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## State Taxation

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The changes made in the state tax laws by the 2001 General Assembly were many. Some were technical, but many were substantive and intended in many cases to increase the rates for some taxes and to accelerate the payment of others. This chapter discusses the changes in taxes levied by the state. Legislation affecting local taxes and financial matters is discussed in Chapter 16, “Local Government and Local Finance,” and Chapter 17, “Local Taxes and Tax Collection.”

### **Tax Administration**

#### **Waiver of Penalties**

S.L. 2001-87 (H 150) adds a new subsection to G.S. 105-249.2 that prohibits the Secretary of Revenue from assessing any penalties for failure to obtain a business license, failure to file a return, or failure to pay taxes, if the license, return, or taxes are due during the time federal tax-related deadlines are extended because of a presidentially declared disaster. The taxpayer residing or having a business in the affected area is still liable for interest that accrues from the original due date until the date the tax is paid. This proposal codifies the Department of Revenue’s current published penalty policy: the occurrence of a disaster is an automatic reason to waive penalties.

#### **Department of Revenue Collection Procedures**

Since 1999, the General Assembly has authorized a pilot program for the collection of tax debts owed by nonresidents and a study of the Department of Revenue’s delinquent collection practices. Project Collect Tax, the Department of Revenue’s initiative to collect at least \$100 million in overdue taxes in the 2001–2003 biennium, is an outgrowth of these efforts. S.L. 2001-380 (S 353) enables the department to execute Project Collect Tax by making the following changes in the tax laws:<sup>1</sup>

- It makes permanent the department’s authority to use collection agencies to collect out-of-state tax debts.
- It authorizes the department to use collection agencies to collect in-state tax debts for two years.

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1. The General Assembly also appropriated funds for fifty-two new positions in the Department of Revenue and twelve contract positions for Project Collect Tax.

- It imposes a collection assistance fee of 20 percent on all tax debts that remain unpaid for ninety days after they become final.
- It allows the Department to use the receipts from the collection assistance fee to provide the resources needed for Project Collect Tax.

S.L. 2001-380 substitutes a broader debt collection program for the pilot program. Under the new program:

- The Department of Revenue may outsource out-of-state tax debts permanently and may outsource in-state tax debts for two years.<sup>2</sup>
- The cost of collecting tax debts that are at least ninety days overdue is shifted from the state's general revenues to the delinquent taxpayer, by providing that the taxpayer must pay a collection assistance fee of 20 percent of the overdue tax debt.<sup>3</sup>

The act provides permanent authority for the Department of Revenue to outsource tax debts as long as it continues its practice of notifying the taxpayer prior to submitting the debt to a collection agency. The taxpayer has thirty days after the notice is sent to pay the tax debt. If the debt remains unpaid at the end of the thirty days, then the debt may be outsourced to a collection agency. The collection agencies that contract to collect tax debts are prohibited from revealing confidential tax information. If a contractor reveals tax information, it is subject to a misdemeanor penalty, its contract is terminated, and it is barred from contracting again for five years. The act also establishes a system under which the cost of collecting overdue tax debts is to be borne by the delinquent taxpayers, not by the taxpayers who pay their taxes on time. The act provides that a collection assistance fee is imposed if the department gives the taxpayer thirty days' notice and the taxpayer does not pay the debt within that period. The thirty-day fee notice may not be mailed until at least sixty days after the final assessment for the tax debt, with the result that the fee applies only to tax debts that remain unpaid for ninety days or more after final assessment. The fee does not apply to a tax debt if the taxpayer entered into an installment agreement within ninety days after the final assessment and remains current with payments under the agreement. In addition, the Secretary of Revenue may waive the fee in other situations to the same extent as if the fee were a penalty. The fee is 20 percent of the overdue tax debt and is a receipt of the department. The proceeds of the collection assistance fee are credited to a special, non-reverting account to be used only for collecting overdue tax debts.<sup>4</sup> The Department of Revenue may use the fee proceeds to pay contractors for collecting tax debts and to pay the fee charged by the federal government for collecting tax debts by offsetting the debt against the taxpayer's federal income tax refund. The remaining proceeds of the fee may be used for collecting overdue tax debts only pursuant to appropriation by the General Assembly.

The Department of Revenue must report periodically on its debt collection activities to the Joint Legislative Commission on Governmental Operations and to the Revenue Laws Study Committee.<sup>5</sup> The reports must include a breakdown of the amount and age of tax debts collected by collection agencies on contract, tax debts collected by the Department through warning letters, and tax debts otherwise collected by department personnel. They must also include a long-term collection plan, a timeline for implementing each step of the plan, a summary of steps taken since the last report and the results of those steps, and any other data requested.

The act makes several conforming changes:

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2. Section 8 of the act provides that the authority to outsource tax debts owed by North Carolina taxpayers sunsets October 1, 2003. During this two-year period, the department would like to outsource low-priority in-state tax cases to a collection agency. The department anticipates referring income tax assessments with a value of \$25 to \$500 in initial referrals.

3. The act states the General Assembly's findings that the Department of Revenue's cost of collecting overdue tax debts equals or exceeds 20 percent of the tax debts and that the cost of collecting overdue tax debts is currently borne by taxpayers who pay their taxes on time. It also states the General Assembly's intent that the collection assistance fee will pass that cost on to delinquent taxpayers who owe overdue tax debts.

4. The Current Operations and Appropriations Act of 2001, S.L. 2001-424, Section 14D.1, provides that the proceeds of the fee are to be transferred to a separate fund code in the Department of Revenue's budget.

5. The reports must be submitted quarterly beginning November 1, 2001, and semiannually beginning November 1, 2002.

- The state submits some tax debts for collection through the U.S. Department of the Treasury Offset Program. Under prior law, the Department of Revenue imposed a \$15 collection assistance fee on each tax debt collected through the federal Treasury Offset Program. Because this act imposes a collection assistance fee on all overdue tax debts, it repeals the fee that applied to debts submitted to the federal Treasury Offset Program, in order to avoid a double fee.
- It deletes a redundant provision allowing the Secretary of Revenue to contract for debt collection.
- It adds a provision to the tax secrecy law allowing the Secretary of Revenue to provide the necessary information to collection agencies to allow them to identify the taxpayers and the amount of the overdue tax debts to be collected.
- It provides funds to pay debt collectors for debts outsourced in the 2000–2001 fiscal year but not collected until after July 1, 2001. The existing law provided authority to pay debt collectors for outsourced debts during the 2000–2001 fiscal year, but because of the time required to collect tax debts, some debts outsourced during the 2000–2001 fiscal year were not collected until after July 1, 2001. For these debts, this act provides that the debt collector may be paid from the proceeds collected.

### **Accelerated Payment of Withholding Taxes**

Under prior law, those employers liable for less than \$500 a month in employee wage withholding were given the option to pay quarterly. Subsections (a) and (b) of Section 5 of S.L. 2001-427 (H 232) change the \$500 threshold to \$250, so that those employers liable for \$250 to \$500 a month will pay monthly, but employers liable for less than \$250 a month may still choose to pay quarterly. These subsections became effective January 1, 2002, and apply to payments of withheld income taxes made on or after that date.

### **Accelerated Payment of Sales and Utility Taxes**

Section 6 of S.L. 2001-427, effective January 1, 2002, accelerates four tax payment schedules:

- Subsection (a) changes the threshold for paying sales taxes semimonthly from \$20,000 a month to \$10,000 a month. The returns continue to be due monthly.
- Subsection (b) allows the Secretary of Revenue to require sales tax returns to be filed electronically. Semimonthly payers are required to pay by electronic funds transfer.
- Subsections (c) and (e) make the payment schedule for electricity and telephone sales taxes the same as the schedule for regular sales taxes. This requires some of the state's largest utilities to shift from monthly to semimonthly payments of sales taxes owed on electricity and telephone.
- Subsection (f) requires piped gas excise taxes to be paid on a semimonthly schedule rather than on the previous monthly schedule.
- Subsection (h) authorizes the Revenue Laws Study Committee to study the reporting requirements for electric power companies and the method by which the franchise tax on these companies is distributed to cities to determine simpler ways to achieve the goals of the current requirements and distribution method.
- Subsection (g) enforces the requirement for employers to remit withheld state income taxes on an accelerated basis (within three days after the payroll date). Some of these employers had been continuing to send the money in monthly.

### **Accelerated Payment of Excise Tax on Conveyances**

The state levies an excise tax on each deed, instrument, or writing by which any interest in real property is conveyed to another person. The amount of the tax is \$1 on each \$500 of the

consideration or value of the interest or property conveyed. The tax must be paid to the county register of deeds before an instrument may be recorded. One-half of this amount is retained by the county and credited to the county's general fund. The remainder is remitted quarterly to the state. Of the amount remitted to the state, 75 percent is credited to the Parks and Recreation Trust Fund and 25 percent is credited to the Natural Heritage Trust Fund.

Section 14 of S.L. 2001-427 requires that the portion of the tax revenue due to the state must be remitted monthly, as opposed to quarterly. This section becomes effective July 1, 2003, and applies to amounts collected on or after that date. Data are not available to estimate the fiscal impact of this change on the affected funds.

## **Income and Franchise Taxes**

### **Corporate Compliance with Tax Laws**

S.L. 2001-327 (H 1157) makes three corporate tax law changes:

- It clarifies that income from using trademarks in this state is taxable to this state and provides a reporting option for royalty payments between related parties.<sup>6</sup>
- It provides that franchise tax will apply equally to corporate assets held by affiliated limited liability companies (LLCs), so that a corporation cannot avoid paying franchise tax on its assets by transferring them to an affiliated LLC. It also restates the fraud penalty for willful evasion of franchise tax on these assets.<sup>7</sup>
- It piggybacks the federal dividends received deduction for state corporate income tax purposes.<sup>8</sup>

#### ***Royalty Reporting Option***

S.L. 2001-327 enhances corporate compliance with taxes on trademark income by partially closing a loophole that allows a corporation to avoid North Carolina tax on income from using intellectual property in this state when the corporation transfers the intellectual property to a related company in another state. This provision solves the problem as it relates to trademarks and trade names but does not address other types of intellectual property, such as patents, or other types of intangible assets. The provision is effective beginning with the 2001 taxable year.

