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Phased Implementation of the 2007 and 2008 Medicaid Funding Reform Legislation in North Carolina

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In 2007, the General Assembly enacted comprehensive legislation to reform the manner in which Medicaid costs are funded in North Carolina (2007 legislation).[1] *Local Finance Bulletin* No. 37, Analyzing the Financial Impact of the 2007 Medicaid Funding Reform Legislation on North Carolina Counties (February 2008), summarized the legislation and detailed its likely impact on county revenue. Legislation passed in 2008 (Sections 13–15 of S.L. 2008-134 (SB 1704)) modified several provisions of the 2007 legislation. Specifically, it made the following substantive changes:

- It amended N.C. Gen. Stat. § 105-522 (hereinafter, G.S.) to ensure that municipalities are held completely harmless for the loss of their portion of the Article 44 tax revenue;
- It amended G.S. 105-523 to explicitly include in the county supplemental payment calculation—that determines if a county is eligible for a supplemental payment from the state—the amount of a county's Article 39 tax proceeds used to hold harmless any eligible municipalities located within its territory for the loss of the municipalities' portion of the Article 44 tax revenue; and
- It amended G.S. 105-502, as of October 1, 2009, to require counties to earmark for public school capital outlay purposes at least as much revenue as would have been earmarked had the change in allocation method of the Article 42 tax proceeds not occurred.

This bulletin, which supersedes *Local Finance Bulletin* No. 37, incorporates these changes and summarizes the major provisions of the 2007 and 2008 acts (collectively, Medicaid funding reform legislation).

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1. Section 31 of S.L. 2007-323; Section 14 of S.L. 2007-345.

Introduction

The General Assembly enacted the Medicaid funding reform legislation after years of intense lobbying by counties across the state to eliminate the counties' share of Medicaid costs.[2] The cornerstone of the legislation is the state assuming the counties' Medicaid costs,[3] but it contains several other provisions that impact counties, municipalities, and local school administrative units. In exchange for the elimination of the counties' Medicaid costs, the legislation temporarily reduced county allocations from the Public School Building Capital Fund (PSBCF) in fiscal year (FY) 2007–08 and required counties to hold local school administrative units harmless for the loss in PSBCF funds. Beginning in October 2008, it phases out the counties' authority to levy a one-half cent local option sales and use tax (local sales tax) and obliges counties to compensate municipalities for their loss in local sales tax revenue. It also changes the allocation method of another portion of the local sales tax, which, among other things, impacts funds that are earmarked for public school capital outlay expenditures. The Medicaid funding reform legislation further requires the state to guarantee counties a certain return from the exchange of Medicaid costs for local sales tax revenue (Medicaid swap) and provides counties with a choice of an additional local option revenue source subject to voter approval.

In order to understand the financial impact of the legislation on North Carolina counties, municipalities, and local school administrative units, it is important to look both at the individual effect of each of these provisions and their collective impact. With respect to counties, aside from the new local option revenue sources, most of the financial "gain" from the funding reform legislation does not result from an actual increase in revenue—instead, the gain results from the state assuming the counties' Medicaid costs.[4] The corresponding financial "loss" to counties from the one-time reduction in allocations from the PSBCF, the repeal of a portion of the local sales tax authorization, and the municipal hold harmless payments, however, does result in an actual decrease in county revenue. In other words, the legislation reduces county expenditures on Medicaid and, in exchange, reduces county revenue. Despite the projected revenue losses, all counties will experience an aggregate financial gain as a result of the comprehensive funding reform—although the amount of financial gain is likely to vary significantly among counties. Municipalities and local school administrative units should not experience a net financial loss as a result of the Medicaid funding reform legislation—the legislation merely modifies the sources of funds to these local units.

This bulletin provides an overview of the various legislative provisions, separating them into two key sections. While the sections are centered on the changes to county revenue, they also detail the relevant modifications to municipal and public school revenues. The first section details the legislative provisions that cause a financial loss to counties. Proceeding chronologically, it begins by describing the temporary decrease in PSBCF funds during FY 2007–08 and the current local sales tax scheme. It then presents a comprehensive overview of how the legislation alters local sales tax levies beginning in FY 2008–09 and provides an illustrative example of the potential financial impact on a hypothetical county and municipality. The second section describes the

2. The counties' Medicaid costs as of July 2007 were 15 percent of the non-federal Medicaid costs and Medicare Part D clawback payments, excluding administrative costs.

3. The state assumes the counties Medicaid costs, excluding the administrative costs, over a three-year period.

4. Some counties may receive additional revenue from the state because of a provision in the legislation requiring the state to guarantee counties a financial gain of at least $500,000 as a result of the Medicaid swap. This revenue guarantee is described in the final section of this bulletin.

legislative provisions that generate a financial gain for counties—including a brief summary of the states' assumption of counties' Medicaid costs, a more detailed discussion of the financial gain guarantee to counties and, finally, an overview of the additional local option revenue sources now available to counties subject to voter approval.

Financial Loss to Counties

In exchange for the state assuming the counties' share of Medicaid costs, the legislation reduces county revenue sources. In the first fiscal year of its implementation, FY 2007–08, it decreased the average daily membership (ADM) funds allocated to counties from the PSBCF.[5] Beginning in FY 2008–09, it repeals the counties' authority to levy the Article 44 local sales tax over a two-year period and requires the counties to hold municipalities harmless for any loss in the municipalities' local sales tax revenue. The legislation also changes the allocation method of the Article 42 proceeds, as of October 1, 2009, which may have a negative financial impact on some counties. Each of these provisions is discussed in turn.

