REVENUE LAWS STUDY COMMITTEE

REPORT TO THE 2005
GENERAL ASSEMBLY OF NORTH CAROLINA
2005 SESSION

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

Senator John H. Kerr, III, Cochair

Representative Paul Luebke, Cochair
Representative David Miner, Cochair

January 25, 2005

TO THE MEMBERS OF THE 2005 GENERAL ASSEMBLY:

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

Respectfully Submitted,

Paul Luebke

Rep. Paul Luebke, Co-Chair

John H. Kerr

Sen. John Kerr, Co-Chair

Miner

Rep. David Miner, Co-Chair

2003-2004

REVENUE LAWS STUDY COMMITTEE

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PREFACE

The Revenue Laws Study Committee is established in Article 12L of Chapter 120 of the General Statutes to serve as a permanent legislative commission to review issues relating to taxation and finance. The Committee consists of sixteen members, eight appointed by the President Pro Tempore of the Senate and eight appointed by the Speaker of the House of Representatives. Committee members may be legislators or citizens. The co-chairs for 2003-2004 are Senator John Kerr and Representatives Paul Luebke and David Miner.

G.S. 120-70.106 gives the Revenue Laws 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 eight members, four appointed by the Senate chair of the Revenue Laws Study Committee and four 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

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

chairs to the Revenue Laws Study Committee appointed the following eight members to the Property Tax Subcommittee: Co-Chairmen Senator Dan Clodfelter and Representative Harold "Bru" Brubaker; Senators Walter Dalton and Fletcher Hartsell; Representative Gordon Allen, Dewey Hill, and Bill McGee; and public member Leonard Jones.

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 twice after the 2004 Regular Session of the 2003 General Assembly adjourned on July 18, 2004. 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 2004 GENERAL ASSEMBLY

The 2004 General Assembly enacted seven of the Revenue Laws Study Committee's eight legislative proposals in whole or in part. Appendix B lists the Committee's recommendations and the action taken on them in 2004. A document entitled "**2004 Finance Law Changes**" summarizes all of the tax legislation enacted in 2004. It is available in the Legislative Library located in the Legislative Office Building.

BUDGET AND REVENUE OUTLOOK

At its first meeting on December 21, 2004, the Revenue Laws Study Committee was briefed by David Crotts, Linda Millsaps, and Lynn Muchmore from the Fiscal Research Division on the current budget situation and the revenue outlook for the upcoming year.

The Committee was informed that although the national economy continues to recover and revenues are coming in ahead of schedule, the General Assembly will be facing a budget shortfall of approximately $1.3 billion in fiscal year 2005-2006. The gap is due to a combination of the carryover of a structural budget shortfall for 2004-2005 (the use of one-time resources to pay for recurring expenditures), a sub par economic recovery, and no relief from the high growth of health care costs. The presentation on the State Budget Outlook may be found in Appendix C.

The Committee was also briefed on three issues facing the General Assembly that will play a significant role in influencing the revenue outlook. The first issue is the expiration of three temporary tax increases: (1) the ½-cent State sales tax expires July 1, 2005 resulting in a decrease from 4.5% to 4%; (2) the 8.25% income tax rate on high income expires January 1, 2006; and (3) federal tax action taken in 2001 has the effect of eliminating the North Carolina estate tax base as of July 1, 2005. The General Assembly will have to decide whether to extend any or all of these taxes, allow them to expire, or make some other modification. Second, the decision whether to conform to the federal Internal Revenue Code will present another budgetary challenge. Generally, the General Assembly enacts legislation every year to update its reference to the Code to track federal changes. This year, conforming to the changes made by the Working Family Relief Act of 2004 and the American Jobs Creation Act of 2004 could result in a loss to the General Fund of over $39 million in FY 05-06. Finally, the General Assembly will need to amend its sales and use tax statutes in order to conform to the Streamlined Sales Tax Agreement. Conformity will require that North Carolina eliminate its multiple sales tax rates. Items that are currently taxed at a preferential rate will either need to be taxed at the general rate or exempted entirely. The presentation on the State's revenue outlook is attached as Appendix D.

INCOME TAX

The Revenue Laws Study Committee spent considerable time reviewing one income tax issue. 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. Legislative Proposal #1, *IRC Update*, changes the statutory reference to the Code from May 1, 2004, to January 1, 2005 and makes other conforming changes. Congress enacted two bills between May 1, 2004, and January 1, 2005, that would affect State tax provisions. The Working Families Tax Relief Act of 2004, P.L. 108-311, enacted on October 4, 2004, makes numerous changes to personal income tax provisions affecting families as well as individual taxpayers and businesses. The American Jobs Creation Act of 2004, P.L. 108-357, enacted on October 22, 2004, made extensive income changes for businesses and individuals. In addition, in its first act of the new session, Congress allowed for accelerated tax benefits for cash contributions made in January 2005 for tsunami relief efforts.

SALES AND USE TAX

The Revenue Laws Study Committee has spent a considerable amount of time over the past five to six years on the Streamlined Sales Tax Project. The Streamlined Sales Tax Project is an effort by states, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and

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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."

administration. The Project began in March 2000 and has the goal of achieving sufficient simplification and uniformity to encourage sellers without nexus in states to voluntarily collect use tax in participating states.

In November 2002, the implementing states approved the Streamlined Sales and Use Tax Agreement. The Agreement contains the uniformity and simplification provisions developed by the Project. The Agreement becomes effective when at least 10 states representing 20% of the population of all states with a sales tax are in compliance with the provisions of the Agreement. The Revenue Laws Study Committee has recommended, and the General Assembly has enacted, changes to North Carolina's sales tax laws to bring it into compliance with the Agreement. As of January 1, 2005, 12 states representing 19.4% of the sales tax states' population are believed to be in compliance. It is anticipated that 15 states representing 24.1% of the applicable population will be in compliance by July 1, 2005, and that 19 states representing 26.3% of the population will be in compliance by January 1, 2006.

Legislative Proposal #2, *Streamlined Sales Tax Changes*, contains a few technical and administrative changes necessary to bring North Carolina into compliance with the Agreement, as amended in November 2003 and November 2004. Other, more substantive changes will need to be made this session for North Carolina to remain in compliance with the Agreement after January 1, 2006. These changes include the preferential rate of tax on certain agricultural items and the rates of tax on telecommunications services, direct-to-home satellite service, and spirituous liquor. Appendices E and F contain a more detailed history of the Project and its status.

MOTOR FUELS TAX

Last year the Revenue Laws Study Committee recommended several changes to the motor fuels tax laws. The General Assembly enacted one of the changes contained in that recommendation, the authorization for law enforcement positions, in the final hours of the 2004 session. Legislative Proposal #3, *Motor Fuel Tax Changes,* contains several of the provisions recommended last year and a few new ones.

ESTATE TAX

At its second meeting on January 25, 2005, the Committee was provided an overview of the estate tax issue that will be facing the General Assembly in the upcoming year.

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.

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.[3] Second, Congress repealed the estate tax effective in 2010.[4] Third,

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[3] 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.

Congress phased out the federal credit for state death taxes over four years.[5] The effect of this reduction and elimination of the state death taxes credit, if conformed to, would be to eliminate the North Carolina estate tax as of January 1, 2005.

In 2002 and 2003, the General Assembly evaluated the changes contained in the federal legislation and responded by partially conforming to the federal changes. North Carolina conformed to the increased exclusion amounts and to the 2010 repeal of the estate tax. Thus, as under previous law, an estate that is not subject to the federal estate tax is not subject to the state estate tax. However, North Carolina did not conform to the phase-out of the state death taxes credit. Based on the 2002 legislation, as amended in 2003, for decedents dying before July 1, 2005, the amount of the North Carolina estate tax is to be computed based on the state death taxes credit without regard to the phase-out and elimination of that credit. Without further legislative action, North Carolina will conform to the elimination of the state death taxes credit as of July 1, 2005, and the North Carolina estate tax will, for practical purposes, cease to exist for decedents dying on or after that date.

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.[6] Since 2001, a number of states have taken legislative action (or declined to take action) to offset the effects of the phase-out. Eleven states, including North Carolina,

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

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

[6] 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.

took affirmative steps to decouple from the phase-out of the federal credit.[7] An additional six states and the District of Columbia decided not to update their reference to the Code for purposes of the federal credit. At least one state has created a stand-along estate tax and at least one state has affirmatively acted to repeal its estate tax.

The Revenue Laws Study Committee acknowledges that the 2005 General Assembly will need to address this issue and notes that North Carolina has essentially four options in regard 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 on July 1, 2005. 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 on July 1, 2005. This option could lead to lower state revenue as early as the 2005-2006 fiscal year.

[7] 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 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 repeal the estate tax. This option could lead to lower state revenues immediately.

The handout on this issue, which was distributed at the second meeting, is attached as Appendix G.

PROPERTY TAX

The Revenue Laws Study Committee reviewed two proposals recommended by the Department of Revenue relating to property tax. Legislative Proposal #4, *Present-Use Value Clarification*, makes clarifying changes to the statutes governing the present-use value taxation of farmland (agricultural land, horticultural land, and forestland). Legislative Proposal #5, *Increase Disabled Vet Property Tax Exclusion*, increases the property tax exclusion for the residence of a disabled veteran receiving federal benefits for a service-connected disability.

A. Present-Use Value Classification

This proposal has been endorsed by the North Carolina Farm Bureau and sets out several changes to help the counties and the Department's Property Tax Division administer the present-use value program. The Proposal clarifies the statutes relating to present-use value tax eligibility and sets out a specific time period for a taxpayer to appeal the tax appraiser's classification and appraisal of the taxpayer's property. In 2002, the Revenue Laws Study Committee proposed numerous amendments to the present-use value statutes including an updated method for calculating the value of farmland at its present-use value, clarification of the sound management requirement for qualifying for use value taxation, and allowing land subject to a conservation easement to continue to qualify for use value taxation. Most of these changes were ratified in S.L. 2002-184. The Department recommends the following clarifying changes to the present-use value statutes.

Under current law, farmland must be part of a unit engaged in commercial production to qualify for present-use value tax status. In 2002, the General Assembly adopted the Revenue Laws Study Committee's proposed definition of a unit. The definition requires that when a unit is composed of multiple tracts located within different counties, the tracts must be within 50 miles of a tract that qualifies as farmland and either share the same classification or use the same equipment and labor force. The proposal deletes the characteristic that the multiple tracts may use the same equipment or labor; thus requiring the multiple tracts to be of the same type classification and within 50 miles of a tract that qualifies as farmland.

The proposal also codifies a procedure that the counties are currently following. Under current law, an individual owner must live on the farmland or have owned the farmland for four years in order for the land to qualify for present-use value classification. An exception to this ownership requirement is allowed if the farmland is transferred to a person who continues to use the land as farmland and the new owner certifies that he or she will be liable for the deferred taxes owing on the land if the land is later disqualified. Counties also allow an exception to the ownership requirement in situations where no deferred taxes are due. This occurs when farmland, that is not appraised and taxed at present-use value, passes to a new owner who already owns farmland meeting the same classification as the newly transferred farmland. The new owner must file an application for present-use value eligibility, but there are no deferred taxes to assume.

The proposal next adds language setting a 60-day time limit for a taxpayer (1) to appeal the assessor's decision regarding the qualification or appraisal of the taxpayer's property as present-use value property or (2) to provide the assessor with additional information after the taxpayer's property has been disqualified for present-use value classification. Current law provides no time limit in the above situations.

B. Increase Disabled Vet Property Tax Exclusion

This proposal increases the property tax exclusion for specially adapted housing used as a residence by a disabled veteran who receives federal grant money for a service-connected disability. In response to an increase in the federal grant amount in 1989, the General Assembly increased the exclusion to the first $38,000 of the assessed value of the house and land. The proposal increases the exclusion to $48,000 because of another increase in the federal grant amount.

CASE LAW UPDATE

The Revenue Laws Study Committee continues to monitor several ongoing court cases involving tax matters that have the potential to affect the State's budget and revenue outlook. At its first meeting, the Committee heard an update on the *A&F Trademark, Inc. v. Tolson* case, often referred to as the Limited case. On December 7, 2004, the North Carolina Court of Appeals upheld the State's position on the taxation of royalty income received by an out-of-state investment company for the use of trademarks in this State. The Court ruled that the out-of-state taxpayers, who hold the trademarks used in North Carolina, were doing business in North Carolina and that the assessment of corporate income and franchise taxes against the taxpayers was not a constitutional violation. A more detailed summary of that case was distributed to the Committee members and is attached as Appendix H.

At its second meeting, the Committee heard an overview of the _Cuno v. DaimlerChrysler_ case and was briefed on recent developments. In Cuno, the Sixth Circuit Court of Appeals held that Ohio's investment tax credit violated the Commerce Clause of the United States Constitution, but simultaneously found that a personal property tax exemption did not violate the Commerce Clause. Shortly after the decision was announced, the State of Ohio petitioned the Sixth Circuit Court of Appeals for a rehearing en banc. On January 18, 2005, the Court denied that request. While this case is not binding on North Carolina, the case is worth monitoring since North Carolina has made extensive use of a variety of economic development incentive programs. A more detailed summary of this case and its application to North Carolina is attached as Appendix I.

COMMITTEE RECOMMENDATIONS AND LEGISLATIVE PROPOSALS

The Revenue Laws Study Committee makes the following six recommendations to the 2005 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. Streamlined Sales Tax Changes
3. Motor Fuels Tax Changes
4. Present Use Value Clarification
5. Increase Disabled Vet Property Tax Exclusion
6. Revenue Laws Technical Changes

LEGISLATIVE PROPOSAL #1

IRC UPDATE

LEGISLATIVE PROPOSAL #1:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2005 GENERAL ASSEMBLY

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: Kerr; Dalton, Hartsell, Hoyle, Webster

BRIEF OVERVIEW: This bill would update to January 1, 2005, the reference to the Internal Revenue Code used in defining and determining certain State tax provisions. This bill would be effective when it becomes law.

FISCAL IMPACT: This bill would result in a loss to the General Fund of approximately $39 million in FY 05-06 and over $56 million in FY 06-07.

EFFECTIVE DATE: This bill would become effective when it becomes law, except for the provision allowing a deduction for state and local taxes in lieu of a deduction for State income taxes, which would become effective for taxable years beginning on or after January 1, 2005.

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

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U **D**

BILL DRAFT 2005-LYxz-13A [v.2] (12/2)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
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Short Title:	IRC Update.	(Public)
Sponsors:	Senators Kerr; Dalton, Hartsell, Hoyle, and Webster.	
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, 2004,~~January 1, 2005, including any provisions enacted as of that date which become effective either before or after that ~~date.~~date, but not including the amendments made to Section 164 of the Code by Section 501 of P.L. 108-357."

SECTION 2. G.S. 105-130.5(a) reads as rewritten:

"(a) The following additions to federal taxable income shall be made in determining State net income:

…

(16) The amount excluded from gross income under Subchapter R of Chapter 1 of the Code."

SECTION 3. Notwithstanding Section 1 of this act, any amendments to the Internal Revenue Code enacted after May 1, 2004, that increase North Carolina taxable income for the 2004 taxable year become effective for taxable years beginning on or after January 1, 2005.

SECTION 4. G.S. 105-228.90(b), as amended by Section 1 of this act, reads as rewritten:

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

...

(1b) Code. – The Internal Revenue Code as enacted as of January 1, 2005, including any provisions enacted as of that date which become effective either before or after that ~~date, but not including the amendments made to Section 164 of the Code by Section 501 of P.L. 108-357.~~date."

SECTION 5. G.S. 105-134.6(c) reads as rewritten:

(c) Additions. – The following additions to taxable income shall be made in calculating North Carolina taxable income, to the extent each item is not included in taxable income:

...

(3) Any amount deducted from gross income under section 164 of the Code as state, local, or foreign income tax or as state or local general sales tax to the extent that the taxpayer's total itemized deductions deducted under the Code for the taxable year exceed the standard deduction allowable to the taxpayer under the Code reduced by the amount the taxpayer is required to add to taxable income under subdivision (4) of this subsection.

..."

SECTION 6. Notwithstanding any other provision of law, a taxpayer whose federal taxable income for 2004 is reduced due to a charitable contribution of cash made in January 2005 for Indian Ocean tsunami relief efforts in accordance with P.L. 109-1 is not required to add back the amount of the deduction related to that contribution in determining North Carolina taxable income for 2004.

SECTION 7. Sections 4 and 5 of this act become effective for taxable years beginning on or after January 1, 2005. The remainder of this act is effective when it becomes law.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL #1: IRC UPDATE

BY: Y. CANAAN HUIE, BILL DRAFTING DIVISION

SUMMARY: This bill updates the reference to the Internal Revenue Code used in determining and defining certain State tax provisions. The bill would become effective when it becomes law.

CURRENT LAW: 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 tracks federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. Under current law, the reference date to the Code is May 1, 2004.

BILL ANALYSIS:

This bill would change the reference date to January 1, 2005. Changing the reference date to January 1, 2005, would incorporate federal changes made in the Working Families Tax Relief Act of 2004 (P.L. 108-311) and the American Jobs Creation Act of 2004 (P.L. 108-357). In addition, in early 2005 Congress enacted an act to enhance the tax benefit for certain charitable contributions made in January 2005 for tsunami relief (P.L. 109-1). That act did not amend the Code, but rather used uncodified language to bring about that result. This bill would conform to that legislation as well.

Working Families Tax Relief Act (WFTRA) of 2004 (P.L. 108-311).
The Working Families Tax Relief Act of 2004 was signed into law by President Bush on October 4, 2004. Despite its title, the act provides tax benefits for businesses as

[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."

well as individuals and families. The following features of the act are important for State tax purposes:

- *Creation of a more uniform definition of "child" throughout the Code starting with the 2005 taxable year.* At the federal level, the definition of "child" is important in five areas: the dependency exemption, the child credit, the earned income credit, the dependent care credit, and head of household filing status. WFTRA creates a uniform definition of "child" that applies to each of these areas. Under the new definition, a child is a qualifying child if the child satisfies three separate conditions. First, the child must have the same principal place of abode as the taxpayer for more than one half the tax year (residency test). Temporary absences due to special circumstances are not included. Second, the child must be the child, stepchild, sibling, stepsibling, or a descendant of any of these relations of the taxpayer (relationship test). Third, the child must satisfy an age condition to be deemed a qualifying child. In general, a child must be under age 19, or under age 24 if a full-time student, to be a qualifying child. However, lower age limits were retained for the dependent care credit (under 13 years of age unless disabled) and the child tax credit (under 17 years of age). For State tax purposes, the changes are important in so far as they relate to the dependency exemption, the child tax credit, and head of household filing status. The new definition of qualifying child for the dependency exemption may result in a change of status of some children – where the new law has a residency test, the old law had a support test (the one claiming the child had to provide at least 50% of the child's support). For the federal child tax credit, some taxpayers may become eligible to claim the credit due to the elimination of some restrictions related to foster children. This is important because eligibility for the State child tax credit is dependent on the taxpayer's eligibility for the federal credit. In general, the uniform definition should not affect head of household filing status.
- *Extension of the above-the-line deduction for educators.* Under previous law, an eligible educator was allowed an above-the-line deduction of up to $250 for amounts paid by the teacher for books or supplies used in the classroom. This provision was set to expire with the 2003 taxable year. WFTRA extended this provision for the 2004 and 2005 taxable years.
- *Extension of elective expensing of qualified environmental remediation expenditures.* Under previous law, a taxpayer could elect to treat qualified environmental remediation expenditures that would normally be charged to a capital account and depreciated over time as deductible in the current year. To be deductible currently, the expenditure must be paid or incurred with the abatement or control of hazardous substances at a qualified contaminated

site. This provision would have expired with the 2003 tax year. WFTRA extended this provision for the 2004 and 2005 taxable years.

- *Extension of enhanced deduction for qualified computer contributions.* Under previous law, corporations were allowed an enhanced charitable contribution deduction for contributions of computer technology or equipment to schools or public libraries that would use the computer equipment for educational purposes. This provision would have expired with the 2003 tax year. WFTRA extended this provision for the 2004 and 2005 taxable years.
- *Elimination of the phase down of the deduction for qualified clean fuel property.* Under previous law, a taxpayer was allowed a specified deduction for clean fuel vehicles or refueling property placed into service before January 1, 2007. The amount of that deduction was to be reduced by 25% in 2004, 50% in 2005, and 75% in 2006, and was to be completely phased out in 2007. WFTRA eliminated the phase down in the 2004 and 2005 taxable years. Without further action, the phase down will resume at 75% in 2006.
- *Extension of Archer Medical Savings Accounts (MSAs).* Archer MSAs were designed to give small employers, their employees, and self-employed individuals a way of creating tax-deferred savings to offset qualifying medical expenses. The program was designed to be limited in scope: no new Archer MSAs could be set up after a certain threshold had been met or after the end of 2003. WFTRA extends the period in which new Archer MSAs may be created until the end of 2005.

American Jobs Creation Act (AJCA) of 2004 (P.L. 108-357).
The American Jobs Creation Act of 2004 was signed into law by President Bush on October 22, 2004. The bill makes many substantial changes in many different areas of tax law. The more significant changes for State tax purposes are listed below.

- *Repeal of the exclusion for extraterritorial income (ETI)/deduction for qualified domestic production income.* Under previous law, U.S. exporters were eligible for an exclusion from gross income for qualifying extraterritorial income. In 2000, the World Trade Organization declared this exclusion an illegal trade subsidy. Congress did not take action regarding this finding until the European Union began placing sanctions on U.S. exports. At the time Congress acted those sanctions were at 12% and were rising by one percentage point per month. This exclusion will be phased out over several years. The ETI exclusion will be reduced by 20% in 2005 and by 40% in 2006. The ETI exclusion will be eliminated altogether beginning in 2007. Based on Congress's enactment of this law, the EU has indicated it will drop sanctions on U.S. imports beginning January 1, 2005.

In part to replace the ETI exclusion, Congress created a new deduction for domestic production activities. "Domestic production activities" is defined fairly broadly and includes a) the sale, lease, or license of property manufactured or produced by the taxpayer in significant part in the United States, b) the sale, lease, or license of United States produced motion pictures and video tapes, c) the sale of electricity, natural gas, or potable water within the United States, d) construction activities performed in the United States, e) engineering or architectural services performed in the United States for construction projects occurring in the United States. For taxable years beginning in 2009, the amount of the deduction is equal to nine percent (9%) of the lesser of the domestic production activities income of the taxpayer or taxable income without regard to the deduction. This deduction will be phased in over several years beginning in 2005. For the 2005 and 2006 taxable years the deduction will be limited to three percent (3%): this amount will grow to six percent (6%) for the 2007 and 2008 taxable years.

- *Extension of 179 expensing limit increase/revisions regarding SUVs.* Section 179 of the Code allows a taxpayer to treat the cost of certain property as an expense which is not chargeable to a capital account. This allows the taxpayer to take a deduction for the property in the year in which it is placed into service rather than depreciating the property over a number of years. In 2003, Congress increased the amount that could be expensed under Section 179 of the Code from twenty-five thousand dollars ($25,000) to one hundred thousand dollars ($100,000).3 The federal change was originally set to expire after the 2005 taxable year. The AJCA extends this provision through the 2007 taxable year.

  One frequent complaint about the federal provision was that it allowed expensing of costs associated with the purchase of a sports utility vehicle by a small business. General rules relating to the depreciation of motor vehicles did not apply to many large SUVs because those rules applied only to vehicles weighing 6,000 pounds or less. The effect of this provision was to allow an immediate write-off for the purchase price of a large SUV, but to require more gradual depreciation for the purchase of most other passenger vehicles. Taxpayers thus had a greater incentive to purchase a large SUV. The AJCA limits the amount of that may be expensed under Section 179 with respect to a vehicle weighing less than 14,000 pounds to twenty-five

[3] The General Assembly conformed to this federal change as part of the 2003 Budget Act (S.L. 2003-284).

thousand dollars ($25,000)4. The federal legislation made this change effective when it become law, October 22, 2004.

- *Establishment of 15-year straight line cost recovery for qualified leasehold improvements and qualified restaurant property.* The AJCA provides for 15-year straight-line depreciation for qualified leasehold improvements to nonresidential real property placed into service after the date of enactment (October 22, 2004) and prior to January 1, 2006. A qualified leasehold improvement is an improvement made to the interior of a building by either the lessor or lessee and placed in service more than three years after the building is placed in service. Under prior law, a qualified leasehold improvement was depreciated using straight-line depreciation over a 39-year period - the same period as for depreciation of nonresidential property in general.

  A similar depreciation schedule is put into place for qualified restaurant property placed into service after the date of enactment (October 22, 2004) and prior to January 1, 2006. In order to qualify as "qualified restaurant property", the property must be a building improvement placed in service more than three years after the building is placed in service and the restaurant must use more than half of the square footage of the building.

  If the leasehold improvement or restaurant property contains tangible personal property that may be segregated from the cost of other improvements and that tangible personal property has a shorter depreciation period, then the taxpayer may depreciate that property separately using the shorter period.

- *Modification of deduction for charitable contribution of used motor vehicles.* The AJCA limits the amount of the deduction for contributions of motor vehicles to charity. Vehicle donation programs have become popular in recent years. Generally, the taxpayer who has donated the motor vehicle has claimed a deduction for the full "blue book" value of the vehicle. The new law will limit the amount of the deduction based on how the donee organization uses the vehicle. If the charitable organization sells the vehicle without using it in any significant way, the amount of the deduction cannot exceed the gross proceeds of the sale. If the charity retains the vehicle for its own use, the taxpayer must receive an acknowledgment from the charity as to the value of the vehicle. The deduction may not exceed the acknowledged value of the

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[4] There are some exceptions to this rule for certain vehicles. These exceptions were put in place to ensure that the legislation would apply only to SUV and not other types of heavy motor vehicles (such as delivery trucks) that have a weight greater than 6,000 pounds but less than 14,000 pounds.

vehicle to the charity. These changes become effective with the 2005 taxable year.

