penalty for nonpayment of taxes of the greater of 10% or $25. However, currently G.S. 105-358(a) authorizes waiver of only the 10% penalty.
Section 11	Supplies missing language.
Section 12	Clarifies that the Constitution prohibits the General Assembly from contracting away its taxing power.

APPENDIX A

AUTHORIZING LEGISLATION
ARTICLE 12L OF CHAPTER 120
OF THE
GENERAL STATUTES

APPENDIX A

AUTHORIZING LEGISLATION
ARTICLE 12J OF CHAPTER 120
OF THE
GENERAL STATUTES

Article 12L.

Revenue Laws Study Committee.

§ 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.)

§ 120-70.108. Property Tax Subcommittee.

(a) The Revenue Laws Study Committee shall establish a Property Tax Subcommittee consisting of six members. The Senate cochair of the Committee shall designate three members appointed by the President Pro Tempore of the Senate to serve on the Subcommittee and shall name one of those members a cochair of the Subcommittee. The House cochair of the Committee shall designate three members appointed by the Speaker of the House of Representatives to serve on the Subcommittee and shall name one of those members a cochair of the Subcommittee. The Subcommittee shall meet upon the call of the Subcommittee cochairs.

(b) The Property Tax Subcommittee shall study, examine, and, if necessary, recommend changes to the property tax system. The Subcommittee shall include in its study an examination of all classes of property, including exemptions and exclusions of property from the property tax base. The Subcommittee shall also study the present-use value system, including the following:

(1) Examine the implementation and application of the current present-use value statutes.

(2) Evaluate other tax credits, including adjustments to and credits for ad valorem taxes, to encourage agricultural, forestry, horticultural, and conservation use of land.

(3) Evaluate the treatment of undeveloped land in ad valorem tax.

(4) Evaluate the possibility of amending the present-use value system and developing other tax incentives to encourage conservation and environmental protection of land. The study shall include the feasibility of allowing lands managed for conservation and the preservation of water quality, wildlife habitats, and other conservation purposes to be taxed at their present-use value.

(5) Evaluate the possibility of adding more specific land and resource management criteria to the sound management programs required for all lands enrolled in the present-use value system.

(6) Review other issues related to the taxation of agricultural land, horticultural land, and forestland, including reducing the acreage requirement for land to qualify as forestland.

(c) The Subcommittee shall report any recommendations to the Revenue Laws Study Committee. (2002-184, s. 8.)

APPENDIX B

DISPOSITION OF COMMITTEE'S RECOMMENDATIONS TO THE 2002 SESSION OF THE GENERAL ASSEMBLY

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DISPOSITION OF COMMITTEE'S RECOMMENDATIONS TO THE 2002 SESSION OF THE GENERAL ASSEMBLY

FINAL DISPOSITION OF BILLS RECOMMENDED BY THE REVENUE LAWS STUDY COMMITTEE - 2002 REGULAR SESSION

SHORT TITLE	SENATE SPONSORS	HOUSE SPONSORS	BILL #	FINAL STATUS*
Revenue Laws Technical Changes	Hartsell		S1160	Enacted* SL 2002-72
Conform Mobile Telecommunications Sourcing		Allen	H1521	Enacted SL 2002-16
Revenue Administrative Changes		Holliman	H1509	Original bill not enacted. The provisions were put into SB 1161, which was enacted, SL 2002-184
Revenue Laws Enforcement Enhancements	Clodfelter		S1218	Enacted SL 2002-106
Amend Property Tax Laws		Hill	H1523	Enacted* SL 2002-156
Amend Use Value Statutes	Hartsell		SB 1161	Enacted* SL 2002-184
Disclose Social Security # to Tax Collector				The proposal was not introduced as a bill.
Extend Qualified Business Venture Tax Credit	Hoyle	Allen	SB 1223 HB 1520	Enacted SL 2002-99

* Bills were modified prior to enactment.

APPENDIX C

DEPARTMENT OF REVENUE REPORT ON THE COLLECTION OF TAX DEBT

APPENDIX C

DEPARTMENT OF REVENUE REPORT ON THE COLLECTION OF TAX DEBT

North Carolina Department of Revenue

Michael F. Easley
Governor

November 1, 2002

E. Norris Tolson
Secretary

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

General Statute 105-243.1(f) requires the Department to submit a quarterly report, beginning November 1, 2001 through November 1, 2002 (changed in Senate Bill 1115 to June 30, 2005), and semiannually thereafter, to the North Carolina General Assembly 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: 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 by the Department. Beginning July 1, 2002, the report must list itemized collections by tax type. 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 last report for the period ending June 30, 2002 was previously submitted on August 1, 2002. This report provides an update through September 30, 2002.

Tax Debt Collections for the Fifteen-Month Period July 1, 2001 Through September 30, 2002

Collection Agency	$7,061,419
Fee Warning Letters	$48,915,127
Departmental Personnel and other Collection Initiatives	$165,340,942
Total Tax Debt Collected for the Fifteen-Month Period	$221,317,488
Non-Filers and Miscellaneous Delinquent Payments	$80,047,587
Total Collections—Fifteen-Month Period (Exhibit 1)	$301,365,075
Less Baseline Collections (Monthly Collections from FYE 00-01)	$208,353,131
Project Collect Tax Collections	***$93,011,944***

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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 three primary goals: reduce accounts receivable, collect $150 million in delinquent taxes above normal revenue collections, and implement best practices for collecting tax debt as standard operating procedures for the Department. General Assembly budget writers assigned specific collection targets in 2001 of $50 million and in 2002 of $65 million. An additional $17.5 million was assigned bringing the total to $82.5 million for 2002-03

Reduce Accounts Receivable for Accounts Billed Prior to July 1, 2001

Accounts Receivable--July 1, 2001	$359 Million
Total Reductions	$ 82 Million
Balance of 7/01/01 Accounts Receivable	* $277 Million

We anticipate older accounts receivable to decline further as the full impact of "Project Collect Tax" is realized.

Generating $150,000,000 of New Revenue and Implementing Best Practices

To achieve the Department's goal of collecting $150,000,000, several initiatives are being employed. The primary initiatives are:

- Warning Letters—On August 21, 2001, the Department began sending 20% fee warning letters to taxpayers. Notices continue to be issued on accounts over 60 days old. If the taxpayer fails to enter into a payment arrangement or pay the tax in full, the fee is assessed after 90 days. For the period ending September 30, 2002, tax debt collected from these notices totaled $48.9 million.

- Tax Delinquents on the Internet—The Department began posting certain delinquent tax accounts on its website on January 7, 2002. Since that date, 816 accounts have been listed with tax liabilities totaling $24 million. We have removed 96 accounts from the list after taxpayers made payment arrangements or otherwise resolved the liability. The Department continues to add accounts to the list each month. Accounts posted on the Web have resulted in $176 thousand directly attributable to the posting. We believe the larger impact of this program has been in increased compliance in the early stages of the billing process as taxpayers try to avoid this exposure.

** Accounts Receivable total not updated this quarter due to computer related issues. AR totals will be updated for the past and current quarters in the January 2003 report.*

- Hire 44 New Collection Division Employees—To date, 39 of the 44 have been hired and remain on the Department's payroll. These employees have collected a total of $22.6 million.

- Hire Former Employees as Contract Workers—Ten former, highly experienced revenue officers were hired as contract employees on October 15, 2001. As of September 30, 2002, these employees had collected a total of $3 million. Four of these employees continue to participate in this initiative.

- Civil Enforcement Team—Eight senior revenue officers were formed into a team that has conducted special operations in Charlotte, Gastonia, Shelby, Greensboro, Burlington, Raleigh, and Durham. As of September 30, 2002, this team has collected a total of $9 million. The team's current membership includes nine revenue officers.

- Enhance Bankruptcy Collections—Process improvements and increased attention on bankruptcy cases allowed for increased collections this fiscal year from the Department's Bankruptcy Unit. Bankruptcy is focusing on adopting best practices from across the nation to enhance collections. The Unit collected $6.8 million for the fifteen-month period ending September 30, 2002.

- Develop a Request For Proposals for Outsourcing Tax Debt—The Department issued a Request for Proposals for Collection Agency Services on January 22, 2002. Nineteen agencies responded to the request. A selection committee consisting of representatives from the Department of Revenue and the Department of Justice reviewed each proposal. After receiving approval from State Purchasing and Contracts, the Department executed contracts with 4 agencies on April 18, 2002.

  Under the new contract, the Department realizes significant cost savings. Under the Attorney General's contract, the Department paid a 20% commission rate for collection services. Commission rates for firms awarded the Department of Revenue's contract range from 13.9% to 15.45%. Of the four available on convenience contract, the Department currently uses two. Total collections from outside agencies as of September 30, 2002 totaled $7.1 million.

- Redirect Existing Personnel — During the off-peak processing season, the Department redirects positions from the Documents and Payments Processing Division and trains them to issue wage garnishments on individuals owing tax debt. As of September 30, 2002, these employees had reviewed 68 thousand accounts and issued 28 thousand wage

garnishments. Originally, the Department trained and dedicated 7 personnel to this effort. Because of its success, more personnel have been trained and are used on an as available basis. Currently we have 38 personnel redirected to this effort.

