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State Taxation

The 2005 regular session saw numerous tax changes, ranging from bold reforms to minor, temporary adjustments. As in 2001 and 2003, the General Assembly failed to address its structural budget shortfalls, extending for two more years hundreds of millions of dollars in “temporary” taxes: the additional one-half percent state sales tax, the additional one-half percent income tax on upper-income individuals, and the estate tax. In contrast to its timidity regarding those issues, the General Assembly enacted several tax reforms, dramatically increasing the excise tax on cigarettes and tobacco products, providing uniformity in gross premiums tax rates, and simplifying the sales tax structure to enable multistate retailers to collect tax on Internet and mail order sales. As usual, a number of economic development incentives were enacted—these are discussed in Chapter 8, “Economic and Community Development.”

Income Taxes

Upper Income Tax Rate

Section 36.1 of The Current Operations and Capital Improvements Appropriations Act of 2005, S.L. 2005-276 (S 622), delays the sunset of the upper-income individual income tax bracket from January 1, 2006, to January 1, 2008. In 2001, the General Assembly added a new tax bracket that imposed an additional 0.5 percent income tax (for a total rate of 8.25 percent) on certain North Carolina taxable income, as indicated in the chart below. The 8.25 percent tax bracket had previously been set to expire January 1, 2004, but S.L. 2003-284 had extended the sunset to 2006.

Tax Rate	Married Filing Jointly	Heads of Household	Single Filers	Married Filing Separately
6.00%	Up to \$21,250	Up to \$17,000	Up to \$12,750	Up to \$10,625
7.00%	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 and up to \$200,000	Over \$80,000 and up to \$160,000	Over \$60,000 and up to \$120,000	Over \$50,000 and up to \$100,000
8.25%	Over \$200,000	Over \$160,000	Over \$120,000	Over \$100,000

Internal Revenue Code Reference 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 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. 2005-276, the reference date to the Code was May 1, 2004. Part 35.1 of S.L. 2005-276 changes the reference date to January 1, 2005. Updating the reference date to January 1, 2005, incorporates federal changes made by the Working Families Tax Relief Act of 2004 (Pub. L. No. 108-311) and the American Jobs Creation Act of 2004 (Pub. L. No. 108-357). These acts made numerous tax changes affecting individuals, businesses, and other entities; those changes that are important for North Carolina tax purposes are described in detail in *2005 Finance Law Changes*, written by the legislature's tax staff and available on its Web site at: <http://www.ncleg.net/LegislativePublications/>. Part 35.1 of S.L. 2005-276 also conforms to a federal act (Pub. L. No. 109-1) that enhanced the tax benefit for charitable contributions made in January 2005 for tsunami relief.

There are some areas in which the General Assembly chose not to conform to federal law. Part 35.1 of S.L. 2005-276 does not conform to (1) the optional exclusion of income on qualified shipping activities in exchange for being subjected to a federal tonnage tax or (2) a new federal deduction for domestic production activities enacted to replace the exclusion for qualifying extraterritorial income that is being phased out because the World Trade Organization declared the exclusion an illegal trade subsidy. In addition, as with the current federal deduction for state income taxes, the law will require taxpayers to add back to state taxable income the new alternative deduction for state sales taxes. Finally, as required by the North Carolina Constitution, the act delays until January 1, 2005, conformity to any federal changes that would increase North Carolina taxable income retroactively for an earlier tax year.

Hurricane Relief

Six hurricanes in the late summer and fall of 2004 caused substantial flooding, landslides, and wind damage both in the mountains and on the coast of North Carolina. S.L. 2005-1 (S 7) provides relief, including individual and corporate income tax exemptions for state disaster relief payments and a requirement that agencies disbursing disaster relief include with the disbursement a written statement of the state and federal income tax treatment of the funds or property disbursed.