- *Establishment of an above-the-line deduction for certain attorney fees and court costs.* The AJCA allows an individual taxpayer an above-the-line deduction (i.e. from gross income) for attorney fees and court costs associated with certain civil rights actions, claims against the government, and Medicare fraud claims. Under previous law, these costs were deductible only as an itemized deduction, meaning that they were deductible only if the taxpayer itemized deductions and only to the extent aggregate itemized deductions exceeded 2% of the taxpayer's adjusted gross income. This provision became effective when the legislation became law, October 22, 2004.

- *Modification of deduction for automobile expenses of United States Postal Service employees.* The AJCA allows United States Postal Service employees who deliver and collect mail on rural routes and receive qualified reimbursements of automobile expenses involving these duties to deduct their actual automobile expenses that exceed the reimbursement amount. This is an itemized deduction and therefore may be claimed only to the extent aggregate deductions exceed 2% of the taxpayer's adjusted gross income. Under previous law, the deduction could not exceed the amount of the qualified reimbursements, regardless of actual expenditures. As under previous law, reimbursements in excess of the amount of actual expenditures do not have to be included in gross income.

- *Exclusion of National Health Service Corps Loan Program repayments from gross income and from employment taxes.* The National Health Service Corps is an agency housed within the U.S. Department of Health and Human Services and has as its mission improving the health of the nation's underserved populations. Under the National Health Service Corps Loan Repayment Program, participants in the program may receive up to $25,000 per year for two years to pay off qualified educational loans. The loan repayment is in addition to any salary the participant receives from the employing community site. Under previous law, the amount of loan repayment was included in taxable income and was also subject to employment taxes (i.e. FICA). Under the AJCA, these loan repayments are to be excluded from both gross income and from employment taxes. This provision became effective with the 2004 taxable year.

- *Creation of a deduction for start-up costs and amendments to the expensing schedule for such costs.* Under the AJCA, a taxpayer may take a deduction of up to $5,000 for start-up and organization expenses. However, the amount of the deduction is reduced by the amount by which those expenses exceed $50,000. Any expenses in excess of $5,000 must be amortized over a 15-year period. Under previous law, no current expensing was allowed, the full amount of the start-up and organizational expenses would be amortized over 5 years. This provision is effective for expenses that occur on or after the date the legislation became effective, October 22, 2004.

- *Modification regarding the treatment of gain on the sale of a principal residence when the residence was acquired in a like-kind exchange.* Under current law, a taxpayer is allowed to exclude up to $250,000 of gain from the sale of a residence ($500,000 if a married couple filing jointly) if the taxpayer owned and used the residence as a principal residence for at least 2 of the last 5 years. The AJCA makes a change to this provision when the home was acquired as part of a like-kind exchange.[5] Under the AJCA, a residence received in a like-kind exchange must be owned by the taxpayer for at least five years and must be used as a principal residence of the taxpayer for at least two of the last five years in order to qualify for the exclusion from gross income of the gain on the sale of the residence. This provision became effective for residences sold on or after the date the legislation was enacted, October 22, 2004.

- *Creation of a tonnage tax in lieu of an income tax on qualifying shipping activities.* The AJCA provides that a corporation can elect to be subject to a tonnage tax rather than an income tax on its qualified shipping activities. The tonnage tax is based on the taxpayer's "notional shipping income." Notional shipping income is determined by reference to a monetary rate per ton shipped. The rate is 40 cents per 100 tons per day for the first 25,000 tons shipped per vessel and 20 cents per 100 tons per day for the amount shipped in excess of 25,000 tons per vessel. Once notional shipping income has been determined, tax is computed on that amount at the rate of 35%. In exchange for electing to be subject to the tonnage tax, the taxpayer may exclude from its gross income any amount resulting from its qualifying shipping activities.

  Conforming to this exclusion would result in income from shipping activities being excluded from taxation in North Carolina. In effect, it would result in a loss of tax revenues at the State level without a corresponding loss at the federal level. In order to maintain this revenue source, North Carolina could follow one of two paths. First, North Carolina could adopt a tonnage tax as has been done at the federal level. This would require the State to develop an apportionment formula to ensure that the State taxes only an appropriate share of the tonnage. Alternatively, the State could require the taxpayer to add back the amounts deducted from gross income because of this new

5 A like-kind exchange is an exchange of property held for productive use in a trade or business or for investment for similar property. Unless cash is received as part of the trade, the exchange is not a taxable event.

provision. **For discussion purposes, this draft includes Section 2, which would require the taxpayer to add back to taxable income any amount deducted because of this new federal provision.**

- *Establishment of deduction of State sales and use taxes in lieu of deduction for State income taxes.* The AJCA allows taxpayers to deduct state and local sales taxes in lieu of deducting state and local income taxes. This provision became effective with the 2004 taxable year and is set to expire for taxes beginning in 2006 and thereafter. Taxpayers that elect to deduct state and local sales taxes instead of state and local income taxes will have two options for determining the deductible amount: a) they may accumulate receipts for the actual amount of sales and use tax paid, or b) they may refer to tables prepared by the Secretary of the Treasury which estimate the amount of taxes paid based on average consumption and other factors.

  This federal provision is of particular benefit to taxpayers who reside in states that do not impose a personal income tax. For most North Carolina taxpayers, the greater benefit would come from deducting state income taxes rather than from deducting state and local sales taxes. Some exceptions to this general statement would include the following:
    - o Nonresidents or part-year residents who reside in a state that does not impose an income tax and who have relatively low income tax liability in North Carolina or other states.
    - o Taxpayers who may have a low tax liability due to eligibility for a significant amount of tax credits.
    - o North Carolina residents for whom a large portion of income is not subject to taxation. This class of taxpayers would include many government retirees whose government pensions are not subject to State income tax under the decisions in *Bailey* and the related cases and whose Social Security payments are not subject to State income tax under G.S. 105-134.6.

  North Carolina law currently requires taxpayers to add back the amount of the deduction allowed under the Code for state, local, and foreign income taxes. In order to treat the deduction for state and local sales taxes equivalent to the deduction for state, local, and foreign income taxes, the General Assembly should require the add back of the deduction for state and local sales taxes if it decides to conform to the federal change. This is problematic, however, given that the federal legislation is effective for the 2004 taxable year and the General Assembly cannot conform to the federal legislation and require the add back unless it acts before the end of the year. Although the practical effect of conforming to the change and requiring the add back is the same as not conforming to the change at all, a court could find that requiring an add back would in effect be a retroactive tax increase. **Therefore, for discussion purposes, this draft does not conform to the change allowing a deduction of state and local sales taxes in the 2004 taxable year, but does conform to that change and require an add back beginning with the 2005 taxable year.** This can be seen in Sections 1, 4, and 5 of the bill.

<u>An Act to accelerate the income tax benefits for charitable cash contributions for the relief of victims of the Indian Ocean tsunami (P.L. 109-1).</u>
On December 26, 2004, a large earthquake centered in the Indian Ocean unleashed a catastrophic tsunami that resulted in widespread devastation in 11 countries in South Asia, Southeast Asia, and Africa. The disaster is estimated to have caused billions of dollars in damages and produced a death toll in excess of 160,000.

On January 6, 2005, the first act of the 109 Congress was to approve accelerated tax benefits for charitable cash contributions for the relief of victims of the Indian Ocean tsunami. President Bush signed the act into law the following day. The act allows a taxpayer to treat a cash contribution for tsunami relief efforts made in January 2005 to be treated as if it were made on December 31, 2004. Thus, the taxpayer would be able to take a deduction in the 2004 taxable year rather than the 2005 taxable year. In order to qualify for the accelerated benefit, the contribution must be cash. Donations of property or cash substitutes, such as marketable securities, are not eligible for the accelerated benefits. In addition, the contribution must be specifically designated to be for tsunami relief. A contribution that is made to charitable organization that is assisting in relief efforts but that is not specifically designated to relief efforts is not eligible for the accelerated benefits. For example, a donation to the Red Cross would be eligible for the accelerated benefit only if the donation were specifically designated for tsunami relief efforts; a general donation to the Red Cross would not be eligible for the accelerated benefit.

Section 6 of this bill contains special language to ensure that North Carolina conforms to this federal act.

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 24, 2005

TO: Revenue Laws Study Committee

FROM: Linda Struyk Millsaps and David Crotts
Fiscal Research Division

RE: IRC Update

FISCAL IMPACT
(millions)

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

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES: General Fund	(39.19)	(56.36)	(21.77)	12.48	(2.07)
EXPENDITURES:					
POSITIONS (cumulative):					

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

EFFECTIVE DATE: Sections 4 and 5 of this act become effective for taxable years beginning on or after January 1, 2005. The remainder of this act is effective when it becomes law.

BILL SUMMARY: This bill updates the statutory reference to the Federal Internal Revenue Code used in defining and determining certain state income tax provisions. NOTE:

Because of the structure of the federal legislation, many of these provisions would be retroactive.

ASSUMPTIONS AND METHODOLOGY: In 1989 the General Assembly decided to link the State personal income tax directly to the federal income tax by adopts the federal taxable income as the starting point for the calculation of state taxable income. In addition, each year the state must proactively determine whether to update its reference to the Internal Revenue Service code to continue this conformance. Under current North Carolina law the reference date in the code is May 1, 2004. The legislation changes the reference date to January 1, 2005. This would effectively incorporate the changes made by both the Working Families Relief Act and the American Job Creation Act. In addition, in early January 2005 Congress enacted additional legislation to enhance the tax benefits associated with charitable contributions made for tsunami relief. The legislation conforms to that change as well.

Working Families Tax Relief Act of 2004
There are six provisions of the code update that potentially affect state law and are a part of this legislation.

1. Uniform Child Definition: The term "child" is defined in numerous places in the federal code. The legislation creates a uniform definition, with three separate conditions. First a residency test that says the child must live with the taxpayer more than ½ the year. Temporary absences due to special circumstances are not included. Second, a relationship test requires the child to be a child, stepchild, sibling, stepsibling, or descendant of the taxpayer. Finally, an age test. Generally a child must be under 19, or 24 if they are a full-time student. However, lower age limits still apply to the dependent care credit and the child tax credit. These changes may result in a change of status for some children in North Carolina. They also potentially affect eligibility for the State child tax credit.

The staff of the Congressional Joint Committee on Taxation (JTC) estimates that this exclusion will cost the federal treasury $84 million in the first year, $206 million in the second, and $209 in the third. The chart below shows the JCT estimate of the federal loss, with adjustments made to apply the estimate to North Carolina.

(millions)

Child Definition	FY 05-06	FY 06-07	FY 07-08	FY 08-09	FY 09-10
JTC Estimate of Federal Tax Loss	(84.0)	-206	-209	-218	-225
Divided by Average Federal Rate	21.9%	21.9%	21.9%	21.9%	21.9%
Estimated Loss of Federal Income	(383.6)	(940.6)	(954.3)	(995.4)	(1,027.4)
NC Children as % of National	2.63%	2.63%	2.63%	2.63%	2.63%
Estimated Loss of NC Taxable Income	(10.09)	(24.74)	(25.10)	(26.18)	(27.02)
Multiply by Average Tax Rate	6.80%	6.80%	6.80%	6.80%	6.80%
Estimated NC Loss	(0.69)	(1.68)	(1.71)	(1.78)	(1.84)

2. Deduction for Educators: Previously educators could take an above the line deduction of up to $250 to cover their out of pocket expenses related to the classroom, such as supplies, books, computers, software, and equipment. This provision expired with the 2003 tax year. The federal legislation extends the provision for the 2004 and 2005 tax years. The Department of Public Instruction estimates, based on the requirements in the bill, 118,462 educators will likely qualify for the $250 credit in 2004. Because the credit can be reduced or eliminated by other tax-free distributions, the fiscal memo assumes a 92% participation rate, with each educator taking the full amount of the credit. This change will also impact the current fiscal year.

Teacher Credit	FY 05-06	FY 06-07	FY 07-08	FY 08-09	FY 09-10
Estimated Affected Educators	113462	115196	116463	117448	118417
Multiply by $250 credit	$250	$250	$250	$250	$250
Estimated Loss of NC Taxable Income	28,365,500	28,799,000	29,115,750	29,362,000	29,604,250
Multiply by Average Tax Rate	6.80%	6.80%	6.80%	6.80%	6.80%
Estimated NC Loss	1,928,854	1,958,332	1,979,871	1,996,616	2,013,089
Loss After Adj. for Participation Rate	1,774,546	1,801,665	1,821,481	1,836,886	1,852,042

3, 4, and 5. Brownfields, Computer Donations, and Clean Fuel Property: The Act includes three additional changes, each with limited fiscal impact. First, it extends the previous elective expensing of qualified environmental remediation expenditures. Since it is unknown how many North Carolina taxpayers will take advantage of this expensing method to cleanup the estimated 1,000 brownfield sites in the state, the memo uses 0.53% of the federal estimate, as North Carolina corporate tax collections are that proportion of federal corporate tax collections. Second, it enhances the deduction, by allowing a deduction in excess of basis, for qualified computer donations by companies to schools and libraries. North Carolina's proportion of the corporate revenues is also used to determine North Carolina' potential loss. Finally, it delayed the planned phase-out of the deduction allowed for the purchase of clean-fuel vehicles and refueling property. These items all extend previous tax relief and primarily affect corporate taxes. The fiscal impact to the state is as follows:

(millions)

Brownfields, Computers, and Clean Fuel	FY 05-06	FY 06-07	FY 07-08	FY 08-09	FY 09-10
JTC Estimate of Federal Tax Loss	-726	-171	57	54	51
NC Proportion of Federal Collections	0.53%	0.53%	0.53%	0.53%	0.53%
Estimated NC Loss	(3.8)	(0.9)	0.3	0.3	0.3
Estimated NC Loss after Fiscal Year Adj.	(2.10)	(1.0)	0.1	0.3	0.3

This loss applies primarily to corporate tax.

6. Archer Medical Savings Accounts: These savings accounts are similar to IRAs, but are used to pay for qualifying medical expenses. It must be set up in conjunction with an IRS qualified high deductible health plan (HDHP). Previously no new Archer MSAs could be created after the end of 2003. The federal legislation retroactively extends that period through 2005. Currently several companies offer Archer accounts in North Carolina. However, no information is available at this time concerning the number or value of policies. In addition, the Joint Select Committee indicates, at the federal level, the revenue impact is limited. Therefore, no fiscal estimate is possible on this portion of the bill.

American Job Creation Act of 2004

There are several provisions of this federal legislation that potentially affect state law and are a part of this bill.

1. Repeal of the Exclusion for Extraterritorial Income (ETI)/Deduction for Qualified Domestic Production Income: Under previous law, U.S. companies that export could exclude from their gross income certain income earned outside the United States. In 2000 the World Trade Organization declared this to be an illegal subsidy. As a result, Congress is phasing out the exclusion, with total elimination set for 2007. However, as a replacement Congress passed a new deduction for domestic production activities. Qualifying activities include 1) the sale, lease or licensing of property manufactured or produced primarily in the U.S. 2) similar activities related to motion pictures and videos, 3) the sale of electricity, natural gas, or potable water within the United States, 4) construction in the U.S. and 5) engineering and architectural services related to U.S. construction. The deduction will be phased in between 2005 and 2008.

The starting point for the North Carolina impact estimate of the Qualified Production Activities Income deduction was the federal income tax amounts projected by the Joint Committee on Taxation. These estimates were converted to tax year amounts by assuming that 22.5% of the ultimately tax for the year is paid during each quarter of the tax year, with the remainder being remitted in March of the following calendar year. The conversion took into account the fact that the federal fiscal year ends September 30.

Next, the calendar year federal estimates were sensitized to North Carolina by relating the manufacturing share of 2002 gross state product in North Carolina to the same share computed for the nation (Bureau of Economic Analysis, U. S. Department of Commerce). This ratio turned out to be 5.1%.

Finally, the estimated calendar year impact was converted to state fiscal year using the same quarterly payment assumption outlined in converting the federal fiscal year estimate back to the appropriate tax year.

The estimate for the elimination of the export exclusion ("FSC/ETI repeal") was similar to the estimate for Qualified Production Activities (see immediately preceding section) except that the calculations took into account the phase in schedule for the change. That schedule eliminates 20% of the benefits for the 2005 tax year, 40% for 2006, and 100% for 2007 and later years.

(millions)

	FY 05-06	FY 06-07	FY 07-08	FY 08-09	FY 09-10
Qualified Production Activities Deduction	-31.2	-45.7	-63.6	-64.2	-79.5
FSC/ETI Repeal	14.8	35.7	55.3	57.9	60.6

This primarily affects corporate revenues.

2. Section 179 Expensing: In 2001 Congress raised the threshold for small business expensing, often referred to as Section 179 expensing, from $25,000 to $100,000. (The benefit is reduced when the purchase exceeds $400,000). This legislation extends the special treatment through 2007. The estimate of the impact of this provision was based on the following analyses:

(1) A review of the 2003 session estimates of the original Section 179 authorization, compared to the state specific estimates of the Center for Budget Policies and Priorities (CBPP).

(2) A conversion of the new federal fiscal year estimates of the federal impact to the relevant tax year. The federal fiscal year estimates were developed by the Joint Committee on Taxation.

(3) A simulation of the year-by-year impact of Section 179 expensing (compared to regular depreciation) for a $75,000 investment (equals the increase the expensing limit). This analysis used both 5-year and 7-year properties and assumed the taxpayer would use the double declining balance method of depreciation.

(4) An allocation of the U. S. total impact data to North Carolina by reviewing the ratio of N.C. personal income to the U.S. and a comparison of North Carolina's marginal tax rate of 6.9% to a federal rate of 34%.

(millions)

	FY 05-06	FY 06-07	FY 07-08	FY 08-09	FY 09-10
Sec. 179	-20.1	-45.6	-13.8	18.8	16.6

3. Tonnage Tax: The federal legislation allows a corporation to elect to be subject to a tonnage tax, rather than an income tax, on its qualifying shipping activities. Because North Carolina does not currently levy a tonnage tax, the net effect of the federal change is a loss of state tax revenues. This legislation requires a taxpayer who elects the tonnage tax at the federal level to add back that deduction at the state level. As a result of the combination of these two items, there is no Fiscal Impact to the state.

4. Deduction for State Sales and Use Taxes: Under previous law, taxpayers could deduct the amount they paid in state income taxes on their federal return. In the new act, as an effort to primarily aid individuals who live in states that do not levy a personal income tax, Congress allows individual taxpayers to elect to deduct either their state income taxes or their state sales taxes paid. Generally, this portion of the legislation will affect few taxpayers as the vast majority pays more in personal income taxes than sales taxes. However, some taxpayers with particularly low taxable income, such as Bailey recipients or others similarly situated individuals, or those who make a substantial purchase, will take advantage of this provision. Because of limited data, no fiscal estimate is possible at this time.

5. Tsunami Relief: Generally charitable donations must be made in a given calendar year to be used to reduce that same year's tax liability. However, this year Congress is allowing donations made in January 2005 to apply to 2004 liabilities. This provision only applies if the donation is made specifically for Tsunami relief and is notated as such. This state legislation conforms to the federal change. Because of the lack of data currently available, no estimate is possible on this portion of the bill.

6. Leasehold Improvements and Restaurant Property: The estimate for this change was based on sensitizing the federal estimates of the Joint Committee on Taxation to North Carolina. The adjustment was based on the state share of personal income and the state tax rate, relative to federal. The estimate ignored a portion of the FY05 federal impact because the Department of Revenue has advised taxpayers to use the new depreciation rule for the 2004 tax year. This means that the 2004 tax year impact will affect the General Fund revenue estimates used for adopting the budget, but will not be a part of the fiscal estimate for the bill.

Before estimating the N.C. impact, the federal numbers were adjusted to a tax year basis and the fact for the 2004 tax year the federal estimates applied to a partial year.

(millions)

	FY 05-06	FY 06-07	FY 07-08	FY 08-09	FY 09-10
Leasehold Improvements	-1.2	-1.5	-1.5	-1.4	-1.3
Restaurants	-0.3	-0.4	-0.4	-0.4	-0.4

7. Other Provisions: There are numerous other provisions in the legislation that affect the tax liability of North Carolina businesses, farmers, and individual taxpayers. These relate to Section 179 expensing of sports utility vehicles (SUV), the donation of automobiles to charity, expensing of attorney's fees and court costs, vehicle modification costs to postal employees, National Health Service Corps Loan repayments, start-up cost deduction, gain on a sale of a principal residents when acquired in a like-kind exchange, and farm losses due to natural disasters. The estimate for this change was also based on sensitizing the federal estimates of the Joint Committee on Taxation to North Carolina. The adjustment was based on the state share of personal income and the state tax rate, relative to federal. The estimate ignored a portion of the FY05 federal impact because the Department of Revenue has

advised taxpayers to use the new depreciation rule for the 2004 tax year. This means that the 2004 tax year impact will affect the General Fund revenue estimates used for adopting the budget, but will not be a part of the fiscal estimate for the bill.

	FY 05-06	FY 06-07	FY 07-08	FY 08-09	FY 09-10
Other Provisions	3.37	5.62	5.66	5.10	5.32

SOURCES OF DATA: North Carolina Department of Public Instruction, North Carolina Department of Revenue, The Joint Committee on Taxation, Economy.com, U.S. Census Bureau, and the Center for Budget and Policy Priorities.

TECHNICAL CONSIDERATIONS: None

LEGISLATIVE PROPOSAL #2

STREAMLINED SALES TAX CHANGES

LEGISLATIVE PROPOSAL #2:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2005 GENERAL ASSEMBLY

AN ACT TO AMEND THE SALES AND USE TAX STATUTES TO CONFORM TO THE STREAMLINED SALES TAX AGREEMENT.

SHORT TITLE: Streamlined Sales Tax Changes

SPONSORS: **Kerr**; Clodfelter, Dalton, Hartsell, Hoyle, Webster

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BRIEF OVERVIEW: This bill amends several of the sales and use tax statutes to conform to the Streamlined Sales Tax Agreement.

FISCAL IMPACT: This proposal would result in an annual General Fund loss of $500,000 and an annual loss of $278,000 for local governments beginning with FY 05-06.

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

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

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-RBxz-6A [v.1] (1/20)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/24/2005 5:27:20 PM

Short Title:	Streamlined Sales Tax Changes.	(Public)
Sponsors:	Senators Kerr; Clodfelter, Dalton, Hartsell, Hoyle, and Webster.	
Referred to:		

A BILL TO BE ENTITLED

AN ACT TO AMEND THE SALES AND USE TAX STATUTES TO CONFORM TO THE STREAMLINED SALES TAX AGREEMENT.

The General Assembly of North Carolina enacts:

SECTION 3.(a) G.S. 105-164.3 reads as rewritten:

"**§ 105-164.3. Definitions.**

The following definitions apply in this Article:

…

(4b) Computer supplies. – Items that are considered to be a 'school computer supply' under the Streamlined Agreement.

…

(10) Food. – Substances that are sold for ingestion or chewing by humans and are consumed for their taste or nutritional value. The substances may be in liquid, concentrated, solid, frozen, dried, or dehydrated form. The term does not include an alcoholic beverage, as defined in G.S. 105-113.68, or a tobacco ~~products,~~ product, as defined in G.S. 105 113.4.

…

(37a) School supplies. – Items commonly used by students in the course of their studies and that are considered to be a 'school supply', a 'school art supply', or a 'school instructional material' under the Streamlined Agreement.

…

(45a) Streamlined Agreement. – The Streamlined Sales and Use Tax Agreement adopted November 12, 2002, as amended on November 19, 2003, and on November 16, 2004."

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

"(a) State Exemption. – Food is exempt from the taxes imposed by this Article unless the food is included in one of the subdivisions in this subsection. The following food items are subject to tax:

~~(1) Alcoholic beverages, as defined in G.S. 105-113.68.~~

(2) Dietary supplements.

(3) Food sold through a vending machine.

(4) Prepared food.

(5) Soft drinks.

(6) **(Repealed effective January 1, 2004)** Candy, unless the item is purchased for home consumption and would be exempt if purchased under the Federal Food Stamp Program, 7 U.S.C. § 51."

SECTION 2.(b) Subdivision (b)(5) of Section 5 of Part IV of Chapter 908 of the 1983 Session Laws, as amended by Chapter 821 of the 1989 Session Laws and S.L. 2001-347, reads as rewritten:

"(b) Definitions. The definitions in G.S. 105-164.3 apply to this Part insofar as they are not inconsistent with the provisions of this Part. In addition, the following definitions apply in this Part:

…

(5) Prepared Food and Beverages. The term ~~has the same meaning as the term "prepared food" in G.S. 105-164.3.~~ includes the following:

a. Prepared food, as defined in G.S. 105-164.3.

b. An alcoholic beverage, as defined in G.S. 18B-101, that meets at least one of the conditions of prepared food under G.S. 105-164.3."

SECTION 2.(c) Subdivision (a)(2) of Section 2 of Chapter 413 of the 1993 Session Laws, as amended by S.L. 2001-347, reads as rewritten:

"Sec. 2. Definitions; Sales and Use Tax Statutes. – (a) The definitions in G.S. 105-164.3 apply to this act to the extent they are not inconsistent with the provisions of this act. In addition, the following definitions apply in this act:

…

(2) Prepared food and beverages. – The term ~~has the same meaning as the term "prepared food" in G.S. 105-164.3.~~ includes the following:

a. Prepared food, as defined in G.S. 105-164.3.

b. An alcoholic beverage, as defined in G.S. 18B-101, that meets at least one of the conditions of prepared food under G.S. 105-164.3."

SECTION 2.(d) Section 2 of Chapter 449 of the 1985 Session Laws, as amended by Chapter 826 of the 1985 Session Laws, Chapter 177 of the 1991 Session Laws, and S.L. 2001-347, reads as rewritten:

"Sec. 2. Definitions. The definitions in G.S. 105-164.3 apply in this act. In addition, the following definitions apply in this act.