- Offer-In-Compromise Program—Financial hardships can impact taxpayers to the degree that they cannot pay their tax debt in full. In these situations, it is in the State's best interest to determine how much the taxpayer can reasonably afford to pay and settle the case. The Department has expanded use of the Offer-In-Compromise program as a part of Project Collect. During the fifteen-month period ending September 30, 2002, we reviewed 694 offers submitted by taxpayers. The Department accepted 203 offers resulting in $1.2 million in collections against a total liability of $4.6 million.

- Non-filer Project—The Examination Division identified non-filers from over half of a million cases using Federal abstract information. These non-filers include individuals who file a Federal return but fail to file a North Carolina return. Total collections from this initiative as of September 30, 2002, totaled $11.8 million.

- Federal Offset Initiative—North Carolina and other states are authorized to offset Federal tax refunds for state individual income tax debt. During the fifteen-month period ending September 30, 2002, this initiative has resulted in state tax debt collections of $4.5 million.

Total new revenue generated from all "Project Collect Tax" initiatives for the fifteen-month period ending September 30, 2002 totaled $93,011,944. This total includes collections from the initiatives listed above and from more intense collection and enforcement efforts across the state.

Additional Collection Initiatives

In an effort to continue the success of "Project Collect Tax," the Department is preparing a number of new initiatives to use in the second year of the project:

- Organizational Structure—We continue to review our organizational structure in an effort to enhance the efficiency and effectiveness of our organization. Opportunities for improvement result in shifting our limited resources into areas where we expect a higher yield. We will also continue to divert lower yield cases to collection agencies and away from highly trained field collectors. Our goal in this ongoing process is to keep the focus of our internal efforts on cases with highest yield potential.

- Increased Use of Special Procedures—We plan to expand our use of all of our collection tools, including a more strategic use of jeopardy assessments, transferee liabilities, and successor liability. DOR is developing policies and procedures to allow the Department to conduct its own levies, thereby reducing our reliance on local sheriffs' offices. The General Assembly provided this authority to the Department in 1991 but it has not been implemented.

- Technology Enablement—The Department continues to review our procedures for opportunities to automate collection processes. Earlier this year, the Department hired an Analyst/Programmer to lead this effort. She began her work by reviewing our work procedures and found several areas for potential automation.

- Performance Measures—Good performance data is required to accurately judge the performance of the overall collection program as well as individual projects and initiatives. In October 2002, the Collection Division published its first annual report. This report included performance data for all projects and initiatives undertaken by the Division. On an ongoing basis, we are building methods of tracking the performance of every new project and initiative that we embark upon. Management has the responsibility for reviewing the data and making improvements continuously.

Exhibit 1 – Tax Debt Collections
July 1, 2001 – September 30, 2002

Age of Assessments	Collection Agencies	20% Fee Warning Letters*	Other DOR Collection Efforts	Totals
0-30 days	$0.00	$0.00	$20,188,718.27	$20,188,718.27
31-60 days	$0.00	$127.00	$24,324,464.30	$24,324,591.30
61-90 days	$11,464.41	$3,910,725.50	$36,448,065.93	$40,370,255.84
90-120 days	$207,183.56	$14,304,135.61	$9,609,534.32	$24,120,853.49
121-180 days	$1,117,348.10	$9,008,343.23	$14,455,236.81	$24,580,928.14
181-365 days	$2,405,636.18	$8,993,413.53	$29,343,510.99	$40,787,560.70
366-730 days	$1,451,772.72	$6,354,947.01	$15,639,472.54	$23,446,192.27
Older than 730 days	$1,823,014.27	$6,343,434.43	$15,331,938.82	$23,498,387.52
Totals	$7,061,419.24	$48,915,126.31	$165,340,941.98	$221,317,487.53
Miscellaneous delinquent tax collections and non-filers				$80,047,586.98
Grand Total- Tax Debt and Non-Filer Collections				$301,365,074.51

Exhibit 2 – Project Collect Tax Collections* By Tax Type
July 1, 2002 – September 30, 2002

Tax Type	July 2002	August 2002	September 2002	TOTAL
Individual Income**	$3,279,883	$4,696,717	$2,882,041	$10,858,641
Sales & Use	$923,631	$1,584,721	$700,743	$3,209,095
Corporate	$282,648	$581,637	$300,917	$1,165,202
Franchise	$205,072	$261,988	$151,431	$618,491
Motor Fuels	$8,682	$23,691	$10,752	$43,125
Other***	$28,845	$540,484	$214,031	$783,360
TOTAL	$4,728,761	$7,689,238	$4,259,915	$16,677,914

*Amounts represent collections above July 1, 2000 – September 30, 2000 baseline.

**Individual Income Tax includes debts owed by businesses for employee withholding taxes withheld but not paid.

**The category "Other" includes License and Excise Taxes, Insurance Premium Tax and the Unauthorized Substances Tax.

APPENDIX D

STATE BUDGET OUTLOOK: MORE OF THE SAME?

APPENDIX D

STATE BUDGET OUTLOOK: MORE OF THE SAME?

STATE BUDGET OUTLOOK:
More of the Same?

Fiscal Research Division

December 18, 2002

DIFFICULT BUDGETS ARE NOT NEW TO NORTH CAROLINA

- **1995-1997** Major tax cuts, teacher pay, and Smart Start
- **1998-2000** Additional tax cuts, lawsuit payouts, Hurricane Floyd, teacher pay
- **2000-2002** Manufacturing recession, stock market crash, Leandro decision

THE 2003-04 BUDGET GAP WILL BE AS LARGE AS THE 2002-03 PROBLEM

- ✓ Little, if any, revenue surplus for current year (affects 03-04 forecast base and one-time availability).
- ✓ Subpar revenue growth for 03-04 due to anemic economic recovery.
- ✓ Use of one-time sources over last two years ($1.3 billion)
- ✓ Usual continuation budget increases (Medicaid, K-12 Enrollment, State Health Plan, Higher Ed Enrollment, Salaries).
- ✓ Governor's education initiatives.
- ✓ Conclusion: 03-04 budget gap of around $2 billion.

FIRST-ROUND OPTIONS THAT ARE LIKELY TO BE DISCUSSED

- ✓ Lottery
- ✓ Continue ½ cent state sales tax for another year
- ✓ Delay 2001 tax cuts for another year
- ✓ Force agencies to absorb inflationary increases
- ✓ Scale back or eliminate salary increase
- ✓ Agency spending cuts (smaller amounts for education, human services)

OTHER OPTIONS THAT COULD RECEIVE ATTENTION

- ✓ Governor's tax modernization package
- ✓ Sin taxes
- ✓ Pull in more one-time funding (Hurricane Floyd funds, highway fund balances, tobacco settlement receipts)
- ✓ Move June pay date to July 1
- ✓ Program elimination
- ✓ Medicaid cuts
- ✓ Tuition increases
- ✓ Deeper education reductions

NORTH CAROLINA IS NOT ALONE IN USING ONE-TIME BUDGET FIXES

- Neither political party wants to hurt classroom
- Advocacy groups resist human services cuts
- Medicaid cuts are difficult to achieve (services to elderly, payments to providers)
- Competitive politics rules out broad-based tax hikes
- These constraints have forced states to be creative in uncovering nonrecurring resources

IS THERE ANY HOPE FOR THE FUTURE ?

- Through November, General Fund revenues are on target (2.0% vs. 1.9% growth budgeted)
- Economists typically underestimate strength of recovery (but not so far)
- North Carolina's recovery is usually stronger than nation
- Health care cost increases may slow as they did in mid-1990's

FEDERAL ACTIONS COULD WORSEN SITUATION

- ✓ Military engagement could adversely affect consumer confidence and oil prices in short run*
- ✓ Federal Reserve does not have much operating room (short-term rate is only 1.25%)
- ✓ The new tax cut plan could hurt state's tax base due to Internal Revenue Code conformity*

*Could have significant long-term benefits.

HOW DOES NORTH CAROLINA'S PLIGHT COMAPRE TO OTHER STATES?

- ✓ Many states adopted 02-03 budget prior to bad April and June numbers and used revenue growth rates of 3-6% (versus 1.9% in North Carolina). Thus, North Carolina could be one of a handful of states that does not have a major budget problem for the current year.
- ✓ Some states still have budget reserves to help out this year.
- ✓ Our FY 04 budget gap is comparable to most states.
- ✓ Some states will consider revenue-enhancements already used by North Carolina in 2001 and 2002.
- ✓ States not choosing to cut deeply into education/human services or to raise taxes may be in a crisis situation due to magnitude of problem and the fact that many options have already been used.

SALES TAX FORECAST CONSIDERATIONS

- A mid-range growth forecast is:
  - FY 03 1.5%
  - FY 04 4.0%
  - FY 05 4.0%
  - FY 06 4.1%
  - FY 07 4.2%
- We may use "pessimistic" forecast for budget purposes. This could lower FY 04 by a couple of percentage points but FY 05 would be higher.
- Positives for short-term include stable energy prices, sharp drop in interest rates, REFI activity.

