

State Taxation

The 1998 General Assembly made a number of important changes with respect to state taxation, including repealing the remaining two cents of the state sales tax on food; replacing the state inheritance tax with a state estate tax; providing state income tax credits for certain taxpayers who purchase long-term care insurance or who pay for health insurance coverage for dependent children; expanding the state income tax credit for taxpayers who make charitable contributions but do not itemize their tax deductions; and providing tax incentives to spur economic development.

This chapter summarizes those laws and other legislation affecting state taxation. Legislation regarding local taxes is discussed in Chapter 17 (Local Taxes and Tax Collection).

Tax Incentives to Encourage Economic Development

S.L. 1998-55 (S 1569) amends the state tax laws to promote economic development throughout the state.

1. It amends the William S. Lee Quality Jobs and Business Expansion Act (referred to hereinafter as the William S. Lee Act) to encourage large investments and remove technical problems with the act.
2. It authorizes enhanced incentives for development zones, which are economically distressed areas located within municipalities.
3. It provides sales tax and property tax reductions for air couriers and provides a temporary bidding law exemption for specific projects of the Piedmont Triad Airport Authority to encourage development of air courier hubs.
4. It provides an investment tax credit for large and major recycling facilities that locate in Tier One counties to encourage development of a recycling industry in Tier One counties. In addition, it provides a refundable reinvestment credit and sales tax reductions for major recycling facilities.

Economic development provisions of S.L. 1998-55 that do not directly affect state taxes or revenues are discussed in Chapter 5 (Community Development and Housing). The act's provisions affecting local sales and property taxes are discussed in Chapter 17 (Local Taxes and Tax Collection).

S.L. 1998-55 is expected to reduce General Fund revenues by \$2.22 million in 1998-99, \$1.21 million in 1999-2000, \$6.81 million in 2000-01, \$12.97 million in 2001-02, and \$16.33 million in 2002-03.

Amendments to the William S. Lee Act

Part I of S.L. 1998-55 makes a number of technical and substantive changes to the William S. Lee Act. Unless a different date is given, these changes all become effective beginning with the 1999 tax year.

The William S. Lee Act, enacted by the General Assembly in 1996, extended the jobs tax credit to all 100 counties, enacted a new tax credit for worker training expenses, enacted a new tax credit for increasing research activities, and enacted two new tax credits for investing in machinery and equipment. In 1997, the General Assembly expanded the types of businesses eligible for the credits and created a new tax credit for taxpayers who purchase or lease real property to be used as central administrative office property.

The act makes two changes to the central administrative office credit that was enacted in 1997. First, it allows the credit to be taken against the insurance gross premiums tax. This change will permit insurance companies to qualify for the credit. Second, it clarifies that a central administrative office meets the requirements for creating new jobs if the jobs begin before the office property is in service but are located at a temporary facility that the business occupies while waiting for its office property to be completed.

It also makes two changes to the credit for investing in machinery and equipment. First, it provides that for projects that span two tax years, the threshold applies only once to the investment. Otherwise, a project put in service over several months within a calendar year would receive more benefit than a project put in service over several months starting in one calendar year and ending in the next. This change went into effect beginning with the 1998 tax year. Second, it expands the credit to include machinery and equipment the taxpayer uses under an operating lease, but only if the machinery and equipment are part of a project valued at \$150 million or more.

The act expands the credit for research and development. This credit piggybacks the federal credit, allowing a state credit equal to approximately one-quarter of the federal credit as it relates to North Carolina activities. In 1997, Congress enacted an alternative credit for research and development. The act modifies the state credit to also allow a credit equal to approximately one-quarter of the federal alternative credit as it relates to North Carolina activities.

The act simplifies the credit for worker training by replacing the credit measured by costs of training with a credit for wages paid to workers while they are being trained (not including on-the-job training). The credit is restricted to employees for whom the taxpayer qualifies for the jobs tax credit and employees being trained to operate machinery and equipment for which the taxpayer qualifies for the credit for investing in machinery and equipment. In order to qualify under former law for this credit, the taxpayer was required to have the planned training certified in advance by the Department of Community Colleges. This requirement was difficult both for taxpayers and for the Department of Community Colleges.

Finally, Part I of the act makes a number of administrative and technical changes to the William S. Lee Act. First, it levies a \$75 application fee on taxpayers who seek to qualify for a credit. The proceeds of the fee will help the Department of Commerce defray its costs in administering the credits. This fee became effective January 1, 1999. Second, the act extends the credit carryforward period for investments over \$150 million. The act provides that for large investments, the excess may be carried forward for up to twenty years, rather than the five years allowed by former law. Third, the act clarifies that credits are allowed only for new and expanding businesses, not for existing businesses that are sold to another taxpayer. An exception is made for a business that has closed, has filed a federally required notice that closure is imminent, or has been purchased in an employee buyout. In these cases, the business will be able to qualify for the credits to the same extent as a new business. Fourth, the act provides that if an industrial park is located in and owned by two counties that both contribute significantly to its

development, the industrial park as a whole is considered to have the tier designation of the lower-tiered county. This change promotes regional cooperation in industrial development and avoids an industrial zone that is split into two tier designations. Fifth, the act clarifies and renumbers the definitions of the different types of businesses that are eligible for credits and clarifies the method of calculating the investment tax credit and the business tax credit for property acquired by a capital lease.

State Development Zones

Part I of S.L. 1998-55 provides for the designation of economically distressed areas located within municipalities as state development zones and authorizes enhanced incentives for businesses that locate in a development zone, effective beginning with the 1999 tax year. The act defines a development zone as an area that consists of one or more contiguous census tracts, block groups, or both; has a population of 1,000 or more, at least 20 percent of whom are below the poverty level; and is located at least partly in a municipality with a population over 5,000. If a business locates in a development zone, the wage standard it has to meet is the same as for Tier One counties—slightly lower than the standard for other counties. In addition, if a business locates in a development zone, its maximum worker training credit is \$1,000 rather than \$500, it receives an additional \$4,000 per job on its jobs tax credit, and there is no threshold for the credit for investing in machinery and equipment.

The Secretary of Commerce will designate development zones upon request of a taxpayer or a local government. The designation is effective for four years. The act provides that a development zone may qualify for priority in receiving community development block grants if the municipality's governing body adopts a strategy to improve the zone and establishes a committee to implement the strategy, in accordance with guidelines established by the Department of Commerce. The Department of Commerce is required to report annually to the Department of Revenue and the General Assembly's Fiscal Research Division on the number of new jobs created within development zones and the percentage of those jobs that were filled by residents of those development zones.

Air Courier Hubs

Part III of S.L. 1998-55 provides sales tax and property tax reductions for interstate air couriers in order to encourage the development of air courier hubs in North Carolina. An air courier is an air carrier that delivers individually addressed letters, parcels, and packages. Effective January 1, 2001, the act provides that sales to an interstate air courier of equipment for handling and storing materials at its hub will be subject to a reduced sales tax of 1 percent, capped at \$80 per item. In addition, the act provides a sales tax exemption for sales to an interstate air courier of aircraft lubricants, aircraft repair parts, and aircraft accessories for use at the air courier's hub in North Carolina. (The act also provides, effective beginning with the 2001 property tax year, a local property tax exemption for aircraft owned by an air courier and apportioned for property tax purposes to the courier's hub in North Carolina.) A hub is the place in North Carolina where the air courier allocates for property tax purposes more than 60 percent of its North Carolina aircraft value and where its primary function is to receive packages from consolidation locations for sorting and distribution, rather than to consolidate packages for delivery to another airport for sorting and distribution.

