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State Taxation

The 1999 General Assembly enacted several new laws providing tax incentives for economic development. These include a number of new incentives for new businesses and community development activities as well as for historic preservation and commercialization of new technologies developed in universities. The legislature substantially revised laws providing tax credits for renewable energy investments. The General Assembly reduced unemployment taxes for additional employers and adopted measures to simplify and improve collection of use taxes.

Legislation affecting local tax collection is covered in Chapter 16 (Local Taxes and Tax Collection). Other finance matters are covered in Chapter 13 (Land Records and Registers of Deeds), Chapter 15 (Local Government and Local Finance), and Chapter 26 (Utilities and Energy).

Tax Incentives: Economic Development and Historic Preservation

Bill Lee Act Amendments and Other Tax Incentives

S.L. 1999-360 (S 1115) amends various tax laws to expand existing tax incentives for businesses, add new tax incentives and tax reductions for specific businesses, and make related changes. The provisions of the act are listed below, along with an estimate of the fiscal impact on future state revenues that will result from the change. Many of these amendments are to the William S. Lee Quality Jobs and Business Expansion Act (the Bill Lee Act). These amendments, each of which is discussed in more detail below, include the following:

- Extend sunset on the Bill Lee Act from 2002 to 2006 and require the Department of Commerce to continue studying the impact of Bill Lee Act incentives. The extension of the sunset will result in a loss of revenue to the General Fund of approximately $13.1 million in the 2002–2003 fiscal year. The loss is expected to increase to as much as $38.1 million by fiscal year 2005–2006.
- Add passenger air carrier training centers to the Bill Lee Act credits. This change will have an insignificant impact on General Fund revenues.

- Allow an interstate passenger air carrier a sales tax exemption for aircraft parts and accessories purchased for use at its hub in this state. This change will reduce General Fund revenues by approximately $1.2 million a year. It will also reduce local sales tax revenues.
- Reduce sales tax from 6 percent to 1 percent with an $80 cap for aircraft flight crew training simulators purchased by an interstate passenger air carrier for use at its hub in this state. This change will reduce General Fund revenues by approximately $400,000 a year. It will also reduce local sales tax revenues.
- Allow certain nonprofit insurance companies an eight-year sales tax refund for taxes paid on building materials and fixtures and a four-year sales tax refund for taxes paid on capitalized computer equipment. These changes will reduce General Fund revenues by approximately $600,000 in fiscal year 2000–2001, by $1.2 million in fiscal years 2001–2002 and 2002–2003, and by approximately $100,000 in fiscal year 2003–2004.
- Extend Bill Lee Act credits to electronic mail-order houses that create at least 250 jobs in tiers one and two, effective January 1, 2000. This change will reduce General Fund revenues by approximately $2.7 million beginning in fiscal year 2001—2002. The loss in revenues is expected to grow to $5.8 million in fiscal year 2004–2005 and to decline slightly in fiscal year 2005–2006 to approximately $4.4 million.
- Extend Bill Lee Act credits to customer service centers in tiers one and two, effective January 1, 2000. This change will reduce General Fund revenues by approximately $600,000 a year in fiscal year 2001–2002. The loss in revenues is expected to grow to an annual loss of $2.4 million by fiscal year 2005–2006.
- Allow annual refund of 6 percent sales taxes paid on capitalized machinery and equipment sold to businesses eligible for Bill Lee Act credits and located in tiers one and two, effective January 1, 2000. This change will reduce General Fund revenues by approximately $100,000 a year beginning in fiscal year 2000–2001. The annual loss is expected to increase to $1 million by fiscal year 2005–2006.
- Give a more favorable tier designation to small counties, effective January 1, 2000. This change is expected to have an insignificant impact on General Fund revenues.
- Close loopholes in definition of development zones. This change is expected to increase General Fund revenues by $100,000 a year in fiscal years 2000–2001 and 2001–2002, by $600,000 a year in fiscal year 2002–2003, and by $300,000 a year in fiscal year 2003–2004.
- Allow a 25 percent credit for contributions to nonprofits for capital projects within development zones, effective January 1, 2000. This change is expected to reduce General Fund revenues by $2.5 million in fiscal year 2001–2002 and by $4 million for each year thereafter.
- Allow a credit for rehabilitating or constructing affordable housing, effective for new projects beginning January 1, 2000, with the credit to expire January 1, 2006. This change is expected to reduce General Fund revenues by $1.5 million a year in fiscal year 2001–2002 and by as much as $10.1 million a year by fiscal year 2005–2006.
- Allow all Bill Lee Act credits to be taken against insurance premiums tax. This change is not expected to significantly affect General Fund revenues.
- Require businesses to provide health insurance and meet environmental, safety, and health standards in order to qualify for Bill Lee Act credits, effective January 1, 2000. This change is not expected to significantly affect General Fund revenues.
- Eliminate the $75 application fee for Bill Lee Act credits in tiers one and two and increase the fee to $500 per credit in other tiers, with a cap of $1,500 per applicant. This change is not expected to significantly affect General Fund revenues.
- Require applicants for Bill Lee Act credits to provide additional information to enable the Department of Commerce to evaluate the effectiveness of the credits in providing employment to residents of development zones.

- Require taxpayers to include with their tax returns the information that they must generate under current law to establish eligibility for the Bill Lee Act credits, effective January 1, 2000.
- Clarify definitions of industries covered by the Bill Lee Act and clarify sales tax refunds for sales of fuel to interstate air carriers.
- Provide that research and development credit will not expire when the corresponding federal credit expires. This change is not expected to significantly affect General Fund revenues.
- Require projects to obtain an environmental certification in order to qualify for funding from the Industrial Development Fund (Building Renovation Fund).
- Require the Department of Commerce to support reasonable efforts to reduce interstate competition in luring businesses from one state to another.
- Increase fees paid to the Department of Environment, Health, and Natural Resources for brownfields agreements. This change is not expected to significantly impact General Fund revenues.

Extend Sunset on Bill Lee Act Credits. The William S. Lee Quality Jobs and Business Expansion Act was enacted in 1996, effective beginning with the 1996 tax year, with a sunset effective in 2002. The act required the Department of Commerce to report annually on the credits allowed by the act. In 1997 the General Assembly added specific issues that the Department of Commerce was required to study and report back on in 1999. Before 1996 North Carolina had made little use of tax incentives to lure businesses to the state, but even without incentives North Carolina was consistently one of the top states in attracting industry. The array of credits authorized by the Bill Lee Act was viewed as an experiment, to be evaluated in five years to determine whether the incentives were cost effective and actually affected behavior or merely provided tax reductions to businesses that would have located or expanded in any case. This act extends the 2002 sunset for an additional four years, to 2006, and it renews the requirement that the Department of Commerce study the effect and effectiveness of the Bill Lee Act incentives and report the results of its study to the 2001 General Assembly.

Incentives for Interstate Passenger Air Carrier Hubs. The act provides three incentives for interstate passenger air carriers with hubs in this state. A *hub* is defined as the airport where the carrier has allocated at least 60 percent of its aircraft property tax value and at which the majority of its boarding passengers are connecting from other airports, not originating at that airport. U.S. Airways, whose hub is in Charlotte, qualifies for the credit. Midway Airlines, whose hub is at Raleigh-Durham, should qualify for the credit by the end of 1999.

The first incentive for passenger air carriers provides that the Bill Lee Act definition of *central administrative offices* includes centralized training offices at an air carrier's hub, effective beginning with the 1999 tax year. This change allows the air carrier to qualify for the central administrative office credit (described below) as well as for the existing Bill Lee Act credits for creating jobs, for investing in machinery and equipment, for research and development, and for worker training. These credits can be taken with respect to the training center only.

The central administrative office credit is allowed for the purchase or lease of real property that is to be used as central administrative office property where forty or more persons are employed. The amount of the credit is equal to 7 percent of the eligible investment amount and may not exceed $500,000. The credit is taken in seven equal installments over the seven years following the taxable year in which the property is first used as a central administrative office.

