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TAX STUDY COMMISSION

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STATE

of

NORTH CAROLINA

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THE COMMISSION FOR THE

STUDY OF THE REVENUE STRUCTURE OF THE STATE

Raleigh, North Carolina

November 10, 1956

Honorable Luther H. Hodges
Governor of North Carolina
Raleigh, North Carolina

Dear Governor Hodges:

Transmitted herewith is a report of recommendations for changes in the tax statutes suggested by The Commission for the Study of the Revenue Structure of the State.

An extensive and intensive study of the revenue structure and the economic impact thereof was conducted in accordance with the requirements of Joint Resolution No. 49 of the 1955 General Assembly. Based on the findings of this study the recommended changes are considered both advisable and necessary.

Respectfully submitted,

Brandon P. Hodges
Chairman

C. Gordon Maddrey, *Vice-Chairman*
Frank Daniels
Howard Holderness
J. Y. Jordan, Jr.
W. P. Kemp, Sr.
E. M. O'Herron, Jr.
James M. Poyner
R. Grady Rankin

ORGANIZATION AND CONTENT OF THE REPORT

This report is presented in two parts and an appendix. Two studies made for the Commission on a contract basis are being published separately without any editing by the Commission. If the studies and surveys made at the direction of the Commission and by the staff of the Commission were incorporated into this report the length would require several volumes. The limitations of publication time and monetary resources preclude the printing of the briefs, studies and surveys. These, however, are on file and, of course, are available for use by the members of the General Assembly and others. Drafts of legislation to implement the recommendations contained herein will be submitted at a later date.

Part I of the report tells the story of the mission, the approach to the problem and the findings which necessitate recommendations for change. The recommendations are outlined and evaluated in terms of the present and future effect of the changes on the State's revenues and the State's economy.

Part II presents detailed recommendations organized by tax schedule and subject matter. The sections appear in order of the revenue importance of the taxes dealt with in the section. Each section has a brief statement as to general criteria and philosophy behind the detailed recommendations. Each recommendation is emphasized in italics and immediately followed by a resume of the present provisions, an explanation of what is changed and why, and a statement as to effect on revenue, if any.

Since tax data for all levels of government in North Carolina are being published as usual by the Department of Tax Research under the title of "Statistics of Taxation", which will be available for distribution to the members of the General Assembly and the public, no statistical series are reported herein.

This is a tax policy report specifically designed for the Governor, members of the General Assembly, and the people they represent.

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SPECIAL ACKNOWLEDGMENTS

To acknowledge each person who contributed to the study conducted by the Commission would require numerous pages. General expressions of appreciation and designations of the sources of assistance appear in appropriate places throughout Part I of this report.

Special acknowledgement is due to Mr. Eugene G. Shaw, Commissioner of Revenue, for his cooperation with the Sales Tax Committee in preparing the recommended recodification of the Sales and Use Tax statutes and the administrative rules to complement the proposed revision.

The following members of the faculty of The University provided surveys and analyses which were especially helpful in the study of the economic and sociological characteristics of the State:

From The University at Chapel Hill: Lowell D. Ashby, Department of Economics; Gordon Blackwell, Director of the Institute for Research in Social Science; Paul Guthrie, Chairman of the Department of Economics; Milton S. Heath, Co-ordinator of Research and Graduate Training of the Graduate School of Business Administration; Harriet L. Herring, Institute for Research in Social Science; C. S. Logsdon, School of Business Administration; Daniel Price, Department of Sociology; and George L. Simpson, Jr., Department of Sociology.

From the University at State College: Dr. C. E. Bishop, Professor of Agricultural Economics; Dr. D. W. Colvard, Dean of the School of Agriculture; Dr. C. Horace Hamilton, Head of Department and Professor of Rural Sociology; Dr. H. B. James, Head of Department and Professor of Agricultural Economics.

LEGISLATIVE DIRECTIVE

A JOINT RESOLUTION AUTHORIZING THE GOVERNOR TO APPOINT A COMMISSION TO STUDY AND MAKE RECOMMENDATIONS FOR REVISION AND RECODIFICATION OF THE REVENUE ACT AND REPORT ITS FINDINGS TO THE 1957 SESSION OF THE GENERAL ASSEMBLY.

WHEREAS, there has been no major revision or basic change in the tax structure of the State of North Carolina since 1932; and

WHEREAS, it is proper and desirable that the State of North Carolina and its tax structure be such as to favor the migration of individuals and business enterprises from other states to come within the bounds of North Carolina to establish their businesses and residences; and

WHEREAS, the technological and industrial advances in manufacturing, scientific and agricultural processes since 1932 have changed the nature of many industries, and many entirely new industries have been developed; and

WHEREAS, it is desirable that the tax structure of the State of North Carolina should be studied and reviewed to ascertain whether it meets the tests of stability and equity, and gives proper economic incentive to the greater productivity of the citizens and business enterprises of this State, and with a steady and adequate provision of revenue for the sound and essential purposes of government;

Now, therefore, be it resolved by the House of Representatives, the Senate concurring:

Section 1. The Governor of North Carolina is hereby authorized and empowered to appoint a Commission to be composed of 9 members, and to be known as the Commission for the Study of the Revenue Structure of the State. One member shall be selected from the membership of the 1955 Senate and 2 members shall be selected from the 1955 House of Representatives. The remaining members shall be selected with a view toward fairly and equitably representing the various economic interests of the State as nearly as possible.

Sec. 2. It shall be the duty of said Commission to make a detailed and careful study of the revenue laws of the State which now comprise the Revenue Act, together with all other laws of the State which have a bearing upon such a study of the Revenue Act, and to make recommendations to the 1957 Session of the General Assembly:

(a) To provide for such revision or recodification of such revenue laws as would provide a more easily understandable and workable system of revenue laws for the State, with separate recommendations being made of all such sources of taxation under the General Fund, as well as the Highway and the Agricultural Fund.

(b) To recommend changes in the basic tax structure of the State and in the rates of taxation, together with predicted revenue effects thereof, together with proposed alternate sources of revenue, to the end that our revenue system may be stable and equitable, and yet so fair when

compared with the tax structures of other states, that business enterprises and persons would be encouraged by the economic impact of the North Carolina Revenue Laws to move themselves and their business enterprises into the State of North Carolina.

(c) To recommend study of alternate sources of revenue found in the tax structures of other states of the Union, and particularly, in the other southeastern states, and to make a report upon the economic impact of the North Carolina tax structure upon the business enterprises of various types of industry, as compared with those of other southeastern states.

(d) To make recommendations for long range revenue planning, and for future amendments of the Revenue Laws of North Carolina.

(e) To make a study of allocation formulas providing for the allocation of income for taxation purposes of corporations and other enterprises and persons doing business in North Carolina and other states, together with recommendations as to flexible adjustment procedures which may be provided, in cases of inequity of application of any allocation formulas which may be adopted or recommended.

Sec. 3. The Commission shall have power to hold public hearings, examine the records of the Revenue Department or any other agencies of the State, to receive testimony of any employees of the State or any other witnesses who may assist the Commission in its duties and to call for assistance in the performance of its duties from any employees or agencies of the State or any of its political subdivisions. The Commission may administer oaths, subpoena and compel attendance of witnesses, and do any and all things necessary to accomplish the objective and purposes of this Resolution. To this end the provisions of G. S. 105-259 shall not apply to the members of the Commission or any of its employees or staff.

Sec. 4. Upon its appointment the Commission shall organize by electing from its membership a chairman and a vice-chairman. The members of the Commission shall be paid a per diem allowance in an amount to be determined by the Governor for the days when they are engaged in the performance of the duties of the Commission, and such necessary travel expenses and subsistence and other expenses as may be incurred by them in the performance of the duties of the Commission. The Commission may adopt by majority vote such rules not inconsistent with this Article as it may deem proper with respect to any and all matters relating to the discharge of its duties under this Article.

Sec. 5. The Commission is authorized, with the approval of the Governor, to employ an executive secretary or a general counsel who shall devote his full time to the work of the Commission and supervise the research, revision and redrafting required to carry out the provisions of this Resolution. Such executive secretary or general counsel shall receive a salary to be fixed by the Commission with the approval of the Governor. He shall be authorized to hold hearings and symposiums at various points throughout the State for the purpose of promoting the work of the Commission and securing the wishes of the public regarding the duties of the Commission. The executive secretary or general counsel is authorized to employ such professional, clerical, and other assistants and services as may be deemed necessary in the performance of the Commission's duties.

Sec. 6. The Commission shall report its findings, including its recommendations for revision and recodification of the Revenue Act, together with the economic and statistical studies related

thereto, to the Governor upon or before November 10, 1956, to be transmitted promptly thereafter to the members-elect of the 1957 General Assembly. Said findings and recommendations shall be published and made available to the public.

Sec. 7. There is hereby appropriated from the Contingency and Emergency Fund the sum of fifty thousand dollars ($50,000.00) for the expenses of the Commission which shall be expended under the direction of the Director of the Budget. The Superintendent of Buildings and Grounds shall provide suitable office space and equipment for the Commission.

Sec. 8. This Resolution shall be in full force and effect from and after its adoption.

In the General Assembly read three times and ratified, this the 23rd day of May, 1955.

L. E. Barnhardt
President of the Senate.

Larry I. Moore, Jr.
Speaker of the House of Representatives.

Examined and found correct,

J. P. Wallace
For Committee.

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PART I

SCOPE OF THE STUDY, CRITERIA USED IN THE STUDY, NECESSITY FOR CHANGE, AND OBJECTIVES TO BE ACCOMPLISHED BY ADOPTION OF RECOMMENDATIONS

STATEMENT OF RECOMMENDED TAX POLICY

Despite the broad scope of study and investigation authorized by Resolution No. 49, the Commission realized the existence of certain definite limitations. The greatest limitations were those of time and money coupled with the existence of a short supply of qualified technicians in the field of state and local taxation. Another limitation found by this Commission is the fact that a state such as North Carolina may only tax the economy contained within its own borders. This is a most disquieting fact in view of our relatively poor economy and the absence of certain natural resources such as iron ore, oil and natural gas. Not only is a State limited in the economic activities it may tax, but it has a practical limitation in regard to the extent to which it may siphon tax revenues from the flow of the economy without deterring proper growth and thereby reducing the future tax potential. In analyzing the possible sources of revenue there is the limiting factor of the prevailing .political and sociological attitudes of the peoples.

Inasmuch as there has been a recent detailed study made of the Highway Fund, the "Parson's Report", there is an impending National Highway building program which may influence state tax planning in this area and since the Highway Fund is principally financed through the levy of taxes based on the theory of payments roughly related to benefits received from the services financed thereby the Commission decided to forego an intensive study of this Fund.

The Agricultural Fund is financed by Agricultural fees supplemented by General Fund monies. The total amount of expenditures through this fund is relatively small in relation to the total budget. No response was made to invitations to point out needs for revision in this fund and no specific recommendations were made to the Commission. Thus, in the absence of any appearance of inequities the Commission decided not to make a detailed survey of the Agricultural Fund.

The expenditures financed by the General Fund are for schools and other governmental functions which are normally financed through types of taxes of broader economic significance, including taxes based upon ability to pay rather than on the basis of services received which results in redistribution of income and wealth. Many recommendations were received concerning desired changes in taxes levied under the General Fund. Thus, the Commission early decided to concentrate the major portion of its efforts on the study of the General Fund schedules and the economic impact thereof.

Resolution No. 49 properly recognized the need for attracting greater investments of capital within North Carolina to stimulate greater economic activity at a more profitable level. This resolution specifically directed a detailed study of the impact of state and local taxes upon industry and specifically alluded to the possibility that the allocation formula under the income and franchise taxes is excessively harsh and inflexible. The language clearly infers that, in the opinion of those drafting the resolution, a tax structure should not discourage the proper utilization of the human and natural resources in the development of industry, agriculture and business.

METHODS EMPLOYED

In determining scope and methodology the Commission obtained available copies of reports of similar study commissions which have been created in the various states since World War II. It obtained the advice of the Council of State Governments and other organizations familiar with the tax study process. It took inventory of all existing state agencies which do research in or deal with state and local fiscal affairs and ascertained the availability of trained tax technicians for short-term employment. Cognizance was taken of the number and variety of professional and trade associations which could possibly contribute to the study process. Based on the information obtained the Commission decided to use a combination of the methodologies employed by various tax study groups throughout the country.

Since any constructive suggestions for change must necessarily be based upon a thorough understanding and measurement of the effects of the existing tax structure, it was early resolved to

employ a tax economist from a geographical and economic climate dissimilar to that of North Carolina to make a thorough study in an attempt to measure the economic impact of state and local taxes on various types of industry in North Carolina as compared with the impact of state and local taxes on industry in the other Southeastern States.

The members of the Commission divided themselves into study groups and made an intensive and extensive study of the existing tax schedules. In accomplishing this study the personnel of the Department of Tax Research augmented by the services of a Certified Public Accountant and temporary clerical employees were relied on heavily. The Department of Revenue was called upon to work with the Sales Tax Committee in rewriting the Sales and Use Tax Laws and was called upon to submit recommendations for changes in the General Fund tax schedules. The Institute of Government was commissioned to make a detailed study of License Taxes.

Appeals were made through the newspapers, personal contacts and public speeches for all interested persons, businesses, corporations, professional groups and trade associations to participate in the study by the presentation of written briefs and oral discussions setting forth recommendations for changes, the reasons therefor and effect thereof. The Commission was gratified at the response. Individuals, businesses, industries, promotional, protective and service associations, professional associations and state agencies provided many briefs, surveys and studies of high quality.

In addition to studying all of the recommendations submitted to the Commission thorough study was made of many surveys, analyses, and studies prepared for the Commission by its own staff and that of the Department of Tax Research. Each Commission member engaged in independent investigation and study to further his knowledge and understanding of the General Fund tax schedules.

STANDARDS AND CRITERIA

From the beginning the Commission adopted certain general principles. These were applied to each problem studied. Thus, a uniform objective was attained through continuity in the application of criteria and standards which met theoretical as well as practical tests.

It was recognized that the level of state and local governmental services should at least be maintained on the present basis of quality and quantity. Thus, it was obvious at the outset that no drastic reduction in the total amount of tax collections would be feasible at this time, but that a total net cost of recommendations for changes would be practicable if the percentage reduction were relatively small and revenue receipts, in the meantime, should not begin to decline.

It was deemed desirable to delete obsolete provisions in the tax statutes and to incorporate existing administrative practices in the law; to introduce clarity and conciseness where possible; to render the statutes more workable in that they could be more easily administered and compliance would be more facile; to eliminate gross inequities wherein there exists unreasonable discrimination between taxpayers in relatively the same situation or discrimination as to the tax liability of competitors in the same line of business with relatively the same investment and profitability; to adopt changes recognizing modern accounting and business practices which would have no serious detrimental effect upon the revenues; to provide more complete and more easily accessible administrative and appeal provisions favorable to the taxpayer which will not jeopardize the State's position; to introduce as much uniformity and consistency as is possible without creating distortions in the tax base; to equalize the tax burden between taxpayers in the same industry without materially increasing the total tax bill of the particular classifications affected; and, to adopt those federal income tax provisions or principles which will provide more uniformity of treatment, reflect better business practices and result in a more desirable and equitable set of tax laws.

At all times the Commission kept in mind the primary standard set forth in Resolution No. 49 that ". . . the tax structure of the State of North Carolina should . . . (meet) the test of stability and equity, and (give) proper economic incentive to the greater productivity of the citizens and business enterprises . . . with a steady and adequate provision of revenue for the sound and

essential purposes of government." A primary criterion being employed throughout the study was that such changes should be made in the revenue structure which will produce a total tax impact that will not, when compared with the tax burden in the other Southeastern States, provide a roadblock to economic expansion. A moderate state and local tax burden provides more freedom for growth for industrial and business concerns which face the necessity of nurturing a dynamic urge to expand or relocate.

ECONOMIC SITUATION—AGRICULTURE, BUSINESS AND INDUSTRY

Since any survey and analysis of the existing tax structure would be meaningless without an understanding of the present economic condition of the State, the characteristics of the components of the economy and the nature of its potentials, the Commission utilized the benefit of the training, experience and studies of the faculty of the University of North Carolina at Chapel Hill and at State College in the fields of economics and sociology in order to make maximum practicable application of the available knowledge to the problem of evaluating the tax structure. Conferences were held on both campuses and studies furnished by the participating personnel were studied in great detail by the members of the Commission. In addition to studying the economic characteristics of the State, the Commission made an extensive survey of the extent to which the various types of businesses and industries, as well as individuals, contributed to the State's General Fund. The findings and conclusions of the study of the impact of state and local taxes on industry were evaluated against the economic potential of the State.

Among the facts found were the following pertinent ones which have been publicized by the press: Per capita income is quite low; a large portion of existing jobs require relatively low skills; many individual proprietorships, businesses, industries, farms and other economic institutions are faced with high costs and unsatisfactory profit margins; there is large net emigration of residents to other states which persons have been educated at the expense of this State; the number of farm units is high and the average size is small; there are large numbers of marginal farm units; there is a large rural population subsisting on such relatively poor economic units that twenty per cent of the farmers are supplementing their income by off-the-farm employment for more than one hundred days per year; many farmers need additional opportunities to supplement their incomes and many need full time employment in other occupations; and the distribution of the total North Carolina population is such that there is a relatively high percentage of school age population, which places great pressure on the General Fund expenditures for public schools, in relation to the proportion of the population in the age groups from which General Fund Revenue receipts may be normally anticipated.

Of course, the Commission found economic facts of which everyone is justly proud. For instances, North Carolina is a leading state in the growth of flue cured tobacco and in the manufacture of cigarettes, it is foremost in the manufacture of wood furniture, it is a leading producer of hosiery, it is outstanding in most facets of the textile industry and, above all, it is the home of a multitude of people who are eager for job opportunities to provide employment and a chance to upgrade their skills. Experience has proven the labor force to be adaptable to ready training and productivity records have been excellent.

It was found that our pride has lulled us into complacency, however, and the State has reached a point in its economic history where it must take stock of its economic potential or seriously impair its possibility for obtaining a larger share of the nation's income. In fact, the State's economy may easily become stagnant or regress from its present position. It was found that some of the apparent increase in the economic progress of North Carolina is due to the gradual inflation that has taken place in the nation with the amount of dollar increase in North Carolina being smaller than the dollar increase in the nation as a whole. In other words some of our so-called economic improvement may be illusory. Of course, there has been steady long range improvement in this State and in the nation which has been principally due to a gradual increase in productivity. The real increase in productivity has not been sufficient to generate the economic activities necessary properly to sustain the buying power of the citizenry of this State at a desirable level, nor

has it been sufficient to provide the future base for producing the amount of General Fund Revenues which can reasonably be expected to be necessary to finance the basic functions of State government at the level of quality apparently desired.

North Carolina was a leader in the early industrialization movement in the South. It has been one of the first twelve industrial states in the nation for several decades. Its industrialization was built around the processing of locally produced agricultural products. These manufacturing enterprises and agricultural pursuits stimulated the development of the services, trades and professions. There is evidence that the generative effect of industrialization has not kept pace with the increase in our population. Conditions necessitating reduced acreage allotments of the principal cash farm crop, tobacco, have placed a ceiling on the agricultural segment. Over 200,000 North Carolinians have indicated their availability for employment were the opportunity available. There are many persons engaged in agriculture, business and industry whose productive potential is only partially utilized in productive pursuits either because of the highly seasonal nature of their endeavors or because of the lack of proper job opportunities. The rate of industrial growth has fallen behind the rate of growth in the other Southeastern States and behind the rate of growth in the nation as a whole.

The need for further industrialization is widely accepted, but, whether or not one desires the immigration of industry and the local development of industry, further growth in the industrial segment of our economy is an absolute necessity because in the process of economic evolution the development of industry precedes and stimulates the secondary development in the service, trade and professional sectors. The economic stimulus provided by industrial payrolls and the purchasing power of the business itself rapidly affects the marketing and distribution businesses. Our business, civic, and political leaders face a challenge to encourage proper industrialization. The additional investment of capital within our borders would provide job opportunities for the peoples and this in turn would result in the creation of a healthier economic base. Unless our human resources are used to a far greater extent we cannot hope to lift ourselves solely by a tug on our economic boot straps.

THE PROBLEM OF THE IMPACT OF STATE AND LOCAL TAXES ON INDUSTRY

It is an incontrovertible fact that state and local taxes are cost factors which are carefully considered by business and industry when it is contemplating expanding or locating at any given place. The effect of state and local taxes as a locational factor is a highly controversial subject. Undoubtedly there are many who overemphasize the effect and, on the other hand, it appears that theoretical investigations on the subject have many times underemphasized the effect, apparently because it is a factor which cannot be measured with statistical preciseness. It has always been known that North Carolina has relatively high income and franchise taxes on corporations. The state has maintained the position that because of the fact that a larger portion of state and local governmental functions have been financed at the state level than is true in any comparable state of the union that local property taxes were consequently at such a reasonably low level that the total tax burden was not too high in comparison with neighboring states.

In order that the Commission be in a position to evaluate the effect of our tax structure on business and industry a tax economist from an entirely different section of the country was employed on a contract basis to undertake the project of measuring the impact of state and local taxes in North Carolina on industry as compared with such impact in the other Southeastern States. The facilities of the Commission were made available to him for this purpose to the extent that time and money permitted.

The Commission has utilized the materials in that study which was made in an atmosphere of absolute academic and intellectual freedom. The study was made at a fraction of the cost that would have been entailed had the project been undertaken on a more extensive and intensive basis with a large staff employed over a period of several years. It is the opinion of the Commission that the "impact study", which is being published without editing on the part of the Commission, furnishes an excellent research tool but that, as in any theoretical survey of such magnitude,

there are findings and conclusions which the Commission does not deem entirely supported by the facts presented. As is true of any such survey the evidence discovered and presented therein is highly useable to the trained tax technician and of great benefit to those statesmen and political leaders who are familiar with the history of the present provisions of the tax laws of the state and local government and the practical effect of these provisions; however, in the hands of unscrupulous promoters from other states engaged in the mad scramble for industrial development some of the evidence may be taken out of context and possibly used to the detriment of North Carolina in its attempts to acquaint industrial leaders of the advantages of locating in our State.

In evaluating the effect of North Carolina's state and local taxes on the growth potential of business and industry which is at present an integral part of our business community and on those dynamic growth concerns which would be welcomed additions, the Commission obtained the services and co-operation of the North Carolina Association of Certified Public Accountants, the North Carolina Department of Conservation and Development, The Chambers of Commerce, the North Carolina Department of Tax Research, the Tax Review Board, and North Carolina businesses and industry, including those businesses indigenous to the State on a historical basis, those which have recently located here, and those which may be classed as potential immigrants to North Carolina.

EFFECT OF NORTH CAROLINA STATE AND LOCAL TAXES ON AGRICULTURE

The similarity of the economic plight of indigenous industry and the agricultural economy out of which it grew has been pointed out above. More job opportunities for members of the rural family are needed so that the farm income of the family unit may be better supplemented. In the farming business there is real need to attract capital investment to reduce the labor input and increase the income of the farmers. There is real need for a mutual understanding between agriculture, business and industry. The cost-price squeeze in North Carolina agriculture and in North Carolina industry is serious. The continuous acreage cuts in cash crops increases the need for further industrialization. There is an ever-increasing need for better utilization of land and labor through diversification and further additions of capital in the farming sector of our economy.

A survey of the impact of taxes on agriculture indicates that taxation is not hampering the further agricultural development of the State and reveals that the only sizeable impact rests on those relatively few farmers who have sufficient net income to subject them to the higher rates of income tax. The real problem is to improve our economy to the extent that farmers and all North Carolinians will enjoy a larger share of the nation's income. The changes recommended herein should aid farmers by removing deterrents to the expansion of processing plants in the State and thereby encourage the creation of greater outlets for farm products.

FINDINGS AND RECOMMENDATIONS AS TO TAXES ON BUSINESS

Based upon the wealth of materials studied by the Commission and the volume of evidence presented to the Commission, it was found that the impact of state and local taxes in many desirable locations in North Carolina is greater on many types of industries and businesses than is the impact of state and local taxes in many locations in the other Southeastern States. In other words, it is not always true that the total tax package in North Carolina is as reasonable as that of the other Southeastern States. We find that concerns with large capital investments here which have a reasonably satisfactory profit margin pay quite a high tax bill. The corporate executives making plant location decisions may well find the present North Carolina tax situation a considerable deterrent. It has proved to be a considerable problem to some concerns which have recently located here. In the language of several recent additions to our industrial family they have decided on North Carolina "despite the comparatively unfavorable tax bill."