Recycling Facilities

Part IV of S.L. 1998-55 provides tax incentives for "large" and "major" recycling facilities located in Tier One counties at the time of initial construction. A recycling facility is a plant that manufactures products, most of which are made from at least 50 percent post-consumer waste material. The facility also includes related infrastructure, buildings, and equipment on land near (and in the same county as) the plant. A large recycling facility is one that will involve at least

\$150 million in new investment and 155 new jobs within a two-year period. A major recycling facility is one that will involve at least \$300 million in new investment and 250 new jobs within a four-year period. In order to qualify for the applicable tax incentives, the owner of the facility must obtain certification from the Department of Commerce that it will meet the minimum investment and new job requirements. If the facility fails to meet either requirement within the applicable time period, it forfeits any tax benefit it received as a result of being certified.

Part IV of the act provides an investment tax credit for both large and major recycling facilities, effective beginning with the 1998 tax year. This investment tax credit is in lieu of the investment tax credit provided in the William S. Lee Act. The recycling facility investment tax credit differs from the William S. Lee Act credit in the following ways:

1. The William S. Lee Act credit is equal to 7 percent of the cost of machinery and equipment, while the large recycling facility credit is equal to 20 percent of the cost and the major recycling facility credit is equal to 50 percent of the cost.
2. The credit is allowed at the time the owner of the recycling facility accrues expenses to purchase or lease machinery and equipment, rather than at the time machinery and equipment are placed in service, as under the William S. Lee Act. If the facility fails to put the machinery and equipment in service within thirty months after taking the credit, the credit is forfeited and must be repaid.
3. The credit is allowed against both the corporate franchise tax and the corporate income tax. The William S. Lee Act allows the credit against either but not both taxes.
4. The credit may equal 100 percent of the tax due from the owner of the facility. The William S. Lee Act limits the credit to 50 percent of tax due.
5. The excess credit may be carried forward for twenty-five years. Under the William S. Lee Act, as revised by this act, the relevant carryforward period is twenty years.

Part IV of the act also provides to major recycling facilities locating in Tier One counties a refundable corporate income tax "credit for reinvestment," effective beginning with the 1998 tax year. The credit applies if the major recycling facility is not accessible by ocean barge or ship and incurs additional expenses due to transporting its materials and products by alternative modes of transportation. The reinvestment credit is equal to the amount of these additional expenses, which must be documented annually to the Secretary of Commerce. The credit is subject to a dollar cap each year, in increasing amounts. In 1999, the cap is \$640,000. In 2004, the cap levels off at \$10.4 million a year. The act sunsets this reinvestment credit effective with the 2008 tax year. The act states the intent, however, to postpone the sunset if any major recycling facility can document that it is still experiencing additional expenses in 2008 due to its inability to use ocean barges or ships to transport materials and products.

The reinvestment credit is refundable; that is, if the amount of credit exceeds the major recycling facility's tax liability after all other credits are subtracted, the balance is paid in cash. For the first ten years the reinvestment credit is in effect, a major recycling facility must use the amount received in credit to invest in rail and roads associated with the facility, in transportation infrastructure to reduce the expense of transporting materials and products to and from the facility, or in land and infrastructure for industrial sites, other than the facility itself, in the same county. If there are not enough reasonable opportunities for investments in those purposes in a given year, however, the major recycling facility may invest the amount of credit received in the facility itself, but only after it has made the minimum investment of \$300 million required to qualify as a major recycling facility. The facility must document its compliance with this reinvestment requirement and forfeits any part of the credit it spends for another purpose.

Part IV of the act provides several sales and use tax reductions for major recycling facilities located in Tier One counties, effective July 1, 1998. First, it provides that a reduced sales tax rate of 1 percent, capped at \$80 per item, applies to cranes, foundations, transportation equipment, and material handling equipment used at the major recycling facility. (These items would otherwise be subject to 4 percent state sales tax and 2 percent local sales tax.) Second, it exempts from sales tax lubricants and other additives for vehicles and machinery used at the plant and other materials and supplies (not including machinery and equipment) that are used or consumed directly in the manufacturing process. (These items would otherwise be subject to a combined

state and local sales tax rate of 6 percent.) Third, it exempts from sales tax electricity purchased for use at the major recycling facility. (This electricity would otherwise be subject to state sales tax at 3 percent or 2.83 percent.) Fourth, it provides an annual sales tax refund for taxes a major recycling facility pays directly or indirectly on building materials, building supplies, fixtures, and equipment that become a part of the real property of the recycling facility located in a Tier One county.

Finally, Part IV of the act provides for major recycling facilities an expanded version of the existing property tax exemption for property used for recycling. This local property tax exemption is discussed in Chapter 17 (Local Taxes and Tax Collection).

Extension of Sunset for Qualified Business Credit

Section 29A.15 of the 1998 Appropriations Act, S.L. 1998-212 (S 1366), extends the sunset for the qualified business investment tax credit by an additional four years, until 2003. This change became effective October 30, 1998.

The qualified business investment tax credit was enacted in 1987 to promote economic development for North Carolina businesses. The initial credits applied to both corporations and individuals taxpayers, and there was a \$12 million cap on the total amount of all tax credits. In response to a 1996 United States Supreme Court decision, the General Assembly reduced the \$12 million cap to \$6 million, limited the credit to individuals and small pass-through entities, and removed the requirement that the qualified businesses be headquartered or operating in North Carolina. The credit was to expire for investments made on or after January 1, 1999, but is now extended until January 1, 2003.

Qualified Business Credit for Movies

Section 29A.16 of the 1998 Appropriations Act, S.L. 1998-212 (S 1366), modifies the qualified business investment tax credit to make it more accessible for investors who provide capital for the film industry. The 1998 amendment, effective for tax years beginning on or after January 1, 1999, modifies the qualified business investment tax credit in two ways:

1. It allows a qualified business venture in the film industry to pay off its investors in less than five years without causing the investors to forfeit the tax credit.
2. It provides that the effective date of registration for a qualified business venture whose application is accepted for registration is sixty days before the date its application was filed.

To obtain a tax credit, a person must purchase the equity securities or subordinated debt directly from the qualified business. Subordinated debt is indebtedness that by its terms matures five or more years after its issuance, is not secured, and is subordinated to all other indebtedness. A taxpayer forfeits the credit if the qualified business redeems the securities purchased by the taxpayer within five years after the investment was made. In the film industry, a project in which a person may invest does not usually last five years, making it difficult to satisfy the five-year minimum for the investment. The act addresses this problem by allowing a business engaged primarily in the film production industry to redeem its securities within five years and to mature its subordinated debt within five years without causing an investor to forfeit the tax credit. The act provides that this redemption is allowed only if (1) the redemption occurred because the qualified business venture completed the production of a film, sold the film, and was liquidated, and (2) neither the qualified business venture nor a related person continues to engage in business with respect to the film produced by the venture.

Under former law, no tax credit was allowed for an investment made in a qualified business venture before the date of the business's registration with the Secretary of State. In the film industry, a person invests in a project before the project is started. The practice is that the investments are placed in an escrow account until a sufficient amount of capital is obtained to begin a film's production. If enough funds are not raised, the money in escrow is returned to the investors. To accommodate this unique situation, the act extends the time in which a taxpayer may make an eligible investment. It provides that the effective date of a business's registration is

sixty days before the date its application is filed, as opposed to the date it is filed. The act also provides that if a taxpayer's investment is placed initially in escrow conditioned upon other investors' commitment of additional funds, the date of the taxpayer's investment is the date escrowed funds are transferred to the qualified business venture free of the condition, as opposed to the date the investment was actually made.