(1) Net proceeds. Gross proceeds less the cost to the county of administering and collecting the tax.

(2) Prepared food and beverages. The term ~~has the same meaning as the term "prepared food" in G.S. 105-164.3.~~includes the following:

a. Prepared food, as defined in G.S. 105-164.3.

b. An alcoholic beverage, as defined in G.S. 18B-101, that meets at least one of the conditions of prepared food under G.S. 105-164.3."

SECTION 2.(e) Subsection (b) of Section 1 of Chapter 449 of the 1993 Session Laws, as amended by S.L. 2001-347, reads as rewritten:

"(b) Definitions; Sales and Use Tax Statutes. – The definitions in G.S. 105-164.3 apply to this section to the extent they are not inconsistent with the provisions of this section. The provisions of Article 5 and Article 9 of Chapter 105 of the General Statutes apply to this section to the extent they are not inconsistent with the provisions of this section. ~~In addition,~~ For the purposes of this section, the term "prepared food and beverages" ~~has the same meaning as the term "prepared food" in G.S. 105-164.3.~~includes the following:

(1) Prepared food, as defined in G.S. 105-164.3.

(2) An alcoholic beverage, as defined in G.S. 18B-101, that meets at least one of the conditions of prepared food under G.S. 105-164.3.

~~The provisions of Article 5 and Article 9 of Chapter 105 of the General Statutes apply to this section to the extent they are not inconsistent with the provisions of this section.~~"

SECTION 2.(f) Subdivision (3) of Section 2 of Chapter 594 of the 1991 Session Laws, as amended by S.L. 2001-347, reads as rewritten:

"Sec. 2. Definitions. The definitions in G.S. 105-164.3 apply to this act to the extent they are not inconsistent with the provisions of this act. The following definitions also apply in this act:

…

(3) Prepared food and beverage. The term ~~has the same meaning as the term "prepared food" in G.S. 105-164.3.~~includes the following:

a. Prepared food, as defined in G.S. 105-164.3.

b. An alcoholic beverage, as defined in G.S. 18B-101, that meets at least one of the conditions of prepared food under G.S. 105-164.3."

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

"(a) The taxes imposed by this Article do not apply to the following items of tangible personal property if sold between 12:01A.M. on the first Friday of August and 11:59 P.M. the following Sunday:

(1) Clothing with a sales price of one hundred dollars ($100.00) or less per item.

(2) School supplies with a sales price of one hundred dollars ($100.00) or less per item.

(3) Computers with a sales price of three thousand five hundred dollars ($3,500) or less per item.

(4) ~~Sport or recreational equipment with a sales price of fifty dollars ($50.00) or less per item.~~ Computer supplies with a sales price of two hundred fifty dollars ($250.00) or less per item.

(5) Sport or recreational equipment with a sales price of fifty dollars ($50.00) or less per item."

SECTION 4. G.S. 105-164.28 reads as rewritten:

"**§ 105-164.28. Certificate of resale.**

(a) Seller's Responsibility. – A seller who accepts a certificate of resale from a purchaser of tangible personal property has the burden of proving that the sale was not a retail sale unless all of the following conditions are met:

(1) For a sale made in person, the certificate is signed by the ~~purchaser,~~ purchaser and states the purchaser's name, address, ~~and~~ registration number, and type of business. ~~describes the type of tangible personal property generally sold by the purchaser in the regular course of business.~~

(2) For a sale made in person, the ~~purchaser is engaged in the business of selling~~ tangible personal property ~~of the type sold.~~ sold is typically used in the type of business stated on the certificate.

(3) For a sale made over the Internet or by other remote means, the sales tax registration number given by the purchaser matches the number on the Department's registry.

(b) ~~Liabilities.~~ Purchaser's Liability. – A purchaser who does not resell property purchased under a certificate of resale is liable for any tax subsequently determined to be due on the sale. ~~A seller of property sold under a certificate of resale is jointly liable with the purchaser of the property for any tax subsequently determined to be due on the sale only if the Secretary proves that the sale was a retail sale.~~"

SECTION 5. G.S. 105-164.42B(1) reads as rewritten:

"**§ 105-164.42B. Definitions.**

The following definitions apply in this Part:

(1) Agreement. ~~The~~ Streamlined ~~Sales and Use Tax Agreement.~~ Agreement, as defined in G.S. 105-164.3.

..."

SECTION 6. This act is effective when it becomes law.

Bill Analysis of Legislative Proposal #2:
STREAMLINED SALES TAX CHANGES

BY: CINDY AVRETTE, RESEARCH DIVISION

SUMMARY: This bill draft makes several technical and administrative changes to the sales and use tax laws to conform to the Streamlined Sales and Use Tax Agreement, as amended in November 2004. The bill becomes effective when it becomes law.

CURRENT LAW: Legislative Proposal 2 makes the following changes to the sales and use tax laws to conform them to the Streamlined Sales and Use Tax Agreement, as amended in November 2004.

Section	Explanation
1, 2	Section 1 conforms the definition of food to the Streamlined Agreement by removing 'alcoholic beverage' from the definition of food. Section 2(a) makes a conforming change to the exemption of food from the State sales tax base. Sections 2(b) through ( ) make conforming changes to the local meals tax statutes.
1, 3	States may allow sales tax holidays, but the items included in the holiday must be defined terms under the Streamlined Agreement. Section 1 defines the terms 'computer supplies' and 'school supplies' to conform to the defined terms in the Streamlined Agreement. The proposal defines the term 'school supplies' to mean the all-inclusive list of items defined as 'school supplies', 'school art supplies', and 'school instructional material' under the Streamlined Agreement. It also defines the term 'Streamlined Agreement' as the Streamlined Sales and Use Tax Agreement, adopted November 12, 2002, as amended November 16, 2003, and November 19, 2004. Section 3 amends the sales tax holiday statute to include the defined terms. The primary difference between the current law and the proposed law is the inclusion of computer supplies in the sales tax holiday. Computer supplies include computer storage media, printers, printer supplies, hand-held electronic schedulers, and personal digital assistants. The State's sales tax holiday included most of these items prior to August of 2004. The General Assembly

	changed the law in 2003 to except these items from the holiday in 2004, in conformity with the Streamlined Agreement. This proposal, based upon amendments to the Streamlined Agreement in November of 2004, expands the holiday to include these items once again so long as the sales price does not exceed $250 per item.
4	Conforms the statutory language to the information actually requested on a certificate of resale.

To remain in compliance, other, more substantive changes involving multiple tax rates will need to be made before January 1, 2006. The Streamlined Agreement allows for one rate and prohibits the use of caps and thresholds. North Carolina currently has multiple rates, such as the preferential rate on certain agricultural items, and the differing rates on telecommunications services, direct-to-home satellite service, and spirituous liquor.

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. <u>This is not an official fiscal note</u>. 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 26, 2005

TO: Revenue Laws

FROM: Linda Millsaps
Fiscal Research Division

RE: Streamlined Sales Tax Changes

FISCAL IMPACT

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

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:					
General Fund	**(500,000)**	**(500,000)**	**(500,000)**	**(500,000)**	**(500,000)**
Local Government	**(278,000)**	**(278,000)**	**(278,000)**	**(278,000)**	**(278,000)**
EXPENDITURES:					
POSITIONS (cumulative):					

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

EFFECTIVE DATE: When it becomes law.

BILL SUMMARY: The bill makes several definitional changes to the state's sales tax statutes, particularly as they relate to alcoholic beverages and the sales tax holiday. These changes are in response to compliance issues with the Streamlined Sales Tax Agreement.

ASSUMPTIONS AND METHODOLOGY: To meet the requirements of the Streamlined Sales Tax Agreement, the legislation removes "alcoholic beverage" from the definition of food, and transfers it to the definition of prepared food. Because alcoholic beverages were already set out as a special type of food that is subject to the general sales tax rate, and prepared foods are also taxed at the general rate, there is no fiscal impact because of this change. The bill makes a similar transfer in the local prepared meals tax statutes. No fiscal impact is expected because of this change.

The legislation also makes changes that relate to the sales tax holiday. Under the agreement, states can host a sales tax holiday, but must apply the holiday to only a specific set of defined terms. The legislation alters several related North Carolina definitions to conform to those in the agreement. While items shift between terms, the only items that actually change tax status are "computer supplies". Under the agreement computer supplies are defined to include computer storage media (such as CDs and discs), printers, printer supplies, hand-held electronic schedulers, and personal digital assistants. North Carolina's sales tax holiday applied to most of these items before August 2004. In 2003, the General Assembly changed the law to exempt these items from the holiday, effective for the 2004 holiday. This change was made to conform to Streamline. In November 2004 the Streamline agreement was amended to allow state holidays to include these items, as long as the sales price is less than $251. Therefore, the revenue loss associated with this portion of the bill is the revenue associated with exempting "computer supplies" from sales tax during the annual sales tax holiday. Based on industry data and original estimates of the impact of the sales tax holiday, the annual cost is expected to be less than $500,000.

TECHNICAL CONSIDERATIONS: None

LEGISLATIVE PROPOSAL #3

MOTOR FUELS TAX CHANGES

LEGISLATIVE PROPOSAL #3:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2005 GENERAL ASSEMBLY

AN ACT TO MODIFY THE TAXATION OF MOTOR FUELS.

SHORT TITLE: Motor Fuel Tax Changes

SPONSORS: **Luebke**; Brubaker, Hill, McGee, Wainwright

BRIEF OVERVIEW: This bill makes several changes to the motor fuels tax laws.

FISCAL IMPACT: No fiscal estimate available at this time.

EFFECTIVE DATE: Several provisions become effective January 1, 2006 and the remainder 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 2005

U **D**

BILL DRAFT 2005-RBxfz-2 [v.6] (12/8)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
12/21/2004 11:29:28 AM

Short Title: Motor Fuel Tax Changes. (Public)

Sponsors: Representatives Luebke; Brubaker, Hill, McGee, and Wainwright.

Referred to:

A BILL TO BE ENTITLED

AN ACT TO MODIFY THE TAXATION OF MOTOR FUELS.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-236(2) reads as rewritten:

"**§ 105-236. Penalties.**

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

...

(2) Failure to Obtain a License. – For failure to obtain a license before engaging in a business, trade or profession for which a license is required, the Secretary shall assess a penalty equal to five percent (5%) of the amount prescribed for the license per month or fraction thereof until paid, not to exceed twenty-five percent (25%) of the amount so prescribed, but in any event shall not be less than five dollars ($5.00). In cases in which the taxpayer fails to obtain a license as required under G.S. 105-449.65 or G.S. 105-449.131, the Secretary may assess a penalty of one thousand dollars ($1,000)."

SECTION 2. G.S. 105-449.39 reads as rewritten:

"**§ 105-449.39. Credit for payment of motor fuel tax.**

Every motor carrier subject to the tax levied by this Article is entitled to a credit on its quarterly report for tax paid by the carrier on fuel purchased in the State. The amount of the credit is determined using the flat cents-per-gallon rate plus the variable cents-per-gallon rate of tax in effect during the quarter covered by the report.

To obtain a credit, the motor carrier must furnish evidence satisfactory to the Secretary that the tax for which the credit is claimed has been paid.

If the amount of a credit to which a motor carrier is entitled for a quarter exceeds the motor carrier's liability for that quarter, the Secretary must refund the excess to the motor ~~carrier.~~carrier in accordance with G.S. 105-266(a)(3)."

SECTION 3. G.S. 105-449.44(a) reads as rewritten:

"(a) Calculation. – The amount of motor fuel or alternative fuel a motor carrier uses in its operations in this State for a reporting period is the ~~ratio of the~~ number of miles the motor carrier travels in this State during that period divided by the calculated miles per gallon for the motor carrier for all qualified vehicles ~~to the total number of miles the motor carrier travels inside and outside this State during that period. multiplied by the total amount of fuel the motor carrier uses in its operations inside and outside the State~~ during that period."

SECTION 4. G.S. 105-449.46 reads as rewritten:

"**§ 105-449.46. Inspection of books and records.**

The Secretary and his authorized agents and representatives shall have the right at any reasonable time to inspect the books and records of any motor carrier subject to the tax imposed by this ~~Article.~~Article or to the registration fee imposed by Article 3 of Chapter 20 of the General Statutes."

SECTION 5. G.S. 105-449.47(a1) reads as rewritten:

"(a1) Registration and Identification Marker. – When the Secretary registers a motor carrier, the Secretary must issue at least one identification marker for each motor vehicle operated by the motor carrier. A motor carrier must keep records of identification markers issued to it and must be able to account for all identification markers it receives from the Secretary. Registrations and identification markers issued by the Secretary are for a calendar year. All identification markers issued by the Secretary remain the property of the State. The Secretary may ~~withhold or~~ revoke a registration or an identification marker when a motor carrier fails to comply with this ~~Article, former Article 36 or 36A of this Subchapter,~~ Article or Article 36C or 36D of this Subchapter.

A motor carrier must carry a copy of its registration in each motor vehicle operated by the motor carrier when the vehicle is in this State. A motor vehicle must clearly display an identification marker at all times. The identification marker must be affixed to the vehicle for which it was issued in the place and manner designated by the authority that issued it."

SECTION 6. Article 36B of Chapter 105 of the General Statutes is amended by adding a new section to read:

"**105-449.47A. Reasons why the Secretary can deny an application for a registration and identification marker.**

The Secretary may refuse to register and issue an identification marker to an individual applicant that has done any of the following and may refuse to register and issue an identification marker to an applicant that is a business entity if any principal in the business has done any of the following:

(1) Had a registration issued under Chapter 105 or Chapter 119 of the General Statutes cancelled by the Secretary for cause.

(2) Had a registration issued by another jurisdiction, pursuant to G.S. 105-449.57, cancelled for cause.

(3) Been convicted of fraud or misrepresentation.

(4) Been convicted of any other offense that indicates that the applicant may not comply with this Article if registered and issued an identification marker.

(5) Failed to remit payment for a tax debt under Chapter 105 or Chapter 119 of the General Statutes. The term 'tax debt' has the same meaning as defined in G.S. 105-243.1.

(6) Failed to file a return due under Chapter 105 or Chapter 119 of the General Statutes."

SECTION 7. G.S. 105-449.51 reads as rewritten:

"**§ 105-449.51. Violations declared to be misdemeanors.**

Any person who operates or causes to be operated on a highway in this State a motor vehicle that does not carry a registration card as required by this Article, does not properly display an identification marker as required by this Article, or is not registered in accordance with this Article is guilty of a Class 3 misdemeanor and, upon conviction thereof, shall ~~only~~ be fined ~~no less than ten dollars ($10.00) nor more than~~ two hundred dollars ($200.00). Each day's operation in violation of any provision of this section shall constitute a separate offense."

SECTION 8. G.S. 105-449.65(b) reads as rewritten:

"(b) Multiple Activity. – A person who is engaged in more than one activity for which a license is required must have a separate license for each activity, unless this subsection provides otherwise. A person who is licensed as a supplier ~~is not required to obtain a separate license for any other activity for which a license is required and~~ is considered to have a license as a distributor. A person who is licensed as an occasional importer or a tank wagon importer is not required to obtain a separate license as a ~~distributor.~~ distributor unless the importer is also purchasing motor fuel, at the terminal rack, from an elective or permissive supplier who is authorized to collect and remit the tax to the State. A person who is licensed as a distributor is not required to obtain a separate license as an importer if the distributor acquires fuel for import only from an elective supplier or a permissive supplier and is not required to obtain a separate license as an exporter. A person who is licensed as a distributor or a blender is not required to obtain a separate license as a motor fuel transporter if the distributor or blender does not transport motor fuel for others for hire."

SECTION 9. G.S. 105-449.69(b) reads as rewritten:

"(b) Most Licenses. – An applicant for a license as a refiner, a supplier, a terminal operator, an importer, a blender, ~~a bulk end user of undyed diesel fuel, a retailer of undyed diesel fuel,~~ or a distributor must meet the following requirements:

(1) If the applicant is a corporation, the applicant must either be incorporated in this State or be authorized to transact business in this State.

(2) If the applicant is a limited liability company, the applicant must either be organized in this State or be authorized to transact business in this State.

(3) If the applicant is a limited partnership, the applicant must either be formed in this State or be authorized to transact business in this State.

(4) If the applicant is an individual or a general partnership, the applicant must designate an agent for service of process and give the agent's name and address."

SECTION 10. G.S. 1015-449.73 reads as rewritten:

"§ 105-449.73. Reasons why the Secretary can deny an application for a license.

The Secretary may refuse to issue a license to an individual applicant that has done any of the following and may refuse to issue a license to an applicant that is a business entity if any principal in the business has done any of the following:

(1) Had a license or registration issued under this Article or former Article 36 or 36A of this Chapter cancelled by the Secretary for cause.

(1a) Had a motor fuel license or registration issued by another state cancelled for cause.

(2) Had a federal Certificate of Registry issued under § 4101 of the Code, or a similar federal authorization, revoked.

(3) Been convicted of fraud or misrepresentation.

(4) Been convicted of any other offense that indicates that the applicant may not comply with this Article if issued a license.

(5) Failed to remit payment for ~~an overdue tax debt~~ <u>tax debt</u> under Chapter 105 or Chapter 119 of the General Statutes. The term ~~"overdue tax debt"~~ <u>"tax debt"</u> has the same meaning as defined in G.S. 105 243.1.

(6) Failed to file a return due under Chapter 105 or Chapter 119 of the General Statutes."

SECTION 11. G.S. 105-449.86(a) reads as rewritten:

"(a) Tax. – An excise tax at the motor fuel rate is imposed on dyed diesel fuel acquired to operate any of the following:

(1) Repealed by Session Laws 2003-349, s. 10.8, effective January 1, 2004.

(2) Either a local bus or an intercity bus that is allowed by § 4082(b)(3) of the Code to use dyed diesel fuel.

(3) A highway vehicle that is owned by or leased to an educational organization that is not a public school and is allowed by § 4082(b)(1) or (b)(3) of the Code to use dyed diesel fuel.

~~(4) A highway vehicle that is owned by or leased to the American Red Cross and is allowed by § 4082 of the Code to use dyed diesel fuel.~~"

SECTION 12. G.S. 105-449.90A reads as rewritten:

"**§ 105-449.90A. Payment by supplier of destination state tax collected on exported motor fuel.**

Tax collected by a supplier on exported motor fuel is payable by the supplier to the destination ~~state if the supplier is licensed in that state for payment of motor fuel excise taxes.~~state. ~~Tax collected by a supplier on exported motor fuel is payable to the Secretary for remittance to the destination state if the supplier is not licensed in that state for payment of motor fuel excise taxes.~~ Payments of destination state tax are due to the destination state ~~or the Secretary, as appropriate,~~ on the date set by the law of the destination state. ~~Payments of destination state tax to the Secretary must be accompanied by a form provided by the Secretary that contains the information required by the Secretary.~~"

SECTION 13. G.S. 105-449.96 is amended by adding a new subdivision to read:

"**§ 105-449.96. Information required on return filed by supplier.**

A return of a supplier must list all of the following information and any other information required by the Secretary:

...

(7) The number of gallons of motor fuel the supplier exchanged with another licensed supplier, pursuant to a two-party exchange agreement, during the month, sorted by type of fuel, person receiving thefuel, and terminal code."

SECTION 14. The catch line for G.S. 105-449.106 reads as rewritten:

"**§ 105-449.106. Quarterly refunds for ~~certain local governmental entities,~~ nonprofit organizations, taxicabs, and special mobile equipment.**"

SECTION 15. G.S. 105-449.115 reads as rewritten:

"**§ 105-449.115. Shipping document required to transport motor fuel by railroad tank car or transport truck.**

(a) Issuance. – A person may not transport motor fuel by railroad tank car or transport truck unless the person has a shipping document for its transportation that complies with this section. A terminal operator and the operator of a bulk plant must give a shipping document to the person who operates a railroad tank car or a transport truck into which motor fuel is loaded at the terminal rack or bulk plant rack.

(b) Content. – A shipping document issued by a terminal operator or the operator of a bulk plant must contain the following information and any other information required by the Secretary:

(1) Identification, including address, of the terminal or bulk plant from which the motor fuel was received.

(2) The date the motor fuel was loaded.

(3) The gross gallons loaded.

(4) The destination state of the motor fuel, as represented by the purchaser of the motor fuel or the purchaser's agent.

(5) If the document is issued by a terminal operator, the document must be machine printed and it must contain the following information:

a. The net gallons loaded.

b. A tax responsibility statement indicating the name of the supplier that is responsible for the tax due on the motor fuel.

(c) Reliance. – A terminal operator or bulk plant operator may rely on the representation made by the purchaser of motor fuel or the purchaser's agent concerning the destination state of the motor fuel. A purchaser is liable for any tax due as a result of the purchaser's diversion of fuel from the represented destination state.

(d) Duties of Transporter. – A person to whom a shipping document was issued must do all of the following:

(1) Carry the shipping document in the conveyance for which it was issued when transporting the motor fuel described in it. <u>When operating an empty transport, carry the shipping document in the conveyance for the motor fuel last contained in the conveyance.</u>

(2) Show the shipping document to a law enforcement officer upon request when transporting the motor fuel described in it.

(3) Deliver motor fuel described in the shipping document to the destination state printed on it unless the person does all of the following:

a. Notifies the Secretary before transporting the motor fuel into a state other than the printed destination state that the person has received instructions since the shipping document was issued to deliver the motor fuel to a different destination state.

b. Receives from the Secretary a confirmation number authorizing the diversion.

c. Writes on the shipping document the change in destination state and the confirmation number for the diversion.

(4) Give a copy of the shipping document to the distributor or other person to whom the motor fuel is delivered.

(e) Duties of Person Receiving Shipment. – A person to whom motor fuel is delivered by railroad tank car or transport truck may not accept delivery of the motor fuel if the destination state shown on the shipping document for the motor fuel is a state other than North Carolina. To determine if the shipping document shows North Carolina as the destination state, the person to whom the fuel is delivered must examine the shipping document and must keep a copy of the shipping document. The person must keep a copy at the place of business where the motor fuel was delivered for 90 days from the date of delivery and must keep it at that place or another place for at least three years from the date of delivery. A person who accepts delivery of motor fuel in violation of this subsection is jointly and severally liable for any tax due on the fuel.

(f) Sanctions Against Transporter. – The following acts are grounds for a civil penalty payable to the ~~Department of Transportation, Division of Motor Vehicles~~Department of Crime Control and Public Safety, or the Department of Revenue:

(1) Transporting motor fuel in a railroad tank car or transport truck without a shipping document or with a false or an incomplete shipping document.

(2) Delivering motor fuel to a destination state other than that shown on the shipping document.

The penalty imposed under this subsection is payable by the person in whose name the conveyance is registered, if the conveyance is a transport truck, and is payable by the person responsible for the movement of motor fuel in the conveyance, if the conveyance is a railroad tank car. The amount of the penalty is five thousand dollars ($5,000). A penalty imposed under this subsection is in addition to any motor fuel tax assessed.

(g) Sanctions Against Terminal Operator. – The Secretary may assess a civil penalty of five thousand dollars ($5,000) against a terminal operator for issuing a shipping document that does not satisfy the requirements of subsection (b) of this section."

SECTION 16. G.S. 105-449.115A reads as rewritten:

"§ 105-449.115A. Shipping document required to transport fuel by tank wagon.

(a) Issuance. – A person who operates a tank wagon into which motor fuel is loaded at the terminal must comply with the document requirements in G.S. 105-449.115(b). A person ~~may not transport motor fuel by~~ who operates a tank wagon into which motor fuel is loaded from some other source must have ~~unless that person has~~ an invoice, bill of sale, or shipping document containing the following information and any other information required by the Secretary:

(1) The name and address of the person from whom the motor fuel was received.

(2) The date the fuel was loaded.

(3) The type of fuel.

(4) The gross number of gallons loaded.

(b) Duties of Transporter. – A person to whom an invoice, bill of sale, or shipping document was issued must do all of the following:

(1) Carry the invoice, bill of sale, or shipping document in the conveyance for which it is issued when transporting the motor fuel described in it.

(2) Show the invoice, bill of sale, or shipping document upon request when transporting the motor fuel described in it.

<u>(3) Keep a copy of the invoice, bill of sale, or shipping document at the place of business for at least three years from the date of delivery.</u>

(c) Sanctions. – Transporting motor fuel in a tank wagon without an invoice, bill of sale, or shipping document containing the information required by this section is grounds for a civil penalty payable to the Department of Transportation, Division of Motor Vehicles, or the Department of Revenue. The penalty imposed under this subsection is payable by the person in whose name the tank wagon is registered. The amount of the penalty is one thousand dollars ($1,000). A penalty imposed under this subsection is in addition to any motor fuel tax assessed."

SECTION 17. G.S. 105-449.123 reads as rewritten:

"**§ 105-449.123. Marking requirements for dyed fuel storage facilities.**

(a) Requirements. – A person who is a retailer of dyed motor fuel or who stores both dyed and undyed motor fuel for use by that person or another person must mark the storage facility for the dyed motor fuel as follows in a manner that clearly indicates the fuel is not to be used to operate a highway vehicle. The storage facility must be marked "Dyed Diesel, Nontaxable Use Only, Penalty For Taxable Use" or "Dyed Kerosene, Nontaxable Use Only, Penalty for Taxable Use" or a similar phrase that clearly indicates the fuel is not to be used to operate a highway vehicle. <u>A person who fails to mark the storage facility as required by this section is subject to a civil penalty equal to the excise tax at the motor fuel rate on the inventory held in the storage tank at the time of the violation. If the inventory cannot be determined, then the penalty is calculated on the capacity of the storage tank.</u>

(1) The storage tank of the storage facility must be marked if the storage tank is visible.

(2) The fillcap or spill containment box of the storage facility must be marked.

(3) The dispensing device that serves the storage facility must be marked.

(4) The retail pump or dispensing device at any level of the distribution system must comply with the marking requirements.

(b) Exception. – The marking requirements of this section do not apply to a storage facility that contains fuel used only for one of the purposes listed in G.S.