The two major reasons for this comparative unfavorable tax burden are to be found within the state income tax and the local property tax. Whereas, there are many desirable available plant sites within North Carolina in locations where the property tax bill would be quite low in comparison with sites in other Southeastern States, there are many existing plants within cities, (and within certain counties wherein there is a large and healthy growth now taking place), which

levy a much higher tax than many such locations in other Southeastern States. Aside from the question of tax exemptions granted in some other states, the ratio of assessed value to fair market value of industrial type property in many locations in other Southeastern States is extremely low and this has a marked effect upon the impact of taxation upon industries in such locations. We can no longer truly say that the total tax package always compares favorably with the other Southeastern States. The sizeable impact of the state income tax is due to the high rate compared with the rate of other states, the fact that North Carolina does not permit the deduction of Federal income taxes (as is permitted in three Southeastern States), and the fact that North Carolina has a very harsh, out-moded, inequitable method by which it ascertains the amount of income allocable as earned in North Carolina by concerns whose total income is derived in other states as well as in North Carolina.

In short, there is clear discrimination against the profitable concern engaged in manufacturing in North Carolina. There is also discrimination against the concern using a North Carolina location for regional marketing and distribution purposes. This discrimination against concerns whose price is determined in the national and world markets, as distinguished from purely local markets, has a material potential effect on the economic possibilities of this State. It is this type of operation that either has high mobility or must at all times consider the possibility of minimization of costs through relocation. There is also serious inequity between existing competing firms in the same type business which is brought about by the allocation formula currently used in the income tax statute. This is not solely a "foreign" versus "domestic" problem. Regardless of whether a concern in North Carolina obtains its charter in North Carolina and thus, is a domestic concern or obtains a charter from another state and is thus a foreign corporation, it may or may not be a concern doing strictly and solely North Carolina business. A domestic company carrying on business operations in other states faces serious inequities in its income tax bill. The so-called foreign concern which carries on business operations in North Carolina faces serious inequities because of our allocation formula. Thus, the net result is that regardless of label we find serious inequities between domestic corporations, between foreign concerns, and between domestic and foreign concerns. In regard to foreign concerns the North Carolina statute clearly takes an approach which says in effect that this State shall to the full extent permitted by the Federal Constitution attribute to North Carolina all of the income of the concern, regardless of where the income was earned. In regard to domestic concerns deduction is permitted only for net income that is taxed in another state so that the North Carolina tax bill is maximized. This also means domestic companies pay this State tax on income earned in a state that has no income tax. This has been the historical approach since the income tax law was enacted in 1921 in this State. Apparently the statute has been amended only when it appeared that the provisions would not stand up under attack in the Courts.

Leaving aside the question as to the corporate rate and the question as to how much total revenues should be obtained from corporations under the income tax, there is urgent need for the adoption of a more equitable basis for the determination of approximately the real amount of earnings that is reasonably attributable to North Carolina for those corporations which are doing business both in North Carolina and other states. The least that North Carolina can do in this respect is to clean up this area of inequity, recognize the business facts of life, sanction modern business methods and thereby make the income tax less onerous to the interstate corporation.

This move is long overdue and should not be postponed further. Most of the states which are more highly industrialized than North Carolina have no tax measured by net income or have an income tax which carries a considerably lower impact on corporations: Without exception those which have a tax measured by net income all use allocation factors which more closely approximate the measure of the true income earned in the states involved. The unrealistic method of apportioning income places North Carolina at a very serious competitive disadvantage. No formula is perfect and all must of necessity be somewhat arbitrary but tax men of all varities, academic, governmental, industrial and professional tax practicioners feel that the basic requirements are not met unless property, payrolls and sales are recognized as major profit generative activities of merchandizing and manufacturing concerns. North Carolina does not provide for the

basic three factor formula business has properly grown to expect. This formula is considered to be more equitable for small, medium and large interstate concerns.

The system of *license taxation* is a hodge podge method of extracting relatively small total amounts of revenue through a very inequitable and irritating hierarchy of levies by three different governmental units, the various levies being on a multitude of various bases in many instances having no relationship to the amount of business done. The total of all licenses levied on a particular business by all levels of government in some instances constitutes a considerable impact. The Commission studied the total impact of the license tax system to obtain a proper perspective for evaluation and analysis. Most businesses affected by these levies are relatively small concerns normally operated by individuals.

There are inequities between competitors in the same categories of businesses, between different types of businesses, and there are inequities because of the locations of businesses. Stated conversely, the Commission has been unable to find any equity in the present license tax situation. The Commission recommends that the present Schedule B license tax structure be superceded by an occupational license levy which for the most part is based on business volume with reasonable rates applied to each category and with the rates for different categories fixed to reflect broad differences in gross profit margins. The proposal adopts a broader base, a more reasonable rate structure, and a more easily understood tax which can be more economically and fairly administered.

The Commission feels that the State should plan to eventually abandon the license tax or privilege tax approach. Until repeal is possible from the revenue standpoint, however, it is highly desirable to clean up this area of taxation by more clearly and equitably defining the businessman's license tax obligation, by removing the overlapping taxing authority of the different levels of government and by setting a ceiling on the licensing authority of local governmental units. The overwhelming inequities in the present license tax system dictates a change. Under the proposal each business endeavor will be liable to pay a tax for the privilege of engaging in economic activity in North Carolina regardless of whether it is profitable or not. It is similar to a franchise tax which is now levied on corporations, however, the franchise tax is over and above this occupational levy which is proposed in that the franchise tax is levied on the priviledge of doing business in the State in the corporate form. In general, business of a strictly local character will be taxed locally and highly mobile businesses will be taxed on a uniform state-wide basis by the State only. This should encourage the creation of such businesses and discourage intercity competition for them on the basis of taxation.

Under the *individual income tax* law the Commission finds a discrimination against the proprietary type business which it recommends be eliminated. Individuals are granted the privilege of using a standard deduction equal to 10% of gross income up to a maximum of $500 in lieu of itemizing their deductions, if the source of their income is solely derived from salaries, commissions, dividends and interest. There is no concept of adjusted gross income as such in the present individual income tax. The result is that large numbers of small business people are denied the use of the standard deduction. We recommend that a standard deduction of 10% of adjusted gross income with a maximum of $500 be granted all individual income taxpayers at their option in lieu of personal exemptions.

Certain utilities which are regulated by Federal agencies are required to pay income tax on a so-called net income which is higher than their real net income and higher than the net income on which other businesses and other utilities are required to pay. The principal reason is that they are denied the privilege of deducting certain business expenses such as interest. There is no justification for the retention of this arbitrary provision. It is, therefore, recommended this provision of the income tax statute be repealed.

FINDINGS AND RECOMMENDATIONS AS TO THE TAXATION OF CERTAIN FINANCIAL INSTITUTIONS

Savings and Loan Associations:

In its study of the license tax provisions the Commission decided that the levy on savings and loan associations has no place in the license tax schedule. As is the case under the principles of taxation of banks, and is the case of taxation of insurance companies, savings and loan associations are taxed in a special manner in lieu of other taxes because of the dissimilarity between each of these financial institutions and between them and other types of businesses. Since it has no logical place in the license tax schedule, it is believed that savings and loan associations should be taxed under a separate schedule.

The current levy is 13¢ per $100 of the value of the shares, which is a fixed levy on the amount of capital on an ad valorem basis that does not fluctuate with profitability of the concerns over a period of years. The levy is a flat levy in the nature of a franchise tax which in those periods of least profitability extracts a tax which can have a heavy impact on the concern. The Commission is of the opinion that a special statute should be drawn to combine the philosophies of both a flat franchise tax for the privilege of engaging in business in North Carolina and a specially designed tax on income keyed to the profitability of the business.

To accomplish this the Commission recommends that the value of the shares be taxed at 6¢ per $100 and that in addition thereto savings and loan associations pay a tax on real net income, after the payment of interest on shares, at the rate of 6%. These rates are designed to produce from savings and loan associations as a group the same amount of tax revenues that would have been realized in the next biennium under the existing schedule. The effect on the tax bill of individual concerns will vary somewhat from their present experience. The benefit to the savings and loan associations will arise in any situation where the ratio of net profits to book value of shares declines. The impact of the tax would at that time be less severe than under the present levy. Should the converse be true and savings and loan operations become relatively more profitable it would be reflected in greater revenue receipts and be paid at a time when the industry could best afford the tax bill.

Banks:

In studying the taxation of state and national banks under the North Carolina tax laws the Commission found banks to be taxed under an archaic and cumbersome share tax system. Stated in an oversimplified fashion, the State Board of Assessments certifies to local property tax jurisdictions the value of the shares of the capital stock of the banks after deducting certain investments from the surplus accounts. Against this valuation of this class of intangible property the several local governmental units each levy a tax at the general property tax rate of the unit. It also found that state banks are subjected to the corporate net income tax but that national banks do not pay the income tax, or any tax directly to the state government. At the time the share tax was first employed, prior to 1921 when the income tax was adopted, it was the only method by which national banks could be taxed under the laws of Congress which prescribe the allowable methods.

The Congress thirty years ago enacted a provision permitting the taxation of national banks under a franchise tax measured by total net income. During this time the postponement of a re-examination of the methods by which banks are taxed has permitted the evolution of a situation of inequitable distribution of the total tax bill of banks between various types of banks. National banks are favored over state banks. Larger state banks are generally favored over smaller state banks. State banks engaged in commercial type operations are favored over state banks engaged in industrial type operations. State banks in different geographical locations pay different taxes because of widely varying property tax rates. Due to the fact that under the North Carolina income tax income from Federal government obligations is not included as taxable income, state banks which act only as depositories receiving the people's deposits, investing the money in government bonds and declining to make loans to any appreciable extent to local businesses and

individuals are favored over the banks that try to fulfill their obligation as a part of the modern business community. Because of the peculiar manner prescribed for ascertaining the tax base of the present share tax state banks with small capital stock accounts are encouraged to increase surplus rather than capital stock creating a disproportionate net worth structure in order to avoid an increased share tax liability. In short, from the viewpoint of the impact of state and local taxes on various types of banking institutions the Commission could find no equity in the present method of measuring tax liability.

The Commission recommends that this situation be alleviated by equalizing the present total tax bill of the state banking institutions by the use of a 4½% excise or franchise tax measured by net income including interest from Federal obligations and other governmental obligations except North Carolina state and local bonds; that the share tax be repealed; and, as is prescribed by Congress under this method of taxing national banks, that banks be exempt from local personal property taxation and that the dividends paid by the banks be deductible from the individual's gross income under the income tax.

This will result in the payment by both national and state banks of an equitable tax to the State Government and will equalize the tax burden between all types of banks. The tax will be in lieu of all other state and local taxes except real estate taxes. The rate was set at 4½% for two reasons. First, it is the rate which will produce relatively the same total tax bill from state banks; and second, it is a rate which, when considered in light of the 6% corporate rate under the income tax, recognizes the lower return from government bonds and recognizes the fact that other corporations and individuals may deduct some of these interest receipts from income under the income tax.

Installment Paper Dealers:

Late in the study process it was called to the attention of the Commission that the ⅓ of 1% levy on installment paper secured by personal property in North Carolina is a levy producing a discriminatory impact on installment paper dealers. Undoubtedly there are other discriminatory situations which were not discovered. The Commission has used an equalization approach but has not recommended the elimination of any tax. It is doubtful that the discriminatory nature of the levy escaped the attention of the 1929 General Assembly which first enacted the tax at a rate of ¼ of 1%.

Since the original levy was enacted banks have entered the field. They are exempted because The Congress does not permit such a levy on national banks. (It would be inequitable to place the levy on state banks only.) In addition to this development, installment paper as a method of consumer financing has now taken a primary place in our system of credit. These changes and the increase in rate enacted in 1939 have increased the impact of the levy.

The General Assembly is urged to consider the advisability of either reducing the rate or repealing the levy although the Commission is not preparing a bill to that effect.

FINDINGS AND RECOMMENDATIONS AS TO THE SALES TAX

The Commission made a detailed study of the present Sales and Use Tax laws which also contain the wholesale sales tax law, the building materials tax law, and a tax on the rental of rooms to transients. It studied the history and the development of the sales tax in this State and made detailed analyses of the provisions of the sales tax laws of the other states. North Carolina had no adequate criterion in drafting its original law because it was a pioneer in the sales tax field. There has been piecemeal amendment of the law by succeeding sessions of the legislature. It has been reinterpreted by successive members of the Attorney General's staff and enforced by several different tax administrators without any recodification on a comprehensive basis. Thus, the most urgent requirement in this area was that these laws be completely rewritten into one well organized, clear, and concise statute which would be consistent in the levy of a retail sales and/or use tax against the consumer, as distinguished from the manufacturer and wholesaler as such, together with the adoption of a complete set of simple rules and regulations to be used in the enforcement of the rewritten statute, to the end that the tax administrator would have a better administrative tool with which to work and so that the businessman would have a statute supple-

mented by rules which would more clearly define his tax liability thus protecting the interests of both the State and the taxpayer. Definitions have been made more complete and clearer, the tax obligation more definitely outlined and existing exemptions clearly specified.

Although one of the primary objectives was to hold material changes in tax liability to a minimum the Commission has recommended a few changes in tax liability which were necessitated by the desire to maintain a reasonable degree of consistency throughout the statute. These changes are outlined in Part II of this report.

Inasmuch as the interwoven wholesale sales tax detracted from the clarity of the retail sales portion of the statute, and since only one other state has this peculiar combination, the Commission recommends that the wholesale sales tax be repealed and that wholesalers be placed under the General Occupational tax which the Commission recommends be enacted in lieu of the present hodge podge Schedule B license taxes.

FINDINGS AND RECOMMENDATIONS AS TO THE TAXATION OF INTANGIBLE PROPERTIES

Aside from considerations of equity or fiscal policy it was found that this subject is probably the area of the greatest misunderstanding in the tax structure. The question of the proper taxation of intangibles has been a live one in North Carolina at least since 1868. Different classes of intangible personal property have been treated in numerous ways including taxation along with realty and tangible personalty at the regular property tax rates. The classification amendment to the Constitution in 1936 and the classified preferential rate structure first enacted by the 1937 General Assembly was a move to equalize the burden between owners of intangibles, provide adequate administrative machinery for collecting the tax and to protect intangibles from the general property tax levies. As more of the wealth of the nation and the State has become represented by the intangibles class of property, demands for either further protection or exemption have become intensified.

Intangibles and the income therefrom are probably treated in more different ways for taxation than is true of any other class of property or income. On the one hand, such property is exempt in some states and at the other extreme it is subject to the general property levy in others. There are transfer taxes and recording fees imposed in some jurisdictions. Another approach is to subject the income from such property to a special surtax. The level of government imposing the tax varies. The present North Carolina approach of classification is often used by other jurisdictions.

The present system and the various alternatives were carefully studied. Since the field of property taxation is significantly guided and controlled by constitutional provisions it is necessary to evaluate the alternatives available in light of probable constitutionality. The General Assembly is not granted authority to exempt intangibles from the property tax. It may place intangibles under the local general property tax. But the General Assembly may not authorize local taxing authorities, in their discretion, to exempt intangible personal property from taxation. The authority granted is that of classification, the power to exempt is specific and not general and uniform property taxation within classes is required.

In addition to the legal problems involved in the consideration of any recommendation as to exemption or local option there is a serious question as to the equity of advising that such a broad class of property be allowed to escape the property tax. Such property, especially bank deposits, is highly mobile and could be placed outside the State. The temptation for removal of large deposits has been minimized by a statutory provision permitting corporations to offset intangibles taxes paid on bank deposits against the tax due under the Franchise Tax. This protection of deposits in North Carolina banks means an annual franchise tax reduction of over $400,000.

Since the problem has been presented to the Commission as such a pressing and important one, we recommend that the General Assembly consider whether it be advisable to offer to the people a Constitutional amendment to exempt all or certain classes of intangibles from property taxation so that the will of the people be known on this question.

There was considerable variety in the opinions of the members of the Commission as to the proper theoretical or practical manner of treating the various classes of intangible personal property for tax purposes. The Commission believes, however, that collections from intangibles taxes should be entirely local revenues since the State government itself levies no general property tax and since the tax is in lieu of local general property levies against these classes of property. It is, therefore, recommended that the State continue to collect the tax because of the impracticability of local administration but that one hundred per cent of the net collections be distributed to local units instead of the present eighty per cent. Additional minor changes for the convenience of the taxpayers have been recommended.

FISCAL CONSIDERATIONS

Although this is not a fiscal affairs commission as such, fiscal considerations other than expenditure recommendations were a necessary facet of the evaluation of the tax structure. The Commission was directed to study the adequacy and stability of the revenue structure. The continuation of the present level and quality of services was assumed but normal increases in the population were taken into consideration. Current maintenance appropriations exceeded current net receipts immediately prior to the tax changes made by the 1955 General Assembly. Those changes and increased economic activities have alleviated this condition.

If the level of expenditures does not become materially accelerated, the present tax laws should, over a reasonable period, produce adequate revenues. *But* this conclusion is seriously jeopardized in light of the Commission's findings concerning the possible impact of tax inequities pointed out herein which may seriously curtail the normal economic growth of the State which is necessary to produce these revenues. Expansion of the business of interstate concerns within our borders cannot be expected to continue in the face of existing inequities. Most concerns have a corporate conscience and a desire to share a just and fair tax load, but they cannot indefinitely live with both a high and a hostile effective rate of tax. There is not only a very real danger of the State being unable to maintain the status quo, but there is danger of a cumulative effect of the present unfavorable tax climate. If the State fails to maintain its relative position as an industrial State in the nation and among the Southeastern States, and there is evidence that it is failing to maintain the pace of recent years, it will be faced with the decision to either reduce services or increase taxes. Whichever road is chosen, the State would become less desirable as a place for plant location and the situation would continue to deteriorate. This regressivity could be quickly generated and the pace of decline become accelerated if corrective action is not taken.

To insure stability and adequacy the Commission considers it necessary to make the adjustments herein recommended.

Centralization of governmental expenditures at the State level to a greater extent than is the case in other states was necessitated by the same economic considerations that produced the variety of tax levies imposed to finance these functions. This variety has produced charges that the multiplicity of levies is vexatious and irritating. The Commission has found no solution to the problem of the general irritating nature of taxation. Fewer taxes at higher rates appears to be an unattractive alternative. This would produce a greater economic impact. The levy of a variety of taxes on several tax bases using different tax theories lessens the temptation for evasion, and the resultant distribution of the tax load is thought to be less economically painful.

The Commission studied the taxes in other Southeastern States which are used to finance the functions comprising what North Carolina terms General Fund functions. The distribution of the tax load between various types of taxes and between different types of taxpayers was carefully studied. Where inequities have rendered North Carolina noncompetitive the Commission has recommended herein curative measures. The presence of variety in tax levies is a characteristic commonly found in the structures of our sister states.

The franchise and license taxes provide a stable base for the structure and the income tax taps those who can better afford to pay. The sales taxes produces a monthly continuity of receipts. As North Carolina finances a large portion of total school costs at the state level, and as a large

portion of the population directly benefits from these expenditures, a sales tax complementing a progressive income tax seems desirable. Sales taxes also serve the purpose of making the taxpayer tax conscious (a useful function in our democratic society). Moreover, since 1933 when North Carolina adopted the sales tax on a narrow base in the pioneer stage of the evolution of such taxes, sales taxes have earned a major place in the tax systems of many states.

The Commission concludes that the equalization of tax burdens between competing taxpayers by eliminating certain inequities is more feasible than reducing the number of levies. If the Commission's recommendations are adopted the resultant structure will, on the whole, place the same relative emphasis on the types of levies now being made but with a more equitable distribution of the specific levies between taxpayers.

Should future expenditure patterns require new monies not produced by the changed structure recommended by this Commission, either because of increased quantity and quality of services or because of economic reverses, the State has open to it the possibility of increasing levies which are usually referred to as consumer taxes. Competing states levy much broader sales taxes with fewer exemptions and they employ excise taxes not now used by North Carolina. The choice of specific levies should be made in light of specific total needs and the relative economic impact of the various levies then considered politically and socially feasible.

Regardless of the reason for considering additional taxes in the future, it is apparent that one of the first possibilities appraised will be a broader use of the sales tax or the use of consumer excise taxes. The situation dictating this is a combination of factors. It is a field which has not been pre-empted by the Federal government and until that is done it is an area which remains open to the states. In comparison with other states in the Southeast the North Carolina inheritance and gift taxes are substantial; the effective rate of individual income tax is the highest; and the intangibles tax is not in a competitive position. These factors operate against raising these taxes on individuals. In regard to corporations: even after making the changes recommended herein, the Franchise Tax will still be higher than that in neighboring states and the effective income tax rate will be higher than other Southeastern States. Thus, if the changed structure proves inadequate, the sales and excise fields will be the logical areas of first consideration.

With or without an extension of the tax base in the area of consumer levies the tax structure produced by the adoption of the recommendations of this Commission should be considered as fair and equitable. In comparison with neighboring states our business taxes should not appear forbidding. These other states will probably face the necessity of increasing levies on business since they now rely more heavily on consumer taxes.

It is sincerely hoped that the Commission's recommendations may be adopted and the State General Fund budget balanced without the imposition of new levies. The recommendations were not made as tax cuts or as tax concessions as such, but the net effect of increases and decreases produced by the changes to effect equalization of the burden is an annual reduction of net receipts in the General Fund of $8,884,000. The revenue effect of each change is reported at the appropriate place in Part II of the report.

There are intergovernmental effects of the changes. Recommendations concerning the license tax, the intangibles tax and the bank share tax affect revenues now collected by local units or collected by the State and shared with local units.

Counties will benefit measurably from an increase of $650,000 per year, resulting from an increase of $950,000 in intangibles tax revenue offset by a $300,000 loss in bank share tax receipts. The power to levy an occupational license tax on retail businesses and some service activities outside cities should replace the license tax revenues now collected by counties.

Cities will benefit measurably from an increase of $378,000 per year, resulting from an increase of $650,000 in intangibles tax revenue offset by a $272,000 loss in bank share tax receipts. Furthermore the city occupational levy should replace present license tax revenues, and cities seeking new revenues will have a choice between an increase in the automobile license tax and a tax on occupations.

FISCAL PROBLEMS OF THE CITIES

In evaluating the total tax structure and its impact on business, especially in studying the license taxes levied by the State, counties and cities, it was necessary to study the fiscal problems of the cities. Part II of the report contains recommendations to alleviate certain state and city tax problems. The license tax study made by the Institute of Government for this Commission sets forth certain of the problems and factual findings in more detail. That report will be made available as a separate publication.

The impact of industry on the city and the impact of the city taxes on industry are both serious problems. Since much of the governmental functions financed by city taxes are services which industry needs or desires, the problem assumes attributes of a service pricing problem. It calls for mutual understanding of problems between the city and the industry. It is a two-way street. Much of our existing industry is within city limits and some of the plants are far from new. The Commission found that all North Carolina local taxes are not so low as to produce a total package when added to state taxes that is competitive.

Some types of industries need city locations but others do not. Whether the industry needs city locations or not it is attracted to areas near attractive towns. Proper urbanization and "suburbanization" is a necessary feature to attract plant personnel required to operate the plants and businesses. The development of regional marketing and distribution centers also hinges on the proper development of urban centers.

Since in certain cities property taxes are becoming relatively high and since certain cities feel cramped because the property assessment machinery is in the hands of the county, some flexibility in city tax levying authority seems desirable. City assessment at present is deemed undesirable. A continuation of certain licensing authority without a limit or ceiling also is deemed undesirable because the improper use of licensing authority can discourage the development of regional distribution businesses and mobile type service establishments.

Cities need flexibility and more variety of revenue sources to finance the desired urban development. On the other hand, the taxpayer needs some protection also. To effect these ends the Commission recommends that tax burdens under the license tax system be equalized by the enactment of an occupational tax based on business volume to replace Schedule B and that a ceiling be placed on the licensing authority of the cities. Under the proposal cities may tax the more immobile types of business and the state taxes the mobile type of local and regional concerns. It is also recommended that additional reasonable authority to license automobiles be granted since traffic control and pavement problems caused by them is one prime reason for increased city government costs. Since certain types of businesses and occupations have little or no property within the city but add to city government costs and derive their livelihood in the city, the Commission recommends limited authority to license their activities. These powers may aid cities which have a fringe development problem.

