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State Taxation

The 2004 session of the General Assembly made numerous miscellaneous changes to the state tax laws.

Tax Administration

Flat Fee for Debt Collection

S.L. 2004-21 (H 1497), effective January 1, 2005, modifies the Setoff Debt Collection Act by imposing a flat \$5.00 collection assistance fee on each debt collected through setoff. Under the Setoff Debt Collection Act, if an individual owes money to a state or local agency, the Department of Revenue sends the individual's income tax refund to that agency in payment of the debt, rather than to the individual. Thus, the debt the individual owes to the agency is set off against the individual's income tax refund.

The Department of Revenue recovers the costs of running the program by charging a percentage of each debt collected as a collection assistance fee. The fee is added to the debt and paid by the debtor from the refund. Before S.L. 2004-21 went into effect, the Department of Revenue calculated its actual costs for the previous year and adjusted the fee amount to reflect those costs.

The change to a flat fee of \$5.00 was recommended to the Revenue Laws Study Committee by the Department of Revenue. According to the department, the process of determining actual cost is tedious and quite cumbersome because many different areas of the department are involved. Thus, the "actual cost" is an estimate at best. The collection assistance fee determined by the Department of Revenue for the four latest calendar years has been less than \$5.00, and collection costs are not expected to grow.

Internal Revenue Code Update

North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.¹ The General Assembly determines each year whether to update its reference to the

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

Internal Revenue Code.² Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the state to the extent that state law tracks federal law. The General Assembly's decision on whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. Under North Carolina law prior to the enactment of S.L. 2004-110 (H 1430), the reference date to the Code was June 1, 2003. Part 1 of S.L. 2004-110 changes the reference date to May 1, 2004. Changing the reference date to May 1, 2004, incorporates federal changes made in the following three acts: the Military Family Tax Relief Act of 2003 (Pub. L. No. 108-121); the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Pub. L. No. 108-173); and the Pension Funding Equity Act of 2004 (Pub. L. No. 108-218).

Military Family Tax Relief Act of 2003 (Pub. L. No. 108-121). The Military Family Tax Relief Act of 2003 (MFTRA) made numerous changes to federal tax laws. These changes include the following:³

- Adoption of special rules regarding the exclusion of gain on sale of a principal residence by a member of the uniformed services or the Foreign Service, effective for sales occurring on or after May 6, 1997⁴
- Exclusion from gross income of certain death gratuity payments
- Exclusion from gross income of amounts received under the Department of Defense Homeowners Assistance Program
- Expansion of combat zone filing rules to contingency operations
- Modification of veterans' organizations' membership requirements for tax-exempt status
- Exclusion from gross income of Dependent Care Assistance Program payments to members of the uniformed services
- Suspension of tax-exempt status of terrorist organizations
- Above-the-line deduction of overnight travel expenses of National Guard and Reserve members
- Extension of certain tax relief provisions to astronauts

Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Pub. L. No. 108-173). The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 contained one significant tax provision. As part of that law, Congress created Health Savings Accounts (HSAs). The federal legislation allows a person to accumulate funds on a tax-preferred basis to pay for certain medical expenses. An employer, an eligible individual, or both may make contributions to the account. The earnings in the account accumulate tax free. Employer contributions to an HSA are excludable from gross income, and contributions by an eligible individual are deductible in computing adjusted gross income.

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

3. A more detailed analysis of these provisions may be obtained from *Technical Explanation of H.R. 3365, The "Military Family Tax Relief Act of 2003," as Passed by the House of Representatives and the Senate*, Joint Committee on Taxation, November 7, 2003, JCX-99-03.

4. The federal legislation provided a one-year period for taxpayers to file an amended return that would otherwise have been barred by the statute of limitations. That one-year period will end on November 11, 2004. This act allows a taxpayer an exception to the state statute of limitations as long as the taxpayer files the claim by the same date, November 11, 2004.

Distributions from an HSA for medical expenses are excludable from income, with the exception of amounts distributed to pay most health insurance premiums. However, tax-free distributions from an HSA may be used to pay the following health insurance premiums: retiree health insurance premiums for individuals who have reached Medicare eligibility; premiums for COBRA coverage; premiums for qualified long-term care insurance contracts; and premiums for a health plan during a period in which an individual is receiving unemployment. Distributions from an HSA for nonmedical expenses are includable in gross income.