105-449.105A(a)(1) and is installed in a manner that makes use of the fuel for any other purpose improbable."

SECTION 18. G.S. 119-15 is amended by adding the following two new subdivisions:

"**§ 119-15. Definitions that apply to Article.**

The following definitions apply in this Article:

...

(1a) Dyed diesel fuel distributor. – A person who acquires dyed diesel fuel from either of the following:

a. A person who is not required to be licensed under Part 2 of Article 36C of Chapter 105 of the General Statutes and who maintains storage facilities for dyed diesel fuel to be used for nonhighway purposes.

b. Another dyed diesel fuel distributor.

(1b) Dyed diesel fuel. – Defined in G.S. 105-449.60."

SECTION 19. G.S. 119-15.1(a) reads as rewritten:

"(a) License. – A person may not engage in business in this State as any of the following unless the person has a license issued by the Secretary authorizing the person to engage in business:

(1) A kerosene supplier.

(2) A kerosene distributor.

(3) A kerosene terminal operator.

(4) A dyed diesel fuel distributor."

SECTION 20. G.S. 119-15.3(a) reads as rewritten:

"(a) Initial Bond. – An applicant for a license as a kerosene supplier, kerosene distributor, or kerosene terminal operator must file with the Secretary of Revenue a bond or an irrevocable letter of credit. A bond or irrevocable letter of credit must be conditioned upon compliance with the requirements of this Article, be payable to the State, and be in the form required by the Secretary. The amount of the bond or irrevocable letter of credit may not be less than five hundred dollars ($500.00) and may not be more than twenty thousand dollars ($20,000)."

SECTION 21. G.S. 20-91 reads as rewritten:

"**§ 20-91. Audit of vehicle registrations under the International Registration Plan.**

(a) Repealed by Session Laws 1995 (Regular Session, 1996), c. 756, s. 9.

(b) The ~~Division~~ Department of Revenue may audit a person who registers or is required to register a vehicle under the International Registration Plan to determine if the person has paid the registration fees due under this Article. A person who registers a vehicle under the International Registration Plan must keep any records used to determine the information provided to the Division when registering the vehicle. The records must be kept for three years after the date of the registration to which the records apply. The ~~Division~~ Department of Revenue may examine these records during business hours. If the records are not located in North Carolina and an auditor must travel to the location of the records, the registrant shall reimburse North Carolina for per diem and travel expense incurred in the performance of the audit. If more than one registrant is audited on the same out-of-state trip, the per diem and travel expense may be prorated.

The ~~Commissioner~~ Secretary of Revenue may enter into reciprocal audit agreements with other agencies of this State or agencies of another jurisdiction for the purpose of conducting joint audits of any registrant subject to audit under this section.

(c) If an audit is conducted and it becomes necessary to assess the registrant for deficiencies in registration fees or taxes due based on the audit, the assessment will be determined based on the schedule of rates prescribed for that registration year, adding thereto and as a part thereof an amount equal to five percent (5%) of the tax to be collected. If, during an audit, it is determined that:

(1) A registrant failed or refused to make acceptable records available for audit as provided by law; or

(2) A registrant misrepresented, falsified or concealed records, then all plates and cab cards shall be deemed to have been issued erroneously and are subject to cancellation. The ~~Commissioner~~ Commissioner, based on information provided by the Department of Revenue audit, may assess the registrant for an additional percentage up to one hundred percent (100%) North Carolina registration fees at the rate prescribed for that registration year, adding thereto and as a part thereof an amount equal to five percent (5%) of the tax to be collected. The Commissioner may cancel all registration and reciprocal privileges.

As a result of an audit, no assessment shall be issued and no claim for refund shall be allowed which is in an amount of less than ten dollars ($10.00).

The results of any audit conducted under this section shall be provided to the Division. The notice of any assessments ~~will~~ shall be sent by the Division to the registrant by registered or certified mail at the address of the registrant as it appears in the records of the Division of Motor Vehicles in Raleigh. The notice, when sent in accordance with the requirements indicated above, will be sufficient regardless of whether or not it was ever received.

The failure of any registrant to pay any additional registration fees or tax within 30 days after the billing date, shall constitute cause for revocation of registration license plates, cab cards and reciprocal privileges.

(d) Repealed by Session Laws 1995 (Regular Session, 1996), c. 756, s. 9."

SECTION 22. Sections 1, 6, 7, 8, 15, and 17 of this act become effective January 1, 2006. The remainder of this act is effective when it becomes law.

Bill Analysis of Legislative Proposal #3: Motor Fuels Tax Changes

By: Cindy Avrette, Research Division

SUMMARY: Legislative Proposal #3 makes several changes to the motor fuel laws. The Revenue Laws Study Committee recommended many of these changes to the 2004 General Assembly.

BACKGROUND & ANALYSIS: Section 1 was a provision that the Committee approved in its Motor Fuel bill last session. It allows the Secretary to impose a $1,000 penalty for failure to obtain a license under G.S. 105-449.65 or G.S. 105-449.131[1]. Currently, the Secretary has general authority to impose a penalty for failure to obtain a license. Under that general authority, the amount of the penalty imposed is equal to 5% of the amount prescribed for the license for each month the taxpayer fails to obtain the license, with a maximum penalty of 25% of the amount prescribed for the license. Because this general authority limits the penalty to a percentage of the amount prescribed for the license, it effectively bars assessing a penalty when there is no charge to obtain a license. There is no charge for the licenses issued pursuant to G.S. 105-449.65 or G.S. 105-449.131. This provision becomes effective January 1, 2006.

Section 2 conforms the refund statute applicable to motor carriers to the general rule applicable to tax refunds of overpaid taxes. Under the general administrative provisions of G.S. 105-266(a)(3), the Secretary does not have to refund a tax overpayment of less than $3.00 unless the taxpayer makes a written request for the refund. A motor carrier is entitled to a credit on its quarterly report for tax paid by the carrier on fuel purchased in this State. If the credit exceeds the amount of tax owed, the statute provides that the Secretary must refund the excess to the carrier. The statute does not set a minimum amount. This statute appears to conflict with the general administrative provision. This section clarifies that the general administrative law applicable to refunds applies to refunds payable to motor carriers. This provision becomes effective when it becomes law.

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[1] G.S. 105-449.65 is contained in the Article dealing with gasoline, diesel fuel, and blended fuel, and requires the following to have a license: refiners, suppliers, terminal operator, importers, exporters, blenders, motor fuel transporters, and distributors who purchase motor fuel from an elective or permissive supplier at an out-of-state terminal for import into this State. G.S. 105-449.131 is contained in the Article dealing with alternative fuels and requires the following to have a license: providers of alternative fuel, bulk-end users, and retailers.

Section 3 removes obsolete language to conform to current administrative practice. G.S. 105-449.44 establishes the calculation by which a motor carrier determines the amount of fuel used in North Carolina. The formula under current law has not been used since 1991. In 1992, North Carolina became a participant in the International Fuel Tax Agreement. The method proposed by this section conforms to the IFTA agreement and is the method motor carriers have been using to determine the amount of fuel used in this State since 1992. This provision becomes effective when it becomes law.

Sections 4 and 21 were included in last year's recommendation. They transfer audit functions related to the International Registration Plan from the Department of Transportation, Division of Motor Vehicles to the Department of Revenue, Motor Fuels Tax Division. The International Registration Plan is the mechanism through which interstate motor carriers are licensed. It helps to ensure that the proper amount of motor fuels tax is credited to each jurisdiction in which the motor carrier travels. It has been suggested that the Department of Revenue has more expertise in auditing taxpayers and would be a more appropriate home for these audit functions. The positions associated with these audit functions were transferred July 1, 2004, through an administrative transfer. These provisions become effective when they become law.

Section 5 removes language that is no longer applicable. G.S. 105-449.47 provides that the Secretary must issue identification markers to motor carriers. The current statute provides that the Secretary may withhold an identification marker if a motor carrier fails to comply with *former Article 36 or 36A*. The General Assembly repealed those articles in 1996. The authority of the Department to issue an assessment under one of those articles has expired and any uncollectible assessments issued under those articles has been written off. Therefore, the language repealed by this section is obsolete. This provision becomes effective when it becomes law.

Section 6 sets forth the reasons the Secretary could refuse to register and issue an identification marker to a motor carrier. The Department requests this change to enable it to only register applicants that are in good standing with North Carolina and other taxing jurisdictions. The statute proposed in this section is very similar to G.S. 105-449.73, which sets forth the reasons the Secretary may refuse to issue a license to an applicant under the motor fuel statutes. This provision becomes effective January 1, 2006.

Section 7 simplifies the criminal penalty imposed on persons who operate in this State as a motor carrier without obtaining the necessary registration and identification markers. A violation of the motor carrier requirements is a Class 3 misdemeanor. Under current law it is punishable by a fine that is no less than $10 nor more than $200. This section sets the amount of the fine at $200. The civil penalty for this offense is $100. This provision becomes effective January 1, 2006.

Section 8 clarifies the current licensing requirements by conforming them to the current Department policy and practice. This provision becomes effective January 1, 2006.

Section 9 removes obsolete language. In 1999, the General Assembly removed the licensing requirements for bulk-end users and retailers of undyed diesel fuel. The legislation did not include a conforming change to G.S. 105-449.69(b). This provision becomes effective when it becomes law.

Section 10 changes the defined term 'overdue tax debt' to the appropriate defined term 'tax debt'. Under the general administrative provisions in G.S. 105-243.1, a tax debt is defined as the total amount of tax, penalty, and interest due for which a notice of final assessment has been mailed to the taxpayer after the taxpayer no longer has the right to contest the debt. An 'overdue tax debt' is any part of a tax debt that remains unpaid *90 days or more after the notice of final assessment* was mailed to the taxpayer. A collection assistance fee is imposed on an overdue tax debt that remains unpaid 30 days or more after the appropriate fee notice is mailed to the taxpayer. G.S. 105-449.73 sets forth the reasons the Secretary can deny a license to an applicant. One of the reasons is failure to remit taxes that remain due after a taxpayer no longer has the right to contest the tax debt. Since G.S. 105-449.73 has nothing to do with the imposition of a collection assistance fee, the term 'overdue tax debt' is not the appropriate term to use. This provision becomes effective when it becomes law.

Section 11 was included in last year's recommendation. It exempts motor fuel acquired to operate a highway vehicle owned by or leased to the American Red Cross from the motor fuel excise tax. In Department of Employment v. United States, 385 U.S. 355, 87 S.Ct. 464 (1966), the United States Supreme Court ruled that the Red Cross is an instrumentality of the United States for state tax immunity purposes. This provision codifies the current administrative practice of the Department of Revenue. This section is effective when it becomes law.

Section 12 removes the ability of a person exporting motor fuel to another state to pay the tax directly to the Department if the person is not licensed in the destination state of the motor fuel because it is no longer necessary. This provision was included in the statutes in 1996 when North Carolina first adopted 'tax at the rack' to accommodate persons exporting product to a state that was not a 'tax at the rack' state. Today, with the exception of Georgia, all of the surrounding states have adopted 'tax at the rack'. The Georgia border in the western part of the State would not be affected by this repeal because the closest terminal to the Georgia line is in Charlotte. This provision becomes effective when it becomes law.

Section 13 provides that a supplier must list on its return to the Secretary the number of gallons of motor fuel the supplier exchanged with another licensed supplier pursuant to a two-party exchange agreement. The Secretary currently requires this information on the supplier return. This provision becomes effective with it becomes law.

Section 14 removes obsolete language from the catch line of G.S. 105-449.106. In 2003, the General Assembly exempted motor fuel sold to a county or city for its use from the motor fuel tax. Although the legislation authorizing the exemption made the appropriate conforming change to the refund statute, it failed to amend the catch line. This provision becomes effective when it becomes law.

Section 15 was included in last year's recommendation. It allows the Secretary of Revenue to assess a penalty of $5,000 on a terminal operator who fails to issue a shipping document that satisfies the requirements for the shipping document. Under G.S. 105-449.115, shipping documents issued by a terminal operator must contain the following information: 1) identification of the terminal or bulk plant from which the fuel was received, 2) the date the fuel was loaded, 3) the gross gallons loaded, 4) the destination state of the motor fuel, 5) the net gallons loaded, and 6) a tax responsibility statement indicating the name of the supplier that is responsible for the tax. The Motor Fuels Tax Division has noticed a problem with some terminal operators failing to issue proper shipping documents. Without an accurate shipping document, it is difficult, if not impossible, for the Department to ensure that the proper amount of tax is being paid.

Section 15 also requires a person operating an empty transport to carry the shipping document in the conveyance for the motor fuel last contained in the conveyance. The US Department of Transportation already requires a transporter to carry this information. This requirement will help the Motor Fuels Division in its enforcement of fuel tax evasion by identifying the product that was last hauled by the transporter and determining if the transporter is truly empty at the time of investigation. If there is product in the conveyance, then Motor Fuels would have the last known delivery to determine if the transporter 'short dropped' the product. The Division could also use the information to verify that the product that was delivered to a retail location is what the retail station had facilities to store. This section becomes effective January 1, 2006.

Section 16 would require the same documentation requirements for a person who operates a tank wagon into which motor fuel is loaded at the terminal as for a person who operates a transport truck into which motor fuel is loaded at the terminal. This provision becomes effective when it becomes law.

Section 17 would impose a civil penalty on a person who does not properly mark the storage facility of motor fuel. Undyed fuel is subject to the motor fuel tax; dyed fuel is not. This section becomes effective January 1, 2006.

Sections 18 and 19 were included in the Committee's recommendations last year. They make changes to Chapter 119 necessitated by legislation enacted in 2003. In 2003, the General Assembly voted to apply the inspection tax to dyed diesel fuels. The inspection tax is imposed on all fuel types at the rate of ¼¢ per gallon. Proceeds of the tax are used to offset the expenses of administering the motor fuels taxes. The changes in these two sections are needed to apply the tax to distributors who purchase only dyed diesel fuel. These two sections are effective when they become law.

Section 20 is a technical change. It becomes effective when it becomes law.

Section 22 is the effective date section and it becomes effective when it becomes law.

LEGISLATIVE PROPOSAL #4

PRESENT-USE VALUE CLARIFICATION

LEGISLATIVE PROPOSAL #4:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2005 GENERAL ASSEMBLY

AN ACT TO CLARIFY PRESENT-USE VALUE ELIGIBILITY AND TO AMEND THE PERIOD FOR APPEAL OF A PRESENT-USE VALUE DETERMINATION OR APPRAISAL.

SHORT TITLE: Present-Use Value Clarification

SPONSORS: **Brubaker**; Hill, Luebke, McGee, Wainwright

BRIEF OVERVIEW: This proposal clarifies the property tax statutes relating to present-use value eligibility and amends the period for appeal of a present-use value determination or appraisal.

FISCAL IMPACT: No fiscal impact.

EFFECTIVE DATE: This act is effective for taxes imposed for taxable years beginning on or after July 1, 2005.

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

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U **D**

BILL DRAFT 2005-LAxz-1 [v.7] (12/16)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/25/2005 11:57:48 AM

Short Title: Present-Use Value Clarification. (Public)

Sponsors: Representatives Brubaker; Hill, Luebke, McGee, and Wainwright.

Referred to:

A BILL TO BE ENTITLED

AN ACT TO CLARIFY PRESENT-USE VALUE ELIGIBILITY AND TO AMEND THE PERIOD FOR APPEAL OF A PRESENT-USE-VALUE DETERMINATION OR APPRAISAL.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-277.2(7) reads as rewritten:

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

~~a. Type of classification.~~

~~b. Use of the same equipment or labor force.~~105-277.3(a)."

SECTION 2. G.S. 105-277.3(b2) reads as rewritten:

"(b2) Exception to Ownership Requirements. – Notwithstanding the provisions of subsections (b) and (b1) of this section, land may qualify for classification in the hands of the new owner if all of the conditions listed in either subdivision of this subsection are met, even if the new owner does not meet all of the ownership requirements of subsections (b) and (b1) of this section with respect to the land.

(1) Exception for Assumption of Deferred Liability. If the land qualifies for classification in the hands of the new owner under the provisions of this ~~subsection,~~subdivision, then the deferred taxes remain a lien on the land under G.S. 105-277.4(c), the new owner

becomes liable for the deferred taxes, and the deferred taxes become payable if the land fails to meet any other condition or requirement for classification. Land qualifies for classification in the hands of the new owner if all of the following conditions are met:

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

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

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

(2) Exception for Expansion of Existing Unit. – If deferred liability is not assumed under subdivision (1) of this subsection, the land qualifies for classification in the hands of the new owner if, at the time title passed to the new owner, the land was being used for the same purpose and had the same classification as other land already owned by the new owner and classified under subsection (a) of this section. The new owner must timely file an application as required by G.S. 105-277.4(a)."

SECTION 3. G.S. 105-277.4(b1) reads as rewritten:

"(b1) Appeal. – Decisions of the assessor regarding the qualification or appraisal of property under this section may be appealed to the county board of equalization and review or, if that board is not in session, to the board of county commissioners. An appeal must be made within 60 days after the decision of the assessor. If an owner submits additional information to the assessor pursuant to G.S. 105-296(j), the appeal must be made within 60 days after the assessor's decision based on the additional information. Decisions of the county board may be appealed to the Property Tax Commission."

SECTION 4. G.S. 105-296(j) and (l) read as rewritten:

"(j) The assessor must annually review at least one eighth of the parcels in the county classified for taxation at present-use value to verify that these parcels qualify for the classification. By this method, the assessor must review the eligibility of all parcels classified for taxation at present-use value in an eight-year period. The period of the review process is based on the average of the preceding three years' data. The assessor may request assistance from the Farm Service Agency, the Cooperative

Extension Service, the Forest Resources Division of the Department of Environment and Natural Resources, or other similar organizations.

The assessor may require the owner of classified property to submit any information, including sound management plans for forestland, needed by the assessor to verify that the property continues to qualify for present-use value taxation. The owner has 60 days from the date a written request for the information is made to submit the information to the assessor. If the assessor determines the owner failed to make the information requested available in the time required without good cause, the property loses its present-use value classification and the property's deferred taxes become due and payable as provided in G.S. 105-277.4(c). ~~The~~ If the property loses its present-use value classification for failure to provide the requested information, the assessor must reinstate the property's present-use value classification when the owner submits the requested information within 60 days after the disqualification unless the information discloses that the property no longer qualifies for present-use value classification. When a property's present-use value classification is reinstated, it is reinstated retroactive to the date the classification was revoked and any deferred taxes that were paid as a result of the revocation must be refunded to the property owner. The owner may appeal the final decision of the assessor to the county board of equalization and review as provided in G.S. 105-277.4(b1).

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

(l) The assessor shall annually review at least one-eighth of the parcels in the county exempted or excluded from taxation to verify that these parcels qualify for the exemption or exclusion. By this method, the assessor shall review the eligibility of all parcels exempted or excluded from taxation in an eight-year period. The assessor may require the owner of exempt or excluded property to make available for inspection any information reasonably needed by the assessor to verify that the property continues to qualify for the exemption or exclusion. The owner has 60 days from the date a written request for the information is made to submit the information to the assessor. If the assessor determines that the owner failed to make the information requested available in the time required without good cause, then the property loses its exemption or exclusion. If the property loses its exemption or exclusion for failure to provide the requested information, the ~~The~~ assessor must reinstate the property's exemption or exclusion when the owner makes the requested information available within 60 days after the disqualification unless the information discloses that the property is no longer eligible for the exemption or exclusion."

SECTION 5. This act is effective for taxes imposed for taxable years beginning on or after July 1, 2005.

Bill Analysis of Legislative Proposal #4: Present-Use Value Clarification

By: Martha Walston, Fiscal Research Division

SUMMARY: This bill is a recommendation of the Department of Revenue to clarify the property tax statutes relating to present-use value eligibility and to amend the period for appeal of a present-use value determination or appraisal.

ANALYSIS: The Property Tax Division of the Department of Revenue has requested the following changes to the statutes governing the present-use value for agricultural land, horticultural land, and forestland (hereinafter farmland). The Division has indicated that these changes need to be made for clarification and that the changes would help the counties and the Division administer the present-use value program. The North Carolina Farm Bureau has endorsed these recommendations.

Section 1 of the bill amends the definition of "unit". Under current law, farmland must be part of a unit engaged in commercial production to qualify for present-use value. If the unit is composed of multiple tracts, these tracts must be under the same ownership. Also, if the tracts are located within different counties, they must be within 50 miles of a tract that meets the definition of farmland and either share the same classification OR use the same equipment or labor force. The Department proposes deleting the language that the tracts may qualify if they use the same equipment or labor force. The proposed language would require that tracts located in different counties be the same type of classification, i.e. every tract in the unit must be all agricultural land, horticultural land, or forestland. A unit composed of a tract of agricultural land in one county and a tract of horticultural land in another county would no longer qualify as a unit even if the tracts used the same equipment or labor force and were within 50 miles of each other.

Section 2 of the bill deletes certain language and adds language to the statute that provides an exception to the ownership requirements of present-use value classification. The proposed language codifies a procedure the counties are currently following. In order to qualify for present-use value taxation under current law, the farmland must be owned by certain qualifying individuals, family business entities, or trusts. Also, individual owners must live on the land or have owned the land in their family for four years. There is an exception to this ownership requirement if use value land is transferred to a person who continues to use it as farmland and meets the other conditions for use value treatment. The deferred taxes that accrued while the land was owned by the first owner continue as a lien on the property in the hands of the new owner. In addition, the new owner must file an application for present-use value treatment within 60 days after acquiring the land. The new owner must certify that the present use will continue and that the new owner will be liable for the deferred taxes if the land is later disqualified.

The proposed language also allows an exception to the ownership requirements when farmland passes to a new owner who does not assume deferred liability. This occurs when farmland, which is not appraised and taxed at its present-use value is transferred to a new owner. To qualify for present-use value under this proposal, the farmland passing to the new owner must have been used for the same purpose and had the same classification as other land already owned by the new owner. The new owner must also file a timely application showing that the property comes within one of the classes of farmland. The proposed language merely codifies an exception to the ownership requirements that the counties currently recognize.

The proposal deletes the condition that to qualify for the current exception to the ownership requirement, the new owner may show that the land was "eligible for appraisal at its present-use value" at the time title passes to the new owner. This language is not applicable since a new owner must assume the deferred taxes when the land is transferred. There are no deferred taxes unless the property is currently appraised at its present-use value.

Section 3 of the bill adds language that a taxpayer has 60 days to appeal the assessor's decision regarding the qualification or appraisal of the taxpayer's property as use value property. Current law requires a taxpayer to submit an application for present-use value appraisal within 60 days of the date of the property's transfer to the taxpayer, but does not specify the time that a taxpayer may appeal the assessor's decision to the county board of equalization and review or to the board of county commissioners.

Section 3 of the bill also adds language that the taxpayer has 60 days to appeal an assessor's decision regarding present-use value classification when that decision is based on additional information. Current law requires an assessor to annually review at least one eighth of the parcels in a county that are classified for present-use value taxation in order to verify that these parcels qualify as farmland. An assessor is also required to annually review at least one eighth of the parcels in the county that are exempted or excluded from taxation. The assessor may require the taxpayer to submit information to make the verification, and the taxpayer has 60 days to respond to a written request for information. If no information is provided within that time, the property loses its classification. The assessor must reinstate the classification when the requested information is submitted. There is no time limit for presenting the additional information after the assessor has disqualified the property.

<u>Section 4 of the bill</u> adds language that when property has been disqualified for present-use value classification or for exemption or exclusion because of failure to submit additional information, the taxpayer has 60 days after the disqualification to submit the requested information and seek reinstatement of the classification or exemption or exclusion.

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 25, 2005

TO: Revenue Laws Study Committee

FROM: Rodney Bizzell
Fiscal Research Division

RE: 2005-LAxz-1v6

FISCAL IMPACT

	Yes ( )	**No (X)**	**No Estimate Available ( )**		
	FY 2005-06	**FY 2006-07**	**FY 2007-08**	**FY 2008-09**	**FY 2009-10**
REVENUES:					
Local Governments (See Assumptions and Methodology)					

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

EFFECTIVE DATE: July 1, 2005

BILL SUMMARY: This bill is a recommendation of the Department of Revenue to clarify the property tax statutes relating to present-use value eligibility and to amend the period for appeal of a present-use value determination or appraisal. Under current law, farmland must be part of a unit engaged in commercial production to qualify for present-use value classification. If the unit is composed of multiple tracks, these tracts must be under the same ownership. Also, if the tracts are located within different counties, they must be within 50 miles of a tract that meets the definition of farmland and either share the same classification or use the same equipment or labor force. This bill would eliminate the qualification under use of the same equipment or labor force.

The bill also amends the section of the statute that allows exceptions to ownership requirements of present-use classification. The current law allows an exception to ownership requirements when use-value land is transferred to a person who continues to use it as farmland and meets the other conditions for use value treatment and assumes deferred liability for taxes accrued under the previous owner. This proposal codifies the recognized practice of allowing an exception when there is no deferred liability upon transfer of the land. This occurs when the land being transferred is not appraised and taxed at the present-use value at the time of transfer.

This bill also adds language that allows 60 days for a taxpayer to appeal an assessor's decision regarding the qualification or appraisal of the taxpayer's property as use-value property. The 60-day timeframe for appeal would also apply following a decision regarding classification during an assessor's review of one-eighth of present-use parcels in which additional information is requested from the taxpayer. The bill also allows 60 days for the taxpayer to submit additional information when the property has been disqualified for present-use classification because of failure to submit information.

ASSUMPTIONS AND METHODOLOGY: No revenue impact is expected because this bill codifies existing practice among county assessors.

SOURCES OF DATA: Property Tax Division, Department of Revenue

TECHNICAL CONSIDERATIONS: None

LEGISLATIVE PROPOSAL #5

INCREASE DISABLED VET PROPERTY TAX EXCLUSION

LEGISLATIVE PROPOSAL #5:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2005GENERAL ASSEMBLY

AN ACT TO INCREASE THE PROPERTY TAX EXCLUSION FOR THE RESIDENCE OF DISABLED VETERANS.