Of course, the granting of these limited powers does not mean they will or must be exercised. The checks and balances of government in our democracy are more direct and more immediately effective the smaller the taxing unit and the lower the level of government. It is also thought that the existance of these additional limited taxing powers should operate to slow down the possible generation of desires to request additional shares of state revenues as a first resort to solve local problems of finance.

FUTURE STUDY AND PLANNING

As our economy changes to use more economically the human and natural resources of North Carolina, our people should receive a larger share of the nation's income. In that event the Commission believes the sales tax receipts from the stimulated volume of business will greatly increase and the income tax receipts will rise because of higher incomes being taxed at our present reasonably progressive rates. As the development of our economy progresses, the structure should be re-examined in light of the people's demands for services and their attitudes towards various types of tax levies. It should also be continually compared with the structures of other states and the place of the Federal Government in the tax field.

The General Fund problems should be the subject of continuous study by appropriate state agencies. No short lived Study Commission can recognize or solve all problems. Tax problems have a manner of refusing to stay solved. Much of the Commission's attitudes as to its hopes for the General Fund of the future is reflected above. Adoption of the recommendations herein should help solve the immediate important problems.

In addition to the normal attention to Highway Fund and Agricultural Fund problems by state agencies, these areas should be subjected to timely special study as particular needs arise.

Periodic re-analysis should be made of each and all of these three major funds in light of legislative and executive program desires.

The property tax problems are always many. Some of them have been alluded to herein. The State long ago recognized the heavy hand of such a tax and virtually removed itself from the field and then adopted a broader state tax structure, (substantially the one studied by this Commission), and centralized state government to provide property tax relief. Since that time, local property taxes in general have had no great impact on agriculture. At the location of many available and highly desirable plant sites, however, and within certain cities, property taxes have reached a level which when combined with the impact of a bad allocation formula under the State Income Tax law, produces a comparatively excessive tax load. A change in the allocation formula should alleviate the total impact distortion for the present. When the need for a comprehensive property tax study arises, it should be made on an intensive and extensive basis with proper staff and proper financing.

Since agricultural production and the manufacture of agricultural raw materials into finished consumer products are of such primary importance to a large portion of North Carolina's population and industry, the General Assembly should consider the advisability of offering a Constitutional amendment to exempt products of the North Carolina soil from property taxes when such property is in the hands of the farmer who raised it or the manufacturer who bought it, or, as an alternative, tax it at a protective low classified property tax rate.

PART II

SPECIFIC RECOMMENDATIONS

BY

TOPIC AND SCHEDULE

INCOME TAX

The Commission has studied the provisions of the Income Tax Act with particular emphasis upon the discovery of inequities in the determination of the tax bases of competing taxpayers and the development of recommendations for the elimination of these inequities which will serve the best interests of both the State and the taxpayers. Often the term inequity is used in the discussion of tax problems from a self-serving viewpoint and it is believed that the definition of inequity is a controversial matter subject to biased application. An attempt has been made to avoid this pitfall. Recommendations for changes to remove inequities in the law are confined to those areas where the difference in treatment of similarly situated taxpayers, or of competing taxpayers, was clearly established to the satisfaction of all members of the Commission.

The provisions of the Income Tax Act were carefully analyzed and they were compared with the income tax laws of other states. In addition, the differences between the State and Federal statutes were fully investigated to ascertain the feasibility of greater uniformity and conformity of provisions. Throughout the investigation the Commission members were guided by the desire to simplify and clarify the provisions of the Income Tax Act wherever possible to the end that administration be facilitated and greater compliance be encouraged. Another objective sought was the achievement of conformity with modern accounting procedures reflecting current business practices. Conformity between the North Carolina tax laws and the Federal Internal Revenue Code is recommended in those instances where the principles of taxation in the two laws appear to be the same and where the objective of simplicity is served and both the interest of the taxpayer and the State are furthered.

The Commission had the benefit of many studies, surveys, recommendations and suggestions from taxpayers, taxpayers' associations and governmental agencies which were presented in the form of written letters and briefs as well as developed at public hearings. The Commission also utilized an extensive study of the impact of taxes on industry made by a tax economist on a contract basis, it studied a multitude of data, recommendations and surveys developed at the direction of the Commission by the Commission staff, by personnel of the Department of Tax Research and by the North Carolina Association of Certified Public Accountants. Thousands of taxpayers contributed information and suggestions which were requested of them.

In the area of taxation of concerns operating multi-state businesses the Commission endeavored to keep the comparative position of North Carolina in focus at all times with the objective of eliminating crass inequalities other than inequalities arising because of disparities in tax rate or disparities caused by other states by permitting the deduction of Federal income taxes. The function of these latter two items of rate and deduction is to determine the amount of money to be secured through taxation of corporations and is, therefore, thought to be within the policy making province of the legislature in its determination of the proper amount of revenues to be sought from this type of taxpayer. Disparities in the treatment of the interstate income of foreign and domestic corporations were thoroughly analyzed. The competitive position of corporations, both as between businesses operating within this state and between businesses operating within this state to those operating without this state, was painstakingly evaluated. The methods prescribed for the allocation and apportionment of income to a particular state together with alternative formulae and approaches to the problem were exhaustively investigated. The impact of the use of various methods of apportionment is a very vital and serious problem for interstate businesses because the price of their product is determined in the national and international marketplace so that exceptionally high local tax costs place them in an untenable competitive position.

The Commission found that the allocation methods used in North Carolina are archaic, harsh, inequitable, legalistic rather than businesslike and unduly discriminatory. There is recommended herein an apportionment method which more clearly and accurately ascertains the proper amount of income earned within this State through the use of allocation factors which recognize those corporate activities which are the principal factors generative of income, the data for which are readily ascertainable from existing corporate records. The solution suggested equalizes the tax burden between businesses doing a truly interstate business whether it be in incorporated or un-

incorporated form and whether the charter is a domestic or foreign one. The recommendation in this respect does not result in the subsidization of interstate business and is not a tax reduction program designed for foreign corporations as such. All studies made by and for the Commission and all recommendations made to the Commission in this respect support the solution to the allocation problem which is recommended.

The income tax law changes recommended constitute a program of equalization of tax burdens between taxpayers in similar situations. The adoption of these recommendations will accomplish a minimum of equalization and equity between individual taxpayers and between corporate taxpayers that is necessary in order to encourage the expansion of economic endeavor within our borders. The adoption of these changes will not result in a highly attractive income tax package lower than that of our sister states, but we believe that these changes will eliminate those inequities which produce a very definite negative reaction when individuals and businesses are considering location in or expansion in North Carolina. The net result of the adoption of these proposals will create a situation in which a prospective new industrial resident will not be forced to seriously consider location in another state purely because of the harsh machinations of the provisions of our income tax laws.

SPECIFIC RECOMMENDATIONS

Determination of Gross Income

A. IT IS RECOMMENDED *that the provisions dealing with recognition of gains and losses be amended to disallow recognition of gains or losses realized by a corporation from the sale of its own stock, including treasury stock.*

Present Provision. There is no specific provision in the present statute for treatment of gains or losses realized by a corporation from trading in its own stock, therefore, such gains or losses are treated as other security gains or losses if the transactions are at arms length. (Citation: G. S. 105-144)

Explanation. The Federal Code of 1954 excludes gains or losses from such transactions from the determination of net income. It is a generally accepted accounting principle that neither the sale of the original stock nor the resale of its own stock by a corporation results in a gain or loss but is rather an adjustment in the capital account.

This Commission is of the belief that such gains or losses should not be recognized for income tax purposes.

Effect upon Revenue. It is believed that the revenue effect of the enactment of this provision would be negligible. For particular taxpayers, however, it could result in either a tax increase or a tax reduction.

B. IT IS RECOMMENDED *that, for property acquired prior to January 1, 1921, the basis for the computation of gain or loss upon the sale or other disposition of such property be the value of the property on January 1, 1921, or the cost, whichever is higher, and that the basis for computing loss be the cost; if the property is sold at a price below the January 1, 1921, value, but above the cost, that no gain or loss be recognized; and that adjustments be made for any expenditures or losses chargeable to the capital account and for depreciation claimed.*

Present Provision. The present law provides that upon the sale or other disposition of property acquired prior to January 1, 1921, the gain or loss reportable for income tax purposes shall be determined from the cost, if known or determinable, and the fair market value of the property on January 1, 1921, if the cost is not known. (Citation: G. S. 105-144)

Explanation. This Commission feels that, as the Income Tax Act became effective on January 1, 1921, it is inequitable to levy an income tax on gains or to permit the deduction of losses accrued, but not realized, prior to the effective date of the income tax law. It is thought, however, that it would be unfair to recognize apparent gains when an actual loss is experienced or when

the actual gain is less than the apparent gain. Either situation could occur if the market value on January 1, 1921, were below the cost of the property. To prevent a taxpayer from being so discriminated against the proposed amendment uses the greater of the cost or value in determining gain or loss.

Effect upon Revenue. The net effect upon revenue of enactment of this provision is believed to be small. Some losses in revenue (and savings to taxpayers) could occur when property acquired prior to 1921 is sold.

C. IT IS RECOMMENDED *that the basis of property (in the hands of the transferee) received by a corporation in complete liquidation of another corporation, eighty per cent of the voting stock of which is owned by the corporation receiving the property, be the same as in the hands of the transferor, except that where the stock held by the parent corporation was purchased within a period of 12 months and the last such stock was acquired not more than 2 years prior to the adoption of the plan of liquidation the basis of the property received in such liquidation be the adjusted basis of such stock, and the provision be patterned after the Federal Code.*

Present Provision. The present statutes provide that the basis of property received by a corporation upon the complete liquidation of another corporation shall be the same as it would be in the hands of the transferor. It is the apparent administrative interpretation that this subsection applies only to transfers wherein no gain or loss is recognized at the time of the transfer which occurs when the corporation receiving the property owns at least eighty per cent of the voting stock of the corporation being liquidated. When the transferee of the property owns less than eighty per cent of the voting stock, the basis is the value used in determining gain or loss upon the transfer of the property of the taxpayer. (Citation: G. S. 105-145 (4) and G. S. 105-144)

Explanation. It is thought that wherever feasible the basis of property, both for determining gain or loss and for computing depreciation, should be the same for preparing State and Federal tax returns. Also administrative practices should be placed in the statutes where the General Assembly does not wish to change such practices.

The present basis of property received by a corporation from the liquidation of another corporation where the transferee owns eighty per cent of the voting stock of the liquidated corporation is the same as in the hands of the transferor. The only change embodied in the recommendation other than changes in wording and the placing of administrative practice into the statutes is to make the basis of property received the cost of of the stock owned of the liquidated corporation where the stock was purchased not more than two years prior to the adoption of the plan of liquidation.

Corporations frequently acquire the stock of another corporation solely to get the assets. It is often the case that the property has been depreciated far below its actual value. The added provision is to permit such corporation to use the cost of the stock as the basis as the cost is the purchase price of the assets in such cases.

This provision is also designed to prevent a corporation from buying the stock of a defunct corporation solely to acquire a "loss" for income tax purposes. This can develop when the book value of the property of such corporation greaty exceeds the actual value of the property. In such cases under the North Carolina law the basis would be the book value, then if the property were sold for actual value the receiving corporation would be able to claim a loss not actually realized.

Effect upon Revenue. The net effect of enactment of this provision would be small.

D. IT IS RECOMMENDED *that taxpayers making installment sales be permitted, at their option, to report the income from such sales in the same manner as under the Federal Code.*

(The Federal Code provides that taxpayers may, at their option, report the income from installment sales on the installment method. Under the installment method of reporting the income to be reported in any taxable year is that proportion of the payments received during the income year for installment sales which the total profit on such sales bears to the total contract price of such sales. The installment method of reporting is allowed for reporting the income from sales

on the installment plan of personal property regularly sold by the taxpayer, the reporting income (capital gains) realized on the sale of other property if the amount of payment during the year of the sale does not exceed thirty per cent of the sale price, and the reporting of casual sales if the sale price is in excess of $1,000 and the amount of payment during the year of the sale does not exceed thirty per cent of the sale price.)

Present Provision. The present law contains no provision for the handling of income from the sale of property on the installment plan. The current administrative practice is to follow the Federal Code and regulations. (Citation: G. S. 105-141)

Explanation. It is the belief of this Commission that a method of handling installment sales should be provided in the statutes to eliminate confusion on the part of taxpayers and to place the practice of the Administration on a firmer base. It appears that the Federal rule is a reasonable one which can be readily understood, and, in view of the general desire for conformity with the Federal Code wherever practicable, there seems to be no logical reason for adopting any other rule.

Stated simply, the Federal method permits a taxpayer, at his option, to spread the reporting of the profits from an installment sale over the period of collection of the installments.

Effect upon Revenue. None. The recommendation coincides with the present practice.

E. IT IS RECOMMENDED *that a provision, similar to the one in the Federal Code, be enacted whereby no gain will be recognized upon the sale of the principal residence of the taxpayer if a substantially similar residence is acquired within one year following or one year prior to such sale, except to the extent that the adjusted sale price of the old residence exceeds the cost of the new one, and that the adjusted basis of the new residence be reduced by the gain not recognized upon the sale of the old residence.*

Present Provision. Under the present law a gain realized upon the sale of the residence of the taxpayer is fully taxable. (Citation: G. S. 105-144)

Explanation. A residence to be occupied by the owner is not acquired as income producing property and, ordinarily, when an owner sells his residence and acquires a new one he is not entering into the transaction for profit. Frequently, such transactions are involuntary, being due to the owner moving to another city. It is considered to be unfair to penalize such persons who have been caught by the inflationary spiral of recent years and who must sell their homes at prices above cost and repurchase homes at the same inflated values.

Effect upon Revenue. It is estimated that the loss of revenue from the enactment of this provision would amount to approximately $105,000 during the 1957-58 fiscal year.

F. IT IS RECOMMENDED *that taxable income from annuities and from pensions be determined in the same manner as under the Federal Code.*

(Under the Federal Code that portion of the income from an annuity received during the income year is taxable which is in excess of that portion of the cost of the annuity determined by dividing the cost of the annuity by the expected life of the annuity under the contract, or, in the case of a lifetime annuity, by dividing the cost by the number of years of life expectancy of the taxpayer as shown on actuarial tables. Income from pension funds to which the employee has made a contribution is taxed as an annuity, except that where part of the cost of the contract is contributed by the employer and the amount contributed by the employee will be returned within three years all payments received are excluded from gross income until the employee has recovered his cost, thereafter all amounts received are fully taxable.)

Present Provision. Under the present statute a taxpayer receiving income from an annuity must include annually in his gross income for income tax purposes three per cent of the cost of the annuity, and a taxpayer receiving a pension to which said taxpayer has made a contribution must include in his gross income annually three per cent of the taxpayer's contribution to the pension fund until the entire contribution has been recovered as tax-free income, after which the entire amount of the pension income is taxable. (Citation: G. S. 105-141 (1) and G. S. 105-142 (5))

Explanation. It is proposed to follow the Federal practice and use an actuarial table to compute the expected life of the annuity or pension, and then to allow annually as tax-free income that portion of the income representing the relationship of the cost to the taxpayer of the annuity or pension to the expected return from the annuity or pension plan, with no adjustment to be made in the event the actual life of the taxpayer varies from the expected life.

The principal reason for recommending this change is to bring the North Carolina law into conformity with the Federal law in this respect and thereby reduce taxpayer confusion as to the meaning and working of the law.

Effect upon Revenue. The effect of the changes in the method of treatment of income from annuities and pensions recommended herein is believed to be small. Some taxpayers would pay more income taxes over the life of the pension or annuity and others would pay less.

G. IT IS RECOMMENDED *that Social Security benefits be excluded from the gross income of the recipient.*

Present Provision. Although there is no specific statutory reference to Social Security benefits, the established practice of the Revenue Department is to exclude such benefits from gross income. (Citation: G. S. 105-141 (2))

Explanation. It is the belief of this Commision that Social Security benefits should not be considered as taxable income and that a specific provision exempting such income should be enacted.

Effect upon Revenue. None.

H. IT IS RECOMMENDED *that the value of meals or lodging furnished to an employee be excluded from the gross income of the employee when furnished solely for the convenience of the employer.*

Present Provision. The present statute provides that ". . . salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, . . ." shall be included in gross income *except* the rental of any dwelling furnished to a minister of the Gospel. The present administrative practice is to include in gross income of an employee the value of subsistence furnished by his employer, regardless of the purpose for which furnished, unless specifically excluded by law. (Citation: G. S. 105-141, Subsections 1 and 2 (f))

Explanation. Employers object to the inclusion of the value of this type of subsistence in the wages or salary of an employee, and many are believed to be negligent in reporting it to the Revenue Department.

The Federal Internal Revenue Code of 1954 contains a provision similar to the one recommended herein, therefore, the desire for conformity with the Federal Code would be served by the enactment of such a provision.

Effect upon Revenue. The effect upon revenue would be negligible due to the apparent lack of compliance with the law as written.

I. IT IS RECOMMENDED *that the provisions which exempted the service pay of members of the Armed Forces from taxation during World War II and the Korean Crisis be deleted.*

Present Provision. The present statute excludes from gross income the service pay of members of the Armed Forces during the continuance of the second World War and the Korean conflict. (Citation: G. S. 105-141 (1) and G. S. 165-44)

Explanation. Both World War II and the Korean conflict have been declared ended, therefore, provisions relating to service pay received during these conflicts are no longer operative. It is thought that as the provision is obsolete the portion of G. S. 105-141 (1) which begins "Provided" and ends with "the armed forces" should be deleted.

Effect upon revenue. None.

J. IT IS RECOMMENDED *that provision be made to exclude from the gross income of an individual payments received under health and accident plans financed from profit sharing trusts.*

Present Provision. Payments received by employees under health and accident plans financed

from profit sharing trusts are taxable income to the employee. The payment to the trust by the employer is deductible to the employer. On the other hand, payments from insurance companies are excludable from the gross income of the recipient of the insurance and the premiums are deductible to the employer if paid by him. (Citation: G. S. 105-141 (2) (e); G. S. 105-147 (13); G. S. 105-147 (1))

Explanation. It is thought that the same treatment should be given to payments received from profit sharing trusts financed by the employer as is given to actual insurance payments where the premiums are paid by the employer. It is to accomplish this that the above recommendation is made.

Effect upon Revenue. It is believed that the loss of revenue from enactment of this provision would be small. Employees receiving benefits from such plans would receive tax relief.

K. IT IS RECOMMENDED *that amounts of premiums paid by an employer for group life, health, accident and/or hospitalization insurance for the benefit of employees be excluded from the gross income of the employee.*

Present Provision. The present statute contains no specific provision relative to the treatment of premiums paid by an employer for group insurance for the benefit of employees.

Under the present interpretation of the law amounts paid by the employer for such insurance are deductible by the employer as ordinary and necessary business expenses and the payments constitute a part of the gross income of the employee. (Citation: G. S. 105-147 (1) and G. S. 105-141)

Explanation. Although the law is interpreted to require employees to include in their gross income for income tax purposes any premiums paid by their employers for group insurance policies of which the employee is a beneficiary, there is very little compliance on the part of the taxpaying public. Under many such plans the premiums are computed for the group and the amount applicable to any one employee cannot be determined.

Due to the difficulties of enforcement it is believed that such amounts should be excluded from the gross income of the employees.

Effect upon Revenue. The loss of revenue from enactment of this provision would be negligible since there is probably no general compliance on the part of the taxpayer.

L. IT IS RECOMMENDED *that income accrued by a cash basis taxpayer prior to death but not received prior to death, and therefore, not properly includible in the tax return of the decedent be included in the gross income of the estate or the person having the right to receive the income. Collections on installment obligations to be reported by the estate or beneficiary on the installment basis if such were used by the decedent. The provision to follow the Federal Code.*

Present Provision. The present statute makes no provision for handling income accrued prior to death by a cash basis taxpayer but not received until after death. A return must be filed for the decedent, but only that income actually received prior to death is included as gross income. The income accrued prior to death is part of the estate at the time of death and as such is not taxable to the fiduciary. (Citation: G. S. 105-139 (b); G. S. 105-141 (2) (c))

Explanation. It is believed that an orderly manner of reporting such income should be provided in the statutes and, as conformity to the Federal Code is desirable wherever practicable, that the provisions of the Federal Code in this respect should be adopted.

Effect upon Revenue. Enactment of this provision would result in a small increase in revenue, by including in gross income amounts now excluded when a cash basis taxpayer accrues income prior to death but does not receive such income prior to death.

M. IT IS RECOMMENDED *that a provision be added to permit a beneficiary of a trust or an estate to exclude from his gross income any income becoming distributable during the taxable year which has been taxed as income of the estate or trust during any prior year.*

Present Provision. Under the present law a fiduciary must report and pay an income tax upon that part of the net income of estates or trusts in their charge ". . . which has not become distrib-

utable during the income year." The beneficiary of a trust or estate must include in his gross income the distributive share of the net income of the estate or trust received or becoming distributable during the income year. (Citation: G. S. 105-139 (a) and G. S. 105-142 (4))

Explanation. It is the belief of this Commission that the same income should not be taxed both the fiduciary and to the beneficiary.

Effect upon Revenue. It is believed that the revenue losses resulting from enactment of this provision would be negligible.

Determination of Net Income

A. DEDUCTIONS

1. IT IS RECOMMENDED *that the provision which limits the deduction of losses realized upon the sale of securities held for less than one year, or from trading in commodities, to gains of like kind be repealed; and that a "wash" sale provision similar to that contained in the Federal Code be enacted.*

(A "wash" sale provision denies the deduction of losses realized from the sale of stock or securities where stock or securities of "substantially identical" kind have been acquired within either 30 days prior to such sale or 30 days after such sale.)

Present Provision. The present law permits a taxpayer to deduct the losses realized from the sale of securities held for less than one year, or from commodity trading where no title to actual commodities passes, only to the extent of "gains from similar sources," all other losses are fully deductible. This provision has been interpreted by the Attorney General to limit "short-term" security losses to "short-term" security gains. (Citation: G. S. 105-147 (6) (c))

Explanation. The provision of the law (as interpreted) limiting the deduction of short-term security losses to short-term security gains arbitrarily classifies taxpayers trading in securities or commodities into "moral" traders who retain the securities for investment purposes by holding them for one year or more and "immoral" speculators who "gamble" in securities or commodities. It is not believed that the tax laws are the proper forum for determining questions of morality, and there is believed to be no satisfactory reason which can be advanced for denying the deduction of losses realized from trading in securities on a legitimate basis. Trading in "futures" serves a definite economic function and should not be penalized by tax statutes.

The "wash sale" provision is considered to be desirable to discourage taxpayers from "taking" losses for tax purposes; that is, by selling stock and then immediately repurchasing identical stock. The proposed statute would delay the recognition of the loss until a legitimate sale is made. The basis for determining the gain or loss upon the final sale would be the original purchase price. The "wash" transaction would be ignored for tax purposes.

Effect upon Revenue. An estimate of the overall loss of revenue from the adoption of this revision is not available at this time. During the 1955-56 fiscal year, however, state banks would have enjoyed a tax reduction of $37,000 and corporations other than banks would have benefited from a reduction of $6,000.

An estimate of the loss of revenue from allowing the deduction of short-term security losses without limit is of small value in fiscal planning, however, as the loss in revenue would vary inversely with the current economic trends, that is, increases in security losses would coincide with a general business decline, and vice versa.

2. IT IS RECOMMENDED *that provisions relative to the amortization of bond premiums, similar to the provisions in the Federal Code, be enacted by which taxpayers would be permitted to amortize premiums paid on taxable bonds on an elective basis and would be required to amortize premiums paid on tax-exempt bonds.*

(The Federal Code permits the amortization of the premiums paid on fully taxable bonds at the election of the taxpayer. The amortizable portion of the premium for the tax year is used as an

adjustment to the cost of the bonds in order that the basis (adjusted cost) of the bonds equal the face value of the bond upon maturity, and is also used as a deduction from gross income (a premium is considered to be a reduction of the interest income from the bond). In addition, the Federal law *requires* the amortization of the premiums paid on fully tax-exempt bonds. The amortizable portion of the premium on such bonds for the tax year is used as an adjustment of the cost of the bond with no deduction against gross income permitted as the interest income from the bonds against which the premium is an offset is excluded from gross income.)