PSBCF Allocation Reduction

During FY 2007–08 only, the legislation reduced the amount of each county's PSBCF funds by the lesser of 60 percent of the expected ADM allocation or 60 percent of the amount of the county's Medicaid share assumed by the state during the fiscal year.[6] Counties were directed to hold their local public school districts harmless for the reduction in ADM funds. Specifically, a county had to "use" funds equivalent to the difference in what the county would have been allotted in ADM funds under G.S. 115C-546.2(a) and what actually was allotted to the county's ADM allocation account (public school hold harmless revenue) for purposes set out in G.S. 115C-546.2(b).[7] The

5. The PSBCF was established by the General Assembly to assist county governments in meeting their public school building capital needs and their equipment needs under local school technology plans. The state makes quarterly distributions to the PSBCF from a portion of its corporate income tax revenue. This revenue is then allocated to each county on a per ADM basis and placed in an ADM allocation account maintained by the Department of Public Instruction (DPI). A county and its local board of education must jointly apply to DPI for distribution of the allocated funds on a project-by-project basis. A local match of one dollar of local funds for every three dollars of state funds must be identified and designated for the requested project, except for school technology projects. If approved by DPI, the requested funds are transferred to a disbursing account established for the county in the State Treasurer's Office and made available for expenditure by the county's finance officer. *See* G.S. 115C, Art. 38A; Procedures Manual: Public School Building Capital Fund, School Planning, Division of School Support, NC Department of Public Instruction (2003), available at http://www.schoolclearinghouse.org/otherinf/ADMFund/ADMfund.htm (last visited Dec. 29, 2007).

6. According to DPI, it deducted 60 percent of the ADM allocation during the November 2007, February 2008, and May 2008 allocations because it had no way of knowing what the state would assume in Medicaid payments in FY 2007–08. DPI adjusted a county's allocation if the county's Medicaid payment assumed by the state was less than its ADM allocation at the end of FY 2007–08. *See* State Assumes Medicaid Responsibilities, at http://www.schoolclearinghouse.org/otherinf/ADMFund/ADMfund.htm (last visited Dec. 29, 2007).

7. G.S. 115C-546.2(b) specifies that a county must use the monies allocated from the PSBCF for "capital outlay projects including the planning, construction, reconstruction, enlargement, improvement, repair,

ADM funds either had to be expended in FY 2007–08 or placed in a capital reserve account for future expenditure for one or more of the authorized purposes.[8] Unlike the funds a county received from the PSBCF, the county and local board of education did not need to seek approval from the Department of Public Instruction before expending the public school hold harmless revenue and the county did not have to supplement the public school hold harmless revenue with a specified match of local revenue.

As of FY 2008–09, the ADM funds once again are allotted to each county according to the provisions in G.S. 115C-546.1. The reduction in allocations applied in FY 2007–08 only.

Repeal of Local Sales Tax Authority

Local Sales Tax Scheme Before October 1, 2008

Before analyzing the impact of the Medicaid funding reform legislation on local sales tax revenue, it is useful to review the local sales tax scheme. North Carolina counties are authorized to levy up to 2.75 percent (2.75 cents per $1.00) in local sales taxes. The 2.75 percent is comprised of five separate local sales taxes—all counties levy four of the five taxes totaling 2.5 percent. Counties received authorization from the General Assembly to levy an additional one-quarter cent local sales tax as of July 31, 2007 (bringing the total authorization from 2.5 percent to 2.75 percent), subject to voter approval in individual counties.[9] All of the local sales taxes apply to specified base transactions.[10] Three of the local sales taxes (totaling 2 percent) apply to the sale of certain food products exempt from the state sales and use tax under G.S. 105-164.13B (exempt food products).

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or renovation of public school buildings and for the purchase of land for public school buildings; for equipment to implement a local school technology plan that is approved pursuant to G.S. 115C-102.6C; or for both." If the county determines that it does not need all or part of the funds allocated to it for the specified capital outlay projects, "the unneeded funds allocated to that county may be used to retire any indebtedness incurred by the county for public school facilities." Finally, if a county determines that its public school building needs and its school technology needs "can be met in a more timely fashion through the allocation of financial resources previously allocated for purposes other than school building needs or school technology needs . . . the county commissioners may, with the concurrence of the affected local board of education, use those financial resources to meet school building needs and school technology needs and may allocate the funds it receives [from the Public School Building Capital Fund] for purposes other than school building needs or school technology needs to the extent that financial resources were redirected from such purposes."

8. The legislation states that "[i]n fiscal year 2007–2008, a county must use a portion of the revenue that is available to it, as a result of the assumption by the State of part of the county's Medicaid payments, for the purposes set out in G.S. 115C-546.2(b)." The portion that must be used for these purposes is an amount equal to the difference between what the county would receive under G.S. 115C-546.2(a) based on its per average daily membership and the adjusted amount it receives [as a result of the ADM funds reduction calculation]. The legislature likely intended that counties supplement their appropriations to local school districts by the amount of the ADM funds reduction in FY 2007–2008, although there is no specific non-supplant language in the legislation.

9. *See* G.S. 105, Art. 46. A county may not levy the additional one-quarter cent local sales tax if it levies a local land transfer tax pursuant to Article 60 of Chapter 105 of the North Carolina General Statutes.

10. The list of base transactions is found in G.S. 105-467.

The taxes are characterized by the articles in G.S. Chapter 105 under which they are levied, and the proceeds attributable to each tax are allocated among the counties by one of two methods—the per capita method, whereby the proceeds are placed in a statewide pool and allocated among the counties based on relative populations, or the point-of-origin method, whereby the proceeds are returned to the counties in which the goods were delivered. The following list details each tax, describing both its application and the allocation method of its proceeds.

- Article 39 One Cent Tax:[11] Applies to the base transactions and to the sale of exempt food products. The proceeds are allocated on a point-of-origin basis.
- Article 40 One-Half Cent Tax: Applies to the base transactions and to the sale of exempt food products. The proceeds are allocated among the counties on a per capita basis.
- Article 42 One-Half Cent Tax: Applies to the base transactions and to the sale of exempt food products. The proceeds are allocated among the counties on a per capita basis.
- Article 44 One-Half Cent Tax:[12] Applies to the base transactions only; it does not apply to the sale of exempt food products. One-half of the proceeds are allocated on a per capita basis and one-half of the proceeds are allocated on a point-of-origin basis.
- Article 46 One-Quarter Cent Tax: Applies to the base transactions only; it does not apply to the sale of exempt food products. The proceeds are allocated on a point-of-origin basis.