Pension Funding Equity Act of 2004 (Pub. L. No. 108-218). The Pension Funding Equity Act of 2004, signed by the President on April 10, 2004, made changes to the Internal Revenue Code and the Employee Retirement Income Security Act (ERISA). The federal legislation allows pension plan sponsors across the board, as well as those in specifically targeted industries, to lower the amount of both their pension contributions and the premiums paid to the Pension Benefit Guaranty Corporation (PBGC). The PBGC is the government agency that insures certain underfunded benefits in defined benefit plans. Underfunded single employer defined benefit plans—those plans that do not have sufficient assets to pay benefits if the plan were to terminate—pose the greatest risk to the PBGC. Sponsors of plans that are considered underfunded must make contributions to their plans in addition to paying variable-rate premiums to the PBGC; premiums are based on the amount of underfunding. Pension plan benefits promised to employees remain the same.

By lowering the amount of required payments to pension plans and to the PBGC, the federal legislation could result in higher taxable income for the affected companies. The legislation also provides temporary relief for many pension plans, which could reduce the increase in some taxpayers' taxable income.

Sales and Use Taxes

Notice Period for Refunds

Under the Streamlined Sales and Use Tax Agreement, purchasers seeking a refund of over-collected sales or use taxes must give the seller written notice and allow the seller sixty days in which to respond before bringing a cause of action against the seller. S.L. 2004-22 (H 1448) brings North Carolina law into conformity with this requirement.

Earlier in 2004, the Department of Revenue adopted this provision as part of a technical bulletin. However, retailers expressed a preference for having the provision codified in the statutes. Therefore, the act codifies the department's policy regarding refund procedures for over-collected sales and use tax.

Major Industrial Facility Sales Tax Refund

Part 4 of S.L. 2003-435 creates an annual refund of state and local sales taxes paid on construction materials and fixtures for facilities that involve the investment of more than \$100 million by the taxpayer and are primarily used either for bioprocessing or for pharmaceutical and medicine manufacturing and the distribution of pharmaceuticals and medicines. The taxpayer must apply for the sales tax refund within six months after the end of the state's fiscal year. The refund is effective for sales taxes paid on or after January 1, 2004. If, after obtaining a refund, the taxpayer does not end up investing the required amount, the taxpayer forfeits the refund.

Part 5 of S.L. 2004-110 amends the sales tax refund for major industrial facilities enacted by S.L. 2003-435 by clarifying that the sales tax refund is allowed only for materials and fixtures purchased during the initial construction of the facility, and not for purchases made for subsequent repairs, renovation, or equipment replacement.

Section 32B.1 of S.L. 2004-124 (H 1414) expands the refund in three ways. First, if the facility is located in an enterprise tier one, two, or three area, a taxpayer is eligible for the refund if the taxpayer will invest at least \$50 million in the facility (rather than \$100 million as was

required under the 2003 law). This change is effective for sales occurring on or after January 1, 2004. Second, the act expands the list of eligible industries to include aircraft manufacturing, computer manufacturing, motor vehicle manufacturing, and semiconductor manufacturing, effective July 1, 2004. This change will sunset effective July 1, 2009. Third, the act makes clarifying changes regarding what items are eligible for the sales tax refund, effective January 1, 2004.

Sales Tax Exemptions

Part 32B of S.L. 2004-124 contains numerous sales and use tax exemptions. It exempts the following things from the sales and use tax, effective October 1, 2004.

- Tangible personal property that is sold to an interstate air business and becomes a component part of or is dispensed as a lubricant into commercial aircraft during maintenance, repair, or overhaul. This exemption supplements an existing sales tax exemption for sales of aircraft lubricants, aircraft repair parts, and aircraft accessories to an interstate air courier or a passenger air carrier for use at the courier's or carrier's hub. The new exemption is broader in that it (1) eliminates the requirement that the items be for use at a hub, (2) allows the exemption for sales to an interstate freight carrier, and (3) expands the types of property that are exempt. The new exemption is narrower in that it is limited to items related to commercial aircraft, which are large aircraft regularly used for carrying—for compensation—passengers, freight, or packages and letters.
- Plastic mulch and plant bed covers that are sold to a farmer for agricultural purposes.
- Delivery charges for delivery of direct mail if those charges are separately stated. Delivery charges, including postage, are taxable in North Carolina.⁵ "Delivery charges" are those charges imposed by the retailer for preparation and delivery of personal property or services to a location designated by the consumer. The exemption is not required by the Streamlined Sales and Use Tax Agreement for compliance but is a permissible exemption. Before 2002, delivery charges were not taxable for in-state transactions subject to sales tax where the title to the property passed at the point of origin. Under the streamlined agreement, all delivery charges are included in the sales price of an item and therefore subject to tax. In order to conform to the agreement, the General Assembly removed the sales tax exemption for delivery charges on in-state transactions, effective January 1, 2002.
- Sales to a professional land surveyor of tangible personal property on which custom aerial data is stored in digital form or is depicted in graphic form.