SHORT TITLE: Increase Disabled Vet Property Tax Exclusion.

SPONSORS: **Brubaker;** Hill, Luebke, McGee, Wainwright

BRIEF OVERVIEW This bill would increase the property tax exclusion for the residence of a disabled veteran so that the exclusion is more in line with the corresponding federal grant amount.

FISCAL IMPACT: This proposal has no General Fund impact but will result in an annual loss of approximately $17,000 to local governments beginning with FY 05-06.

EFFECTIVE DATE: The bill is effective for taxes imposed for taxable years beginning on or after July 1, 2005.

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

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-LAz-2 [v.3] (12/17)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
12/17/2004 5:46:29 PM

Short Title: Increase Disabled Vet Property Tax Exclusion. (Public)

Sponsors: Representatives Brubaker; Hill, Luebke, McGee, and Wainwright.

Referred to:

A BILL TO BE ENTITLED

AN ACT TO INCREASE THE PROPERTY TAX EXCLUSION FOR THE RESIDENCE OF A DISABLED VETERAN.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-275(21) reads as rewritten:

"**§ 105-275. Property classified and excluded from the tax base.**

The following classes of property are hereby designated special classes under authority of Article V, Sec. 2(2), of the North Carolina Constitution and shall not be listed, appraised, assessed, or taxed:

…

(21) The first ~~thirty-eight thousand dollars ($38,000)~~ forty-eight thousand dollars ($48,000) in assessed value of housing together with the necessary land therefor, owned and used as a residence by a disabled veteran who receives benefits under 38 U.S.C. § 2101. This exclusion shall be the total amount of the exclusion applicable to such property."

SECTION 2. This act is effective for taxes imposed for taxable years beginning on or after July 1, 2005.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL #5: INCREASE DISABLED VETERAN PROPERTY TAX EXCLUSION

BY: MARTHA WALSTON, FISCAL RESEARCH DIVISION

SUMMARY: This bill is a recommendation of the Department of Revenue to increase the property tax exclusion for the residence of a disabled veteran so that the exclusion is more in line with the corresponding federal grant amount.

BILL ANALYSIS: G.S. 105-271(21) allows a property tax exclusion for specially adapted housing (including necessary land) owned and used as a residence by a disabled veteran receiving federal benefits under 38 U.S.C. § 2101. The amount of the exclusion is the first $38,000 of the assessed value of the house and land. In 1975, North Carolina allowed a property tax exclusion in the amount of $34,000. The exclusion was increased to $38,000 in 1989 to bring it in line with the corresponding federal grant amount.

The proposal increases the exclusion to $48,000 because of the corresponding increase in the federal grant amount. If a disabled veteran takes this exclusion on his residence, he may not take the homestead exclusion.

Under 38 U.S.C. § 2101, grants are available for veterans who have a service-connected disability due to military service, entitling them to compensation for permanent and total disability due to:

- The loss or loss of use of both lower extremities, such as to preclude locomotion without the aid of braces, crutches, canes, or a wheelchair, or
- Disability which includes blindness in both eyes, having only light perception, plus loss or loss of use of one lower extremity, or
- The loss or loss of use of one lower extremity together with (1) residuals of organic disease or injury, or (2) the loss or loss of use of one upper extremity, which so affects the functions of balance or propulsion as to preclude locomotion without the aid of braces, crutches, canes, or a wheelchair.

The grants may be used to furnish the disabled veteran with a home especially adapted for his needs. The grant may not be more than 50% of the cost of a specially adapted housing unit up to a maximum of $50,000.

<u>Other current North Carolina property tax exclusions available to disabled veterans</u>
G.S. 105-275(5a) exempts a motor vehicle owned by a disabled veteran from property taxes if the vehicle is altered with special equipment to accommodate a service-connected disability. A service-connected disability is an injury incurred or disease contracted in or aggravated by active service. The disability must be loss of

one or both hands or feet, permanent loss of use of one or both hands or feet, or permanent impairment of vision of both eyes.

G.S. 105-275(5) exempts from property tax a motor vehicle given by the U.S. Government to veterans on account of disabilities they suffered in World War II, the Korean Conflict, or the Vietnam War.

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 25, 2005

TO: Revenue Laws Study Committee

FROM: Rodney Bizzell
Fiscal Research Division

RE: 2005-LAz-2v3

FISCAL IMPACT

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

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:					
General Fund			***No General Fund Impact***		
Local Governments	**(17,111)**	**(17,111)**	**(17,111)**	**(17,111)**	**(17,111)**

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: N.C. Department of Revenue and Local Governments

EFFECTIVE DATE: July 1, 2005

BILL SUMMARY: This bill is a recommendation of the Department of Revenue to increase the property tax exclusion for the residence of a disabled veteran from $38,000 to $48,000 so that the exclusion corresponds to the federal grant amount provided to a disabled veteran to adapt a home for the individual's needs.

ASSUMPTIONS AND METHODOLOGY: The current law allows a property tax exclusion for the first $38,000 of assessed value for the home of a disabled veteran. The total value of property that is excluded from property tax under the current law is $6,954,000. Increasing the exclusion to the first $48,000 of assessed value would add an additional $1,830,000 in exclusion value. Applying the weighted average tax rate for county and municipal governments to this property value yields a marginal revenue loss to local governments of $17,111.

SOURCES OF DATA: Department of Revenue, County Tax Assessors

TECHNICAL CONSIDERATIONS: None

LEGISLATIVE PROPOSAL #6

Revenue Laws Technical Changes

LEGISLATIVE PROPOSAL #6:

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2005 GENERAL ASSEMBLY

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

SHORT TITLE: Revenue Laws Technical Changes

SPONSORS: **Hartsell**; Clodfelter, Dalton, Hoyle, Kerr, Webster

---

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

FISCAL IMPACT: No fiscal impact.

EFFECTIVE DATE: When it becomes law.

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

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U **D**

BILL DRAFT 2005-RBxz-7 [v.4] (1/24)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/24/2005 5:16:40 PM

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

A BILL TO BE ENTITLED

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

The General Assembly of North Carolina enacts:

SECTION 1.(a) G.S. 105-113.68(a) reads as rewritten:

"(a) Definitions. – As used in this Article, unless the context clearly requires otherwise:

(1) ~~"ABC Commission" means~~ ABC Commission. – ~~the~~ The North Carolina Alcoholic Beverage Control Commission established under G.S. 18B-200.

(2) Repealed by Session Laws 2004-170, s. 6, effective August 2, 2004.

(3) ~~"ABC permit" means a written or printed authorization issued by the ABC Commission pursuant to Chapter 18B, other than a purchase-transportation permit. Unless the context clearly requires otherwise, "ABC permit" means a presently valid permit.~~ ABC permit. – Defined in G.S. 18B-101.

(4) ~~"Alcoholic beverage" means a beverage containing at least one half of one percent (0.5%) alcohol by volume, including malt beverages, unfortified wine, fortified wine, spirituous liquor, and mixed beverages.~~ Alcoholic beverage. – Defined in G.S. 18B-101.

(5) ~~"Fortified wine" means any wine, of more than sixteen percent (16%) and no more than twenty-four percent (24%) alcohol by volume, made by fermentation from grapes, fruits, berries, rice, or honey; or by the addition of pure cane, beet, or dextrose sugar; or by~~

~~the addition of pure brandy from the same type of grape, fruit, berry, rice, or honey that is contained in the base wine and produced in accordance with the regulations of the United States.~~Fortified wine. – Defined in G.S. 18B-101.

(6) ~~"License" means a~~ License. – A certificate, issued pursuant to this Article by a city or county, that authorizes a person to engage in a phase of the alcoholic beverage industry.

(7) ~~"Malt beverage" means beer, lager, malt liquor, ale, porter, and any other brewed or fermented beverage containing at least one half of one percent (0.5%) and not more than six percent (6%) alcohol by volume.~~Malt beverage. – Defined in G.S. 18B-101.

(8) ~~"Person" has the same meaning as in G.S. 105-228.90.~~Person. – Defined in G.S. 105-228.90.

(9) ~~"Sale" means a transfer, trade, exchange, or barter, in any manner or by any means, for consideration.~~Sale. – Defined in G.S. 18B-101.

(10) ~~"Secretary" means the~~ Secretary. – The Secretary of Revenue.

(11) ~~"Spirituous liquor" or "liquor" means distilled spirits or ethyl alcohol, including spirits of wine, whiskey, rum, brandy, gin, and all other distilled spirits and mixtures of cordials, liqueurs, and premixed cocktails in closed containers for beverage use regardless of the dilution.~~Spirituous liquor or liquor. – Defined in G.S. 18B-101.

(12) ~~"Unfortified wine" means any wine of sixteen percent (16%) or less alcohol by volume made by fermentation from grapes, fruits, berries, rice, or honey; or by the addition of pure cane, beet, or dextrose sugar; or by the addition of pure brandy from the same type of grape, fruit, berry, rice, or honey that is contained in the base wine, and produced in accordance with the regulations of the United States.~~Unfortified wine. – Defined in G.S. 18B-101.

(13) ~~"Wholesaler or importer" when~~ Wholesaler or importer. – When used with reference to wholesalers or importers of wine or malt beverages includes resident wineries that sell their wines at retail and resident breweries that produce fewer than 310,000 gallons of malt beverages per year.

(14) ~~"Wine" means unfortified~~ Wine. – Unfortified and fortified wine.

(15) ~~"Wine shipper permittee" means a~~ Wine shipper permittee. – A winery that holds a wine shipper permit issued by the ABC Commission under G.S. 18B-1001.1."

SECTION 1.(b) G.S. 18B-101(15) reads as rewritten:

"(15) 'Unfortified wine' means any wine of sixteen percent (16%) or less alcohol by volume made by fermentation from ~~pure~~ grapes, fruits, berries, rice, or honey; or by the addition of pure cane, beet, or dextrose sugar; or by the addition of pure brandy from the same type of grape, fruit, berry, rice, or honey that is contained in the base wine and produced in accordance with the regulations of the United States."

SECTION 2. G.S. 105-129.8(a2) reads as rewritten:

"(a2) Installments. – The credit may not be taken in the taxable year in which the additional employee is hired. Instead, the credit must be taken in equal installments over the four years following the taxable year in which the additional employee was hired and is conditioned on the taxpayer's continued employment ~~by the taxpayer~~ in this State of the number of full-time employees the taxpayer had upon hiring the employee that caused the taxpayer to qualify for the credit.

If, in one of the four years in which the installment of a credit accrues, the number of the taxpayer's full-time employees in this State falls below the number of full-time employees the taxpayer had in this State in the year in which the taxpayer qualified for the credit, the credit expires and the taxpayer may not take any remaining installment of the credit. The taxpayer may, however, take the portion of an installment that accrued in a previous year and was carried forward to the extent permitted under G.S. 105-129.5."

SECTION 3.(a) G.S. 105-129.62(c) reads as rewritten:

"(c) Environmental Impact. – A taxpayer is eligible for the credit allowed under this ~~section~~ Article with respect to a facility in this State only if as of the last day of the taxable year for which a credit or carryforward is claimed the taxpayer and the taxpayer's related entities and strategic partners whose employees are included in the taxpayer's increased employment level have no pending administrative, civil, or criminal enforcement actions based on alleged significant violations of any program implemented by an agency of the Department of Environment and Natural Resources, and have had no final determination of responsibility for any significant administrative, civil, or criminal violation of any program implemented by an agency of the Department of Environment and Natural Resources within the last five years. For the taxpayer's related entities and strategic partners, this subsection applies only to the activities of the related entity or strategic partner at the facility with respect to which a credit is claimed. A significant violation is a violation or alleged violation that does not satisfy any of the conditions of G.S. 143-215.6B(d). Upon request, the Secretary of Environment and Natural Resources must notify the Department of Revenue of whether a person currently has any of these pending actions or has had any of these final determinations within the last five years."

SECTION 3.(b) G.S. 105-129.62(d) reads as rewritten:

"(d) Safety and Health Programs. – A taxpayer is eligible for the credit allowed under this ~~section~~ Article with respect to a facility in this State only if as of the last day of the taxable year for which a credit or carryforward is claimed the taxpayer and the taxpayer's related entities and strategic partners whose employees are included in the taxpayer's increased employment level have no citations under the Occupational Safety and Health Act at the facility with respect to which the credit is claimed that have become a final order within the past three years for willful serious violations or for failing to abate serious violations. For the purposes of this subsection, "serious violation' has the same meaning as in G.S. 95-127. Upon request, the Secretary of Labor must notify the Department of Revenue of whether a person has had these citations become final orders within the past three years."

SECTION 3.(c) G.S. 105-129.62(e) reads as rewritten:

"(e) Overdue Tax Debts. – A taxpayer is eligible for the credit allowed under this ~~section~~ <u>Article</u> with respect to a facility only if as of the last day of the taxable year for which a credit or carryforward is claimed the taxpayer and the taxpayer's related entities and strategic partners whose employees are included in the taxpayer's increased employment level have no overdue tax debts that have not been satisfied or otherwise resolved."

SECTION 3.(d) G.S. 105-129.63 reads as rewritten:

"**§ 105-129.63. Determination by the Secretary of Commerce.**

The taxpayer must apply to the Secretary of Commerce for the determination required under G.S. 105-129.62. The application must be made under oath and must provide any information the Secretary requires in order to make the determination. The determination by the Secretary of Commerce is a factual determination. The Secretary must make this determination in any case in which the taxpayer can demonstrate performance or can provide a credible plan for performance.

If the taxpayer fails to create the required number of new jobs or to make the required investment. the information provided by the taxpayer on the application proves to have been false at the time it was given, and the person making the application knew or should have known that the information was false, the taxpayer forfeits any credits claimed under this Article with respect to the facility. A taxpayer that forfeits a credit under this ~~section~~ <u>Article</u> is liable for all past taxes avoided as a result of the credit plus interest at the rate established under G.S. 105-241.1(i), computed from the date the taxes would have been due if the credit had not been allowed. The past taxes and interest are due 30 days after the date the credit is forfeited; a taxpayer that fails to pay the past taxes and interest by the due date is subject to the penalties provided in G.S. 105-236."

SECTION 4.(a). G.S. 105-164.14(j) is amended by adding a new sub-subdivision to read:

"<u>(5) Sunset. – Sub-subdivisions a., d., g., and m. of subdivision (3) of this subsection expire effective for sales made on or after July, 1, 2009.</u>"

SECTION 4.(b) Section 32B.5 of S.L. 2004-124 reads as rewritten:

"**SECTION 32B.5.** The amendment to G.S. 105-164.14(j)(2) made by this part is effective on and after January 1, 2004, and applies to sales made on or after that date. Sections 32B.2 and 32B.3 of this part become effective October 1, 2004, and apply to sales made on or after that date. Section 32B.4 of this part becomes effective July 1, 2005, and applies to sales made on or after that date. The remainder of this part becomes effective July 1, 2004, and applies to sales made on or after that date. ~~The amendments to G.S. 105-164.14(j)(3) made by this part are repealed effective for sales made on or after July 1, 2009.~~"

SECTION 5. G.S. 105-278.1(c)(2) reads as rewritten:

"(c) For purposes of this section:

…

(2) By way of illustration but not by way of limitation, the following boards, commissions, authorities, and institutions are units of State government:

a. The State Marketing Authority established by G.S. 106-529.

b. The Board of Governors of the University of North Carolina incorporated under the provisions of G.S. 116-3 and known as "The University of North Carolina."

c. The North Carolina Museum of Art made an agency of the State under ~~G.S. 140-1.~~G.S. 140-5.12.

…"

SECTION 6. G.S. 106-516.1 reads as rewritten:

"**§ 106-516.1. Carnivals and similar amusements not to operate without permit.**

Every person, firm, or corporation engaged in the business of a carnival company or a show of like kind, including menageries, merry-go-rounds, Ferris wheels, riding devices, circus and similar amusements and enterprises operated and conducted for profit, shall, prior to exhibiting in any county annually staging an agricultural fair, apply to the sheriff of the county in which the exhibit is to be held for a permit to exhibit. The sheriff of the county shall issue a permit without charge; provided, however, that no permit shall be issued if he shall find the requested exhibition date is less than 30 days prior to a regularly advertised agricultural~~ fair and so in conflict with G.S. 105-37.1(d).~~fair. Exhibition without a permit from the sheriff of the county in which the exhibition is to be held shall constitute a Class 1 misdemeanor: Provided, that nothing contained in this section shall prevent veterans' organizations and posts chartered by Congress or organized and operated on a statewide or nationwide basis from holding fairs or tobacco festivals on any dates which they may select if such fairs or festivals have heretofore been held as annual events."

SECTION 7. G.S. 146-22.5 reads as rewritten:

"**§ 146-22.5. Reimbursement of payment in lieu of future ad valorem taxes.**

(a) If a State agency acquires land under G.S. 146-22.3 or G.S. 146-22.4 and later uses this land to mitigate wetlands permitted to be lost in the same county, then the county shall reimburse the State ~~agency for a percentage of~~ agency. The reimbursement shall equal the estimated amount of ad valorem taxes paid for the land in accordance with G.S. 146-22.3 minus ten percent (10%) of this amount ~~times~~ multiplied by the number of years the State agency held the land before the wetlands were lost.

(b) Application. – This section applies only to land acquired in counties designated as an enterprise tier one or enterprise tier two area under G.S. 105-129.3."

SECTION 8. G.S. 160A-215(d) reads as rewritten:

"(d) Administration. – The taxing city shall administer a room occupancy tax it levies. A room occupancy tax is due and payable to the city finance officer in monthly installments on or before the ~~20th~~15th day of the month following the month in which the tax accrues. Every person, firm, corporation, or association liable for the tax shall, on or before the ~~fifteenth~~ 20th day of each month, prepare and render a return on a form prescribed by the taxing city. The return shall state the total gross receipts derived in the preceding month from rentals upon which the tax is levied. A room occupancy tax return filed with the city finance officer is not a public record and may not be disclosed except in accordance with G.S. 153A-148.1 or G.S. 160A-208.1."

SECTION 9.(a) S.L. 2004-123 is amended by a adding a new section to read:

"**SECTION 3.1.** This act applies to Dare County only."

SECTION 9.(b) S.L. 2004-123, as amended by this act, is reenacted.

SECTION 10. Section 5 of S.L. 2004-204 reads as rewritten:

"**SECTION 5.** Section 3 of this act becomes effective January 1, 2005, and applies to sales made on or after that date. The remainder of this act is effective for business activities occurring on or after November 1, 2004, and for taxable years beginning on or after January 1, 2005. Section 4 of this act is repealed for business activities occurring in taxable years beginning on or after January 1, 2020."

SECTION 11. This act is effective when it becomes law.

Bill Analysis of Legislative Proposal #6: Revenue Laws Technical Changes

By: Cindy Avrette, Research Division

SUMMARY: ***This draft bill makes the following technical and clarifying changes to the revenue laws and related statutes.***

ANALYSIS: Legislative Proposal 6 makes the following technical and clarifying changes:

Section	Explanation
1	Section 1(a) cross-references the applicable definitions in the *Alcoholic Beverage License and Excise Tax* Article to the definitions in Chapter 18B and makes stylistic changes. Section 1(b) conforms the definition of 'unfortified wine' in Chapter 18B to the definition in G.S. 105-113.68. The General Assembly changed the definition of 'unfortified wine' in S.L.2004-135. The definition in Chapter 18B inadvertently left an unnecessary word.
2	Clarifies that the jobs tax credit installments should end if the number of jobs in this State should fall below the number the taxpayer had in this State when the taxpayer claimed the credit.
3	Substitutes the appropriate reference to 'Article,' as opposed to 'section."
4	Section 4(a) sets the sunset date in the statute. Section 4(b) removes the sunset language from the effective date part of the 2004 law. Placing the sunset date in the statute reduces the possibility of errors and confusion when and if the relevant subdivisions are amended.
5	Corrects a statutory reference.
6	Deletes an obsolete reference.
7	Clarifies the reimbursement language.
8	Conforms the date by which a city must file an occupancy tax return to the same date by which a county must file an occupancy tax return.
9	Section 9(a) clarifies that the authorization for the additional local sales tax enacted in S.L. 2004-123 applies only to Dare County. Section 9(b) provides that the original bill, as amended by this act, is effective when it becomes law.
10	Provides that the exception in the tax secrecy statute created to correspond with a change in the law sunsets at the same time as that tax law change.
11	The bill is effective when it becomes law.

APPENDIX A

AUTHORIZING LEGISLATION
ARTICLE 12L 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.)

APPENDIX B

DISPOSITION OF COMMITTEE'S RECOMMENDATIONS TO THE 2004 SESSION OF THE GENERAL ASSEMBLY

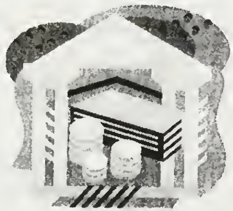
SHORT TITLE	SENATE SPONSORS	HOUSE SPONSORS	BILL #	FINAL STATUS*
IRC Update		Miner	H1430	Enacted* SL 2004-110
Amend Franchise Tax Loophole	Clodfelter		S51	Enacted SL 2004-74
Just Compensation – Outdoor Advertising	Dalton		S1056	Original bill not enacted. Some of the provisions were put into HB 1213, which was enacted, SL 2004-152.
Motor Fuels Tax Changes	Kerr		S1171	Not enacted.
Allow Family Business to Lease Farmland		Brubaker	H1465	Enacted SL 2004-8
Adopt Flat Fee for Debt Collection		Wainwright	H1497	Enacted SL 2004-21
Notice Period for Sales and Use Tax Refunds		Luebke	H1448	Enacted SL 2004-22
Revenue Laws Technical Changes	Hartsell		S1145	Enacted SL 2004-170

* Bills were modified prior to enactment.

APPENDIX C

STATE BUDGET OUTLOOK

STATE BUDGET PROSPECTS: WHERE IS THE SURPLUS?

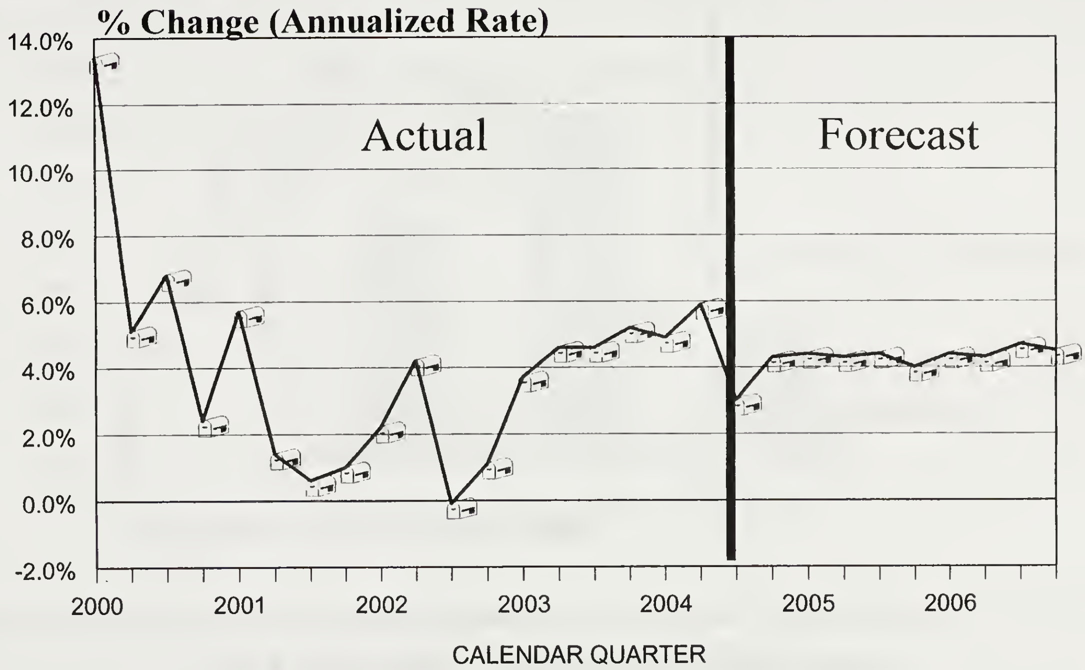


Fiscal Research Division
December 21, 2004

SUMMARY

- The economy continues to recover and revenues are coming in ahead of schedule.
- During a typical business cycle rebound, improving revenues would lead to talk of a budget surplus.
- However, the current cycle is anything but typical. Let's see why.

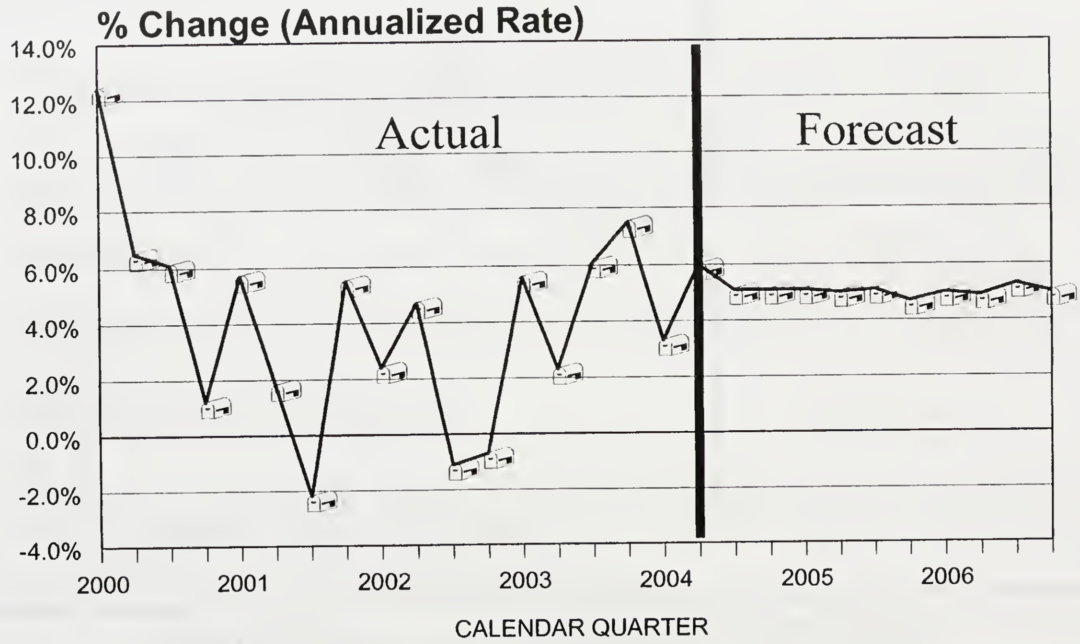
THE NATIONAL ECONOMY CONTINUES TO EXPERIENCE A RECOVERY: U.S. PERSONAL INCOME*



*The total income of the nation's residents (includes inflation).