SALES TAX FORECAST CONSIDERATIONS (CONTINUED)

- Concerns include build-up to military engagement (rhetoric, troop deployment), depressed equity prices, high consumer debt burdens
- We are pessimistic about congressional assistance on remote sales issue (catalog, internet). It is hard to quantify impact.
- Governor's Commission is looking at services tax. The final outcome might be a more serious review of rate changes for major state taxes (maybe on a temporary basis).

APPENDIX E

MEMO FROM THE DEPARTMENT OF REVENUE
TO THE
REVENUE LAWS STUDY COMMITTEE
ON THE
TAX CREDIT FOR PREMIUMS PAID ON
LONG-TERM CARE INSURANCE

North Carolina Department of Revenue
www.dor.state.nc.us

Michael F. Easley
Governor

E. Norris Tolson
Secretary

January 16, 2003

MEMORANDUM

TO: Revenue Laws Study Committee
Senator John Kerr, Co-Chair
Representative Paul Luebke, Co-Chair

FROM: Sabra J. Faires
Assistant Secretary for Tax Administration

SUBJECT: Tax Credit for Premiums Paid on Long-Term Care Insurance

This memo expresses the concerns of the Department of Revenue about the individual income tax credit for premium costs paid during the taxable year on qualified long-term care insurance contracts and urges the Committee to conduct a thorough analysis of the credit before considering an extension or removal of the current sunset on the credit. The concerns arise from the Department's review of a limited number of returns claiming the credit.

G.S. 105-151.28 contains the long-term care credit. The credit became effective for tax years beginning on or after January 1, 1999, and is scheduled to expire for tax years beginning on or after January 1, 2004. The credit is allowed for premiums paid on qualifying long-term care insurance contracts that provide insurance coverage for a taxpayer or a taxpayer's spouse or dependent. The credit is 15% of the premiums paid, not to exceed $350 for each qualified long-term care insurance contract for which a credit is claimed. A long-term care insurance contract is defined in section 7702B of the Internal Revenue Code as any insurance contract under which the only insurance protection provided is for coverage of qualified long-term care services. Qualified long-term care services are those services required by a chronically ill individual and provided under a plan of care prescribed by a licensed health care practitioner.

The Department reviewed some of the returns on which the credit was claimed and found that the vast majority of the credits claimed on the returns were claimed in error. Our auditors reviewed 2,155 electronically filed 2001 income

tax returns on which taxpayers claimed long-term care credits greater than $350. The auditors selected these returns because the amount of credit taken exceeded the $350 cap. Before examining the returns, auditors thought the taxpayers likely made an error in the amount of credit taken. What they found is that most of the taxpayers claiming the credits were not eligible for them and that the error was ineligibility for the credit rather than the amount of credit taken.

Of the 2,155 returns reviewed, only 192 contained allowable long-term care credits. Taxpayers were not eligible for the credits claimed on the remaining 1,963 returns in this group. As a group, therefore, over 90% of the returns incorrectly claimed the credit.

For tax year 2001, 51,959 returns claimed credits of $10,367,883. If a 90% error rate applies to all returns on which the credit was claimed, then over $9,000,000 was claimed in error for tax year 2001. We do not know the error rate for the entire group. A significantly lower error rate of 75%, 50% or 25%, however, would still be cause for considerable concern.

We believe the high error rate is largely attributable to two factors. One factor is the complicated nature of the credit and the other is confusion of this credit with the repealed child health insurance credit.

Proper application of the credit requires the taxpayer to distinguish premiums for long-term care insurance from other types of premiums paid for general health care, hospitalization, or disability. It also requires the taxpayer to exclude premiums that have been deducted from or not included in federal taxable income. The income tax instructions explain the requirements of the credit, but many taxpayers may not read or understand the instructions.

The former credit for child health insurance premiums was repealed effective for tax year 2001. During the examination process, our auditors discovered that many taxpayers who claimed the credit for premiums paid on long-term care insurance contracts on 2001 returns were in fact attempting to claim the credit for child health insurance premiums. Because the 2001 return no longer provided a line for the child health insurance premiums credit, taxpayers simply entered an amount on the long-term care credit line. The errors were made even though the 2001 income tax instructions contained information about the repeal of the child health insurance tax credit.

The number of credits claimed for tax year 2001 (51,959) was significantly higher than the number claimed for tax year 2000 (29,206) or tax year 1999 (21,029). This increase supports the conclusion that repeal of the child health insurance premiums credit resulted in incorrect claims for the long-term care credit. The increase could also be the result of an increased awareness by taxpayers of the availability of the long-term care credit, growth in the number of taxpayers that purchase long-term care insurance, or other factors.

The purpose of the long-term care credit is to encourage people to have long-term care insurance. For tax year 2001, the credit reduced tax revenue by $10,367,883. The credit will expire in tax year 2004 unless the General Assembly extends or removes the sunset. The Department urges the Revenue Laws Study Committee to obtain more data on the effectiveness of the credit in achieving its goal and on alternative ways to achieve the credit's goal before taking any action on the sunset.

cc: Secretary E. Norris Tolson

APPENDIX F

HISTORY OF DIVIDEND DEDUCTION

History of Dividend Deduction 1969 – 2002

Deduction for NC Dividends: Before 1969, individual and corporate taxpayers were allowed to deduct a portion of stock dividends received, in proportion to how much business the issuing company did in NC. If the company that issued the stock was 100% taxable in NC, the stockholder could deduct 100% of the dividends from its stock. If the issuing company did no business in NC, then the stockholder could not deduct any of the dividends from its stock. In 1966, the North Carolina Supreme Court ruled in Gulf Oil Corp. v. Clayton,[1] that NC could not tax dividends received by a non-NC corporation from subsidiaries that have no connection with NC and are not part of a unitary business with the parent. As a result of this decision, if a NC corporation received dividends from a non-NC, non-unitary subsidiary, it paid NC tax on those dividends. A non-NC corporation receiving the same dividends would pay no NC tax on the dividends.

Enactment of Subsidiary Dividend Deduction: The subsidiary dividend deduction was added to former G.S. 105-130.7 effective January 1, 1969.[2] It allowed a corporation domiciled in North Carolina that held more than 50% of the outstanding voting stock of another corporation (a subsidiary) to deduct dividends it received from the subsidiary. It appears that the intent of this legislation was to extend to NC corporations the same benefit that the Gulf Oil case had given non-NC corporations.[3]

Deduction Was Net of Expenses. The subsidiary dividend deduction for NC corporations was not a gross dividend deduction. In 1969, and until 1987, G.S. 105-130.5(c)(3) explicitly stated that no deduction was allowed for expenses related to dividend income deductible under the subsidiary dividend provision in G.S. 105-130.7.

Ambiguous Amendment Leads to Gross Dividend Deduction: In 1987, legislation was introduced to expand the rule of (c)(3), which disallowed deduction of expenses related to deductible subsidiary dividends, so that it would apply to expenses related to all untaxed income. The bill passed, but only after an amendment adding an ambiguous proviso was adopted: the rule disallowing deduction of expenses related to tax exempt income would not apply to "adjustments addressed in G.S. 105-130.5(a) and (b)."[4] Subsequent analyses and interpretations of this amendment by the Attorney General's Office and the Secretary of Revenue indicate that no one knows what its original intent was.

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[1] 267 N.C. 15, 147 S.E.2d 522 (1966)

[2] Chapter 1124 of the 1969 Session Laws.

[3] Bill Baker, then director of the Corporate Income Tax Division at the Department of Revenue, stated in April 1996 that "The subsidiary dividend deduction evolved from an allowance of a deduction to [the] extent of activity in this state to a full deduction by domiciled controlling corporations effective January 1, 1969, which followed the Gulf Oil Corp. v. Clayton decision basically preventing the state from including in income subject to tax dividend income received from subsidiaries by foreign corporations, i.e., nondomiciled corporations. One of the largest corporations domiciled in the state at the time sponsored this change."

[4] Chapter 804 of the 1987 Session Laws.

After a contrary interpretation by the Attorney General in 1991, the amendment was interpreted by the Secretary of Revenue in 1992 to allow the deduction of expenses related to deductible subsidiary dividends.

Constitutional Problem with Special Rule for NC Corporations: Allowing domestic corporations a gross deduction with no netting of expenses gave them more favorable tax treatment than identical corporations domiciled out of State. Out-of-state parent companies were allowed an exclusion for nonbusiness dividends but were required to adhere to the basic tax principle that expenses incurred to generate the tax-free dividend income cannot also be deducted. In 1996, the United States Supreme Court held in the Fulton[5] case that an intangibles tax preference for domestic but not foreign companies violated the Interstate Commerce Clause of the United States Constitution. Based on Fulton, experts agreed that requiring only out-of-State corporations to net expenses from untaxed dividends was unconstitutional. The Revenue Laws Study Commission recommended that the 1995 General Assembly treat domestic and out-of-State corporations alike by requiring both to net expenses from deductible dividends. The General Assembly did not address this issue during the 1995-1996 session.