The act creates a new statute in the Corporate Income Tax Act addressing trademark payments between related members. It states 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 North Carolina income tax. Some corporations have argued that an out-of-state investment company's receipt of royalty income from the use of trademarks in this state does not subject the investment company to North Carolina income tax on the royalties. Corporations also have relied on such an argument to create an arrangement to avoid North Carolina tax on their North Carolina income. Consider, for example, a hypothetical corporation that has substantial profits from operating retail stores or manufacturing facilities in North Carolina. As part of its business, it uses trademarks on these stores or on the goods it manufactures. The operating corporation creates a subsidiary in another state and transfers its trademarks to the subsidiary. It therefore owes the subsidiary

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6. The Senate initially considered this part of the act in S 1058, introduced by Senator Kerr. It was recommended by the Governor's Loophole Study Commission. The Senate included it as one of its revenue raising items in its budget bill, the third edition of S 1005.

7. The Revenue Laws Study Committee recommended legislation on this issue—S 242 introduced by Senator Dalton. It also was recommended by the Governor's Loophole Study Commission and the Governor. As a result of study and talks during the session, this act addresses the loophole differently. The Senate included this provision as one of its revenue raising items in its budget bill, the third edition of S 1005.

8. The Governor's Loophole Study Commission and the Governor recommended this provision to the General Assembly. The Senate included it as one of its revenue raising items in its budget bill, the third edition of S 1005.

royalties for the use of the trademarks in North Carolina. If the operating corporation is late paying these royalties, it also owes the subsidiary late fees. The operating corporation deducts against its North Carolina income the royalties and late fees it owes the subsidiary. The subsidiary likely pays little or no tax to another state on these receipts because the receipts may be exempt or apportioned away from that state. The subsidiary's receipts are paid back to the operating corporation as dividends but remain free of North Carolina tax because subsidiary dividends are deductible. As a result of this arrangement, although the operating corporation may generate substantial profits from its retail or manufacturing activities in the state, it ends up paying little or no North Carolina tax on these profits by deducting the royalties and late fees it passes through its subsidiary in another state.

S.L. 2001-327 addresses these arrangements by restating that a company's receipts from royalty payments for the use of trademarks in North Carolina are income from doing business in North Carolina. It then provides adjustments to ensure full and fair accountability for this income in the state in which it was earned. In cases where the recipient of the North Carolina royalty income is unrelated to the payer, the recipient is required to pay North Carolina tax on the income. In cases where the recipient and the payer are related, they have an option on how the income is reported to North Carolina. The payer may deduct the North Carolina royalty payments on its North Carolina return while the recipient includes them on its North Carolina return, or the payer may add the royalty payments to its North Carolina income while the recipient deducts them on its North Carolina return.<sup>9</sup>

#### ***Franchise Tax on Corporate Affiliated LLCs***

S.L. 2001-327 closes a loophole that existed in the state's corporate tax laws. Prior to the enactment of this provision, a corporation could avoid paying franchise tax on its assets by transferring them to an LLC.<sup>10</sup> Under North Carolina law, LLCs are not subject to the franchise tax.<sup>11</sup> In 1997 the North Carolina law regarding LLCs was changed to allow for a single-member LLC. This change had the unintended consequence of opening a loophole in North Carolina tax law. It enabled a corporation subject to North Carolina franchise tax to set up an LLC and transfer assets to the LLC in a tax-free transfer.<sup>12</sup> The assets transferred to the LLC would not be subject to the franchise tax. Thus, the corporation could avoid a significant portion of its franchise tax liability without affecting its income tax liability by transferring assets into a wholly owned LLC subsidiary. The act closes this loophole by requiring a corporation to include in its franchise tax base some or all of the assets of an LLC if (1) the corporation is a member of the LLC and (2) the corporation (and/or members of its affiliated group) is entitled to receive 70 percent or more of the LLC's assets upon dissolution. If the corporation is entitled to receive 100 percent of the LLC's assets upon dissolution, the corporation must include 100 percent of the LLC's assets in its franchise tax base. If the corporation is entitled to receive less than 100 percent of the LLC's assets, then the corporation must include in its franchise tax base only that percentage of the LLC's assets that it would be entitled to receive upon dissolution. If a corporation is required to

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9. See *Geoffrey, Inc. v. South Carolina Tax Com'n*, 437 S.E.2d 13 (S.C. 1993), cert. denied by U.S. Supreme Court, 114 S. Ct. 50 (1993). The South Carolina Supreme Court held that (1) royalty income of a foreign corporation, obtained from trademark licenses issued to an affiliate, could be taxed without violating due process clause, and (2) tax could be imposed without violating interstate commerce clause.

10. A limited liability company (LLC) is a business entity that is essentially a hybrid of a partnership and a corporation. Like a corporation, an LLC limits the liability of its owners. Like a partnership, an LLC is usually not subject to entity-level taxation.

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

12. S.L. 2001-508 simplified this transfer by permitting the board of directors of a corporation to transfer corporate assets to a wholly owned limited liability company, limited partnership, registered limited liability partnership, or any other unincorporated entity *without the approval of the shareholders*.

include an LLC's assets in its franchise tax base, it is allowed to exclude its investment in the LLC from its franchise tax base. In S.L. 2001-327, the General Assembly stated its intent to apply the franchise tax equally to assets held by corporations and assets held by corporate-affiliated limited liability companies. To this end, the act provides that a taxpayer who fraudulently underpays the franchise tax on assets it transfers to an affiliated LLC is guilty of a Class H felony, the existing law penalty for tax fraud.

The LLC franchise tax provision is effective for taxes due on or after January 1, 2002.

### ***Corporate Subsidiary Dividend Deduction***

S.L. 2001-327 repeals North Carolina's dividends received deduction and instead piggybacks the federal law. The act also equalizes the tax treatment of domestic and foreign source dividends by providing that dividends of foreign corporations may be deducted from taxable income to the extent that they are included in federal taxable income.<sup>13</sup> Adopting the federal approach simplifies tax administration and compliance. To the extent that North Carolina income tax law conforms to federal law, tax administration and compliance are simplified because the taxpayer is required to make fewer adjustments to taxable income in order to calculate state net income. This part of the act became effective beginning with the 2001 tax year.

Prior to this tax law change, a corporation could deduct from its state taxable income all dividends received from corporations in which it owned more than 50 percent of the outstanding voting stock. Under the federal approach, a parent company may continue to receive a 100 percent deduction if it owns 80 percent or more of the stock of a subsidiary. If a parent company owns more than 50 percent but less than 80 percent of a subsidiary, the amount of its deduction is reduced from 100 percent under prior law to 80 percent under this act. If a company owns 50 percent or less of another company, it had no dividends deduction under prior North Carolina law, but under this act it will receive a dividend deduction of 80 percent if it owns 20 percent or more of the company or a dividend deduction of 70 percent if it owns less than 20 percent of the company. Thus, it is likely that some parent companies will gain under the act and some will lose. If a parent company is subject to the federal cap limiting deductible dividends to 70 percent or 80 percent of its taxable income, the limit will reduce the amount it can deduct for North Carolina purposes. The federal deduction is a gross deduction. However, under G.S. 105-130.5(c)(3), the dividend deduction for U.S. companies under North Carolina tax law is net of related expenses. S.L. 2001-427 amends this act to clarify that foreign source dividends must also be net of related expenses and must be treated for state income tax purposes the same as domestic source dividends.<sup>14</sup>

This provision is effective for tax years beginning on or after January 1, 2001.

### **Modification of Partnership Tax Credit**

S.L. 2001-335 (H 146) corrects and clarifies the law governing allocation of partnerships' tax credits, so that any dollar amount limitation on a credit allowed to a partnership applies to the total credit. The limited amount is then allocated by the partnership among the partners on a proportional basis. The original bill was a recommendation of the Revenue Laws Study Committee.

Generally, partnerships are treated the same under North Carolina law as under federal law. Both North Carolina and federal law recognize that a partnership is a separate entity. When the partnership is entitled to a tax credit, the partnership allocates the credit among its partners on a proportional basis. The partners can then claim the amount of credit allocated to them. This is done because the partnership itself is not a taxable entity. Under prior North Carolina law, a

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13. Under federal law, foreign dividends are generally included in income and the taxpayer is allowed a credit for foreign tax paid.

14. G.S. 105-130.5(c)(3) does not apply to adjustments made under G.S. 105-130.5(a) or (b). Since the deduction for foreign source dividends is contained in G.S. 105-130.5(b), the proviso in G.S. 105-130.5(c)(3) requiring that the expenses be netted does not apply. See also the summary for S.L. 2001-427 (H 232).

partnership that passed an income tax credit through to its partners would be subject to all limitations on the credit, except<sup>15</sup>

1. the limitation that the credit may not exceed the amount of the income tax imposed on the taxpayer, and
2. a cap on the otherwise allowable amount of the credit, expressed as a specific maximum dollar amount or a specific percentage of the tax imposed on the taxpayer.

Federal law does not recognize the second of these, the exemption from a specific dollar amount limitation. Additionally, North Carolina law does not recognize such an exemption for S corporations.<sup>16</sup> Thus, this provision of North Carolina law regarding taxation of partnerships was inconsistent with both federal law regarding taxation of partnerships and North Carolina law regarding taxation of S corporations.

S.L. 2001-335 removes the partnership's exemption from the specific dollar amount limitation. This makes North Carolina law consistent with federal law on this point as well as consistent with North Carolina law regarding S corporations. Limited liability companies are treated like partnerships under North Carolina law for income tax purposes. Thus, this change also applies to limited liability companies.

The change affects relatively few tax credits. The following tax credits have specific dollar amount limitations:

- Worker training (G.S. 105-129.11)
- Investing in central administrative office property (G.S. 105-129.12)
- Investing in business property (G.S. 105-129.16)
- Investing in renewable energy property (G.S. 105-129.16A)
- Real property donations (G.S. 105-151.12)
- Conservation tillage equipment (G.S. 105-151.13)
- Construction of a poultry composting facility (G.S. 105-151.25)

S.L. 2001-335 is effective beginning in the 2002 tax year but delays until 2005 the imposition on partnerships and limited liability companies of the dollar amount limitation on the credit allowed for real property donations. The credit for real property donations is allowed when a person makes a qualified donation of an interest in real property that is useful for public beach access, public access to public waters or trails, fish and wildlife conservation, or other similar land conservation purposes. The credit is equal to 25 percent of the fair market value of the donated property interest. To be eligible for the credit, the interest in property must be donated to and accepted by the state, a local government, or a body that is both organized to receive and administer lands for conservation purposes and qualified to receive charitable contributions under the Internal Revenue Code. The credit amount may not exceed \$250,000.