Section 32B.4 of S.L. 2004-124 exempts certain free-distribution periodicals from sales tax, effective July 1, 2005. To qualify for the exemption, the periodical must be free, published at recurring intervals monthly or more frequently, and distributed in any manner other than by mail.

Under current law, supplies (paper, ink, and other tangible personal property) sold for free-distribution publications are subject to sales and use tax. Before October 1, 1999, a sales tax exemption was given for sales of paper, ink, and other tangible personal property to commercial printers and publishers for use as component parts in free-distribution publications that contained advertising of a general nature. The exemption applied to general shoppers' guides but not to more specialized publications, such as real estate guides, because the statute specifically required that the free-distribution publication contain advertising of a general nature. The exemption was repealed because it was believed to be unconstitutional. The First Amendment of the United States Constitution generally does not allow a state to discriminate between publications based on content. A 1987 U.S. Supreme Court decision held that a similar tax provision was unconstitutional.⁶

5. At least one state supreme court has found that the United States Constitution prohibits the taxation of pass-through postage charges on catalogs and fliers mailed by a retailer. *H.J. Wilson Co. Inc. v. State Tax Comm'n*, 737 So.2d 981 (Miss. 1998). The court held that postage is an obligation of the federal government and that the state is constitutionally prohibited from taxing postage charges.

6. *Arkansas Writers' Project, Inc. v. Ragland*, 481 U.S. 221 (1987).

Sales Tax on Electricity Used by Manufacturers

Generally, electricity that is sold to a manufacturer for use at a manufacturing facility and 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. In 2001, the General Assembly reduced to 0.17 percent the sales tax rate on electricity sold to manufacturers that use more than 900,000 megawatt-hours of electricity annually, effective January 1, 2002.⁷ As part of the 2001 legislation, the General Assembly also established a rate schedule that would reduce the sales tax on electricity sold to manufacturers that use more than 5,000 but less than 900,000 megawatt-hours annually, effective July 1, 2005.⁸

Part 6 of S.L. 2004-110 repeals the 2001 legislation, effective October 1, 2004. The sales tax rate on electricity used by manufacturers will remain at 2.83 percent. At the time S.L. 2004-110 was enacted, there were no manufacturers in the state that used a high enough volume of electricity annually to qualify for the 0.17 percent rate.⁹

Part 6 also provides that electricity sold to an aluminum smelting facility for use in the operation of that facility and measured by a separate meter or measuring device is taxable at 0.17 percent. The state does not presently have an aluminum smelting facility; however, such facilities use a high volume of electricity and would have been eligible for the former 0.17 percent rate repealed by S.L. 2004-110. Thus, the retention of the lower sales tax rate for an additional three years encourages the operation of such a facility in North Carolina. The provision establishing the lower rate for aluminum smelting facilities sunsets for sales made on or after October 1, 2007.

Franchise, Privilege, and Excise Taxes

Franchise Tax Loophole

Under North Carolina law, limited liability companies (LLCs)¹⁰ are not subject to the franchise tax.¹¹ In 1997, the North Carolina law regarding LLCs was changed to allow single-member LLCs in addition to multiple-member LLCs. This change had the unintended consequence of allowing a corporation subject to North Carolina franchise tax to set up an LLC and transfer assets to the LLC in a tax-free transfer. The assets held by 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.