The second incentive for passenger air carriers is a sales tax exemption for the carrier's purchases of aircraft lubricants, parts, and accessories for use at its hub, effective May 1, 1999. These purchases would otherwise be subject to sales tax at 6 percent, but interstate air carriers are allowed a partial refund of the tax under G.S. 105-164.14(a). In 1998 the General Assembly enacted a similar exemption for air couriers (such as Federal Express), effective January 1, 2001.

The third incentive for passenger air carriers is a sales tax reduction from 6 percent to 1 percent with an $80 cap for purchases of aircraft simulators for flight crew training at the hub, effective May 1, 1999. The tax reduction would also apply to interstate air couriers. U.S. Airways

plans to establish a flight crew training center at its Charlotte hub, where it would use aircraft simulators.

Incentives for Nonprofit Insurance Companies. The act provides a sales tax refund to certain nonprofit insurance companies for state and local taxes they pay on building materials, supplies, fixtures, and equipment that become a part of their real property and on capitalized computer systems hardware and software. The refund is effective beginning with taxes paid on May 1, 1999. The computer equipment refund expires for taxes paid on or after January 1, 2004, and the building materials refund expires for taxes paid on or after January 1, 2008. To qualify for these refunds, the insurance company must operate for the exclusive purpose of providing insurance products to nonprofit charitable organizations and their employees. In addition the Secretary of Commerce must have certified that the insurance company will invest at least $20 million in this state. Teachers Insurance Annuity Association (TIAA), which has announced plans to build an office in Mecklenburg County, fits this description.[1] If TIAA fails to make the $20 million investment within five years after it first receives a refund, it forfeits all refunds it received as a result of this incentive.

Incentives for Enterprise Tiers One and Two. The act provides three incentives for development in enterprise tier one and two counties, which are the counties considered most in need of economic development based on high unemployment, low per capita income, and low population growth.[2] The first incentive extends all of the Bill Lee Act credits to electronic mail-order houses that create at least 250 jobs in an enterprise tier one or two county. The second incentive extends all of the Bill Lee Act credits to certain customer service centers in an enterprise tier one or two county. An eligible customer service center is a subdivision of a telecommunications or financial services company that provides support services to the company's customers by telephone to support the company's products and services. For a center to qualify, at least 60 percent of the center's calls must be incoming. This requirement will prevent telemarketing operations from qualifying. The credits allowed under the Bill Lee Act, which the new act extends to these electronic mail-order houses and customer service centers effective January 1, 2000, are the credits for creating jobs, for investing in machinery and equipment, for research and development, for worker training, and for investing in central administrative office property.

The third incentive allows an annual sales tax refund on taxes paid at 6 percent (6.5 percent in Mecklenburg County) on capitalized machinery and equipment, sold to a taxpayer engaged in one of the businesses eligible for Bill Lee Act credits, for use in an enterprise tier one or two county. This provision will become effective for taxes paid on or after January 1, 2000. In addition to tier one and two customer service centers and electronic mail-order houses discussed above, the following businesses are eligible for Bill Lee Act credits: air courier services, central administrative offices (with at least forty new jobs), data processing, manufacturing, warehousing, and wholesale trade.

Incentives for Small Counties. The act allows certain counties to qualify for a lower enterprise tier designation, effective January 1, 2000. Under the Bill Lee Act all counties are divided into five enterprise tiers, ranked by economic distress as measured by a formula that combines unemployment, per capita income, and population growth. Those counties in lower-numbered tiers receive more favorable incentives than those in higher tiers. First, this act changes the rules for assigning enterprise tier designations to provide that the tier number that would otherwise be assigned by the formula is reduced by one for counties that have a population of less than 50,000 and also have more than 18 percent of their residents below the federal poverty level. Under this provision Alleghany, Ashe, Beaufort, Cherokee, Perquimans, Scotland, Vance, and Yancey counties move from tier two to tier one; Bladen, Hoke, Jones, Madison, Pamlico, and

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1. One or more other nonprofit insurance companies could qualify, but only if they make a $20 million investment.

2. The following thirteen counties are in tier one for 1999: Bertie, Edgecombe, Graham, Halifax, Hertford, Hyde, Martin, Northampton, Richmond, Swain, Tyrrell, Warren, and Washington. The following fifteen counties are in tier two for 1999: Alleghany, Anson, Ashe, Beaufort, Cherokee, Columbus, Mitchell, Montgomery, Onslow, Perquimans, Robeson, Rutherford, Scotland, Vance, and Yancey.

Pasquotank counties move from tier three to tier two; and Duplin, Greene, and Watauga counties move from tier four to tier three.

Second, the act provides that a county that has a population of less than 25,000 cannot be designated higher than tier three. Under this provision, Polk and Currituck counties move from tier five to tier three.

Third, the act provides that a county is designated as tier one if it has a population of less than 10,000 and also has more than 16 percent of its residents below the federal poverty level. Under this provision Camden, Clay, and Jones counties become tier one counties.

Close Development Zone Loopholes. In 1998 the General Assembly amended the Bill Lee Act to provide additional incentives for businesses that locate or expand in development zones, which are economically distressed areas located within cities. The statutory conditions for qualifying as a development zone were designed to target only these relatively small, economically distressed areas. The statutory conditions contained loopholes, however, that allowed large areas outside of cities to qualify, even if they were not economically distressed throughout. The act closes those loopholes, effective for development zone designations made on or after January 1, 2000.

The 1998 legislation defined a *development zone* as an area that meets all of the following conditions: (1) consists of one or more contiguous census tracts, block groups, or both; (2) has a population of 1,000 or more, at least 20 percent of whom are below the poverty level; and (3) is located at least partly in a city with a population over 5,000. The new act closes the loopholes in this definition by requiring that:

- Every census tract and census block group in the zone must be located in whole or in part within the primary corporate limits of the city.
- Every census tract and census block group in the zone must have more than 10 percent of its population below the poverty level, or must be immediately adjacent to a tract or group that has more than 20 percent of its population below the poverty level.
- None of the census tracts or census block groups may be located in another development zone.

The act also shortens the period during which designation as a development zone is effective, from four years to two years, and requires zone applicants to notify every city in which part of the proposed zone would be located.

The following enhanced incentives apply in development zones. If a business locates in a development zone, the wage standard it has to meet is the same as for tier one counties, which is 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 it has no threshold for the credit for investing in machinery and equipment.

Credit for Development Zone Projects. The act creates a new tax credit for taxpayers that contribute cash or property to certain nonprofit agencies to be used for an improvement project in a development zone. An *improvement project* is a project to construct or improve real property for community development purposes or to acquire real property and convert it for community development purposes. The new credit becomes effective beginning with the 2000 tax year.

The credit allowed is 25 percent of the amount contributed by the taxpayer. The total amount of credits that may be allowed in a taxable year is capped at $4 million, and taxpayers are required to apply to the Secretary of Revenue for these credits. If the total amount applied for in a year exceeds $4 million, the Secretary will reduce each applicant's credit proportionally.

The credit is allowed for contributions to a *development zone agency,* defined as a community action agency, a community-based development organization, a community development corporation, a community development financial institution, a community housing development organization, or a local housing authority. To qualify for the credit, all of the following conditions must be met:

- The agency must contract in writing to use the contribution for an improvement project in a development zone and to repay the taxpayer with interest if the contribution is not so used.
- The Department of Commerce must certify that the agency will undertake an improvement project in a development zone.[3] To support this certification, the agency must provide the department with documentation establishing the identity of the agency, the nature of the project, and that the project is for a community development purpose in a development zone.
- The taxpayer must be unrelated to the agency and must not control, be controlled by, or be under common control with the agency.
- The taxpayer must not receive anything of value for the contribution.

A taxpayer forfeits the tax credit for a contribution to the extent the development zone agency uses the contribution for anything other than an improvement project in a zone. Development zone agencies are required to file with the Department of Commerce annual, audited financial statements. If the Department of Commerce finds that any part of a contribution was used for a purpose other than an improvement project, it must notify the Department of Revenue of the resulting forfeiture.

