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State Taxation

In 2007 the General Assembly finally resolved the temporary half-cent state sales tax enacted in 2001, by making permanent one-fourth cent of the tax. In addition, the General Assembly converted a half-cent local sales tax to a state sales tax as part of the Medicaid swap, in which it phased-out county responsibility for part of the nonfederal share of Medicaid costs. Other legislation this session capped the variable component of the motor fuels tax rate for two years, allowed a small refundable earned income tax credit, and reformed the process for resolving tax disputes with the Department of Revenue. Tax incentives for economic development are discussed in Chapter 8, “Economic and Community Development,” and property tax issues are covered in Chapter 18, “Local Taxes and Tax Collection.”

Motor Fuels and Energy

Cap Motor Fuel Tax Rate

In 2006 the General Assembly reacted to substantial increases in the price of oil and of gas at the pump by capping the variable component of the motor fuel excise tax rate at 12.4 cents from July 1, 2006, through June 20, 2007. Section 31.15 of the 2007 appropriations act, S.L. 2007-323 (H 1473), extends this temporary cap for two more years. Unlike in 2006, this time the General Assembly did not provide a reserve in the General Fund to reimburse the Highway Fund and the Highway Trust Fund for any revenue lost due to the motor fuel tax rate cap.

Renewable Energy Investment Tax Credit

North Carolina provides a generous 35 percent tax credit in G.S. 105-129.16A for individuals and businesses that invest in renewable energy property. Renewable energy property includes biofuel production equipment, hydroelectric generators, windmills, and solar energy equipment for water heating, active space heating and cooling, passive heating, daylighting, generating electricity, and other purposes. As part of a package of changes relating to renewable energy, S.L. 2007-397 (S 3) enacts new G.S. 105-129.16G to allow a tax-exempt nonprofit corporation to pass through to a donor the tax credit for which the nonprofit would have been eligible (if it were

taxable) for investing the donation in renewable energy property. The new credit becomes effective beginning with the 2008 tax year.

Fuel Used by Farmers and Manufacturers

S.L. 2007-397 phases down over several years the state taxes on the sale of energy to farmers and manufacturers, and eliminates the taxes as of July 1, 2010. Section 10 of S.L. 2007-397 amends G.S. 105-164.4 and G.S. 105-164.13 to set the sales tax rate on electricity sold to farmers for farming purposes and electricity sold to manufacturers for manufacturing use as follows:

<u>Effective Date</u>	<u>Rate</u>
10/1/07	1.8%
7/1/08	1.4%
7/1/09	0.8%
7/1/10	-0-

In lieu of sales tax, the state imposes an excise tax on piped natural gas. The rate is based on monthly volume received by the end user and ranges from \$.047 to \$.003 per therm. Section 11 of S.L. 2007-397 amends G.S. 105-187.41 to phase out this tax on natural gas received by a farmer for use in farming and natural gas received by a manufacturer for use in manufacturing, as follows:

<u>Effective Date</u>	<u>Range</u>
10/1/07	\$.032–\$.002
7/1/08	\$.025–\$.002
7/1/09	\$.014–\$.001
7/1/10	-0-

Other fuels sold to farmers for farming purposes are already exempt from sales taxes. In lieu of sales tax, the state imposes a 1 percent privilege tax on fuels, other than electricity and piped natural gas, sold to manufacturers to operate manufacturing industries and plants. Section 12 of S.L. 2007-397 amends G.S. 105-187.51A to phase out this tax as follows:

<u>Effective Date</u>	<u>Rate</u>
10/1/07	0.7%
7/1/08	0.5%
7/1/09	0.3%
7/1/10	-0-

Fuel Alcohol and Biodiesel

S.L. 2007-527 (S 540) provides that fuel alcohol providers and biodiesel providers are not required to file a bond when applying for a license unless they (1) have expected annual liability of \$2,000 or more or (2) are either a position holder or a person that receives motor fuel pursuant to a two-party exchange bond. S.L. 2007-524 (S 1272) exempts from the motor fuel tax any biodiesel that is produced by an individual for personal use in the individual's private passenger vehicle.

Highway Use Tax Sunset

S.L. 2007-527 repeals Section 8.4 of 1989 N.C. Sess. Laws Ch. 692, which would have repealed the Highway Use Tax, the Highway Trust Fund, and the Joint Legislative Transportation Oversight Committee upon completion of contracts for projects under the Highway Trust Fund.