In 2001 the General Assembly enacted S.L. 2001-327 to close this loophole. The 2001 legislation attempted to address the problem by requiring a corporation to pay tax on assets owned by an LLC if the corporation, including its affiliates, indirectly owned at least 70 percent of the

7. S.L. 2001-476, as amended by S.L. 2001-487.

8. <u>Megawatt-hours used annually</u>	<u>Rate</u>
5,000 or less	2.83 percent
Over 5,000 and up to 250,000	2.25 percent
Over 250,000 and up to 900,000	2.0 percent
Over 900,000	.17 percent

9. The only manufacturer that used this volume of electricity at the time the General Assembly changed the law in 2001 was the aluminum manufacturer, Alcoa.

10. A limited liability company 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 franchise tax 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 the appraised value of real and tangible personal property in North Carolina; or (3) total actual investment in tangible property in North Carolina.

LLC's assets.¹² However, tax planners found that the tax could still be avoided by using an additional paper transaction. If the corporation interposed a partnership between itself and the LLC holding its assets, then technically the 2001 legislation would not apply and the assets would continue to escape franchise tax.

In 2002 the General Assembly enacted S.L. 2002-126 to tighten the 2001 law. The 2002 legislation required attribution of an LLC's assets through related members (other entities and individuals), who may cooperate with one or more corporate entities to own the LLC that will hold the assets. *Related members* is a defined term and includes certain shareholders, partnerships, estates, trusts, and corporations. The 2002 legislation provided that if a corporation and its related members indirectly owned at least 70 percent of an LLC's assets, each corporation would pay franchise tax on its relative share of the LLC's assets. The relative share was calculated after excluding those related members that were not corporations. Thus, the entire assets were subject to franchise tax, with the tax burden shared proportionally by the corporations involved in the ownership scheme.

After the 2002 legislation was enacted, it became apparent that it not only failed to close the loophole but also extended the franchise tax to situations that did not involve corporate control of LLC assets. The loophole remained open because there were additional paper transactions that could be interposed between the corporation and the LLC in order to circumvent the attribution of the LLC's assets to the corporation. For example, control could be passed through a business trust.¹³ The 2002 legislation apparently went too far, because it extended the franchise tax to assets owned by individuals or entities over which the corporation has no control.

The 2003 Revenue Laws Study Committee recommended legislation to the 2003 General Assembly to correct the LLC franchise tax loophole.¹⁴ The proposal was introduced as Senate Bill 51. Each chamber passed a version of Senate Bill 51, but they were unable to resolve the differences between the two versions. After the 2003 session adjourned, the Revenue Laws Study Committee appointed a working group—including the Department of Revenue, certified public accountants, and tax attorneys—which recommended a new approach that the group believed would be effective, workable, and fair. During the 2004 session, the recommendation was enacted as a conference committee substitute for the 2003 bill.

Effective January 1, 2003, S.L. 2004-74 (S 51) closes the LLC franchise tax loophole by extending the franchise tax to all LLC assets that a corporation controls through trusts and other entities. The Revenue Laws Study Committee determined that franchise tax is appropriate if a corporation controls assets owned by a related LLC, but not if the corporation gives up both control and ownership of the assets. The new legislation limits the scope of the 2002 legislation to only those LLC assets that a corporation controls. As well, it further limits the reach of the 2002 act by exempting small LLCs.

Control of an LLC's assets is determined by tracing ownership of the capital interests in the assets. A capital interest is the right, under an LLC's governing law, to receive some or all of the assets if the LLC is dissolved. Ownership of the capital interests in an LLC is traced, using the principles of constructive ownership, through any noncorporate entities; the chain of constructive ownership can run through layers of noncorporate entities, but not through individuals. The franchise tax is payable by the corporation or affiliated group of corporations to which ownership of the capital interests is traced.

12. Indirect ownership of an LLC's assets is determined based on who is entitled to receive those assets upon dissolution of the LLC.

13. A business trust is not considered a *related member* as defined in G.S. 105-130.7A, because the corporation, not the shareholders, would form the trust.

14. The Department of Revenue, in its 2003 reports to the Revenue Laws Study Committee, noted that there exists a general franchise tax inequity because the imposition of the tax depends on the type of entity. The Governor's Commission to Modernize State Finances recommended that the state impose the franchise tax on all types of business entities, not just on traditional corporations. The commission recommended that the revenues generated by broadening this base be used to establish a minimum net worth threshold for payment of the tax.

Ownership of capital interests in an LLC is determined as of the last day of the LLC's tax year. If an LLC and a corporation engage in a pattern of trading assets back and forth so that neither owns them on its respective trigger date, the determination must be made as of the last day of the corporation's tax year.

