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## State Taxation

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In its 2002 session, the General Assembly made numerous changes in North Carolina tax laws, especially concerning tax breaks to encourage economic development. Also, the budget bill contained a number of changes in the tax laws.

### **Mobile Telecommunications Sourcing**

S.L. 2002-16 (H 1521) conforms state sales tax law to the federal Mobile Telecommunications Sourcing Act and codifies the sourcing rules for other types of telecommunications, as recommended by the Revenue Laws Study Committee. While this legislation may redistribute tax revenue between jurisdictions because of changes in sourcing, the total amount available to local governments will not change.

Most of the act became effective for taxable services reflected on bills dated on or after August 1, 2002. This effective date corresponds with the effective date of the federal Mobile Telecommunications Sourcing Act. Two provisions are delayed until January 1, 2004: a new sourcing principle for private lines and a requirement that postpaid calling service be sourced based on the origination point of the signal.

### **Housing Tax Credit/Estate Tax**

S.L. 2002-87 (S 1416) modifies the low-income housing tax credit to make it simpler and more efficient. In 1999 North Carolina authorized a state income tax credit equal to a percentage of the developer's federal tax credit for low-income housing constructed in North Carolina. A project developer sells the tax credits to receive funds to finance the project.<sup>1</sup> Developers indicate that the state tax credit sells for no more than forty-five cents on the dollar.

During the 2002 session, the General Assembly became aware of several concerns with the low-income housing tax credit:

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1. To buy a credit, a taxpayer invests in the project in exchange for the right to claim a share of the credits available for the project.

- The sale of a dollar tax credit for less than forty-five cents is an inefficient use of state tax expenditures.
- The process of selling the tax credits is complex. It involves finding investors, negotiating prices, and completing legal documents.
- The pool of investors interested in purchasing the credit is limited and is diminishing. S.L. 2002-87 addresses these concerns in two ways:
  - To address the short-term problem of utilizing the tax credits allocated to developers, the act reduces the tax basis required of a purchaser from 100 percent to 40 percent.
  - To address the long-term problem of the complexity and inefficiency of the credit, the act converts the state credit, which is sold to investors, to a refundable credit received directly by the owner and invested directly in the project. The modification saves the state significant revenue over a five-year period while maintaining the same level of investment in low-income housing developments.

The low-income housing tax credit changes are effective beginning with the 2002 tax year for the existing credit and in 2003 for buildings that are awarded a federal credit allocation on or after January 1, 2003.

S.L. 2002-87 also modifies the formula for calculating estate tax on estates with property in more than one state from a net value calculation to a gross value calculation. This change makes North Carolina's treatment on this issue the same as that of the majority of states that have estate taxes. The change has little or no impact on the General Fund and is effective for the estates of decedents dying on or after January 1, 2002.

## **Economic Development**

### **Extension of Qualified Business Venture Tax Credit**

S.L. 2002-99 (H 1520) extends the tax credit for qualified business investments and the state ports tax credit from January 1, 2003, to January 1, 2004. It also revises the definition of *qualified grantee business* to alleviate a constitutional concern by replacing specific named entities with general descriptions of entities. This change is effective January 1, 2003. The amount of the tax credit on qualified business investments that is given each year is capped at \$6 million. Because requests for credits have exceeded this cap for four out of the last five years, it is likely that the \$6 million annual cost of the program will continue until its sunset in 2004. The impact on the General Fund due to the extension of this tax credit will occur in the 2003–2004 fiscal year because the investments made in 2003 will be awarded credits on returns filed in the spring of 2004. The extension of the state ports tax credit is estimated to cost the General Fund \$650,000 in the 2003–2004 fiscal year.

The act also clarifies that the North Carolina State Ports Authority has fee-setting authority for its rates and tariffs, gives the Authority guidelines to use in setting those fees, requires the Authority to report to the Joint Legislative Commission on Governmental Operations no later than thirty days after it establishes or increases a fee, and exempts the Authority's fee setting from the rule-making portion of the Administrative Procedure Act. The changes to the fee-setting authority became effective August 29, 2002, and have no fiscal impact.