State Individual and Corporate Income Taxes

Tax Credit for Purchase of Dependent Health Insurance

Section 5 of S.L. 1998-1 (Ex. Sess.) (S 2) creates a refundable individual income tax credit for certain taxpayers who use "post-tax" dollars to purchase health insurance for their dependent children. The credit is equal to \$300 for those taxpayers with incomes below 225 percent of the federal poverty level and \$100 for those taxpayers above the 225 percent threshold. Taxpayers whose adjusted gross income is higher than the threshold amount set by the act do not qualify for the credit. The threshold amount for married taxpayers who file jointly is \$100,000; the threshold amount for a taxpayer filing as head of household is \$80,000. The credit is effective for tax years beginning on or after January 1, 1999, and it expires on the effective date of an act repealing the Health Insurance Program for Children established by S.L. 1998-1. It is estimated that the tax credit will produce a General Fund revenue loss of \$64.5 million in 1999–2000.

To prevent a double tax benefit, the tax credit may not be claimed if the amount paid by the taxpayer for insurance coverage is deducted from or not included in the taxpayer's gross income for income tax purposes. If a taxpayer claimed a deduction for health insurance costs of self-employed individuals for the tax year, the amount of credit otherwise allowed is reduced by the amount of the deduction. [In 1999, a self-employed individual may deduct 45 percent of health insurance costs from income tax. This percentage increases to 100 percent by the year 2007.] If a taxpayer claims a deduction for medical care expenses, the taxpayer is not allowed a credit. Lastly, if a taxpayer uses "pre-tax" dollars to pay the health insurance premiums through a cafeteria plan, the taxpayer is not allowed a credit. Roughly 40 percent of the parents now paying health insurance premiums for their children do so with "pre-tax" dollars and, therefore, are not eligible for the credit.

The tax credit may not exceed the amount of health insurance premiums the taxpayer paid during the tax year that provided insurance coverage for the taxpayer's dependent children. However, the amount of the credit may exceed the amount of tax owed by the taxpayer. If the credit allowed exceeds the amount of tax imposed, the excess is refundable to the taxpayer. In computing the amount of tax against which multiple credits are allowed, nonrefundable credits are subtracted before refundable credits. This credit is North Carolina's first refundable tax credit. To claim and receive this refundable credit, approximately 20,000 families that do not currently have to file a state income tax return will have to file a tax return. Many low-income families do not currently file income tax returns because their personal exemptions and standard deductions exceed their tax liability.

The ability of the Department of Revenue to ensure compliance with this credit will be difficult. The department does not currently require a taxpayer to include a copy of the taxpayer's federal return with the state income tax return. However, the department will need this information to ensure that the taxpayer did not claim a self-employed health insurance deduction or a medical expenses deduction for the premiums. The department will probably require that the federal return be attached if the credit is claimed. How to determine whether premiums were paid with "pre-tax" dollars is more difficult since the wage and tax statement does not state whether health insurance premiums were paid with pre-tax dollars. To help the department ensure compliance with the law, the act states the General Assembly's intent to appropriate funds to the department for the 1999–2001 biennium to cover the costs of auditing 10 percent of the tax

credits claimed for child health insurance premiums. The department believes it will need ten auditors and two clerical support positions to monitor 10 percent of the tax credits claimed.

Tax Credit for Charitable Contributions by Non-Itemizers

S.L. 1998-183 (H 20) increases the individual income tax credit for charitable contributions by non-itemizers in order to provide an additional incentive for charitable giving. It increases the amount of the credit from 2.75 percent to 7 percent of eligible contributions, effective beginning with the 1999 tax year. The act is expected to reduce General Fund revenues by almost \$8 million a year.

Under the federal Internal Revenue Code, an individual who itemizes deductions may deduct contributions to nonprofit charitable organizations. Individuals who elect the standard deduction, however, may not deduct charitable contributions. An individual's North Carolina income tax is based on the federal calculation of taxable income, with some adjustments. The federal disallowance of charitable deductions for non-itemizers is "piggybacked" by North Carolina tax law.

In 1996, the General Assembly enacted G.S. 105-151.26, which allows a North Carolina income tax credit for 2.75 percent of a non-itemizer's charitable contributions to the extent that the contributions exceed 2 percent of the taxpayer's adjusted gross income. By raising the credit from 2.75 percent to 7 percent, the 1998 act makes the credit equivalent to the deduction currently enjoyed by most taxpayers who itemize.

Tax Credit for Purchase of Long-Term Care Insurance

Section 29A.6 of the 1998 Appropriations Act, S.L. 1998-212 (S 1366), allows a state individual income tax credit of 15 percent of the premium paid each year on long-term care insurance. The credit may not exceed \$350 for each policy for which the credit is claimed. The credit may not exceed the amount of tax owed by the taxpayer, and there is no provision to allow unused portions of the credit to be carried forward. The credit becomes effective for tax years beginning on or after January 1, 1999, and expires for tax years beginning on or after January 1, 2004. The new credit is expected to reduce General Fund revenues by \$7.98 million in 1999–2000, \$8.87 million in 2000–01, \$9.82 million in 2001–02, and \$10.89 million in 2002–03. The Legislative Research Commission is directed to study the effect of the credit on the state's Medicaid costs and to report its findings to the 2004 session of the General Assembly.

A taxpayer may claim a credit for policies that provide coverage for the taxpayer, the taxpayer's spouse, or a family member for whom the taxpayer provides over half of the support and whose income is below an exemption amount. A long-term care insurance policy is one that provides only coverage of long-term care services and that meets the following requirements:

1. It is guaranteed renewable.
2. It does not provide for a cash surrender value.
3. It provides that refunds and dividends may be used only to reduce future premiums or to increase future benefits.
4. It does not pay or reimburse expenses that are reimbursable under Medicare.
5. It satisfies consumer protection laws.

Under the federal Internal Revenue Code (IRC), premiums paid on long-term care insurance contracts are treated as deductible medical expenses. Under the medical expense itemized deduction, unreimbursed medical expenses may be deducted to the extent that the expenses exceed 7.5 percent of adjusted gross income. To the extent that a taxpayer will receive a deduction for long-term care insurance premiums under the IRC, the taxpayer will receive a deduction for state income tax purposes as well since North Carolina uses federal taxable income as the starting point for calculating state taxable income. To prevent a double tax benefit in those cases, the credit is limited to those expenses for which a deduction has not been claimed.

Tax Credits for Child Care and Construction of Dwelling Units for the Handicapped

S.L. 1998-100 (H 1422) amends two individual income tax credits (for child care and for construction of dwelling units for the handicapped) to remove restrictions that prevent nonresidents from taking the credits. These restrictions were probably unconstitutional in light of a 1998 decision of the United States Supreme Court. The act is effective for tax years beginning on or after January 1, 1998. Its impact upon the General Fund is expected to be no more than \$600,000 a year.

On January 21, 1998, the United States Supreme Court held, in *Lunding v. New York*, ___ U.S. ___, 139 L. Ed. 2d 717 (1998), that a state's tax laws must treat nonresidents on terms of "substantial equality" with residents. The court concluded that while the privileges and immunities clause of the United States Constitution affords states considerable discretion in formulating their income tax laws, there must be a substantial reason for the difference in treatment of residents and nonresidents within a tax structure.