Present Provision. No provision is made in the present statute for the amortization of premiums paid on bonds or other securities. When the bond is sold or retired the difference between the sale price and the original cost is to be reported as a gain or loss realized on the sale. The same treatment is given to fully taxable, partially taxable and exempt bonds. (Citation: G. S. 105-144)

Explanation. The principal purpose of enacting these provisions is to bring conformity with the Federal law and eliminate unnecessary confusion on the part of the taxpayer. In addition, it is a more orderly method of handling the premiums and will prevent taxpayers from deducting a "loss" on tax-exempt bonds upon the maturity or sale of such bonds to the extent of the amortizable premium paid. As was previously stated the premium is, in essence, an adjustment of the interest rate and should not be considered as a capital gain or loss if the bond is redeemed at its face value.

It should be noted, however, that in the event the Federal provisions are adopted the *same* bonds would not *necessarily* receive the same treatment on both Federal and State returns as the provisions determining the taxability of bond interest for income tax purposes are not the same in the Federal and State laws.

Effect upon Revenue. It is believed that the net effect upon revenue would be small. The elective feature relative to fully taxable bonds would permit the taxpayer to either take the entire deduction upon maturity or to spread it over the life of the bond. The recommended provisions for the tax-exempt bonds would result in a revenue gain because under present treatment such premiums are treated as capital losses upon the sale or redemption of such bonds.

3. IT IS RECOMMENDED *that taxpayers be permitted to carry forward "net economic losses" as defined in the present statute for five years succeeding the year of the loss.*

Present Provision. The present law permits "net economic losses" to be carried forward for two years succeeding the year of the loss. (Citation: G. S. 105-147 (6) (d))

Explanation. It is believed that the longer period is necessary to enable new and rapidly expanding businesses to benefit from the provision as, frequently, there is a period of several years before such businesses reach their "break even" point and begin earning a profit.

Effect upon Revenue. It is not believed that any appreciable loss of revenue would materialize immediately following enactment of the proposed change. This situation is similar to that of deduction of short-term security losses and the amount of revenue losses would vary inversely with general revenue trends.

4. IT IS RECOMMENDED *that the provision limiting the deduction of net economic losses in years subsequent to the year of the loss to that proportion of the loss determined by the ratio of net income allocable to this State be amended to provide that the net economic loss may be deducted in the proportion represented by the apportionment ratio for the year in which the loss was incurred.*

Present Provision. The present statute permits the deduction of economic losses sustained in either or both of the two preceding income years. For a taxpayer doing business in two or more states ". . . only such proportionate part of the net economic loss of a prior year or years shall be deductible from the income taxable in this State as would be determined by the ratio of net income allocable to this State as compared to all net income received both within and without this State."

The administrative practice is to use the ratio of the year of the loss in determining the amount of the loss which may be deducted. (Citation: G. S. 105-147 (6) (d) Third)

Explanation. The provision in the statutes does not specify which year should be used in determining the ratio to be used in apportioning the loss to North Carolina. It is believed that the statutes should specify which year should be used and the year of loss appears to be the most logical one to use for this purpose.

Effect upon Revenue. None.

5. IT IS RECOMMENDED *that (in the event of the adoption of the proposal for the separate allocation of dividend income) deductible dividends be separately allocated within or without North Carolina under the same rules as the dividend income.*

Present Provision. The law permits the deduction from gross income of the portion of dividend income which represents North Carolina income of the paying corporation. (Citation: G. S. 105-147 (5))

Explanation. It is proposed in the following sections that the dividend income of a corporation be excluded from apportionable income and be separately allocated according to the principal place of business of the corporation receiving the income. The deduction of "domestic" dividends should be treated in the same manner as the income from the dividends to prevent distortion, inequity, and unjustified deductions.

Effect upon Revenue. There would be no effect upon revenue from enactment of this provision. Should the recommendations relative to allocation of net income be enacted and this provision not be enacted a loss of revenue could result.

6. IT IS RECOMMENDED *that provision be made to permit the deduction by employers of payments made to the estate or to the beneficiaries of a deceased employee, paid by reason of the death of the employee, if the amount of the payment is reasonable and is related to the service of the employee and that Federal regulations and Tax Court decisions be used by the Commissioner of Revenue in determining the amounts which are reasonable in each case.*

IT IS FURTHER RECOMMENDED *that such income in the hands of the person receiving the payment be considered as income and be taxable as such, except that an aggregate amount of $5,000 of such income paid in respect to the death of any one employee be excludable from gross income. The provisions to be patterned after the Federal Code.*

Present Provision. The present law contains no reference to "employee death benefits." The amounts paid to the beneficiaries of an employee by reason of the death of the employee are considered to be gifts and as such are not deductible by the employer nor are such amounts includible in the gross income of the beneficiary. (Citation: G. S. 105-141 (2) (c) ; G. S. 105-147 (1))

Explanation. It is considered to be desirable to encourage such payments. Such encouragement is best accomplished by a tax deduction to the employer. It is not believed to be desirable, however, to allow unlimited deductions of this type.

The Federal government permits the deduction of reasonable amounts paid as continuation of the salary of the employee for a limited period. There is no fixed limit. There is a limit of $5,000, however, upon the exclusion by the beneficiaries of the payment.

In order to follow the policy of conformity to the Federal Code wherever practicable, and in order to prevent the use of "employee death benefits" as an instrument of tax evasion while encouraging such payments by corporations, it is the thinking of this Commission that the Federal Code should be followed and the payments defined as gross income to the recipient rather than as gifts, with an exclusion of up of $5,000 permitted.

Effect upon Revenue. The effect upon revenue of the enactment of this proposal is believed to be negligible.

7. IT IS RECOMMENDED *that provisions which permit certain deductions to be made by accrual basis taxpayers if payment is actually made within two and one-half months after the close of the income year or if the payment is included in the gross income of the person or corporation to whom it is to be made be amended to permit the deduction if the payment is actually made with-*

in the time set for filing the taxpayers' return or if the payment is included in the gross income of the person or corporation to whom it is to be made, and that the provision apply to the following deductions: business expenses, interest, taxes, contributions, payments into pension trusts and alimony payments.

Present Provision. The present law permits deduction of accrued expenses, interest and taxes, if payment is actually made within two and one-half months of the close of the income year, or if the amount of the payment is included in the gross income of the person or corporation to whom payment is due. Similar provisions relate to deduction of payments into pension trusts. Deduction of accrued contributions is permitted by administrative interpretation. (Citation: G. S. 105-147 (12) ; G. S. 105-147 (13) ; G. S. 105-147 (14))

Explanation. It is felt that there should be uniformity in the provisions for allowing accrued deductions by accrual basis taxpayers; this can best be done by placing all such provisions in one subsection. It is also felt that the period over which the payment may be delayed should conform to the period between the close of the income year of the taxpayer and the date upon which he is required to file his return.

Effect upon Revenue. There would be a small loss of revenue during the first year following the effective date of such a provision with no loss thereafter.

8. IT IS RECOMMENDED *that the provision permitting the deduction by cooperatives of patronage dividends be amended to require that the refund be made on or before the fifteenth day of the ninth month following the close of the income year in which deducted for the deduction to be allowed. The provision to be patterned after the Federal Code.*

Present Provision. There is no provision in the present law specifying the period within which distribution of patronage dividends by cooperatives must be made to qualify for deduction of such payments. (Citation G. S. 105-138 (9))

Explanation. The above recommendation is made in order to bring this provision into closer conformity with the Federal law and to provide a definite period within which refunds must be made in order to qualify for deduction.

Effect upon Revenue. None, although small increases in revenue could result if cooperatives failed to qualify for the deduction.

9. IT IS RECOMMENDED *that all taxpayers, regardless of the type of income received, be allowed to claim a standard deduction of 10 per cent of adjusted gross income, or $500, whichever is the lesser, in lieu of all deductions, other than expenses incurred in deriving the income and other than personal exemptions and dependency deductions, and that adjusted gross income be defined as gross income less all allowable expenses incurred in deriving the income.*

Present Provision. Under the present law a taxpayer with all of his income from wages, salaries, commissions, interest and dividends may, at his option, claim a standard deduction of 10 per cent of his gross income or $500, whichever is the lesser, in lieu of all other deductions. (Citation: G. S. 105-147 (15))

Explanation. In order to insure the constitutionality of the standard deduction provisions it may be necessary to extend them to include all taxpayers, and, in any case, it is believed that equity demands that it apply equally to all taxpayers. It cannot apply equally unless the merchant, for example, is permitted the deduction of the cost of doing business before applying the standard deduction.

Effect upon Revenue. It is estimated that the enactment of the proposed changes relative to the standard deduction would result in a loss of revenue of approximately $650,000 during the 1957-58 fiscal year. About 110,000 taxpayers would share in this tax saving, with almost 80 per cent of the total going to individuals with net taxable income of less than $4,000.

10. IT IS RECOMMENDED *that the limit of $1,000 upon the amount of alimony payments which may be deducted be deleted.*

Present Provision. Under the present law alimony received by a divorced or separated person is taxable income and alimony paid by a divorced or separated persons is deductible from gross income, *except* that when alimony is paid for the support of the spouse receiving the income and one or more dependents of the spouse making the payments the amount of the deduction is limited to $1,000. The provision limiting the amount of the deduction is not enforced at the present time. (Citation: G. S. 105-147 (14))

Explanation. It is apparent that the limitation is not the intent of the General Assembly. Prior to amendments enacted in 1951 alimony received as income was not taxable and the deduction of alimony payments up to $1,000 was permitted as an adjustment of the personal exemption of the paying spouse. The 1951 amendments made alimony received fully taxable and alimony payments fully deductible except in the situation, noted above, in which the payments are for the support of the spouse and a dependent of the paying spouse. In the prior law the limitation appeared in three places, first as a general limitation, then as a limitation on the deduction of lump sum payments or settlements and, finally, the limitation noted above. The first two were deleted by the amendment and the third, apparently, was overlooked. It is inconceivable that the General Assembly would, intentionally, permit unlimited deductions of lump sum payments and limit the deduction of support payments to a wife and child.

Effect upon Revenue. None.

11. IT IS RECOMMENDED *that the provision permitting a taxpayer to deduct a lump sum payment or a transfer of property made to satisfy a legal obligation to support a divorced or estranged spouse of the taxpayer be deleted, and that the provisions relative to the inclusion of alimony payments in gross income and the deduction of alimony payments from gross income be amended along the lines of the Federal Code.*

(The Federal Code provides that payments of alimony are deductible to the payer and taxable to the recipient if: (1) they are required under the terms of a decree of divorce or separation, (2) are paid in discharge of a legal obligation based on the marital relation, directly, or out of property transferred in discharge of such an obligation, (3) are paid after the decree, and (4) constitute periodic payments. By regulation "periodic payments" are defined to be payments where the entire sum is not determinable or where payment wiil not be completed in ten years, in addition payment in any one year may be deducted only to the extent of 10 percent of the principal amount.)

Present Provision. The present law permits the deduction of a payment in a lump sum or a transfer of property paid to satisfy a legal obligation to support a divorced or estranged spouse, and all payments made for separate support of a spouse are included in the gross income of the recipient. (Citation: G. S. 105-147 (14) ; G. S. 105-141 (1))

Explanation. Lump sum payments are, in many cases, property settlements rather than support money and as such it appears that the payments should not be deductible. Further, it is considered desirable to follow the Federal Code wherever practicable.

The recommendation for revision of the provision for inclusion of alimony payments in the gross income of the recipient is believed to be necessary to prevent the inequity which would result from denying the deduction to the paying spouse and including the payment in the income of the recipient.

Effect upon Revenue. None, the tax on this type of payment would be shifted from the recipient to the payor.

12. IT IS RECOMMENDED *that the maximum deduction allowed as medical expenses be increased to $5,000.*

Present Provision. The present law permits the deduction of medical expenses paid during the income year in excess of 5% of net income up to a maximum of $2,500 per taxpayer. (Citation: G. S. 105-147 (7½))

Explanation. It is recommended that the maximum deduction be increased to $5,000. It is the belief of this Commission that those taxpayers in the greatest need of that relief to be realized

from the deduction of medical expenditures are those with extremely large medical expenses, which, in many cases, must be paid almost entirely out of the savings of the taxpayer. The above recommendation is designed to provide additional relief in such cases.

Effect upon Revenue. It is estimated that increasing the maximum medical expense deduction to $5,000 would result in a loss of revenue of from $20,000 to $25,000 during the 1957-58 fiscal year.

13. IT IS RECOMMENDED *that any taxpayer maintaining one or more dependent relatives in an institution for the care of mental or physical defectives be permitted to deduct from gross income actual expenditures for such maintenance in excess of the deduction for dependents up to a maximum of $800 provided the relative is a bona fide dependent of the taxpayer.*
IT IS FURTHER RECOMMENDED *that any excess over the dependency deduction* PLUS *$800 be considered as medical expenses.*

Present Provision. The present law permits the deduction of amounts paid for the maintenance of a dependent relative in an institution for the mentally or physically defective which are in excess of the personal exemption claimed for the dependent to a maximum of $800 *if the taxpayer is not a married woman living with her husband,* or, *if the taxpayer is not entitled to a personal exemption of $2,000.* Amounts in excess of the deduction may be handled as medical expenses under current administrative practice. Taxpayers entitled to $2,000 personal exemption may handle the entire amount as medical expenses. Married women are entitled to no deduction nor are they permitted to claim such expenditures as medical expenses. (Citation: G. S. 105-147 (9½) ; G. S. 105-147 (7½))

Explanation. It is the belief of this Commission that taxpayers should be encouraged to contribute to the cost of maintaining relatives in such institutions, and that the extension of this deduction to all taxpayers would have this effect.

Effect upon Revenue. It is believed that the effect upon revenue of the enactment of this provision would not be great, at most not in excess of $5,000.

14. IT IS RECOMMENDED *that non-residents be permitted to deduct on a pro rata basis all items deductible to residents, except that non-residents be permitted to claim the standard deduction of 10 per cent of adjusted gross income only upon that portion of their adjusted gross income attributable to sources within this State and that the maximum deduction be limited to a pro rata portion of $500.*

Present Provision. The present statute denies to non-residents the privilege of making deductions allowed to taxpayers in general except to the extent they are connected with income arising within this State. In the case of non-resident owners of established unincorporated businesses in this State the deductions are permitted on a *pro rata* basis. The provisions permitting the use of a standard deduction to certain taxpayers does not apply to non-residents. (Citation: G. S. 105-142 (3) ; G. S. 105-147 (11) ; and G. S. 105-147 (15))

Explanation. The present statutes are inconsistent in this respect and it is believed that the provision permitting deductions on a *pro rata* basis is the better rule. The proviso with respect to standard deductions was also added for consistency as it is recommended above that the standard deduction be extended to all individual taxpayers.

Effect upon Revenue. It is estimtted that the enactment of the proposed provision would reduce revenue collections during the 1957-58 fiscal year by approximately $125,000.

15. IT IS RECOMMENDED *that the Subsection which provides for the deduction of certain dividends, or a portion of such dividends, be amended to permit the beneficiary of a trust to deduct dividends which would be deductible to taxpayers in general even though the dividends were paid to the trust and distributed to the beneficiary by the trustee.*

Present Provision. The present statute provides for the inclusion of dividends in gross income and the deduction of the portion of dividend income representing income which was taxable in North Carolina to the corporation paying the dividend. Where a trust or an estate receives divi-

dends which are "deductible" and distributes such dividends during the year they become gross income to the beneficiary, but there is no provision for deduction of such dividends by the beneficiary. (Citation: G. S. 105-147(5))

Explanation. Prior to 1955 a provision was contained in the statute which permitted the deduction by the beneficiary of "deductible" dividends received from a trust. The provision was omitted when the section was rewritten by the 1955 General Assembly. It is the belief of this Commission that the omission was inadvertent and that a similar provision should be enacted into the statute. There appears to be no logical reason for denying the deduction of dividends otherwise deductible solely for the reason that they were paid to the beneficiary through a trust or estate rather than direct.

Effect upon Revenue. The change in the law enacted in 1955 will not affect revenue until the 1956 returns are received, therefore, there would be no change in revenue from re-enactment of this provision as compared with the current year. It is believed that the revenue loss in 1957-58 would be small.

B. IT IS RECOMMENDED *that Section 105-136 of the General Statutes prescribing the method of taxing certain public service corporations be repealed and such corporations be taxed under Section 105-134 in the same manner as other corporations. (Recommendations of methods of apportionment for public service corporations are presented in the section on apportionment of net income.)*

Present Provision. Under the above section public utilities required by the I.C.C., the F.C.C. or a successor regulatory agency to keep their accounts according to a standard system of accounting prescribed by such regulatory agency are required by this State to file their income tax returns on a different basis than are other corporations. The net taxable income of such corporations is their net operating income attributable to operations in this State less taxes paid in this State. The method of determining the portion of net operating income attributable to North Carolina is prescribed in the statutes. (Citation: G. S. 105-136)

Explanation. This method of determining the taxable income of those public utilities coming within the purview of the section contains many faults, the principal ones are as follows:

The section is considered inequitable by those required to file thereunder as it denies them the right to deduct non-operating expenses, the most important of which is interest payments on long term indebtedness. It also excludes non-operating income. By excluding non-operating expenses and income it departs from the philosophy of a "net income" tax.

The section, by basing net taxable income on accounts prescribed by a Federal agency, has been construed by some taxpayers to permit the deduction of taxes paid in North Carolina and uncollectible revenue both prior to allocation and after allocation thereby allowing a "double" deduction of these items. This interpretation resulted as the system of accounts for motor carriers was prescribed by the I.C.C. several years after the last material revision of Section 105-136.

The method of allocating operating revenue and operating expenses to this State which is prescribed in the law for motor carriers and telephone companies is such that the necessary data for compliance cannot be obtained from their accounts kept in accordance with the prescribed system.

The section could be considered inequitable as all utilities are not required to file thereunder. Pipelines, airlines, power companies, and small and/or intrastate trucking companies and telephone companies are not required to file under this section.

The effect of these provisions is, therefore, to require different corporations in the same type of business, e.g., small and large motor carriers, to determine their taxable income by different methods which frequently give substantially different results.

Effect upon Revenue. It is estimated that the repeal of G. S. 105-136 would result in a loss of revenue of approximately $350,000 for the 1957-58 fiscal year.

C. IT IS RECOMMENDED *that, in the event G. S. 105-136 is repealed as was recommended above, those corporations currently filing income tax returns under this section be permitted to*

amortize "emergency facilities" within 60 months only if such facilities are acquired subsequent to January 1, 1957.

Present Provision. Corporations filing under G. S. 105-134 are permitted to amortize "emergency facilities" in five years if such facilities were acquired on, or after, January 1, 1955. This privilege is denied to corporations filing under G. S. 105-136. (Citation: G. S. 105-147 (8½))

Explanation. The repeal of G. S. 105-136, as recommended above, would automatically extend the privilege of 60 month amortization to corporations now filing thereunder. In order to prevent the complications of a change-over period it is considered preferable to limit the use of this provision by public utilities now filing under G. S. 105-136 to property acquired on, or after, January 1, 1957.

Effect upon Revenue. There would be no long run effect upon revenue, but there would be a temporary gain in revenue as large amortization deductions would be denied on "emergency facilities" acquired between January 1, 1955, and January 1, 1957. The deductions would be spread over a number of years.

ALLOCATION OF NET INCOME

A. IT IS RECOMMENDED *that the provisions in the General Statutes relative to the allocation or apportionment of the net income of corporations be rewritten to the end that an income tax be levied only upon that income which is reasonably attributable to operations performed or property owned in North Carolina.*

Present Provision. Under the present statute three methods of allocation are provided for foreign corporations. Corporations whose *principal business in this State* is manufacturing must allocate their entire net income to this State on the basis of a formula consisting of the ratios of property and of manufacturing costs. Corporations whose principal business in this State is selling must allocate their entire net income to this State upon the basis of a formula consisting of the ratios of property and sales, with sales in this State being defined as sales by or through offices, branches or agencies in this State. Corporations whose principal business in this State is other than manufacturing or selling are required to allocate their entire net income to this State on the basis of their gross receipts ratio.

Domestic corporations are taxed upon their entire net income, except that in determining their net income domestic corporations *having an established business or investment in property in another state* are permitted to deduct income subjected to a net income tax by such other state provided the amount of income deducted may not exceed the amount allocated to such other state by use of the applicable allocation formula for a foreign corporation engaged in the same business. (Citation: G. S. 105-134 II and G. S. 105-147 (10) (a))

Explanation. In accordance with the directive of the General Assembly the Commission has made an exhaustive study of the problem of allocation of the net income of corporations. This study included the examination of all available data, recommendations, and comparative studies, and of reports of studies conducted at the direction of the Commission. In addition, the Commission conducted investigations and research and gave studied consideration to all of the facets of the problem. It was found that the methods of allocation prescribed in the present statute are inadequate for the purpose, may be considered to be inequitable and are unduly harsh in their application when compared with the formulae in general use by other states levying a net income tax on corporations.

The inequity in the statutory formulae becomes evident when it is noted that, if all states adopted an income tax law patterned after the North Carolina law, a corporation manufacturing in one state and making all of its sales through offices in other states could be subjected to income tax levies upon 150 per cent of its net income. This possibility results from the use of different formulae, not according to the principal business of the corporation, but according to the principal business of the corporation *in North Carolina.* The corporation in the hypothetical situation men-

tioned above would be required to allocate almost 100 percent of its income to the state in which it performed its manufacturing and 50 percent of its income to the states in which its sales were made.

It may be seen that the present statute does not recognize selling as an income producing function of corporations manufacturing in this State nor does it recognize manufacturing as an income producing function of corporations whose principal business in this State is selling.

It is, therefore, obvious that the formulae appearing in the statute result in the taxing of a greater portion of the net income of corporations operating in interstate business than is reasonably attributable to this State from any practical business viewpoint.

When the statutory allocation formulae of this State are compared with those of other income tax states, it is immediately apparent that North Carolina is in the undesirable position of standing alone in the harshness of the method prescribed for allocating the net income of corporations manufacturing in this State and manufacturing and/or selling in other states. South Carolina is the only state other than North Carolina using a two factor formula one of the factors of which is costs of manufacturing, but South Carolina permits separate accounting as a general practice. Only six states employ the manufacturing cost ratio in their formula as this ratio is difficult to determine accurately and cannot be audited satisfactorily. Of the 32 states levying a corporation net income tax 20 use three factor formulae for manufacturing corporations, 3 require separate accounting, 3 use a sales ratio only and 6 use two factor formulae. Only eight states differentiate between manufacturing and merchandising businesses.

A study entitled "The Impact of State and Local Taxes in North Carolina and the Southeastern States" was made under the direction of this Commission. The findings of this study indicated that the total tax bill of a corporation operating in North Carolina is, in general, higher than the total tax bill in other Southeastern states for similar operations, and that this disparity is almost entirely due to the severity of the corporation income tax with the allocation formulae being an important factor in the differential of the income tax.

The unusually high income tax resulting from the combination of the formula and the high tax rate places interstate corporations with appreciable operations in this State in a difficult competitive position with respect to competitors with operations in other states.

In consideration of these major objections to the statutory method of allocation, this Commission has formulated a plan for the allocation or apportionment of net income with the purpose of providing for the equitable taxation of net income as between competing corporations and of providing a method of allocation which would encourage, or, at worst, would not discourage, industrial development in the State.

The briefs, studies and letters received by the Commission from taxpayers, taxpayers' associations, the Association of Certified Public Accountants, the Department of Tax Research, and the Commission's own staff, and all studies conducted in recent years by independent research groups and associations of government officials support the general solution of the problem adopted by this Commission.

It is believed that the formulae recommended by this Commission would insure that this State would not tax more of the income of corporations than is reasonably attributable to business operations herein; would place North Carolina in a more competitive position among her sister states in this respect; would insure that corporations having or establishing regional distribution offices in this State would not be taxed on the income from sales made throughout the region; and would insure that corporations would not be encouraged to move home offices, sales offices, or accounting offices outside of the state as a means of reducing their income taxes. It is not the intention of this Commission to incorporate a general tax reduction to all corporations into the allocation formula as it is believed that this is a question of rate adjustment and not one of determination of the proper tax base.

It is the belief of this Commission that any statute dealing with the allocation of net income should be written in sufficient detail to permit businessmen, who often are not tax experts, to de-

termine how the law would apply to their type of operations. The provisions of the proposed statute were designed to prevent misunderstanding of their intent.

(A "proposed" allocation statute containing the recommended provisions in detail may be found in the appendix. This proposed statute is intended as a description of the provisions of the allocation law which this Commission deems to be most desirable for North Carolina and not as a draft of a bill to implement these proposals; a bill containing the revisions to the General Statutes will be submitted to the General Assembly.)