### **Interstate Air Couriers**

S.L. 2002-146 (H 1665) makes several changes to the William S. Lee Quality Jobs and Business Expansion Act (Bill Lee Act) as it applies to air courier hubs. In 1998 the General Assembly provided incentives in the Bill Lee Act to encourage FedEx to construct an air courier hub in the Piedmont Triad region. The interstate air courier industry faces many regulatory, administrative, and legal hurdles—particularly in the construction of hubs—that are not generally faced by other industries. Due to these extra burdens, construction time frames in this industry are

generally longer than in other industries. To accommodate these longer time frames, S.L. 2002-146 extends the regular Bill Lee Act sunset of January 1, 2006, to January 1, 2010, for an interstate air courier that enters into a major real estate lease with an airport authority on or before January 1, 2006. The act also extends from two years to seven years the time that an interstate air courier has to qualify for the enhanced incentives, and it extends the sunset on the Piedmont Triad Airport Authority's exemption from the bidding laws from January 1, 2008, to January 1, 2010. Finally, the act rewrites the definition of interstate air courier hub to conform to industry practice.

The initial estimates of the fiscal impact of the air courier incentives have not changed with the delay in the FedEx project. The 1998 estimates indicate that the lower sales tax rate on handling and storage equipment will amount to a cost of \$400,000 for the first two years that the project is getting started and \$100,000 per year thereafter. The impact of the sales tax exemption for lubricants and repair parts comes into play only after the facility is up and running. The cost estimate for this incentive is \$200,000 a year. The uncertainty surrounding the timing of the project means that it is impossible to predict in which year the effects will be felt. Under current scheduling, the first year of the handling and storage equipment incentive could be 2005–2006, while the sales tax incentives will not occur until at least 2005–2006.

In addition, the extension from 2006 to 2010 of the Bill Lee Act's sunset for interstate air couriers will allow FedEx and other eligible taxpayers to take tax credits under the act during the 2006–2009 period. Data from the state's 1998 offer of financial benefits to FedEx indicated that Bill Lee Act credits of \$2 million would be taken over a four-year period.

S.L. 2002-146 also amends the wage standards under the Bill Lee Act for all taxpayers. In order for a taxpayer to be eligible for any of the credits under the Bill Lee Act, the average wage of the jobs created by the taxpayer must meet or exceed the wage standard for the county in which the jobs are located. Included in this calculation are part-time jobs, converted to a full-time equivalency. Because part-time jobs generally pay less than full-time jobs, the inclusion of part-time jobs in determining eligibility for credits under the Bill Lee Act can render a taxpayer ineligible for those credits. S.L. 2002-146 provides that part-time jobs for which the taxpayer provides health insurance will be considered to have a wage that meets the applicable wage standard.

The air courier hub definition rewrite became effective October 1, 2002, and applies to sales made on or after that date. The bidding law exemption effective date change became effective when the act became law, October 7, 2002. The remaining provisions in the act are effective for tax years beginning on or after January 1, 2002.

### **North Carolina Economic Stimulus and Job Creation Act**

S.L. 2002-172 (H 1734) has six parts.

- Part 1 amends the Bill Lee Act by reducing the machinery and equipment credit available in tier three, four, and five counties, by eliminating the wage standard in tier one and two counties and in development zones, and by eliminating the wage standard for the worker training credit. These changes are effective for taxable years beginning on or after January 1, 2003, and apply to business activities that occur on or after that date. They do not, however, apply to business activities occurring on or after January 1, 2003, that are subject to a letter of commitment signed before January 1, 2003. The changes will generate approximately \$3.45 million in additional revenue for fiscal year 2003–2004, \$7 million for fiscal year 2004–2005, and \$10.56 million for fiscal year 2005–2006.
- Part 2 creates the Jobs Development Investment Grant Program, a discretionary program that awards grants to businesses based on a percentage of employee withholdings over a number of years. The term of a grant cannot exceed twelve years. The program grants are structured quite differently from those of the Bill Lee Act tax incentives. The exact cost of the program cannot be determined. The program is limited, however, to fifteen projects per year and \$10 million in grants per year, and it sunsets on January 1, 2005.