If the capital interests in an LLC are owned by an affiliated group of corporations, the value of the assets is allocated among the members of the group for franchise tax purposes, so that there will not be double taxation of any assets. The allocation is in proportion to each affiliate's ownership interest.

S.L. 2004-74 exempts from the attribution rules those LLCs whose total assets do not exceed \$150,000. Under the laws governing business entities, LLCs pay an annual report fee of \$200, while corporations pay an annual report fee of \$20. The approximate threshold at which there would be no tax advantage from transferring corporate assets to an LLC is \$130,000.

The act also makes a number of other changes to the law. It reduces the threshold percentage of an LLC's assets that a corporation must control before the franchise tax is triggered. The current threshold is 70 percent or more but applies to a much broader realm of parties through whom ownership may be attributed. This act sets the threshold at more than 50 percent beginning in 2005. The new legislation also corrects the formula for tracing ownership to remove the 2002 law's potential effect of attributing 100 percent of an LLC's assets to a corporation even though the corporation actually controls less than 100 percent. Finally, the act removes membership in the LLC as an additional condition for attribution of an LLC's assets to a corporation. That condition created a loophole and served no purpose.

Privilege Tax on Amusements

The state levies a privilege tax at the rate of 3 percent on the gross receipts derived from amusements that a person gives, offers, or manages, unless the amusement is exempted by statute.¹⁵ G.S. 105-40 exempts several forms of amusements from the privilege tax, including local talent shows, elementary and secondary school athletic contests and dances, and certain arts and community festivals.

S.L. 2004-84 (H 1303) creates two new exemptions from the amusements tax. First, the act exempts a youth athletic contest that has an admission price that does not exceed \$10 and is sponsored by a person exempt from income tax. Each participating athlete must be younger than twenty years of age. Second, the act exempts all exhibitions, performances, and entertainments promoted and managed by a nonprofit arts organization that is exempt from corporate income tax. This second exemption does not apply to athletic contests, but it applies to other amusements regardless of where they are held and regardless of the amount of compensation paid to provide the amusement or the amount of the receipts derived from the amusement. The amusement tax exemptions became effective July 1, 2004.

Excise Tax Reductions

Before August 1, 2003, distributors and wholesalers who timely paid the excise taxes on cigarettes, other tobacco products, wine, beer, and liquor were eligible for a discount equal to 4 percent of the tax due. In 2003 the General Assembly eliminated these discounts (S.L. 2003-284). S.L. 2004-84 reinstates the discounts, but at a rate of 2 percent of the tax due. The discounts for cigarette and tobacco suppliers are intended to cover expenses incurred in preparing tax reports and the expense of furnishing a bond. The discounts for alcoholic beverage suppliers are intended

15. The amusement tax was originally intended to piggyback the sales tax. The law taxed entertainment "at the rate of tax levied" by the sales tax statutes. In 1989 when the sales tax rate was 3 percent, the piggyback language was changed to a stated 3 percent rate. When the sales tax was increased from 3 percent to 4 percent, the amusement tax should have been increased as well, but due to oversight, the change was not made.

to cover the same expenses as well as losses due to spoilage or breakage. The discounts are effective for reporting periods beginning on or after August 1, 2004.

Tax Credits

Low-Income Housing Credit

Part 4 of S.L. 2004-110 extends the sunset on the low-income housing tax credit from January 1, 2006, until January 1, 2010. This change benefits developers of low-income housing, who secure options on sites months in advance and need to know what financing will be available. The act also makes a technical correction to the credit by replacing the term “eligible basis” with the term “qualified basis.”

Congress enacted the federal Low Income Housing Tax Credit in 1986 to fund housing for low- and moderate-income households. Each state receives a limited amount of credit each year. The Internal Revenue Service (IRS) allocates the per capita low-income housing tax credit to state housing agencies, such as the North Carolina Housing Financing Agency (HFA), which in turn allocate the credit to project developers who agree to lower project rents for low-income tenants.