Conservation Tax Credits

For tax years beginning on or after January 1, 1999, Section 29A.13 of S.L. 1998-212 (S 1366) increases an individual taxpayer's limit for the conservation tax credit from \$100,000 to \$250,000 and increases a corporate taxpayer's credit limit from \$250,000 to \$500,000. This change is expected to reduce General Fund revenues by \$1.2 million per year. The act also repeals the requirement that individual taxpayers add back the fair market value of the donated real property to their taxable income. This add-back requirement was originally placed in the law to prohibit individual taxpayers from receiving both a tax credit and a charitable deduction for the donated property.

This tax credit is allowed to individual and corporate taxpayers who make a qualified donation of an interest in North Carolina real property that is useful for public beach access or use, for public access to public waters or trails, for fish and wildlife conservation, or for other similar land conservation purposes. The tax credit is equal to 25 percent of the fair market value of the property donated to the state, a local government, or a body that is both organized to receive and administer lands for conservation purposes and qualified to receive charitable contributions. Both corporate and individual taxpayers are allowed to carry forward for five years any unused portion of the credit.

North Carolina is the only state that allows a conservation tax credit. The credit was enacted in 1983. The General Assembly did not want an individual to receive a double tax benefit for the donation, so it prohibited a charitable contribution deduction for the portion of the donation used to calculate the tax credit. In 1989, federal taxable income became the starting point in determining North Carolina taxable income. In order to maintain the single tax benefit, an addition to the federal taxable income in the year of the donation was required in the amount of the fair market value of the donated property. This add-back can be a disincentive to donating property in two cases:

1. If the taxpayer never deducts the entire fair market value of the donation as a charitable deduction. This situation can occur because federal law imposes limitations on the amount of charitable contributions to be deducted in any year based on the taxpayer's adjusted gross income (usually 30 percent of adjusted gross income).
2. If the taxpayer never claims the entire tax credit for the donation. This can occur because the taxpayer may be unable to claim the entire amount of the credit within the six-year period.

The act remedies these disincentives by no longer requiring an individual taxpayer to add the fair market value of the donated property to federal taxable income in arriving at North Carolina taxable income. This change results in an individual taxpayer receiving both a charitable contribution deduction and a tax credit for the donation. Current law does not allow a corporation to take a charitable contribution deduction for its donation.

Under the Internal Revenue Code, a donation of real property for conservation purposes is treated as a charitable deduction. A qualified appraisal of the donated land is required if the claimed deduction is more than \$5,000. This appraisal must be attached to the federal tax return. No appraisal is required by the N.C. Department of Revenue.

Tax Credit for Poultry Composting Facilities

S.L. 1998-134 (H 1617) removes the sunset from the individual income tax credit for constructing a poultry composting facility in North Carolina for composting poultry carcasses resulting from commercial poultry operations. The credit would otherwise have expired in the 1998 tax year. The individual income tax credit was available only to individuals, shareholders in Subchapter S corporations, and other individual owners of pass-through entities. This act expands the credit to C corporations. The act is expected to reduce General Fund revenues by approximately \$30,000 a year.

The amount of the credit allowed is 25 percent of the installation, equipment, and materials costs of building the facility, not to exceed \$1,000. The credit does not apply to costs paid with funds provided to the taxpayer by a state or federal agency. The amount of the credit allowed may not exceed the amount of tax imposed for the tax year, and any unused credit may not be carried forward to succeeding tax years.

The purpose of the credit is to encourage people who raise turkeys, chickens, or other poultry to compost the dead poultry rather than burn it or put it in a pit. The by-product of composting poultry carcasses can be converted into a useful product.

Deduction for Subsidiary Dividends to Nonresident Corporations

The 1998 Appropriations Act, S.L. 1998-212 (S 1366), also extends the deduction for subsidiary dividends to corporations domiciled in other states. This is a technical change only because, due to the requirements of the interstate commerce clause of the United States Constitution, the Department of Revenue was forced in 1997 to extend the deduction to out-of-state corporations. The statutory change conforms the statutes to the current practice and to the requirements of the U.S. Constitution.

The 1994-95 Revenue Laws Study Committee had recommended a different solution to this problem: allowing both North Carolina corporations and out-of-state corporations to deduct subsidiary dividends but not expenses related to the deductible dividends. This recommendation was based on the basic tax principle, reflected in section 265 of the Internal Revenue Code and in G.S. 105-130.5(c)(3), that expenses related to untaxed income should not be deductible from taxed income. The Revenue Laws Study Committee's recommendation was introduced in 1996 but was not enacted.

Corporate Income Tax Carryforward for Net Economic Losses

S.L. 1998-171 (H 1326) extends the corporate income tax carryforward for net economic loss deductions from five years to fifteen years, effective beginning with the 1999 tax year. Losses from 1993 and later tax years will benefit from this extension. For the first three years this extension is in effect, the carryforward deduction for losses more than five years old is restricted to 15 percent of taxable income. Beginning with the 2002 tax year, there will be no cap on the deduction for losses carried forward.

A net economic loss is the amount by which a corporation's deductions for a tax year exceed its income from all sources, including income not taxed by North Carolina (such as income that is deductible in determining net income or a multistate corporation's nonbusiness income that is allocable to another state).

The carryforward period for the similar net operating loss deduction under the Internal Revenue Code was recently extended from fifteen to twenty years, but most states allow no more than a fifteen-year carryforward period. Because it may be difficult for an auditor to substantiate

a loss carryforward based on deductions that are ten to fifteen years old, the act clarifies that the corporation must maintain records that verify the amount of the loss deduction claimed and also provides that the taxpayer or the Secretary of Revenue may redetermine an item for a tax year that is closed under the statute of limitations in order to calculate a loss carried forward to an open year. The net economic loss carryforward is expected to reduce General Fund revenues by \$3.7 million for each fiscal year beginning 1999–2000 through 2001–02. The reduction for 2002–03 and thereafter will be \$16 million a year.

Income Tax Withholding from Payments to Nonresidents

S.L. 1998-162 (H 1318) limits the withholding requirement for payments to nonresident contractors so that it applies only to payments to contractors doing business as athletes and entertainers. It clarifies that radio programs, like television and film programs, are a form of entertainment for purposes of the withholding requirement. It also limits the requirement to payments to a nonresident contractor in excess of \$1,500 a year. These changes relating to withholding are effective retroactively to January 1, 1998.

Originally, the nonresident withholding requirement also applied to construction-related trades. Although this act removes construction-related trades from the income tax withholding requirements, it does require occupational licensing boards for construction-related trades to cooperate with the Department of Revenue to assure that nonresidents pay delinquent taxes before being licensed to do business in North Carolina. Most of these changes affecting occupational licensing become effective July 1, 1999. The changes made by this act are expected to reduce General Fund revenues by \$7 million a year.

Many nonresidents who derive income from North Carolina do not pay the North Carolina tax due on this income. To address this collection problem, the 1997 General Assembly enacted S.L. 1997-109 to require payers to withhold 4 percent from the compensation paid to nonresident individuals and nonresident entities for personal services performed in North Carolina if the compensation exceeded \$600 in the calendar year. Beginning January 1, 1998, the withholding requirement applied to payments to individuals for any personal services and payments to entities for services relating to entertainment, athletic events, and construction. It would have been expanded to payments to entities for all personal services effective January 1, 1999.

After S.L. 1997-109 became law, legislators, staff, and the Department of Revenue were contacted by businesses that were required to withhold from their payments for personal services. These businesses stated that the withholding requirement would create an expensive, time-consuming burden on them. They would have to reprogram their accounting software, examine invoices manually, and make difficult judgment calls regarding where services were performed. Large, multistate corporations in particular claimed that the new law would be burdensome. In response to these concerns, the General Assembly enacted this legislation, which repeals the entire withholding requirement except as it relates to entertainment and athletic events.