Gross Dividend Deduction Extended to non-NC Corporations: The Attorney General's Office advised the Department of Revenue that, if the General Assembly did not resolve the constitutional problem with this tax preference, the Department of Revenue could not enforce it. There was too much risk of personal liability on the part of Department of Revenue personnel in enforcing a provision that was so clearly flawed in the wake of the Fulton decision. The Department of Revenue therefore stopped enforcing the expense netting requirement against out-of-State corporations. In 1998, the General Assembly amended the statutes to expand the subsidiary dividend deduction to out-of-State corporations, conforming the statute to the Department's practice.[6]

Deduction Piggybacked to Federal Dividend Deduction: In 2001, the General Assembly enacted legislation to piggyback the federal dividends received deduction for State income tax purposes, effective with the 2001 tax year.[7] The amount of the federal deduction for dividends from domestic corporations varies based on how much stock the taxpayer owns in the issuing corporation, as indicated in the following chart:

Percent Owned	Percent Deductible
80% - 100%	100%
20% - less than 80%	80%
Less than 20%	70%

[5] Fulton Corp. v. Faulkner, 516 U.S. 325, 116 S. Ct. 848, 133 L. Ed. 2d 796 (1996).
[6] Section 29A.5 of S.L. 1998-212.
[7] S.L. 2001-327, as amended by S.L. 2001-427. The act also equalized the tax treatment of domestic and foreign source dividends by providing that dividends of foreign corporations may be deducted from taxable income to the extent they are included in federal taxable income. Under federal law, foreign dividends are generally included in income and the taxpayer is allowed a credit for foreign tax paid.

As a result of this change, the deduction for dividends received from domestic corporations was no longer a special adjustment, and therefore was no longer protected by the ambiguous proviso from the general law requiring expenses to be netted from untaxed income. In a separate act, the General Assembly specifically required expenses to be netted from foreign dividends.

Expense Netting Requirement Modified: After adjournment of the 2001 session, taxpayers sought further changes in the new expense netting requirement. First, they requested guidelines on how the determine to amount of expenses attributable to dividends. Second, they sought to limit how much of those attributable expenses must be netted. Bank holding companies and electric power holding companies, in particular, discovered that the new law would significantly increase their tax burden because federal law requires them to have multiple subsidiaries. The 2002 General Assembly enacted legislation providing guidelines and limitations.[8] The act states the intent of the General Assembly that it will be effective during 2001 and 2002 but will be studied and may be revised effective beginning with the 2003 tax year. If the 2003 General Assembly does not act, the new law will remain in place. The new law provides limitations as follows:

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

[8] S.L. 2002-136.

APPENDIX G

HISTORY OF BANK EXPENSE DEDUCTION

History of Bank Expense Deduction

Excise Taxes, 1957 – 1974: Beginning in 1957, North Carolina levied an excise tax on banks and both an excise tax and a capital stock tax on savings institutions. The excise tax on banks was a percentage of net income, including interest on federal obligations. The excise tax on savings institutions was a percentage of net income, excluding interest on federal obligations. The capital stock tax on savings institutions was a dollar amount per $100 of share value.

Tax Rates:

	1957	1969
Excise Tax - Banks	4½%	6%
Excise Tax - Savings	6%	7½%
Stock Tax - Savings	6¢	7½¢

Bank Consultant Study, January 1973: In January 1973, Richard E. Slitor, an independent economic consultant, published a study of bank taxation in North Carolina, prepared under contract with the North Carolina Tax Study Commission. The report, entitled Taxation of Banks in North Carolina, examined a number of options for revising taxation on banks, including a proposal that banks be subject to the corporate income tax generally applicable to other corporations, rather than the bank excise tax.[1]

Dr. Slitor stressed the significant revenue loss to the State that would result from allowing banks to be taxed under the general corporate income tax, with both an exemption for interest on federal obligations and a deduction for

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[1] The report concluded that "the impression is unmistakable that commercial banks are not heavily taxed in North Carolina and that their tax contribution may even be regarded as relatively light, compared with banks throughout the country and with industrial corporations in North Carolina." Dr. Slitor discussed the option of subjecting banks to the general corporate income tax at length. He pointed out that this proposal would allow them an exemption for interest on federal obligations (taxable under the then-current bank excise tax) and also a simultaneous deduction for expenses incurred in earning the exempt income, not allowed to other corporations. Dr. Slitor pointed out three reasons why he believed this approach to taxing banks should be examined carefully: "(1) The full deduction of tax-exempt interest with allocation has the unintended and anomalous effect of virtually exempting from net income-based tax liability a whole enterprise which puts a modest fraction of its resources into tax-exempt investments if it operates with large borrowed capital, i.e., a thin equity, or has relatively large operating expenses in the servicing of customers who furnish the equivalent of borrowed capital as depositors do. (2) The allowance of deductions for interest paid and operating expenses related to tax-exempt investments contains elements of a double deduction for the same income: once as the income is received and again for the use of the income to pay interest or expenses necessary to carry or sustain the investment. If the income is deducted out at the start, the related interest and other expenses in effect spill over to exempt other earnings. (3) The result may be logical in terms of giving the enterprise the same value for the tax-exempt feature as other taxpayers, but it is offensive in creating a blind spot in the law with respect to its capacity to assess a tax commensurate with the general size of certain financial corporations. Financial leverage becomes tax-exemption leverage. The consequences are not good for taxpayer morale, or calculated to enhance the public image of the banking industry as a `good tax citizen'."

expenses incurred in producing the interest income. He stated that the existing bank excise tax, which did not exempt interest on federal obligations, "has been sustained only through denial of the deduction for Federal bond interest; it or any net income tax would be a weak instrument in the absence of that denial."[2]

Legislation, 1974: In 1974, the General Assembly repealed the excise tax on banks' net income, subjected banks to the general corporate income tax, the corporate franchise tax, and the intangibles tax, and levied a privilege license tax on the value of each bank's assets at the rate of $30 per $1 million in assets (.003%).[3] The new law became effective beginning with the 1974 tax year.

Deduction of Banks' Expenses Allocable to Federal Obligation Income: Subjecting banks to the general corporate income tax had the effect of exempting from tax their interest income from federal obligations. Although the legislation did not address the question of the simultaneous deduction for expenses incurred in generating this income, banks apparently interpreted it as allowing the deduction. The North Carolina Corporation Income Tax Act provided generally in G.S. 105-130.5(a)(2) that "interest paid in connection with income exempt from taxation" was required to be added to taxable income, but did not specifically address banks.

In 1974, section 265 of the federal Internal Revenue Code generally disallowed a deduction for interest incurred or continued to purchase or carry tax exempt obligations. This federal law had, however, been interpreted as not applying to banks and comparable financial institutions. In 1986, Congress amended section 265 of the Code to repeal that interpretation and provide that, except in the case of obligations of small issuers, the deduction would no longer be allowed to banks.

In 1987, the North Carolina Attorney General ruled that the intent of the State law enacted in 1974 was indeed not to disallow the deduction for expenses allocable to tax-exempt interest income but to follow the federal interpretation in effect in 1974. Despite the 1986 change in the federal law, the Attorney General ruled that the 1974 intent governed until changed by the General Assembly.

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[2] Dr. Slitor continued, later in the report, "So great are the revenue losses involved in the exemption of Federal bond interest to banks..., even the revenue gains associated with the tangible personal property tax...the corporation franchise tax...and the intangible personal property tax...would fall short of offsetting the revenue losing impact." (References to dollar amounts omitted). This revenue loss could be offset by approximately eighty-five percent (85%), however, by requiring banks to prorate expenses according to taxable and federal obligation income and disallowing deduction of expenses allocable to federal obligation income, according to Dr. Slitor.

[3] Chapter 1053 of the 1973 Session Laws (1974 Regular Session).

APPENDIX H

FISCAL REPORT ON DIVIDEND ISSUE

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January 6, 2003

TO: Revenue Laws Study Committee

FROM: Dave Crotts
Fiscal Research Division

SUBJECT: Fiscal Estimate For Subsidiary Dividend Legislation

A comparison of the impact of various proposals on the subsidiary dividend issue is shown below. The analysis of actual returns by the Tax Research Division of the Department of Revenue indicates that the expected additional revenue of $25 million per year from the banking sector for the 2001 and 2002 tax years has occurred. The Department is continuing to analyze whether the original $32 million annual impact from other taxpayer categories has taken place.

Additional General Fund Revenue By State Fiscal Year ($Mil.)

	01-02	02-03	03-04	04-05
2001 Legislation	30.8	32.3	33.6	34.5
2002 Budget Re-estimate*	30.8	82.3	83.6	84.5
2002 Session Fiscal Note**	30.8	82.3	59.9	62.9
2002 Post-Legislative Update***	30.8	82.7	61.8	64.9

*The amount used in modifying the 2002-03 budget.
**The analysis indicates that a major portion of the unanticipated 2001 tax year impact would be paid in 2002-03.
***The Department of Revenue is continuing to analyze tax returns to determine whether the $32.3 million from non-bank taxpayers for 02-03 has occurred.