Once the tax proceeds are allocated among the counties, the DOR distributes revenue from the Articles 39, 40, 42 and 44 taxes among each county and its eligible municipalities according to one of two distribution formulas—per capita or *ad valorem*. The board of county commissioners of each county selects the distribution formula and may change it in April of each year, taking effect for the following fiscal year.

Under the per capita formula, the county's total population is added to the population of all eligible municipalities in the county. This adjusted population figure is divided into the local sales tax revenue available to the county to determine the county's per capita amount. The resultant figure is then multiplied by the population of the county and each eligible municipality to determine each unit's share of the county's allocation.

Under the *ad valorem* formula, the tax levy of the county and the tax levy of each eligible municipality are added to determine the total levy. Each taxing unit's levy as a proportion of the total levy represents the proportion of the local sales tax revenue that each taxing unit receives.[13]

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11. References to the Article 39 one cent tax include the Mecklenburg County one cent sales and use tax under S.L. 1967-1096. Mecklenburg County also levies an additional 0.5 percent local sales tax pursuant to local legislation, the proceeds of which are restricted to funding public transportation.

12. Some counties receive an additional distribution based on the transitional hold harmless provisions in G.S. 105-521. During the 2001 legislative session, the General Assembly repealed reimbursements that had been made to local governments by the state since the mid-1980s in compensation from the loss, through legislative action, of important local government revenue sources, including the removal from the property tax base of manufacturers', wholesalers', and retailers' inventories, the repeal of the intangibles tax, the expansion of the property tax homestead exclusion, and the repeal of the sales tax on food stamp purchases. In an effort to mitigate any adverse effect on local government from the repeal of the reimbursements, the legislature authorized counties to levy the Article 44 tax and adopted a transitional hold harmless provision in G.S. 105-521 to compensate any county that received less revenue from the new tax than it would have received from the reimbursements during the 2002-03 fiscal year. The transitional hold harmless payment currently sunsets in 2012.

13. Under the *ad valorem* distribution method, the amount of taxes levied by a taxing unit on behalf of other taxing districts is included in the total. The county or municipality must share any local tax proceeds proportionally with the other taxing districts. *See* G.S. 105-472.

Ad valorem tax figures used in the formula are those of the fiscal year immediately preceding the fiscal year in which the distributions are made.

The DOR distributes the proceeds of the Article 46 tax (if levied) to the county only—there is no requirement and, in fact, no authorization for a county to share the proceeds with municipalities in the county.

Municipalities may spend their portion of local sales tax proceeds for any public purpose that they are authorized to undertake, and counties may do the same with the proceeds of the Article 39 one cent tax, the Article 44 one-half cent tax, and (if levied) the Article 46 one-quarter cent tax. For counties, however, the proceeds of the other two one-half cent taxes are partially earmarked until at least 2011; for the Article 40 tax, 30 percent is earmarked, and for the Article 42 tax, 60 percent is earmarked for school capital outlay or for debt service on county borrowing for school projects.

Table 1 illustrates the annual local sales tax distribution scheme for a hypothetical, representative county—Carolina County—which has one incorporated municipality located within its territorial boundaries. Carolina County's total population is 139,786, with a municipal population of 85,641. The county levies four of the five local sales taxes, totaling 2.5 percent. The table depicts how the revenue derived from the Articles 39, 40, 42, and 44 taxes is allocated to Carolina County and then shared between the county and its single municipality.

The total amount of the allocable proceeds to Carolina County collected by the state during the fiscal year is $41,426,769, which represents the county's portion of the revenue from the Articles 40, 42 and 44 taxes that is allocated among all 100 counties on a per capita basis and the revenue from the Articles 39 and 44 taxes that is derived from goods delivered in the county.

The proceeds allocated to Carolina County are distributed between the county and its incorporated municipality on a per capita basis, the distribution method selected by the county's board of commissioners. The county's share of the local sales tax is $25,688,504. This amount is determined by dividing the total distributable proceeds of $41,426,769 by the adjusted population of 225,427 (determined by adding the total county and municipal populations), which equals $183.7702183 (the DOR uses seven decimal places to calculate the per capita ratio). The per capita ratio of $183.7702183 is multiplied by the total county population of 139,786 to determine the county's share of the local sales taxes of $25,688,504. The same methodology is used to determine the municipality's share, where the per capita ratio of $183.7702183 is multiplied by the municipality's population of 85,641. The resulting amount is $15,738,265.

Table 1. Annual Local Option Sales and Use Tax Allocation and Distribution for Carolina County Before October 1, 2008

Population Figures for Carolina County	
County Population	139,786
City Population	85,641
Adjusted Population	**225,427**
Allocation of Local Sales and Use Tax Proceeds to Carolina County	
Article 39 (1.0 percent point of delivery)	$ 16,575,027
*Article 40 (.5 percent per capita)	8,705,149
*Article 42 (.5 percent per capita)	8,629,265
Article 44 (.25 percent per capita/.25 percent point of delivery)	7,517,328
Total Allocation	**41,426,769**
Distribution of Local Sales and Use Tax Proceeds to County	
Article 39	10,278,080
Article 40	5,398,013
Article 42	5,350,958
Article 44	4,661,452
Total Distribution	**25,688,504**
Distribution of Local Sales and Use Tax Proceeds to City	
Article 39	6,296,947
Article 40	3,307,136
Article 42	3,278,307
Article 44	2,855,876
Total Distribution	**$ 15,738,265**

* Note that the total distributable proceeds derived from both the Articles 40 and 42 taxes are based on a one-half cent tax and on a per capita allocation method. However, the amounts are different. This is primarily due to the statutory provisions in G.S. 105-501, requiring that certain monies (to support the DOR, the Property Tax Commission, the School of Government Training Program in Property Tax Appraisal and Assessment, and the Local Government Commission) be deducted from the proceeds of the Article 42 tax. This adjustment also impacts the cost of collection retained by the state and the per capita adjustments required by G.S. 105-486(b).