### **Taxation of HMOs and Medical Service Companies**

Section 34.22 of S.L. 2001-424 (S 1005) imposes a uniform gross premiums tax on Health Maintenance Organizations and on Article 65 corporations. As amended by S.L. 2001-489, the tax rate is 1.1 percent for taxable years beginning on or after January 1, 2003, and 1 percent for taxable years beginning on or after January 1, 2004.<sup>17</sup>

Under current law, Article 65 corporations, such as Blue Cross/Blue Shield and Delta Dental Corporation, pay a gross premiums tax of 0.5 percent. HMOs do not pay a gross premiums tax; however, they are subject to the state's corporate income and franchise tax levies. Other insurance providers pay a gross premiums tax of 1.9 percent. Companies that pay a gross premiums tax are automatically exempt from corporate income and franchise taxes. S.L. 2001-424 subjects all

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15. All limitations on the tax credit also apply to each partner individually.

16. An S corporation is a business entity that for tax purposes is similar in most respects to a partnership.

17. Originally, the tax rate would have been 0.833 percent for the 2002 tax year and 1 percent for taxable years beginning on or after January 1, 2003. The General Assembly modified the tax rates at the request of the HMO and medical service corporation industry because they had already sent their customers rate notices for the 2002 tax year that did not include the 0.83 percent rate for the 2002 tax year.

insurance carriers to the gross premiums tax in lieu of the state's corporate income and franchise taxes. All fifty states impose a gross premiums tax on insurance companies; twenty-three states extend the tax to HMOs. The extension of the tax base to include gross premiums on insurance contracts issued by HMOs was part of the Governor's recommendation for closing tax loopholes.

### **Clarification of Changes in Subsidiary Dividend Provisions**

Section 10 of S.L. 2001-427 amends S.L. 2001-327 to clarify that foreign source dividends are treated the same for state income tax purposes as domestic source dividends. Under S.L. 2001-327, North Carolina piggybacks the federal dividends received deduction for State corporate income tax purposes. This deduction pertains to dividends of domestic (U.S.) corporations. The federal deduction is a gross deduction, but under G.S. 105-130.5(c)(3) the expenses are required to be netted.

To equalize the tax treatment of domestic and foreign source dividends, S.L. 2001-327 provided in G.S. 105-130.5(b) that dividends of foreign corporations could also be deducted from taxable income to the extent they are included in federal taxable income. Because the deduction for foreign source dividends is contained in G.S. 105-130.5(b), the provision in G.S. 105-130.5(c)(3) requiring that the expenses be netted does not apply. S.L. 2001-427 clarifies that the dividends of domestic and foreign source dividends are to be taxed the same by providing that the deduction for foreign source dividends is also net of related expenses. This section became effective for taxable years beginning on or after January 1, 2001. There is no fiscal impact.

### **Technical and Clarifying Changes to the Franchise Tax**

In 1996, the General Assembly repealed the corporate income tax credit for qualified business investments, effective for investments made on or after January 1, 1997, because it was advised by the Attorney General's Office that the credit unconstitutionally favored businesses headquartered and operating in North Carolina. Prior to its repeal, the corporate income tax credit could have been claimed against the franchise tax, and a reference to this credit was in the franchise tax law. When the corporate credit was repealed, a conforming change to the franchise tax statute was not made. Section 12 of S.L. 2001-427 makes this conforming change. It also adds standard language to the remaining credit referenced in G.S. 105-122(d1)<sup>18</sup> clarifying that the credit is not a refundable tax credit. Section 12 became effective September 28, 2001.

### **Pass-Through Entity/Housing Tax Credit**

S.L. 2001-431 (S 181) amends the low-income housing tax credit in two ways:

- It allows a pass-through entity to allocate the low-income housing credit to any of its owners at its discretion. In effect, it allows developers of low-income housing to sell federal and state low-income housing tax credits to separate investors. The credit amount may not exceed the owner's adjusted basis in the pass-through entity. If the credit is ever forfeited, the forfeiture applies to the owners in the same proportion as the credit was allocated.
- It expands the credit by allowing it to be taken against the gross premiums tax on insurance companies.

The act is effective for taxable years beginning on or after January 1, 2001, and applies to buildings that are placed in service on or after January 1, 2001.

In the Tax Reform Act of 1986, Congress created the Low Income Housing Tax Credit program to fund housing for low- and moderate-income households. Each state receives a limited amount of credit each year. The IRS allocates the per capita low-income housing tax credits to state housing agencies such as the North Carolina Housing Finance Agency (NCHFA). The NCHFA reviews housing project proposals and awards the tax credits to project developers based

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18. A corporation may claim a credit against its franchise tax liability equal to one-half of the amount of excise tax it paid on piped natural gas during the taxable year.

on selection criteria designed to reward projects that will serve the lowest income tenants for the longest periods. The federal credit program requires that the low-income housing be used for that purpose for at least thirty years. If that requirement is not met, all or part of the taxpayer's credit is recaptured.

Prior to S.L. 2001-431, an investment group had to purchase both the state and federal credits. This restriction limited the number of investors able to use the state tax credit primarily to in-state groups. This act allows the state credits to be allocated in a different manner than the federal credits. It allows a pass-through entity to allocate the credit among any of the entity's owners, in the entity's discretion, as long as the amount of credit allocated does not exceed the owner's adjusted basis in the pass-through entity. In effect, the act allows developers of low-income housing to sell federal and state low-income housing tax credits to separate investors. It is similar to the bifurcation or separate sale of federal and state historic tax credits approved in the 1999 Session of the General Assembly in S.L. 1999-381. Most housing finance experts agree that this act will increase the competition for state tax credits and that this competition will affect the price paid for a credit put up for bid. However, there are no data to predict whether these changes will increase the participation of developers in the state credit program. The statutory mandates on the number of rent controlled units in a project appear to prevent the 100 percent utilization of the state tax credit, and this act does not change those restrictions.<sup>19</sup>

Under S.L. 2001-431, when an allocation is claimed by a pass-through entity, the pass-through entity and its owners must include a statement with their tax return that shows both the allocations made and the allocation that would otherwise have been required.<sup>20</sup> If an owner of a pass-through entity that qualified for the credit disposes of all or a portion of the owner's interest in the pass-through entity within five years from the date the federal credit was first claimed, so that the owner's interest is reduced to less than two-thirds of its interest at the time the federal credit was first claimed, the owner must forfeit a portion of the credit. This recapture does not apply if the change in ownership is due to the death of the owner or to a merger or consolidation requiring approval of the members of the taxpayer's pass-through entity to the extent the entity does not receive cash or property in the merger or consolidation. Under existing law, any forfeiture of the credit triggers the taxpayer's liability for all past taxes avoided plus interest. The past taxes and interest are due thirty days after the credit is forfeited.

### **Pass-Through Entity Allocation Extension**

Taxpayers are allowed an income tax credit of 20 percent of the expenses of rehabilitating an income-producing historic structure if the taxpayer qualifies for the federal credit. A pass-through entity may qualify for the rehabilitation credit and pass the credit on to its owners. A pass-through entity is an entity, such as a partnership, a limited liability company, or a Subchapter S corporation, that is treated as owned by individuals or other entities under federal tax law and whose income, losses, and credits are reported by the owners on their state income tax returns. Generally, under North Carolina law, the pass-through entity is required to allocate a tax credit among its owners in the same proportion that other items, such as the federal rehabilitation credit, are allocated under the Internal Revenue Code. In 1999 the General Assembly amended G.S. 105-129.35 to allow a pass-through entity to allocate this particular credit among its owners at its discretion. That change would have expired for taxable years beginning on or after January 1, 2002. S.L. 2001-476 (S 748) extends that provision for an additional two years.

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19. All seven projects in tier one and two counties and all six projects in tier three and flood relief counties utilized the 75 percent state tax credit. However, only twelve of the twenty-three projects in tier four and five counties utilized the 25 percent state tax credit.

20. See G.S. 105-131.8 and G.S. 105-269.15.

### **Sunset on State Ports Tax Credit Extended**

S.L. 2001-517 (H 1388) extends the sunset on the state ports tax credit an additional thirty-four months. Before the enactment of this act, the credit expired for tax years ending on or before February 28, 2001. The bill is effective for taxable years beginning on or after March 2, 2000. The bill is effective retroactive to March 2, 2000, so that the availability of the credit remains uninterrupted.

### **New Individual Income Tax Bracket**

Section 34.18 of S.L. 2001-424 adds a new tax bracket that will apply an additional 0.5 percent income tax to certain North Carolina taxable income for three years. Under prior North Carolina law, tax was imposed at the following rates on individuals' North Carolina taxable income (NCTI):

<u>Tax Rate</u>	<u>NCTI married filing jointly</u>	<u>NCTI heads of household</u>	<u>NCTI unmarried individuals</u>	<u>NCTI married filing separately</u>
6.0%	Up to \$21,250	Up to \$17,000	Up to \$12,750	Up to \$10,625
7.0%	Over \$21,250 and up to \$100,000	Over \$17,000 and up to \$80,000	Over \$12,750 and up to \$60,000	Over \$10,625 and up to \$50,000
7.75%	Over \$100,000	Over \$80,000	Over \$60,000	Over \$50,000

This section creates a fourth tax bracket with a marginal tax rate of 8.25 percent on taxable income over \$200,000 for married couples filing jointly, over \$160,000 for heads of household, over \$120,000 for unmarried individuals, and over \$100,000 for married individuals filing separately. This change will affect approximately 2 percent of North Carolina taxpayers. The new bracket will be in effect only for the 2001, 2002, and 2003 tax years.