- Part 3 requires production companies to spend at least \$1 million in North Carolina to be eligible for a grant from the Film Industry Development Account. No fiscal impact is expected from this change to the film industry incentives.
- Part 4 makes a technical change to the North Carolina Railroad's condemnation authority. It does not appear to have any substantive effect on the railroad's power to condemn property.
- Part 5 relaxes the public hearing requirements for Industrial Development Bond financing to facilitate the process for smaller manufacturers.
- Part 6 authorizes initiation of the planning and development of a new biopharmaceutical training center and a cancer rehabilitation treatment center.

Parts 2, 3, 4, and 6 were effective October 31, 2002. Part 5 is effective January 1, 2003.

## **Pollution Abatement Tax Exclusion**

S.L. 2002-104 (S 1253), recommended by the Environmental Review Commission, provides that an animal waste management system may not qualify for property tax exclusion as a pollution control device unless it eliminates or substantially eliminates certain discharges, emissions, and contamination. The act also requires the Revenue Laws Study Committee to study property tax exemptions for pollution control equipment. The legislation will not affect the state General Fund, but it will affect the amount of revenue in each county's property tax base. Since no exclusions have yet been granted to waste facilities, current county revenues have not been affected. Had the legislation not been enacted, however, potential revenue losses would have been distributed among counties based on the number of animal waste management systems maintained in each county. Potential losses had been estimated using the total property value of a county's swine, poultry, and turkey facilities. The potential property tax revenue losses statewide could have totaled \$9.9 million per fiscal year.

The act is effective for property tax years beginning on or after July 1, 2002.

## **Revenue Law Enforcement Enhancements**

S.L. 2002-106 (S 1218) enhances tax law enforcement by (1) providing for increased punishment for income tax return preparers who aid or assist in the filing of false or fraudulent documents with the Department of Revenue, (2) making it an offense for tax preparers to defraud taxpayers, and (3) allowing the Department of Revenue to share information concerning the commission of any offense with appropriate state or federal law enforcement agencies.

The section allowing Department of Revenue disclosure became effective September 6, 2002. The remainder of the act was effective December 1, 2002.

## **Fuel Tax**

S.L. 2002-108 (S 1407) gives local fuel distributors a contract right to delay reimbursing federal fuel tax to the supplier until one day before the supplier is required to remit the tax to the federal government. The act also converts the local government fuel tax refund to an exemption and makes several other changes to the motor fuel tax laws. The only provision with a fiscal impact is that converting the local government fuel tax refund to an exemption. The exemption will produce some additional revenue for local governments because of the interest earned on moneys that once went to fuel tax payments before being refunded. Based on refund amounts for past years, the General Assembly's Fiscal Research Division estimates the annual float gain for local governments would have been \$227,030 for fiscal year 2000–2001 and \$252,860 for fiscal year 1999–2000.

The contract right provision was effective September 1, 2002. The motor fuel tax provisions become effective January 1, 2003.

## Tax Changes in the Budget Bill

The Current Operations, Capital Improvements, and Finance Act of 2002, S.L. 2002-126 (S 1115), made numerous changes in the tax laws. These changes are summarized below.