As enacted by S.L. 1997-109, the withholding requirement applied to payments made to nonresident contractors only if the total payments exceeded \$600 during a calendar year. The \$600 threshold is the federal threshold for tax reporting under Section 6041 of the Internal Revenue Code. This act raises the threshold for withholding from contract payments to nonresident athletes and entertainers from \$600 to \$1,500 a year. The higher threshold will have the effect of insulating organizations, such as parent-teacher associations, from having to withhold on their occasional payments to out-of-state entertainers.

The rollback of the withholding requirement is effective retroactively to January 1, 1998. Anyone who had been complying with the law by withholding for services other than those performed by athletes and entertainers may refund the withheld taxes if the taxes have not yet been paid into the Department of Revenue. All nonresident taxpayers who had taxes withheld from their payments under the repealed law will receive a credit for the withheld taxes when they file their income tax return.

The rationale for limiting the withholding requirement to athletes and entertainers is that athletic and entertainment events can easily be identified by those required to withhold, the entire

performance is clearly taxable by the state where it occurs, and because of the large sums often involved, the administrative burden of withholding is small compared to the benefit the state receives. For other personal services performed by nonresidents, the burden of compliance outweighs the benefit because the services are less easily identified and may be performed partly in this state and partly in another state. For those, such as large, multistate corporations, who deal with a myriad of contractors for goods and services throughout the nation, the burden can be significant.

The act also adds reporting and licensing requirements for nonresident individuals and foreign entities that seek occupational licenses for construction-related occupations. These changes affect four state occupational licensing boards:

1. The Licensing Board for General Contractors
2. The Board of Examiners of Plumbing, Heating, and Fire Sprinkler Contractors
3. The Board of Examiners of Electrical Contractors
4. The Board of Examiners for Engineers and Surveyors

The act provides that each of these licensing boards must require a nonresident corporation or a nonresident limited liability company to first obtain a certificate of authority from the Secretary of State before being licensed by the board to do business or, in the case of engineers and surveyors, before having their certificate of licensure renewed. This requirement is effective July 1, 1999. General law requires all foreign corporations and foreign limited liability companies to obtain a certificate of authority from the Secretary of State before transacting business in this state. G.S. 55-15-01, G.S. 57C-7-02.

The act also provides a mechanism to prevent nonresident individuals and foreign entities from renewing their occupational licenses if they (or one of their partners or members, in the case of a partnership or limited liability company) owe a delinquent income tax debt. A delinquent income tax debt is a final debt after the taxpayer has been notified of the final assessment and no longer has the right to contest the amount. The provisions relating to individuals go into effect July 1, 1999. The provisions relating to entities go into effect July 1, 2000.

If requested by the Secretary of Revenue, each construction-related licensing board will provide the Secretary of Revenue annual lists identifying the name, address, and tax identification number of every nonresident individual and foreign entity licensed by the board. Occupational licensing boards are already required to obtain individual licensees' social security numbers under G.S. 93B-14. The Department of Revenue will check these lists against its records of taxpayers who owe delinquent income tax debts. If the Department of Revenue finds that a nonresident individual or a foreign corporation owes a delinquent tax debt, the department will instruct the licensing board not to renew the taxpayer's license until the debt has been settled. If the Department of Revenue finds that a partner in a foreign partnership or a member of a foreign limited liability company owes a delinquent tax debt, the department will instruct the licensing board not to renew the partnership or limited liability company's license until the debt has been settled. The license may be renewed once the licensing board receives written notice from the Secretary of Revenue that the debt has been settled. Section 8 of the act clarifies that taxpayers are not entitled to an additional administrative hearing regarding a board's refusal to renew a license based on a delinquent income tax debt. The Department of Revenue will block renewals only for those debts for which the taxpayer has already been afforded full procedural rights required by the due process clause of the United States Constitution.

Relationship between State and Federal Income Tax Laws

S.L. 1998-171 (H 1326), recommended by the Revenue Laws Study Committee, rewrites the definition of the Internal Revenue Code used in state tax statutes to change the reference date from January 1, 1997, to September 1, 1998.

Updating the Internal Revenue Code (IRC) reference makes recent amendments to the IRC applicable to the extent that North Carolina's state tax law tracks the federal tax law (IRC). This update generally has the greatest effect on state corporate and individual income taxes because these taxes are based on federal taxable income and are therefore closely tied to federal law.

Congress made numerous, significant changes to the IRC in 1997 that will affect taxable income. Other changes to the IRC were made by the Internal Revenue Service Restructuring and Reform Act of 1998. Because the state corporate and individual income taxes are based upon federal taxable income, these changes affect state policies and revenues.

The act provides that the recent federal tax changes that could increase a taxpayer's North Carolina taxable income for the 1997 tax year will not become effective until January 1, 1998. Under Article I, Section 16, of the North Carolina Constitution, the General Assembly cannot pass a law that will increase a tax retroactively. There are a number of provisions in the federal Taxpayer Relief Act of 1997 and the Internal Revenue Service Structuring and Reform Act of 1998 that could increase taxable income for the 1997 tax year. Because legislation updating the IRC reference could not be acted upon until the General Assembly's 1998 session, these changes had to be given a delayed effective date.

S.L. 1998-171 is expected to reduce General Fund revenues by \$6.97 million in 1998-99, \$4.01 million in 1999-2000, \$10.70 million in 2000-01, \$18.53 million in 2001-02, and \$33.64 million in 2002-03.

The following list summarizes some of the more significant changes resulting from the IRC update:

1. Former rules on rollover and one-time exclusion for capital gains on the sale of a taxpayer's principal residence are replaced with an exclusion of \$250,000 (\$500,000 for joint filers) of capital gain from the sale of a residence occupied by a taxpayer as a principal residence for two of the previous five years.
2. The business expense deduction for self-employed individuals' health insurance is increased to 50 percent effective in 2000 and increased to 100 percent by 2007.
3. Roth IRAs, effective for tax years beginning on or after January 1, 1998, allow nondeductible contributions of up to \$2,000 of compensation (limited for those with an adjusted gross income above a certain amount).
4. For existing IRAs, the income limits are increased and the spouse of a disqualified active participant is allowed to have an IRA, effective for tax years beginning on or after January 1, 1998.
5. Annual earnings on amounts contributed to qualified tuition programs, such as North Carolina's Parental Savings Trust Fund, for the future payment of room or board at an institution of higher education are exempted from tax. (Since North Carolina law already exempted these earnings, the North Carolina exemption is repealed because the law will automatically piggyback the federal exemption.)

Since the state corporate income tax was changed in 1967 to a percentage of federal taxable income, the reference date to the Internal Revenue Code has been updated periodically. In discussing bills to update the IRC reference, the question frequently arises as to why the statutes refer to the IRC on a particular date instead of referring to the IRC and any future amendments to it, thereby eliminating the necessity of bills like this. The answer to the question lies in both a policy decision and a potential legal restraint.

First, the policy reason for specifying a particular date is that, in light of the many changes made in federal tax law from year to year, the General Assembly may not want to adopt automatically all federal changes. By linking references to the IRC to a certain date, the General Assembly ensures that it can examine any federal changes before making the changes effective for North Carolina.