### **Reduction of the Marriage Tax Penalty**

S.L. 2001-424 reduces North Carolina income taxes on married couples that claim the standard deduction. Section 34.19 of this act increases the standard deduction for married couples from \$5,000 to \$6,000, so that it will be twice that of a single taxpayer. The increase in the deduction is phased in over the 2002 and 2003 tax years. The standard deduction for married persons filing separately is one-half that for a married couple filing jointly, so this act phases it up from \$2,500 to \$3,000 over the 2002 and 2003 tax years. It is estimated that this change will benefit 762,340 couples in tax year 2002.

Roughly 70 percent of North Carolina taxpayers claim the standard deduction. The so-called marriage tax penalty is the result of a tax system that recognizes that a married couple's living expenses are less than the expenses of two single people living separately but more than the expenses of one single person. In addition, if one spouse is not employed full-time, a married couple's income will be less than that of two comparable single people who work full-time but more than that of one single person. The tax law addresses these situations through the tax brackets, the personal exemptions, and the standard deduction. The effect of these tax provisions on couples that marry is that if only one spouse works, the couple experiences a tax reduction; if one spouse earns substantially more than the other, the couple experiences no tax reduction or increase; and if both spouses earn roughly the same amount, the couple experiences a tax increase.

### **Increase in Tax Credit for Children**

The 1995 General Assembly enacted a tax credit of \$60 per child for married couples with dependent children and a family adjusted gross income below \$100,000 and for heads of household with dependent children and a family adjusted gross income below \$80,000. Section

34.20 of S.L. 2001-424 increases the tax credit to \$75 for the 2002 tax year and \$100 for the 2003 tax year. The credit is in addition to the federal and state tax credits or exclusions for child care expenses. The credit is allowed for each dependent child for whom the eligible taxpayer could take a federal personal exemption under section 151(c)(1)(B) of the Internal Revenue Code. That section of the Internal Revenue Code allows an exemption for each dependent child who either is less than nineteen years old at the end of the taxable year or is a student and is less than twenty-four years old at the end of the taxable year. A child is a son, stepson, daughter, or stepdaughter. A dependent child is a child over half of whose support was provided by the taxpayer.

### **Elimination of Children's Health Insurance Credit**

In 1998 the General Assembly enacted a refundable individual income tax credit for certain taxpayers who purchase health insurance for their dependent children. The credit was equal to the amount of premiums paid, up to \$300 for those taxpayers with incomes below 225 percent of the federal poverty level and up to \$100 for those taxpayers with incomes above the 225 percent threshold. Taxpayers who had their health insurance premiums deducted from their income before it was taxed did not qualify for the credit. Taxpayers whose adjusted gross income was higher than \$100,000 (joint return) did not qualify for the credit. Section 34.21 of S.L. 2001-424 repeals this credit, effective for taxable years beginning on or after January 1, 2001.

## **Sales, Use, and Motor Fuels Taxes**

### **Streamlined Sales and Use Tax Agreement**

Part 1 of S.L. 2001-347 (S 144) establishes the Uniform Sales and Use Tax Administration Act and outlines the parameters under which the Secretary of Revenue may enter into the Streamlined Sales and Use Tax Agreement. The purpose of the agreement is to develop a substantially simplified sales tax system that can better accommodate interstate commerce and thereby help equalize the playing field between remote (catalog and Internet) vendors and "Main Street" merchants. The General Assembly enacted many of the provisions codified in Part 1 as the Uniform Sales and Use Tax Administration Act in 1999.<sup>21</sup> Under the Uniform Sales and Use Tax Administration Act, the Secretary of Revenue may not enter into the Streamlined Sales and Use Tax Agreement unless the agreement requires each state to abide by the following requirements:

- Uniform state rate
- Uniform standards
- Uniform definitions
- Central registration
- No nexus attribution
- Consumer privacy
- Monetary allowances
- State compliance certification
- Local sales and use tax limitations

This part of the act became effective August 8, 2001. It will expire January 1, 2006, unless one of the following occurs: (1) fifteen states have signed the Streamlined Sales and Use Tax Agreement, or (2) states representing a combined resident population equal to at least 10 percent of the national resident population, as determined by the 2000 federal decennial census, have signed the Streamlined Sales and Use Tax Agreement.

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21. S.L. 2000-120 took the first step in simplifying and streamlining the sales and use tax collection system for remote and in-state retailers. It authorized the Secretary of Revenue to enter into the Streamlined Sales and Use Tax Agreement and made statutory changes to enable North Carolina to enter the agreement.

The act also simplifies North Carolina's sales and use tax laws by adopting many of the uniform provisions that must be adopted before a state can participate in the Streamlined Sales and Use Tax Agreement. The key features of the Streamlined Sales and Use Tax Agreement include:

- Uniform definitions within tax bases. Legislatures will still choose what is taxable and what is exempt but will use the common definitions.
- Simplified exemption administration for use- and entity-based exemptions. Sellers will be relieved of the "good faith" requirements that exist in current law and will not be liable for uncollected tax. Purchasers will be responsible for incorrect exemptions claimed.
- Rate simplification. States will be responsible for the administration of all state and local taxes and the distribution of the local taxes to the local governments. State and local governments will use common tax bases and will accept responsibility for notice of rate and boundary changes. States will be encouraged to simplify their own state and local tax rates.
- Uniform sourcing rules. The states will have uniform sourcing rules for all property and services.
- Uniform audit procedures. Sellers who participate in one of the certified Streamlined Sales Tax System technology models either will not be audited or will have a limited scope audit, depending on the technology model used.
- Paying for the system. To reduce the financial burdens on sellers, states will assume the responsibility for implementing the Streamlined Sales and Use Tax Agreement.

S.L. 2000-120 made several changes to the sales and use tax statutes in anticipation of the Streamlined Sales Tax Project. These changes included: simplified exemption administration, uniform audit procedures, certification of software and tax collectors, uniform sourcing rules, limitation of local government rate changes to twice a year, and payment by "direct pay certificates." Part 2 of S.L. 2001-347 builds upon this earlier legislation by establishing uniform definitions and uniform sourcing rules. It also begins the process of establishing uniform rates by shifting the 1 percent, \$80 sales tax cap on mill machinery and mill machinery parts and accessories from a sales tax to a privilege tax of the same rate.<sup>22</sup> The part of the act that shifts the tax on mill machinery and mill machinery parts and accessories from a sales tax to a privilege tax of the same rate becomes effective January 1, 2006. The remainder of Part 2 of this act became effective January 1, 2002.

### ***Conforming Changes: Uniform Definitions***

Sections 2.1 through 2.5 of S.L. 2001-347 add or amend the following definitions to the state's sales and use tax laws: *candy, delivery charges, dietary supplements, food, food sold through a vending machine, purchase price, soft drink, prepared food, retail sale, and sales price*. Sections 2.18 through 2.22 conform the definition of *prepared food* used in the local prepared meals tax acts with the one amended by Section 2.3. Use of the defined terms results in the following changes to the state's sales and use tax laws:

**Food exempt from sales tax.** S.L. 2001-347, as amended by Sections 3(a) and 3(b) of S.L. 2001-489, maintains the current exemption for foods that may be purchased with food stamps. The food stamp program applies to food purchased for home consumption. The act, as amended, provides that candy, prepared food, and soft drinks are taxed unless they are purchased for home consumption and would be exempt if purchased under the Federal Food Stamp

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22. The Streamlined Sales and Use Tax Agreement requires states to have a limited number of sales and use tax rates. The states have until 2005 to simplify their rates.

Program.<sup>23</sup> Alcoholic beverages, dietary supplements, and foods sold through vending machines also continue to be taxed under G.S. 105-164.13B, as amended by S.L. 2001-489.<sup>24</sup>

**Delivery charges.** Under the Uniform Sales and Use Tax Administration Act, all delivery charges are included in the sales price of an item and are therefore subject to tax. Under prior N.C. law, delivery charges may or may not have been included as part of the sales price, depending upon where the title to the property passed to the purchaser. Part 2 of S.L. 2001-347 adopts the uniform definition of sales price that includes all delivery charges; therefore, under this act, delivery charges are subject to tax. Section 2.11 repeals the previous law concerning sales tax on freight and delivery transportation charges.

**Installation charges.** Under the Uniform Sales and Use Tax Administration Act, installation charges are included in the sales price of an item. S.L. 2001-347 includes these charges in the definition of sales price, but Section 2.12 maintains the current exemption by specifically providing that installation charges are exempt from sales and use tax.

**Food purchased from vending machines.** Under the Uniform Sales and Use Tax Administration Act, food purchased from vending machines is considered food. Prior to the act, North Carolina taxed food purchased from vending machines because it was not considered food for home consumption. However, the state's definition of sales price provided that any tangible item purchased through a vending machine, other than closed container soft drinks or tobacco products, would be taxed at 50 percent of its sales price. Section 2.13 of the act, as amended in Section 3(b) of S.L. 2001-489, provides that food purchased through a vending machine is subject to tax. However, Section 2.12 maintains the 50 percent exemption by specifically listing it as an exemption from the sales and use tax.

**Certain deposits.** The Streamlined Sales and Use Tax Agreement considers certain deposits on beverage containers and certain deposits on aeronautic, automotive, industrial, marine, or farm replacement parts to be part of the sales price.<sup>25</sup> Part 2 of this act adopts the uniform definition of sales price. However it maintains the tax exempt status of these deposits by adding them to the list of items exempt from sales and use tax.

**Definition of use.** Section 2.6 conforms the definition of *use* for sales and use tax purposes to the definition used in neighboring states. The change in the definition provides that the use tax is applicable to the distribution of direct mail catalogs printed out of state to in-state residents by a business that has nexus with the state. The definition in the act is consistent with the U.S. Supreme Court's decision in *D. H. Holmes v. McNamara*, 486 U.S. 24 (1988).

### ***Conforming Changes: Uniform Sourcing Rules***

Section 2.9 of S.L. 2001-347 adopts the sourcing rule established in the Streamlined Sales and Use Tax Agreement. Under prior law, the point of sale of a product was determined by the location of the retailer's business. Under the new act, the point of sale of a product is determined by the location where the purchaser receives the product, as follows:

- If the purchaser receives the product at a business location, then the sale is sourced to that business location.
- If the purchaser receives the product at a location specified by the purchaser and the location is not a business location of the seller, then the sale is sourced to the location where the purchaser receives the product.