In 1999 North Carolina authorized a state income tax credit modeled after the federal housing credit. To benefit from the credit, a project developer had to sell the tax credits to receive funds to finance the project.¹⁶ In 2002 the General Assembly changed the state credit so that a taxpayer may elect to receive the credit in the form of either a credit against tax liability or a loan generated by transferring the credit to the HFA in return for a zero-percent interest, thirty-year balloon loan equal to the credit amount.¹⁷ Neither a tax refund generated by the credit nor a loan received as a result of the transfer of the credit is considered taxable income by the state. Although a state tax refund would be considered taxable income by the IRS if the taxpayer itemizes deductions, a private letter ruling from the IRS provides that the loan proceeds would not.

The purpose of the 2002 changes was to promote efficiency and cost savings. The modified tax credit eliminates the need to sell the credit and ensures that each state dollar dedicated for low-income housing is used to develop that housing. The state is saving revenue over a five-year period while maintaining the same level of investment in low-income housing developments.¹⁸ This innovative approach received a national award. The HFA found that in 2003 the percentage of federal credits used to develop projects in rural counties rose from about 25 percent to about 50 percent. As well, the HFA determined that all urban projects had some units affordable to families below 30 percent of the median income for the area. The HFA also noted that the federal credits have become attractive to more buyers because the buyer does not also need to purchase a state credit. The resulting higher prices for federal credits increase the amount of affordable housing for North Carolina.

Qualified Business Investment Credit

The qualified business investment tax credit is allowed for an individual taxpayer who purchases the equity securities or subordinated debt of a qualified business venture, a qualified

16. Developers indicated that the state tax credit sold for no more than forty-five cents on the dollar.

17. Owners of all but one of the fifty-one rental developments awarded federal credits in 2003 elected to use the state credit as part of their funding. All fifty project developers chose the loan option.

18. From 2000 to 2002, the state housing credit leveraged \$420 million of rental development. A total of 120 projects with 5,900 units were awarded \$140 million of state housing credits for an average of \$24,000 per unit in state investment. In 2003 the credit leveraged \$197 million of rental development. A total of 49 projects with 2,336 units were awarded \$33.2 million of state housing credit for an average of \$14,200 per unit of state investment.

grantee business, or a qualified licensee business directly from that business. The credit is equal to 25 percent of the amount invested and may not exceed \$50,000 per individual in a single taxable year. An individual investor may also claim the allocable share of credits obtained by pass-through entities of which the investor is an owner. Pass-through entities include limited partnerships, general partnerships, S corporations, and limited liability companies. The credit may not be taken in the year the investment is made. Instead, the credit is taken in the year following the calendar year in which the investment was made, but only if the taxpayer files an application with the Secretary of Revenue. Any unused credit may be carried forward for the next five years.

The total amount of credits allowed to all taxpayers for investments made in a calendar year may not exceed a maximum amount set in the statute. Part 32C of S.L. 2004-124 increases the maximum amount from \$6 million to \$7 million. The Secretary of Revenue calculates the total amount of tax credits claimed, based on the applications filed. If the amount exceeds the maximum, the Secretary allows a portion of the tax credits claimed, by allocating the statutory maximum amount in tax credits in proportion to the size of the credit claimed by each taxpayer.

The credit was set to expire as of January 1, 2007. Part 32C of this act extends the credit one year, until January 1, 2008.

Research and Development Tax Credit

Part 32D of S.L. 2004-124 creates a new research and development tax credit as an alternative to the Bill Lee research and development credit, which is set to expire along with the entire Bill Lee Act as of January 1, 2006. A taxpayer will not be allowed to take both the new credit and the Bill Lee Act credit for the same activity.

The Bill Lee research and development tax credit uses the federal credit for research and development as its starting point. In order to be eligible for the research and development credit under the Bill Lee Act, a taxpayer must meet all of the general eligibility requirements of that act. This includes satisfying requirements related to employee wages, the principal activity of the establishment, the provision of health insurance, the taxpayer's Occupational Safety and Health Act record, the taxpayer's environmental record, and the absence of overdue tax debts. Under the Bill Lee Act, the research and development credit may be applied against the income tax, the franchise tax, or the gross premiums tax. The amount of credit taken in a particular year may not exceed 50 percent of the liability for the tax against which it is claimed, and any excess may be carried forward for fifteen years.

The alternative credit created in this part, which becomes effective for expenses on or after May 1, 2005, differs from the research and development credit allowed under the Bill Lee Act in the following ways.