SOURCE: Historical data from U.S. Department of Commerce. Forecast data based on Economy.com (November 2004).

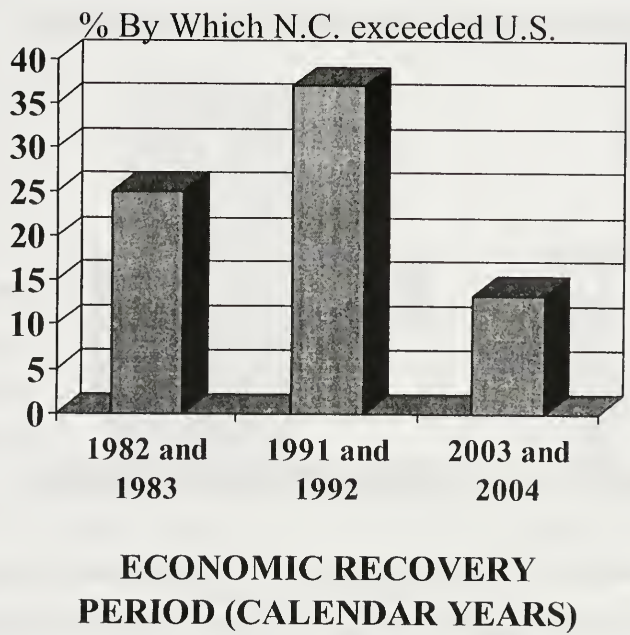
NORTH CAROLINA IS ROUGHLY TRACKING THE U.S. PICTURE: N.C. PERSONAL INCOME*



*A measure of the total income of the state's resident population (includes inflation).

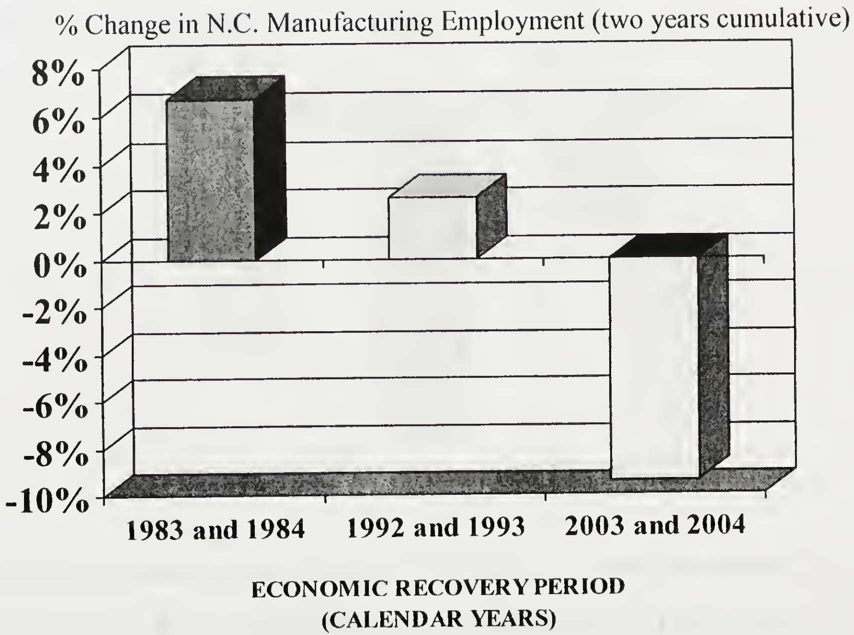
SOURCE: Economy.com (November 2004).

HOWEVER, NORTH CAROLINA IS NOT EXPERIENCING THE USUAL RECOVERY PREMIUM: PERSONAL INCOME GROWTH



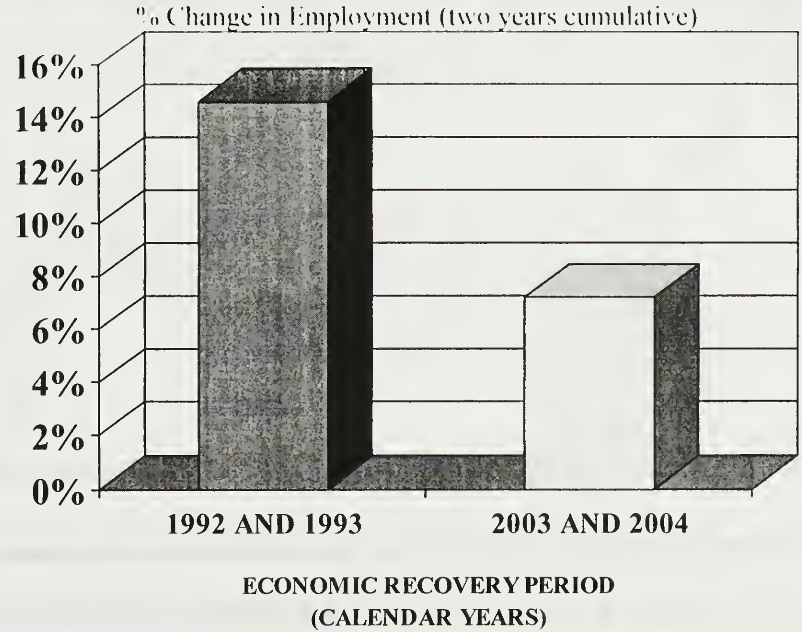
SOURCE: Economy.com (November 2004).

PRIMARY REASONS: HIGH N.C. DEPENDENCE ON MANUFACTURING* AND LACK OF TURNAROUND IN THIS SECTOR



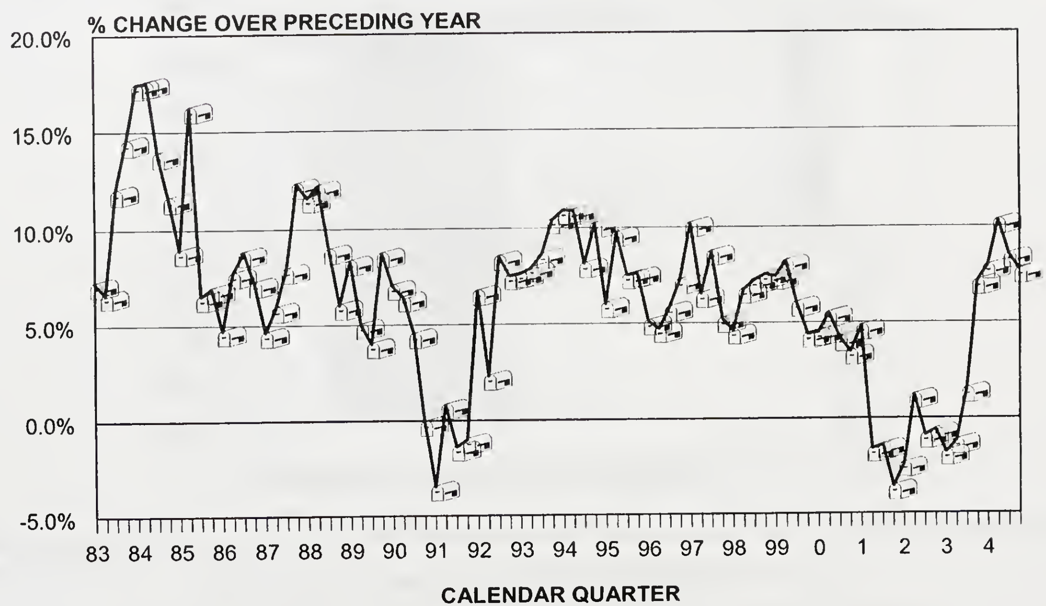
SOURCE: North Carolina's manufacturing employment is 15% of workforce versus 11% for U.S.

EMPLOYMENT RECOVERY HAS BEEN SLUGGISH IN OTHER SECTORS AS WELL: EDUCATION AND HEALTH SERVICES EMPLOYMENT



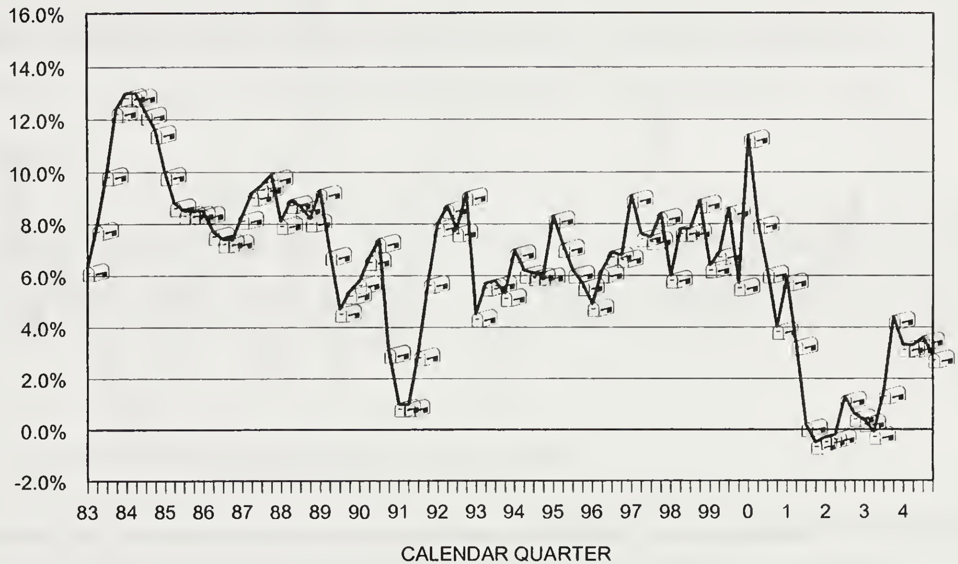
SOURCE: Economy.com.

SALES TAX REVENUES ARE STARTING TO BE AFFECTED BY PROLONGED HIGH ENERGY PRICES (UNIQUE TO THIS RECOVERY)



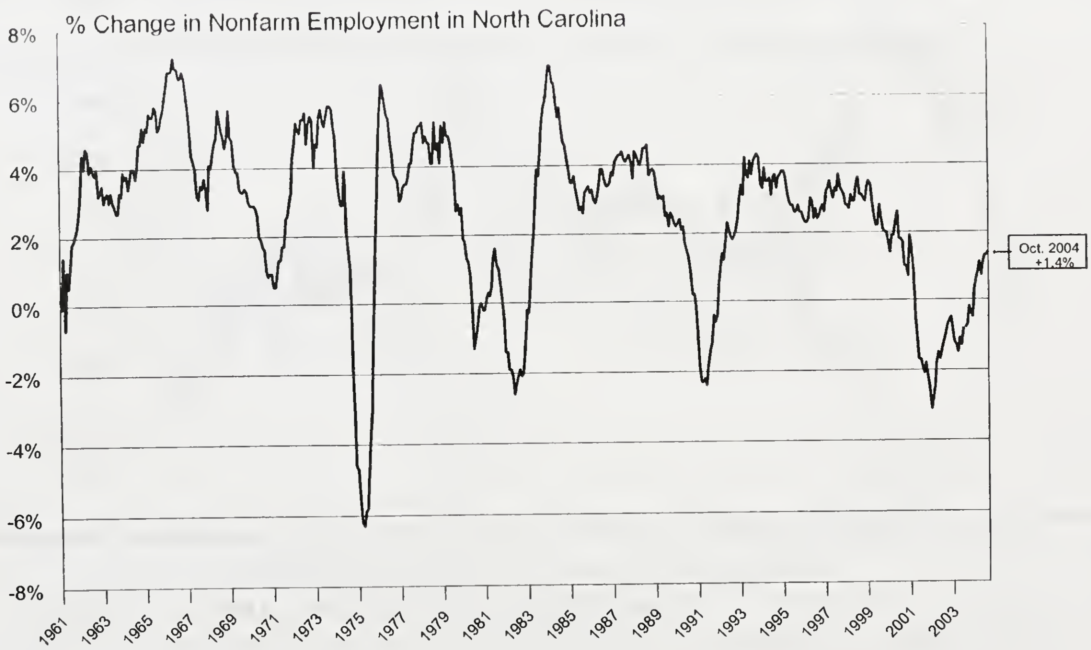
NOTE: The numbers reflect gross state and local sales tax collections, adjusted for tax law changes by Fiscal Research Division. Data for the current quarter includes October and November only.

WAGE AND SALARY PAYMENTS IN NORTH CAROLINA, A DRIVING FORCE BEHIND WITHHOLDING TAX RECEIPTS, HAVE EXPERIENCED A SUBPAR RECOVERY



SOURCE: Historical data based on Employment Security Commission. Data for second quarter 2004-fourth quarter 2004 comes from Fiscal Research Division estimate based on withholding tax receipts.

THE PRIMARY REASON HAS TO DO WITH SLUGGISH JOB GROWTH (RELATIVE TO PRIOR RECOVERIES)



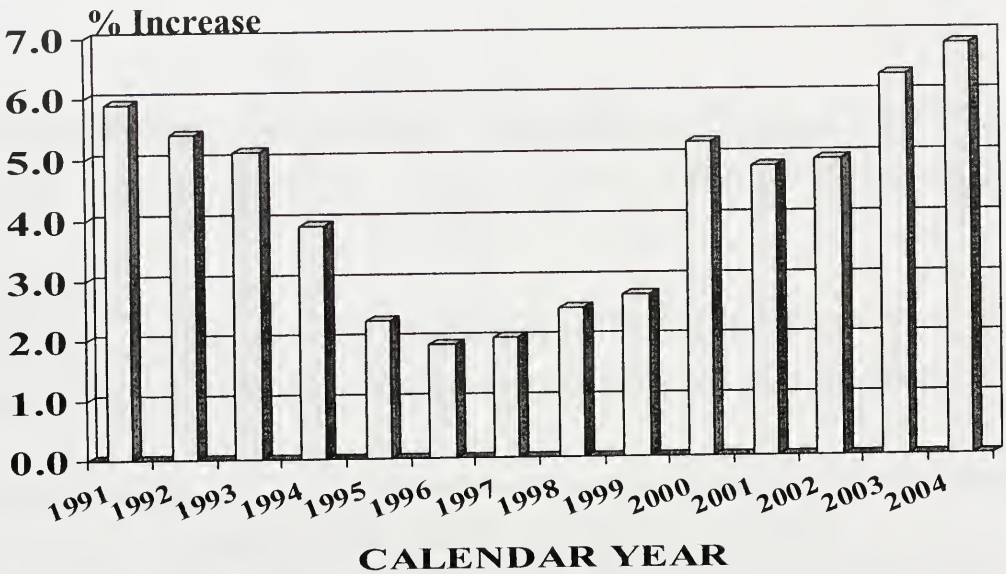
SOURCE: Employment Security Commission

ANOTHER UNIQUE FEATURE OF THE CURRENT RECOVERY IS STUBBORNLY HIGH HEALTH CARE COST INCREASES: IMPLICATIONS

- The State's cost of the Medicaid budget amounts to $2.4 billion. Thus, 9% annual growth amounts to over $200 million.

- Budget requirements for the cost of state health plan for teachers, state employees, and retirees will be substantial.

HERE IS AN EXAMPLE: AVERAGE EMPLOYMENT BENEFIT COSTS FOR CIVILIAN WORKERS*: NOTE MID-90'S SLOWING FOLLOWING 1990-91 RECESSION



*The primary source is the increase is health insurance costs.

SOURCE: Economy.com (November 2004)

LET'S RECAP THE UNIQUE FEATURES OF THE CURRENT ECONOMIC RECOVERY

- Stubbornly high energy prices are beginning to hurt spending on items subject to sales tax.
- Withholding tax receipts have been hampered by subpar job growth (personal income tax is 53% of revenue base and withholding payments make up 77% of this tax source).
- Health care cost increases have not experienced the usual decline following a recession.

HOW ARE OVERALL REVENUES PERFORMING?

- Through November, General Fund revenues are running about \$67.2 million ahead of \$5.9 billion target for the period (1.2%).

- Expressed in growth terms, receipts are up at 6.7% rate versus 5.5% "economy-based" budget forecast.

- However, the corporate income tax is \$74.1 million ahead of the target. This means that the remaining 93% of the revenue base is experiencing a \$6.9 million shortfall. Clearly, the revenue recovery is not broad-based.

- Of the \$67.2 million revenue surplus, \$30 million is from a one-time settlement of long-outstanding tax dispute. This means that the total recurring surplus is only \$37.2 million out of a \$5.9 billion target.

THE 2005-06 BUDGET OUTLOOK REFLECTS THE CARRY FORWARD OF THE STRUCTURAL BUDGET SHORTFALL FROM 2004-05

- A unique feature of state budget solutions around the country during 2001-04 was the abnormal dependence on one-time budget fixes. Some reasons:
    - Resistance to tax hikes
    - No appetite for deep cuts to education, human services, corrections/judicial (90% of most state budgets).
    - Perception that normal economic recovery would bail out future budgets.
- One-time measures used in the states included temporary tax hikes, special fund transfers, one-time budget cuts, tax payment accelerations, tax compliance initiatives, debt financing.
- Result: Even with revenue improvement, practically every state faces a 2005-06 budget gap.

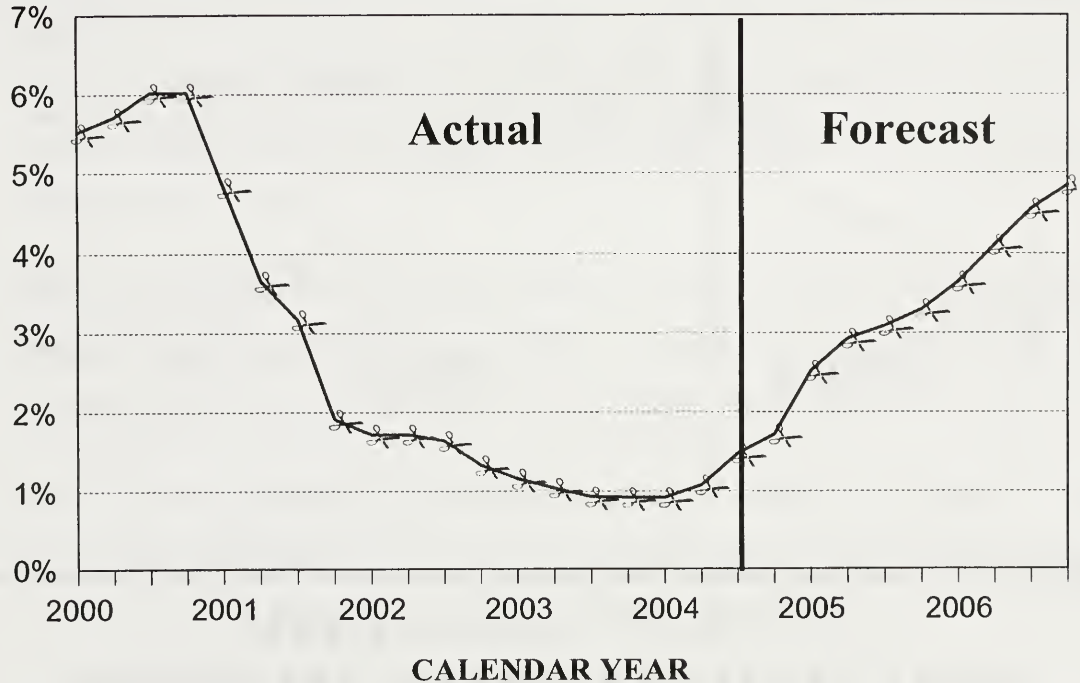
STATES ARE PESSIMISTIC ABOUT FEDERAL BUDGET PROSPECTS

- Renewed concentration on reining in ballooning deficit, combined with recent round of tax cuts and defense spending needs, may lead to sharp cuts in discretionary spending. State and local aid is part of this category.

- New federal tax cuts present a conformity decision for states (simplicity for taxpayers versus loss of revenue)

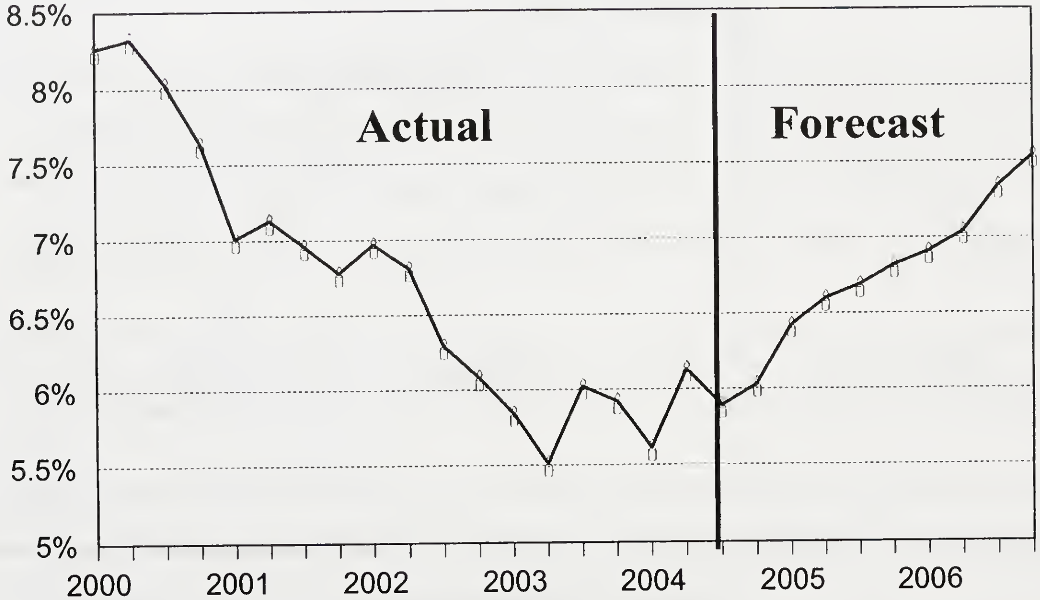
- State and local units are concerned that Congress may prohibit sales taxes on remote transactions (mail-order, internet) and internet telephone calls.

WHERE ARE INTEREST RATES HEADED: 3-MONTH TREASURY BILLS



SOURCE: Economy.com (November 2004).

WHERE ARE INTEREST RATES HEADED: FIXED MORTGAGE RATES



SOURCE: Economy.com (November 2004).

OUTLOOK FOR CAPITAL GAINS (STOCK PRICES)

- Stock market bubble led to explosive growth of capital gains reported on income tax returns (up 252% between 1994 and 2000).
- Bursting of bubble caused 85% drop in level of reported gains between 2000 and 2002. In short, most of the run-up in income tax collections has disappeared.
- Decline in gains or equities has been offset to some extent by gains on bonds, investment real estate, and other assets.

OUTLOOK FOR CAPITAL GAINS (STOCK PRICES) (Continued)

- 1982 to 1994 rise in stock prices (307%) caused by drop in interest rates from double-digit levels.
- With secular decline of interest rates and the stock market bubble behind us, equity prices should revert to typical business cycle behavior (affected by interest rates, corporate profits).
- Current high valuations cause experts to warn of modest 5-8% annual returns on stocks for next few years.
- This means that capital gains reported on income tax returns should track economic growth versus the super-heated period of 1982-2000. The good news is that carry forward losses from market crash have largely been used up.

APPENDIX D

STATE REVENUE OUTLOOK

Revenue Issues before the 2005 General Assembly

Linda Struyk Millsaps
Revenue Laws Study Committee
Fiscal Research Division

December 21, 2004

Overview

- Expiring Taxes
- Estate Tax
- IRC Update
- Streamlined Sales Tax
- E-911

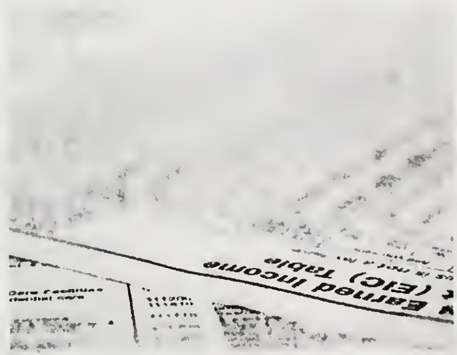
* Presentation does not address general revenue and budget issues.

Expiring Taxes

- **Sales Tax**
  - Most recent ½ cent state expires June 30, 2005.
  - Has been extended once.
  - Revenue estimates assume sunset takes place.
  - Value: $397 million
  - Options:
    - Allow to expire
    - Extend
    - Give to Counties (NCACC)
    - Replace, in part, with extension of sales tax into services and increase taxes on other items currently taxed at less than the general rate.

Expiring Taxes

- The **8.25% personal income tax** rate expires January 1, 2006.
- Was part of a package of “temporary” increases.
- Revenue estimate assumes sunset takes place
- Levied on the highest income taxpayers
  - $200,000 of taxable income-couple
  - $120,000 of taxable income-single
- Value: $46 million for 2005-06.
- Options:
  - Allow to expire
  - Continue
  - Combine with other items in a package



Estate Tax

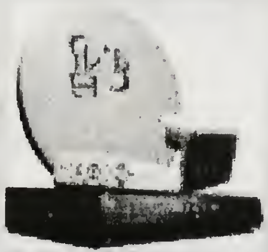
- History:
  - In 1998 NC ended state inheritance tax and replaced with an estate tax.
  - This tax is linked to the federal estate tax credit for state death taxes. Thus, it "picks up" the dollars that would otherwise go to Washington.
  - Federal "pick-up" expires 1/1/05 under 2001 federal legislation (phase out between 2002 and 2005)
  - Effectively eliminates the estate tax in NC
- Revenue estimates assume assume that tax expires
- Options:
  - Allow to expire.
  - Continue by linking to federal credit in place prior to federal action to phase-out.
  - Develop a free-standing inheritance or estate tax.