Changes to Local Sales Tax Scheme

While the Medicaid funding reform legislation does not alter the basic mechanics of the local sales tax scheme, it does eliminate the counties' authority to levy the Article 44 one-half cent tax over a two year period—increasing the state's comparable sales and use tax by one-quarter cent as of October 1, 2008, and one-quarter cent as of October 1, 2009—and it changes the allocation method of the Article 42 one-half cent tax revenue among counties from per capita to point-of-origin. It also sets forth certain hold harmless provisions that impact the amount of local sales tax revenue actually distributed to counties.[14]

14. The legislation also makes conforming changes to the transitional hold harmless funds calculation in G.S. 105-521 to account for the repeal of the Article 44 tax.

October 1, 2008 through September 30, 2009

From October 1, 2008 through September 30, 2009, the authorization for the Article 44 one-half cent tax is reduced to one-quarter cent. All counties are authorized to levy up to 2.5 percent in local sales taxes (including the Article 46 one-quarter cent tax) during this time period. The net proceeds of the remaining Article 44 one-quarter cent tax are allocated on a point-of-origin basis—returned to the county in which the goods were delivered.

Each county is required to hold all eligible municipalities located within the county, and incorporated as of October 1, 2008, harmless for the loss of the Article 44 one-quarter cent tax.[15] The monthly hold harmless payment for each municipality is calculated as 50 percent of the amount of local sales tax revenue a municipality receives from the Article 40 tax. The reason for indexing the hold harmless proceeds to the Article 40 one-half cent tax is to approximate the actual loss of revenue from the repealed portion of the Article 44 tax and to ensure that the funds reflect growth in local sales tax revenue over time. The hold harmless amount is reduced to account for revenue distributed from the repealed portion of the Article 44 tax during the second quarter of the fiscal year.[16] Thus, municipalities likely will not receive a hold harmless distribution until January 2009. Figure A illustrates the municipal hold harmless calculation for FY 2008–09.

Figure A. Municipal Hold Harmless Calculation for FY 2008–09

A = Municipal Share of Article 40 Tax Proceeds

.50 x A = Municipal Hold Harmless Amount*

*This amount is reduced by any actual distributions from the repealed portion of the Article 44 tax during October, November, and December 2008.

The proceeds are distributed directly to each eligible municipality by the DOR from the county's Article 39 local sales tax proceeds. Because of the hold harmless requirement, although a county may levy up to 2.5 percent in local sales taxes (2.25 percent if it has not adopted the new Article 46 tax), the county will not receive its full share of the revenue, causing its effective tax distribution[17] to be lower.

October 1, 2009 and Beyond

The authorization for the remaining Article 44 one-quarter cent tax is repealed as of October 1, 2009. All counties are authorized to levy up to 2.25 percent in local sales taxes (including the Article 46 one-quarter cent tax) after this date. The method for allocating the proceeds from the

15. Note that although counties are required to hold eligible municipalities harmless for the municipalities' loss of local sales tax revenue, counties are not required to likewise compensate other taxing units eligible for a local sales tax distribution under G.S. 105-472 (such as fire districts or service districts).

16. Although local sales tax distributions occur monthly, there typically is a three-month lag period between collection and distribution.

17. For purposes of this bulletin, the term effective tax distribution refers to the percentage distribution of the proceeds received by a county or its municipalities from the local sales tax levied by the county.

Article 42 one-half cent tax among the counties also switches from per capita to point-of-origin. The four remaining local sales taxes are as follows:

- Article 39 One Cent Tax: Applies to the base transactions and to the sale of exempt food products. The proceeds are allocated on a point-of-origin basis.
- Article 40 One-Half Cent Tax: Applies to the base transactions and to the sale of exempt food products. The proceeds are allocated among the counties on a per capita basis.
- Article 42 One-Half Cent Tax: Applies to the base transactions and to the sale of exempt food products. The proceeds are allocated on a point-of-origin basis.
- Article 46 One-Quarter Cent Tax: Applies to the base transactions only; it does not apply to the sale of exempt food products. The proceeds are allocated on a point-of-origin basis.

Each county is required to hold all eligible municipalities located within the county, and incorporated as of October 1, 2008, harmless for the loss in revenue from the repeal of the entire Article 44 one-half cent tax.[18] The monthly hold harmless payment for each eligible municipality is calculated as the amount of local sales tax revenue a municipality receives from the Article 40 tax. Figure B illustrates this calculation under Step 1. The reason for indexing the hold harmless amount to Article 40 tax proceeds is to approximate the actual loss of revenue from the repealed Article 44 tax and to ensure that the funds reflect growth in local sales tax revenue over time.

The hold harmless calculation also must factor in any increase or decrease in municipal revenue due to the change in the Article 42 tax proceeds allocation method from per capita to point-of-origin. To calculate the revised hold harmless amount, subtract the amount determined by taking 25 percent of the amount of local sales tax revenue a municipality receives from the Article 39 tax from the amount determined by taking 50 percent of the amount of local sales tax revenue a municipality receives from the Article 40 tax. This calculation helps offset the effect of the allocation change in the Article 42 one-half cent tax because the Article 39 tax proceeds are allocated on a point-of-origin basis and the Article 40 tax proceeds are allocated on a per capita basis.[19] Figure B illustrates this calculation under step 2. The difference, positive or negative, is added to the hold harmless amount to determine the revised hold harmless amount. Therefore, the hold harmless amount is increased if a municipality loses revenue because of the switch of the Article 42 tax revenue allocation method from per capita to point-of-origin. Alternatively, the hold harmless amount is decreased if a municipality gains revenue because of the switch in the allocation method. (In FY 2009–10, the revised hold harmless amount is reduced to account for revenue distributed from the repealed portion of the Article 44 tax during the second quarter of the fiscal year.)

The proceeds are distributed directly to each eligible municipality by the DOR from the county's Article 39 local sales tax proceeds. Again, because of the hold harmless requirement, although a county may levy up to 2.25 percent in local sales taxes (2.0 percent if it has not adopted the new

18. Note that although counties are required to hold eligible municipalities harmless for the municipalities' loss of local sales tax revenue, counties are not required to likewise compensate other taxing units eligible for a local sales tax distribution under G.S. 105-472 (such as fire districts or service districts).