<i>Section</i>	<i>Description and Effective Date</i>	<i>Fiscal Impact</i>
30A.1	<b>Local Government Revenues</b> Accelerates the repeal of the tax reimbursements from July 1, 2003, to July 1, 2002. Also authorizes local governments to raise or lower property taxes between July 1 and the following January 1 in any year to compensate for unanticipated revenue increases or decreases.	This provision will create a General Fund revenue gain of \$333.4 million per year beginning in FY 2002–2003.
30B.1	<b>2001 Tax Break Delay: Elimination of Marriage Penalty for Standard Deduction</b> Delays the enactment by one year of the tax break enacted in 2001 eliminating the marriage penalty for the standard deduction, originally effective beginning with the 2002 tax year. Now, the standard deduction for married couples filing jointly will increase from \$5,000 to \$5,500 in tax year 2003 and then to \$6,000 in tax year 2004.	The net gain to the General Fund as the result of delaying the first \$500 increase is \$31.9 million for FY 2002–2003. For the \$6,000 standard deduction delayed until 2004, the estimated revenue loss is \$32.4 million for FY 2003–2004. Since the original estimate for the 2003–2004 loss was \$45 million, the General Fund will gain \$12.6 million that year.
30B.2	<b>2001 Tax Break Delay: Increase of Tax Credit for Children</b> Delays by one year the effective date of the increased tax credit for children enacted in 2001. Beginning with tax year 2003, the tax credit for children is increased from \$60 to \$75 per child and then to \$100 in tax year 2004.	The delay will eliminate the \$19.8 million General Fund loss originally projected for FY 2002–2003 and result in a revenue gain of the same amount. Because the revenue loss for the \$75 credit is less than that for the \$100 credit originally scheduled for 2003–2004, there will be a revenue gain for that year of \$34.9 million. The increase to \$100 in tax year 2004 will result in a \$54.8 million loss in FY 2004–2005.

<i>Section</i>	<i>Description and Effective Date</i>	<i>Fiscal Impact</i>										
30C.1	<p><b>Update of IRC Reference</b> Updates the Internal Revenue Code reference from January 1, 2001, to May 1, 2002, with exceptions for accelerated depreciation and the estate tax credit. This update conforms North Carolina law to federal law with regard to recent pension tax changes, education initiatives, the increased estate tax exemption limitations, and the extension of the carryback period for net operating losses for tax years ending in 2001 and 2002.</p>	<p>The following General Fund revenue losses are expected:</p> <table> <tr> <td>2002–2003</td> <td>\$16.9 million</td> </tr> <tr> <td>2003–2004</td> <td>\$25.5 million</td> </tr> <tr> <td>2004–2005</td> <td>\$49.7 million</td> </tr> <tr> <td>2005–2006</td> <td>\$76.9 million</td> </tr> <tr> <td>2006–2007</td> <td>\$77.3 million</td> </tr> </table>	2002–2003	\$16.9 million	2003–2004	\$25.5 million	2004–2005	\$49.7 million	2005–2006	\$76.9 million	2006–2007	\$77.3 million
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30C.2	<p><b>Accelerated Depreciation Provisions</b> Decouples North Carolina law from federal law by requiring taxpayers to add back to federal taxable income a percentage of the additional 30% accelerated depreciation allowed under federal law, effective for taxable years beginning on or after January 1, 2002. Taxpayers will continue to be able to deduct the same amount of an asset's basis under both federal and state law, but the timing of the deductions will differ. The percentage is 100% for the 2001 and 2002 taxable years and 70% for the 2003 taxable year. There is no add-back for the 2004 taxable year. In tax years beginning on or after January 1, 2005, a taxpayer may deduct from federal taxable income the total amount of the add-backs required in earlier years, divided into five equal installments.</p>	<p>The impact of the changes is essentially revenue neutral over the long term since the conformity deals with an acceleration of depreciation, not the total amount of the deduction over the life of an asset. The General Fund impact is estimated as follows:</p> <table> <tr> <td>2002–2003</td> <td>\$38.2 million</td> </tr> <tr> <td>2003–2004</td> <td>\$ 8.6 million</td> </tr> <tr> <td>2004–2005</td> <td>-\$60.8 million</td> </tr> <tr> <td>2005–2006</td> <td>0</td> </tr> <tr> <td>2006–2007</td> <td>0</td> </tr> </table>	2002–2003	\$38.2 million	2003–2004	\$ 8.6 million	2004–2005	-\$60.8 million	2005–2006	0	2006–2007	0
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30C.3	<p><b>Estate Death Tax Credit Provision</b> Decouples North Carolina law from the phaseout of the estate death tax credit under federal law, effective for estates of decedents dying on or after January 1, 2002. This provision sunsets for decedents dying on or after January 1, 2004.</p>	<p>The General Fund revenue loss is estimated as follows:</p> <table> <tr> <td>2002–2003</td> <td>\$5.5 million</td> </tr> <tr> <td>2003–2004</td> <td>\$7.3 million</td> </tr> <tr> <td>2004–2005</td> <td>\$3.8 million</td> </tr> <tr> <td>2005–2006</td> <td>\$5.9 million</td> </tr> </table>	2002–2003	\$5.5 million	2003–2004	\$7.3 million	2004–2005	\$3.8 million	2005–2006	\$5.9 million		
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30C.5	<p><b>Federal Gift Tax Annual Exclusion</b> Conforms the North Carolina gift tax exclusion to the federal inflation-adjusted gift tax exclusion, effective January 1, 2002.</p>	<p>The General Fund revenue loss is estimated as follows:</p> <table> <tr> <td>2002–2003</td> <td>\$0.2 million</td> </tr> <tr> <td>2003–2004</td> <td>\$0.2 million</td> </tr> <tr> <td>2004–2005</td> <td>\$0.2 million</td> </tr> <tr> <td>2005–2006</td> <td>\$0.4 million</td> </tr> <tr> <td>2006–2007</td> <td>\$0.4 million</td> </tr> </table>	2002–2003	\$0.2 million	2003–2004	\$0.2 million	2004–2005	\$0.2 million	2005–2006	\$0.4 million	2006–2007	\$0.4 million
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30D.	<p><b>Unauthorized Substance Tax Expenses</b> Provides that local governments will bear 70% of the state's expenses in collecting the unauthorized substance tax, effective June 30, 2002. The expenses are drawn from local sales tax distributions. This section does not, however, change the amounts that are distributed to local law enforcement agencies.</p>	<p>The General Fund will be reimbursed for 70% of the Unauthorized Substance Tax Division's operating expenses, resulting in an annual gain of \$900,000.</p>										