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23. Section 2.13 of the act arguably broadened the sales tax exemption for prepared foods to include all take-out food items from restaurants and fast food chains and all catered food. These food items are taxable under current law. An exemption for take-out food items would have resulted in a General Fund loss of approximately \$60 million a year.

24. Section 2.2 of the act excluded alcoholic beverages from the definition of food in the Uniform Act. Because local meals tax laws are linked to the sales tax definitions, this language would have inadvertently exempted prepared alcoholic beverages (beer, wine, and mixed drinks) from the local meals taxes.

25. These deposits were not considered part of the definition of *sales price* under the sales and use tax statutes prior to the enactment of this act.

- If the seller does not know the address where a product is received, then the sale is sourced to either the business or home address of the purchaser, the billing address of the purchaser, or the address of the seller.

This sourcing rule does not apply to telecommunications services.<sup>26</sup>

Sections 2.10, 2.15, and 2.16 provide that the uniform sourcing rule established in Section 2.9 applies to the state use tax and to the local sales and use tax acts.

### ***Conforming Changes: Uniform Rate***

The Streamlined Sales and Use Tax Agreement requires a state to have a limited number of sales and use tax rates. The states have until 2005 to simplify their rates. This act begins the process of simplifying North Carolina's rates by exempting mill machinery and mill machinery parts and accessories from the sales and use tax and imposing in its place a privilege tax on these items. The privilege tax rate will be the same as the current sales and use tax rate: 1 percent of the sales price of the machinery, part, or accessory, subject to a maximum tax of \$80. This change in the law means that retailers are not responsible for collecting and remitting the tax. Section 2.8 repeals the current sales and use tax rate of 1 percent and the \$80 tax cap on mill machinery and mill machinery parts and accessories. Section 2.12 adds mill machinery and mill machinery parts and accessories to the list of exemptions from the sales and use tax. Section 2.17 establishes the privilege tax on mill machinery. These changes in Sections 2.8, 2.12, and 2.17 do not become effective until January 1, 2006.

### ***Conforming Changes: Administration of Returns***

The Streamlined Sales and Use Tax Agreement provides that a taxpayer is required to file only one return a month. Under prior law, taxpayers who were consistently liable for at least \$20,000<sup>27</sup> a month in state and local sales and use taxes were required to pay the tax and file a return twice a month. Section 2.14 provides that the taxpayer must pay the tax owed twice a month, but only needs to file the return once a month. The monthly return must cover both semimonthly payments.

## **Sales Tax Increase**

Section 34.13 of S.L. 2001-424 increases the state sales tax from 4 percent to 4.5 percent, effective October 16, 2001. The tax increase is repealed July 1, 2003. The state sales tax rate was last increased in 1991, from 3 percent to 4 percent.

## **Sales Tax Holiday**

Section 34.16 of S.L. 2001-424 provides that certain purchases made during the first weekend in August of each year are exempt from the state and local sales and use tax, beginning in August 2002. The exempt purchases include the following:

- clothing with a sales price of \$100 or less per item,
- clothing accessories with a sales price of \$100 or less per item,
- footwear with a sales price of \$100 or less per item,
- school supplies with a sales price of \$100 or less per item, and
- computers, printers and printer supplies, and educational computer software with a sales price of \$3,500 or less per item. The term "computer" means a central processing unit and any peripherals sold with it and any computer software installed at the time of purchase.

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26. See S.L. 2001-430, as amended by S.L. 2001-424 and S.L. 2001-487, for the tax treatment of telecommunications services.

27. S.L. 2001-427 changes the semi-monthly threshold for remitting sales and use tax from \$20,000 a month to \$10,000 a month.

S.L. 2001-476 makes several technical and conforming changes to the sales tax holiday. The act incorporates definitions from the Streamlined Sales and Use Tax Agreement into the definitions of items eligible for and excluded from the sales tax holiday.

### **Taxation of Satellite TV and Cable TV**

Section 34.17 of S.L. 2001-424 establishes a 5 percent state sales tax on the gross receipts derived from providing satellite TV services. The new tax became effective January 1, 2002. The gross receipts are not subject to the local 2 percent sales tax. Currently, cable TV may be subject to a local franchise tax of up to 5 percent. Satellite TV is not subject to a local franchise tax. This part of the act equalizes the taxation of satellite TV and cable TV by providing that both are subject to a 5 percent tax on their gross receipts, a local tax for cable TV and a state tax for satellite TV. The equalization of the taxation of cable TV and satellite TV was part of the Governor's recommendation for closing tax loopholes.

The state's taxation of entertainment varies depending upon the type of entertainment. S.L. 2001-424 begins taxing two similar types of entertainment at the same rate. However, other forms of entertainment will continue to be taxed differently. For example, live entertainment is subject to a 3 percent gross receipts tax, while movies are subject to a 1 percent gross receipts tax and video rentals are subject to a 6.5 percent state and local sales tax.

### **Sales and Excise Tax on Spirituous Liquor**

Section 34.23 of S.L. 2001-424 imposes a 6 percent sales tax on spirituous liquor, effective December 1, 2001, and reduces the excise tax on spirituous liquor from 28 percent to 25 percent, effective February 1, 2002. Under prior law, mixed beverages were subject to sales tax, but spirituous liquor (liquor sold in ABC stores) was exempt. The statute levying the 28 percent excise tax on liquor sold in ABC stores stated that the excise tax was in lieu of sales tax. This section repeals the sales tax exemption for spirituous liquor and provides that liquor sold in ABC stores is subject to a 6 percent state sales tax, effective December 1, 2001. If the liquor is sold to a mixed beverage permittee or guest room cabinet permittee for resale, the permittee may apply for a certificate of resale under existing law and not be subject to the sales tax. Mixed beverages will continue to be subject to sales tax at a combined state and local rate of 6.5 percent.

The excise tax (reduced in this act to 25 percent) levied on liquor sold in ABC stores is levied on the price of liquor calculated as the sum of the following components:

- the distiller's price,
- the state ABC warehouse freight and bailment charges, and
- a markup for local ABC boards.

### **No Tax Break for Luxury Cars/No Fire and Rescue Vehicle Tax**

Section 34.24 of S.L. 2001-424 deletes the \$1,500 cap on the 3 percent highway use tax on all noncommercial vehicles except recreational vehicles.<sup>28</sup> It also exempts from the highway use tax fire trucks and rescue vehicles owned by volunteer fire departments and volunteer rescue squads. To qualify for the exemption, the volunteer fire department or rescue squad must not be a part of a unit of local government, must have no more than two paid employees, and must be exempt from state income tax under G.S. 105-130.11. The vehicles that may be exempt from the tax are: an emergency services vehicle, a fire truck, a pump truck, a tanker truck, a ladder truck used to suppress fire, and a four-wheel drive vehicle intended to be mounted with a water tank and hose and used for fighting forest fires. An ambulance is not a Class A or B commercial vehicle and so

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28. This act removed the \$1,500 cap on all noncommercial vehicles. S.L. 2001-497 (H 72) reinstated the \$1,500 cap for recreational vehicles that are not subject to the \$1,000 cap. A *recreational vehicle* is defined as "a motorized or towable vehicle that combines transportation and temporary living quarters for travel, recreation, and camping."

would be subject to the full 3 percent tax if it were not exempted by this section. The remaining fire and rescue vehicles would be considered Class A or Class B commercial vehicles and would be subject to the \$1,000 maximum highway use tax if not exempted by this act. These changes became effective for certificates of title issued on or after October 1, 2001.<sup>29</sup>

### **Sales Tax on Certain Electricity**

Section 17 of S.L. 2001-476, as amended by S.L. 2001-487 (H 338), reduces the sales tax on electricity sold to manufacturers. Currently, electricity that is sold to a manufacturer for use at a manufacturing facility and that is separately metered or measured is subject to the sales and use tax at a rate of 2.83 percent. Most other sales of electricity are taxed at the rate of 3 percent. Section 17 enacts a new tax rate schedule that will apply to all manufacturers, based on the volume of electricity used annually. Beginning January 1, 2002, each taxpayer will pay one rate on electricity throughout the year. The rate will be based initially on actual usage the previous year or, in the case of a new manufacturer, estimated usage for the current year. At the end of the year, if the taxpayer has used a volume of electricity that qualifies the taxpayer for a different rate, the taxpayer will be eligible for a refund of excess taxes paid or liable for a deficiency. Beginning on January 1, 2002, manufacturers who use more than 900,000 megawatt-hours of electricity annually will pay a rate of 0.17 percent, while all other manufacturers will continue to pay a rate of 2.83 percent. Beginning July 1, 2005, the following rate schedule goes into effect:

Megawatt-hours used annually	Rate
5,000 or less	2.83%
Over 5,000 and up to 250,000	2.25%
Over 250,000 and up to 900,000	2.0%
Over 900,000	.17%

This section also clarifies that electricity does not “enter into” or become a component part of tangible personal property that is manufactured and is not an accessory to equipment.

Section 15 of the act requires the Revenue Laws Study Committee to review the taxation of electricity and piped natural gas used by manufacturers.

### **Exemption for Newspapers Sold in Vending Machines**

S.L. 2001-509 (S 400), effective January 1, 2002, exempts all sales of newspapers through vending machines from sales and use tax. Confusion had arisen about the tax status of newspapers sold through vending machines at convenience stores, shopping areas, and malls. This act simplifies the taxation issue by exempting all sales of newspapers sold through vending machines.

### **Tax Revenue for Turfgrass Research**

S.L. 2001-514 (H 688), effective February 1, 2002, imposes the 6.5 percent state and local sales tax on seeds and fertilizers sold to nonfarmers.<sup>30</sup> Prior to the enactment of this act, fertilizers used for agricultural purposes and seeds were not subject to state or local sales tax. The General Assembly enacted this exemption when primarily farmers used these items. Today, nonfarmers purchase an increasing volume of these items.