19. The repeal of the Article 44 tax (0.50 percent, allocated one-half per capita and one-half point-of-origin) and change in allocation method of the Article 42 tax (0.50 percent, changed from allocated per capita to allocated point-of-origin) are fully off-set by the combination of indexing the hold harmless calculation to the Article 40 tax proceeds—which off-sets the effect of repealing a 0.50 percent local sales tax allocated on a per capita basis—and including in the hold harmless calculation the difference between 50 percent of the Article 40 tax proceeds and 25 percent of the Article 30 tax proceeds—which measures the effect of allocating a 0.25 percent tax on the basis of point-of-origin instead of per capita.

Figure B. Municipal Hold Harmless Calculation as of FY 2009–10

Step 1:

Municipal Share of Article 40 Tax Proceeds = Municipal Hold Harmless Amount

Step 2:

A = Municipal Hold Harmless Amount (from *Step 1*)
B = .50 x Municipal Share of Article 40 Tax Proceeds
C = .25 x Municipal Share of Article 39 Tax Proceeds

A + (B - C) = Revised Municipal Hold Harmless Amount

*For FY 2009–10 only, this amount is reduced by any actual distributions from the repealed Article 44 tax during October, November, and December 2009.

Article 46 tax), the county will not receive its full share of the revenue, causing its effective tax distribution to be lower.

A county also is required to hold its local school administrative unit harmless for the loss of any Article 42 tax revenue earmarked for public school capital outlay or debt service on county borrowing for school projects due to the change in allocation method of the Article 42 proceeds from a per capita to a point-of-origin basis. Recall that until October 1, 2009, 60 percent of the amount a county receives from the Article 42 tax is specifically earmarked for these purposes. After that date, when the allocation method of the Article 42 proceeds changes, the legislation directs a county to use 60 percent of the following for public school capital outlay purposes or to retire any indebtedness incurred by the county for public school capital outlay purposes:

- The amount of revenue the county receives from the Article 42 tax, plus
- If the amount allocated to the county under G.S. 105-486 (Article 40 tax) is greater than the amount allocated to the county under G.S. 105-501(a) (Article 42 tax), the difference between the two amounts.[20]

It appears that the legislature intended that the phrase “amount allocated to the county” be interpreted to refer to the amount a county receives from both the Article 40 tax and Article 42 taxes—after the full amount of the proceeds due to the county from these taxes are distributed among the county and any eligible municipalities.[21]

20. The earmark currently is set to sunset in 2011.

21. Note, however, that the phrase “amount allocated to the county” may have a specific meaning under G.S. 105-486 and G.S. 105-501(a)—referring to the full amount of local sales tax revenue due to the county before the revenue is divided out among the county and its eligible municipalities. *See* A. Fleming Bell, II, et. al. *Local Government and Local Finance*, in N.C. Legislation 2008 (Christine Wunsche ed. Forthcoming 2009). Under this interpretation, at least some counties would be required to earmark significantly more revenue for public school capital outlay than they would have been required to earmark had the change in allocation method not occurred. (A few counties even may have to earmark more money than they actually receive in Article 42 proceeds.) This interpretation appears contrary to what the legislature intended, which was simply to hold public schools harmless for any loss in earmarked Article 42 proceeds. The legislature likely did not intend to cause counties to earmark significantly more revenue for capital school outlay purposes. That said, it is unclear how a court would interpret the phrase “amount allocated to

Table 2 illustrates the financial impact on Carolina County's local sales tax revenue after the total repeal of the Article 44 tax, which reduces its local sales tax from 2.5 percent to 2.0 percent, and the allocation change of the Article 42 tax proceeds.[22] The population figures and distributable proceeds used in Table 1 also are used in Table 2. There are two important differences, though. First, the distributable proceeds from Article 44 are not found in Table 2 because of the Medicaid swap. Second, the allocation method for the proceeds of the one-half cent Article 42 tax has been changed from the per capita to the point-of-origin basis, which lowers the amount distributed to the county from $8,629,265 to $8,287,514. This decrease suggests that Carolina County benefits more from the state-wide per capita allocation rather than the point-of-origin allocation.[23] The impact of these two changes lowers the total amount of allocable proceeds from $41,426,769 as shown in Table 1 to $33,567,690 as shown in Table 2.

The first column illustrates how the allocable proceeds of $33,567,690 would be shared between the county and its municipality using the per capita distribution method before the hold harmless payment is made to the municipality. The effective tax distribution for both the county and the municipality is 2.0 percent.

The second column includes the hold harmless payment to the municipality of $3,386,467, which is subtracted from the county's distribution of its Article 39 tax proceeds. The municipality's hold harmless payment represents the sum of its share of Article 40 or $3,307,136 and the amount determined by subtracting 25 percent of its share of Article 39 tax proceeds from 50 percent of its share of the Article 40 tax proceeds or $79,331. Because the hold harmless payment to the municipality is taken from the county's distribution of its Article 39 tax proceeds, Carolina County's effective tax distribution decreases to 1.67 percent. On the other hand, the municipality's effective tax distribution in this example increases to 2.53 percent. These percentages will vary among all 100 counties based on the number of municipalities within a county and their relative populations or their relative property tax levies.

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the county" if the amount earmarked by a county for public school capital outlay is challenged by its local school administrative unit.

22. Regardless of whether Carolina County adopts the new Article 46 tax, it would not be part of this calculation.

23. Note that some counties may receive compensation for the revenue loss due to the change in allocation method pursuant to the provisional revenue guarantee from the state, which is discussed later in this bulletin.