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

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

N.C. Political Parties Financing Fund

G.S. 105-159.1 permits an individual to direct that \$1 of the individual's income tax liability will be credited to the Political Parties Financing Fund without increasing or decreasing the amount of any tax refund the individual is otherwise due. Section 46 of S.L. 2005-345 (H 320) adds a provision to the budget act, S.L. 2005-276, to increase the amount that may be designated from \$1 to \$3. In the case of a married couple filing a joint return, each spouse may designate \$3 to the fund. The increase makes the amount that may be designated to the Political Parties Financing Fund the same as the amount that may be designated to the Public Campaign Financing Fund under G.S. 105-159.2.

Tobacco Taxes

Part 34 of S.L. 2005-276 increases the cigarette tax from \$0.05 a pack to \$0.30 a pack effective September 1, 2005, and to \$0.35 a pack effective July 1, 2006. It also increases the tax on other tobacco products from 2 to 3 percent of the cost price, effective September 1, 2005. S.L. 2005-406 (S 868) allows tobacco products dealers a refund of tobacco products excise tax paid on stale or otherwise unsalable cigars returned to the manufacturer, also effective September 1, 2005.

Estate Taxes

Part 8 of S.L. 2005-144 (H 1630) repeals the July 1, 2005, sunset on the North Carolina estate tax, so that the amount of this tax remains equal to the amount of the federal state death tax credit allowed in 2001 under the Internal Revenue Code. The North Carolina estate tax is then automatically repealed in 2010, when the federal estate tax is repealed.

Sales Taxes

The General Assembly made numerous changes to the sales tax law in 2005. Most significantly, Section 9.1 of S.L. 2005-144 and Section 33.1 of S.L. 2005-276 extend until July 1, 2007, the sunset on the additional 0.5 percent state sales and use tax, which would have otherwise expired July 1, 2005.

Other sales tax increases in Part 33 of S.L. 2005-276 include reclassifying candy as a nonfood, so that it is no longer eligible for the lower tax rate on food; applying a 7 percent sales tax to cable television services, subject to a credit for any local franchise taxes paid; and increasing the sales tax on satellite television services from 5 to 7 percent, to conform to the Streamlined Sales and Use Tax Agreement.

The Streamlined Sales Tax Project is an effort by states, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The goal of the project is to enhance collection of sales and use taxes on interstate transactions, which should result in substantial revenue gains for state and local governments. The project, which began in March 2000, is intended to achieve sufficient simplification and uniformity to encourage sellers to voluntarily collect use tax in participating states even if the seller does not have nexus there. In November 2002 the implementing states approved the Streamlined Sales and Use Tax Agreement, which contains the uniformity and simplification provisions developed by the project. The Agreement becomes effective when at least ten states representing 20 percent of the population of all states with a sales tax are in compliance with the provisions of the Agreement. As of April 2005, fourteen states representing 24 percent of the population had petitioned for membership, signifying that their individual state laws conform to the uniform provisions of the Agreement. North Carolina is one of those states.

Part 33 of S.L. 2005-276 modifies the sales tax statutes extensively to bring them into compliance with the uniformity requirements of the Agreement. It updates various sales tax definitions, extends the annual sales tax holiday to include computer supplies costing up to \$250, clarifies that voice mail is

part of telecommunications services for tax purposes, and revises the taxation of the following items to eliminate tax caps and thresholds and nonuniform tax rates, as required by the Agreement.

Item	Former Sales Tax	Under S.L. 2005-276
Trains	3% capped at \$1,500 per item	7%, with partial refund
Telecommunications	6%	7%
Spirituous liquor	6%	7%
Mobile classrooms and offices	3% capped at \$1,500 per item	7%
Supplies consumed by freezer locker plants	1%	7%
Sales of horses and mules to farmers, commercial sales of animal semen, and sales of fuel other than electricity to farmers and commercial cleaners	1%	Exempt
Sales to manufacturers of fuel other than electricity or piped gas	1%	1% privilege tax
Sales of certain property to major recycling facilities	1% capped at \$80 per item	1% privilege tax capped at \$80 per item
Sales to farmers of machinery, parts, containers, and facilities	1% capped at \$80 per item	Exempt
Sales of certain machinery to commercial cleaners, interstate air businesses, telephone companies, and radio and television providers	1% capped at \$80 per item	Exempt
Funeral services	Exemption for up to \$1,500 of goods and services combined	Exempt
Funeral goods	Exemption for up to \$1,500 of goods and services combined	7%