Effect upon Revenue. It is estimated that the enactment of the provisions relative to allocation of corporate income recommended herein would result in a loss of revenue of approximately $7,000,000 for the 1957-58 fiscal year. This estimate reflects all of the changes in methods of allocation recommended by this Commission. Separate estimates for each change will not be presented in the following paragraphs.

Although it is estimated that the enactment of these provisions would result in an overall loss of revenue, and although the great majority of corporate taxpayers would either experience a decrease or no change in their tax liability, a few taxpayers would find that their tax liability has been increased. (It is hoped that removal of excessive harshness in the existing formulae will eliminate a deterrent to further industrialization which will accelerate economic activity in the State with an eventual recoupment of immediate tax losses.)

B. IT IS RECOMMENDED *that domestic corporations be taxed according to the same rules as foreign corporations and pay an income tax only upon that income attributable to sources within North Carolina.*

Present Provision. Under the present statute foreign corporations are taxed upon that portion of their net income allocated to this State by the application of statutory formulae, while domestic corporations are taxed upon all net income not subject to taxation elsewhere. (Citation: G. S. 105-134 II and G. S. 105-147 (10))

Explanation. The above recommendation is designed to put domestic and foreign corporations on an equal footing. There seems to be no justification, other than a legalistic one, for taxing domestic corporations on income attributable to business or property outside of North Carolina, when such corporations are in competition with other corporations not so taxed. The inequity of the present method of taxing domestic corporations may be demonstrated by noting that the levy by another state of a net income tax with a rate of 1/10 of 1 percent or even less, would entitle a corporation to deduct any income so taxed, while the absence of any tax would subject the entire amount of income from sources within such state to the 6 percent North Carolina tax.

The great majority of domestic corporations would experience no change in their tax liability as they do not operate in interstate business. Those domestic corporations having interstate operations would, in general, receive some tax relief from enactment of this provision.

C. IT IS RECOMMENDED *that corporations "doing business", as this phrase is used for income tax purposes, in at least one other state be permitted to allocate or apportion income, and that corporations, "doing business" in North Carolina only, pay upon their entire net income.*

Present provision. The present law permits all foreign corporations to allocate their net income but denies to domestic corporations the deduction of out-of-state income unless such income is taxed by another state *and* the corporation has an established business or owns property in the taxing state. (Citation: G. S. 105-147 (10) (a))

Explanation. The present law is more restrictive as far as domestic corporations are concerned than the provision recommended above. This provision was incorporated into the proposed statute because of the addition of a sales factor to the allocation formula prescribed for manufacturing corporations, the particular sales factor selected and the extension of the allocation privilege to domestic corporations. These liberalizations of the law would permit tax avoidance in certain areas should the restriction be omitted. Specifically, this restriction is designed to prohibit a corporation which is a 100 percent North Carolina corporation, that is, having no business operations and no

property outside of North Carolina, from allocating a part of their income to other states on the basis of mail order shipments to other states, or sales made on sporadic trips outside of the state, or sales made for out-of-state shipment, but made while the customers are in this state for business or other reasons.

D. IT IS RECOMMENDED *that income from investment property be separately allocated; that income from intangible property be allocated according to the principal place of business of the corporation and that income from tangible property be allocated according to the situs of the property.*

Present Provision. The present law provides that the entire net income of a corporation be included in the amount subject to apportionment. It is, however, considered unconstitutional to include in the apportionable income of a foreign corporation income from sources not connected with the business operations a part of which are conducted in the taxing state. The Administrator, therefore, excludes such income if it is from without North Carolina. (Citation: G. S. 105-134)

Explanation. The provisions recommended by this Commission for separate allocation of non-unitary income brings the statutes into conformity with constitutional law and puts into the statutes the present administrative practice and in addition, it permits taxing 100 percent of such non-unitary income as is derived from sources wholly within North Carolina.

The only taxpayer who would be materially affected by this provision are those corporations having non-unitary income which is attributable to sources entirely within this State; such taxpayers would experience a tax increase in proportion to the amount of such income which is currently allocated outside of this State.

E. The following recommendations are relative to formulae for apportioning the remainder of the net income, to be referred to hereafter as "net apportionable income." Formulae are presented for manufacturing or selling corporations, railroads, telephone companies, motor carriers and all other corporations.

Explanation. It is the opinion of this Commission that all corporations should be treated alike and that wherever practicable the same method of allocation should be used for the allocation of income, but, as the methods of doing business and the accounting systems of public service corportions differ from those of other corporations and as public utilities are regulated by Federal and State agencies, it is considered desirable to prescribe separate methods of apportioning the net income of such corporations. Different formulae are prescribed only where necessary to accomplish similarity of result.

The methods of allocation offered herein are designed to reflect that portion of the entire net income of the corporation which is reasonably attributable to operations conducted and property owned in this State and to utilize amounts readily available in the accounts of the corporations, both to avoid excessive cost of compliance and to facilitate verification. Detailed descriptions of the formulae are given in the recommendations.

a. IT IS RECOMMENDED *that corporations engaged in manufacturing or selling tangible personal property use the arithmetic average of the ratios of property, payrolls and sales.*

Present Provision. The present law prescribes a two factor formula of property and manufacturing costs for corporations whose principal business in this State is manufacturing, and a two factor formula of property and sales for corporations whose principal business in this State is selling. (Citation: G. S. 105-134 (II))

Explanation. It may be seen that the present statute does not recognize selling as an income producing function of corporations manufacturing *in this State* nor does it recognize manufacturing as an income producing function of corporations whose principal business *in this State* is selling.

It is believed by this Commission that there is no justification for providing different formulae for corporations classified according to the principal business *in this State* as such a system will almost inevitably result in many corporations being taxed upon a greater portion

of their net income than is reasonably attributable to this State. It is further believed that selling is an income producing function of corporations which sell tangible personal property, regardless of whether the property is manufactured in this State by the seller or not and should be recognized in the allocation formula. In the final analysis, all property which is manufactured is manufactured for the purpose of eventual sale for profit. Without the sale there can be no profit.

It is recognized that the amount of effort put into the selling activity and the relative ease or difficulty experienced in making sales of products manufactured by the seller vary; and, therefore, the importance of the selling function as an income producer varies from corporation to corporation. No satisfactory means has been found, however, of measuring these variations for the purpose of providing variable weights for the factors. Therefore, equal weights are recommended.

Labor is one of the factors of production and the utilization of labor is believed to be an income producing function. Furthermore, payrolls, being a measure of the activity of labor, reflect most of the activities of a corporation; manufacturing, selling, administration, accounting, research, etc. The payroll factor is also easier for the taxpayer to compute and for the administrator to verify.

Property, representing capital, is, of course, a primary income producer, being the only income producer for the owner of the property which is recognized by economic theory, and should be included in the allocation formulae of all corporations wherein tangible property is an important item of investment and wherein the value and the physical location of such property may be readily ascertained.

Those taxpayers affected by this provision would, in general, benefit from its enactment. There may be a few instances where the combination of factors recommended herein would result in a tax increase while in others no change in tax liability would result.

(1) IT IS RECOMMENDED *that the property factor be the same as in the present statute except that the capitalized value of leased real estate and tangible personal property be included in the value of property, and that property the income from which is excluded from the net apportionable income of the taxpayer be excluded from the ratio.*

Present Provision. The present statute includes in the ratio all real and tangible personal property owned by the taxpayer and values such property, other than inventories, at its book value at the end of the income year. Inventories are valued at a periodic average. (Citation: G. S. 105-134 II (1) (a))

Explanation. The inclusion of rented property in the property ratio is considered to be desirable as the current trend of renting industrial property has progressed to the point where leased property is an appreciable part of all property employed in the operations of many businesses, and as property used in the operation of a business is believed to be income producing whether owned by the business or not.

If a property ratio is to be a measure of income producing activity, it should include only property used in the deriving of the income; therefore, it is believed to be proper to exclude from the ratio any property the income from which is not subject to apportionment under the formula.

The inclusion of rented property in the property ratio would result in adjustments in the tax liability of corporations; some corporations would benefit from the change, while others would experience a tax increase. When this change is taken in combination with other changes, particularly, the addition of a third factor to the apportionment ratio and the change in the definition of sales in this State, the net effect upon such taxpayers is a tax reduction.

(2) IT IS RECOMMENDED *that the payroll factor be defined to include all wages, salaries and other compensations for personal services of regularly employed employees except that general executive officers' salaries be excluded from the ratio, with wages, salaries, etc. of employees attributed to the state of principal activity of the employee.*

Present Provision. The only payroll ratio in the present statute is one which the Tax Review Board is permitted to authorize. The definition of this payroll factor contains a provision attributing the salaries of residents of North Carolina to this State regardless of the place of performance of duties. Thus, a corporation with an employee living in North Carolina but working across the state line would have to attribute the salary of this employee to North Carolina.

Explanation. The residence of an employee appears to be irrelevant to the production of income and any reference thereto is, therefore, omitted from the proposed law. Although executives contribute to the production of income, their salaries should be omitted from the payroll ratio because of the difficulty, in many cases, of determining the state in which the major portion of their time was spent and to insure that no company will have an incentive by reason of this factor to base such officers outside of the State. The difficulty of prorating the salaries of employees who perform their duties partly within and partly without this State and the difficulty of verifying such proration operate against the use of this device. It is believed that the error due to attributing the entire salary of an employee to the state in which he spent the largest number of working days during the year would be a minor consideration and would probably be offset by errors in the opposite direction.

(3) IT IS RECOMMENDED *that the sales factor attribute sales to the state of destination of shipments.*

Present Provision. The present statute attributes sales to this State if made ". . . through or by offices, agencies, or branches located in North Carolina . . . ".

Explanation. It is believed that the sales factor recommended herein reflects the income earned from sales effort or activity with more accuracy than any other sales factor which could be proposed. It is thought that the necessary amounts may be more readily determined from the usual corporate records and thus, the law could be more easily complied with and more easily audited by the administrator than if alternate sales definitions were adopted.

Office activity or negotiation approach, such as is currently used by North Carolina in allocating the income of selling corporations, is undesirable as compliance is difficult and effective enforcement is even more difficult. This method of measuring sales activity is subject to "control" by the management of a company to avoid taxation and could also discourage the establishment of regional sales offices or accounting offices in this State as it could prove expensive tax-wise to have such offices here. All sales made through such an office might well be attributed to North Carolina although the customers were located throughout the region.

Adoption of this definition of "sales in North Carolina" would be beneficial to corporations with sales from North Carolina offices or distribution points to customers outside of this State. It would not be beneficial to those corporations with customers located in North Carolina who are currently routing such sales through offices outside of North Carolina. It should be recognized, of course, that a corporation must be "doing business" in this State for any tax liability to accrue.

b. IT IS RECOMMENDED *that railroads use the ratio of "railway operating revenue" from business done within this State to "total railway operating revenue" from all business done by the company as shown by its records kept in accordance with the standard classification of accounts prescribed by the Interstate Commerce Commission. "'Railway operating revenue' from business done within this State" to be defined as "railway operating revenue" from business wholly within this State, plus the equal mileage proportion within this State of each item of "railway operating revenue" received from the interstate business of the company. "Equal mileage proportion" to be defined as the proportion which the distance of movement of property and passengers over lines in this State bears to the total distance of movement*

of passengers and property over lines of the company receiving such revenue. "Interstate business" to be defined as "railway operating revenue" from the interstate transportation of persons or property into, out of, or through this State.

IT IS FURTHER RECOMMENDED *that in determing the taxable income of a railroad company operating two or more lines of railroad not physically connected, when one of such railroad lines is located wholly within this State, the actual earnings and expenses of such line in this State, insofar as they may be severable, be used in determining net income taxable in this State.*

IT IS FURTHER RECOMMENDED *that where a railroad is being operated by a partnership which is treated as a corporation for income tax purposes and pays a net income tax to this State, or if located in another state would be so treated and so pay if located in this State, each partners' share of the net profits be considered as dividends paid by a corporation for purposes of the Income Tax Act and be so treated for inclusion in gross income, deductibility, and separate allocation of dividend income.*

Present Provision. The present statutes do not provide for allocation of the net income of railroads, but, rather, for the allocation of gross operating revenue from which a proportional part of operating expenses are deductible.

The statutory method of determining the gross operating revenue attributable to North Carolina requires the separation of the interstate and intrastate revenue. The North Carolina portion of the interstate operating revenue of a railroad is added to the North Carolina intrastate operating revenue. The North Carolina portion of interstate revenue is the "equal mileage proportion" of the operating revenue from business into, out of, or through this State. (Citation: G. S. 105-136)

Explanation. The method of apportionment of net apportionable income recommended for railroads is a variation of the gross receipts ratio. Actually it is the ratio of gross receipts from operations with the method of determining gross receipts attributable to North Carolina given in detail and with the terms corresponding to the terms in the standard system of accounts prescribed for railroads by the Interstate Commerce Commission.

The proposed ratio employs the same amounts and methods that are currently being used by railroads for the determination of North Carolina gross operating revenue to apportion the net income of railroads. This method is deemed to be as nearly an exact method as it is possible to find.

Two special provisions are added to the recommendation. These two provisions are included to take care of peculiar circumstances.

The first of these special provisions relates to a railroad operating two lines not physically connected. This provision is in the present law and should be continued, as any other course would, probably, result in litigation in the Federal Courts. A ruling in a similar situation in South Carolina preceded the enactment of the above provision in the present law.

The second relates to a railroad operated by a partnership. There is such a partnership in North Carolina. The partners are other railroads. The partnership is required by the Commissioner of Revenue to file as a corporation and to pay an income tax on any net income. The residue or net profits are then split between the railroads. Such profits are similar in every respect to dividends and it is thought that they should be so considered for income tax purposes to prevent the double taxation of this income.

The present law contains no such provision as the net profits of the partnerships are classified as non-operating income and, as such, are not taxable.

c. IT IS RECOMMENDED *that telephone companies use the ratio of gross operating revenue from local service in this State, plus gross operating revenue from toll services performed wholly within this State plus the proportion of revenue from interstate toll services attributable to this State as shown by the records of such company plus the gross operating revenue*

in North Carolina from other service less the uncollectible revenue in this State to the total gross operating revenue from all business done by the company less total uncollectible revenue: Where a company is required to keep its records in accordance with the standard classification of accounts prescribed by the Federal Communications Commission, amounts in such accounts to be used in determining the apportionment ratio.

Present Provision. The present statutes do not provide for allocation of the net income of telephone companies, but, rather, for the allocation of gross operating revenue from which a proportional part of operating expenses are deductible.

The statutory method of determining the gross operating revenue attributable to North Carolina requires the separation of interstate and intrastate revenue. The North Carolina portion of the interstate operating revenue of a telephone company is added to the North Carolina intrastate operating revenue. The North Carolina portion of interstate revenue is the "equal mileage proportion" of the operating revenue from messages into, out of, or through this State. (Citation: G. S. 105-136)

Explanation. The method of allocating gross operating revenue which is prescribed in the statutes cannot be readily applied to telephone companies. Further, there is very little relationship between the gross revenue from long distance calls going over so-called "long lines" and the earnings of the company over whose lines the call is "placed" or received. The entire amount of revenue from such calls is placed in a "pool" from which all receipts from such calls are distributed to the members of the pool (virtually all telephone companies) on the basis of the value of the operating property of each member. The accounts of interstate telephone companies are so set up that the revenue from local service is separated by states and the revenue from the "pool" is separated by states according to the same rules used for allocating to each company.

The method of apportionment of the net apportionable income of telephone companies recommended herein makes use of these records, conforms to the methods of doing business practiced by telephone companies and is believed to be a very accurate method of apportionment.

d. IT IS RECOMMENDED *that motor carriers of property use the ratio of vehicle miles in this State to total vehicle miles of the business everywhere, and that vehicle miles be defined to exclude miles by vehicles traveling empty.*

Present Provision. The present statutes do not provide for allocation of the net income of those motor carriers required to file under G. S. 105-136, but, rather, for the allocation of gross operating revenue from which a proportional part of operating expenses are deductible.

The statutory method of determining the gross operating revenue attributable to North Carolina requires the separation of interstate and intrastate revenue. The North Carolina portion of the interstate operating revenue of a motor carrier is added to the North Carolina intrastate operating revenue. The North Carolina portion of interstate revenue is the "equal mileage proportion" of the operating revenue from transportation into, out of, or through this State.

The present practice of most carriers, however, is to use the ratio of vehicle miles to allocate total gross operating revenue to North Carolina.

Those foreign motor carriers not required to file under G. S. 105-136 (carriers having gross receipts of less than $200,000 per year or operating entirely intrastate) are required to allocate their net income by use of a gross receipts ratio. (Citation: G. S. 105-136 and G. S. 105-134 II (3))

Explanation. The method of determining the portion of gross revenue which is attributable to North Carolina which was briefly described above does not conform to the accepted accounting practices of motor carriers of property. None of the motor carriers attempt to comply with the statute. Extensive and expensive additional record keeping would be necessary to enable them to comply with the statute.

The method of allocation proposed herein is the method most frequently used by motor carriers of property. Necessary data can be readily obtained from their records. It is admitted that the results of the proposed ratios are not as exact as could be desired but it is a reasonable measure and conforms to the accounting practices of the industry.

e. IT IS RECOMMENDED *that motor carriers of passengers use the arithmetic average of the following two ratios:*

(1) *The ratio of vehicle miles in this State to total vehicle miles of the business everywhere. Vehicle miles to exclude miles by vehicles traveling empty.*

(2) *The ratio of gross operating revenue in this State to gross operating revenue of the business everywhere. Gross operating revenue in this State to be defined as revenue from passenger ticket sales in the State plus revenue from merchandise shipped prepaid or received collect in this State.*

Present Provision. As was stated in the preceding section, the present statutes do not provide for allocation of the net income of those motor carriers required to file under G. S. 105-136, but, rather, for the allocation of gross operating revenue from which a proportional part of operating expenses are deductible.

The statutory method of determining the gross operating revenue attributable to North Carolina requires the separation of interstate and intrastate revenue. The North Carolina portion of the interstate operating revenue is added to the North Carolina intrastate operating revenue. The North Carolina portion of interstate revenue is the "equal mileage proportion" of the operating revenue from transportation into, out of, or through this State.

The present practice of many passenger carriers, however, is to use the ratio of vehicle miles to allocate total gross operating revenue to North Carolina. (Citation: G. S. 105-136)

Explanation. The method of determining the portion of gross revenue which is attributable to North Carolina does not conform to the accepted accounting practices of motor carriers of passengers. None of the passenger carriers attempt to comply with the statute in this respect. Extensive and expensive additional record keeping would be necessary to enable them to comply with the statute.

The method of allocation proposed herein is believed to be a reasonable method which would insure that the State receive all of the revenue to which it is entitled while not being unduly harsh to the taxpayer. All amounts can be readily obtained from the records of such carriers. Passenger carriers are now using the vehicle miles ratio contained in the recommendations but it is believed that the addition of the gross receipts factor would increase the accuracy of the determination of taxable income.

f. IT IS RECOMMENDED *that corporations engaged in businesses other than those appearing above use the ratio of gross receipts, and that gross recipts be defined to include all receipts from all sources, except that gross receipts from business operations or from property the net income from which is excluded from apportionable net income be excluded from the gross receipts ratio.*

Present Provision. Under the present law, corporations filing under Section 105-134 of the General Statutes, other than those engaged in manufacturing or selling tangible personal property, are required to allocate their net income on the basis of the ratio of their gross receipts in North Carolina to their gross receipts everywhere. Gross receipts are defined to include the entire gross receipts of the company. (Citation: G. S. 105-134 II (3))

Explanation. The provision recommended above for the apportionment of the apportionable net income of "other" corporations applies, generally, to businesses performing services such as contractors and public service corporations for which no special formula is recommended, including electric and power companies, telegraph companies, pipelines, and airlines.

The definition of gross receipts is the same as that appearing in the present statute except that receipts from sources the income from which is excluded from apportionable net income is excluded from the ratio. It is believed that this exclusion is desirable to prevent dis-

tortion in the effects of the use of the ratio. Inclusion of such receipts in the ratio would either penalize or unjustifiably favor the taxpayer, according to the circumstances in each case.

F. IT IS RECOMMENDED *that where an established,* UNINCORPORATED BUSINESS *in this State, having operations in one or more other states, is owned by a non-resident individual or by a partnership having one or more non-resident members the net income from such business be allocated to this State in the same manner and under the same rules as the income of a corporation operating the same type of business is allocated, and that such individual or partnership be permitted to petition the Tax Review Board for relief where the prescribed method of allocation inflicts an undue hardship upon the taxpayer.*

Present Provision. The present statute contains no provision for the allocation of income earned partly within and partly without this State by an unincorporated business. (Citation G. S. 105-142 (3))

Explanation. It is the opinion of this Commission that a definite method of allocation should be contained in the statutes to remove uncertainty on the part of the taxpayer and to provide the Commissioner of Revenue with statutory backing for administration of the law which requires that the North Carolina income of a non-resident be taxed, but does not provide a method of determining the amount of income attributable to each state. There seems to be no justification for adoption of a method of allocation for unincorporated businesses which differs from the method provided for corporations, and it does appear desirable to permit appeal in hardship cases.

Effect upon Revenue. It is believed that no net change in revenue collections would result from the enactment of this provision, although there would be some adjustments, either up or down, in the tax liability of some non-resident taxpayers.

PERSONAL EXEMPTIONS

A. IT IS RECOMMENDED *that married women living with their husbands and receiving a separate income be allowed to claim a personal exemption of $2,000, provided the husband receives a total gross income not in excess of $1,000.*

Present Provision. Under the present statute a married woman is permitted to claim $2,000 personal exemption if the gross income of her husband is less than $500. (Citation: G. S. 105-149 (1) (b))

Explanation. It is believed that in the interest of equity the maximum gross income allowed to the husband should be raised to $1,000. Such action would place such couples in a position more nearly equal to that of other married couples with both spouses receiving separate income.

Effect upon Revenue. It is estimated that enactment of this proposal would result in a reduction of revenue of approximately $75,000 during the 1957-58 fiscal year.

B. IT IS RECOMMENDED *that the provision which defines "head of household" for purposes of claiming the $2,000 personal exemption be amended to allow persons maintaining a household for a dependent in another state to claim this exemption.*

Present Provision. The present statute defines a "head of household" to include taxpayers maintaining *in this State* a household for a dependent. (Citation: G. S. 105-132 (3))

Explanation. It is thought to be inequitable to deny the personal exemption of $2,000 to taxpayers maintaining a household for a dependent solely on the basis of the geographical location of the household.

Effect upon Revenue. A very small revenue loss would result from the enactment of this provision.

C. IT IS RECOMMENDED *that where parents are divorced the parent furnishing the chief support of his (or her) child or children during the income year be entitled to the $300 exemption whether that parent has custody of the child or children or not.*

Present Provision. The present law permits the deduction of $300 for a dependent except that in the case of *the child of a taxpayer* the deduction may be claimed only by the parent entitled to the $2,000 personal exemption. Thus, where the parents are divorced only the parent having custody of the child is entitled to the $300 personal exemption and then only if such parent is also maintaining a household for the child and furnishing the chief support of the child. (Citation: G. S. 105-149 (1) (e))

Explanation. It is considered to be inequitable to deny this deduction to the parent furnishing the chief support of the child, and, in certain cases, to deny the deduction to either parent.

Effect upon Revenue. There would be a negligible loss of revenue if this provision were adopted.

D. IT IS RECOMMENDED *that, for purposes of determining the right to personal exemptions, the status during the major portion of the year be used by taxpayers divorced or separated during the income year and by taxpayers either becoming or ceasing to be "heads of households" during the income year, and that a taxpayer be entitled to the exemption for a dependent if such taxpayer furnished the chief support of the dependent during the income year.*

Present Provision. The present law provides that the status on the last day of the year shall determine the personal exemption which may be claimed. (Citation: G. S. 105-149 (3))

Explanation. These recommendations are made in the interest of equity. It appears inequitable to deny the dependency deduction to the parent of a child who was married, or became 18, or accepted employment near the close of the income year. The above recommendation is designed to remove this inequity. A parent would still be able, under the proposed amendment, to claim the deduction for a child born near the end of the year.

It is also thought to be inequitable to allow a taxpayer who entered into the condition qualifying him to be a "head of household" a few days or a few weeks prior to the end of the year to claim $2,000 personal exemption and to deny such exemption to a taxpayer who is in the status of a "head of household" for 10 or 11 months but loses that status prior to the last day of the year. The same line of reasoning applies to persons separated during the year but living together as husband and wife for the major portion of the year. It is, therefore, proposed that the status during the major portion of the year rule in such cases.

These recommendations apply only in situations where the status changes during the income year.