Sales Tax

State Sales Tax Rate

In 2006 the General Assembly began the process of phasing out the temporary additional 0.5 percent state sales tax, reducing the tax rate from 4.5 to 4.25 percent effective December 1, 2006, and then to 4 percent effective July 1, 2007. The 2007 General Assembly changed course, however. Section 31.2 of S.L. 2007-323 repeals the reduction to 4 percent that would have become effective July 1, 2007. As part of the Medicaid swap, in which it phased-out county responsibility for a portion of the nonfederal share of Medicaid costs, the act also converted the one-half cent local sales tax in Article 44 of G.S. Chapter 105 to a state sales tax, making the state rate 4.5 percent effective October 1, 2008, and 4.75 percent effective October 1, 2009. For a detailed description of the local tax changes associated with the Medicaid swap, see Chapter 16, “Local Finance” and Chapter 18, “Local Taxes and Tax Collection.”

Bundled Transactions

S.L. 2007-244 (H 257) modifies the sales tax statutes governing bundled transactions by defining a *bundled transaction* as the sale of two or more distinct products for one non-itemized price and providing that sales tax applies to a bundled transaction unless one of three exceptions applies. The first exception applies if (1) the bundle contains no services, (2) the bundle includes exempt food, exempt drugs, and/or exempt medical products, and (3) the price of the taxable products in the bundle is no more than 50 percent of the price of the bundle. The second exception applies if the bundle contains a service and the retailer can determine an allocated price for each product in the bundle; in this case, sales tax applies to an allocated price of each taxable product in the bundle. The third exception applies if neither of the first two exceptions applies and the price of the taxable products in the bundle does not exceed 10 percent of the price of the bundle. The act also makes conforming changes to G.S. 105-164.12B (property sold below cost with conditional service contract). These changes bring state law into compliance with the Streamlined Sales Tax Agreement. The agreement is part of the Streamlined Sales Tax Project, an effort by states, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration.

Sales Tax Holiday/School Instructional Materials

Section 31.14 of S.L. 2007-323 amends the sales tax holiday statute effective October 1, 2007, to increase the maximum price for school instructional materials to qualify for exemption from \$100 to \$300 per item.

Use Tax on Boats and Aircraft

North Carolina sales tax is collected by retailers from purchasers on sales made in this state. The use tax complements the sales tax by taxing transactions in which property is purchased in another state or by Internet or mail order for use in this state. Unlike the sales tax, the use tax must be remitted by the purchaser, not the retailer. Businesses must pay monthly or quarterly, but G.S. 105-164.16(d) allows consumers to pay the use tax annually on their nonbusiness mail-order and other out-of-state purchases. The use tax may be reported on the consumer’s individual income tax return. Section 12 of S.L. 2007-527 excludes use tax on aircraft and boats from the annual payment provision. As a result, consumers must now pay aircraft and boat use taxes quarterly under the standard sales and use tax payment schedule.

Targeted Sales Tax Exemptions

In S.L. 2007-368 (S 1240), the General Assembly granted an exemption from state and local sales tax for bread, rolls, and buns that are sold at a bakery thrift store. In S.L. 2007-500 (H 487), the General Assembly exempted baler twine used by farmers.

Income Tax

Earned Income Tax Credit

For years, advocates for low-income citizens have lobbied unsuccessfully for an earned income tax credit (EITC); 2007 was the year that their efforts finally bore fruit, although the result is more like a grape than a melon. Section 31.4 of S.L. 2007-323 enacts new G.S. 105-151.31, which grants an individual a state EITC equal to only 3.5 percent of the individual's federal EITC. The new EITC is effective beginning in the 2008 tax year and sunsets at the end of 2012. Despite its small size, the credit is expected to cost the General Fund more than \$48 million in 2008-09. Like the federal credit, the state credit is refundable, resulting in a grant for individuals whose income is too low to be taxable. Unlike the federal credit, there is no provision for advance payment of the credit through the individual's periodic paychecks. Section 24.3 of the act, as amended by Section 14.3 of S.L. 2007-345, requires the Department of Revenue to promote the federal and state EITCs in the tax instruction booklet and encourages tax software developers to provide for automatic calculation of the EITC.