In a related change, S.L. 2005-276 extends for five more years the inclusion of a line on the individual income tax form to facilitate payment of consumer use taxes. The use tax is owed by consumers on purchases for which no sales tax was paid and, unlike with the sales tax, it is the consumer rather than the retailer who must remit the tax to the state. To simplify use tax collection, the General Assembly established an annual filing period in 1997 for the payment of use taxes owed by consumers on mail-order and other out-of-state purchases and in 1999 provided that the use tax must be paid with consumers' income tax returns. The provision was set to expire in anticipation that use tax collection would be handled by retailers as a result of the Streamlined Sales and Use Tax Agreement, but the sunset date was overly optimistic. S.L. 2005-276 extends the sunset from January 1, 2005, to January 1, 2010.

Section 33.32 of S.L. 2005-276 directs the Revenue Laws Study Committee to study the equity of taxation of providers of cable service, direct-to-home satellite service, satellite digital audio radio service, video programming service, and data service. The act also directs the committee to study application of sales and use tax to maintenance agreements, stating the General Assembly's intent to tax these agreements beginning July 1, 2006.

Other miscellaneous sales tax changes made by S.L. 2005-276 include subjecting satellite radio services to a 7 percent tax, exempting potting soil sold to farmers, and repealing the sales tax refund for school boards (in exchange for an equivalent annual transfer to the State Public School Fund). The latter change is discussed in more detail in Chapter 10, "Elementary and Secondary Education."

Incentives

The General Assembly made a number of tax changes in an attempt to lure businesses to the state, including delaying the sunset on the Bill Lee Act tax credits, allowing special tax credits for the film industry, and providing sales tax refunds for specific industries. These provisions are discussed in detail in Chapter 8, "Economic and Community Development." In Sections 4 and 5 of S.L. 2005-413 (S 1149), the General Assembly extended from 2006 to 2011 the sunset on the tax credit for investing in renewable energy property and increased the maximum credit for nonresidential renewable energy projects from \$250,000 to \$2.5 million per installation.

Business Taxes

Motor Fuels Taxes

S.L. 2005-377 (S 356) adds pumper trucks and sweepers to the group of vehicles that receive a partial refund of motor fuel taxes to reflect the fact that part of their fuel is used for nonhighway purposes. S.L. 2005-435 (H 105) makes a number of changes to the motor fuels tax laws, including the following.

- It authorizes the Secretary of Revenue to impose a penalty of \$1,000 for a person's failure to obtain certain required fuel tax licenses.
- It provides that taxpayers who are required to file motor fuels tax returns electronically must also pay the tax by electronic funds transfer.
- It transfers responsibility for audits related to the International Registration Plan from the Division of Motor Vehicles to the Motor Fuels Tax Division of the Department of Revenue.
- It authorizes the Secretary of Revenue to refuse to register a motor carrier if the carrier has had a registration cancelled for cause; has been convicted of fraud, misrepresentation, or any other offense indicating that the applicant may not comply with motor carrier fuel tax requirements; or has failed to pay a state tax or file a return.
- It sets out the conditions for establishing a defense to the \$5,000 civil penalty imposed on fuel transporters who deliver fuel to a state other than the state shown on the shipping document.
- It authorizes the Secretary of Revenue to assess a civil penalty of \$5,000 against a terminal operator who intentionally issues a shipping document that does not contain all the required information.
- It extends shipping document requirements to a person who operates a tank wagon into which motor fuel is loaded at the terminal and requires fuel transporters to retain shipping documents at a central office for at least three years after the fuel is delivered.
- It imposes a civil penalty on a person who intentionally fails to mark a storage facility for dyed (untaxed) motor fuel.
- It requires distributors of dyed diesel fuel to be licensed.