The act appropriates \$700,000 from the General Fund for turfgrass research and education for each of the two fiscal years in this biennium. Of this amount, \$600,000 is appropriated to The University of North Carolina to be allocated to North Carolina State University (NCSU). The

29. This effective date was amended by S.L. 2001-489 (H 748) so that it did not apply to certificates of title issued as a result of a purchase made before October 1, 2001, or made pursuant to a contract entered into or awarded before October 1, 2001.

30. The Governor’s Loophole Study Commission and the Governor recommended this provision to the General Assembly. The Senate included it as one of its revenue raising items in its budget bill, the third edition of S 1005.

remaining \$100,000 is appropriated to the Department of Agriculture and Consumer Services for the purpose of educating the public on the results of the research conducted by the Center for Turfgrass Environmental Research and Education at NCSU.

### **Motor Fuels Tax**

S.L. 2001-205 (S 967) clarifies information sharing, provides a procedure for fuel tax refunds using third party credit cards, modifies refunds for kerosene used for certain nonhighway purposes, and makes technical changes. Section 1 of the act makes an exception to the tax secrecy law to allow the Department of Revenue to provide identifying information about motor carriers whose licenses have been revoked. The information can be provided only to the administrator of a national criminal justice system that serves as an information clearinghouse for use only by criminal justice agencies and public safety organizations. The Department of Revenue currently participates in such a system, the State On-Line Enforcement Network (STOLEN). Sharing information about motor carriers whose licenses have been revoked will promote cooperative efforts under the International Fuel Tax Agreement (IFTA), an agreement between taxing jurisdictions to assist each other in the collection and administration of taxes paid by interstate motor carriers on their use of motor fuel. Under the IFTA, a motor carrier declares one member jurisdiction to be its base jurisdiction for registering vehicles for purposes of the road taxes and reporting the taxes due to all the member jurisdictions. The base jurisdiction then collects the road taxes payable to every member jurisdiction and remits the taxes collected to the appropriate jurisdictions. By centralizing the payment and collection of road taxes, the IFTA greatly simplifies the payment of road taxes by motor carriers and the collection of road taxes by the member jurisdictions.

Sections 3 through 5 of the act establish a procedure for administering tax refunds on fuel sold to an exempt entity that uses a third-party exempt credit card to purchase the fuel. This legislation became effective October 1, 2001. Under existing law, an entity whose use of motor fuel is exempt from tax may obtain a refund of the tax it pays on fuel. In the alternative, a person who sells motor fuel to an exempt entity may obtain a refund of the tax it pays on the fuel if it does not pass the tax on to the exempt entity. The prior law also specified that a supplier may issue a card or code to the exempt entity that enables the entity to purchase motor fuel at retail without paying the tax. The supplier is liable if such a card is issued to an entity whose use of fuel is not exempt. The exempt entity is liable if it uses the card to purchase fuel for a purpose other than an exempt purpose. The prior law did not cover a third situation: a credit card company, rather than the supplier, issues the exempt card. When the exempt entity uses the exempt card to purchase motor fuel, the seller does not charge the entity for the tax but subsequently bills the credit card company for the entire sale, including the tax. The credit card company pays the seller and seeks a refund of the tax from the state. Section 3 of S.L. 2001-205 provides that the credit card company may obtain a refund of the tax in this situation. Section 4 of the act provides that the credit card company is responsible for determining that the entity to which the card is issued is exempt. It also provides that the credit card company is liable if the card is issued to an entity that is not exempt. Section 5 of the act authorizes the Secretary of Revenue to require a credit card company to file a bond if the secretary determines after an audit that a bond is necessary to assure collection of tax due pursuant to the audit.

Sections 6 and 7 of the act expand the situations in which a monthly rather than an annual refund is allowed for motor fuel tax paid on kerosene. This legislation became effective October 1, 2001. Under existing law, if a person purchases tax-paid fuel and uses it for a nonhighway purpose, the person can obtain an annual refund of the fuel tax (less the applicable sales tax). In addition, a distributor may obtain a monthly refund for fuel tax it pays on kerosene it dispenses into an end user's storage facility that contains fuel used only for heating. This monthly refund is not net of applicable sales tax, but the distributor collects and remits sales tax on the sale to the end user. Section 6 of the act adds two more exempt purposes to the distributor's monthly refund: drying crops and manufacturing. Heating, drying crops, and manufacturing are the same three purposes designated in the statute allowing dyed (untaxed) diesel fuel to be stored in

containers installed in a manner that makes it improbable that the fuel can be used for any purpose other than those three. Section 7 makes a technical change to the diesel fuel storage statute to cross-reference the purposes listed in the kerosene statute.

### **Mulch Blower Fuel Tax Refunds**

S.L. 2001-408 (H 170) allows a commercial vehicle that delivers and spreads mulch and similar materials, and that uses a power takeoff to deliver or unload the materials, to receive a partial annual refund of the motor fuel taxes paid on the fuel consumed by the vehicle. The act applies to fuel consumed on or after January 1, 2001.

### **Community College Fuel Tax Exemption**

Section 9 of S.L. 2001-427 exempts community colleges from paying the motor fuels tax, effective January 1, 2002.

### **Telecommunications Taxes**

S.L. 2001-430 (H 571), as amended by S.L. 2001-424 and 2001-487, simplifies the collection of telecommunications taxes by (1) combining multiple tax rates into one uniform rate equal to 6 percent,<sup>31</sup> (2) broadening the tax base by eliminating exemptions for interstate calls and for telephone membership corporations, (3) taxing prepaid phone cards at the point of sale instead of at the point of use, (4) adjusting the tax on the gross receipts from pay phones, (5) setting a call center tax cap of \$50,000 a year, and (6) replacing the 3.09 percent franchise tax distribution to municipalities with a distribution of 18.26 percent of the new revenue total (less the previous freeze amount).

Prior to this act, the General Assembly had not revised the tax structure for telecommunications since 1987. Since that time, changes in the telecommunications industry that were not contemplated by the 1987 tax law changes have occurred. Under former law, two taxes applied to telecommunications services. The applicability of the tax varied depending upon the identity of the provider and the type of service. One of these taxes was a gross receipts franchise tax equal to 3.22 percent of the gross receipts derived by the provider for the provision of local telecommunications services. The second tax was a sales tax. The rate of sales tax varied from 3 percent for local telecommunications to 6.5 percent for intrastate long-distance calls (that is, toll telecommunications services or private telecommunications services that both originate from and terminate in the state). By definition, the taxes did not apply to interstate long-distance calls. Telephone membership corporations had been exempt from the sales tax on telecommunications for many years, and coin-operated pay telephone calls, where the call is paid for by a coin, were exempted from the sales tax in 1998.

Under the prior law, cities received a distribution of part of the tax revenue equal to 3.09 percent of the gross receipts franchise tax that was collected from sales of local telecommunications service within the city, subject to a freeze deduction and a hold-harmless provision. Cities did not receive a percentage of the sales tax revenues. This distribution became increasingly complicated to administer. The advent of cellular phones made the task of deciding to which city a call is attributable very difficult.

During the 1990s, prepaid calling cards became increasing popular and easy to use. They could be purchased at retail stores and other places. However, unlike most items sold in the stores where the cards were most often purchased, prepaid calling cards were not taxable as tangible personal property under the state and local sales tax laws. Because the card represented a

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31. This act originally set the uniform rate at 4.5 percent. Section 34.25(a) of S.L. 2001-424 changed the uniform rate to 6 percent.

telecommunications service, the gross receipts franchise tax and the telecommunications sales tax were imposed on the air time, and the tax rate differed depending on the type of call. To levy the tax correctly, telephone companies had to track the minutes used and the types of calls placed by the cardholders.

S.L. 2001-430 addresses some of the difficulties in the existing tax structure in the following ways:

- It taxes prepaid telephone calling arrangements as personal property at the point of sale.
- It applies one tax at one rate to telecommunications services.
- It taxes all telecommunications services equally by eliminating exemptions for interstate telecommunications service, coin-operated telephone calls, and telephone membership corporations.
- It establishes a sourcing rule for mobile telecommunications.
- It preserves the revenue stream to cities while simplifying the distribution formula.

Sections 1 and 6 of S.L. 2001-430 add definitions for use in telecommunications taxation. The definition for *prepaid telephone calling arrangement* is consistent with the definition used in other states. Many of the definitions are similar to the ones previously used in G.S. 105-120. The act defines the new terms *service address* and *mobile telecommunications service*. Those definitions are consistent with the definitions in the federal Mobile Telecommunications Sourcing Act and in the draft legislation being developed by a working group established by the National Conference of State Legislatures. Section 2 repeals the definition of *utility* from the sales tax statutes because it is no longer needed. With the separate taxation of telecommunications and piped natural gas, the only industry remaining in the definition of utility is electricity. The act rewrites the sales tax statutes pertaining to electricity so that the term is not needed (Sections 3, 7, and 8). Section 4 originally set a uniform tax rate of 4.5 percent for all telecommunications services except prepaid telephone calling arrangements. The 4.5 percent rate was chosen as a revenue-neutral rate for the General Fund. Section 34.25(a) of S.L. 2001-424 changed the uniform rate to 6 percent. Section 5 taxes prepaid telephone calling arrangements as personal property at the point of sale and identifies the point of sale. Consequently, it sets the tax rate for prepaid calling arrangements at the general state rate plus the applicable local rates.