Real Estate Investment Trusts

Section 31.18 of S.L. 2007-323 is the latest in an ongoing effort to close tax loopholes exploited by creative tax professionals representing business interests. The act limits a corporation's ability to use a captive real estate investment trust (REIT) to avoid North Carolina taxes, effective beginning with the 2007 tax year. A REIT is an organization that uses the pooled capital of investors to purchase and manage real estate. The REIT pays no tax on the income it distributes to its shareholders as dividends because it deducts the dividends. The shareholders should pay tax on the dividends received. A REIT owned or controlled by a single entity is a captive REIT. The General Assembly found that corporations were creating captive REITs and passing the dividends through an out-of-state corporation or using other strategies to result in no tax being paid to North Carolina on income generated from North Carolina real estate. Section 31.18 of S.L. 2007-323 disallows this strategy by prohibiting a captive REIT from taking a deduction for dividends paid to entities subject to North Carolina corporate income tax. As a result, a captive REIT will pay North Carolina tax on income derived from North Carolina property. Double taxation is avoided by allowing a corporate dividends received deduction for dividends received from a captive REIT.

The act requires the Department of Revenue to report to the Revenue Laws Study Committee by May 1, 2009, on the amount of corporate income tax revenue generated in the 2007 tax year by the captive REIT provision. The study committee must calculate a revenue neutral corporate income tax rate based on the revenue generated and include the rate in a report to the 2010 Session of the General Assembly. This provision implies that the General Assembly will consider using the revenue gained by the captive REIT provision to lower corporate income taxes for all corporations.

Parental Savings Trust Fund Deduction

The 2006 General Assembly enacted G.S. 105-134.6(d)(4), permitting certain individuals to deduct from taxable income up to \$2,000 (\$4,000 for married couples filing jointly) for contributions to the Parental Savings Trust Fund of the State Education Assistance Authority. To

qualify, the taxpayer's adjusted gross income must be below specified thresholds. The deduction was due to sunset after the 2010 tax year. Effective beginning with the 2007 tax year, Section 31.19 of S.L. 2007-323 modifies the Parental Savings Trust Fund by (1) repealing the sunset, (2) increasing the maximum deduction to \$2,500 (\$5,000 for joint filers), and (3) temporarily removing the income thresholds for the period 2007 through 2011.

The Parental Savings Trust Fund is a qualified tuition program under Section 529 of the Internal Revenue Code. Distributions from qualified tuition programs are excludable from taxable income to the extent the distributions are used to pay for qualified higher education expenses. Because contributions are deductible and distributions are excludable, North Carolina provides a double tax benefit, as compared to federal law. The Parental Savings Trust Fund deduction must be added back to taxable income if the amount is withdrawn from the fund but not used to pay for qualified higher education expenses of the designated beneficiary, unless the withdrawal was made because of the death or permanent disability of the beneficiary.

Firefighter/Rescue Squad Deduction

Effective beginning with the 2007 tax year, Section 31.24 of S.L. 2007-323 allows eligible unpaid volunteer firefighters and rescue squad workers to take an income tax deduction of \$250.

Tax Credits

Long-term Care Tax Credit

Effective beginning with the 2007 tax year, Section 31.5 of S.L. 2007-323 reenacts G.S. 105-151.18, the individual income tax credit for premiums paid on long-term care insurance. The credit, which had expired at the end of 2003, is 15 percent of the premium costs, up to \$350 per insurance contract. The act modifies the credit by limiting it to taxpayers with adjusted gross income below specified amounts and expanding the class of dependents for whom the taxpayer may claim a credit for insurance coverage. The act sunsets the credit effective January 1, 2013. The credit is designed to reduce state Medicaid costs for long-term care by encouraging more individuals to obtain long-term care insurance. In the absence of data indicating that the credit affects taxpayer behavior, there is a question as to whether the credit merely subsidizes expenditures that taxpayers would have made anyway, yielding no benefit to the state.

Adoption Tax Credit

Section 31.6 of S.L. 2007-323 enacts new G.S. 105-151.32 to allow an individual income tax credit equal to 50 percent of the amount of the federal adoption tax credit, effective beginning with the 2007 tax year and sunset beginning with the 2013 tax year. Section 23 of the Internal Revenue Code provides a tax credit for adoption fees, court costs, attorney fees, traveling expenses, and other expenses directly related to legally adopting an eligible child. The credit amount is subject to dollar limits and income limits.