IRC Update

- Traditional Federal Code conformity bill.
- Generally has not been expensive or controversial.
- However…
  - Working Family Relief Act of 2004
  - American Jobs Creation Act of 2004

- Includes substantial changes for small business, agriculture, extension of some individual credits.
- Allows deduction of sales taxes paid.
- Options:
  - Full Conformity
  - Limited Conformity
  - No conformity (difficult)

Streamlined Sales Tax



- NC has been a leader in the Streamline effort since 2000.
- One of the final key pieces to conformity.
- Rubber meets the road.
- Requires moving the following categories from special rates (with caps) to the general rate or exempt entirely:
  - Farm equipment (1% or 1% with $80 cap)
  - Telecommunications (6%)
  - Direct TV (5%)
  - Funeral Expenses ($1,500 exemption)
  - Spirituous liquor (6%)
  - Fuel Oil for Farmers and Manufacturers (1%)

E-911

- Currently a 80 cent per month charge on mobile phones.
- Revenue goes to the Wireless Board:
  - Some county emergency expenditures (PSAPs)
  - Providers
- Historically the fund has been tapped by the Governor and the General Assembly.
- Agency has a significant fund balance.
- Federal Legislation now prohibits "fund raiding" in exchange for potential grant funds.

APPENDIX E

STREAMLINED SALES TAX UPDATE
CHARLES COLLINS, TAXWARE, INC.

Revenue Laws Study Committee

State of North Carolina
General Assembly

Streamlined Sales Tax Update

December 21, 2004
Charles Collins
Vice President, Taxware
First Data Government Solutions

Taxware

The Streamlined Sales Tax Initiative

- Nationwide, multi-state effort to "radically simplify sales and use tax compliance"
- Modernize tax administration
- Utilizing simplification, uniformity and technology
- Government effort with input and support of business, solution providers and legislators
- Targeted at obtaining federal and state transaction tax collection mandates

Who's Who:

Streamlined Sales Tax Project	Streamlined Sales Tax Implementing States	Streamlined Sales Tax Conforming States
Members are state tax administrators and business representatives	Members are state tax legislators or representatives appointed by Governor	Members are states that have enacted legislation to adopt streamlined sales tax agreement
42 states and District of Columbia involved. Need executive order from Governor or legislature to participate.	39 states and DC involved. States must enact legislation agreeing to the principles of streamlined sales tax agreement set forth by NCSL.	States were selected by co-chairs of Implementing States group
Drafted Streamlined Sales Tax Agreement language. Develops white papers on technical tax issues.	Debates recommendations of Streamlined Sales Tax Project from legislative perspective.	19 states have enacted legislation to conform their state sales tax laws to streamlined sales tax agreement
Votes on recommendations to be forwarded to Implementing states.	Votes on final language for Agreement and set out governance procedures for Agreement. Can amend agreement.	Focusing on administrative issues to get ready for Governing Board and implementation of Agreement

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Current Status

- Agreement adopted in Nov. 2002
- Focus has shifted to:
  - Passing and implementing Agreement in states
  - Implementing technology requirements
  - Planning and activating governing organization
- Current target date of 10/1/2005 for Agreement to be effective
- Provisions are effective per state law but effective date of Agreement brings potential of more taxpayers collecting
- Effort by government and business to verify that states are in conformance
- Education remains the key

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SSTI Legislative & Implementation Progress

- Fifteen states are in compliance with SSTI legislation
- Four states come into compliance in 2005
- 22 additional states are in process of enacting SSTI laws
- ***Proposed federal legislation could mandate sales tax collection after sufficient number of states enact SSTI laws***
- Other countries considering similar solutions
- Conforming States and TIGERS putting standards and technology provisoions in place now.
- Governing board effective 10/1/05

Blue states are in compliance with SSTI model legislation.

Red states have enacted SSTI model legislation, with prospective effective dates (Arkansas: 10/01/05; Ohio: 07/01/05; Tennessee: 07/01/05; Utah: 07/01/05).

Green states are participating in the SSTI. Many of these states have enacted most SSTI model legislation, although not enough to be in "substantial compliance."

states do not participate in the SSTI in any way.

Black states have no sales taxes.

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Chart of Conforming States:

	State	Population		Effective Dates	Percentage By 1/1/05
1	IN	6,080,485		1/1/2004	2.22
2	IA	2,926,324		7/1/2004	1.07
3	KS	2,688,418		7/1/2003	0.98
4	KY	4,041,769		7/1/2004	1.47
5	MI	9,938,444		9/1/2004	3.62
6	NE	1,711,263		1/1/2004	0.62
7	NC	8,049,313		1/1/2004	2.93
8	OH	11,353,140		1/1/2005	4.14
9	OK	3,450,654		11/1/2003	1.26
10	SD	754,844		1/1/2004	0.28
11	WV	1,808,344		01/01/04	0.66
12	WY	493,782		01/12/04	0.18
	Total	53,296,780			19.43

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Chart of Conforming States:

	State	Population		Effective Dates	Percentage By 7/1/05
13	MN	4,919,479		7/1/2005?	1.79
14	TN	5,689,283		7/1/2005	2.07
15	UT	2,233,169		7/1/2005	0.81
		12,841,931			4.67
Total		66,138,711			24.1

Taxware

Chart of Conforming States:

	State	Population		Effective Dates	By 1/1/06
16	AR	2,673,400		01/01/06?	0.97
17	ND	642,200		01/01/06	0.23
18	NV	1,998,257		01/01/06	0.73
19	VT	608,827		01/01/06?	0.22
		5,922,684			2.15
Total		72,061,395		Total	26.25

Chart of Conforming States:

	State	Population		Effective Dates	By 1/1/06
16	AR	2,673,400		01/01/06?	0.97
17	ND	642,200		01/01/06	0.23
18	NV	1,998,257		01/01/06	0.73
19	VT	608,827		01/01/06?	0.22
		5,922,684			2.15
Total		72,061,395		Total	26.25

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Timeline as of Fall 2004

- 7/1/05: Effective date of state conforming legislation where 20 percent threshold is met.
- 10/1/05: First day of a calendar quarter at least 60 days after the population threshold met on conforming legislation.

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Impact on States

- Improved compliance increases collections
- Simpler administration
- Gain more voluntary sellers
- Addresses remote commerce issue

Taxware

Impact on Merchants

- Simpler tax structure (multi-state merchants)
- Lower compliance cost
- Greater accuracy of tax calculations
- Less monitoring of tax law changes
- 3rd parties maintaining transaction tax systems
- Easier audits with less exposure (reduced audit defense & indemnification benefits)
- Addresses parts of Sarbanes Oxley

Taxware

What Is At Stake

- Increased collection due to improved compliance
- Increased collection of remote commerce

July 2004 Update: E-commerce loss to state and local governments is $15-16 Billion in 2003

By 2008 revenue projected loss for state and local governments ranges between $21.5 billion and $33.7 billion

North Carolina share: 2003 $342M to $356M

2008 $489M to $765M

Compliance Issues for N C

- Technical changes
- Provisions with delayed effective date (1-1-06)
  - Multiple rates
  - Caps and thresholds
- Clarification of sales tax holiday

Federal Legislation v. Agreement

Federal Legislation Provisions	Streamlined Sales Tax Agreement Provisions
Collection of taxes by remote sellers would be mandatory, except for certain small businesses with less than $5M in sales.	Collection of taxes by remote sellers would be voluntary, but sellers would need to volunteer to collect taxes for all "member" states.
States are required to provide sellers with "adequate compensation" to cover their costs of collecting taxes.	No compensation is provided to sellers, but compensation is provide to CSP's. Voluntary collectors relieved of certain liabilities.
Contains similar "simplification requirements" as SSTP, but requires SSTP to address additional issue, such as digital equivalents and multiple taxation relating to foreign sales.	Current version of Agreement does not address these issues, but SSTP project is working on recommendations that would be amended into Agreement. Would require states to enact additional legislation for any amendments.

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Federal Legislation v. Agreement

Federal Legislation Provisions	Streamlined Sales Tax Agreement Provisions
Gives sellers and taxpayers the right to have Federal Court review of simplifications.	Provides for review by Governing Board, which is comprised of states. Decisions of the Governing Board are final.
Simplifications must also apply to telecommunications taxes by 2006.	Simplifications only apply to sales taxes and do not apply to telecommunications taxes.
Applies to all states that meet "higher" federal simplification standards once threshold number of states has been met.	States must apply for membership and be certified by Governing Board vote. Agreement commences once threshold number of states has been met.

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Federal Legislation v. Agreement

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Applies to all states that meet "higher" federal simplification standards once threshold number of states has been met.	States must apply for membership and be certified by Governing Board vote. Agreement commences once threshold number of states has been met.

Taxware

Questions?

Charles.collins@taxware.com

Taxware

APPENDIX F

STREAMLINED SALES TAX PROJECT UPDATE
ANDREW SABOL, DIRECTOR OF THE SALES AND USE TAX DIVISION, DEPARTMENT OF REVENUE

STREAMLINED SALES TAX PROJECT UPDATE
December 2004

The Streamlined Sales Tax Project is an effort by states, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The Project began in March 2000 and has the goal of achieving sufficient simplification and uniformity to encourage sellers without nexus in states to voluntarily collect use tax in participating states. Forty-two states and the District of Columbia have by legislative or executive action authorized participation in the Project. This body of states is formed as the Implementing States.

In November 2002, the Streamlined Sales and Use Tax Agreement was approved by the Implementing States. The Agreement contains the uniformity and simplification provisions developed by the Project. The Agreement has been amended in each of the last two years to adopt items that the Project has continued to address. The Agreement becomes effective when at least ten (10) states representing 20% of the population of all states with a sales tax are in compliance with the provisions of the Agreement.

Over the last few years, states, including North Carolina, have enacted provisions to bring themselves into compliance with the Agreement. As of January 1, 2005, twelve (12) states representing 19.4% of the sales tax states' population are believed to be in compliance; as of July 1, 2005, fifteen (15) states representing 24.1% of the applicable population will be in compliance; and as of January 1, 2006, nineteen (19) states representing 26.3% of the population will be compliant.

The states that have taken actions necessary to bring themselves into compliance with the Agreement are in the process of completing a document termed a "compliance checklist." Each state indicates on the checklist which provision in the law or administrative code places them into compliance with each section of the Agreement. Completed checklists will be available for public comment, and states will be able to respond. Over the first half of 2005, the fifteen states that have indicated they will be in compliance with the Agreement as of July 1, 2005 will review each other's checklists. A meeting is planned for July 1, 2005, at which time a formal vote will be taken in consideration as to whether each state is in compliance. If the required thresholds are met, the ratified Agreement will be effective October 1, 2005.

The co-chairs of the Implementing States have appointed a subcommittee known as the Conforming States to develop administrative policies and procedures for carrying out the provisions of the Agreement once it is ratified. Each member state will have representation on a Governing Board, which has oversight of the terms of the Agreement once it is effective. The Conforming States Subcommittee has drafted bylaws and rules for the Governing Board and has issued an RFP for the obtaining of proposals for third-party certified service providers. The certified service provider concept is one of the technology models provided for in the Agreement that is expected to encourage remote sellers to voluntarily come forward to collect tax on sales to purchasers in the member states by relieving sellers of collection and reporting responsibilities.

North Carolina has adopted measures necessary for our State to currently come into compliance with the Agreement, although our Department will be making some technical recommendations for a few items. There are several multiple tax rate issues that need to be addressed in the 2005 Session in order for North Carolina to remain in compliance with the Agreement after January 1, 2006. These include the preferential rate of tax on certain agricultural items and the rates of tax on telecommunications services, direct-to-home satellite service, and spirituous liquor. We look forward to working with members of the General Assembly and their staff on these issues.

Our Department is working on technology items necessary under the Agreement. These include the ability to receive information from a central registration database for retailers participating under one of the Agreement's technology models, a simplified electronic return for use by these retailers, and a rate and boundary database for accessing the appropriate State and local rate of tax by zip code.

Thank you for the opportunity to present this update. My staff and I are always glad to provide any additional information. 2005 will be a milestone year for the Streamlined Project. We continue to appreciate the General Assembly's support and look forward to working on measures necessary for continued participation in the Project.

Submitted by: Andy Sabol, Director
Sales and Use Tax Division
N. C. Department of Revenue

APPENDIX G

HANDOUT ON THE ESTATE TAX ISSUE, PREPARED BY CANAAN HUIE, BILL DRAFTING DIVISION

Recent History of North Carolina Wealth Transfer Taxes
Y. Canaan Huie

Prior to 1999, North Carolina had a system for taxing wealth transfers that was composed of an inheritance tax on property transferred by a decedent and a gift tax on property transferred by a living donor. For both the inheritance and the gift tax, the amount of tax due was calculated based on tax rate schedules that varied depending on the relationship of the person transferring the property to the person receiving the property. This was in contrast to federal law in effect at that time, which had a unified rate schedule for estates and gifts.

For the inheritance tax, 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 were allowed a credit against the inheritance tax that effectively exempted from the inheritance tax the first $600,000 of the estate received by Class A beneficiaries. Class B beneficiaries had higher rates and were not allowed a credit. Class C beneficiaries had the highest rates and were not allowed a credit. Thus, North Carolina's rate structure favored transfers to ancestors, descendants, stepchildren, and children-in-law by giving those transfers the lowest rates and a credit and preferred transfers to other close family members over transfers to more distant relatives or to persons who were not related.

A similar structure was in place for the gift tax. Under the North Carolina gift tax at that time, gifts not exceeding a value of $10,000 from any particular donor to any particular donee were excluded from taxation. After applying this exclusion, gifts were taxed at varying graduated rates based on the relationship between the donor and the donee. Gifts that were made to lineal descendants, lineal ancestors, adopted children, or stepchildren were taxed at the lowest rates and were subject to a lifetime cumulative exemption of $100,000.[1] Gifts that were made to siblings, descendants of siblings, or aunts or uncles by blood were taxed at higher rates and did not enjoy the benefit of the exemption. Gifts that were made to other donees were taxed at the highest rates and did not enjoy the benefit of the exemption. Thus, as with the inheritance tax, North Carolina's gift tax rate structure favored transfers to children and parents by giving those transfers the lowest rates and an exemption and preferred transfers to other close family members over transfers to more distant relatives or to persons who were not related.

Other than a change in the annual exclusion amount, the General Assembly has not enacted any major changes to the gift tax since before 1998.[2] By contrast, the General Assembly

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[1] For gift tax purposes the favored class is slightly different than it was for inheritance tax purposes. A child-in-law whose spouse was not entitled to any of the decedent's property was a Class A beneficiary for inheritance tax purposes. Children-in-law are not mentioned in either of the preferred classes for gift tax purposes; therefore, gifts to children-in-law are taxed at the highest rates.

[2] In 2002, the General Assembly conformed the annual exclusion amount to the inflation-adjusted exclusion amount allowed for federal purposes. S.L. 2002-126, s. 30C.5(a). That amount is currently $11,000.

completely restructured the inheritance tax in 1998. As part of the Appropriations Act of 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 federal credit allowed under the Internal Revenue Code (the Code) for state death taxes.

In 2001, Congress amended the Code by enacting several major changes to the federal estate tax that have had a substantial impact on the North Carolina estate tax. First, Congress gradually increased the amount of the estate that is excluded from taxation.[3] Second, Congress repealed the estate tax effective in 2010.[4] Third, Congress phased out the state death taxes credit over four years.[5] The effect of this reduction and elimination of the state death taxes credit, if conformed to, would be to eliminate the North Carolina estate tax as of January 1, 2005.

In 2002 and 2003, the General Assembly evaluated the changes contained in the federal legislation and responded by partially conforming to the federal changes. North Carolina conformed to the increased exclusion amounts and to the 2010 repeal of the estate tax. Thus, as under previous law, an estate that is not subject to the federal estate tax is not subject to the state estate tax. However, North Carolina did not conform to the phase-out of the state death taxes credit. Based on the 2002 legislation, as amended in 2003, for decedents dying before July 1, 2005, the amount of the North Carolina estate tax is to be computed based on the state death taxes credit without regard to the phase-out and elimination of that credit. Without further legislative action, North Carolina will conform to the elimination of the state death taxes credit as of July 1, 2005, and the North Carolina estate tax will, for practical purposes, cease to exist for decedents dying on or after that date.

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[3] 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.

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

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

APPENDIX H

SUMMARY OF THE LIMITED CASE, PREPARED BY MARTHA WALSTON, FISCAL RESEARCH DIVISION

A&F Trademark, Inc. v. Tolson (The Limited Case)

(Summary prepared by Finance Team, December 20, 2004)

OVERVIEW: *This North Carolina Court of Appeals decision, filed December 7, 2004, upholds the State's position on the taxation of royalty income received by an out-of-state investment company for the use of trademarks in this State. The Court ruled that the out-of-state taxpayers, who hold the trademarks used in North Carolina, were doing business in North Carolina and that the assessment of corporate income and franchise taxes against the taxpayers was not a constitutional violation.*

FACTS

In this case, the taxpayers are nine wholly-owned subsidiaries[6] of the Limited Stores, Inc. The Limited also owns 100% of eight retail companies[7] who have retail subsidiaries doing business in more than 130 locations in North Carolina. These retail subsidiaries pay North Carolina corporate income and franchise taxes. During the 1980's and early 1990's, the Limited incorporated the taxpayers in Delaware to hold the trademarks owned by the Limited and the related retail companies. The taxpayers do not own or lease any real property or tangible personal property in any state except Delaware. The taxpayers have no employees in any state. The taxpayers entered into the following paper transactions, which had no substantive effect other than eliminating their North Carolina taxable income:

1. The taxpayers received the trademarks from the related retail companies for little or no consideration.
2. The taxpayers then entered into licensing agreements with the corresponding related retail companies. The licensing agreements authorized the related retail companies to continue to use the trademarks they had previously owned in exchange for royalty payments to the taxpayers. The royalty payments were based on a percentage of the retail companies' gross sales. However, the payments were not made by any transfer of funds but only by a bookkeeping entry.
3. The Limited and the related retail companies deducted these royalty payments from their income for North Carolina tax purposes.
4. Taxpayers then loaned these royalty payments back to the related companies for use in their retail operations. Taxpayers charged the retail companies a market rate of interest, which generated further income tax deductions for the related retail companies. No attempt was ever made by taxpayers to collect on outstanding loans. The taxpayers did not pay any income tax to any state on any of the income received from the related retail companies.

For the year at issue (1994), taxpayers recorded $301,067,619 in royalty income and $122,031,344 in interest income from the related retail companies. This accounted for 100% of taxpayers' income.

In September 2000, the Secretary of Revenue rendered a final decision finding that the taxpayers were doing business in this State and as such were subject to North Carolina corporate income and franchise tax. The Tax Review Board[8] confirmed the Secretary's decision. On May 22, 2003, the Wake County Superior Court affirmed the Tax Review Board's administrative decision in its

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[6] A&F Trademark, Inc.; Caciqueco, Inc., Expressco, Inc.; Lanco, Inc.; Lernco, Inc.; Limco Investments, Inc.; Limtoo, Inc.; Structureco, Inc.; V. Secret Stores, Inc.

[7] Lane Bryant, Inc.; Lerner, Inc.; Victoria's Secret, Inc.; Cacique, Inc.; Abercrombie & Fitch, Inc.; Limited Too, Inc.; Express, Inc.' and Structure, Inc.

[8] The Tax Review Board is composed of the following members: the State Treasurer, the chair of the Utilities Commission, a member appointed by the Governor, and the Secretary of Revenue.

entirety. The taxpayers then appealed to the North Carolina Court of Appeals.[9] In a decision filed December 7, 2004, the Court of Appeals affirmed the decision of the Wake County Superior Court. The following issues were presented on appeal:

1. Whether the taxpayers were "doing business" in North Carolina under the relevant statutory provisions.
2. Whether the State's attempt to assess the income and franchise taxes offends the Commerce Clause of the U.S. Constitution.

The Court of Appeals concluded that the taxpayers WERE doing business in the State and that the Commerce Clause did NOT forbid the imposition of corporate and franchise taxes against the taxpayers.

DECISION

The North Carolina Court of Appeals affirmed the lower court's decision and upheld the imposition of income and franchise taxes against taxpayers on the following grounds:

<u>Taxpayers were "doing business" in North Carolina under the relevant statutory provisions.</u>
Under G.S. §105-130.3, a tax is imposed on the net income of a corporation doing business in the State. The Secretary of Revenue adopted an administrative rule interpreting this statute and defining "doing business" to mean "the operation of any business enterprise or activity in North Carolina for economic gain, including...the owning, renting, or operating of business or income-producing property in North Carolina including...[t]rademarks [and] tradenames...." [10] The language adding trademarks and tradenames to the definition was added in 1992. In 2001, the General Assembly enacted § 105-130.7A stating that royalties received for the use of trademarks in this State are income derived from doing business in this State and thus are subject to N.C. income tax. The 2001 act also provided "taxpayer with an option concerning the method by which these royalties can be reported for taxation when the recipient and the payer are related members."[11] In finding that the taxpayers were doing business in North Carolina, the Court of Appeals emphasized that the 2001 legislation did not change what was already considered taxable income but merely enhanced compliance with the State tax on income generated from using trademarks and added a reporting option to the income tax statute. The Court concluded that the 2001 legislation supports the premise that the Secretary's interpretation of G.S. 105-130.3 set out in the administrative rules was consistent with the language of this statute. The administrative rule properly reflected the policy of the General Assembly for income taxation of trademark royalty payments and did not, as taxpayers argued, unlawfully expand the statute.

The Court of Appeals also rejected the taxpayers' argument that the imposition of franchise taxes exceeded statutory authority. North Carolina imposes a franchise tax on every corporation doing business in the State. Under G.S. 105-114(b)(3), "doing business" for franchise tax purposes is defined as "[e]ach and every act, power, or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State." The franchise tax is imposed on corporations for the opportunity and privilege of transacting business in the State. The Court found that the State "has provided privileges and benefits that fostered and promoted the

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[9] No. COA03-1203

[10] 17 NCAC 5C.0102

[11] S.L. 2001-327. The General Assembly expressly found that most corporations engaged in manufacturing and retailing activities in the State comply with the State tax on income generated from using trademarks in those activities; and it was the intent of this statute to reward taxpayers who comply by giving them an option on how to file tax returns involving royalty income.

related retail companies". Consequently, additional benefits have inured to the taxpayers. As support for its holding, the Court sited *Geoffrey, Inc. v. South Carolina Tax Commission,* 437 S.E.2d 13 (S.C. 1993). There the South Carolina Supreme Court upheld income tax imposed on that portion of a non-domiciliary trademark holding company's income derived from the use of its trademarks and trade names within South Carolina by a related retail company. The North Carolina Court of Appeals adopted the rationale of the *Geoffrey* court stating "that by providing an orderly society in which the related retail companies conduct business, North Carolina has made it possible for the taxpayers to earn income pursuant to the licensing agreements."

<u>North Carolina's attempt to assess income and franchise taxes against taxpayers did not offend the Commerce Clause of the U.S. Constitution.</u>

The Court of Appeals also rejected the taxpayers' argument that the Commerce Clause of the United States forbids the State from imposing income and franchise taxes on them. Taxpayers argued that the Commerce Clause requires that an activity must have substantial nexus with a taxing state before that activity can be taxed. Because they have no offices, facilities, employees, and real or tangible property in North Carolina, taxpayers claimed they have no physical presence in the State and, therefore, no substantial nexus. As support, taxpayers cited the U.S. Supreme Court rulings in *National Bellas Hess, Inc. v. Department of Revenue,* 386 U.S. 753, 18 L.Ed.2d 505 (1967) and *Quill Corp. v. North Dakota,* 504 U.S. 298, 119 L.Ed. 2d 91 (1992).[12] In rejecting the taxpayers' argument, the Court of Appeals found that the two cases cited by the taxpayers required a physical presence only for the imposition of sales and use taxes. The Court stressed that the physical presence requirement has never been established by judicial precedent for other forms of taxation. The Court also pointed out the distinctions between sales and use taxes and income and franchise taxes that make the physical presence test inappropriate here. For example, the *Bellas Hess* and *Quill* cases were use tax collection cases based on the vendor's activities in the state. The income and franchise taxes in the instant case are based solely on the taxpayers' receipt of income from the use of the taxpayers' property in this State by a commonly-owned third party. Moreover, a sales and use tax can make a taxpayer an agent of the state who is obligated to collect the tax from the consumer at the point of sale and then pay it over to the taxing entity. A state income tax is usually paid only once a year to one taxing jurisdiction at one rate, while a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates.

[12] *Bellas Hess* and *Quill* involved attempts by a state to require out-of-state mail-order vendors to collect and pay use taxes on goods purchased within the state despite the fact that the vendors had no outlets or sales representatives in the state. The Court in *Bellas Hess* concluded that the vendors' only contacts with the state were by mail or common carrier and that such contact did not satisfy the "substantial nexus" requirement of the Commerce Clause. The Court found that physical presence constituted nexus. The *Quill* Court reaffirmed the requirement that the vendors must have a physical presence in the state to satisfy the "substantial nexus" requirement,

APPENDIX I

SUMMARY OF THE CUNO CASE AND RECENT DEVELOPMENTS

Memorandum

Date: January 24, 2005

To: All Interested Parties

From: Canaan Huie, Staff Attorney, Bill Drafting Division

CanaanH@NCLEG.NET Ph. (919) 733-6660, Fax (919) 715-5459

Subject: Effect of *Cuno v. DaimlerChrysler* on North Carolina Economic Development Incentives – Updated

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I. Executive Summary

This memo is in response to questions about the effect of the decision in *Cuno v. DaimlerChrysler* on economic development incentives. The *Cuno* decision was handed down by the United States Court of Appeals for the Sixth Circuit and therefore is not binding in North Carolina. This memo will discuss the effect on North Carolina's economic development incentive programs if a similar ruling applied to them. At the present time it is impossible to predict the ultimate outcome of this case or its effects on North Carolina's, or any other state's, tax incentive programs. Nor is it possible to predict the outcome if a similar case were filed in North Carolina. Staff will monitor this issue closely and consult with the Attorney General's Office and other experts in order to advise the General Assembly as it contemplates any revisions to North Carolina's tax incentive programs.