Affordable Housing Tax Credit. The act creates a new tax credit for rehabilitating or constructing low-income housing, effective for buildings allocated federal credits on or after January 1, 2000. The credit expires for buildings allocated federal credits on or after January 1, 2006. The credit is equal to a percentage of the amount of the taxpayer's federal credit for low-income housing with respect to eligible North Carolina low-income housing. The credit is 75 percent for buildings located in tier one or two and 25 percent for buildings located in other tiers. North Carolina low-income housing is eligible if it meets one of the following conditions:

- It is located in a tier one or tier two enterprise area.
- It is located in a tier three or tier four enterprise area and at least 40 percent of its residential units are rent-restricted and occupied by individuals whose income is 50 percent or less of the area median gross income.
- It is located in a tier five enterprise area and at least 40 percent of its residential units are rent-restricted and are occupied by individuals whose income is 35 percent or less of the area median gross income.

The credit is not taken in one year but is spread out over five years, beginning when the federal credit is first claimed for the building. The federal credit is first claimed either when the building is placed in service or the next year, at the taxpayer's election. The federal credit is taken over eleven years.

The federal credit requires that either (1) at least 20 percent of the residential units are rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income or (2) at least 40 percent of the residential units are rent-restricted and occupied by individuals whose income is 60 percent or less of area gross income. By providing a higher credit for tier one and two projects and by limiting the state credit to projects that are either in tier one or two or serve lower-income residents, the act is designed to steer investments toward these projects.

The federal credit requires that the low-income housing be used for that purpose for at least thirty years. If this requirement is not met, all or part of the taxpayer's credit is recaptured. Under the state credit, if federal recapture is required, the taxpayer forfeits the North Carolina credit to the same extent. In addition, if the taxpayer no longer qualifies for the federal credit during one of the five years a state installment could otherwise be claimed, the taxpayer is no longer eligible for the state credit. This situation could occur if the taxpayer sold its interest in the low-income housing.

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3. The Secretary of Commerce may not certify a development zone agency if it, any of its officers or directors, or any partner of the agency has ever used part of an improvement project contribution for any purpose other than the improvement project.

Under federal law a limited amount of credit is allowed to each state each year, and these credits are allocated among applicants based on selection criteria designed to reward projects that will serve the lowest income tenants for the longest periods. At least 10 percent of the credits each year must be set aside for projects sponsored by nonprofits. The amount of federal credit allocated to North Carolina will be $9.2 million for the 2000 through 2002 tax years and is expected to increase to $13 million for the 2003 and 2004 tax years. By limiting the state credit to a percentage of the federal credit, the act automatically caps the potential revenue loss to the state.

Extend Bill Lee Act Credits to Insurance Company Administrative Offices. The act allows all the Bill Lee Act credits to be taken against gross premiums tax, effective beginning in the 1999 tax year. Currently only the real property credit for central administrative offices may be taken against gross premiums tax.

In 1997 the General Assembly (1) extended the Bill Lee Act credits to central administrative offices that created at least forty new jobs and (2) created a new tax credit for taxpayers who purchase or lease real property to be used as central administrative office property. In 1998 the General Assembly allowed the real property credit for central administrative offices to be taken against the gross premiums tax as well as against the income tax and the corporate franchise tax. Insurance companies pay gross premiums tax in lieu of income tax. The 1998 legislation did not change the rule that the other Bill Lee Act credits could be taken against only income tax and corporate franchise tax. The 1998 change created a situation in which insurance companies were treated differently from other businesses with respect to central administrative offices. A business, other than an insurance company, that builds a central administrative office can take against income tax not only the real property credit for that office but also the jobs credit, the investment tax credit, and the worker training credit. An insurance company can take against gross premiums tax only the real property credit but not the jobs credit, the investment tax credit, or the worker training credit. By extending the other Bill Lee Act credits to gross premiums tax, the act provides uniform treatment for insurance companies and other businesses that build central administrative offices.

Quality Jobs Assurance. The purpose of the original Bill Lee Act was to provide incentives for “high quality jobs.” Accordingly only certain industries qualify for the Bill Lee Act credits, and a taxpayer must meet a wage standard with respect to the jobs at the locations for which it claims a credit. This act adds three additional standards to assure that credits are allowed only with respect to high quality jobs. These standards become effective for new credits beginning January 1, 2000. First, the taxpayer must pay at least 50 percent of basic health insurance coverage for the full-time positions for which it takes a credit. Second, the taxpayer must certify that the business location with respect to which it claims a credit has not had a significant environmental violation in the last five years and has no pending enforcement actions for significant environmental violations. Third, the taxpayer must certify that the business location with respect to which it claims a credit has no outstanding or unresolved Occupational Safety and Health Administration (OSHA) citations and has had no serious violation within the last three years. The Department of Environment and Natural Resources and the Department of Labor are authorized to audit the environmental and OSHA certifications respectively and report to the Department of Revenue if they determine that a certification was inaccurate.

Application, Fee, and Information Changes. A taxpayer that wishes to claim a Bill Lee Act credit must apply to the Department of Commerce for certification that it meets the eligibility requirements for the credit. The application must include information to enable the Department of Commerce to determine the applicant’s eligibility and be accompanied by a $75 fee to defray part of the costs of administering the program. The act requires applicants to include information necessary to enable the Department of Commerce to provide data required in its periodic reports to the General Assembly. This data will assist the General Assembly in evaluating the cost effectiveness of the Bill Lee Act credits.

The act also eliminates the $75 fee for credits claimed with respect to enterprise tier one and two counties. For other credits the fee is increased to $500 per credit claimed, not to exceed $1,500 per taxpayer. The Department of Commerce will retain one-fourth of the fee proceeds for the costs of administering the program and remit the remaining proceeds to the Department of Revenue for its use in administering and auditing the Bill Lee Act credits.

The Bill Lee Act incentives recommended by the Department of Commerce over the last four years have contained many conditions and standards a taxpayer must meet to be eligible for the incentives. The incentives also contain what are known as "claw-back" provisions, which require a taxpayer to forfeit a targeted incentive if it turns out the taxpayer did not meet the conditions for qualifying for the incentive and to lose future installments of a tax credit if the job or investment on which the credit was based does not remain in place. The act requires taxpayers that claim Bill Lee Act credits to include with their tax returns information about whether the jobs and investments have remained in place and whether other conditions have been met. The act allows the Department of Revenue to share this information with the Employment Security Commission (ESC) and the Department of Commerce, and this sharing should enable the Department of Commerce to evaluate whether the incentives are accomplishing their purpose of creating high-quality jobs throughout the state.

Clarify Business Definitions and Refunds. The act clarifies the statutory definitions of the types of businesses that are eligible for the Bill Lee Act credits. In 1998 the General Assembly changed the statutory references from the Standard Industrial Classifications (SIC) to the North American Industrial Classification System (NAICS) to conform to the federal system adopted effective January 1, 1999. This system is used to classify most of the data available about industries or kinds of businesses in the economy. Upon review of the NAICS, North Carolina administrators discovered that further terminology changes were needed to the Bill Lee Act definitions to assure that the credits would be available to the types of businesses covered by the prior law's definitions.

The act clarifies that interstate air carriers are allowed a partial refund of sales taxes paid on fuel. This clarification will not change the way the law is currently administered.

Research and Development Credit. The act modifies the research and development credit so that it will not automatically expire if the corresponding federal credit expires. The credit for research and development is allowed only to taxpayers that claim one of the federal research and development credits. In past years the federal credit has expired and then been renewed retroactively, creating uncertainty for taxpayers. This act amends the state credit so that it is based on the federal credit as of January 1, 1999. Expiration of the federal credit will not affect the state credit. If the federal credit is later modified, the General Assembly can consider whether to update its cross-reference to adopt the federal modifications.

Industrial Development Fund Environmental Certification. The act requires, as a condition for funding from the Industrial Development Fund (Building Renovation Fund), that a project receive certification from the Department of Environment and Natural Resources that it will not have a significant adverse effect on the environment.

Department of Commerce to Pursue Interstate Cooperative Efforts. The act requires the Department of Commerce to encourage reasonable interstate agreements and federal legislation to control the use of excessive incentives in interstate competition in luring businesses from one state to another. The department is to report on these efforts by March 1, 2000, and March 1, 2001.