Work Opportunity Tax Credit

Effective beginning with the 2007 tax year, Section 31.21 of S.L. 2007-323 enacts new G.S. 105-129.16G, allowing taxpayers who are eligible for the federal work opportunity tax credit to take a state credit equal to 6 percent of the amount of the federal credit. There is no sunset on the credit. The federal work opportunity credit provides employers an incentive to hire individuals from targeted groups that have a particularly high unemployment rate or other special employment needs. The credit can be as much as 40 percent of the "qualified first year wages." Targeted groups include the following, and the employee must also meet additional conditions to qualify:

- Recipients of assistance under temporary assistance for needy families.
- Veterans.
- Ex-felons.
- High-risk youth.
- Individuals referred for vocational rehabilitation.
- Summer youth employees.
- Food stamp recipients.
- Supplemental Security Income (SSI) recipients.

Conservation Tax Credit

Effective beginning with the 2007 tax year, S.L. 2007-309 (H 463) amends the 25 percent income tax credit for donations of conservation real property in G.S. 105-130.34 (corporate income tax) and G.S. 105-151.12 (individual income tax) to specify that the corporate tax credit applies to Subchapter C corporations and the individual tax credit applies to individuals and pass-through entities (Subchapter S corporations, partnerships, and limited liability companies). The act increases the maximum annual credit for pass-through entities from \$250,000 to \$500,000. The maximum annual credit remains at \$500,000 for corporations and \$250,000 for individuals, although the act specifies that a married couple filing a joint return may claim \$500,000. The corporate and individual maximums apply whether the taxpayer made the donations directly or received the credit from a pass-through entity. If the maximum prevents the owner of a pass-through entity from taking the entire credit, the credit may not be reallocated among the other owners.

S.L. 2007-309 replaces the catch-all purpose for which the credit was allowed, *other similar land conservation purposes*, with specific, itemized conservation purposes, including farmland conservation and historic landscape conservation. The act requires the taxpayer to either provide an approved appraisal report of the value of the property or use the county appraisal to determine the value.

Historic Rehabilitation Tax Credit

Since 1994 North Carolina tax law has allowed income tax credits for the rehabilitation of historic buildings. Currently, a taxpayer may claim either 20 percent of rehabilitation expenditures that qualify for a companion federal credit or 30 percent of eligible rehabilitation expenditures that do not qualify for the federal credit. The state credits may be used by a pass-through entity so that the tax benefits are allocated directly to and used by the entity's owners, who report the income and credits as owners on their own income tax returns. For most state tax credits, a pass-through entity is required to allocate the credit among its owners in the same proportion that other items, such as the federal rehabilitation credit, are allocated under the Internal Revenue Code. The 20 percent rehabilitation tax credit provides for the separate sale of the credit, however, by allowing a pass-through entity to allocate the tax credit among its owners at its discretion as long as each owner's adjusted basis is at least 40 percent of the amount of credit allocated to that owner. This provision was set to expire January 1, 2008. S.L. 2007-461 (H 1259) removes the sunset, making the allocation provision permanent.

Reform Tax Appeals

S.L. 2007-491 (S 242) substantially revises the process for resolving disputes between taxpayers and the Department of Revenue.¹ The sweeping changes of the act will affect relatively few taxpayers, however, because most taxpayers never contest a tax matter, and fewer than 100

1. The act does not affect property tax procedures or class action cases.

each year proceed to a hearing or to court. Under prior law, the tax appeal procedure differed based on whether the dispute started as a refund claim or a proposed assessment, and it also differed based on whether a refund claim asserted that the tax was unconstitutional or merely incorrect. The statutes were confusing and did not describe all of the informal procedures available for resolving tax disputes. Effective January 1, 2008, S.L. 2007-491 provides a clear and comprehensive tax appeal system that is unified for tax assessments and refund claims.

Under the new procedures, a tax dispute is first negotiated informally within the Department of Revenue. The act extends from thirty to forty-five days the time the taxpayer has to request this informal pre-hearing review process. If the process does not resolve the issue, the taxpayer is not required to pay the tax in order to seek further review. The taxpayer may pursue the case using the Administrative Procedure Act's contested case hearing procedure before a neutral administrative law judge. Under prior law, the Department of Revenue was both a party and the decision maker at the administrative level; the taxpayer was required to pay the tax before seeking review in an impartial forum.