<i>Section</i>	<i>Description and Effective Date</i>	<i>Fiscal Impact</i>
30E.	<b>Insurance Regulatory Charge</b> Sets the insurance regulatory fee, which is assessed on the premiums tax paid by insurers, at 6.5% for the 2002 calendar year. The revenue generated by this charge is used to reimburse the General Fund for appropriations to the Department of Insurance to pay expenses incurred in regulating the industry.	The fee is expected to generate \$25 million for FY 2002–2003.
30F.	<b>Regulatory Fee for Utilities Commission</b> Sets the public utility regulatory fee, which funds the operations of the Utilities Commission and the Public Staff, at 0.1% for FY 2002–2003. It also sets the electric membership corporation regulatory fee at \$200,000 for FY 2002–2003. These rates are the same as in 2001.	The fee is expected to produce \$11.7 million for FY 2002–2003.
30G.1	<b>Closing of Corporate Tax Loophole: Broadening Definition of Business Income</b> Broadens the definition of <i>business income</i> to include all income that states can apportion for corporate income tax purposes under the U.S. Constitution, effective with taxable years beginning on or after January 1, 2002.	The General Fund revenue gain is estimated as follows: 2002–2003 \$70.0 million 2003–2004 \$50.0 million 2004–2005 \$53.7 million 2005–2006 \$56.7 million 2006–2007 \$59.5 million
30G.2	<b>Closing of Corporate Tax Loophole: Equalizing Franchise Tax on Corporate-Affiliated LLCs</b> Tightens 2001 legislation intended to close a loophole allowing corporations to evade the franchise tax by transferring assets to a controlled limited liability corporation (LLC), effective beginning with payments due in March 2003.	The General Fund revenue gain is estimated as follows: 2002–2003 \$20.0 million 2003–2004 \$21.2 million 2004–2005 \$22.5 million 2005–2006 \$23.8 million 2006–2007 \$25.2 million
30H.	<b>Housing Tax Credit</b> Expands the class of taxpayers eligible for an enhanced credit for investing in low-income housing in a county that sustained severe or moderate damage from a hurricane in 1999 by backdating the effective date for eligibility from 2001 to 2000.	Assuming the project investors take 100% of the available tax credit, the credits granted by this section would total \$10.7 million. Since the state tax credit is taken over five years, the General Fund revenue loss is spread over five fiscal years. The annual loss is \$2.15 million for fiscal years 2002–2003 to 2006–2007.