Brownfields Property Fee Changes. The act makes changes related to the fees collected by the Department of Environment and Natural Resources in connection with brownfields agreements. These changes increase the application fee from $1,000 to $2,000 and increase the agreement fee from $500 to the actual cost to the state of all activities relating to the brownfields agreement. The $2,000 application fee is a credit against the agreement fee. These sections provide that interest on fees accrues to the department's Brownfields Account rather than to the General Fund, that unpaid fees are a lien on all of the developer's property as well as on the brownfields property, and that the department may contract for services necessary to implement the brownfields property law.

Brownfields property is abandoned, idle, or underused property at which expansion or redevelopment is hindered by actual or possible environmental contamination and that is or may be subject to cleanup requirements under state or federal law. Under current law the Department of Environment and Natural Resources can enter into a brownfields agreement with the owner of brownfields property under which the owner is allowed to clean up the property to a level that will allow the property to be used for specified purposes but would not meet current cleanup standards. The owner agrees to clean up the property as specified in the agreement and to limit future uses of the property to those specified in the agreement, that is, uses that are safe given the less than complete cleanup of the property. This agreement benefits the state by causing a contaminated property to be at least partially cleaned up and put to productive use in place of having a "greenfield" pristine site developed. Under the agreement the owner is relieved of liability for further cleanup of the property.

Renewable Energy Tax Credits

S.L. 1999-342 (H 1472) repeals nine corporate and individual income tax credits relating to energy saving devices and replaces them with a tax credit for investing in renewable energy property. The act becomes effective beginning with the 2000 taxable year. The effect of this act on General Fund revenues cannot be estimated.

The General Assembly enacted several individual and corporate income tax credits in the 1980s to encourage the following energy saving investments:

- solar energy equipment
- conversion of industrial boilers to wood fuel
- peat facility
- olivine brick facility
- methane gas facility
- wind energy device
- hydroelectric generator.

Of these credits, no evidence indicates that the ones for peat, wind energy, olivine bricks, or methane have ever been used. This act repeals nine income tax credits for these types of property and substitutes a general credit for investing in renewable energy property. The new credit applies to a broader category of property and is generally more generous than the prior law credits. The act intends that the broader category of renewable energy property will reflect technological advances in renewable energy and that the more generous credit percentages, caps, and carry-forwards will encourage more investment in renewable energy property.

The credit percentage for the prior law credits ranged from 10 percent to 40 percent of the taxpayer's investment; the new credit percentage is 35 percent of the investment. Most of the prior law credits were capped at between $1,000 and $25,000 per installation. The renewable energy credit is capped at between $1,400 and $10,500 for residential installations and at $250,000 per installation for nonresidential installations (although the credit must be taken in five annual installments unless it is for a single-family dwelling installation). The prior law credits were allowed against income tax only; the renewable energy credit is allowed against either income or franchise tax but may not exceed 50 percent of the taxpayer's tax liability for a taxable year. Only about half of the prior law credits allowed carryforwards; the renewable energy credit may be carried forward for five years.

The act defines *renewable energy property* as any of the following machinery and equipment or real property:

- biomass equipment that uses renewable biomass resources for biofuel production of ethanol, methanol, and biodiesel (renewable biomass resources are organic matters produced by terrestrial and aquatic plants and animals, such as standing vegetation, forestry and agricultural residues, landfill wastes, and animal wastes);

- hydroelectric generators;
- solar energy equipment;
- wind equipment.

The credit is patterned after the business tax credit and is codified in the same article. Like the business tax credit, the renewable energy tax credit has the following limitations and conditions:

- The renewable energy tax credit may not exceed 50 percent of the tax against which it is claimed for the taxable year. Any unused portion of the credit may be carried forward for the succeeding five years.
- A taxpayer that claims any other credit allowed with respect to renewable energy property may not take the renewable energy tax credit with respect to the same property.
- A taxpayer may not take the renewable energy tax credit if the taxpayer leases the property from another person, unless the taxpayer obtains the lessor's written certification that the lessor will not claim a credit with respect to this property.

The Department of Revenue must report each year on the number of taxpayers claiming the credits, the cost of the property for which the credits were claimed, and the total cost to the General Fund of the credits claimed.

The business tax credit is repealed effective January 1, 2002, while the remainder of the article is repealed effective January 1, 2006. Consequently the renewable energy tax credit is set to sunset on January 1, 2006.

Incentives for Commercial Use of University Technology

S.L. 1999-305 (S 1110) adds a new investment tax credit, the technology commercialization credit, to the William S. Lee Quality Jobs and Business Expansion Act, effective for taxable years beginning on or after January 1, 2000. Beginning with the 2000–2001 fiscal year, the maximum annual General Fund revenue loss is expected to be $2.1 million per year.

The new investment tax credit is an alternative to the existing 7 percent tax credit for investing in machinery and equipment. The technology commercialization credit applies only to investments in machinery and equipment used in production based on technology licensed from a research university. In addition, to qualify the machinery and equipment must be located in a tier one, two, or three enterprise area. Finally, the taxpayer's investment must equal at least $10 million during the taxable year and must total at least $100 million over a five-year period. If the investment totals between $100 million and $150 million over five years, the technology commercialization credit is equal to 15 percent of the amount invested. If the investment equals or exceeds $150 million over five years, the technology commercialization credit is equal to 20 percent of the amount invested. The technology commercialization credit remains available for ten years of investments at a single location. The taxpayer's eligibility for the technology commercialization credit is based on the Secretary of Commerce's certification that the taxpayer will invest either $100 million or $150 million over five years. If the taxpayer does not achieve the certified level of investment, the credit is forfeited. As for the existing investment tax credit, forfeiture of the credit triggers forfeiture of any worker training credit taken for training workers to operate the new machinery and equipment.

The technology commercialization credit is more generous than the existing investment tax credit under the Bill Lee Act in the following ways:

- The existing investment tax credit is 7 percent of the amount invested. The technology commercialization credit is 15 percent or 20 percent of the amount invested, depending upon the size of the investment.
- The existing investment tax credit must be taken in seven annual installments, beginning the year after the year the investment is placed in service. The technology commercialization credit may be taken in the year the investment is placed in service.
- The existing investment tax credit applies only to the extent that the new investment is not offset by the amount of machinery and equipment the taxpayer either sold or took out of service in the three-year period before the new investment was placed in service. This

restriction limits the existing credit to net increases in North Carolina investment and disallows it for investments that, in effect, are a replacement or relocation of preexisting machinery and equipment. The technology commercialization credit is not required to be offset by machinery and equipment sold to another taxpayer if the new owner keeps the machinery and equipment in service in North Carolina. In addition this new investment tax credit is not required to be offset by machinery and equipment the taxpayer takes out of service if it was in service at a separate location and was used in a business that is not competitive with the technology commercialization business.

- The existing investment tax credit, like all other Bill Lee Act credits, may be taken against the taxpayer's income tax or franchise tax, but not both. The technology commercialization credit may be taken against both income tax and franchise tax. The taxpayer must determine what percentage of the credit will be taken against each tax and must maintain the same percentage for the purpose of carryforwards. If new investment is made in a second or subsequent tax year, the taxpayer may elect a different percentage with respect to the credit for each tax year. The election is binding.
- The existing investment tax credit, like all other William S. Lee Act credits, may be carried forward for five years unless the investment amount exceeds $150 million over a two-year period, in which case it may be carried forward for twenty years. The technology commercialization credit may be carried forward for twenty years.

Historic Properties

S.L. 1999-389 (S 251) modifies the tax credit for rehabilitating income-producing historic property, effective for taxable years beginning on or after January 1, 1999. The fiscal impact of the tax credit changes is unclear. This act modifies the tax credit for rehabilitating income-producing historic property in two substantive ways and one technical way:

- It allows a pass-through entity, such as a Subchapter S corporation, to allocate the credit among any of the entity's owners as long as the credit does not exceed the owner's adjusted basis in the pass-through entity. The credit amount may be allocated among any of the pass-through entity's owners, in the entity's discretion. The allocation provision sunsets in three years. Under prior law, the credits were allocated in the same proportion as other income items allocated to the owners under the code.
- It adds provisions to recapture the credit if the taxpayer is required to recapture the credit under the code or if a partner or owner disposes of its interest in the pass-through entity.
- It consolidates the credits for rehabilitating a historic property into one tax article. The credits had been duplicated in two separate statutes in the individual and corporate parts of the income tax article in Chapter 105.