Section 6 is the heart of the act. It sets forth the taxation of telecommunications as follows:

- It adopts a sourcing rule for mobile telecommunications service that is substantially the same as the sourcing rule in the federal Mobile Telecommunications Sourcing Act. Mobile telecommunications service is considered to have been provided in this state if the customer's service address is in this state. A service address for mobile telecommunications service may be determined by the provider based upon the customer's telephone number, the mailing address to which the bills are sent, or a street address provided by the customer.
- It addresses the taxation of telecommunications service that is bundled with a service that is not taxable. In those cases, a proportion of the gross receipts from the total charges are taxable based on the unbundled price of each service or on an allocation of revenue to each service.
- It taxes all telecommunications service, including interstate telecommunications service and service provided through a telephone membership corporation. When the General Assembly last changed the telecommunications tax laws in 1987, it was unclear whether states could constitutionally tax interstate telecommunications. However, in 1989, the U.S. Supreme Court removed this uncertainty in *Goldberg v. Sweet*, 488 U.S. 252, 109 S. Ct. 582, when it held that states can tax interstate telecommunications.
- It replaces the 3.22 percent franchise tax on local telecommunications and the 3 percent and 6.5 percent sales taxes on local telecommunications with a uniform gross receipts sales tax on telecommunications.
- It eliminates the tax exemption for telecommunications service provided by public coin-operated pay telephones and paid for by coin (see Section 4). It excludes from tax the receipts from the sale of pay telephone service because the provider pays the sales tax on its purchase of those services.
- It taxes interstate private lines as follows:

- 100 percent of the charge imposed at each channel termination point in this state,
  - 100 percent of the charge imposed for the total channel mileage between each channel termination point in this state, and
  - 50 percent of the charge imposed for the total channel mileage between the first channel termination point in this state and the nearest channel termination point outside this state.
- It caps the tax on call centers at \$50,000 a year. The cap applies to a person who purchases interstate telecommunications service that originates outside the state and terminates in this state and who has a direct pay permit issued by the Secretary of Revenue. A direct pay permit authorizes the holder to purchase telecommunications service without paying tax to the seller and authorizes the seller not to collect any tax on a sale to a permit holder. The permit holder pays the tax directly to the Department of Revenue (Section 9).

Section 10 establishes a new distribution formula that replaces the 3.09 percent distribution to cities from the telephone gross receipts franchise tax with a distribution from the sales tax on telecommunications service established under this act. The new distribution formula eliminates the need for telephone companies to separately track and report local versus other calling services. It also eliminates the need for telephone companies to determine where wireless calls fall in the local/nonlocal mix of calls. Under the new distribution formula, each quarter the Secretary of Revenue must first deduct from the net amount of the tax to be distributed to the cities the amount of \$2,620,948. This is the amount by which the distribution to the cities of the gross receipts franchise tax on telephone companies was required to be reduced in fiscal year 1995–1996. After the required deduction, the secretary must distribute the remaining net tax proceeds to the cities. Cities incorporated before January 1, 2001, will receive a proportionate share based on the amounts they received from the gross receipts franchise tax on telephone companies. Cities incorporated on or after January 1, 2001, will receive a per capita share.

Section 11 of S.L. 2001-430 makes a conforming change to the local franchise tax distribution formula by eliminating references to the gross receipts franchise tax on telephone companies and by clarifying that the freeze deduction applies only to the receipts attributable to electric power companies and natural gas companies. Section 12 repeals the 3.22 percent gross receipts franchise tax on telephone companies. The tax is repealed because it is merged into the uniform tax on telecommunications services established in this act. Sections 13 and 14 conform the local sales tax statutes by adding prepaid telephone calling arrangements to the local sales tax base. Section 15 requires the Department of Revenue to report to the Revenue Laws Study Committee in October 2003 and October 2007 on the amounts collected under this act and on the distributions made to cities. The department, in consultation with the League of Municipalities, may recommend changes to the distribution formula. Sections 16 and 17 preserve the prohibition on county and city taxes on telecommunications services that is now contained in G.S. 105-120(d). Section 18, as amended,<sup>32</sup> requires the Utilities Commission to reduce the rates set for telecommunications services to reflect the repeal of G.S. 105-120 and the resulting liability of local telecommunications companies for the new uniform sales tax. The North Carolina Supreme Court upheld the Utilities Commission's authority under its rulemaking procedure to reduce rates to reflect a tax reduction that affects an industry uniformly. *State ex rel. Utility Commission v. Nantahala Power & Light Company*, 326 N.C. 190 (1990). Section 19 directs the Revenue Laws Study Committee to recommend to the 2002 Session of the General Assembly any changes necessary to conform North Carolina's tax laws with the federal Mobile Telecommunications Sourcing Act.

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32. Section 119 of S.L. 2001-487 amended Section 18 of this act to clarify that the Utilities Commission has some flexibility in lowering rates, rather than being limited to lowering only basic local line rates by the exact amount of the reduced tax burden.

## Changes to the Bill Lee Act

The William S. Lee Quality Jobs and Business Expansion Act (the Bill Lee Act) was enacted in 1996, effective beginning with the 1996 tax year with a 2002 sunset. The Bill Lee Act is a package of state tax incentives and has been modified in each subsequent year. The incentives are primarily in the form of tax credits for investment in machinery and equipment and real property, for job creation, for worker training, and for research and development. Counties are divided into five economic distress tiers based on the unemployment rate, per capita income, and population growth of the county. For many of the credits, the lower the tier of a county, the more favorable the incentive.

S.L. 2001-476, as amended by S.L. 2001-487, makes the following changes to the Bill Lee Act.

### Eligible Business Rules and Definitions

Sections 1 and 6 of S.L. 2001-476 make numerous clarifications and changes to the definitions regarding *eligible businesses* under the Bill Lee Act. Section 1(a) clarifies that a taxpayer is eligible for a credit under the Bill Lee Act only if the primary business of the taxpayer is an eligible business under that act. There had been some confusion on the part of taxpayers as to whether a taxpayer whose primary business was not an eligible business but who nonetheless engaged in eligible business activities at a specific location was eligible for credits under the Bill Lee Act. This clarification is consistent with the interpretation of the Bill Lee Act by the Department of Revenue.<sup>33</sup> This is a clarifying amendment and does not change existing law.

Section 1(a) of S.L. 2001-476 became effective when it became law, November 29, 2001. Section 1(b) amends the definitions to remove the requirements regarding primary business. Section 6(a) moves these requirements to the eligible business statute, G.S. 105-129.4(a). Section 1(b) also amends the definition of *data processing* by splitting it into two definitions, *computer services* and *data processing*, and restricting it so that in order for a taxpayer to be engaged in one of these activities, the services must be provided primarily to entities that are not related entities of the taxpayer.<sup>34</sup> In addition, Section 1(b) provides a new definition of data processing that does not explicitly refer to the NAICS definition. Section 1(b) is effective for taxable years beginning on or after January 1, 2001.

Section 6(a) amends G.S. 105-129.4(a), effective for taxable years beginning on or after January 1, 2001, to relax the eligible business requirements as follows:

- Computer services. The law is expanded to allow a taxpayer to qualify for credits if the taxpayer has an establishment whose primary activity is in computer services. Under previous law, a taxpayer was eligible for a credit for this industry only if the primary business of the taxpayer was in that industry.
- Electronic mail order house. The law is expanded to allow a taxpayer to qualify for credits if the taxpayer has an establishment whose primary activity is an electronic shopping and mail order house. Under previous law, a taxpayer was eligible for a credit for an electronic mail order house only if the primary business of the taxpayer was an electronic shopping and mail order house.
- Warehousing. Under previous law, a taxpayer was engaged in warehousing only if the primary business of the taxpayer was warehousing. S.L. 2001-476 expands the definition to include a taxpayer whose primary business is not an eligible business if the taxpayer has an establishment whose primary activity is warehousing and that establishment meets each of the following conditions:
  - The establishment is located in an enterprise tier one, two, or three area.
  - The establishment is at a site separate from other subdivisions of the taxpayer.

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33. G.S. 105-264 imposes the duty of interpreting the tax laws upon the Secretary of Revenue.

34. Section 1(b) incorporates the definition of *related entity* found in G.S. 105-130.7A.

- The establishment serves at least twenty-five establishments in at least five different counties in one or more states.
- Multiple businesses. S.L. 2001-476 expands the law to allow a taxpayer to claim credits under the Bill Lee Act if the taxpayer's primary business is manufacturing, warehousing, or wholesale trade and the jobs, investment, or activity with respect to which a credit is claimed are used in any of those types of business. Under previous law, a taxpayer could claim a credit under the Bill Lee Act only if the jobs, investment, or activity with respect to which a credit was claimed were used within the primary business of the taxpayer.

In each of these cases, it has been argued that a taxpayer whose primary business is in another industry might nonetheless engage in significant activities in one of these areas. Section 6(a) allows such a taxpayer to be eligible for credits under the Bill Lee Act.

### **Tier Designation Formula Change**

Section 3 of S.L. 2001-476 makes two changes to the tier designation formula. In general, counties are divided into five economic distress tiers based on the unemployment rate, per capita income, and population growth of the county. In 1999, the General Assembly amended the tier designation formula to give a more favorable tier designation to certain lower-population counties. Under previous law there were three exceptions for lower-population counties:

1. A county with a population of less than 10,000 and more than 16 percent of its population below the federal poverty level was designated an enterprise tier one area.
2. A county with a population of less than 50,000 and more than 18 percent of its population below the federal poverty level was given a tier designation one level lower than it otherwise would have received.
3. A county with a population of less than 25,000 could not be designated higher than an enterprise tier three area.

This act increases the population thresholds that are used in items one and three, above, from 10,000 to 12,000 and from 25,000 to 35,000, respectively. The Department of Commerce reports that the counties that are affected by the first change are Alleghany and Jones. The counties affected by the second change are Alexander, Dare, Davie, Macon, and Transylvania. This section became effective when it became law on November, 29, 2001, and applies to tier designations that are made on or after that date.

### **Call Centers**

In 1999 the General Assembly amended the Bill Lee Act so that certain call centers (electronic mail order houses and customer service centers) were eligible for credits under the Bill Lee Act. Section 6 of S.L. 2001-476 expands the number of taxpayers eligible for credits under the Bill Lee Act by including customer service centers and electronic mail order houses located in enterprise tier three areas. This change is effective for taxable years beginning on or after January 1, 2001.

### **Clarification of Expiration of Credits**

In 2000 the General Assembly amended the Bill Lee Act to clarify that if a taxpayer ceased to engage in an eligible business, credits under the Bill Lee Act would expire and the taxpayer would not be allowed to take any further installments of the credit. Expiration of a credit, however, does not prevent a taxpayer from taking any carryforwards of previous installments of the credit. In several instances, an eligible business is defined not only by industry type, but also by the number of jobs created or the enterprise tier designation of the location. It was not entirely clear what the effect would be on a taxpayer's credits if the taxpayer was still involved in an eligible industry, but the number of employees dropped below the applicable threshold or the enterprise tier designation of the location rose above the applicable threshold. Section 6 of this act clarifies that credits under

the Bill Lee Act expire if the number of jobs at a central administrative office drops below 40 or if the number of jobs at an electronic mail order house drops below 250. Section 6 further clarifies that a change in the tier designation of the location of a customer service center or an electronic mail order house does not result in expiration of the credits. These changes became effective when the act became law, November 29, 2001. Section 6 also clarifies the period of time during which a central administrative office may meet the requirement that it create at least forty jobs.