Second, and more important, the N.C. Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Section 2(1) of Article V of the constitution provides in pertinent part that the "power of taxation ... shall never be surrendered, suspended, or contracted away." Relying on this provision, North Carolina court decisions on the delegation of legislative power to administrative agencies, and an analysis of the few federal cases on the 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."

The Revenue Laws Study Committee explored the possibility of legislation that would automatically adopt federal changes to the IRC each year, with legislative review and approval required in the succeeding legislative session. It was hoped that this approach would avoid the practical difficulties that occur when IRC changes go into effect many months before the General Assembly has a chance to pass legislation adopting the changes. The Attorney General's office concluded that this approach, too, would be unlikely to withstand a constitutional challenge.

Sales, Gross Receipts, and Use Taxes

Repeal of State Sales Tax on Food

In 1996, the General Assembly reduced the state sales tax on food from 4 percent to 3 percent, effective January 1, 1997. In 1997, the General Assembly reduced the state sales tax on food from 3 percent to 2 percent, effective July 1, 1998. Section 29A.1 of the 1998 Appropriations Act, S.L. 1998-212 (S 1366), completes the reduction by eliminating the remaining 2 percent state sales tax on food, effective May 1, 1999. The act also authorizes the Secretary of Revenue to earmark up to \$174,000 of sales tax collections for 1998-99 for the administrative costs of revising and mailing forms. Eliminating the final two cents of the state sales tax on food is expected to reduce General Fund revenues by \$18.4 million in 1998-99, \$184.5 million in 1999-2000, \$190 million in 2000-01, \$195.7 million in 2001-02, and \$201.6 million in 2002-03.

This legislation does not affect the 2 percent local sales tax on food.

Sales Tax Refunds for Public Schools

Section 29A.4 of S.L. 1998-212 (S 1366) adds local school administrative units to the list of governmental entities that may obtain an annual refund of the state and local sales and use taxes they pay. This change became effective July 1, 1998, and applies to taxes paid on or after that date. The refunds apply to direct purchases of tangible personal property. They also apply to sales and use tax liability indirectly incurred by a local school administrative unit on building materials, supplies, fixtures, and equipment that become a part of any building that is owned or leased by the unit and is being built, altered, or repaired for use by the unit. To obtain the refund, a local school administrative unit must request the refund in writing within six months after the end of the unit's fiscal year. The request must include any information and documentation required by the Secretary of Revenue. This change is expected to reduce General Fund revenues by \$14.8 million in 1999-2000, \$15 million in 2000-01, \$14.4 million in 2001-02, and \$12.6 million in 2002-03.

Prior to 1961, the state granted sales and use tax exemptions to state and local governmental entities, including public schools, and nonprofit entities. Because of the number of abuses involving the exemption and the difficulty of auditing these transactions, the General Assembly changed the law in 1961 to allow refunds as opposed to outright exemptions. The statute lists those entities that are entitled to a refund. Nonprofit educational institutions, as well as most other nonprofit entities, are entitled to a semiannual refund of state and local sales and use tax.

The General Assembly did not include state agencies in the list of entities entitled to an annual refund of state and local sales taxes because the refund process would not benefit the General Fund, from which the agencies receive their appropriations, and would create unnecessary paperwork for the agencies. The General Assembly did not include public schools in the list of entities entitled to an annual refund for similar reasons. First, public school books and school lunches are exempt from sales tax. Second, most of the operating money for public schools comes from the General Fund, although most of the capital money comes from the counties.

Although a school board could not receive sales tax refunds, a county was entitled to a refund of state sales and use taxes paid if it purchased items on behalf of its school board. More

than one-half of the counties have statutory authority to acquire property on behalf of their school boards and thus may receive sales tax refunds if they exercise that authority. The other counties do not have this express statutory authority, but the Attorney General's office has stated that they may acquire property on behalf of their school board if they enter into an interlocal agreement with the school board. The 1998 amendments allow a school board to receive the refunds directly, without having to arrange for the county to acquire the property and apply for the refunds on its behalf.

Amusements Tax Exemption for Certain Nonprofit Arts Organizations and Community Festivals

The state levies a 3 percent gross receipts privilege license tax on anyone engaged in the business of offering amusements, athletic events, dances, and entertainments for which an admission is charged. S.L. 1998-96 (S 1001) creates two new, narrow exemptions from this privilege license tax for nonprofit arts festivals and community festivals that meet certain conditions. The act applies to events such as First Night of Raleigh and the Azalea Festival of Wilmington. The act became effective August 14, 1998. The Department of Revenue estimates that the revenue loss to the General Fund will be less than \$25,000 per year.

Under the act, an arts festival is exempt from the privilege license tax if the person holding the festival meets all of the following conditions:

1. The person holds no more than two festivals a year.
2. Each of the festivals lasts no more than seven days.
3. The arts festivals are held outdoors on public property and involve a variety of exhibitions, entertainments, and activities.
4. The person is exempt from state income tax.

Under the act, a community festival is exempt from the privilege license tax if the person holding the festival meets all of the following conditions:

1. The person holds no more than one community festival a year.
2. The festival lasts no more than seven days.
3. The festival involves a variety of exhibitions, entertainments, and activities, the majority of which are held outdoors and are open to the public.
4. The person is exempt from state income tax.

Sales Tax Exemption for Local Pay Phone Services

S.L. 1998-197 (H 1126) exempts from sales tax pay telephone calls that are paid for by coin, effective January 1, 2000. Credit card calls and other calls not paid for by coin will not be exempt. The sales tax exemption allowed by this act is expected to reduce General Fund revenues by approximately \$2 million annually. The gross receipts from sales of all local telecommunications services are subject to state sales tax at 3 percent [G.S. 105-164.4(a)(4a)] and state gross receipts tax at 3.22 percent (G.S. 105-120). There is no local sales tax on these services.

House Bill 1126 was introduced in 1997, when pay telephone calls were regulated so that the owners were not permitted to raise the price of a call above 25¢. The owners complained that the sales tax forced them to operate at a loss because they could not increase the price of the calls to cover the tax. Later in 1997, however, pay telephones were deregulated and the price of most calls immediately increased by 40 percent or more, generating more than enough revenue to cover the 3 percent tax. Therefore, the effect of this act is to grant additional tax relief to pay phone owners.

Other Sales Tax Changes

S.L. 1998-121 (H 1367) makes three changes to the sales tax law, as recommended by the Revenue Laws Study Committee:

1. It raises the sales tax quarterly threshold from \$50 to \$100, effective July 1, 1999.
2. It repeals the annual wholesale sales tax license, effective July 1, 1998.
3. It changes the name of the retail sales tax license to certificate of registration.

The act is expected to reduce General Fund revenues by about \$1.3 million per year. It will also cause a one-time shift of about \$2 million from the 1999–2000 fiscal year to the 2000–01 fiscal year.

State Inheritance, Estate, and Gift Taxes

Inheritance Tax Repeal; Establishment of Estate Tax

Section 29A.2 of the 1998 Appropriations Act, S.L. 1998-212 (S 1366), repeals the state's inheritance tax and replaces it with a state estate tax that is equivalent to the federal state death tax credit allowed on a federal estate tax return. This type of state estate tax is known as a "pick-up" tax because it picks up for the state the amount of federal estate tax that would otherwise be paid to the federal government. The repeal of the state's inheritance tax is effective January 1, 1999, and applies to the estates of decedents dying on or after that date. The repeal of the state's inheritance tax is expected to reduce General Fund revenues by \$52.5 million in 1999–2000, \$79.4 million in 2000–01, \$85.7 million in 2001–02, and \$92.6 million in 2002–03.