Effect upon Revenue. Enactment of this revision would result in a small net loss of revenue. There would be, however, both tax increases and tax decreases with the taxpayers receiving tax relief being greater in number than those experiencing tax increases. It should be noted that the effects of this revision would be felt in only one year for each taxpayer, the year in which his status, or that of a dependent, changes.

TAX CREDITS

A. IT IS RECOMMENDED *that the provisions permitting the deduction of the income of residents taxed by other states be repealed and that residents be permitted to claim a tax credit against taxes due under the Income Tax Act for net income taxes paid to another state upon income derived from sources within such other state with a further provision that the tax credit be denied if the other state grants a tax credit to residents of North Carolina for taxes paid to North Carolina.*

Present Provision. The present law provides for the deduction by resident individuals of the net income earned in another state if such income is subjected to taxation by such other State. No tax credit is provided. (Citation: G. S. 105-147 (10) (b) and G. S. 105-151 (1))

Explanation. The present method of treating the out-of-state income of residents is inequitable. Taxpayers with substantially the same types and amounts of income now pay different income

taxes dependent upon the state from within which their income is derived. It is believed that individuals receive benefits from residence in North Carolina and incur an obligation for sharing in the support of the government apart from the location of the source of their income. Exemption of all out-of-state income is, therefore, not thought to be desirable. If the position is accepted that out-of-state income of residents should not be excluded from taxation, it seems that equity demands that all taxpayers be treated alike and that a taxpayer having income from a non-income tax state should not pay a greater income tax than a taxpayer with part of his income from a state with lower tax rates.

It is believed, however, that resident taxpayers should be protected from the possibility of paying an income tax to two or more states on the same income.

Both objectives, equality and protection, can be achieved by the adoption of the tax credit device.

A further fault which may be found with the current law is that the provisions relating to residents are not coordinated with the provisions relating to non-residents. The combination of provisions now used permits other states to tax their residents for income (of certain types) derived from within this State and to also tax North Carolina residents for income earned within such other State. Thus, this State is in a position to lose revenue to other states. The use of a tax credit, with proper restrictions upon its use, would prevent inroads by other states upon revenue rightfully belonging to North Carolina.

Effect upon Revenue. It is estimated that the adoption of this recommendation would result in an increase in revenue of approximately $60,000. A large part of this increase in revenue would be derived at the expense of other states through the granting of tax credits to residents of North Carolina.

B. IT IS RECOMMENDED *that the provision be deleted which denies a tax credit to non-residents for taxes paid to their home state on income from an established unincorporated business located in this State.*

Present Provision. The present statutes allow a non-resident to claim a tax credit against income taxes due this State for taxes paid to his home state upon income derived from sources in North Carolina *except* that such tax credit is denied if the income is from an established unincorporated business in this State. (Citation: G. S. 105-151 (2))

Explanation. The limitation upon the use of the tax credit by non-residents prevents this State from practicing complete reciprocity with other states. It is believed that the best interest of the State and of its citizens would be served by authorizing complete reciprocity.

Effect upon Revenue. None. It is believed that no net change would result in either the revenue collections or in the total income tax liability of individual taxpayers. The principal effect would be that certain non-residents would shift part of their tax payments to their home states while residents having unincorporated businesses in certain other states would shift part of their tax payments to this State. The only circumstance in which revenue could be affected would be if North Carolina has more such businesses owned by non-residents than are owned by North Carolina residents in other states.

OTHER CHANGES

A. IT IS RECOMMENDED *that religious, charitable, scientific, and educational trusts be exempted from the income tax.*

Present Provision. *Corporations* organized for religious, charitable, scientific or educational purposes are exempt from the income tax under the provisions of G. S. 105-138 but there is no provision for the exemption of trusts established for such purposes.

Explanation. It is believed to be desirable to exempt such trusts from the income tax.

Effect upon Revenue. Negligible.

B. IT IS RECOMMENDED *that fiduciaries filing returns for trusts or estates pay an income tax at the same rates as individuals.*

Present Provision. There is no provision specifying the tax rates to be applied to the net taxable income of trusts or estates. The statutes have been interpreted, however, to require the use of the rates levied upon individuals. (Citation: G. S. 105-153 and G. S. 105-133)

Explanation. It is believed that the statutes should be specific on this point.

C. IT IS RECOMMENDED *that a corporation which ceases its operations in this State before the end of the income year due to dissolution or withdrawal from the State be required to file its return within 75 days from the date of dissolution or withdrawal.*

Present Provision. Under the present law corporations dissolving or withdrawing from the State during the income year are required to file their return within two and one-half months of the end of their income year in the same manner as corporations in general, as there is no specific provision to the contrary. (Citation: G. S. 105-155)

Explanation. Under the present law a corporation may withdraw from the State and dispose of all of its assets long before the Department of Revenue can determine whether there is any tax liability or not. The State is in a position to lose revenue in such situations.

The Federal Code contains a provision similar to that proposed herein.

Effect upon Revenue. Relatively small gains in revenue would result from enactment of this provision.

D. IT IS RECOMMENDED *that a corporation which ceases its operations in this State before the end of the income year due to dissolution or withdrawal from the State be required to value its property for allocation ratio purposes as of the last day of operations in this State with inventories to be valued on the basis of a periodic average during the period of operation in this State.*

Present Provision. Under the present law corporations employing an allocation ratio which contains a property factor in the determination of their net income are required to value property as of the last day of the income year, except that inventories are to be valued at the average value during the year. There is no specific provision relating to corporations dissolving or withdrawing from the State. (Citation: G. S. 105-134 II)

Explanation. A corporation withdrawing from the State during the year would, in all likelihood, have no property in the State at the end of the year. When this happens the allocation ratio is distorted and results in a smaller portion of income being allocated to the State than is the apparent intent of the law. It is believed, therefore, that a specific provision should be enacted to prevent such distortion.

Effect upon Revenue. Relatively small gains in revenue would result from the enactment of this provision.

E. IT IS RECOMMENDED *that the section of the law requiring the filing of returns by individuals be amended to provide that every individual having a gross income in excess of his personal exemption without benefit of the exemption for dependents be required to file a return.*

Present Provision. The present law provides that every individual having a *net income* in excess of his personal exemption or having a gross income in excess of $5,000 must file a return. A list of persons who must file similar to the list of personal exemptions is written into the law. (Citation: G. S. 105-152)

Explanation. It is proposed to require every individual having a *gross income* in excess of his personal exemption without benefit of the personal exemption for dependents to file an income tax return.

It is believed that such an amendment would accomplish two purposes. First it would simplify the statute and second it would prevent loss of revenue. As many returns, filed as non-taxable returns, are found, upon audit, to be taxable, it seems safe to assume that many individuals who do not file would also be found to have a tax liability if their returns were available for audit. If returns

were filed by all individuals with a gross income in excess of their personal exemption a careful audit would uncover the errors which under the present statute may prevent filing and would, thereby, recover revenue now lost.

Effect upon Revenue. There would be some recovery of revenue upon audit of the returns which would be brought in by this revision. It is believed that the amount would be small.

F. IT IS RECOMMENDED *that the signature of only one officer be required upon filing corporation income tax returns.*

Present Provision. The present statute requires that corporation income tax returns be signed by two officers. a "principal officer" and either the treasurer or assistant treasurer. (Citation: G. S. 105-152 (3))

Explanation. It is believed that the requirement that two officers sign the return of a corporation does not add assurance of the accuracy of the return and is, therefore, needlessly burdensome upon the corporation.

G. IT IS RECOMMENDED *that the requirement that income tax returns be signed by a competent witness to the signature of the taxpayer be deleted from the statutes.*

Explanation. It is believed that the requirement that income tax returns be signed by a competent witness serves no useful purpose. (Citation: G. S. 105-155)

H. IT IS RECOMMENDED *that departments or agencies of the Federal government and corporations having an employee or a place of business in this State be required to furnish "Information at the Source" reports of wages, salaries and other compensation, rents, etc., paid to taxpayers in North Carolina.* IT IS FURTHER RECOMMENDED *that the filing of such informational reports not be construed as evidence that the business so filing is "doing business" in this State for income tax purposes.*

Present Provision. Under the present law every individual, partnership, corporation, etc., ". . . having a place of business in this State . . ." must furnish the Commissioner of Revenue with a return of any and all payments made to taxpayers. (Citation: G. S. 105-154)

Explanation. Officials of the Federal government have indicated willingness to furnish reports on wages and salaries paid to Federal employees under their supervision who are stationed in North Carolina if required by North Carolina statute to do so.

Corporations having salesmen or factory representatives in this State but which are not "doing business" in this State for income tax purposes are reluctant to file "Information at the Source" reports on such employees for fear that such reports might be construed to mean that they are "doing business" in North Carolina with the result that they would be required to pay corporation income taxes to this State. It is believed, therefore, that such corporations should be required to file reports but should be assured that such filing would not be construed as evidence that the corporation so filing is "doing business" in this State.

Effect upon Revenue. Enactment of these provisions would result in an increase in income tax collections to the extent that the employees affected by the reports are not now filing income tax returns or are filing incorrect returns. It is believed that increases in revenue of approximately $100,000 per year would result.

I. IT IS RECOMMENDED *that any accounting period accepted by the Federal government be accepted for income tax purposes and that taxpayers not be required to file an application for change of the accounting period with the Commissioner of Revenue but be required to submit a notification of a change after the change has been approved by the Federal Internal Revenue Service where application for change is required by the Commissioner (Federal) and where application is not required that notification be submitted prior to filing the short period income tax return.*

Present Provision. The present law provides that a taxpayer may change his income year with the approval of the Commissioner of Revenue. (Citation: G. S. 105-142 (2))

Explanation. It is believed that taxpayers should always be permitted to use the same accounting period for Federal and for State purposes. The provision recommended above appears to be the best method of accomplishing this purpose.

J. IT IS RECOMMENDED *that where individuals change their income year they be required to file an income tax return for the period of less than one year between the ending date of their old income year and the beginning date of their new income year; that for purposes of the short period return they be permitted to deduct only that portion of their personal exemption represented by the portion of 12 months covered by the return; and that the tax rates apply to that portion of each income "bracket" represented by the portion of 12 months covered by the return.*

Present Provision. The present law has no provision for treatment of short period returns. (Citation: G. S. 105-133; G. S. 105-142 (2); and G. S. 105-149)

Explanation. Under the present statute a taxpayer is able to change his income year with the short period being for two or even for one month and is entitled to claim a full personal exemption for this portion of a year and to compute his tax at 3 percent of the first $2,000, etc. This obviously gives a taxpayer an undue advantage and encourages the changing of the income year for tax benefit. The Federal Code requires that exemptions and income brackets be prorated. It is believed that a rule of this type is desirable for State income tax purposes also.

Effect upon Revenue. The enactment of these provisions would result in an increase in revenue collections. The amount, however, would not be great in any one year.

SALES AND USE TAXES

HISTORICAL BACKGROUND

North Carolina was the second state to impose a retail sales tax when in 1933 the levy was originally enacted as an emergency revenue measure. The biennial revenue bills of 1935 and 1937 re-enacted substantially the same levy and in 1939 it was made a part of our permanent revenue structure at which time the compensating use tax was added.

Mississippi pioneered in this field of taxation in 1932 and hence this state had little precendent for administrative policy, practice and procedure or compliance requirements in 1933.

Similarly the Attorney General found meager legal authority of courts of last resort for interpretative opinions respecting legal phases of the levy particularly constitutional questions. By 1939 many other states had enacted sales and use tax levies out of which arose many court opinions including the Supreme Court of the United States. Those legal authorities together with the enactment of the use tax law greatly clarified liability and strengthened enforcement.

The Use Tax Article is far superior in text to its companion the Sales Tax Article because the language of the latter is essentially related to an original emergency revenue measure and its present form denotes amendments rather than revision. Its arrangement is unorderly in some respects and many of its sections combine the substantive and administrative features of the law.

ITS RELATED PROBLEMS

By reason of this historical background there have accumulated a number of practices, policies and interpretations of the Department of Revenue incompatible with sound revenue administration together with numerous conflicting and contradictory interpretative opinions. Many items have been exempted by administrative practice unsupported by the law as written. This situation is firmly entrenched with the merchandising industry and ought to be corrected and clarified. This cannot be accomplished by administrative action because tacit approval by many legislative sessions has given sanction to past administrative practice.

RECOMMENDED RECODIFICATION

It is therefore recommended that the existing sales and use tax articles be completely repealed together with all related rules, regulations, administrative policies and practices, administrative and legal interpretations and in lieu thereof an entirely new article be enacted clearly defining liability and providing a simple, understandable and comprehensible guide for administration as well as compliance. To that end this Commission has prepared for submission to the General Assembly of 1957 the draft of a combined Sales and Use Tax Act, incorporating therein the changes which will be more fully explained hereinafter.

This Commission has also examined and approved in principle administrative rules for the interpretation and enforcement of the proposed new Act submitted by the Commissioner of Revenue, which, when adopted and promulgated, is recommended should be published and widely distributed with the new Act for the information and guidance of the general public and taxpayers affected thereby.

STATEMENT OF GENERAL POLICY

The Commission has been primarily concerned with the general policy of the sales and use tax levies and to that end we have endeavored in rewriting the sales and use tax article to embrace therein the following fundamental policies regarding the imposition of a retail sales and/or use tax:

(1) That retail sales and/or use tax is a tax levied against the consumer on the sale or rental and/or use, storage and consumption of tangible personal property to be collected from him by the retailer and paid to the State.

(2) That retail sales tax should be levied on certain types of services such as hotels and motels and in some cases where services are furnished in connection with the sale of tangible per-

sonal property and the charge therefor is not separable, the tax should be levied on the transaction; however, insofar as practicable it is deemed advisable to avoid levying the tax on personal services as such.

RECOMMENDED CHANGES IN THE LAW

(1) The Commission recommends the repeal of the wholesale tax at the rate of 1/20 of 1% on wholesale sales for the purpose of resale and on sales classified by statute as wholesale sales. But it is recommended that the annual wholesale merchant's license be retained and that such merchants be required by law to keep the same records now so required in order to afford the Department of Revenue essential information for efficient administration of the retail sales and/or use tax.

(2) The Commission recommends that the present levies on the retail sale and/or use, storage or consumption of tangible personal property now subject to the retail sales and/or use tax be retained in the main. There is, however, included in the proposed recodification some recommended changes as follows:

(a) A uniform definition of "tangible personal property" conforming to the present use tax definition rather than "an article of commerce" as now contained in the sales tax definition which will result in a number of differences in respect to liability as compared with the present law and established administrative policies and interpretations. These changes and the revenue effect thereof will be more fully explained hereinafter.

(b) Certain transactions or kinds of personal property now exempt by statute have been removed from the exempt status or the liability redefined in conformity with the general statement of policy herein set out.

(c) Certain transactions or kinds of tangible personal property now exempt by administrative interpretation which in the opinion of the Commission should continue to be exempt are specifically set forth in the exemption section.

There has also been incorporated in the proposed recodification statutory provisions covering administrative policies and determinations with respect to liability not directly affecting the tax base.

The Commission submits herewith a summary of the principal changes in the present law which would result from the enactment of the proposed recodification of the present Sales and Use tax Articles.

REPEAL OF WHOLESALE TAX

REPEAL TAX ON WHOLESALE SALES.

Present Law:

Wholesale sales and consumer sales classified as such are now subject to the wholesale rate of tax of 1/20 of 1%.

Problems:

1. In order to afford certain consumers of tangible personal property a preferential rate of tax some sales to consumers have been classified by statue as wholesale sales and made subject only to the wholesale rate. This has resulted in classifying many consumers as wholesale merchants and requiring them to file monthly reports.

2. The wholesale merchant cannot recover the wholesale tax from the retail merchant and therefore has to absorb it as a business expense. This is not in accord with the concept of the Commission previously expressed that the sales tax is basically a tax against the consumer.

3. The use tax is not applicable at the wholesale rate and hence out-of-state wholesale merchants have a business advantage over the North Carolina wholesale merchants. This also adds to the confusion concerning liability of consumers who are taxed at the wholesale rate.

Estimated Annual Revenue Value: $910,000 — LOSS

CHANGES RESULTING FROM ADOPTION OF THE UNIFORM DEFINITION OF "TANGIBLE PERSONAL PROPERTY."

(1) SALES OF PRINTED MATERIAL

Present Law:

Printed materials are not exempt under the present statute but through administrative interpretation have been classified as one of the graphic arts principally because of the labor component.

Problem:

Various types of printed advertising material are subject to the sales and/or use tax. Much of the printed material is in the advertising category and consistent treatment would require that this type of tangible personal property be taxed.

Estimated Annual Revenue Value: $500,000

(2) SALES OF PHOTOGRAPHS, PORTRAITS, ART WORK AND OBJECTS OF ART.

Present Law:

This classification of tangible personal property has been exempted by administrative interpretation because of the personal nature of the article.

Problem:

Pictures, printed reproductions of well recognized art works and other types of interior decoration have not been exempt and there appears to be no policy support to exempt works of art merely because they may be of a personalized nature.

Estimated Annual Revenue Value: $150,000

(3) SALES OF DEVELOPED AND PRINTED FILMS.

Present Law:

Developed films and prints therefrom have been exempted by administrative ruling because of their individual characteristic which was considered to remove them from a classification of customary articles of commerce.

Problem:

The developer and printer of exposed photographic negatives for customers is both a processor and retail merchant. He processes the films and prints and sells the prints to his customer. The tax should be levied against the consumer. The elimination of the narrow concept of "articles of commerce" removes any justification for the exemption on an administrative basis.

Estimated Annual Revenue Value: $60,000

(4) SALES OF BLUE PRINTS AND PHOTOSTATS.

Present Law:

Sales of blue prints and photostats have been administratively exempted because blue prints for architects, engineers and surveyors and photostats for various commercial and business purposes have not been considered articles of commerce and these materials have been exempted on the theory of graphic arts.

Problem:

These articles of tangible personal property are produced and sold generally by units to the customer. Consistency in the theory of consumer taxation requires that they be taxed.

Estimated Annual Revenue Value: $15,000

CHANGES RESULTING FROM THE REPEAL OF THE EXISTING LAWS, ADMINISTRATIVE INTERPRETATIONS, POLICIES AND PRACTICES, ETC.

A. Resulting in Increased Tax Base.

(1) SALES TO LAUNDRIES AND DRY CLEANERS.

Present Law:

Sales of machinery to laundries and dry cleaners have been administratively construed to fall within the purview of sales to manufacturing plants and industries. Similarly, sales of detergents, compounds and cleaning fluids to laundries and dry cleaners have been administratively exempted as ingredient and component parts as in the case of sales to manufacturers.

Problem:

Laundries and dry cleaners are processors and not manufacturers and hence this exemption finds no support in the statute. They are users and consumers of the tangible personal property referred to. They do not sell a manufactured product and neither is their service subject to the sales or use tax.

Estimated Annual Revenue Value: $150,000

(2) SALES OF ASPHALT BY ASPHALT PLANTS.

Present Law:

Prior to July 1, 1955, asphalt plants together with ready-mixed concrete plants had been subject to tax on their purchases of tangible personal property entering into its manufactured product. By administrative interpretation sales of its finished product were exempt from the retail rate of tax since tax had been paid on taxable purchases.

Problem:

An asphalt plant should be properly classified as a manufacturing plant and purchases of tangible personal property entering into the manufactured product should be exempt from tax. Sales of asphalt by asphalt plants should be subject to the 3% retail rate of tax when sold to users or consumers.

Estimated Annual Revenue Value: $90,000

NOTE: Ready-mixed concrete is now subject to the retail sales and/or use tax on the sales price thereof. No change is recommended with respect to the tax on that product. The above recommended change places these two similar and competitive products on the same basis.

(3) ADVERTISING MATERIALS OBTAINED BY BOTTLING COMPANIES THROUGH USE OF DISCOUNT ON SYRUP PURCHASES.

Present Law:

When bottling companies purchase syrup the vendors place five cents of the purchase price of each gallon of syrup in an advertising account. The bottling companies are furnished advertising material by the suppliers to the extent of the monies in the advertising account. By an Attorney General's opinion the advertising materials obtained by bottling companies through this method are not subject to the 3% sales and/or use tax.

Problem:

Advertising materials are subject to sales and/or use tax and if a bottling company purchases directly advertising material from out of the state it is liable for the 3% use tax. The above method is an indirect purchase of such materials. Mere trade practice of an industry does not justify different treatment or affect its tax liability.

Estimated Annual Revenue Value: $6,000

(4) SALES OF ALL TYPES OF PAPER TO THE USER OR CONSUMER (BUSINESS ENTERPRISES OPERATING THEIR OWN PRINTING PRESSES) AND NOT TO COMMERCIAL PRINTERS FOR RESALE.

Present Law:

Under present administrative practice sales of bulk paper to firms operating their own printing presses are exempt from retail sales and/or use tax.

Problem:

Many firms operate their own printing presses and sales of paper to such industries are not sales to commercial printers for the purpose of resale. Since the firms are the users or consumers of such paper, there is no basis in the law for this exemption from tax.

Estimated Annual Revenue Value: $3,000.

(5) PAINT SOLD TO SERVICE STATIONS, AUTOMOTIVE REPAIR SHOPS, GARAGES FOR UPKEEP AS WELL AS PAINTING MOTOR VEHICLES.

Present Law:

By administrative practice paint sold to service stations, automotive repair shops and garages for painting motor vehicles and maintenance purposes is taxed at the wholesale rate and the purchaser becomes liable for remitting the retail tax when the paint is theoretically sold.

Problem:

Sales of paint by auto parts and supply jobbers to service stations, automotive repair shops and garages are sales to users since the purchaser does not sell paint, as such, but consumes it in painting a vehicle. Those sales are sales to consumers and should be taxed as such.

Estimated Annual Revenue Value: $20,000.

(6) SALES OF MEALS BY BOARDING HOUSES.

Present Law:

Meals served by operators of boarding houses are not exempt under present statute but through administrative interpretation boarding houses have not been classified as retail merchants if they did not advertise or solicit patrons.

Problem:

Boarding houses sell or serve meals to the occupants of the boarding house and also to other patrons. This is in direct competition with the operators of restaurants; therefore, operators of boarding houses should be liable for the same tax as the operators of restaurants. Often boarding houses serving meals and restaurants are located in the same vicinity and the Department of Revenue receives constant complaints from the operators of restaurants that they should not be liable for tax if the boarding houses which serve the same patrons are exempt from tax on their sales.

Estimated Annual Revenue Value: $12,500.

(7) SALES TO AND SALES BY INDIANS ON INDIAN RESERVATIONS.

Present Law:

By an opinion of the Attorney General, Indians living on Indian reservations are not liable for sales tax on their purchases or on their sales of tangible personal property insofar as their business is carried on with Indians. This opinion is based upon the status of the Indian as a ward of the Federal Government.

Problem:

Sales to Indians living on an Indian reservation would not create a great problem; however, this does not apply to Indians or other persons operating retail establishments on Indian reservations. A majority of the retail establishments on Indian reservations are not operated by Indians, although Indians are employed, and they are not collecting and remitting sales tax on their sales.

Estimated Annual Revenue Value: $17,500

(8) PAINT SOLD TO MANUFACTURERS FOR PAINTING MACHINERY.

Present Law:

By administrative practice sale of paint to manufacturing industries for painting machinery is not exempt from tax under the provisions of Section 406 (m) of the Revenue Act or under the provisions of Sales and Use Tax Regulation No. 4. However, by administrative practice the Department of Revenue has classified paint as an accessory to mill machinery, therefore, exempt from the retail rate of tax.

Problem:

Since paint is not exempt by statute or regulation and since manufacturers purchase considerable paint for use by them in painting buildings or structures and machinery, it is difficult for the seller to determine if he is making a taxable or nontaxable sale. The seller is further confused by the fact that this item is not included in the statute or regulation.

Estimated Annual Revenue Value: $19,000

(9) SALES OF WIPING RAGS TO MANUFACTURERS.

Present Law:

Sales of wiping rags to manufacturers for use in wiping off dirt, oil, grease and other deleterious matter are not exempt from tax under the provisions of Section 406(m) of the Revenue Act or under the provisions of Sales and Use Tax Regulation No. 4. However, by administrative practice the Department of Revenue has declared wiping rags to be classified as an accessory to mill machinery, therefore, exempt from the retail rate of tax.

Problem:

Sales of wiping rags to manufacturers are not included in the exemption as provided by statute or by regulation and since the exemption rests upon a broad interpretation of the term "accessories to manufacturing industries," the rewrite will result in taxing this type of tangible personal property.