Taxpayers are allowed an income tax credit of 20 percent of the expenses of rehabilitating an income-producing historic structure and a credit of 30 percent of the expenses of rehabilitating a historic structure that is not income-producing. The credit for income-producing structures is lower because federal law also allows a 20 percent credit for those expenses, yielding a combined credit of 40 percent. The 20 percent credit is allowed only if the taxpayer qualifies for the federal credit, and the 30 percent credit is allowed only if the taxpayer does not qualify for the federal credit. The credit may not be taken for the tax year the property is placed in service but must be taken in installments over five years after the historic structure is placed in service. Any unused portion of a credit may be carried forward for a five-year period.

A pass-through entity may qualify for the rehabilitation credits and pass the credits on to its owners. A *pass-through entity* is an entity, such as a partnership, a limited liability company, or a Subchapter S corporation, that is treated as owned by individuals or other entities under federal tax law and whose income, losses, and credits are reported by the owners on their state income tax returns.

Under the code, tax credits are allocated among S corporation shareholders in accordance with their pro rata shares of the corporation, which are determined on the basis of stock ownership, and tax credits are allocated among partners in a partnership in accordance with the partnership agreement. The allocation made by the partnership agreement must have a substantial economic effect, which means that the allocation agreement must reflect the economic interests of the partners in the partnership and cannot be based solely on tax consequences. Therefore the allocation agreement of partners cannot give one partner 100 percent of the income, loss, or credits of the partnership. Under prior North Carolina law the pass-through entity was required to allocate a tax credit among its owners in the same proportions that other items, such as the federal rehabilitation credit, were allocated under the code. This meant that if foreign investors were involved in a qualifying rehabilitation project, their tax credits could not be redistributed to North Carolina investors with state income tax liability.

In putting together an investment group for an income-producing historic rehabilitation project, the project sponsors may find some investors that can benefit from only the federal credit because they have little or no North Carolina tax liability and other investors that can benefit from both the federal and the North Carolina credit because they have both types of tax liability. This act changes the allocation of the credit to allow the maximum tax credit available for each of the project investors. It allows a pass-through entity to allocate the credit for rehabilitating an income-producing historic structure among any of its owners, as long as the amount of the allocated credit does not exceed the owner's adjusted basis in the entity as determined under the code. The adjusted basis is determined at the end of the taxable year in which the historic structure is placed in service. Each year an allocated credit is claimed, the pass-through entity and its owners must include a statement with their tax return that shows both the allocation made and the allocation that would otherwise have been required under G.S. 105-131.8 and G.S. 105-269.15. G.S. 105-131.8 provides that the tax credit allowed a shareholder in a Subchapter S corporation is based on the percentage of stock held by the shareholder in the corporation. G.S. 105-269.15 provides that the tax credit allowed a partner is based on the partnership agreement, which must have substantial economic effect.

The act also requires forfeiture of all or part of the credit for an income-producing historic structure when the following occurs:

- Forfeiture for Disposition. When a taxpayer is required by the code to recapture part or all of the federal credit, the taxpayer must forfeit the corresponding part of the state credit. Under the code the recapture does not apply if the property is disposed of because of the death of the taxpayer, a mere change in the form of doing business, or a transfer between spouses or incident to a divorce.
- Forfeiture for Change in Ownership. If an owner of a pass-through entity that qualified for the credit disposes of all or a portion of the owner's interest in the pass-through entity within five years after the date the structure was placed in service so that the owner's interest is reduced to less than two-thirds of its interest at the time the structure was placed in service, the owner must forfeit a portion of the credit. This recapture does not apply if the change in ownership is due to the death of the owner or to a merger or consolidation requiring the approval of the members of the taxpayer pass-through entity to the extent the entity does not receive cash or property.

If a taxpayer or owner of a pass-through entity forfeits the credit, the taxpayer or owner is liable for all past taxes avoided plus interest. The past taxes and interest are due thirty days after the credit is forfeited.

Unemployment Tax

Zero Rate/Funding Worker Training

S.L. 1999-321 (H 275) makes two changes to unemployment insurance taxes. First, it changes the minimum credit ratio of employers who are granted a zero tax rate from 5 percent to 4 percent. Second, it temporarily reduces unemployment insurance taxes for most employers by 20 percent and levies a corresponding contribution to be used for enhanced reemployment services and worker-training programs, effective January 1, 2000 (this change will sunset in two years). The rate of contribution is the lesser of 20 percent or a percentage that yields an amount that, when combined with the employer's unemployment insurance taxes, is no greater than the amount of tax the employer would have paid under existing law.

In 1995 the General Assembly set a zero unemployment insurance tax rate for employers with credit ratios of 5 percent or greater. This act allows more employers to have a zero unemployment tax rate by lowering the threshold from 5 percent to 4 percent. As of April 30, 1999, the balance in the Unemployment Insurance Trust Fund stood at $1.22 billion. In addition, a reserve fund contains an additional $200 million, due to the fund's solvency and North Carolina's low unemployment rate. The ESC estimates this change will affect over 10,000 employers, giving them tax savings of over $1 million in the first year. With an additional 6,400 employers reaching the 4 percent credit ratio each year, the ESC estimates that 38,000 employers will benefit from this zero tax rate by 2004.

The act also reduces the unemployment insurance taxes employers pay to the ESC. The reduction is 20 percent for most employers, slightly less for new employers, and less for roughly 3,400 employers with a high debit ratio. Those employers who pay at a zero tax rate are not affected by this change. The act levies a new tax, called a "training and reemployment contribution," equal to a percentage of each employer's unemployment insurance tax. These changes become effective January 1, 2000, and sunset January 1, 2002.

It is estimated that the new contribution will generate $22.9 million in state fiscal year (SFY) 1999–2000 and $60.8 million in SFY 2000–2001. The new contribution will be credited to a nonreverting account, called the "Employment Security Commission Training and Employment Account," subject to appropriation by the General Assembly. The act states as the General Assembly's intent that four-fifths of the proceeds will be appropriated annually from the account to the Department of Community Colleges for nonrecurring expenditures for various worker-training programs. The act amends the Current Operations and Capital Improvements Appropriations Act of 1999 to appropriate from the Employment Security Commission Training and Employment Account to the Community Colleges System Office $18 million for the 1999–2000 fiscal year and $48.5 million for the 2000–2001 fiscal year. The act states as the General Assembly's intent that the remaining one-fifth of the proceeds will be appropriated annually from the account to the ESC for the costs of collecting and administering the new contribution and for nonrecurring expenditures for enhanced reemployment services. The act amends the budget bill to appropriate from the account to the ESC $4.5 million for the 1999–2000 fiscal year and $12.1 million for the 2000-2001 fiscal year.

Other Amendments

S.L. 1999-340 (H 276) contains a number of changes recommended by the ESC. In addition to technical and conforming changes, it includes the following tax law changes:

- Section 1 authorizes electronic funds transfers and credit card payments for unemployment insurance taxes.
- Section 2 extends the requirement for automated filing of employee information in the Employer's Quarterly Tax and Wage Report to employers with 100 or more employees.
- Section 8 authorizes the Department of Revenue to share with the ESC additional taxpayer information for use in the N.C. WORKS study. G.S. 108A-29(r) requires each county's Job Service Employer Committee or Workforce Development Board to study

the working poor in that county and report annually to various oversight committees of the General Assembly. This report is called the N.C. WORKS report. Section 10 prohibits the ESC from disclosing this information.

Sales, Use, and Motor Fuels Taxes

Miscellaneous Sales and Use Tax Amendments

S.L. 1999-438 (S 1112) makes a variety of tax law changes. Taken as a whole, the act is expected to increase General Fund revenues by less than $1 million a year the first three years it is in effect and then to reduce General Fund revenues by less then $1 million a year the next two years it is in effect.