APPENDIX I

DEPARTMENT OF REVENUE REPORT ON THE EFFECTS OF TAX LAW CHANGES

North Carolina Department of Revenue

Michael F. Easley
Governor

E. Norris Tolson
Secretary

January 7, 2003

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). It includes recommendations by the Department of Revenue for 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 final of three reports required by the act. The first report was dated November 30, 2001. That report summarized the law changes and identified the actions taken by the Department to implement the act. The second report was dated May 1, 2002. That report identified a list of questions that had been raised by taxpayers and tax practitioners with respect to the income tax on royalty income and the franchise tax on corporate members of LLCs. That report also included two issues the Department recommended the General Assembly to consider. One issue dealt with the income tax treatment of income from royalties other than trademarks. The other issue dealt with an alternative entity structure that would allow taxpayers to defeat the General Assembly's attempt to close the franchise tax loophole.

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, the Department has little hard evidence from which 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.

Based on the information we have, we offer the following observations

- We have reviewed the list of trademark holding companies previously identified by the Department. Only approximately 25% of those companies have filed 2001 income and franchise tax returns. Regardless of the election made by the affiliated group as to how to report the royalties, the holding company is still required to file a tax return. This suggests that voluntary compliance has not increased significantly.
- The few telephone contacts we have received from affiliated groups suggest that most groups will report an addition for the royalty payment deductions on the operating company's return and exclude the royalty payment income from the holding company's return. We believe the primary reason for this decision is that the operating company usually uses the three-factor apportionment method while the holding company in many cases is an excluded corporation by definition and is limited to just the sales factor.
- We have no statistics at this time as to whether corporations that are members of LLCs are complying with the law change regarding calculation of the franchise tax. As explained in more detail in the **Issues** section below, we were advised of the potential for taxpayers to avoid this loophole-closing effort by inserting a partnership between the corporation and LLC.
- We also have no statistics at this time as to whether corporations in general are deducting dividends and attributing expenses to the deductible dividends properly on tax returns. As explained in more detail in the **Issues** section below, we do know that the financial institution industry and other taxpayers are aware of the law change as evidenced by their efforts to modify the law to limit its impact.

Technical Advice Directives

Franchise Tax on Corporate Members of LLCs: The Department of Revenue has issued two Directives to explain the law change and to answer questions about the franchise tax on corporate members of LLCs. Directive CD-02-1 is dated May 31, 2002 and addresses general issues of nexus and filing obligations of corporate members of LLCs. Directive CD-02-2 is also dated May 31, 2002 and deals more specifically with the changes to G.S. 105-114 as amended by Session Law 2001-327. The Directive provides a background for why the law was changed and then instructs taxpayers on how to compute the tax.

Income Tax on Royalty Income: The Department of Revenue is still working on a Directive that addresses the taxation of intangible property used in North Carolina. The Directive will address the Department's nexus standard and what constitutes "use" of an intangible. The Directive will also explain how to source income to North Carolina when intangible property is used in this State and the filing option for related entities available in G.S. 105-130.7A as a result of the enactment of Session Law 2001-327. Numerous examples will be provided.

The Department had planned to issue this Directive earlier but decided to wait and to broaden its scope to include guidance on how to source income from royalties other than trademarks. The Department is reviewing how other states treat income from royalties other than trademarks. The Department plans to issue the Directive by January 31, 2003.

Issues

The Department of Revenue recommends that the General Assembly consider the following issues related to the law changes included in Chapter 327:

Intangible Property

- Chapter 327 specifically provides a filing option to related entities with respect to reporting royalty income from the use of trademarks. The Department has recently seen several cases in which an operating company transferred patents to a holding company that then licensed the patents back to the operating company. This raises the issue of whether the reporting election in G.S. 105-130.7A should be extended to include income from patents or other kinds of intangible property.

- In the preamble to the law changes providing the royalty reporting option, the law states that "it is the intent of this section to reward taxpayers who comply, by giving them an option on how to file tax returns involving royalty income." However, a taxpayer receiving royalty income from a related member can still choose not to file a return and report the royalty income and gamble that it is not discovered by the Department of Revenue. If the taxpayer is later discovered by the Department, the law does not prevent the taxpayer from then electing to not report the income and have the royalty-paying related member add the royalty expense to federal taxable income.

  Our experience is that it is generally beneficial to the taxpayer group for the royalty payer to forgo the deduction instead of including the royalties in the receiver's income. To accomplish the legislation's stated intent, consideration should be given to allowing taxpayers to exercise the royalty reporting option only on a timely filed return. If a timely filed return reporting the royalty income is not filed by the entity receiving the royalty payments, the law should require the royalty payer to forgo its deduction for royalty payments to related members by adding the royalty payments to federal

taxable income. Federal law contains numerous examples of elections that must be made by the due date of the return.

Franchise Tax

- The Department previously mentioned in the November 30, 2001 report and the May 1, 2002 report that tax practitioners had 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 General Assembly addressed this concern in Session Law 2002-126. To close this loophole, G.S. 105-114(c) was recodified as G.S. 105-114.1. New G.S. 105-114.1 was amended to require the LLC's income, assets, liabilities, or equity to be attributed to a corporation if the corporation and its related members together own indirectly seventy percent (70%) or more of the LLC's assets. A person owns indirectly assets of an LLC if the LLC's governing law provides that seventy percent (70%) or more of its assets, after payments to creditors, must be distributed to the person upon dissolution. The LLC's assets are attributed only to the related members that are corporations. None of the LLC's assets are attributed to the related members that are not corporations. Instead, the amount that would be attributed to that member is also attributed to the corporate members.

  While the General Assembly may have closed this specific loophole, there still exists a general franchise tax inequity because the imposition of the tax depends on the type of entity. Consideration should be given to subjecting LLCs to the franchise tax as recommended by the North Carolina Efficiency and Loophole-Closing Commission. Consideration should also be given to extending the franchise tax to partnerships.

Dividends

- As explained in the November 30, 2001 report, Session Law 2001-327 amended several sections of the law to generally conform to the federal tax treatment of dividend income. One of the changes was the repeal of G.S. 105-130.7(b), which addressed subsidiary dividends. G.S. 105-130.7(a), which addresses dividends received from a regulated investment company or a real estate investment trust, was not amended.

  Under federal law, dividends from a regulated investment company qualify for the dividends received deduction; therefore, G.S. 105-130.7(a) is

unnecessary for the dividends to be taxed the same for State and federal purposes. However, because the taxability of dividends from regulated investment companies is determined under G.S. 105-130.7(a) instead of under federal law, as is the case for dividends from corporations, it is not clear whether a taxpayer is required to attribute expenses to the dividends as is required for dividends from corporations.

Dividends from real estate investment trusts do not qualify for the federal dividends received deduction; therefore, G.S. 105-130.7(a) results in dividends from real estate investment trusts being taxed more favorably for State tax purposes. G.S. 105-130.7(a) and G.S. 105-130.5(b)(3) should be repealed repeal to ensure that the State category of dividends with respect to real estate investment trusts is the same as under federal law and that dividends received from a regulated investment company are subject to the same rules concerning attribution of expenses as dividends received from other corporations.

cc: Secretary Tolson

APPENDIX J

MEMO FROM MARTHA WALSTON, STAFF ATTORNEY
TO THE
REVENUE LAWS STUDY COMMITTEE
RE: NORTH CAROLINA'S
ALLOCATION & APPORTIONMENT OF
INCOME FOR CORPORATIONS

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MEMORANDUM

TO: Revenue Laws Study Committee Members
FROM: Martha Walston, Staff Attorney
RE: North Carolina's allocation and apportionment of income for corporations
DATE: December 18, 2002

BACKGROUND AND CURRENT LAW

Since 1921, North Carolina has imposed a corporate income tax on foreign and domestic C corporations doing business in the State. The current 6.9% rate is imposed on State net income. "State net income" is defined as federal taxable income with certain additions, deductions, and other adjustments (See N.C.G.S. § 105-130.5). If a corporation is doing business in this State as well as another state, then the State net income is the income from business activity[1] that is taxable within and without this State based upon an apportionment formula (See N.C.G.S § 105-130.4). This apportionment formula provides for a multistate corporation to allocate its net income or net loss taking into account how much sales, property, and payroll the corporation has in each state. For most corporations, business income is apportioned by multiplying the total business income of the corporation by an apportionment fraction. The numerator of this fraction is the sum of the property factor, the payroll factor, and twice the sales factor. The denominator of this fraction is four. A multistate corporation calculates its income tax by adding together its property factor, its payroll factor, and twice its sales factor[2] and then dividing the total by four:

$$\text{Business income} \times \frac{\text{property factor} + \text{payroll factor} + 2 \times \text{sales factor}}{4}$$

$$\text{Property factor} = \frac{\text{average value of corp. property owned or rented and used in NC during year}}{\text{average value of all corp. property owned or rented and used during year}}$$

$$\text{Payroll factor} = \frac{\text{total amount paid in NC during year by corp. as compensation}}{\text{total compensation paid by corporation everywhere during year}}$$

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ffective for taxable years beginning January 1, 2002, business income is defined to include all income that is apportionable under the U.S. nstitution. (S.L.2002-126). Prior law defined business income as income related to the regular trade or business of the taxpayer. This inition is vague and narrower than what is allowed under the U.S. Constitution and permits a corporation to avoid tax by shifting much of its ome into nonbusiness income, which North Carolina does not share in. This situation could happen even though the corporation had ducted as a business expense the same items that it later claimed were not business items when the time came to pay tax on profits. amples of the types of business income that corporations most often re-characterize are rents, royalties, gain or loss from the sale of perty, interest, and dividends. Currently five other states define business income as all that the U.S. Constitution allows a state to apportion.

to 1988, North Carolina gave equal weight to the property, payroll, and sales factors. The double-weighting of the sales factor was d in 1988 as part of an inducement to get RJR Nabisco to build a cookie-baking factory and distribution center in Garner, North Carolina. e factory was never built. Double-weighting a state's sales factor tends to benefit in-state corporations that sell a large portion of their oducts outside the state and is less favorable to out-of-state corporations selling into the state.