- Bill Lee limitations on the principal activity of the establishment at which the research and development is conducted do not apply. This change will make more taxpayers eligible for the new credit for research and development expenditures than for the existing Bill Lee Act credit.
- The taxpayer is not required to be free of overdue tax debts. However, the taxpayer must still satisfy Bill Lee Act requirements related to employee wages, the principal activity of the establishment, the provision of health insurance, the taxpayer's Occupational Safety and Health Act record, and the taxpayer's environmental record.
- In the case of research and development conducted in North Carolina by a research university, the new credit is 15 percent of the amount the taxpayer paid to the university for the research and development.
- For other research and development, the new credit is based on North Carolina research and development expenditures rather than on an apportioned share of nationwide increases in expenditures. The rate is determined as follows:
 - For small businesses, the rate is 3 percent.
 - For research and development conducted in enterprise tiers one, two, or three, the rate is 3 percent.

- For other research and development expenditures, the rate ranges from 1 percent to 3 percent as the amount of those expenditures increases.
- The new credit will sunset with the 2009 taxable year, rather than with the 2006 taxable year.

This part specifically sunsets the existing Bill Lee research and development credit as of January 1, 2006. Although the entire Bill Lee Act is set to sunset January 1, 2006, if that date is extended, this part provides that the Bill Lee Act research and development credit will nonetheless be repealed, allowing only one year of overlap with the new credit.

This part also requires the Department of Revenue to make annual reports regarding the new credit to the Revenue Laws Study Committee and the Fiscal Research Division.

Dollar Limit on Credit for Partnerships

The income tax credits in G.S. 105-151.12 and G.S. 105-130.34 are allowed to individual and corporate taxpayers who make a qualified donation of an interest in North Carolina real property that is useful for conservation purposes. The tax credit is equal to 25 percent of the fair market value of real property donated to the state, a local government, or an entity that is both organized to receive and administer lands for conservation purposes and qualified to receive tax deductible charitable contributions. The credit for a corporation may not exceed \$500,000, and the credit for an individual may not exceed \$250,000. Both corporate and individual taxpayers are allowed to carry forward for five years any unused portion of the credit.

In S.L. 2001-335, the General Assembly corrected and clarified the law governing allocation of partnerships' tax credits, so that any dollar amount limitation on a credit applies to the total credit allowed to a partnership. The limited amount is then allocated among the partners on a proportional basis. Before this change, the limit applied separately to each partner. The 2001 act delayed this dollar amount limitation until 2005 for partnerships that are allowed a credit for real property donations. S.L. 2004-134 (H 1602) postpones for one more year the imposition of the dollar amount limitation on partners taking this credit. As a result, the maximum dollar amount limits on this credit will continue to apply separately to each partner until 2006.

S.L. 2004-134 also authorizes the Revenue Laws Study Committee to study the credit and report its findings to the 2005 General Assembly by February 1, 2005.

Renewable Fuel Tax Credits

Article 3B of Chapter 105 of the General Statutes allows an income or franchise tax credit of 35 percent of the cost of constructing or purchasing renewable energy property, up to \$250,000 per installation for nonresidential property. Renewable energy property may include equipment for producing biodiesel or ethanol.

S.L. 2004-153 (H 1636) adds two new credits to Article 3B: a 15 percent credit for the costs of constructing a facility for dispensing renewable fuel, and a 25 percent credit for the costs of constructing a facility for producing renewable fuel. Unlike the other Article 3B renewable energy property credit, these credits are not limited to a certain amount per facility. The dispensing credit must be taken in three annual installments, and the production credit must be taken in seven annual installments. There is no double credit—the taxpayer must choose between any available credits and take only one with respect to the same costs.

Like the other credits in Article 3B, the new credits created by this act may be claimed against income tax or franchise tax. Each credit is limited to 50 percent of the amount of tax liability against which it is claimed. Any excess may be carried forward for up to five years. Although Article 3B is set to sunset January 1, 2006, the sunset for these two new credits would be 2008.

Tobacco Export Credit

S.L. 2004-170 (S 1145), in Section 16, provides that in determining whether a taxpayer is eligible for the new tobacco export credit, positions located within North Carolina for six months or less are not considered to be part of the taxpayer's employment level. Eligibility is based on maintaining an employment level that exceeds by a certain amount the taxpayer's employment level at the end of 2004.