Privilege Tax on Loan Agencies. Under prior law, loan agencies were subject to an annual privilege tax of $750. Section 2 of S.L. 1999-438 reduces the tax to $250 a year and expands its scope to apply to pawnbrokers and check cashers. This change is expected to reduce General Fund revenues by less than $300,000 a year. Pawnbrokers and check cashers are engaged in a business similar to loan agencies, and the intent of the act is that similar taxpayers should be treated similarly. Earlier versions of the bill would have retained the tax at $750, but the tax was reduced in response to complaints from pawnbrokers. The privilege tax statute caps at $100 the local privilege tax that counties and towns may levy on these businesses. Under former law counties and towns were authorized to levy a local privilege tax of up to $275 on pawnbrokers.

Repeal Sales Tax Registration Fee. Under prior law retailers and wholesalers were required to pay a fee of $15 when registering with the Department of Revenue for sales and use tax purposes. Registration is a one-time requirement before a merchant can begin a business that is subject to sales or use tax. Sections 1 and 1.1 of S.L. 1999-438 repeal the $15 fee effective January 1, 2000. Eliminating the fee will enable the Department of Revenue to handle registrations electronically. This change is expected to reduce General Fund revenues by approximately $540,000 a year.

Sales Tax on Medical Equipment and Sundries. Section 5 of S.L. 1999-438 exempts from sales tax durable medical equipment and medical sundries that are eligible for coverage under Medicare and Medicaid. This change is expected to reduce General Fund revenues by approximately $700,000 a year. The new exemption applies only to items purchased on prescription or by a certificate of medical necessity. While the item must be eligible under Medicare or Medicaid, the exemption applies whether or not it is purchased by a beneficiary under those programs. Durable medical equipment includes a variety of medical items, such as wheelchairs, intravenous (IV) bag holders, and cane stands. Medical sundries are items that are easily and frequently disposed of, like latex gloves, gauze, medical tape, and syringes.

Sales Tax on Prescription Drugs. Sections 6 and 7 of S.L. 1999-438 exempt from sales tax all prescription drugs. This change is expected to reduce General Fund revenues by approximately $2 million a year. Under prior law most prescription drugs were already either exempt from state and local sales and use taxes or refundable. The prior exemptions for prescription drugs applied to drugs purchased with a prescription [G.S. 105-164.13(13)], prescription drugs distributed free of charge by the manufacturer of the drugs [G.S. 105-164.13(13b)], and prescription drugs purchased for use in the commercial production of animals [G.S. 105-164.13(2a)]. Prescription drugs distributed free of charge by the manufacturer include samples given to physicians to give to patients and drugs donated to groups such as the American Red Cross.

Most hospitals receive refunds of state and local sales and use taxes paid on prescription drugs they acquire. G.S. 105-164.14(b) allows all nonprofit hospitals, except those operated by the state, and all for-profit hospitals to receive refunds of state and local sales and use taxes paid on prescription drugs. G.S. 105-164.14(c) allows The University of North Carolina (UNC) Hospitals at Chapel Hill to receive refunds of state and local sales and use taxes paid on prescription drugs

acquired for use by the hospital. The state General Fund receives a refund of local sales and use taxes paid by the other state hospitals on prescription drugs.

Thus after combining the exemptions and refunds for prescription drugs, the only entities that were paying tax on prescription drugs were physicians and other medical professionals who buy the drugs to administer to patients in the course of their practices and state hospitals other than the UNC Hospitals. The exemptions and refunds for prescription drugs had evolved over the years in a piecemeal fashion, leaving this small segment subject to the taxes.

In addition to the UNC Hospitals, the state operates four psychiatric hospitals: Dorothea Dix Hospital, Broughton Hospital, Cherry Hospital, and John Umstead Hospital. The state also operates various alcohol and drug treatment centers and mental retardation centers, which are in-patient facilities similar to hospitals. State agencies generally do not receive a refund of state sales and use taxes. These agencies receive an appropriation from the state that includes the amount needed to pay sales and use taxes.

Repeal Sales Tax Exemption for Traded-in Items. Section 8 of S.L. 1999-438 simplifies the sales tax treatment of traded-in items by repealing the exemption for certain traded-in items. This change is expected to increase General Fund revenues by approximately $1.2 million a year. Under prior law, if a used item were traded-in on the purchase of a new item, the used item would not be subject to sales tax when it was resold if the person who traded it in paid the full amount of sales tax on the new item purchased. This law created problems for retailers, who were required to retain the tax records on the new item with the used item to determine the sales tax treatment of the used item when it was resold. If the items in question were subject to a reduced tax rate, as farm equipment is, then upon resale the traded-in item would be subject to local but not state sales tax, an added complication for retailers. Under this section traded-in items will be subject to full state and local sales tax, as are other used items.

Unconstitutional Sales Tax Provisions. Sections 9 and 10 of S.L. 1999-438 address two sales tax provisions that are probably unconstitutional. Under prior law, certain nonprofit corporations were not required to collect sales taxes on items sold as part of an annual fund-raiser. To qualify for the exemption, the corporation was required to have been chartered in North Carolina for two years. This classification does not have a rational basis and thus probably violated the uniformity requirements of the constitution. Section 9 of this act repeals the requirement that the corporation be chartered in North Carolina. This change is expected to have a negligible impact on General Fund revenues.

Prior law granted a sales tax exemption for sales of paper, ink, and other tangible personal property to commercial printers and publishers for use as component parts in free circulation publications that contained advertising of a general nature. The exemption applied to general shoppers guides but not to more specialized guides, such as real estate guides. The First Amendment to the United States Constitution does not allow a state to discriminate between publications based on their content. The prior law exemption clearly violated this rule by exempting guides with general content but not those with narrower content. Section 10 of this act repeals the exemption so that supplies sold for all free publications will be subject to tax on a uniform basis. This change is expected to increase General Fund revenues by approximately $2.5 million a year.

Airport Authority Sales Tax Refunds. Under prior law, a local airport authority created by a local act of the General Assembly was entitled to an annual refund of sales and use taxes it paid if the local act creating it gave it all the rights of a municipality, declared it to be a municipality, or specifically authorized it to receive sales tax refunds. Section 14 of S.L. 1999-438 expands the refunds to all local airport authorities created by the General Assembly. This change is expected to reduce General Fund revenues by between $4,000 and $18,000 a year.

Tax Penalty and Assessment Changes. Sections 15, 16, 17, and 19 of S.L. 1999-438 make changes in tax penalties and tax assessment rules. No estimate is available regarding the impact these changes will have on General Fund revenues.

Under prior law, the Secretary of Revenue was permitted to waive all tax penalties except the penalty for bad checks. The exception had been made at the request of the Department of Revenue to reduce the administrative burden of having to consider and act on waiver requests with respect

to bad checks. Sections 15 and 17 repeal the exception for the bad check penalty, so that all tax penalties will be subject to the same waiver authority. This change is not expected to have a significant impact on General Fund revenues. The penalty for bad checks is 10 percent of the amount of the check, with a minimum of $1 and a maximum of $1,000.

Under prior law, there were three general categories of negligence penalties: a general negligence penalty of 10 percent and two large tax deficiency penalties of 25 percent. The large negligence penalty applied to income tax only if the taxpayer understated taxable income by an amount equal to one-fourth or more of its gross income. The large negligence penalty applied to other taxes if the taxpayer understated tax liability by one quarter or more. The large deficiency test for income taxes is more forgiving than the stricter large deficiency test for other taxes. Section 16 of this act, requested by the Department of Revenue, limits the more forgiving large deficiency test to individual income taxes and moves corporate income taxes to the stricter large deficiency test that applies to other taxes.

The authority of the Department of Revenue to assess taxes and to make refunds of taxes is subject to statutory time limitations. Under prior law, a taxpayer who is under investigation by the Department of Revenue could voluntarily waive the time limit for assessments in order to allow time for the investigation to be completed properly. The time limit for making refunds could not be extended, however. Thus, if the additional investigation to which the taxpayer agreed showed that a refund, rather than an assessment, was appropriate, the refund could not be made. Section 19 of this act, requested by the Department of Revenue, modifies the tax refund time limitations to state that the taxpayer’s extension of the assessment time limits automatically extends the time in which the taxpayer can request a refund.

Special Mobile Equipment Changes. Sections 22, 24, and 27 through 29 of S.L. 1999-438 make changes related to special mobile equipment. *Special mobile equipment* is a vehicle that has a permanently attached crane, mill, ditch-digging apparatus, or similar attachment. The vehicle is driven on the highway only to get to and from a nonhighway job, and it is not designed or used primarily for the transportation of persons or property.