Sales factor = total sales of corp. in NC during the year
total sales of corp. everywhere during the year

Currently 23 states utilize a three-factor formula with double-weighted sales factor or receipts factor.

ALTERNATIVE APPORTIONMENT FORMULAS[3]

North Carolina law applies alternative apportionment formulas to the following types of businesses:

- Railroad company – all business income is apportioned by a factor calculated by dividing railway operating revenue from business done in NC by total railway operating revenue.
- Telephone company – all business income is apportioned by a factor calculated by first adding gross operating revenue from local telephone service in NC, gross operating revenue from toll services performed wholly within NC, and that portion of revenue from interstate toll services attributable to NC. The sum of those revenue sources is then divided by the company's total gross operating revenue to produce the factor that is then applied to determine income taxable in NC.
- Motor carrier – all business income is apportioned by a factor calculated by dividing the number of vehicle miles driven in NC by the carrier's total vehicle miles.
- Public utility or excluded corporation – all business income of any other public utility or of an excluded corporation is apportioned by the single sales factor. Excluded corporations are defined as building or construction contractors, securities dealers, loan companies, or corporations that receive more than 50% of their ordinary gross income from intangible property.
- Air or water transportation corporation – all business income is apportioned by a factor calculated by dividing revenue ton miles within NC by the corporation's total revenue ton miles. A "revenue ton mile" is defined as one ton of passengers, freight, mail, or other cargo carried a distance of one mile.

EQUITABLE RELIEF FROM STATUTORY APPORTIONMENT FORMULA

If any corporation believes that the statutory apportionment formula has or will subject it to taxation on a greater portion of its income that is attributable to its business in the State, then the corporation may file a petition with the Tax Review Board[4] requesting permission to use an alternative formula. If the corporation proves by clear, cogent and convincing evidence that an alternative formula should be used, then the Board will issue a written decision setting out the alternative formula. If the corporation disagrees with the decision, it may appeal to superior court.

DEPARTMENT OF REVENUE PROPOSAL

The Department of Revenue recommends two changes to the apportionment rule:

1. Adopt alternative apportionment formulas for the publishing industry and the broadcasting industry.
2. Exclude outerjurisdictional property from the property factor. Outerjurisdictional property is property that is not physically located in any state, such as orbiting satellites and undersea transmission cables.

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[3] The following material is excerpted from a summary of North Carolina Tax Law written by Kay Miller Hobart.

[4] The State Tax Review Board consists of the State Treasurer, the chairman of the Utilities Commission, and a member of the public appointed by the Governor. At the hearing, the membership is augmented by the Secretary of Revenue, who joins the Board as a member with full power.

APPENDIX K

COPY OF THE MULTISTATE TAX COMMISSION'S REGULATIONS RE: APPORTIONMENT OF INCOME FOR BROADCASTING & PUBLISHING COMPANIES

••• Reg.IV.18(h). **Special Rules: Television and Radio Broadcasting**
[Adopted August 31, 1990; amended April 25, 1996]

The following special rules are established in respect to the apportionment of income from television and radio broadcasting by a broadcaster that is taxable both in this state and in one or more other states.

(1) In General. When a person in the business of broadcasting film or radio programming, whether through the public airwaves, by cable, direct or indirect satellite transmission or any other means of communication, either through a network (including owned and affiliated stations) or through an affiliated, unaffiliated or independent television or radio broadcasting station, has income from sources both within and without this state, the amount of business income from sources within this state shall be determined pursuant to Article IV. of the Multistate Tax Compact and the regulations issued thereunder by this state, except as modified by this regulation.

(2) Business and Nonbusiness Income. For definitions, regulations and examples for determining whether income shall be classified as "business" or "nonbusiness" income, see Reg. IV.1.

(3) Definitions. The following definitions are applicable to the terms contained in this regulation, unless the context clearly requires otherwise.

(i) "Film" or "film programming" means any and all performances, events or productions telecast on television, including but not limited to news, sporting events, plays, stories or other literary, commercial, educational or artistic works, through the use of video tape, disc or any other type of format or medium.

Each episode of a series of films produced for television shall constitute a separate "film" notwithstanding that the series relates to the same principal subject and is produced during one or more tax periods.

(ii) "Outer-jurisdictional" property means certain types of tangible personal property, such as orbiting satellites, undersea transmission cables and the like, that are owned or rented by the taxpayer and used in the business of telecasting or broadcasting, but which are not physically located in any particular state.

(iii) "Radio" or "radio programming" means any and all performances, events or productions broadcast on radio, including but not limited to news, sporting events, plays, stories or other literary, commercial, educational or artistic works, through the use of an audio tape, disc or any other format or medium.

Each episode of a series of radio programming produced for radio broadcast shall constitute a separate "radio programming" notwithstanding that the series relates to the same principal subject and is produced during one or more tax periods.

(iv) "Release" or "in release" means the placing of film or radio programming into service. A film or radio program is placed into service when it is first broadcast to the primary audience for which the program was created. Thus, for example, a film is placed in service when it is first publicly telecast for entertainment, educational, commercial, artistic or other purpose. Each episode of a television or radio series is placed in service when it is first broadcast. A program is not placed in service merely because it is completed and therefore in a condition or state of readiness and availability for broadcast or, merely because it is previewed to prospective sponsors or purchasers.

(v) "Rent" shall include license fees or other payments or consideration provided in exchange for the broadcast or other use of television or radio programming.

(vi) A "subscriber" to a cable television system is the individual residence or other outlet which is the ultimate recipient of the transmission.

(vii) "Telecast" or "broadcast" (sometimes used interchangeably with respect to television) means the transmission of television or radio programming, respectively, by an electronic or other signal conducted by radio waves or microwaves or by wires, lines, coaxial cables, wave guides, fiber optics, satellite transmissions directly or indirectly to viewers and listeners or by any other means of communications.

(4) Apportionment of Business Income.

(i) In General. The property factor shall be determined in accordance with Regulation IV.10 through 12., the payroll factor in accordance with Regulation IV.13. and 14., and the sales factor in accordance with Regulation IV.15. and 16., except as modified by this regulation.

(ii) The Property Factor.

A. In General

1. In the case of rented studios, the net annual rental rate shall include only the amount of the basic or flat rental charge by the studio for the use of a stage or other permanent equipment such as sound recording equipment and the like; except that additional equipment rented from other sources or from the studio not covered in the basic or flat rental charge and used for one week or longer (even though rented on a day-to-day basis) shall be included. Lump-sum net rental payments for a period which encompasses more than a single income year shall be assigned ratably over the rental period.

2. No value or cost attributable to any outerjurisdictional, film or radio programming property shall be included in the property factor at any time.

B. Property Factor Denominator.

1. All real property and tangible personal property (other than outer-jurisdictional and film or radio programming property), whether owned or rented, which is used in the business shall be included in the denominator of the property factor.

2. Audio or video cassettes, discs or similar medium containing film or radio programming and intended for sale or rental by the taxpayer for home viewing or listening shall be included in the property factor at their original cost. To the extent that the taxpayer licenses or otherwise permits others to manufacture or distribute such cassettes, discs or other medium containing film or radio programming for home viewing or listening, the value of said cassettes, discs or other medium shall include the license, royalty or other fees received by the taxpayer capitalized at a rate of eight times the gross receipts derived therefrom during the income year.

3. Outer-jurisdictional, film and radio programming property shall be excluded from the denominator of the property factor.

C. Property Factor Numerator.

1. With the exception of outer-jurisdictional, film and radio programming property, all real and tangible personal property owned or rented by the taxpayer and used in this state during the tax period shall be included in the numerator of the property factor as provided in Regulation IV.10.(d).

2. Outer-jurisdictional, film and radio programming property shall be excluded from the numerator of the property factor.

Example: XYZ Television Co. has a total value of all of its property everywhere of $500,000,000, including a satellite valued at $50,000,000 that was used to telecast programming into this state and $150,000,000 in film property of which $1,000,000's worth was located in this state the entire year. The total value of real and tangible personal property, other than film programming property, located in this state for the entire income year was valued at $2,000,000; and the movable and mobile property described in subparagraph C.1. was determined to be of a value of $4,000,000 and such movable and mobile property was used in this state for 100 days. The total value of property to be attributed to this state would be determined as follows:

Value of property permanently in state:	$2,000,000
Value of mobile and movable property: (100/365 or .2739 x $4,000,000):	$1,095,600
Total value of property to be included in the state's property factor numerator (outer-jurisdictional and film property excluded):	$3,095,600
Total value of property to be used in the denominator ($500,000,000-$200,000,000)	$300,000,000
Total property factor ($3,095,600/$300,000,000):	.0103

(iii) The Payroll Factor.