Under prior law, North Carolina imposed an inheritance tax on property transferred by a decedent. The amount of tax depended on the relationship of the person transferring the property (the decedent) to the person receiving the property (the beneficiary). This was in contrast to federal law, which has a single rate schedule for estates.

State law classified beneficiaries into three classes and set different inheritance tax rates for each class. A Class A beneficiary was a lineal ancestor, a lineal descendant, an adopted child, a stepchild, or a son-in-law or daughter-in-law whose spouse was not entitled to any of the decedent's property. A Class B beneficiary was a sibling, a descendant of a sibling, or an aunt or uncle by blood. A Class C beneficiary was anyone who was not a Class A or Class B beneficiary.

Class A beneficiaries had the lowest inheritance rates and a \$600,000 inheritance tax exemption. Class B beneficiaries had higher rates and no exemption. Class C beneficiaries had the highest rates and no exemption. Thus, North Carolina's rate structure favored transfers to children and parents by giving those transfers the lowest rates plus an exemption and preferred transfers to other close family members over transfers to more distant relatives or to persons who were not related.

Tax Waivers for Transfer of Decedents' Property

Effective for the estates of decedents dying on or after August 1, 1998, S.L. 1998-69 (S 1229) repealed the provisions of the former inheritance tax law (which was itself repealed by S.L. 1998-212) that required an inheritance tax waiver before the property of a decedent could be transferred. The new estate tax, which replaces the former inheritance tax effective for decedents dying on or after January 1, 1999, has no inheritance tax waiver requirement.

Gift Tax Treatment of Contributions to Qualified Tuition Programs

S.L. 1998-171 (H 1326) adopts for North Carolina gift tax purposes the provisions of federal law listed below.

1. A distribution from a qualified tuition program is not a taxable gift, unless a new beneficiary, who is a generation below the original beneficiary, is named to the account or receives the account in a rollover.
2. A contribution to a qualified tuition program is a gift to the designated beneficiary but not a gift of a future interest. If the contribution were considered a gift of a future

interest, a gift tax return would have to be filed even if the amount were under the \$10,000 annual exclusion amount.

3. A contribution to a qualified tuition program is not a direct payment of tuition. If it were, it would be exempt from gift tax.
4. If a contribution exceeds the \$10,000 annual gift tax exclusion amount, the donor may elect to avoid gift tax by treating the contribution as if it had been made over a five-year period. For example, a \$25,000 contribution would not be taxable because it would be considered a gift of \$5,000 a year over five years and thus would be below the \$10,000 annual exclusion amount.

These provisions apply to any qualified state tuition program under section 529 of the Internal Revenue Code. North Carolina's Parental Savings Trust Fund is such a program. Conforming to federal law will relieve taxpayers from unexpected gift tax liability and will simplify tax compliance and administration. The changes are effective for tax years beginning on or after January 1, 1998.

Motor Fuels Taxes

S.L. 1998-146 (S 1230) clarifies the taxation of kerosene, provides automatic refunds to motor carriers, imposes a penalty for improper reporting, and makes several clarifying and conforming changes to the motor fuels tax laws.

Tax on Kerosene

As a means to address motor fuels tax evasion, the federal government in 1994 began requiring motor fuel to be dyed if it was a non-tax-paid fuel. North Carolina passed a similar act in 1994. Under federal and state law, it is unlawful to use dyed diesel fuel in a vehicle used on the highway because the dye indicates that fuel taxes have not been paid on that fuel. Effective July 1, 1998, the federal government began requiring kerosene to be dyed. This act conforms North Carolina's law with the federal law by amending the definition of the term "diesel fuel" to include kerosene. This change makes it a state violation, as well as a federal violation, to use dyed kerosene for a highway use.

This change in the law also means that undyed kerosene will be taxed "at the rack." Prior to July 1, 1998, the taxation of kerosene occurred when it was blended with other fuel to be used for highway purposes. This part of the act applies to kerosene sold on or after July 1, 1998.

The act makes conforming changes to the motor fuels tax laws to provide the proper exemptions from, and refunds of, the excise tax on motor fuels for undyed kerosene used for nonhighway purposes. It also clarifies that kerosene sold for a nonhighway use is subject to sales tax.

Other State Taxes

Excise Tax on Controlled Substances

S.L. 1998-218 (S 1554) reduces the excise tax on controlled substances in order to remove features of the tax found unconstitutional by the United States Court of Appeals for the Fourth Circuit in *Lynn v. West*, 134 F.3d. 582, *cert. denied*, 119 S. Ct. 47 (1998). This legislation is discussed in Chapter 7 (Criminal Law and Procedure).

White Goods Disposal Tax

S.L. 1998-24 (S 124) reduces the white goods tax rate, delays the sunset of the tax, changes the formula for distributing the tax proceeds, clarifies the purposes for which counties may use

the proceeds of the tax, and provides for detailed reporting on counties' white goods management programs, effective July 1, 1998. The act also provides that counties that have excess tax proceeds may not receive additional distributions until they have spent the excess tax proceeds, effective January 1, 1999. The act does not affect the General Fund. The 1998 amendments to the state white goods tax are discussed in greater detail in Chapter 16 (Local Government and Local Finance) and Chapter 10 (Environment and Natural Resources).

Privilege License and Excise Taxes

S.L. 1998-95 (S 1252) incorporates two bills that the Revenue Laws Study Committee recommended to the 1998 General Assembly: Senate Bill 1252 and House Bill 1320. Senate Bill 1252 made numerous changes to the state privilege license taxes on amusements, professionals, installment paper dealers, banks, and alcoholic beverages. H 1320 reduced the current 3 percent gross receipts tax on motion pictures to 1 percent.

Amusements. The former law imposed an annual \$50 state privilege license tax and a 3 percent gross receipts tax on any form of entertainment not otherwise taxed or specifically exempted under Article 2 of Chapter 105 of the General Statutes. The state privilege license tax on amusements was treated as an advance payment of the corresponding gross receipts tax, and the license tax was applied as a credit upon the gross receipts tax. This act repeals the state privilege license tax on amusements. Amusements will continue to pay a 3 percent gross receipts tax and any existing local license taxes. This repeal simplifies the taxes assessed on amusements. It does not reduce revenues because the license tax was a credit against the gross receipts tax. This part of the act becomes effective July 1, 1999.

This act also reorganizes the list of amusements exempt from the tax so that all of the exemptions appear in one statute. Exempt amusements set out in Article 2 are high school and elementary school athletic contests, teen centers, dances and amusements promoted and managed by a corporation that operates a center for the performing and visual arts when the dance or amusement is held at the center, and amusements on the Cherokee Indian reservation where the entity providing the amusement is authorized to do business on the reservation and pays the tribal gross receipts levy to the tribal council.

The act expands the exemption for elementary and secondary school dances and other amusements to include all such amusements. Former law exempted only the first \$1,000 of gross receipts derived from dances and amusements actually promoted and managed by secondary schools when the proceeds were used exclusively for the school and not to defray expenses.

Motion Pictures. The act imposes a lower rate of tax on one form of amusements: motion picture shows. The act imposes a 1 percent gross receipts tax on this form of amusement, effective October 1, 1998, as opposed to the 3 percent gross receipts tax imposed on other forms of amusements. A 1 percent gross receipts tax on movie admissions is expected to generate \$1.5 million in General Fund revenue in 1998-99.