Table 2. Local Option Sales and Use Tax Allocation and Distribution for Carolina County (After Full Implementation of Medicaid Funding Reform Legislation)

	Before Municipal Hold Harmless	After Municipal Hold Harmless
Population Figures for Carolina County		
County Population	139,786	139,786
City Population	85,641	85,641
Adjusted Population	**225,427**	**225,427**
Allocation of Local Sales and Use Tax Proceeds to Carolina County		
Article 39 (1.0 percent from point of delivery)	$ 16,575,027	16,575,027
Article 40 (.5 percent from per capita)	8,705,149	8,705,149
Article 42 (.5 percent from point of delivery)	8,287,514	8,287,514
Total Allocation	**33,567,690**	**33,567,690**
Distribution of Local Sales and Use Tax Proceeds to County		
Article 39	10,278,080	6,891,613
Article 40	5,398,013	5,398,013
Article 42	5,139,040	5,139,040
Total Distribution	**20,815,134**	**17,428,667**
Effective Tax Distribution	**2.00**	**1.67**
Distribution of Local Sales and Use Tax Proceeds to City		
Article 39	6,296,947	6,296,947
Article 40	3,307,136	3,307,136
Article 42	3,148,474	3,148,474
Hold Harmless Payment		3,386,467
Total Distribution	**$ 12,752,556**	**16,139,023**
Effective Tax Distribution	**2.00**	**2.53**

Financial Gain to Counties

Understanding the impact of the Medicaid funding reform legislation on county, municipal, and public school revenue is important, but it cannot be considered in isolation. To fully comprehend the financial impact of the legislation, the changes to county, municipal, and public school revenue must be viewed within the context of the legislation's other provisions—the provisions that will generate a financial gain for counties.

State Assumes Counties' Medicaid Share

As of July 1, 2007, the counties' share of Medicaid costs was 15 percent of the non-federal Medicaid costs and Medicare Part D clawback payments.[24] The legislation phases out the counties' share of

24. For a description of North Carolina's Medicaid program and an overview of how the program was financed before the Medicaid funding reform legislation, see Kara A. Millonzi, *Impact on Local School*

these costs over a three-year period—with the state assuming 25 percent beginning October 1, 2007, 50 percent beginning June 1, 2008, and 100 percent beginning June 1, 2009.[25] Counties will continue to pay local administrative expenses associated with their Medicaid programs.

State Guarantees Financial Gain to Counties

The state guarantees that all counties experience an annual financial gain of at least $500,000 as a result of the Medicaid swap. The guarantee requires that the difference between the financial gain a county experiences from the state assuming its Medicaid costs and the financial loss it experiences from either the loss in ADM funds or the loss of its projected share of local sales tax proceeds is at least $500,000. The state will make a supplemental payment to the county for the difference if the amount is less than $500,000.[26] The loss of a county's projected share of local sales tax proceeds includes the amount that the county must expend to hold municipalities harmless for the loss of their portion of the repealed local sales tax proceeds.

In FY 2007–08, the state reimbursed the county for the absolute value of the difference if the amount of the county's Medicaid share paid by the state minus the amount by which the county's PSBCF allocation was reduced did not equal or exceed $500,000. (Recall that counties had to use a portion of their additional revenue capacity to hold local school systems harmless for the reduction in ADM funds.) Figure C illustrates the county supplemental payment calculation for FY 2007–08.

Figure C. County Supplemental Payment Calculation for FY 2007–08

A = Amount of County Medicaid Share Assumed by the State
B = Amount of County ADM Funds Reduction

If A - B < $500,000, then $500,000 - | A - B |* = State Supplemental Payment to County**

*If A < B, subtract the absolute value of (A - B) from $500,000.
**The state did not have to reimburse the county if the resulting amount was less than $100.

Thereafter, G.S. 105-523 requires the DOR to calculate the projected revenue loss to the county from the local sales tax changes and compare that loss with the amount of revenue a county gains from the state assuming the county's Medicaid payments.

For the period after the first one-quarter cent of the Article 44 tax is repealed (October 1, 2008, through September 30, 2009), the state must reimburse the county for the absolute value of the difference if the amount of a county's Medicaid costs assumed by the state minus $500,000 (county hold harmless threshold) is less than the county's repealed local sales tax amount plus its municipal hold harmless amount. A county's repealed local sales tax amount is calculated as 50 percent of the Article 40 tax proceeds distributed to a county. (This amount is reduced to account

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Administrative Units of the 2007–2008 Legislation to Reform Medicaid Funding, School Law Bulletin Vol. 39 (Laurie Mesibov, ed. forthcoming 2008).

25. According to the authorizing legislation, the state assumes: (1) 25 percent of the counties' Medicaid claims from October 1, 2007 through May 31, 2008; (2) 50 percent of the counties' Medicaid claims from June 1, 2008 through May 31, 2009; and (3) 100 percent of the counties' Medicaid claims as of June 1, 2009.

26. To obtain revenue for the supplemental payments to any qualifying counties, the Secretary of Revenue must withhold proceeds from the sales and use tax collections under G.S. 105, Art. 5.

for revenue distributed from the repealed portion of the Article 44 tax during the second quarter of the fiscal year.) The municipal hold harmless amount is the amount of a county's Article 39 tax revenue distributed to eligible municipalities in the county to compensate those municipalities for their loss in Article 44 tax revenue. Figure D illustrates the county supplemental payment calculation for FY 2008–09.

Figure D. County Supplemental Payment Calculation for FY 2008–09

Step 1:

A = County Share of Article 40 Tax Proceeds

.50 x A = Repeated Sales Tax Amount*

Step 2:

B = Amount of County Medicaid Share Assumed by the State
C = Repealed Sales Tax Amount (calculated in *Step 1*)
D = Municipal Hold Harmless Amount

If B – $500,000 < (C + D), then [(C + D) – | B – $500,000 |] = State Supplemental Payment to County.**

*This amount is reduced by any actual distributions from the repealed portion of the Article 44 tax during October, November, and December 2008.