Estimated Annual Revenue Value: $7,500

(10) SALES TO COMMERCIAL FISHERMEN.

Present Law:

Under a ruling of the Attorney General sales of fuel oil, engines, machinery, rigging and equipment to commercial fishermen have been classified as sales to manufacturing plants and industries.

Problem:

While it is true that processing commences on board fishing boats prior to the subsequent manufacturing after the catch is delivered to the plant, nevertheless, the language of the statute, (G. S. 105-169) is not sufficiently broad to cover commercial fishermen.

Estimated Revenue Value: $18,000

(11) SALES OF MACHINERY, PAPER, ETC., TO FREEZER LOCKERS, POULTRY PROCESSORS.

Present Law:

Under the authority of an opinion of the Attorney General sales of machinery, packaging and cartons to freezer locker plants and poultry processors used by them to process customers' products have been construed as sales to manufacturing plants and industries.

Problem:

Freezer locker plants and poultry processors who process and/or store food and poultry products for customers are not manufacturing plants within the meaning of G. S. 105-169 (m).

Estimated Annual Revenue Value: $500

B. Resulting in Decreased Tax Base.

(12) SALES OF OPTICAL SUPPLIES TO OPTICIANS AND OPTOMETRISTS TO BE EXEMPT FROM RETAIL SALES TAX.

Present Law:

Sales of optical supplies to opticians and optometrists are now subject to the retail sales tax by a Department of Revenue regulation and practice.

Problem:

Such supplies are primarily ingredient or component parts of eyeglasses which by administrative practice are exempt from the retail sales tax. The proposed rewrite includes eyeglasses as a statutory exemption under the medical group. Component and ingredient parts of other items in that classification are not subject to tax and consistent treatment would require the elimination of tax on the above tangible personal property.

Estimated Annual Revenue Value: $90,000—LOSS

CHANGES RESULTING FROM REMOVAL OF STATUTORY EXEMPTION OR RE-DEFINING LIABILITY

(1) FUNERAL EXPENSES (INCLUDING SERVICES) IN EXCESS OF $150.

Present Law:

Sales of coffins or caskets which do not sell for more than $100 are exempt from tax.

Problem:

In many instances charges for caskets, services, vaults, clothes, flowers, etc., are not made in such a manner that the selling price of the coffin or casket can be determined. Two alternate methods have been prescribed by regulation for use in determining the amount of tax due on coffins or caskets and other services and materials furnished by funeral directors, morticians and undertakers but the question of the amount paid for service charges and for tangible personal property is often indistinguishable. The recodification allows an exclusion or exemption of $150 on the total expenses of a funeral, and states that the remainder of such expenses are taxable.

Estimated Annual Revenue Value: $145,000

(2) PEANUTS AND POPCORN SOLD AT THEATRES OR AT CONCESSION STANDS.

Present Law:

G. S. 105-169 (i) exempts food and food products for human consumption, defines such products and excludes certain food products from the exemption. By interpretation the above items have been exempted as "food products for human consumption" while other similar products sold for "on premises" consumption by theatres or at concession stands have been taxed.

Problem:

All other tangible personal property ordinarily sold by concession stands, located in theatres and elsewhere, is subject to sales tax and it does not appear that G. S. 105-169 (i) contemplated treating these items differently.

Estimated Annual Revenue Value: $95,000

(3) FOOD PRODUCTS, DISPENSED THROUGH VENDING MACHINES, INCLUDING COFFEE

Present Law:

By Attorney General's opinion, liquid coffee dispensed through vending machines which are not located in a place where prepared meals and/or foods are sold is exempt from tax and sales of certain other food items such as nabs from dispensing machines located in places having no facilities for preparing or serving prepared meals and/or food are exempt from tax.

Problem:

It is felt that it was not the intent of G. S. 105-169 (i) to exempt such sales in one instance and to tax them in another very similar instance, depending upon the location of the vending machine.

Estimated Annual Revenue Value: $35,000

(4) USED ARTICLES TAKEN IN TRADE.

Present Law:

Sales of used articles taken in trade or a series of trades as a credit or part payment on the sale of a new article provided the tax levied in this article is paid on the full gross sales price of the new article (are exempt), G. S. 105-169 (h).

Problem:

The merchant is required under the present law to pay tax on the full gross sales price on the sale of a new article without taking into account profit or loss he may sustain by reason of the article taken in trade. The article taken in trade becomes tax exempt. In some types of merchandise a profit may be reasonably expected whereas in others a calculated loss is incurred. This results in an inequity. A fairer tax base is to tax the difference.

Recommended Change:

G. S. 105-166, subsection 16, proviso 1, "where used articles are taken in trade or in a series of trades as a credit or part payment on the sale of new or used articles 'sales price' means the price of the new article sold less the credit for the used article taken in trade."

Estimated Annual Revenue Value: No Change.

ITEMS NOW EXEMPT BY ADMINISTRATIVE PRACTICE WHICH ARE SPECIFICALLY EXEMPTED IN THE PROPOSED NEW LAW

(1) SCHOOL LUNCHES

Present Law:

Sales by school lunch rooms are not exempt from tax by the present statute. However, the School Machinery Act provides that lunch rooms shall be operated as part of the functions of the public schools of this State. In view of this Act, the Attorney General issued an opinion stating that school lunch rooms were not subject to sales and/or use tax.

Problem:

It would be contrary to the operation and maintenance of our public school system to levy a sales tax on school lunches which are a part of the program. The collection of the tax from school children would also present an almost insurmountable compliance problem.

(2) SALES IN DINING ROOMS OPERATED BY STATE OR PRIVATE EDUCATIONAL INSTITUTIONS.

Present Law:

The present statute does not exempt sales in dining rooms operated by state or private educational institutions; however, such sales have been administratively exempted from tax if the sales were made to students attending the institutions.

Problem:

Students are required to pay sales tax when eating in public restaurants, clubs, etc., but do not pay tax on meals served by the school, although the student pays for the food when it is consumed and the charge is not included in his regular tuiton. In some instances, a flat fee is charged for tuition, room and board; therefore, it would be difficult to separate the charges for meals from other charges.

(3) SALES TAX LIABILITY OF BLIND MERCHANTS.

Present Law:

Although not exempt by statute, sales by blind merchants, operating under the supervision of the Commission for the Blind, have been administratively exempt from tax. Also blind merchants having a net income per annum of less than $1,200 were also exempt from tax on their sales.

Problem:

The Commission for the Blind is a State agency which should not be taxed but the exemption should be provided by statute.

(4) MEALS SERVED BY RESTAURANTS AND OTHER EATING ESTABLISHMENTS TO THEIR EMPLOYEES.

Present Law:

In accordance with a directive of the Commissioner of Revenue, meals served by restaurants, cafes, etc., to their employees are exempt from tax.

Problem:

Meals served by restaurants and cafes to their employees are furnished incidental to the employment as a part of their compensation and for convenience. Since there is no sale as such the furnishing of meals is not a taxable transaction. The proposed new definition of "sale" makes it desirable to statutorily exempt such meals from tax.

(5) SALES BY CONCESSION STANDS OPERATED BY THE STATE PRISON SYSTEM.

Present Law:

Although not specifically referred to by statute, sales by concession stands operated by the State Prison System are exempt from sales tax under an administrative ruling of the Sales & Use Tax Division of the Department of Revenue.

Problem:

In addition to prisoners and guards purchasing from the concession stands, all visitors are able to purchase taxable tangible personal property without paying sales tax. However, the concession stands are operated as a part of the State's Prison System for the benefit of the prisoners. It would be a hardship to require prisoners to pay sales tax but uniformity would require collection of tax from all patrons. It is therefore desirable to statutorily exempt sales of this activity.

(6) SALES OF CENTRAL OFFICE EQUIPMENT AND SWITCH BOARD AND PRIVATE BRANCH EXCHANGE EQUIPMENT TO TELEPHONE AND TELEGRAPH COMPANIES.

Present Law:

By administrative interpretation and practice sales of central office equipment and switchboard and private branch exchange equipment to telephone and telegraph companies have been classified as sales to manufacturing plants and industries.

Problem:

In view of the long standing interpretation and practice the Commission concludes that the exemption should be recognized and written into the statute under a proper classification.

(7) SALES OF EYEGLASSES GROUND ON PRESCRIPTION OF PHYSICIANS OR OPTOMETRISTS.

Present Law:

Eyeglasses ground on prescription of physicians or optometrists are not included in the other physical aids now exempt under G. S. 105-169 (k) but blank lenses, frames and other parts of eyeglasses are taxable to the physician or optometrist as a consumer. Eyeglasses sold by department and variety stores are taxable at the retail rate.

Problem:

Eyeglasses are similar physical aids to dentures, artificial limbs and artificial hearing devices now exempt by statute. It is proposed to include glasses ground on prescription with those other physical aids.

(8) SALES OF NEWSPRINT PAPER AND NEWSPAPERS.

Present Law:

By administrative practice sales of newsprint paper to newspaper publishers have been exempted on the basis of a component or ingredient part of a manufactured product. Sales of newspapers to the public have been exempted by interpretation that since they are not articles of commerce they are not subject to the tax.

Problem:

The recodification would tax newsprint paper as an item consumed by newspaper publishers since it is not an ingredient or component part of a manufactured product. Similarly under the new definition newspapers would be included as tangible personal property. The Commission has therefore included these items in the statutory exemptions to conform to present policy and practice.

(9) SALES OF WRAPPING PAPER, LABELS, WRAPPING TWINE, PAPER, CLOTH, PLASTIC BAGS, CARTONS, PACKAGES AND CONTAINERS, CORES, CONES, OR SPOOLS, WOODEN BOXES, BASKETS, COOPS AND BARRELS, INCLUDING PAPER CUPS, NAPKINS AND DRINKING STRAWS, AND LIKE ARTICLES SOLD TO MANUFACTURERS, PRODUCERS AND RETAILERS, WHEN SUCH MATERIALS ARE USED FOR PACKAGING, SHIPMENT OR DELIVERY OF TANGIBLE PERSONAL PROPERTY WHICH IS SOLD EITHER AT WHOLESALE OR RETAIL OR WHEN SUCH ARTICLES CONSTITUTE A PART OF THE SALE OF SUCH TANGIBLE PERSONAL PROPERTY AND ARE DELIVERED WITH IT TO THE CUSTOMER.

Present Law:

These articles are exempt in part by regulation and in part by administrative practice.

Problem:

These articles are essential in packaging, shipment and delivery of tangible personal property which is sold at wholesale or retail and have been included in the statutory exemptions to conform to present practice and also to specifically exclude from tax liability these materials which are an essential part of every sale.

(10) LEASE OR RENTAL OF FILMS, TRANSCRIPTIONS AND RECORDINGS TO RADIO AND TV STATIONS.

Present Law:

Radio transcriptions were held by the Supreme Court of North Carolina in the case of *Watson Industries* vs. *Shaw, Commissioner,* not to be taxable.

Problem:

The continued development and improvement of broadcasting and telecasting by radio and television stations makes it desirable to include in the statute the principle decided by the Supreme Court.

NOTE: For the reasons set forth with respect to each of the above items, it is not anticipated that the inclusion of said items in the statutory exemptions would have any effect on revenue but would clearly define liability.

PROVISIONS INCORPORATED IN THE RECODIFICATION WHICH CLEARLY DEFINE CERTAIN COMPLIANCE REQUIREMENTS CONFORMABLE TO PRESENT PRACTICES WITH SOME MODIFICATIONS.

(1) RETAIL BRACKET SYSTEM:

Present Law:

The bracket system for the collection of sales tax by a retail merchant is not incorporated in the present law, but is recommended for use by them in accordance with a regulation promulgated in 1937 which is in general use.

Problem:

It is sometimes difficult for a merchant to collect sales tax under the bracket system. The bracket system defined by statute will facilitate the collection thereof by merchants and should decrease customer resistance and thereby relieve the merchant of the necessity of absorbing the tax as is sometimes the case at present.

(2) DELIVERY OR TRANSPORTATION CHARGES:

Present Law:

Under the provisions of G. S. 105-218 (e) and an opinion of the Attorney General, all costs of transportation or delivery charges to the purchaser whether paid by the purchaser to the retailer or the carrier is included in the tax base.

Problem:

Transportation charges are subject to tax whether the merchandise is purchased within or without the State of North Carolina even though such charges are shown separately on the bill of sale. This has created a problem and has the effect in some cases of taxing transportation charges as such. It is proposed that where title to the tangible personal property passes to the purchaser at the point of origin transportation charges would not be subject to the sales or use tax. If title passes at the destination point such charges would be includable in the tax base.

(3) EXCISE TAXES.

Present Law:

Although not so defined in the present statute, the Federal Manufacturers' Excise Tax is an inseparable part of the selling price of merchandise and is included in the sales price subject to the retail rate of tax in accordance with an Attorney General's opinion. The Retailers' Excise Tax is not a part of the selling price of merchandise and therefore is not included in the sales price subject to tax.

Problem:

The retailer has difficulty in determining whether the excise tax should be included in the selling price of merchandise. The merchant also encounters resistance from his customer when sales tax is added to a manufacturer's excise tax. The recodification includes the Federal Manufacturers' Excise Tax but excludes the Retailer's Excise Tax.

(4) COLLECTIONS IN EXCESS OF 3%.

Present Law:

Under the present law the retail merchant is liable for the sales tax at the rate of 3% on his gross taxable sales. The Attorney General has ruled that when the merchant collects tax in excess of his liability he is not required to pay such excess to the State.

Problem:

Customers complain about having to pay sales tax to variety stores, drug stores, chain stores and other merchants when the full amount of the tax under the bracket system is collected in each department during a single shopping tour. This situation will probably be corrected to some

degree by reason of the trend toward self-service but a requirement that the merchant pay the tax at 3% of total net taxable sales or the amount collected (whichever is greater) will probably result in the merchant providing a method whereby excessive sales tax collections will not be made.

NOTE: For the reasons set forth above with respect to each of the recommended provisions, it is not anticipated that the inclusion thereof in the proposed recodification would have any material effect on revenue.

GENERAL SUMMARY

The foregoing explanation of the changes in the present sales and use tax laws which would result from the enactment of the proposed recodification of the combined articles points out specifically all the various items so affected which the officials of the Department of Revenue are presently able to segregate and classify. But such sweeping change in the statute, regulations, interpretations, policies and practices will no doubt affect other items and transactions which may not presently be foreseen or anticipated.

Of greater importance, however, is the value of a completely new text more clearly defining liability, compliance requirements and administrative practices and procedures. Thus, the Commission proposes the recodification as a suitable framework for the sales and use tax laws sufficiently stable to sustain the basic policies declared herein but likewise sufficiently flexible to permit amendments from time to time whereby the tax base may be enlarged, restricted or modified as changing economic conditions may require in order to provide for the State's fiscal needs from this particular source of revenue.

THE FRANCHISE TAX

No major changes in the franchise taxes levied for the privilege of engaging in business in corporate form in North Carolina are considered to be desirable at this time. Proposals, however, for three relatively minor changes are presented below.

SPECIFIC RECOMMENDATIONS

A. IT IS RECOMMENDED *that the section of the statutes which levies a gross receipts tax upon telegraph companies be amended by deleting the subsection which states that the tax shall not be levied upon interstate commerce.*

Present Provision. Under the present statute a franchise tax is levied upon telegraph companies measured by the gross receipts from business within this State including business which originates and terminates in this State even though the message may go outside of the State in the course of transmission, except that "nothing in this section shall be construed to authorize the imposition of any tax upon interstate commerce." (Citation: G. S. 105-119)

Explanation. Decisions of both North Carolina and Federal Courts have ruled that messages originating and terminating in the State, but going outside the State in the course of transmission are messages in interstate commerce. As the telegraph company for its convenience routes virtually all messages in this way, the application of this ruling to the franchise tax on telegraph companies would virtually eliminate all of the tax liability of the company.

It is believed that the deletion of the subsection which prohibits a tax on interstate commerce would eliminate the difficulty.

Effect upon Revenue. Adoption of this recommendation would have no effect upon the revenue currently being collected, but would remove the threat of the loss of approximately $22,000 per year.

B. IT IS RECOMMENDED *that, in the event the recommendations for the revision of the sections of the Income Tax Act relating to the allocation of corporate net income are adopted, the methods of apportionment of net apportionable income contained in these recommendations be adopted for the allocation of the capital stock, surplus, and undivided profits of those corporations filing under G. S. 105-122.*

Present Provision. Under the present law the same allocation formulae are used for allocation of capital stock, surplus, etc., for franchise tax purposes as are used for corporation income tax purposes. The only difference is that domestic and foreign corporations use the same method of allocation for franchise tax purposes but not for income tax purposes. (Citation: G. S. 105-122 (3))

Explanation. It is believed that the present practice of using the same ratio for income and franchise tax purposes should be continued.

Effect upon Revenue. The estimated effect upon revenue of enactment of these provisions is included in the estimate given in the section of this report entitled "Allocation of Net Income." The amount applicable to the franchise tax is relatively small.

C. IT IS RECOMMENDED *that scientific corporations not operated for profit be exempted from the corporation franchise tax levied under Sections 105-122 and 105-123 of the General Statutes.*

Present Provision. Under the present statute religious, fraternal, benevolent, or educational corporations not operated for profit are exempt from the franchise tax, but there is no reference to corporations engaged in scientific research. (Citation: G. S. 105-125)

Explanation. Under the income tax laws, corporations organized for scientific purposes are exempt from the income tax if no part of the profits inures to the benefit of any private individual or stockholder. The franchise tax laws are silent with respect to this type of corporation. It is believed that corporations organized for the purpose of conducting scientific research should be ex-

empt from the franchise tax. There is at present a corporation in North Carolina conducting research into uses of nuclear energy.

Effect upon Revenue. There would be a negligible loss of revenue if this proposal were adopted.

D. IT IS RECOMMENDED *that the signature of only one officer be required upon filing corporation franchise tax returns and that the requirement that the returns be signed by a competent witness of the signature be deleted.*

Present Provision. The law requires that corporation franchise tax returns filed under Section 105-122 of the General Statutes be signed by the president or vice-president *and* by the treasurer, assistant treasurer, secretary or assistant secretary. It is also required that such returns be signed by a competent witness of the signatures. (Citation: G. S. 105-122 (1))

Explanation. It is believed that the requirement that two officers sign returns does not add assurance of the accuracy of the return and is, therefore, needlessly burdensome upon the corporation. It appears that the requirement that returns be signed by a witness serves no useful purpose.

Effect upon Revenue. None.

TAXES UPON INSURANCE COMPANIES

It is the belief of this Commission that the method of taxing insurance companies under the present statutes is the most satisfactory method that has been advanced. It is also believed that the establishment of rates is a matter of legislative policy and does not require any comment or suggestion from this Commission. There is one area, however, where clarification is thought to be needed, this is the provision exempting insurance companies from all other taxes except ad valorem taxes and certain fees and licenses.

IT IS RECOMMENDED *that Section 105-228.5 of the General Statutes be amended to provide that nothing in this section be construed as exempting insurance companies paying the gross premiums tax from paying sales and/or use taxes upon purchases for use or consumption or from collecting the sales tax on sales of tangible personal property to employees or to others including sales of meals and remitting such collections to the Commissioner of Revenue.*

Present Provision. The present statute levies a tax on insurance companies measured by the gross premiums received by the company from North Carolina business.

The statute provides that this tax shall be in lieu of all other taxes except ad valorem taxes and fees and licenses levied specifically upon insurance companies by the General Statutes. The current administrative practice is to levy the sales tax on sales to or by insurance companies and to levy the use tax on purchases from out-of-state sources by insurance companies. (Citation: G. S. 105-228.5)

Explanation. It is the thinking of the Commission that insurance companies should pay sales taxes upon equipment and materials purchased and that insurance companies which furnish cafeteria service to their employees or purchase other tangible property for sale to their employees should collect the proper amount of sales tax on such sales. Although this is the current administrative practice, the wording of the statute gives rise to some doubt as to the proper interpretation. It is believed, therefore, that the statute should be clarified.

Effect upon Revenue. None.

INTANGIBLE PERSONAL PROPERTY TAX

The Commission thoroughly investigated the theory of the present intangible property tax levy and weighed the relative merits of the theory and administrative practicality of alternate methods of taxing this type of wealth and the income therefrom. The present method is considered far from perfect but no completely satisfactory solution could be developed. Legal, equitable, fiscal and administrative considerations led the Commission to consider only specific possibilities as to what changes would be of convenience to the taxpayer and whether the State should continue to share in the proceeds of the tax. (Other considerations and a general recommendation appear in Part I of this report.)

SPECIFIC RECOMMENDATIONS

A. IT IS RECOMMENDED *that trusts established for religious, educational, charitable or benevolent purposes be exempt from all taxes levied upon intangible personal property where none of the property or the income from the property owned by such trust may inure to the benefit of any individual or any organization conducted for profit.*

Present Provision. Religious, educational, charitable or benevolent organizations not conducted for profit are exempt from the intangible personal property taxes. There is no reference in the statutes to trusts established for such purposes. (Citation: G. S. 105-212)

Explanation. It is believed to be desirable to exempt such trusts from the taxes levied on intangible property.

Effect upon Revenue. It is believed that the effect of adoption of this recommendation would result in loss of a negligible amount of revenue.

B. IT IS RECOMMENDED *that 100 per cent of the net amount of taxes collected under the Intangible Personal Property Tax Act be distributed to the counties and the municipalities on the same basis as the present distribution is made.*

Present Provision. Under the present law 80 percent of the taxes collected under the Intangible Personal Property Tax Act is distributed to the counties and the municipalities. The remaining 20 percent goes into the General Fund. (Citation: G. S. 105-213)

Explanation. It is believed that as the State levies no general *ad valorem* tax it should either withdraw entirely from the property tax field or continue to levy the tax on intangible personal property but should distribute the entire amount collected therefrom to the local units.

Withdrawal from the property tax field can be accomplished by exemption of intangible property from taxation or by returning the responsibility for the levy and collection of taxes on intangible property to the local units. Exemption of intangible property by the General Assembly is, in the opinion of the Attorney General, unconstitutional, and, therefore, may be omitted from further consideration except as a constitutional amendment.

The return of the responsibility for the levy and collection of *ad valorem* taxes on intangible property to the counties and municipalities is considered to be both undesirable and impractical: It is undesirable because the rates applied by the local governments would in all likelihood be the same as the rates levied on other property, (unless the General Assembly specified minimum and maximum rates), which, in some instances, aggregate to over $4 per $100 of assessed value, and because inequities would result between properties the existence and value of which are readily ascertainable from the records of the taxpayer and other property; it is impractical because the administration of this tax by county tax supervisors and tax collectors is exceedingly difficult, and such enforcement as might be attempted would be accomplished at an excessive cost because of the duplication of efforts by many counties.

When alternate solutions were eliminated, the Commission decided to recommend distribution of all of the proceeds of the tax to the localities.

Effect upon Revenue. It is estimated that the adoption of this recommendation would result in a loss of revenue of $1,600,000 during the 1957-58 fiscal year.

C. IT IS RECOMMENDED *that all corporations or individuals filing income tax returns on a fiscal year basis report money on hand, accounts receivable and bonds, notes, demands, claims and other evidences of debt as of the last day of their fiscal year.*

Present Provision. Under the present statute such intangible property must be reported as of December 31 of each year. (Citation: G. S. 105-200; G. S. 105-201; and G. S. 105-202)

Explanation. The proposal that certain intangible property be reported as of the last day of the fiscal year of the taxpayer is made for the convenience of the taxpayer. It is believed to be an unnecessary hardship upon the taxpayer to require him to ascertain the value of such property upon a day other than one upon which the books of the taxpayer are closed.

Effect upon Revenue. No appreciable change is anticipated.

PRIVILEGE LICENSE TAXATION

For more than 150 years taxes on the privilege of doing business in North Carolina have been levied by the State, the counties and the cities of North Carolina. Once a major source of tax revenues in North Carolina, the privilege license tax now produces about $10 million or about 3% of all tax funds collected by the state and local units of government. Unlike the sales, income and property taxes, the privilege license tax structure has not been built in a comprehensive fashion, but rather has grown through the years in an inequitable and illogical fashion to form an appendage to the state and local tax structure, not an integral part of that structure.

The privilege license tax in North Carolina is a revenue-producing tax, not a regulatory fee. In this sense the use of the term "license" is misleading. Some of the businesses taxed are also subject to regulation by the state and local units of government for the protection of the public health and welfare, but this regulation must be and is handled in a different fashion, independent of the tax payment.