Sections 22, 24, and 27 address a problem relating to motor fuel tax. The motor fuel tax is designed to apply only to fuel used for highway purposes. Motor fuel used for nonhighway purposes is instead subject to sales tax. Thus special mobile equipment should not have to pay motor fuel tax on the fuel it uses for nonhighway purposes. However, under prior law, it could not use dyed (untaxed) diesel fuel and was not authorized to receive a refund of motor fuel tax paid on clear (taxed) diesel fuel. Section 22 provides that dyed (untaxed) diesel fuel may be used in special mobile equipment. Section 24 allows a quarterly refund for tax paid on motor fuel used to operate special mobile equipment off-highway, effective for taxes paid on or after January 1, 1999. As a result of these changes, the motor fuel used in special mobile equipment will be subject to sales tax rather than motor fuel tax. This change will result in a small but unknown reduction in Highway Fund revenues and a corresponding increase in General Fund revenues. Section 27 of this act increases the registration fee for special mobile equipment from $20 to $40, effective January 1, 2000. This increase should generate about $40,000 or more in annual Highway Fund revenues to offset the decrease that will result from the motor fuel tax changes in sections 22 and 24.

Section 28 of this act expands the maximum width of special mobile equipment from 96 inches to 102 inches. Section 29 provides that vehicles being towed by special mobile equipment may carry property that does not exceed the weight of the towed vehicle. These sections conform the law to reflect prevailing practices with regard to special mobile equipment.

Vehicle Rental Tax and Motor Fuel Tax Information

S.L. 1999-452 (H 280) makes numerous changes to the motor vehicle laws and two changes to the tax laws. The tax law changes are (1) an expansion of the scope of the transit authority vehicle rental tax to include more types of vehicles and (2) an expansion of the Department of Revenue’s authority to share motor fuel tax information to help in collecting motor fuel taxes.

Sections 26 through 28 of this act broaden the scope of the transit authority vehicle leasing tax to include certain property-hauling vehicles. A regional transit authority may levy a gross receipts tax on a retailer who leases or rents vehicles. The tax rate may not exceed 5 percent of the gross receipts derived from the short-term (less than 365 continuous days) lease or rental of the vehicles. This tax is added to the lease or rental price and is paid by the lessee. This act broadens the scope of the leasing tax from its current scope ("U-drive-it" passenger vehicles and motorcycles) to include U-drive-it property-hauling vehicles as well. A *U-drive-it vehicle* is defined in G.S. 20-4.01 as any of the following rented to a person who will operate it: a motorcycle, a property hauling vehicle under 7,000 pounds rented for a term of less than one year (and not hauling products for hire), and a private passenger vehicle rented for a term of less than one year (and not rented to public schools for driver training instruction).

The affected regional transit authorities are the Triangle Transit Authority and Piedmont Authority for Regional Transportation.

The tax secrecy law authorizes the Department of Revenue to exchange taxpayer information with the Division of Motor Vehicles to the extent necessary for these agencies to fulfill their duties. Section 28.1 of the act amends this provision to allow the Department of Revenue to exchange information with the International Fuel Tax Association, Inc. The International Fuel Tax Association is a nonprofit, membership organization whose mission is to provide oversight, planning, and coordination of activities necessary to promote uniform administration of the International Fuel Tax Agreement (IFTA). The IFTA is an agreement between member taxing jurisdictions to assist each other in the collection and administration of taxes paid by interstate motor carriers on their use of motor fuel.

Other Taxes and Fees

Newsprint Recycling Tax

S.L. 1999-346 (H 1479) modifies the excise tax on virgin newsprint by postponing the increase in the percentage of recycled content required and by expanding the credit for recycling. The act is expected to reduce revenues in the Solid Waste Management Trust Fund by less than $1,000 a year.

A publisher must pay a privilege license tax of $15 for each ton of newsprint it consumes that does not have a minimum recycled content. The General Assembly enacted this excise tax on newsprint in 1991 to encourage the use of recycled newsprint. The minimum amount of recycled paper required has been phased up since 1991 from 12 percent to 35 percent and was set to increase to 40 percent in 2001. This act delays the increase in the minimum recycled content percentage until 2005.

Publishers who develop and operate, or who contract for the operation of, a newspaper recycling program are eligible for a credit that can be used toward the recycled content percentage goals. Under prior law, a publisher could receive a one-half ton credit toward its total recycled content tonnage for each ton of newsprint it recycled. This act increases the credit from one-half ton to one ton and expands it to include recycling of magazines as well as newsprint.

The proceeds of the tax, which generates less than $2,000 a year in revenue, are earmarked for the Solid Waste Management Trust Fund. The tax does not apply if the producer cannot meet the recycled content goal because of an inability to obtain newsprint made from recycled paper at a price or quality comparable to other newsprint, to acquire an amount needed for a publication, or to acquire the amount needed in a reasonable amount of time.

Administration and Enforcement of State Tax Laws

Payment by Electronic Funds Transfer

S.L. 1999-389 (S 251) requires corporations that are required to pay federal income tax estimated payments by electronic funds transfer (EFT) to pay state income tax estimated payments by EFT, effective for taxable years beginning on or after January 1, 2000. The Department of Revenue estimates an annual gain of $334,662 to the General Fund from the EFT requirement.

This change in the law will eliminate thousands of returns, not payments, each year. It will enable the state to receive tax payments more quickly and thus gain three to five days of interest on the payments.

For federal purposes a corporation whose depository taxes exceed $200,000 in a twelve-month period must pay its corporate income tax estimated payments by EFT. The federal regulations list the different types of depository taxes. Examples of depository taxes include social security taxes, withheld income taxes, and corporate estimated income taxes. The Internal Revenue Service raised the threshold from $50,000 to $200,000 in July 1999. The higher threshold will limit the EFT requirement to the largest 9 percent of taxpayers, but other taxpayers are expected to use EFT voluntarily.

Use Tax Collection

S.L. 1999-341 (H 1433) simplifies use tax collection and seeks to improve tax collection in several ways:

- It provides that an individual who owes use tax to the state on nonbusiness purchases can pay the tax with the individual's income tax return.
- It promotes the electronic filing of semimonthly sales tax reports.
- It directs the Secretary of Revenue to contract for the collection of delinquent tax debts owed by nonresidents and foreign entities.
- It directs the Department of Revenue and the State Controller to study the feasibility of a central collection operation.
- It prohibits state agencies from contracting with a vendor who is required under G.S. 105-164.8(b) to collect state sales and use tax but refuses to do so.

The act is expected to increase General Fund revenues by $1.67 million in fiscal year 1999–2000, $1.75 million in fiscal year 2000–2001, $1.84 million in fiscal year 2001–2002, $1.93 million in fiscal year 2002–2003, and $2.03 million in fiscal year 2003–2004.

North Carolina has a state and local sales and use tax at the combined rate of 6 percent. The combined rate is 6.5 percent in Mecklenburg County. The sales tax is paid on purchases made in this state, is collected by the retailer, and is remitted to the state. The use tax complements the sales tax by taxing transactions that are not subject to the sales tax because of movement in interstate commerce. Like the sales tax, the use tax is imposed on the purchaser. Unlike the sales tax, the responsibility for remitting the use tax to the Department of Revenue is also on the purchaser.

The 1997 General Assembly enacted S.L. 1997-77, which established an annual filing period for the payment of use taxes owed by consumers on mail-order and other out-of-state purchases. This change relieved consumers of the need to file either monthly or quarterly returns.

The act further simplifies use tax collection by providing that the use tax will be paid on the taxpayers' income tax returns, effective for taxable years beginning on or after January 1, 1999. An individual who owes use tax on nonbusiness purchases and who must remit a state income tax return must pay the use tax owed with the income tax return. The income tax return will have space on it to indicate the amount of use tax owed. It is hoped that by placing the use tax on the individual income tax return, as opposed to sending a separate use return with the income tax return, that taxpayer awareness of the responsibility to pay the tax will increase, as every taxpayer must affirm that the information on the income tax return is true and complete by signing the return. The Secretary of Revenue is required to provide information on the individual income tax

form and instructions to explain a person's obligation to pay use tax on items purchased from mail-order, Internet, or other sellers that do not collect state sales tax on those items. The Secretary must also provide a method to help a person determine the amount of use tax owed. This method must list categories of items that are commonly sold by mail-order or Internet businesses and must include a table that gives the average amounts of use tax payable by taxpayers in various income ranges.