A. Payroll Factor Denominator.

The denominator of the payroll factor shall include all compensation, including residual and profit participation payments, paid to employees during the income year, including that paid to directors, actors, newscasters and other talent in their status as employees.

B. Payroll Factor Numerator.

Compensation for all employees shall be attributed to the state or states as may determined by the application of the provisions of Reg.IV.13. and 14.

(iv) The Sales Factor.

A. Sales Factor Denominator.

The denominator of the sales factor shall include the total gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business, except receipts excluded under Reg.IV.18.(c).

B. Sales Factor Numerator.

The numerator of the sales factor shall include all gross receipts of the taxpayer from sources within this state, including, but not limited to the following:

1. Gross receipts, including advertising revenue, from television film or radio programming in release to or by television and radio stations located in this state.

2. Gross receipts, including advertising revenue, from television film or radio programming in release to or by a television station (independent or unaffiliated) or network of stations for broadcast shall be attributed to this state in the ratio (hereafter "audience factor") that the audience for such station (or owned and affiliated stations in the case of networks) located in this state bears to the total audience for such station (or owned and affiliated stations in the case of networks).

The audience factor for television or radio programming shall be determined by the ratio that the taxpayer's in-state viewing (listening) audience bears to its total viewing (listening) audience. Such audience factor shall be determined either by reference to the books and records of the taxpayer or by reference to published rating statistics, provided the method used by the taxpayer is consistently used from year to year for such purpose and fairly represents the taxpayer's activity in the state.

3. Gross receipts from film programming in release to or by a cable television system shall be attributed to this state in the ratio (hereafter "audience factor") that the subscribers for such cable television system located in this state bears to the total subscribers of such cable television system. If the number of subscribers cannot be accurately determined from the books and records maintained by the taxpayer, such audience factor ratio shall be determined on the basis of the applicable year's subscription statistics located in published surveys, provided that the source selected is consistently used from year to year for that purpose.

4. Receipts from the sale, rental, licensing or other disposition of audio or video cassettes, discs, or similar medium intended for home viewing or listening shall be included in the sales factor as provided in Reg. IV. 16.

••• **Reg.IV.18.(j). Special Rules: Publishing** [Adopted July 30, 1993]

The following special rules are established with respect to the apportionment of income derived from the publishing, sale, licensing or other distribution of books, newspapers, magazines, periodicals, trade journals or other printed material.

(1) In General. Except as specifically modified by this regulation, when a person in the business of publishing, selling, licensing or distributing newspapers, magazines, periodicals, trade journals or other printed material has income from sources both within and without this state, the amount of business income from sources within this state from such business activity shall be determined pursuant to [Article IV. of the Multistate Tax Compact and the regulations adopted thereunder].

(2) Definitions. The following definitions are applicable to the terms contained in this regulation, unless the context clearly requires otherwise.

(i) "Outer-jurisdictional property" means certain types of tangible personal property, such as orbiting satellites, undersea transmission cables and the like, that are owned or rented by the taxpayer and used in the business of publishing, licensing, selling or otherwise distributing printed material, but which are not physically located in any particular state.

(ii) "Print or printed material" includes, without limitation, the physical embodiment or printed version of any thought or expression including, without limitation, a play, story, article, column or other literary, commercial, educational, artistic or other written or printed work. The determination of whether an item is or consists of print or printed material shall be made without regard to its content. Printed material may take the form of a book, newspaper, magazine, periodical, trade journal or any other form of printed matter and may be contained on any medium or property.

(iii) "Purchaser" and "Subscriber" mean the individual, residence, business or other outlet which is the ultimate or final recipient of the print or printed material . Neither of such terms shall mean or include a wholesaler or other distributor of print or printed material.

(iv) "Terrestrial facility" shall include any telephone line, cable, fiber optic, microwave, earth station, satellite dish, antennae or other relay system or device that is used to receive, transmit, relay or carry any data, voice, image or other information that is transmitted from or by any outer-jurisdictional property to the ultimate recipient thereof.

(3) Apportionment of Business Income.

(i) The Property Factor.

A. Property Factor Denominator.

1. All real and tangible personal property, including outer-jurisdictional property, whether owned or rented, which is used in the business shall be included in the denominator of the property factor.

B. Property Factor Numerator.

1. All real and tangible personal property owned or rented by the taxpayer and used in this state during the tax period shall be included in the numerator of the property factor.

2. Outer-jurisdictional property owned or rented by the taxpayer and used in this state during the tax period shall be included in the numerator of the property factor in the ratio which the value of such property that is attributable to its use by the taxpayer in business activities in this state bears to the total value of such property that is attributable to its use in the taxpayer's business activities everywhere.

The value of outer-jurisdictional property to be attributed to the numerator of the property factor of this state shall be determined by the ratio that the number of uplinks and downlinks (sometimes referred to as "half-circuits") that were used during the tax period to transmit from this state and to receive in this state any data, voice, image or other information bears to the total number of uplinks and downlinks or half-circuits that the taxpayer used for transmissions everywhere.

Should information regarding such uplink and downlink or half-circuit usage not be available or should such measurement of activity not be applicable to the type of outer-jurisdictional property used by the taxpayer, the value of such property to be attributed to the numerator of the property factor of this state shall be determined by the ratio that the amount of time (in terms of hours and minutes of use) or such other measurement of use of outer-jurisdictional property that was used during the tax period to transmit from this state and to receive in this state any data, voice, image or other information bears to the total amount of time or other measurement of use that was used for transmissions everywhere.

3. Outer-jurisdictional property shall be considered to have been used by the taxpayer in its business activities within this state when such property, wherever located, has been employed by the taxpayer in any manner in the publishing, sale, licensing or other distribution of books, newspapers, magazines or other printed material and any data, voice, image or other information is transmitted to or from this state either through an earth station or terrestrial facility located in this state.

Example: One example of the use of outer-jurisdictional property is where the taxpayer either owns its own communications satellite or leases the use of uplinks, downlinks or circuits or time on a communications satellite for the purpose of sending messages to its newspaper printing facilities or employees in a state. The state or states in which any printing facility that receives the satellite communications is located and the

state from which the communications were sent would, under this regulation, apportion the cost of the owned or rented satellite to their respective property factors based upon the ratio of the in-state use of said satellite to its total usage everywhere.

Assume that ABC Newspaper Co. owns a total of $400,000,000 of property everywhere and that, in addition, it owns and operates a communication satellite for the purpose of sending news articles to its printing plant in this state, as well as for communicating with its printing plants and facilities or news bureaus, employees and agents located in other states and throughout the world. Also assume that the total value of its real and tangible personal property that was permanently located in this state for the entire income year was valued at $3,000,000. Assume also that the total original cost of the satellite is $100,000,000 for the tax period and that of the 10,000 uplinks and downlinks of satellite transmissions used by the taxpayer during the tax period, 200 or 2% are attributable to its satellite communications received in and sent from this state. Assume further that the company's mobile property that was used partially within this state, consisting of 40 delivery trucks, were determined to have an original cost of $4,000,000 and such mobile property was used in this state for 95 days.

The total value of property to be attributed to this state would be determined as follows:

Value of property permanently in state:	$3,000,000
Value of mobile property: 95/365 or (.260274) x $4,000,000:	$1,041,096
Value of leased satellite property used in-state: (.02) x $100,000,000:	$2,000,000
Total value of property attributable to state:	$6,041,096
Total property factor %: $6,041,096/($500,000,000):	1.2082%

(ii) The Payroll Factor.

The payroll factor shall be determined in accordance with Article IV.14. of the Multistate Tax Compact and the regulations promulgated thereunder.

(iii) The Sales Factor.

A. Sales Factor Denominator.

The denominator of the sales factor shall include the total gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business, except

receipts that may be excluded under Reg.IV.15 through 18.

B. Sales Factor Numerator.

The numerator of the sales factor shall include all gross receipts of the taxpayer from sources within this state, including, but not limited to, the following:

1. Gross receipts derived from the sale of tangible personal property, including printed materials, delivered or shipped to a purchaser or a subscriber in this state.

2. Except as provided in subparagraph (3)(iii)B.3., gross receipts derived from advertising and the sale, rental or other use of the taxpayer's customer lists or any portion thereof shall be attributed to this state as determined by the taxpayer's "circulation factor" during the tax period. The circulation factor shall be determined for each individual publication by the taxpayer of printed material containing advertising and shall be equal to the ratio that the taxpayer's in-state circulation to purchasers and subscribers of its printed material bears to its total circulation to purchasers and subscribers everywhere.

The circulation factor for an individual publication shall be determined by reference to the rating statistics as reflected in such sources as Audit Bureau of Circulations or other comparable sources, provided that the source selected is consistently used from year to year for such purpose. If none of the foregoing sources are available, or, if available, none is in form or content sufficient for such purposes, then the circulation factor shall be determined from the taxpayer's books and records.