The act clarifies that if a taxpayer offers an entertainment or amusement that includes both a motion picture and an entertainment or amusement that is subject to the 3 percent gross receipts tax, then the higher rate applies. The act also clarifies the exemption of motion pictures that are shown at a center for the performing and visual arts that is promoted and managed by an organization established for religious, charitable, scientific, literary, or educational purposes.

Prior to July 1, 1997, the state imposed a privilege tax on motion picture shows. Motion picture shows were not subject to the 3 percent gross receipts tax imposed on other forms of entertainment or amusement because it does not apply to amusements "otherwise taxed." During the second extra session of 1996, the General Assembly repealed a number of state privilege license taxes, including the privilege taxes on motion picture shows. As a result, motion picture shows fell into the category of amusements not otherwise taxed and, therefore, became subject to the 3 percent gross receipts tax. The Department of Revenue chose not to assess this tax until the General Assembly clarified that the tax should be collected. The department's uncertainty arose

from the absence of debate by the 1996 General Assembly on the issue of imposing a gross receipts tax on movies.

The Revenue Laws Study Committee considered this issue at length and heard from several interested parties. The committee learned that twenty-seven states tax movie admissions in one fashion or another. Movie taxes in twenty-five of those twenty-seven states are higher than North Carolina's 3 percent gross receipts tax. After much debate, the committee recommended imposing a 1 percent gross receipts tax on movies, as opposed to the 3 percent gross receipts tax imposed on other, similar forms of entertainment and amusements.

Professionals. The act makes several clarifying and technical changes to the statewide privilege license tax on persons practicing certain professions or engaging in certain businesses. It also reorganizes the existing exemptions from the tax found throughout the statutes so that all exemptions will appear in one place. Lastly, it ends the practice of charging half the privilege license tax to an individual who applies after the midpoint of the fiscal year. This part of the act becomes effective July 1, 1999.

The statute exempts persons who are seventy-five years of age and older and certain persons practicing the professional art of healing from the privilege license tax. The act adds to this list blind persons engaging in a trade or profession as a sole proprietor. The exemption for blind persons was formerly set out in another section of Chapter 105, which this act repeals.

The act repeals an exemption from occupational license taxes for persons serving in the armed forces and replaces it with a general provision in Chapter 93B of the General Statutes that allows an individual who is serving in the U.S. armed forces an extension of time to pay any license fee charged by an occupational licensing board if the individual qualifies for the extension of time to file a tax return under G.S. 105-249.2.

Alcoholic Beverages. The act repeals annual privilege licenses on ABC permittees, raises the ABC permit fees by the corresponding amounts, and simplifies the tax rate on malt beverages. This part of the act becomes effective May 1, 1999.

Excise Tax on Piped Natural Gas

S.L. 1998-22 (S 1327) combines the current gross receipts and sales taxes on piped natural gas into a single, per therm excise tax and applies the tax uniformly to all sales of piped natural gas not exempt from the tax, effective July 1, 1999. The act also preserves the tax-exempt status for piped natural gas sold by the eight municipalities that operate their own piped gas systems, by exempting them from the excise tax.

For several years before 1998, the Department of Revenue did not impose the general 4 percent state and 2 percent local sales and use tax on the sale of piped natural gas. However, upon reexamination of the law, the department determined that piped natural gas is tangible personal property, as that term is defined in the sales and use tax statutes, and therefore that all sales of piped natural gas are subject to tax. Based on this determination, all retail sales of piped natural gas would have become subject to the general sales and use tax effective July 1, 1998, had they not been exempted by this act.

Insurance Regulatory Charge

The 1998 Appropriations Act, S.L. 1998-212 (S 1366), decreases the insurance regulatory charge from 8.75 percent to 6 percent, effective January 1, 1998. This charge was first imposed in 1991. Its purpose is to make the Department of Insurance receipt-supported and thereby eliminate General Fund support of the department. The regulatory charge is imposed on insurance companies that pay the gross premiums tax, other than service corporations such as Blue Cross-Blue Shield and Delta Dental Corporation. Health maintenance organizations do not pay the regulatory charge because they do not pay the gross premiums tax. The charge is a percentage of the insurance company's premiums tax liability.

Public Utility Regulatory Fee

The 1998 Appropriations Act, S.L. 1998-212 (S 1366), sets the public utility regulatory fee for 1998–99 at 0.09 percent. This rate maintains the current 0.09 percent rate set in 1997–98. The utility regulatory fee was imposed in 1989. Its purpose is to defray the state's cost in regulating public utilities. The regulatory fee is imposed on all utilities that are subject to regulation by the North Carolina Utilities Commission. The fee is a percentage of the utility's North Carolina jurisdictional revenues. In general, jurisdictional revenue is revenue derived from providing utility service in North Carolina.

Administration and Enforcement of State Tax Laws

Criminal Penalties for Violation of State Tax Laws

S.L. 1998-178 (S 1228), which increases the criminal penalties for willful tax evasion and for aiding and abetting tax evasion, became effective December 1, 1998. The act was recommended by the Revenue Laws Study Committee.

Before 1995, a person who willfully attempted to evade paying the amount of tax due, or who willfully helped another taxpayer attempt to evade paying the amount of tax due, could be punished by an active prison sentence, a monetary fine, or both. Effective January 1, 1995, however, a person who committed these crimes could be punished only by a monetary fine. In some cases, the amount of tax money involved is quite large. In others, the deception is egregious. Some offenders are charged repeatedly.

The Criminal Investigations Division of the Department of Revenue informed the General Assembly that punishment by fine only is not sufficient to deter many would-be tax evaders. For this reason, the division recommended changing the classification of these two crimes from a Class I felony to a Class H felony, so that a sentencing judge would have the discretion to sentence defendants to active time if the circumstances justified such a punishment.

Uniform Tax Penalties

The 1998 Appropriations Act, S.L. 1998-212 (S 1366), amends several sections of the Revenue Act to make tax penalties uniform. These amendments, which are effective January 1, 1999, do the following:

- Repeal several penalties that are obsolete or ineffective.
- Provide that refunds of sales taxes, motor fuels taxes, and excise taxes on sacramental wine are barred only if filed more than three years after their due date. The current law provides a reduction of the amount refunded for late applications filed before the three-year period expires.
- Clarify that additional taxes are assessable as penalties, so that it is clear that the taxes may be waived by the Secretary of Revenue. The act also clarifies that penalties are assessable as additional taxes to ensure that the taxpayer receives the full administrative and judicial remedies applicable to tax assessments.
- Provide a uniform penalty for most tax deficiencies that exceed 25 percent of the tax liability.
- Expand the statute concerning the personal liability of corporate officers who fail to remit certain taxes when due to include the manager and managing members of a limited liability company.

Sharing Tax Information with Local Governments

S.L. 1998-139 (H 1489) makes three changes relating to local taxes. The changes, which became effective September 14, 1998, relate to the sharing of certain tax information and to property taxation of motor vehicles. First, the act authorizes the Department of Revenue and

county tax officials to share information about the taxes paid on leased vehicles with each other and with a regional public transportation authority or a regional transportation authority. Second, it authorizes state tax officials to share information regarding sales and use taxes with city and county government representatives. Third, it also gives counties the specific authority to release or refund the taxes on a motor vehicle when the taxpayer moves out of state and surrenders his or her license plate. This last change was recommended by the Revenue Laws Study Committee. This legislation is discussed in Chapter 17 (Local Taxes and Tax Collection).

Technical and Conforming Changes to State Revenue Laws

S.L. 1998-98 (S 1226) makes numerous technical and clarifying changes to the revenue laws and related statutes as recommended by the Revenue Laws Study Committee.

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