North Carolina's economic development incentive programs based on grants, infrastructure development, or bonds would not be affected by a ruling relying on the reasoning laid out in the *Cuno* decision. The Sixth Circuit court specifically stated that "attempts to create location incentives through the state's power to tax are to be treated differently from direct subsidies despite their similarity in terms of end-result economic impact." However, many of North Carolina's tax incentives would potentially be affected by a ruling applicable in this jurisdiction that relied upon reasoning similar to that laid out in the *Cuno* decision.

II. Summary of *Cuno* Decision

On September 2, 2004, the Sixth Circuit Court of Appeals issued its decision in *Cuno v. DaimlerChrysler*, 386 F.3d 738 (2004, 6th Cir. (Ohio)). In that decision, the Court found that Ohio's investment tax credit violated the Commerce Clause of the United States Constitution, but simultaneously found that a personal property tax exemption did not violate the Commerce Clause. Shortly after the decision was announced, the State of Ohio petitioned the Sixth Circuit Court of Appeals for a rehearing *en banc*. On January 18, 2005, the Court denied that request.

Ohio's investment tax credit allows a nonrefundable credit against the state's corporate franchise tax for a taxpayer who purchases new manufacturing machinery and puts it in use in Ohio. The credit is equal to a percentage of the excess cost of the new machinery over a measure of average machinery and equipment expenditures in the county in which the machinery is put in use.

Ohio's tax statutes also allow municipalities to offer personal property tax exemptions to businesses that a) agree to establish, expand, renovate, or occupy a facility and b) hire new employees or maintain employment opportunities for current employees. The exemption applies to tangible personal property first used at the facility by the business after the date of the agreement entered into between the municipality and the business.

Plaintiffs in the case argued that the investment tax credit interfered with interstate commerce by encouraging further investment in the state at the expense of development in other states. The plaintiffs argued that the tax credit "coerced" businesses already subject to the Ohio tax to expand in-state rather than out-of-state to offset existing tax liability. Plaintiffs cited numerous Supreme Court cases in which the Court struck down tax schemes that had the effect of encouraging greater investment in the state at the expense of development in other states[13]. Plaintiffs further argued that the property tax exemption violated the Commerce Clause because it required the taxpayer to maintain a specified level of employment and investment in the state.

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[13] *See Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 97 S.Ct. 599 (1977); *Maryland v. Louisiana*, 451 U.S. 725, 101 S.Ct. 2114 (1981); and *Westinghouse Electric Corporation v. Tully*, 466 U.S. 388, 104 S.Ct. 1856 (1984). In *Boston Stock Exchange* the Supreme Court invalidated a New York tax provision that provided a significant reduction to the state's transfer tax when a sale of stock occurred within the state. The transfer tax applied to transfers of securities when any one of five taxable events, including deliveries or transfers of stock, occurred in the state. The purpose of the tax reduction when the stock was sold in the state was to encourage greater use of the New York Stock Exchange at the expense of regional stock exchanges. In *Maryland v. Louisiana*, the Supreme Court invalidated a complicated system of taxes and tax credits that had the effect of encouraging certain producers of natural gas to expand production in Louisiana at the expense of expanding production in other jurisdictions. In *Westinghouse* the Supreme Court invalidated a New York tax credit that was based on the portion of a taxpayer's exports that were shipped from within the State.

The defendants argued that the Supreme Court decisions should be read to allow tax incentives so long as they do not penalize out-of-state economic activity. They argued that the Supreme Court decisions prohibited tax credits and exemptions only to the extent they would either function like a tariff or provide different effective rates of taxation based on the mix of in-state and out-of-state activities.

The Sixth Circuit court held that Ohio's investment tax credit violated the Commerce Clause because the credit encouraged in-state economic development at the expense of out-of-state economic development and because the credit allowed the taxpayer to reduce pre-existing income tax liability by investing in-state but not by investing out-of-state. The Sixth Circuit rejected the defendants' arguments and found the distinction between laws that benefit in-state activity and laws that burden out-of-state activity to be one that was not supported by the relevant Supreme Court cases. The court noted that "economically speaking, the effect of a tax benefit or burden is the same." The court stated that the relevant Supreme Court opinions suggest that "constitutionality [should] not depend upon whether one focuses upon the benefited or burdened." (Quoting *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 273 (1984).)

The court limited its holding to tax incentives as opposed to grant incentives. It noted the Supreme Court's decisions in *New Energy Company of Indiana v. Limbach*, 486 U.S. 269, 108 S.Ct. 1803 (1988) and *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 114 S.Ct. 2205 (1994) and stated that "attempts to create location incentives through the state's power to tax are to be treated differently from direct subsidies despite their similarity in terms of end-result economic impact." The court concluded that tax incentives involve state regulation of interstate commerce but grant incentives do not.

The Sixth Circuit found that the property tax exemption did not violate the Commerce Clause. The court based its ruling on the following factors. First, the exemption applied only to the new personal property acquired for the facility and the "conditions imposed on the receipt of the Ohio property tax exemption are minor collateral requirements and are directly linked to the use of the exempted personal property." Second, the exemption did not require actions that might interfere with interstate Commerce, such as a requirement for creation of new jobs or for the operation of additional business activities. Third, the exemption differed from a credit in that it reduced only potential future tax liability rather than any pre-existing liability. Fourth, the property would escape Ohio taxation regardless of in which state the property was placed – either because of the exemption in Ohio or because the property was placed out-of-state where Ohio could not tax it.

III. Possible Ultimate Outcomes of *Cuno*

There are any number of possible ultimate outcomes of the *Cuno* decision. As mentioned previously, the *Cuno* decision is a decision by the Sixth Circuit Court of Appeals. As such, the decision is persuasive throughout the nation, but binding only in the Sixth Circuit, which is composed of Kentucky, Michigan, Ohio, and Tennessee.

In addition, there remains one opportunity for appeal that could overturn this decision. As mentioned earlier, the defendants in this case asked for a hearing by the Sixth Circuit *en banc*. The Sixth Circuit denied that request. The defendants could still ask the United

States Supreme Court to review the decision. The Supreme Court might or might not chose to hear the case and, if it accepts the case, one cannot predict whether it would uphold the Sixth Circuit ruling. Any decision by the Supreme Court would be binding not only on the states in the Sixth Circuit, but on the entire nation.

At the present time it is impossible to predict the ultimate outcome of this case or its effects on North Carolina's, or any other state's, tax incentive programs. Nor is it possible to predict the outcome if a similar case were filed in North Carolina. Staff will monitor this issue closely and consult with the Attorney General's Office and other experts in order to advise the General Assembly as it contemplates any revisions to North Carolina's tax incentive programs.

IV. Application to North Carolina's Economic Development Incentive Programs

North Carolina has made extensive use of a variety of economic development incentive programs. These programs can be divided into four broad categories: tax incentive programs such as the Bill Lee Act and the tax credits for recycling facilities, grant programs such as JDIG and the One North Carolina Fund, infrastructure development programs such as the Industrial Development Fund, and bond programs such as the Industrial Revenue Bond program.

Given the Sixth Circuit's ruling in this case and the Supreme Court's rulings in *New Energy Co.* and *West Lynn Creamery*, one can fairly safely assume that a ruling based on the Commerce Clause would not affect three of the four broad categories of incentives utilized in North Carolina – grant programs, infrastructure development programs, and bond programs.[14] While never having "squarely confronted the constitutionality of subsidies,"[15] the Supreme Court has stated that, "[d]irect subsidization of domestic industry does not ordinarily run afoul of [the Commerce Clause]."[16] However, many of North Carolina's tax incentive programs would likely be negatively affected by a ruling such as *Cuno* if applied in this State.

North Carolina's tax incentives for economic development fall into two major categories, which will be analyzed separately below. In some cases, the incentive takes the form of an exemption from, refund of, or preferential rate for sales and use taxes. Examples of these types of tax incentives include the following:

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[14] This should not be read as a categorical statement that these economic development incentive programs would withstand any constitutional challenge. For example, it has been argued that economic development incentive grant programs may violate the North Carolina Constitution's requirement that the power of taxation be used only for a public purpose (Article V, Section 2(1), North Carolina Constitution) or its prohibition against exclusive emoluments (Article V, Section 32, North Carolina Constitution). However, the North Carolina Supreme Court's opinion in *Maready v. City of Winston-Salem*, 342 N.C. 708, 467 S.E.2d 615 (1996), is generally read to authorize such programs.

[15] *West Lynn Creamery*, 512 U.S. at 199, n. 15.

[16] *New Energy Co.*, 486 U.S. at 278.

- The sales and use tax exemption authorized under G.S. 105-164.13(22a) for sales of audiovisual masters made or used by a production company in making visual and audio images for first generation reproduction.

- The refund, authorized under G.S. 105-164.14(g) and (j), of sales and use taxes paid on building materials that become part of certain industrial facilities.

- The preferential sales and use tax rate on manufacturing machinery authorized under G.S. 105-164.4(1d) and G.S. 105-164.4A.

Most often, however, the tax incentive takes the form of a credit against the income, franchise, or gross premiums tax. There are numerous examples of these types of credits, including the tax credits under the Bill Lee Act and the tax credits for major recycling facilities.

A. Sales and Use Tax Incentives. The tax incentives that take the form of an exemption from or preferential rate for sales and use taxes would not violate the Commerce Clause under the reasoning of the Sixth Circuit court in the *Cuno* decision. As with the personal property tax exemption in Ohio, these tax incentives are related to "the use or location of the property itself." In addition, the applicability of the exemption or preferential rate is not conditioned on the consumer having any economic presence in this State and is not limited to property that is put into service in this State.

It is less clear whether the refunds of sales and use taxes paid on building materials would violate the Commerce Clause under the reasoning laid out in *Cuno*. In order to qualify for the sales tax refund on building materials that become part of a major recycling facility or of an eligible industrial facility the taxpayer must make a significant and continuing economic investment in this State.[17] This requirement appears to be problematic for two reasons. First, because eligibility for the refund requires that the project be located in this State, building materials that are purchased in this State for use in a project located outside of the State are not eligible for the refund. This tax treatment discriminates against building materials purchased in this State for use in other states. In addition, this gives the taxpayer additional encouragement to in-State economic investment at the expense of out-of State economic development. Second, the refund encourages a company that has decided to locate within this State to also purchase building materials within this State because other states' sales taxes on material purchased outside North Carolina would not qualify for the refund.[18] The effect of this provision is to encourage the business to engage in an additional

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[17] In the case of a major recycling facility, the taxpayer must invest at least $300 million in the facility and create at least 250 new, full-time jobs at the facility. If the taxpayer fails to make the required amount of investment or create the required number of jobs within the required periods, the taxpayer is liable for any sales and use taxes previously refunded. *See G.S. 105-164.14(g) and G.S. 105-129.26.* In the case of an eligible industrial facility, the taxpayer must invest at least $50 million, depending on facility location, to construct the facility. In this case, construction costs include the costs of acquisition and equipping the facility.

[18] Although the refund applies to both sales and use taxes, use taxes are due only to the extent that the taxpayer has not paid a sales tax on the materials in another jurisdiction.

form of commerce in this State, the purchase of building materials and supplies. For both of these reasons, it is possible that a court could strike down the sales tax refund provision as violating the Commerce Clause.

B. Income, Franchise, and Gross Premiums Tax Incentives. Before 1996, North Carolina had made little use of tax incentives to lure businesses to the State. The General Assembly created the William S. Lee Quality Jobs and Business Expansion Act (Bill Lee Act) in 1996 effective beginning with the 1996 tax year. The Act is a package of State tax incentives, primarily in the form of tax credits for investment in machinery and equipment and certain real property, job creation, worker training, and research and development. Most of the Bill Lee Act credits are set to expire January 1, 2006. Shortly following the enactment of the Bill Lee Act, the General Assembly enacted numerous other tax credits targeting recycling facilities, business and energy property, historic rehabilitation, and low-income housing. The State also has a number of tax credits available to businesses engaging in specific activities, some of which predate the mid-1990s. Many of these credits appear to be vulnerable to a decision such as that issued in *Cuno*. The remainder of this memo will analyze these credits taking into consideration the issues raised in *Cuno*.

1. Bill Lee Act. All of the credits under the Bill Lee Act are similar to the Ohio credits and therefore appear to be vulnerable to constitutional attack based on the reasoning in the *Cuno* decision. In order to be eligible for credits under the Bill Lee Act, a taxpayer must engage in certain activities in this State. The credits allowed under the act are applied against the income, franchise, or gross premiums tax. All of the credits under the Act, with the possible exception of the credit for increasing research and development expenditures, are similar to Ohio's investment tax credit in that they allow a credit for business activities that occur in-State but not for identical activities that occur out-of-State. As with the Ohio investment tax credit, "the economic effect ... is to encourage further investment in-state at the expense of development in other states and ... the result is to hinder free trade among the states."

Several of the credits under the Bill Lee Act raise additional concerns in that receipt of the credit is conditioned on another independent factor that also appears to violate the Commerce Clause. The inherent problem with the credits relating to investment in central administrative or aircraft property (G.S. 105-129.12) and to substantial investment in other property (G.S. 105-129.12A), (that they encourage in-State investment at the expense of out-of-State investment), is compounded by the fact that these two credits also require the creation and maintenance of new jobs in this State. In effect, in order to be eligible for these credits, the taxpayer must not only decide to invest in more property in this State, but must also increase operations at those facilities.

The analysis regarding the credits for increasing research and development expenditures is more complex than the analysis for other credits under the Act. There are two research and development credits, the original credit that is set to expire in 2006 and the new credit, which goes into effect May 1, 2005. The new research and development credit is similar to the other Bill Lee Act credits and will be vulnerable to a *Cuno* attack for the same reasons. The original research and development credit, however, is allowed to a taxpayer that increases research and development expenditures regardless of where those new expenditures are made. At first glance, the original credit would appear to survive under the reasoning laid out in *Cuno* because the taxpayer receives the benefit of the credit regardless of where the increase in research and development expenditures occurs. However, the manner in which this credit is calculated is problematic. The amount of the credit allowed is equal to 5% of the State's apportioned share of the taxpayer's expenditures for increasing research and development. Therefore, two companies subject to tax in North Carolina that have identical increases in expenditures could receive very different credits based on the cumulative percentage of research and development performed in this State. At the extreme, one taxpayer could receive a tax credit equal to 5% of increased expenditures whereas the other taxpayer could receive no credit at all. Even though its discriminatory tax effect is smaller than that of the new credit or the other credits of the Bill Lee Act, the original credit may still be vulnerable under the reasoning in the *Cuno* decision because it clearly encourages further research and development expenditures in this State at the expense of further expenditures in other jurisdictions.

2. Tax Incentives for Recycling Facilities. The credits regarding large and major recycling facilities appear to be vulnerable to constitutional attack based on the reasoning in the *Cuno* decision. Eligibility for these credits is based upon the taxpayer making a substantial investment in a facility and creating new jobs within an enterprise tier one area in this State. If the taxpayer satisfies these requirements, the taxpayer is eligible for a credit equal to a percentage of the cost of machinery and equipment purchased or leased for use in the facility. As with the Bill Lee credits and the Ohio investment tax credit, this credit is problematic in that the clear purpose is to encourage investment in this State at the expense of development in other jurisdictions. Further, as with those credits, this credit lowers the overall pre-existing tax burden of companies that invest in-State rather than out-of-state.

In addition, a major recycling facility that is accessible by neither ocean barge nor ship and that transports materials to the facility or products away from the facility is eligible for a reinvestment credit equal to its additional expenses due to its inability to use ocean barges or ships. Although the reinvestment credit appears similar to the Ohio property tax exemption in some ways, there are significant differences. First, this is an income tax credit rather than a property tax exemption and thus can offset preexisting liability if the taxpayer was already doing business in the State. The Sixth Circuit in *Cuno* found there to be a "fundamental difference" between tax credits that offset pre-existing income tax liability and exemptions that allow a taxpayer to avoid liability for new property. Second, receipt of the reinvestment credit requires that the taxpayer invest at least $300 million in the facility in this State and that the facility create at least 250 new jobs. The taxpayer must then have additional expenses related to infrastructure improvements or addition facility costs before the taxpayer is eligible for the credit. Receipt of this credit therefore clearly requires a substantial and ongoing presence in this State. As with the other credits discussed so far, the credit is vulnerable to attack under the *Cuno* reasoning because the purpose is to encourage investment in this State at the expense of development in other jurisdictions.

3. Business and Energy, Historic Rehabilitation, and Low-Income Housing Tax Credits. The credits in Articles 3B, 3D, and 3E of Chapter 105 of the General Statutes are more difficult to analyze than either the Bill Lee Act credits or the recycling facility credits. Although more limited in scope than Ohio's investment tax credit, these credits are similar to the Ohio incentive in that a credit against existing tax liability is allowed to a taxpayer that undertakes certain activities in this State but not if the activity occurs in another state. All of these credits arguably are facially discriminatory in that they offer a credit for activity that occurs in-State but do not offer a credit for the exact same activity when it occurs out-of-State. The Supreme Court has held that legislation that may appear to be facially discriminatory may still be upheld if it advances "a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." *New Energy Co.,* 486 U.S. at 278. *See also Maine v. Taylor*, 477 U.S. 131, 106 S.Ct. 2440 (1986). Although the tax credits contained in these Articles clearly advance legitimate local purposes such as historic rehabilitation, the provision of low-income housing, and the use of renewable energy, it is clear that there are other reasonable nondiscriminatory alternatives available. These alternatives could include direct subsidies for these activities or exemptions of relevant property from the property tax.

On the other hand, one could argue that these statutes are not facially discriminatory in that in-State and out-of-state businesses are treated alike and that the statutes do not encourage in-State investment at the expense of out-of-state development. When a statute is not facially discriminatory it must be subjected to "a sensitive case-by-case analysis of purposes and effects," to determine if the provision "will in its practical operation work discrimination against interstate commerce." *West Lynn Creamery*, 512 U.S. at 201. The purpose of these statutes does not appear to be encouraging economic activity in this State at the expense of activity in other states, but rather providing an incentive for solving a specific local problem. For example, the intent of the credit for low-income housing is add new affordable housing in this State, not to shift low-income housing from another state to this State. It is unclear at the present time whether these credits would be found to have the effect of working discrimination against interstate commerce.

It is very unclear how most of these credits would fare under the reasoning applied in the *Cuno* decision. Although one cannot with certainty state how a court would rule on this issue, these credits appear to be less vulnerable to attack under the court's reasoning in *Cuno* than either the Bill Lee Act credits or the tax credits for recycling facilities. One possible exception to this general statement is the newly enacted credit for construction of renewable fuel facilities.[19] Unlike the other credits in these Articles, this credit involves an on-going business operation rather than a discrete, one-time investment in property. For that reason, a court relying on the reasoning laid out in *Cuno* is probably more likely to find this credit to be similar to the Ohio investment tax credit and thus to violate the Commerce Clause by encouraging in-State investment at the expense of out-of-State investment.

4. Other Corporate Income Tax Credits. North Carolina also has numerous other corporate income tax credits that may be vulnerable under the reasoning in *Cuno*. Many of the arguments regarding the constitutionality of these credits are the same as the arguments thoroughly discussed above. The following points will briefly state whether the specific credits appear to be fairly vulnerable to attack like the Bill Lee Act credits, fairly safe from attack, or whether the credit's vulnerability is very uncertain.

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[19] G.S. 105-129.16D was enacted in S.L. 2004-153. It becomes effective with the 2005 taxable year and expires as of January 1, 2008.

a. *G.S. 105-130.22, Credit for construction of dwelling units for handicapped persons.* The reasoning that applies to the tax credits for low-income housing is equally applicable here. This credit appears to be less vulnerable to attack than the Ohio investment tax credit or the Bill Lee Act credits or recycling facility credits. However, this credit could not be described as "safe."

b. *G.S. 105-130.25, Credit against corporate income tax for construction of cogenerating power plants.* The reasoning that applies to the Bill Lee Act credits and the recycling facility credits appears to be most appropriate here. This credit encourages economic development in this State at the expense of the same development in other states.

c. *G.S. 105-130.28, Credit against corporate income tax for construction of a renewable energy equipment facility.* The reasoning that applies to the Bill Lee Act credits and the recycling facility credits appears to be most appropriate here. This credit encourages economic development in this State at the expense of the same development in other states.

d. *G.S. 105-130.34, Credit for certain real property donations.* The reasoning that applies to the tax credits for historic rehabilitation appears to be most appropriate here. This credit appears to be less vulnerable to attack than the Ohio investment tax credit or the Bill Lee Act credits or recycling facility credits. However, this credit could not be described as safe.

e. *G.S. 105-130.36, Credit for conservation tillage equipment.* The reasoning that applies to the tax credits for renewable energy property appears to be most appropriate here. This credit appears to be less vulnerable to attack than the Ohio investment tax credit or the Bill Lee Act credits or recycling facility credits. However, this credit could not be described as safe.

f. *G.S. 105-130.37, Credit for gleaned crops.* This credit makes no distinction as to whether the activity occurs in-State or out-of-State. This credit is not vulnerable under the reasoning in the *Cuno* decision.

g. *G.S. 105-130.39, Credit for certain telephone subscriber lines.* This credit seeks to compensate a taxpayer for added burdens placed on the taxpayer by the State. Because the credit compensates the taxpayer for a burden placed on the taxpayer by the State and does not favor in-State economic interests over out-of-State interests, this credit is not vulnerable under the reasoning in the *Cuno* decision.

h. *G.S. 105-130.41, Credit for North Carolina State Ports Authority wharfage, handling, and throughput charges.* This credit raises issues regarding the State's role as market participant as opposed to being a market regulator. Since this credit involves the application of the State's tax code, the State is acting more in a role as a market regulator than as a market participant. Under this interpretation, this credit would be vulnerable under the *Cuno* reasoning since the State is clearly encouraging in-State economic interests at the expense of out-of-State economic interests. In addition, other reasonable nondiscriminatory alternatives exist. The State could, as a market participant, provide a direct subsidy for exports through the State Ports.

i. *G.S. 105-130.43, Credit for savings and loan supervisory fees.* This credit seeks to compensate a taxpayer for added burdens placed on the taxpayer by the State. Because the credit compensates the taxpayer for a burden placed on the taxpayer by the State and does not favor in-State economic interests over out-of-State interests, this credit is not vulnerable under the reasoning in the *Cuno* decision.

j. *G.S. 105-130.44, Credit for construction of poultry composting facility.* The reasoning that applies to the tax credits for renewable energy property appears to be most appropriate here. This credit appears to be less vulnerable to attack than the Ohio investment tax credit or the Bill Lee Act credits or recycling facility credits. However, this credit could not be described as safe.

k. *G.S. 105-130.45, Credit for manufacturing cigarettes for exportation.* This credit is not vulnerable to attack under the reasoning in the *Cuno* decision because the credit does not favor in-State economic interests over out-of-State economic interests. However, this credit could be vulnerable under the Commerce Clause under other theories.[20] This credit is allowed for exports to foreign nations or to United States possessions or United States commonwealths that are not states. It is unclear how United States possessions and non-state commonwealths should be treated for purposes of analysis under the Commerce Clause. It is also unclear whether this credit would violate the Commerce Clause's provision stating that the federal government has the power to "regulate trade with foreign Nations...". U.S. Const., art. I, § 8, cl. 3.

l. *G.S. 105-130.46, Credit for manufacturing cigarettes for exportation while increasing employment and utilizing State Ports.* This credit is vulnerable to attack under the reasoning in the *Cuno* decision. This credit differs from the other credit for manufacturing cigarettes for exportation in several key ways. First, this credit requires the taxpayer to create 800 new jobs in North Carolina and to maintain those jobs for up to 12 years to take full advantage of the credit. Second, this credit requires the taxpayer to make some use of the State Ports, although no percentage is specified. For these reasons, the credit is vulnerable to attack under the reasoning in the *Cuno* decision because it favors in-State economic activity over out-of-State economic activity and it requires a substantial ongoing economic investment in this State. It is also unclear whether this credit would violate the Commerce Clause's provision stating that the federal government has the power to "regulate trade with foreign Nations...". U.S. Const., art. I, § 8, cl. 3.

m. *Article 3G of Chapter 105, Tax Incentives for Major Computer Manufacturing Facilities.* This credit is vulnerable to attack under the reasoning in the *Cuno* decision. The credit is similar to Ohio's investment tax credit in that it allows a credit for business activities that occur in-State but not for identical activities that occur out-of-State. As with the Ohio investment tax credit, "the economic effect ... is to encourage further investment in-state at the expense of development in other states and ... the result is to hinder free trade among the states." The credit raises additional concerns because receipt of the credit is conditioned on another independent factor that may violate the Commerce

[20] In addition, questions have been raised as to whether this provision would violate certain federal trade agreements such as NAFTA or GATT. The same issues arise with respect to G.S. 105-130.46, discussed later in this memo.

Clause. The inherent problem with the credit is compounded by the fact that the credit also requires the creation and maintenance of new jobs in this State. In effect, in order to be eligible for these credits, the taxpayer must not only decide to invest in more property in this State, but must also increase operations at those facilities. Additionally, the credit requires an investment of at least $100 million in real and personal property in the State.