Contested case procedures for tax disputes are confidential until final. The judge's decision in a contested case is returned to the Department of Revenue for final review. The taxpayer may appeal an adverse decision to superior court, but only after paying the tax. Complex cases may be handled by the business court. The act requires taxpayers to follow these levels of review; unlike under prior law, the taxpayer cannot bypass the administrative process and take the dispute directly to court.

Miscellaneous

Internal Revenue Code Reference Update

North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the code.² The General Assembly determines each year whether to update its reference to the Internal Revenue Code.³ 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. Section 31.1 of S.L. 2007-323 updates the reference date to the code from January 1, 2006, to January 1, 2007. Updating the reference date to January 1, 2007, incorporates the federal changes to the code enacted during 2006. As required by the North Carolina Constitution, the act delays until January 1, 2007, the incorporation of any federal changes that would increase North Carolina taxable income retroactively for an earlier tax year.

Five major pieces of federal legislation amending the Internal Revenue Code became law in 2006: the Deficit Reduction Act of 2005 (P.L. 109-71); the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222); the Heroes Earned Retirement Opportunities Act (P.L. 109-227); the Pension Protection Act of 2006 (P.L. 109-280); and the Tax Relief and Health Care Act of 2006 (P.L. 109-432). The tax changes made by the Deficit Reduction Act of 2005 have

2. 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.

3. 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."

little or no impact on North Carolina taxes. The remaining four federal acts, however, made numerous changes that will affect North Carolina taxes for individuals, businesses, and other entities. These changes are described in detail in *2007 Finance Law Changes*, written by the legislature's tax staff and available on the Legislative Publications page of the General Assembly's website at www.ncleg.net. Among the most notable are

- Extending until 2008 the sunset on above-the-line deductions for higher education expenses.
- Extending until 2008 the sunset on above-the-line deductions for qualified expenses of elementary and secondary school teachers.
- Extending until 2009 the sunset on deductions for energy efficient commercial buildings.
- Extending until 2010 the sunset on enhanced small business expensing thresholds.
- Expanding to all minors under eighteen the "kiddie tax" on unearned income.
- Expanding the charitable deductions for contributions of food inventories and book inventories.
- Prohibiting a taxpayer from claiming a deduction for the fair market value of charitable donations of clothing and household items unless the items are in "good" or better used condition.
- Increasing the deduction for donations of conservation easements, and further increasing the deduction if the donation is made by a farmer or rancher for agricultural use.
- Allowing an individual over 70½ years old to distribute up to \$100,000 a year from an IRA to charitable institutions without recognizing the income.
- Excluding up to \$3,000 of otherwise taxable distributions from a government pension plan of a retired public safety officer when the money is used to pay for health insurance premiums.
- Allowing members of the Armed Forces serving in a combat zone to make contributions to retirement plans, effective retroactively to 2004.
- Removing the income limit for converting a traditional IRA to a Roth IRA, beginning in 2010.
- Increasing the deduction limits for employer contributions to defined benefit plans.

Cigarette and Tobacco Products Taxes

S.L. 2007-435 (H 1460) amends G.S. 105-113.35(d) to provide that if permission to be relieved of paying the tax on tobacco products is granted to a tobacco products manufacturer (that is not also a retailer), the permission also applies to an integrated wholesale dealer that is an affiliate of the manufacturer. If a cigarette manufacturer granted permission to be relieved of paying the cigarette excise tax is also a wholesaler of tobacco products other than cigarettes, then the manufacturer's permission also applies to the tax imposed on tobacco products other than cigarettes.

Gross Premiums Tax

Effective January 1, 2008, S.L. 2007-250 (S 238) reduces the tax on gross premiums on insurance contracts for property coverage from 0.85 to 0.74 percent. This act is discussed in detail in Chapter 16, "Local Finance."

Solid Waste Disposal Tax

S.L. 2007-550 (S 1492) imposes a \$2-per-ton statewide excise tax on the disposal of solid waste. This act is discussed in detail in Chapter 16, "Local Finance."

Tax Incentives

S.L. 2007-422 (H 1598), which extends the sunset on the qualified business tax credits, is discussed in Chapter 8, “Economic and Community Development.” Chapter 8 also covers the economic incentive tax breaks enacted in the 2007 appropriations act for the following industries: software publishing, research and development, renewable fuel production, aircraft parts manufacturing, medical and testing laboratory analytical services, datacenter hosting and data processing services, and railroad intermodal facilities.

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