Bill Lee Credits for Certain Major Industries

In 2002 the General Assembly extended the sunset date on the Bill Lee Act for certain interstate air couriers until January 1, 2010, and increased various time frames in the Bill Lee Act from two years to seven years.¹⁹ The rationale for these extensions was that 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, there is usually a long period between the time a project is announced and a location selected and the time the facility is placed in service.

Part 3 of S.L. 2003-435 (H 2, Extra Session) makes the same extensions for eligible major industries, effective beginning with the 2004 taxable year. An eligible major industry is one in which the taxpayer will invest at least \$100 million to acquire, construct, or equip a facility to engage in either bioprocessing or pharmaceutical and medicine manufacturing and the distribution of pharmaceuticals and medicines.

If the taxpayer does not invest the required amount, the taxpayer forfeits the benefits of the extensions and must repay the credits.

Enhanced Cigarette Exportation Tax Credit

Part 6 of S.L. 2003-435 creates a new, alternative corporate tax credit for tobacco manufacturers who export cigarettes to foreign countries, who use the North Carolina State Ports, and who maintain employment levels in North Carolina that exceed the manufacturer's employment level in the state at the end of 2004 by at least 800 full-time employees.²⁰ The credit is effective for taxable years beginning on or after January 1, 2006, and expires for exports occurring on or after January 1, 2018.

This new credit is a dollar amount per cigarette exported for those manufacturers who meet the above eligibility requirements. The credit amount is 40 cents per 1,000 cigarettes exported. The credit is capped at the lesser of \$10 million per year or 50 percent of the manufacturer's tax liability for any given year. The credit may be taken against the corporate income tax, against the franchise tax, or against a combination of the two, at the election of the taxpayer. Once made, a taxpayer's election is binding and applies to all carryforwards of the credit. The taxpayer may, however, make a different election each year for credits earned during that year. Unused portions of a credit may be carried forward for ten years. Part 6 of the act also allows a partial credit for taxpayers who previously met all eligibility requirements but who failed to maintain the required employment level. In computing the partial credit, the credit that would otherwise have been allowed is reduced in proportion to the amount by which the taxpayer's employment level is below the required level.

The credit created in Part 6 of S.L. 2003-435 differs from the credit allowed under G.S. 105-130.45 in several key ways. This new credit has a higher cap (\$10 million as opposed to 6 million) and may be taken against the income tax and/or the franchise tax (as opposed to only against the income tax). In addition, the new credit requires job creation, whereas the credit allowed under

19. See S.L. 2002-146.

20. Section 16 of S.L. 2004-170 amends the new credit to provide that in determining whether a taxpayer is eligible for the credit, positions located within North Carolina for six months or less are not considered to be part of the taxpayer's employment level.

G.S. 105-130.45 does not. The new credit applies to cigarettes exported only to foreign countries (whereas the credit under G.S. 150-130.45 applies to cigarettes exported to foreign countries, to possessions of the United States, or to United States commonwealths that are not states), and it requires only that the taxpayer “export” through the North Carolina State Ports (as opposed to requiring “waterborne export” through the North Carolina State Ports). A taxpayer may take either the new credit in this part or the original credit in G.S. 105-130.45 but may not claim both credits for the same activity.

While the original cigarette exportation tax credit was being considered during the 1999 legislative session, the issue was raised as to whether the credit would violate the General Agreement on Tariffs and Trade (GATT). The General Assembly staff was of the opinion that the tax credit would violate GATT, while counsel for one of the four tobacco manufacturers disagreed. This issue has not been resolved with respect to the original credit, and the new tax credit added by this part presents the same issue. It is clear, however, that any challenge to either the original credit or the new credit must come from a foreign government. If a foreign government were to challenge the credit, then the United States Justice Department could sue North Carolina. However, should the state lose such a lawsuit, federal law provides that relief would be prospective only and that persons who had already used the credit could not be required to repay it. Private citizens have no cause of action on the issue.

Jobs Credit

Section 43 of S.L. 2004-170 amends the Bill Lee Act credit for creating new jobs. The new legislation allows the credit only for jobs created in a taxable year that represent a net increase over the number of North Carolina employees the taxpayer had during the twelve months preceding the taxable year. If the taxpayer cut jobs in one year and then added jobs in the next year, the credit would be allowed only to the extent of a net increase over the previous year. This change is effective beginning with the 2004 tax year.

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