3. When specific items of advertisements can be shown, upon clear and convincing evidence, to have been distributed solely to a limited regional or local geographic area in which this state is located, the taxpayer may petition, or the [Tax Administrator] may require, that a portion of such receipts be attributed to the sales factor numerator of this state on the basis of a regional or local geographic area circulation factor and not upon the basis of the circulation factor provided by subparagraph (3)(iii)B.2. Such attribution shall be based upon the ratio that the taxpayer's circulation to purchasers and subscribers located in this state of the printed material containing such specific items of advertising bears to its total circulation of such printed material to purchasers and subscribers located within such regional or local geographic area. This alternative attribution method shall be permitted only upon the condition that such receipts are not double counted or otherwise included in the numerator of any other state.

4. In the event that the purchaser or subscriber is the United States Government or that the taxpayer is not taxable in a State, the gross receipts from all sources, including the receipts from the sale of printed material, from advertising, and from the sale, rental or other use of the taxpayer's customer's lists, or any portion thereof that would have been attributed by the circulation factor to the numerator of the sales factor for such State, shall be included in the numerator of the sales factor of this State if the printed material or other property is shipped from an office, store, warehouse, factory, or other place of storage or business in this State.

APPENDIX L

LIST OF STATES ADOPTING THE MTC REGULATIONS IN WHOLE OR IN PART

Multistate Tax Commission

ADOPTION OF MTC MODEL STATUTES/REGULATIONS/GUIDELINES

On November 8, 2000, MTC staff electronically mailed a questionnaire to all tax administrators inquiring whether their state, had either formally or informally, adopted any of the Multistate Tax Commission's model statutes/regulations/guidelines. Twenty-six states responded to that initial survey. On July 10, 2002, staff electronically mailed a similar questionnaire to all tax administrators (see attachment). A total of thirty-six states responded to one or both of the surveys. I am pleased to report that a majority of the Compact Member states, and all Project Member states responded. A summary of those responses is attached. Individual state responses are also available.

The following is a list of States that have adopted all or some of the uniformity recommendations adopted by the Multistate Tax Commission. The list was compiled from state responses to the 2002 survey and other sources.

INCOME & APPORTIONMENT

General Allocation & Apportionment: (25)AL, AK, AZ, AR, CA-FTB, CO, DC, FL, GA, HI, ID, IN, KS, KY, MO, MT, NE, NM, NC, ND, OK, OR, PA, UT, WI

Construction Contractors: (10) AK, AL, CA-FTB, CO, ID, KY, MO, MT, NM, ND, OR, UT

Airlines: (11) AK, AL, CO, ID, KS, MO, MT, NE, NM, ND, OR

Railroads: (12) AK, AR, CA-FTB, CO, ID, KY, MN, MO, MT, NM, ND, OR, UT

Trucking: (12) AL, AK, CA-FTB, CO, ID, MO, MT, NE, NM, ND, OR, UT

Television & Radio Broadcasting: (8) AL, AZ, CA-FTB, CO, HI, ID, MO, NH, ND

Publishing: (4) AL, CA-FTB, ID, ND

APPENDIX M

DEPARTMENT OF REVENUE'S RECOMMENDED CHANGES TO NORTH CAROLINA'S APPORTIONMENT LAWS

Subject: Recommended Changes to North Carolina's Apportionment Laws
Tax: Corporate Income and Franchise Tax
Law: G.S. 105-130.4 and 105-122

I. Special Apportionment Rules for Certain Industries

G.S. 105-130.4 requires a corporation with business income from both North Carolina and other states to apportion its net income or loss to North Carolina in determining its North Carolina income tax liability. The corporation also uses the same apportionment formula to apportion its capital stock, surplus and undivided profits for franchise tax purposes under G.S. 105-122. The apportionment formula applicable to most corporations is described in G.S. 105-130.4(i). Generally, a corporation adds its property factor, its payroll factor, and its sales factor twice and divides by four. The property factor, payroll factor, and sales factor are defined in subsections (j), (k), and (l), respectively.

Special apportionment rules for certain industries are provided in subsections (m) through (s). The table below identifies those industries that have special apportionment rules and the statutory references for those special rules.

Industry	Statutory Reference
Railroad Company	G.S. 105-130.4(m)
Telephone Company	G.S. 105-130.4(n)
Motor Carrier of Property	G.S. 105-130.4(o)
Motor Carrier of Passengers	G.S. 105-130.4(p)
Building or Construction Contractor	G.S. 105-130.4(r)
Securities Dealer	G.S. 105-130.4(r)
Loan Company	G.S. 105-130.4(r)
Public Utility	G.S. 105-130.4(r)
Corporation With More than 50% of Ordinary Gross Income from Intangible Property	G.S. 105-130.4(r)
Air or Water Transportation Company	G.S. 105-130.4(s)

The Department of Revenue recommends that special apportionment rules be adopted for two more industries – publishing and broadcasting. The Multistate Tax Commission (MTC) adopted a model apportionment regulation for publishing on July 30, 1993. The regulation modifies the standard sales factor by sourcing gross receipts derived from advertising and the sale, rental, or other use of the taxpayer's customer lists by the taxpayer's "circulation factor." The MTC adopted a model apportionment regulation for broadcasting on August 31, 1990 and amended the regulation on April 25, 1996. The regulation modifies the standard sales factor by sourcing gross receipts, including advertising revenue, from television, film, or radio programming by the taxpayer's "audience factor." Our research indicates that several states have adopted one or both of the regulations or similar provisions. Most recently, Louisiana enacted legislation to provide special rules for broadcasting businesses during the 2002 legislative session. Copies of the model regulations and Act 65 enacted by Louisiana are enclosed.

The following examples describe how the circulation and audience factors would affect taxpayers:

Example 1. A national publishing company with nexus in North Carolina and several other states generates advertising revenue from one of its magazines. Ten percent of the magazine's subscribers are in North Carolina. All of the income producing activities with respect to the advertising is conducted outside of North Carolina. Under current law, none of the advertising revenue is included in the numerator of the North Carolina sales factor fraction. Under the circulation factor provision, ten percent of the advertising revenue would be included in the numerator of the North Carolina sales factor fraction.

Example 2. A national broadcasting company with nexus in North Carolina and several other states owns a television station in Charlotte and generates advertising revenue from Charlotte-area merchants. Twenty percent of the television station's audience is in South Carolina. All of the income producing activities with respect to the advertising is conducted in North Carolina. Under current law, all of the advertising revenue is included in the numerator of the North Carolina sales factor fraction. Under the audience factor provision, twenty percent of the advertising revenue would be excluded from the numerator of the North Carolina sales factor fraction.

II. "Throw-Out Rule" for Outerjurisdictional Property

In determining its property factor, a corporation includes in the numerator the average value of the corporation's real and tangible personal property owned or rented and used in this State during the year. The denominator includes the average value of the corporation's real and tangible personal property owned or

rented and used during the year. With the proliferation of taxpayers using orbiting satellites and undersea transmission cables, there is a significant amount of property that is not properly attributable to any state. The Department of Revenue recommends that North Carolina's property factor law be amended to add a "throw-out" provision for property that is not physically located in, and thus attributable to, any state. To accomplish this change, G.S. 105-130.4(j)(1) could be amended to read as follows:

"The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned or rented and used in this State during the income year and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used during the income year. Where tangible personal property owned or rented by the corporation is not physically located in any state, such as orbiting satellites, undersea transmission cables and the like, the property shall be excluded from the numerator and the denominator of the property factor."

Please note that this change does not cause property located in a foreign country to be thrown out. The definition of "state" in G.S. 105-130.4(a)(9) includes any foreign country or political subdivision thereof. Also note that the throw-out of outerjurisdictional property is specifically provided for within the MTC's special apportionment rules for publishing and broadcasting discussed above.

The following example describes how the throw-out rule would affect taxpayers:

Example: A cellular phone service provider has nexus in North Carolina and several other states. The company owns an orbiting satellite with a value of $2 million. It has property in North Carolina worth $2 million and property in other states worth $6 million. Under current law, the taxpayer's North Carolina property factor would be twenty percent ($2 million of North Carolina property divided by $10 million of everywhere property). Under the throw-out provision, North Carolina's property factor would be twenty-five percent ($2 million of North Carolina property divided by $8 million of property physically located in any state).

Enclosures

APPENDIX N

Revenue Changes under Special Apportionment Rules for Publishing and Broadcasting Firms, prepared by the Tax Research Division of the Department of Revenue

Revenue Changes Under Special Apportionment Rules For Publishing and Broadcasting Firms

	Number of Firms	Tax Paid 2001	Projected Change
No Net Income	193	$0	$0
By Apportionment Factor			
< 10%	31	$4,654,299	$5,600,000
10% - 99%	20	$2,776,458	-$1,400,000
100%	65	$1,053,389	-$200,000
Total	309	$8,484,146	$4,000,000

Projected Change for <10% apportionment assumes that all firms in this category will increase their factors by one percentage point.

Projected Change for 10%-99.9% apportionment assumes that all firms in this category will cut their approtionment factor in half.

Projected Change for 100% apportionment assumes that all broadcasting firms in this category will cut their approtionment factor in half, but that publishers will stay at 100%.