### **Wage Standard**

In order for a taxpayer to be eligible for the credits under the Bill Lee Act, jobs must meet the applicable wage standard. Section 6 of S.L. 2001-476 makes several changes to the wage standard test. First, this act clarifies that the average wage of all jobs at the facility must exceed the applicable average weekly wage in order for the taxpayer to be eligible for the credit for investing in machinery and equipment, the credit for research and development, the credit for investing in central office and aircraft facility property, and the credit for substantial investment in other real property.<sup>35</sup> Second, this act changes the wage standard test for the credit for worker training and the credit for creating new jobs. For those two credits, the average wage of the jobs for which the credit is claimed *and* the average wage of all jobs at the facility must exceed the applicable average weekly wage.

### **Safety and Health and Environmental Eligibility Amendments**

Section 5 of S.L. 2001-476 makes changes to the safety and health program eligibility requirement under the Bill Lee Act. Previously, a taxpayer was ineligible for a credit under the Bill Lee Act if the taxpayer had any outstanding violations under the Occupational Safety and Health Act or had had any serious violations of that act in the past three years. Section 5 of S.L. 2001-476 changes this standard in two ways. First, the new standard focuses only on citations that have become final orders. Second, instead of looking for “serious” violations the new standard looks for “willful serious” violations or the “failure to abate serious” violations. The new standard makes more taxpayers eligible for credits under the Bill Lee Act. Section 5 is retroactive to taxable years beginning on or after January 1, 2000.

Section 6 of this act also changes the reporting procedures for the safety and health eligibility requirement and for the environmental impact requirements. Under previous law, the Department of Commerce had to report to the Department of Labor those taxpayers who claimed to meet the safety and health eligibility requirement, and the Department of Labor could audit those taxpayers randomly. Section 6 of S.L. 2001-476 provides that the Department of Labor must now report to the Department of Revenue those employers who have final orders that would make them ineligible for credits. Similarly, under previous law, the Department of Commerce had to report to the Department of Environment and Natural Resources (DENR) those taxpayers who claimed to meet the environmental impact eligibility requirements, and DENR could perform random audits. Section 6 of the act provides that DENR must now report to the Department of Revenue those persons who have pending or final determinations that would disqualify them from claiming credits.

### **Extended Carryforward Periods**

The Bill Lee Act credits may not exceed 50 percent of the tax against which they are claimed. This limitation applies to the cumulative amount of credit claimed by the taxpayer, including carryforwards. As a general rule, any unused portion of a credit may be carried forward five years. Previously, the Bill Lee Act provided three exceptions that allowed longer carryforwards. Those three exceptions were

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35. This is a new credit created by this act and is discussed in more detail below.

1. Any unused portion of a credit with respect to a large investment may be carried forward for twenty years. A *large investment* is one where an eligible business purchases or leases, and places in service within a two-year period, \$150 million worth of one or more of the following: real property, machinery and equipment, or central office or aircraft facility property.
2. Any unused portion of a credit with respect to the technology commercialization credit may be carried forward for twenty years. The General Assembly created the technology investment credit in 1999 as an alternative to the 7 percent credit for investing in machinery and equipment. The credit applies only to investments in machinery and equipment used in production that is based on technology licensed from a research university. The investments must be located in a tier one, two, or three county, must equal at least \$10 million during the taxable year, and must total at least \$100 million over a five-year period.
3. Any unused portion of a credit may be carried forward for ten years if the Secretary of Commerce certifies that the taxpayer will purchase or lease, and place in service in connection with an eligible business within a two-year period, at least \$50 million worth of one or more of the following: real property, machinery and equipment, or central office or aircraft facility property. If the taxpayer fails to make the level of investment certified within the two-year period, the taxpayer forfeits the enhanced carryforward period.

Section 7 of S.L. 2001-476 creates two additional exceptions that allow longer carryforwards. Under this act, any unused portion of a credit with respect to research and development under G.S. 105-129.10 may be carried forward for fifteen years. Additionally, any unused portion of a credit for substantial investment in other property<sup>36</sup> under G.S. 105-129.12A may be carried forward for twenty years. These changes are effective for taxable years beginning on or after January 1, 2002, and apply to credits that are first claimed on or after that date.

### **Statute of Limitations**

Section 7 of S.L. 2001-476 establishes a statute of limitations so that Bill Lee Act credits cannot be taken more than six months after the deadline for filing the tax return (including extensions) on which they are claimed. This change is effective beginning with the 2001 tax year. In general, an overpayment may be refunded only if the discovery or the written request for a refund is made within three years of the date set by statutes for filing the return or within six months of the date of the overpayment, whichever is later.

### **Bill Lee Act Credit Applications, Fees, and Reports**

Under previous law, to claim a credit under the Bill Lee Act, a taxpayer had to provide with the tax return the certification of the Secretary of Commerce that the taxpayer met all of the eligibility requirements with respect to each credit that the taxpayer claimed. Section 8 (among other sections) of S.L. 2001-476 eliminates the requirement that a taxpayer must obtain the certification of the Secretary of Commerce in order to claim a Bill Lee Act credit. The Department of Commerce will continue to establish enterprise tier and development zone designations and will make written determinations regarding the requirements for development zone projects, large investments, the investment amount for enhanced carryforwards, and the investment amount for the new credit for substantial investment in other property. As amended by S.L. 2001-489, this change is effective for business activities occurring on or after January 1, 2002, and for business activities occurring before January 1, 2002, for which no application has been filed with the Department of Commerce by January 1, 2003. For business activities occurring before January 1, 2002, for which an application is filed with the Department of Commerce before

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36. This is a new credit created by this act and is discussed in more detail below.

January 1, 2003, special interim procedures are used. The taxpayer must file an application with the Department of Commerce and pay any applicable fees. The Department of Commerce will not make any determination regarding eligibility for the credits and will not issue a certification, but will instead mark the application as paid and return it to the taxpayer. The taxpayer must then submit the marked application to the Department of Revenue with the relevant tax return. The fees will be divided between the two departments as under previous law. These interim procedures were put into place as the result of a compromise between the Department of Commerce and the Department of Revenue. Since the Department of Commerce's role in certification was being eliminated, it wanted to end all association with certification as soon as possible. The Department of Revenue needed the interim period because it had no feasible way to collect the fees during 2002. Taxpayers must still pay the fee that is currently due with the application, but under this act the fee must be submitted to the Department of Revenue with the tax return for the year in which the taxpayer engaged in the eligible activity. The fee may be paid late, however, as long as it is paid before the credit is claimed.

Under Section 6 of S.L. 2001-476, a taxpayer may seek an advisory ruling from the Secretary of Revenue regarding the taxpayer's eligibility for a credit. Such a ruling will help the taxpayer determine in advance whether a planned activity will qualify for a credit. This change became effective beginning with the 2002 taxable year.

Section 9 of S.L. 2001-476 changes the requirement that taxpayers report the number of development jobs that are filled by residents of development zones. This requirement now applies only to jobs located in development zones. This change became effective beginning with the 2002 taxable year.

### **Machinery and Equipment Credit Changes**

Section 10 of S.L. 2001-476 clarifies how the minimum investment threshold applies to taxpayers who invest in more than one tier. The threshold varies depending on the enterprise tier where the machinery and equipment are placed in service. Previous law stated that if machinery and equipment were placed in service in more than one area, the threshold applied separately to each area. The Department of Revenue interpreted "area" to mean "enterprise tier area." Section 10 of this act clarifies that the threshold applies separately to each of the taxpayer's establishments rather than to each enterprise tier area. An *establishment* is generally a site or location. Section 10 became effective for machinery and equipment placed in service on or after January 1, 2002.

### **Central Office or Aircraft Facility Property Credit**

Section 12 of S.L. 2001-476 removes a provision regarding the expiration of the credit for investing in central office or aircraft facility property. Under previous law, the credit for investing in central office or aircraft facility property expired if the total number of people employed at the taxpayer's central office or aircraft facilities statewide decreased by forty or more. This provision applied only to the credit for investing in central office or aircraft facility real property—the other credits under the Bill Lee Act were not affected by a decrease of forty or more employees. Section 12 removes this provision. However, as is clarified in Section 6 of S.L. 2001-476, the credit for investing in central office or aircraft facility property expires if the number of employees at the office or facility falls below 40. Section 12 is effective for taxable years beginning on or after January 1, 2001.

### **New Credit for Substantial Investment in Other Property**

Section 13 of S.L. 2001-476 creates a new credit under the Bill Lee Act for substantial investment in other real property. This credit is modeled upon the existing credit for investment in central office or aircraft facility property. There are, however, some notable differences between the two credits. In order for the taxpayer to claim the credit for substantial investment in other property, the Secretary of Commerce must make a written determination that the taxpayer is

expected to invest at least \$10 million in real property at a certain location within a three-year period and that the location will create at least 200 new jobs within two years of the time that the property is first used in an eligible business. In contrast, there is no minimum investment amount for the credit for investing in central office or aircraft facility property. For both credits, the taxpayer may begin to claim the credit once the property is first used in an eligible business. The amount of the credit for substantial investment in other property is equal to 30 percent of the eligible investment amount and must be taken in installments over a seven-year period. There is no ceiling on the amount of the credit. In contrast, the credit for investing in central office or aircraft facility property is equal to 7 percent of the eligible investment amount and has a ceiling of \$500,000. The credit for substantial investment in other property expires if the number of people employed at the location falls below 200. As mentioned earlier, the carryforward period for the credit for substantial investment in other property is twenty years, whereas the carryforward period for the credit for investment in central administrative office or aircraft facility property is the standard five years. A taxpayer may not claim both the credit for substantial investment in other property and the credit for investing in central office or aircraft facility property with respect to the same property. Conforming changes related to this new credit were made in several other sections of the act. This credit is effective for taxable years beginning on or after January 1, 2002, and applies to property first used in an eligible business on or after that date.

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