Employment Security Tax

In 1999 the General Assembly enacted S.L. 1999-321, temporarily suspending 20 percent of the unemployment insurance taxes employers pay to fund the unemployment insurance fund, which is used for unemployment benefits as required by federal law. In place of this 20 percent reduction, the act substituted an equal temporary tax, the training and reemployment contribution, which is paid instead into state coffers to be appropriated annually by the General Assembly to the Department of Community Colleges for various worker training programs. This arrangement thus has the effect of redirecting payments from the unemployment insurance fund to appropriations for state programs. Accordingly, the statute automatically suspends the training and reemployment contribution any time the unemployment insurance fund falls to \$900 million or less or any time the state unemployment rate rises above 4.3 percent. The training and reemployment contribution program was originally set to

expire in two years, but its expiration was extended to 2006 by Section 30.5 of S.L. 2001-424. Section 8.8 of S.L. 2005-276 extends the sunset date to 2011.

Gross Premiums Tax

Business corporations are generally subject to income and franchise taxes while insurers, instead of paying these taxes, pay the gross premiums tax. Before 2001, HMOs and nonprofit medical service corporations (such as Blue Cross Blue Shield and Delta Dental Corporation) were treated as general corporations, not insurers. In 2001, these entities were moved from the general tax law to the gross premiums tax, but at the reduced tax rate of 1 percent. Effective January 1, 2004, the General Assembly increased the rate on nonprofit medical service corporations to 1.9 percent. Part 38 of S.L. 2005-276 equalizes the gross premiums tax effective January 1, 2007, by increasing the rate on HMOs from 1 percent to 1.9 percent. When Part 38 of S.L. 2005-276 goes into effect, all health insurers will be taxed at the same rate.

Tax Administration

Property Tax Commission Salary

The Property Tax Commission is the five-member state board of equalization and review that hears and decides taxpayers' administrative appeals from decisions concerning the listing, appraisal, or assessment of property made by county boards of equalization and review and boards of county commissioners. Three of its members are appointed by the Governor and two by the General Assembly. The expenses of the Property Tax Commission are not paid from the General Fund but by local governments. The Department of Revenue collects local sales taxes on behalf of local governments and distributes the proceeds quarterly. In making these distributions, the department is required under G.S. 105-501 to deduct the state's costs relating to local property tax administration, the Property Tax Commission, the School of Government's property tax training program, and the Local Government Commission.

Section 22.5 of S.L. 2005-276 authorizes the Property Tax Commission to set the salary for its members, effective September 1, 2005. Under prior law, the commission members were compensated \$200 a day for their work on the commission. In the fourth edition of Senate Bill 622, Section 22.5 changed the salary of commission members from \$200 to \$400 a day and set the salary for the commission chair at \$450 a day. Although the final budget act did not set the salaries at this amount, Section 36 of S.L. 2005-345, Modify 2005 Appropriations Act, added a Section 22.5A to S.L. 2005-276 specifying the amount of funds appropriated to the Department of Revenue that must be used to pay the increased salaries of commission members.

Collection Assistance Fee

In 2001 the General Assembly established a system under which the cost of collecting overdue tax debts is borne by delinquent taxpayers, not by the taxpayers who pay their taxes on time. Under this system, a collection assistance fee of 20 percent is imposed on delinquent tax debts. Part 22 of S.L. 2005-276 makes several changes regarding the collection assistance fee. First, Part 22 clarifies that the amount of the fee is the lesser of the actual cost of collection or 20 percent. Second, Part 22 authorizes the use of the fee proceeds for additional purposes and requires the Department of Revenue and the Office of State Budget and Management to account for the use of the fee proceeds with accounting procedures that distinguish costs allocable to collecting overdue tax debts from costs allocable to other purposes. Third, Part 22 requires the Department of Revenue to report annually to the General Assembly regarding use of the fee proceeds.

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