**If B < $500,000, subtract the absolute value of the difference of (B - $500,000) from (C + D).

After the Article 44 tax is completely phased out on October 1, 2009, the state must reimburse the county for the difference if the amount of a county's Medicaid costs assumed by the state less $500,000 (county hold harmless threshold) is less than the county's repealed local sales tax amount plus its municipal hold harmless amount. A county's repealed local sales tax amount is calculated as the amount distributed to the county under Article 40. Added to this figure is the amount, positive or negative, determined by subtracting 25 percent of the Article 39 tax proceeds distributed to a county from 50 percent of the Article 40 tax proceeds distributed to a county. This calculation helps offset the effect of the change in allocation method of the Article 42 one-half cent tax revenue because the Article 39 tax proceeds are allocated on a point-of-origin basis and the Article 40 tax proceeds are allocated on a per capita basis. Thus, if a county loses revenue because of the switch of the Article 42 tax revenue allocation method from per capita to point-of-origin, the repealed local sales tax amount is increased by the amount of the projected loss. Alternatively, if a county gains revenue because of the switch in allocation method, the amount of the projected gain lowers the repealed local sales tax amount. (In FY 2009–10 only, a county's repealed local sales tax amount is reduced by any actual distributions from the repealed Article 44 tax during October, November, and December 2009.) Figure E illustrates the county supplemental payment calculation beginning in FY 2009–10.

The state supplemental payments are made semiannually. The Secretary of Revenue estimates the hold harmless amount and sends each county 90 percent of the estimated amount with the March local sales tax distribution. The Secretary of Revenue determines the actual amount at the end of the fiscal year and remits the balance to each county by August 15.

Figure E. County Supplemental Payment Calculation as of FY 2009–10

Step 1:

County Share of Article 40 Tax Proceeds = Repealed Sales Tax Amount

Step 2:

A = Repealed Sales Tax Amount (from *Step 1*)
B = .50 x County Share of Article 40 Tax Proceeds
C = .25 x County Share of Article 39 Tax Proceeds

A + (B – C) = Revised Repealed Sales Tax Amount*

Step 3:

F = Amount of County Medicaid Share Assumed by the State
G = Revised Repealed Sales Tax Amount (calculated in *Step 2*)
H = Municipal Hold Harmless Amount

If F - $500,000 < (G + H), then [(G + H) - |F – $500,000|] = State Supplemental Payment to County**

*In FY 2009–10 only, this amount is reduced by any actual distributions from the repealed Article 44 tax during October, November, and December 2009.
**If F < $500,000, subtract the absolute value of the difference of (F - $500,000) from (G + H).

Table 3 illustrates how the Medicaid swap impacts Carolina County. The county's hold harmless threshold is $7,311,036 as shown under Step 1, representing Medicaid costs assumed by the state of $7,811,036 minus the provisional revenue guarantee of $500,000. The county's repealed local sales tax amount is $5,527,500 as shown under Step 2, which includes the amount distributed to the county under Article 40 and the adjustment in Article 42 from per capita to point of origin. The county's total repealed local taxes is $8,913,967 as shown in step 3, which is the sum of the repealed local sales tax amount of $5,527,500 and the municipal hold harmless amount of $3,386,467. Because Carolina County's total repealed local taxes (repealed sales tax amount plus its city hold harmless amount) exceeds its hold harmless threshold, the state is required to hold the county harmless for the difference.

Step 4 shows the calculation for the county's supplemental payment from the state. Carolina County would receive $1,602,931 from the state in this example, which would meet the requirement that each county experience a financial gain of at least $500,000 from the Medicaid swap.[27]

27. Counties would receive 90 percent of the estimated amount in March and the remaining amount the following August.

Table 3. Impact of Medicaid Swap on Carolina County

Step 1: Calculating county's hold harmless threshold	
Medicaid costs	$ 7,811,036
Provisional revenue guarantee	(500,000)
Hold Harmless Threshold	**7,311,036**
Step 2: Calculating county's repealed local sales tax amount	
Amount distributed to county under Article 40	5,398,013
Adjutment in Article 42 (per capita to point of origin)	129,487
Repealed Local Sales Tax Amount	**5,527,500**
Step 3: Calculating county's total repealed local sales tax amount	
Repealed local sales tax amount	5,527,500
Municipal hold harmless amount	3,386,467
Total Repealed Local Sales Taxes	**8,913,967**
Step 4: Calculating county's supplemental payment from state	
If county's total repealed local sales taxes exceeds county's hold harmless threshold, the state is required to hold county harmless for the difference	
Total repealed local taxes	8,913,967
Hold harmless threshold	(7,311,036)
Supplemental Payment from State	**$ 1,602,931**

New Local Option Taxes

The General Assembly authorized two new local option revenue sources for counties in addition to the Medicaid swap. The new revenue sources are intended to help counties fund additional services and facilities necessitated by growth, including, but not limited to, public school facilities and other infrastructure projects. As of July 1, 2007, the legislation allows counties to adopt either up to a 0.4 percent land transfer tax (in 0.1 percent intervals) or an additional one-quarter cent local sales and use tax (the Article 46 tax), the proceeds of which may be used for any public purpose.[28] There is no requirement and, in fact, no authorization for a county to share the proceeds of either of these new revenue sources with municipalities.

28. Note that a bill introduced during the 2008 Legislative Session (SB 1951) would have repealed counties' authority to levy the local land transfer tax. It also would have allowed county commissioners the option of specifying a particular purpose or purposes for expenditure of the proceeds of the quarter-cent Article 46 tax on the ballot put forth to the voters as to whether or not to approve the additional local sales and use tax authority. The bill passed in the Senate but did not make it out of the House Committee on Rules, Calendar and Operations.

A county must hold an advisory referendum on either additional revenue source and may hold a referendum on both at the same time.[29] If the majority of those voting in the referendum vote for the levy of the local land transfer tax or additional local sales tax, the board of county commissioners may adopt a resolution levying the tax after providing ten days' public notice. (If both ballot measures are successful, a board of county commissioners may implement either but not both of the additional revenue options.) The board of county commissioners is not required to levy either tax even if the tax receives voter approval.

Local Land Transfer Tax

The local land transfer tax applies to transfers of interests in real property located within the county. It is payable by the seller of the interest and applies to the consideration or value, whichever is greater, of the interest conveyed, including the value of any lien or encumbrance remaining on the property at the time of the conveyance. If the property is located in two or more counties, a transfer of an interest in the property is taxable only by the county in which the part with the greater value lies.