## Subsidiary Dividend Changes

During the 2001 session, the General Assembly enacted legislation conforming state law to the federal rules for the deduction of dividends received. This change eliminated the adjustments that had previously been required to reflect differences between the federal and state dividends deduction. Eliminating the adjustments also made the dividends subject to the general state law

mandating that expenses related to untaxed income cannot be deducted from taxable income. As a result, expenses related to deductible dividends must be netted from those dividends.

The law did not provide guidelines for calculating the amount of expenses related to deductible dividends. Without knowing exactly how to determine the amount of related expenses, taxpayers were faced with uncertainty and potentially greater liability than they had originally anticipated. The new law was expected to have an especially significant impact on bank holding companies and electric power holding companies, because federal law requires them to have multiple subsidiaries.

In the 2002 session, the General Assembly enacted S.L. 2002-136 (H 1670) to clarify the expense attribution law as it applies to deductible dividends and to provide limits on the additional tax liability. These limits were calculated so that the act should yield revenue at least equal to what had been included in budget availability estimates based on the 2001 law. In summary, the act limits tax liability in the following ways.

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

S.L. 2002-136 is effective for taxable years beginning on or after January 1, 2001.

## Revenue Laws Technical Changes

S.L. 2002-72 (S 1160) makes numerous technical and clarifying changes to the revenue laws and related statutes. It also makes one substantive change by allowing a one-time exception to the requirement that a letter of commitment under the Bill Lee Act be signed before year's end. This provision will reduce the General Fund by \$725,000 a year through the 2006–2007 fiscal year and by \$25,000 a year for three years thereafter. The remainder of the act has no fiscal impact.

Except for Section 9 of the bill, which conforms the payment date for the insurance regulatory charge on HMOs to the date they file their premium tax returns and which becomes effective for taxable years beginning on or after January 1, 2003, this act became effective when it became law, August 12, 2002.

## Studies

The 2002 General Assembly enacted several bills authorizing or requiring studies pertaining to the state tax laws.

- Part IX of S.L. 2002-180 (S 98) authorizes the Revenue Laws Study Committee to study the sales tax on construction materials.
- S.L. 2002-104 directs the Revenue Laws Study Committee to study issues related to the application of the property tax exemption for certain animal waste management systems.
- S.L. 2002-136 directs the Revenue Laws Study Committee to study (1) tax treatment of expenses related to dividends received and other nontaxed income and (2) the taxation of affiliated corporations, holding companies, and financial institutions under current law. The committee is directed to report to the 2003 General Assembly its recommendations for creating more equitable and stable sources of revenue through the modification of S.L. 2002-136 and other provisions pertaining to the taxes on corporations and businesses. The act states the intent of the General Assembly to address the issues raised by S.L. 2002-136 during the 2003 Regular Session and enact related changes effective for taxable years beginning on or after January 1, 2003.
- S.L. 2002-172 directs the Revenue Laws Study Committee to study the use, effectiveness, and cost versus benefits of the Job Development Investment Grant Program, the Bill Lee Act credits, and the Industrial Recruitment Competitive Fund.

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