The act allows the Department of Revenue to use some of the additional use tax revenue collected to promote tax collections. The department may use $150,000 to pay for the costs of programming, form revision, and resources for taxpayer assistance in connection with the new use tax collection method. The department may use $500,000 to implement a program to allow semimonthly sales and use taxpayers to file their returns electronically.

The department may use some of the revenue to contract for the collection of delinquent tax debts owed by nonresidents and foreign entities. A delinquent tax debt is the amount of tax due as stated in a final notice of assessment issued to the taxpayer when the taxpayer no longer has the right to contest the debt. The department must report on its collections pursuant to this contract to the Revenue Laws Study Committee.

The department may use up to $50,000 to conduct a study, in cooperation with the State Controller, to identify and evaluate proposals for more efficient collection of taxes. The department must report its findings, recommendations, and estimated revenue gains to the Revenue Laws Study Committee by May 1, 2000.

The state is prohibited from contracting with a vendor for goods or services if the vendor is required by G.S. 105-164.8(b) to collect use tax for the state but refuses to do so. G.S. 105-164.8 requires a retailer that is engaged in business in this state to collect use tax on a mail-order sale. Subsection (b) of this statute provides that a retailer that makes a mail-order sale is engaged in business in this state if the retailer meets one or more of the following conditions:

- is a corporation engaged in business under the laws of this state;
- maintains offices in this state;
- has representatives in this state who solicit business or transact business on behalf of the retailer;
- is purposefully or systematically exploiting the market in this state by any media-assisted, media-facilitated, or media-solicited means, including direct-mail advertising, distribution of catalogs, computer-assisted shopping, and so forth;
- resides in a jurisdiction that has a compact or reciprocity with North Carolina to support North Carolina's taxing power;
- consents to the imposition of the collection of the tax.

The act also amends the tax secrecy provisions to allow the Secretary of Revenue to make two disclosures. The Secretary may provide the Secretary of Administration with a list of vendors who refuse to collect the state's use tax even though they are required to do so under G.S. 105-164.8. The Secretary may provide the public with access to a database containing the names and account numbers of taxpayers who are not required to pay sales and use tax because of an exemption or because they are authorized to pay the tax directly to the department.

Tax Withholding

S.L. 1999-414 (H 1466) requires a person paying pensions, annuities, and deferred compensation to withhold North Carolina individual income tax from the payments unless the recipient elects not to have the tax withheld, effective January 1, 2001. Income that is exempt from tax is exempt from this withholding requirement. The act does not apply to federal, state, and local retirement benefits paid to retirees with five years of creditable service as of August 12, 1989, because this retirement income is exempt from state income tax due to a court decision in the *Bailey/Emory/Patton* lawsuits. The impacts of this litigation on the state budget is discussed in Chapter 2 (The State Budget).

Under federal law, withholding is required on pensions, annuities, and certain deferred income, including Individual Retirement Accounts (IRAs). Prior to this act, North Carolina had not piggybacked this aspect of federal law. This act provides that a pension payer required to withhold federal income tax on a pension payment to a resident of North Carolina must also withhold state income tax. A recipient may elect to not have tax withheld from the pension payment. The pension payer must notify each recipient of the right to elect not to have tax withheld. An individual who elects not to have tax withheld from the pension payment must estimate his or her income tax liability each year and pay the tax in four installments.

In the case of periodic payments, the pension payer must withhold as if the recipient were a married person with three exemptions, unless the recipient provides an exemption certificate reflecting a different filing status or number of exemptions. For a nonperiodic payment, the pension payer must withhold 4 percent of the payment. A pension payer who fails to withhold or remit the tax that is withheld is liable for the tax.

Currently the Department of Revenue allows voluntary withholding by employers. The holder of an IRA, although not an employer, may also enter into a voluntary withholding agreement. However, if the payer withholds the tax but does not pay it to the Department of Revenue, the taxpayer's only recourse is against the payer. The department cannot credit the taxpayer and pursue the payer. Under this act, effective for taxable years beginning on or after January 1, 2001, the withholding will be mandatory unless the recipient elects not to have the tax withheld.

Other Amendments

S.L. 1999-415 (H 1476) makes several changes relating to tax law.

Update Code Reference. S.L. 1999-415 rewrites the definition of the Internal Revenue Code used in state tax statutes to change the reference date from September 1, 1998, to June 1, 1999. Updating the Internal Revenue Code reference makes recent amendments to the code applicable to the state to the extent that state law previously tracked federal law. 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.

Since the General Assembly updated the state's reference to the Internal Revenue Code to September 1, 1998, Congress has enacted two bills that affect the code. On October 21, 1998, President Bill Clinton signed into law Public Law 105-277, which includes the Tax and Trade Relief Extension Act of 1998. On April 19, 1999, the President signed into law Public Law 106-21, which extends the tax benefits available with respect to services performed in a combat zone to services performed in the Kosovo area. The code update is expected to increase General Fund revenues by $11.55 million in fiscal year 1999–2000, $2.95 million in fiscal year 2000–2001, $1.4 million in fiscal year 2001–2002, $900,000 in fiscal year 2002–2003, and $100,000 in fiscal year 2003–2004.

Conform Criminal Deadline to Federal. S.L. 1999-415 conforms the state statute of limitations, with respect to the willful failure to comply with the state's tax laws, to the federal statute of limitations. Under North Carolina law it is a Class 1 misdemeanor to willfully fail to collect, withhold, or pay over taxes or to willfully fail to file a return or pay the tax due. Under prior law, the state had three years from the date of the violation to prosecute the taxpayer who violated the tax law. Under federal law, the IRS has six years from the date of the prosecution to pursue the violation. Sections 2 and 3 of this act conform the state statute of limitations to the federal statute of limitations by extending the time the state has to pursue a violation of the tax laws from three years to six years. This change is effective December 1, 1999, for cases in which the three-year statute of limitations has not already expired.

Refund Statute of Limitations. S.L. 1999-415 extends the time a taxpayer has to challenge the unconstitutionality of most taxes from one year to three years, effective for taxes paid on or after January 1, 1999. The time limit remains at thirty days for excise taxes on alcoholic beverages, soft drinks, tobacco products, and controlled substances. In North Carolina, if a taxpayer believes a tax is unconstitutional, the taxpayer must pay the tax and contest the tax by requesting a refund after payment is made. This procedure is known as "paying under protest."

Tax Research Positions. Upon recommendation of the Revenue Laws Study Committee, Section 4(a) of S.L. 1999-415 authorizes the Secretary of Revenue to draw funds from the revenues generated by updating the Internal Revenue Code reference to fund four tax research positions in the Department of Revenue, effective January 1, 2000. The Revenue Laws Study Committee determined that there is a need for in-depth tax research that cannot be met by the current three-person staff. Adding four new tax analyst positions will provide a tax research resource capable of serving the needs of the legislative and executive branches for analyses of various tax proposals and of the effects of changes in the economy on the tax base.

Performance Audit. S.L. 1999-415 directs the Office of the State Auditor to conduct a performance audit of the Department of Revenue, addressing the following areas: (i) tax collection and tax auditing activity, with particular attention to the cost, efficiency, and effectiveness of the Integrated Tax Administration System and subsequent automation projects; (ii) current methods of processing tax returns and payments and the ability to employ the latest technology in this processing; (iii) internal organization and management; (iv) budgeting and fiscal management; (v) current and future staffing requirements; and (vi) any other issues the State Auditor considers necessary or desirable. The State Auditor is to submit an interim progress report to the Senate and House Appropriations Subcommittee on General Government and the General Assembly's Fiscal Research Division by May 30, 2000, and a final report to the General Assembly by January 1, 2001. The Secretary of Revenue is directed to draw $100,000 from funds generated by the act to pay for the performance audit.

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