The legislation specifically exempts certain transferors from the tax, specifically governmental units and instrumentalities of governmental units. It also exempts certain conveyances of interests in real property to the same extent that they are exempt from the state land transfer excise tax[30]—transfers that are required by operation of law; leases for a term of years; transfers by or pursuant to the provisions of a will, by intestacy, or by gift; transfers where no consideration in property or money is due or paid by the transferee to the transferor; transfers that are accomplished by merger, conversion, or consolidation; and transfers made by an instrument securing indebtedness.[31] And the local land transfer tax does not apply to instruments conveying an interest in property as the result of foreclosure.[32]

Once the levy of the land transfer tax is approved by the voters and authorized by a resolution of the governing board, it may become effective the first day of the second succeeding calendar month after the date the resolution is adopted.[33] No county has received voter approval to levy the land transfer tax as of the date of this writing.[34]

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29. The legislation prescribes the form of the ballot questions for both the local option land transfer tax and additional local option sales tax.

30. The state imposes an excise tax on each conveyance of an interest in real property at a rate of $1.00 per $500 of the consideration or value of the interest conveyed. The tax is collected by the register of deeds of each county. One-half of the proceeds are credited to the county's general fund and one-half of the proceeds, less the county's allowance for administrative expenses, are remitted to the DOR. G.S. 105, Art. 8E.

31. Unlike the state land transfer excise tax, the local land transfer tax does not apply to contracts for the sale of standing timber, although it is unclear whether it applies to timber deeds. *See* Kara A. Millonzi, *Local Finance*, in N.C. Legislation 2007 (Martha Harris and Christine Wunsche eds. 2007).

32. G.S. 45-45.2.

33. The administrative provisions for the state land transfer excise tax, codified in G.S. 105-228.32 through G.S. 105-228.37, apply to the local land transfer tax. A county may repeal or reduce the rate of the local land transfer tax by resolution, but the repeal or reduction may not become effective until the end of the fiscal year in which the repeal or reduction resolution is adopted.

34. The local land transfer tax is projected to generate a significant amount of revenue for counties. The North Carolina Association of County Commissioners has provided revenue estimates for the local land transfer tax in each county, if levied at the maximum rate of 0.4 percent , at http://www.ncacc.org/documents/ revenueauthority_073107.pdf (last visited July 29, 2008). It may prove difficult to actually levy, though. As of August 2008, 19 counties have held a referendum on the local land transfer tax. The referendums failed

Article 46 Local Sales and Use Tax

As previously discussed, counties have authority to levy an additional one-quarter cent local sales tax (the Article 46 tax). The adoption, levy, collection, administration, and repeal of the Article 46 tax must be in accordance with the Article 39 local sales and use tax provisions,[35] except that the new tax does not apply to the sale of exempt food products. The proceeds of the new local sales tax also are allocated on a point of origin basis—returned to the county where the goods were delivered.

According to the authorizing legislation, the county commissioners must adopt a resolution to levy the tax once the additional local sales tax is approved by the voters in a county. The tax does not become effective until the first day of the calendar quarter after the resolution is adopted and only after the county gives the Secretary of Revenue at least sixty days advance notice. Six counties— Alexander, Catawba, Martin, Pitt, Sampson, and Surry —have received voter approval to levy the additional one-quarter cent local sales tax as of the date of this writing.[36]

Summary

The Medicaid swap as authorized in the 2007 Appropriation Act (S.L. 2007-323) and modified by S.L. 2007-345 and S.L. 2008-134, represents a major financial reform for North Carolina counties. It eliminates the counties' share of Medicaid costs over a three-year period, which historically has been one of the fastest growing expenditure areas in county government. Another important feature of this reform is that it eliminates disparities among counties regarding the wide-range of Medicaid costs as a percentage of total county budgets. In exchange for the state assuming the counties' share of Medicaid costs, the legislation temporarily reduced county allocations from the Public School Building Capital Fund and, beginning in October 2008, phases out the counties' authority to levy a one-half cent local sales tax.

A critical aspect of the legislation is that counties are required to hold municipalities harmless for their loss in local sales tax revenue, which reduces the effective local sales tax rate of counties because the hold harmless proceeds are taken from the counties' local sales tax revenue. The state guarantees, however, that each county experience a financial gain of at least $500,000 each fiscal year as a result of the Medicaid swap.

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to pass in any of the counties, often by a wide margin. Local land transfer tax referendums were defeated in Ashe, Brunswick, Chatham, Davie, Gates, Graham, Harnett, Henderson, Hoke, Johnston, Macon, Moore, Orange, Pender, Rutherford, Swain, Tyrrell, Union, and Washington Counties. Five of the counties put both the local land transfer tax and the additional local sales and use tax on the ballot; voters rejected both in all five counties. A county considering this option in the future likely will have to engage in a wide-spread public information campaign to educate voters about the nature of the tax and the individual county's specific needs for additional revenue; even then there is no guarantee that a referendum will be successful.

35. Note, however, that G.S. 105-537 requires that the advisory referendum on the question of whether to levy the new local sales tax be held in accordance with the procedures of G.S. 163-287.

36. As of August 2008, 35 counties held a referendum on the Article 46 tax. The referendums were successful in 8 of the counties—Alexander, Catawba, Cumberland, Haywood, Martin, Pitt, Sampson, and Surry. Referendums failed in 27 counties—Columbus, Davie, Graham, Greene, Harnett, Hertford, Johnston, Lenoir, Robeson, Rutherford, Duplin, Edgecombe, Gaston, Green, Guilford, Henderson, Lee, Lincoln, Moore, Nash, Onslow, Randolph, Rockingham, Stanly, Wayne, Wilkes, and Wilson.

The General Assembly also recognized that escalating Medicaid costs are not the only financial difficulty facing North Carolina counties. Therefore, the new legislation gives counties the option of adopting one of two new local option revenue sources, subject to voter approval, to aid them in funding other operational and capital needs.

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