The Commission has been disturbed to find that some businesses pay rather large license taxes while other businesses, often competing businesses, pay very small license taxes; that many different bases of taxation are used, most of them having no relation to amount of business activity; that in some cases the overlapping taxes of cities and the state result in startling inequities; that some businesses having a great mobility are protected by the state while others pay the penalty of taxation by several different governmental units; that the cost of collecting the tax on all levels of government is out of proprotion to the revenue derived; that the number of licenses required from most businesses is a source of great annoyance. Further detail will be found in the body of this report. Here it is sufficient to say that the Commission could not make any recommendations for changes in the state's tax structure without making recommendations for revising the system of privilege license taxation.

Since the privilege license tax is now levied by three different levels of government, the Commission's recommendations of necessity cover the license tax powers of all three levels of government. These overlapping powers of taxation and the probable effect that changes in the license tax schedule would have on local tax policy as well as state tax policy made formulation of these changes one of the Commission's most difficult tasks. The Commission would have preferred to repeal all license taxes on the state level, but demands for state services made such a step inadvisable at the present time.

Since the changes recommended in this area of taxation are fundamental ones, it is appropriate to review here the objectives that the Commission sought to achieve.

1. Comprehensive revision of Schedule B of the Revenue Act, and of local powers to tax business, to introduce a new concept in business taxation in this state that will insure equitable taxes and a protection to all businesses, small and large alike.

2. Protection of the revenue-producing potential of both state and local governments so that no unit of government will be hampered in its ability to meet service demands.

3. Recognition, insofar as possible, of the principle of local legislative discretion and the desirability of strengthening local units of government.

4. Levy of taxes on business that will be easier to collect and less annoying to the business community.

As the body of this report will show, the Commission could not realize each of these objectives completely for they are, in some ways, contradictory. Every effort has been made, however, to strike a satisfactory balance between all competing considerations. The Commission believes that its recommendations will result in a more equitable tax; that the state will match in revenue the present yield of Schedule B; that local units of government will derive as much revenue from business taxes as they do now (and will benefit from other recommendations of this Commission); and that business taxes will be much easier to collect and make more sense to the businessman.

RECOMMENDATIONS

The Commission makes the following recommendations concerning Schedule B of the Revenue Act and local taxing power in the field of business licenses:

1. That the present hodgepodge system of privilege license taxation be replaced by a broad-based occupational levy on the privilege of doing business in the State of North Carolina.

2. That the present overlapping taxing powers of the state and local units of government be abolished; that the state levy an occupation tax on specified forms of business activity and that local units be given the power to levy an occupation tax on other forms of business activity.

3. That the occupation tax levy be based insofar as possible on the amount of business activity engaged in by separate business endeavors, taking into account differing patterns in profit margins from one category of business to another. Specific exceptions to this principle are unavoidable and will be listed below.

4. That all types of business be divided into a minimum number of categories for determining liability for the occupation tax. These categories are recommended by this Commission: Retail trade; wholesale trade; services; amusement activities; manufacturing; contractors and construction trades; financial institutions; and professions. A few miscellaneous taxes may be necessary.

5. That the State of North Carolina levy occupation taxes on the following major types of business to the exclusion of local units of government: wholesale trade; selected service trades; selected amusement activities; contractors and construction trades; professions; financial institutions; miscellaneous activities to be specified in (10).

6. That cities and counties levy occupation taxes on the following types of business to the exclusion of the State of North Carolina: retail trades; selected service trades; selected amusement activities and manufacturing concerns.

7. That the cities and counties have the power to establish classification within retail and service categories and to levy different rates of taxation on business in such classifications, so long as the rate for the category is not exceeded and so long as no classification is exempt from taxation.

8. That the following tax rates be adopted for state and local occupation tax levies, each rate being applied to total gross receipts (with certain exceptions, noted hereafter, in taxation of wholesale businesses and manufacturing activities):

Category of Business	State Tax Rate	Maximum City Rate	Maximum County Rate
Retail Trade	None	.09 of 1%	.045 of 1%
Eating Establishments	None	.15 of 1%	.075 of 1%
Wholesale Trade	.075 of 1%	None	None
Service Trades *	.3 of 1% (selected)	.3 of 1% (selected)	.15 of 1% (selected)
Amusements * (with exceptions noted in this report)	(selected)	.6 of 1% (selected)	.6 of 1% (selected)
Contractors and Construction *	.1 of 1% (selected)	.1 of 1% (selected)	.1 of 1% (selected)
Manufacturing	None	.1 of 1% (Maximum Tax of $2,500)	.05 of 1% (Maximum Tax of $1,250)

Category of Business	State Tax Rate	Maximum City Rate	Maximum County Rate
Bottlers of Soft Drinks	.4 of 1%	None	None
Ice Cream Manufacturers	.1 of 1%	None	None
Newspapers	.1 of 1%	None	None
Radio and TV Broadcasting	.1 of 1%	None	None

* Details upon which governmental unit would levy these taxes will be found on page ~~41~~. 79.

9. That the annual tax on professions now contained in G. S. 105-41 be increased from $25 to $50.

10. That the taxes in the following sections of the General Statutes remain substantially without change: G. S. 105-41.1; G. S. 105-50; G. S. 105-57; G. S. 105-67; G. S. 105-68; G. S. 105-72; G. S. 105-77; G. S. 105-83; G. S. 105-88; G. S. 105-90; G. S. 105-90.1; G. S. 105-92; G. S. 105-93; G. S. 105-101; G. S. 105-102.1.

11. That cities be permitted to levy license taxes on automobiles of up to $10 per automobile instead of $1 per automobile and that cities be permitted to levy a tax of up to $10 on individuals earning salaries and wages in the city for the privilege of engaging in occupations within the city boundary.

REASONS FOR THESE RECOMMENDATIONS

ANALYSIS OF PRIVILEGE LICENSE TAXATION IN NORTH CAROLINA TODAY

Privilege license taxes—taxes imposed and collected for the privilege of carrying on a business, trade or occupation—are the oldest state taxes in North Carolina, having been levied in some form since 1784. These taxes are also notable in that they constitute the only form of tax now levied and collected at three separate levels of government in North Carolina. Privilege license taxes are levied by the state under Schedule B of the Revenue Act. That schedule also authorizes counties to levy privilege license taxes on a limited number of businesses. Cities in North Carolina have a broad authority to levy license taxes on businesses, trades and occupations, authority granted under the provisions of G. S. 160-56, but this broad authority is limited with respect to taxes imposed on those businesses also taxed by the state in Schedule B of the Revenue Act.

A brief description of the levy and collection of privilege license taxes by all three levels of government, including an analysis of the impact of the tax and its use by each level of government, follows.

Schedule B of the Revenue Act

Taxes on the privilege of doing business in a particular way have been levied by the State of North Carolina since 1784, and three of the present license taxes—those on attorneys, peddlers, and pool tables—have been levied by the state since that time. Important to an understanding of Schedule B as it exists today is the fact that it has never undergone basic, comprehensive revision. Only occasionally has any attempt been made to change the basic structure of the tax, and none of these attempts have been lasting in their effect. The present 73 sections of Schedule B have been added, one or two sections at a time, over the past 170 years, and changes have been made from time to time in the basis of a particular tax levy. In some cases businesses are paying the same license tax to the state that they paid in 1933, during the depths of the depression. What was then a substantial tax has, with inflationary economic developments, become a minimal tax. On the other hand, the tax on some businesses is keyed to amount of economic activity and has

increased in proportion to the rise in economic activity. The result has been a continual redistribution of the tax load under Schedule B of the Revenue Act.

The 73 sections of Schedule B can be said to levy taxes on 160 separate business occupations and separate privileges. Following the same system of enumeration, however, it was determined that municipal ordinances in six cities and towns, chosen at random, levied taxes on 333 separate businesses, exclusive of those defined in Schedule B. Such definitions are limited only by the ingenuity of those drafting tax ordinances. Perhaps the overall effect of Schedule B, insofar as it applies to the whole range of business activity in the state, can better be expressed in another fashion.

At the present time the Department of Tax Research classifies all business activity in North Carolina into about 90 different types, and these 90 types are grouped together into a smaller number of categories, namely Agriculture and Extractive Industry, Construction, Finance, Manufacturing, Public Utilities, Recreation and Amusement Companies, Service Corporations, and Trade Corporations. When the taxes levied by Schedule B are compared with these types of businesses, it is at once apparent that over one-half the business types in North Carolina are not specifically taxed under any section of Schedule B. Many other businesses are affected only insofar as they engage in a taxable activity which is not in itself a principal type of business. For example, many businesses pay the state a tax for the privilege of selling soft drinks but pay no tax for the privilege of engaging in their principal activity. Table 1 shows in general the business categories affected by Schedule B.

Table 1.

PRIVILEGE LICENSE TAXES LEVIED BY THE STATE OF NORTH CAROLINA BY CATEGORY OF BUSINESS

Business Category	Taxes Levied by Schedule B
Agriculture and Extractive Industry	None
Construction	Architects (G. S. 105-41)
	Contractors (G. S. 105-54)
	Elevator and Sprinkler Installation (G. S. 105-55)
	Plumbers and Electricians (G. S. 105-91)
Finance	Collection Agencies (G. S. 105-45)
	Pawnbrokers (G. S. 105-50)
	Mercantile Agencies (G. S. 105-57)
	Security Brokers (G. S. 105-67)
	Building and Loan Associations (G. S. 105-73)
	Installment Paper Dealers (G. S. 105-83)
	Loan Agencies (G. S. 105-88)
Manufacturing	Cotton Compresses (G. S. 105-63)
	Soft Drink Bottlers (G. S. 105-69)
	Packing Houses (G. S. 105-70)
	Marble Yards (G. S. 105-96)
	Ice Cream Manufacturers (G. S. 105-97)
Professions	Professions (G. S. 105-41)
Public Utilities	See Schedule C of the Revenue Act
Recreation and Amusement	Film Distributors (G. S. 105-36)
	Theatres (G. S. 105-35,-36.1,-37)
	Other Staged Amusements (G. S. 105-37.1)
	Circuses and Carnivals (G. S. 105-38,-39)
	Gypsies and Fortune Tellers (G. S. 105-58)
	Pool Halls and Bowling Alleys (G. S. 105-64,-64.1)
	Entertainment Devices (G. S. 105-65,-66)

Business Category	Taxes Levied by Schedule B
Services	Detectives (G. S. 105-42) Undertakers (G. S. 105-46) Elevator and Sprinkler Repair (G. S. 105-56) Hotels and Motels (G. S. 105-60,-61) Eating Establishments (G. S. 105-62) Dry Cleaning and Laundries (G. S. 105-74,-85) Barber and Beauty Shops (G. S. 105-75) Shoe Shine Parlors (G. S. 105-76) Advertising (G. S. 105-86,-87)
Trades	
(1) Automotive	Accessory Stores (G. S. 105-89) Motor Vehicle Dealers (G. S. 105-89) Service Stations (G. S. 105-89) Motorcycle Dealers (G. S. 105-89.1) Gas and Oil Distributors (G. S. 105-99)
(2) Beverage, Food and Drug—Wholesale and Retail	Vending Machines (G. S. 105-65.1) Sale of Bottled Drinks (G. S. 105-79) Sale of Tobacco Products G. S. 105-84)
(3) Equipment and Supplies—Wholesale and Retail	Office Equipment (G. S. 105-51) Sewing Machines (G. S. 105-52)
(4) General Merchandise—Wholesale and Retail	Bicycle Dealers (G. S. 105-49) Peddlers (G. S. 105-53) Newsdealers on Trains (G. S. 105-78) Pistols (G. S. 105-80) Musical Merchandise (G. S. 105-82) Trading Stamps (105-92) Chain Stores (G. S. 105-98) Junk (G. S. 105-102)
(5) Miscellaneous	Professional Bondsmen (G. S. 105-41.1) Real Estate Auctions (G. S. 105-43) Coal and Coke Dealers (G. S. 105-44) Horse and Mule Dealers (G. S. 105-47) Cotton Brokers and Commission Merchants (G. S. 105-68) Tobacco Warehouses (G. S. 105-77) Employment Agents—Emigrant (G. S. 105-90)

In other words, Schedule B is not a broad based tax and affects the different categories of business in varying ways. Some form of tax is levied upon most service activities, for example, but only a few selected taxes are levied on retail trades. While no taxes are levied on wholesale trades as such, the sales tax levied on wholesalers is paid by wholesalers and not by consumers.

Selective taxation of this nature is not necessarily bad unless the taxes imposed tend to affect competition. There is more than a suggestion that some of the taxes now levied by the state have this effect.

Mention has already been made of the fact that the basis of taxation varies from section to section of the Revenue Act. One state official has identified 23 separate bases of taxation in the schedule. The most commonly used bases of taxation are the following:

1. Flat fee.
2. A scale of taxes, graduated on the basis of the population of the city or community in which the business is located.
3. A tax based on the type and/or number of fixtures used in the business.
4. A tax based on the gross receipts of the business.

These bases are cited not only to give a sampling of the bases of taxation employed but also to demonstrate the inherent inequity of this type of tax schedule. In one form of retail activity, for example, businesses have been paying a tax graduated on population and ranging from $10 to $50 a year for the last 25 years. At the same time another form of trade has been paying a tax based on its gross sales. It is obvious that the latter has paid a rapidly-increasing amount of tax —statewide—while the former has paid a decreasing tax. In fact, if taxes under Schedule B had been progressively amended in keeping with economic conditions in the country, this schedule would today produce two to three times the yield in 1955-56.

The Commission does not believe that that much revenue necessarily should have been produced by Schedule B. Rather, the Commission is concerned over the fact that (1) the tax burden shifts from business to business with a rise or fall in economic conditions generally rather than affecting each business in the same fashion and (2) that there is inequity in the amount of tax paid by competing businesses of the same type and in the same categories.

In total yield revenues from Schedule B have been consistently on the increase over the last 35 years, but at the same time the relative position of the license tax in the tax structure has declined. Table 2 shows the amount of revenue produced by Schedule B in relation to all general fund collections, for several years since 1921. The reason for the sharp change after 1933 is, of course, that collections for sales and income tax sources have become the most productive state revenues since their adoption in the early 30's.

Table 2.

AMOUNT OF REVENUE PRODUCED BY SCHEDULE B IN RELATION TO GENERAL FUND COLLECTIONS

Year	Total Schedule B Revenues	Percent of General Fund Collections
1921	$ 300,712	7.7%
1933	2,386,704	9.4%
1953-54	5,810,376	3.0%
1954-55	6,041,041	2.9%
1955-56	6,843,845	3.2%

At the same time, analysis of the increase in revenue from Schedule B discloses some interesting facts. Since 1933 revenues from this schedule have increased from $2,386,704 to $6,843,845 or about 200%. The increases have resulted from (1) revenue from additional taxes imposed (relatively few of these); (2) an increase in the number of businesses paying taxes under most of the sections; (3) more efficient collections; (4) a higher level of economic activity; and (5) increases in the amount of tax under many sections. Table 3 on page 67 shows more clearly where the large increases have originated and where most of the state's license tax revenues are derived.

In other words, during the 9-year period Schedule B revenues increased by $3,383,497 and 92.2% of this increase was realized from revenues from these 16 taxes. At the present time 80.3% of all Schedule B revenue is derived from these taxes. This result naturally raises the question whether these business activities are bearing too large a share of the total tax load.

One further point should be made. In the tax year ending June 30, 1955, the State of North Carolina issued more than 215,000 licenses under Schedule B. Most of these licenses were issued from the Raleigh office (and they were collected efficiently) but this total amounts to 2.5 licenses for every person, firm and corporation doing business in North Carolina, not taking into consideration local license taxes and licenses. Should businesses be required to obtain this number of licenses in order to do business, or should one license be sufficient for most of them?

Table 3.

SCHEDULE "B" LICENSES BY SELECTED SOURCES 1946-47 AND 1955-56

General Statutes	Type of Business or Occupation	Revenue 1946-1947	% of Total Sched. B ($3,460,048)	Revenue 1955-1956	% of Total Sched. B ($6,843,545)	Increase of 1955-1956 over 1946-1947
105-37	Theatres	$ 239,115	6.9%	$ 276,068	4.0%	$ 36,953
105-41	Professionals	187,979	5.4%	310,163	4.5%	122,184
105-54	Contractors	71,120	2.1%	236,799	3.5%	165,679
105-62	Restaurants	141,067	4.1%	226,197	3.3%	85,130
105-65.1	Vending Machines	31,224	0.9%	393,670	5.8%	362,446
105-69	Bottlers	85,808	2.5%	145,409	2.1%	59,601
105-73	Building and Loan	227,608	6.6%	915,557	13.4%	687,949
105-74	Dry Cleaners	76,135	2.2%	120,098	1.8%	43,963
105-79	Soda Fountains and Bottled Drinks	153,828	4.4%	268,960	3.9%	115,132
105-83	Installment Paper Dealers	74,591	2.2%	525,007	7.7%	450,416
105-84	Tobacco	264,732	7.7%	297,216	4.3%	32,484
105-85	Laundries	222,404	6.4%	267,456	3.9%	45,052
105-88	Loan Agencies	143,850	4.2%	344,968	5.0%	201,118
105-89	Auto Dealers	366,033	10.6%	706,368	10.3%	340,335
105-98	Chain Stores	203,610	8.2%	263,263	3.8%	59,653
105-99	Wholesale Distributors Motor Fuels	80,326	2.3%	204,663	3.0%	124,337
		$2,569,430	76.7%	$5,501,862	80.3%	$2,932,432

The City License Tax

North Carolina cities have had general power since 1854 (now contained in G. S. 160-56) to "annually lay a tax on all trades, professions and franchises carried on or enjoyed within the city, unless otherwise provided by law." A few cities have had charter power to levy such taxes since the first decade of the nineteenth century. The limitations placed on municipal authority by the 73 sections of Schedule B are the only statutory limitations on this broad power, although any tax levied under this section must, of course, be reasonable.

Under this authority almost every city and town in North Carolina levies and collects privilege license taxes. The larger cities and towns enact comprehensive ordinances seeking to tax all business activities in the town. Many small towns, on the other hand, levy and collect only those taxes specifically mentioned for cities in Schedule B with perhaps a catchall tax of $10 to $25 for any business not specifically listed in the ordinance.

The bases for taxation used by cities are almost as varied as those employed at the state level, although the pattern in small cities and towns is to employ flat fee taxes almost exclusively. Larger cities, on the other hand, use a variety of bases, and in the cities above 25,000, a tax based on gross sales is most common. The gross receipts tax can apply only to those businesses not taxed under Schedule B, with the result that it is levied almost exclusively on retail and wholesale trades. Gross receipts rates in these cities vary from 25¢ per $1,000 gross sales to 65¢ per $1,000 gross sales.

Despite the broad authority of cities and towns in G. S. 160-56, actual tax levies in the cities and towns have not tended to be high. City governing boards hesitate to levy high taxes on those businesses coming within the full taxing power of the city when Schedule B keeps the city tax very low on other businesses such as barber shops, automobile dealers, and appliance dealers.

This limitation is reflected in the relatively small amount of revenue derived from privilege license taxes by cities. In 1953-54, cities and towns collected $2,087,428 in license taxes or 4.9% of all municipal taxes in that year, between 2 and 3% of all general fund revenues (that is, all taxes plus

fees, the city's share of state-collected taxes, ABC revenues, and all other revenues except utility charges.)

A sample of collections will be of interest. Table 4 shows the importance of license tax revenues to a number of North Carolina cities.

Table 4.

LICENSE TAX REVENUE IN SELECTED CITIES, 1953-54

City	License Tax Revenue	Per cent of General Fund	Per Capita	Per cent of License Tax Revenue from Schedule B Businesses
Above 25,000				
Charlotte	$329,726	4.3	$2.46	21.2
High Point	42,824	2.1	1.07	46.3
10,000-25,000				
Gastonia	39,675	4.35	1.72	44.5
Salisbury	47,863	5.45	2.38	34.3
Lexington	4,831	1.1	.36	71.4

This table shows the range for cities having a population of more than 10,000. In cities of from 5,000 to 10,000 in population, the license tax revenues range from 1% to 11.1% of general fund revenues. In cities of below 5,000, the range is similar except that no town of from 1,000 to 5,000 in population derives as much as 10 per cent of its general fund revenues from license taxes.

The existence of such a wide range in license tax revenues does not necessarily reflect differences in volume of business. The range is understandable only if there is a basic comprehension of the principal sources of municipal revenues. At the present time, most city revenues come from one or more of the following sources:

1. The property tax
2. The privilege license tax
3. State-collected locally shared taxes (gasoline tax, beer and wine tax, intangible property tax, and utilities franchise tax)
4. ABC revenues (in those cities and counties containing ABC stores)
5. Utility revenues (in some cities, profits from these operations are made available for general fund activities)

Reliance upon the privilege license tax as a source of revenue will depend on (a) the extent to which revenues listed in (4) and (5) are available and (b) the need of the city for additional revenues. If there are substantial profits from the distribution of electricity, as there are in many North Carolina cities, collections from property taxes and license taxes may be relatively low. If there are no utility profits or ABC revenues to rely on, property and license tax revenues tend to be high. Every city will not fall into this pattern, however, and some cities with electrical profits, for example, may levy high license taxes to keep property taxes very low.

Cities have considerable difficulty in administering the privilege license tax. There is, of course, no question of non-taxability unless the state has absolutely prohibited taxation. On the other hand, there are two very difficult situations. The first is the extent to which Schedule B places a limit on the city's power. Tax collectors are faced with questions such as these. The state levies a tax on the sale of radios and radio accessories under G. S. 105-82 (Section 147 of the Revenue Act), and the Revenue Department has interpreted this section to include the sale of television sets and accessories. The city's power to levy license taxes on the sale of radios is limited to $5 under this section, and some cities have not interpreted the section as applying to television sets. The city obviously can proceed with a different tax on the sale of television sets barring a court decision, but the practical problem of dealing with dissatisfied taxpayers is a difficult one for collectors. Thus the collector is frequently faced (1) with determining the interpretation placed by the state on the section, and (2) determining whether that interpretation limits the city in its taxing power.

The second difficult situation faced by collectors is determining whether some business activities have a taxable situs in the city. Many businesses—wholesale houses, distributors, retail trades and services—may have a principal place of business in one city or outside city boundaries but carry on business activities in one or more other cities. Under existing North Carolina law they are subject to a privilege license tax levied by any city within which substantial business operations are conducted.

In addition to these problems of legal interpretation, there are the usual practical problems of finding and collecting taxes from itinerant or mobile businesses which do business in the city but have no established place of business.

In most cities the same person collects both property and privilege license taxes and this is feasible since privilege license taxes are collected during the summer, before property taxes become due. Most cities collect as many taxes as possible by mail, but in the larger cities intensive door-to-door checks of all business activities, taking from one to three months, are necessary to insure that all license taxes are collected.

The County License Tax

Counties are authorized to levy and collect small license taxes under 31 sections of Schedule B of the Revenue Act and under three miscellaneous general law provisions. In general the maximum amount of the county tax is determined on the basis of a percentage of the state tax. On only one business activity—gypsies and fortune tellers—is the county's power unlimited.

Of the 100 counties in North Carolina, 97 exercise the power to levy and collect license taxes. Total collections from these 97 counties in 1953-54 were $484,633 or just short of an average of $5,000 per county. This total represented just .76 of 1% of all county tax revenues in that year. Only two counties collected more than $25,000—Guilford County with $53,521 and Mecklenburg County with $41,670—and in Guilford County this amount represented only 1.27% of all tax revenues. Most counties collect considerably less than 1% of all tax revenues from this source.

Counties face the same difficulties in collection faced by cities, except that counties have no general tax power on which to rely if Schedule B cannot be interpreted to grant a taxing power. Schedule B is, then, a statute of delegation rather than limitation. There are a number of situations in which county collectors and county attorneys have determined that the county can levy and collect a tax, only to discover that the state, by administrative ruling, was *not* collecting a tax. While counties theoretically could challenge the state ruling by collecting the tax, most counties do not wish to encourage law suits for the sake of a few dollars.

Most of the county licenses are for small amounts of money and most of them are levied on traveling businesses or individuals—such as peddlers, sewing machine salesmen, radio salesmen and junk dealers. In order to collect the taxes due, counties must keep a collector busy checking all parts of the county. The average county simply does not have the personnel to assign to this task, and even if they did, the revenue to be obtained would not justify the cost of collection. On the other hand, Guilford County keeps two collectors busy with privilege license taxes during busy times of the year, and the cost of collection in that county approximates 20% of the revenue derived.

The Impact of License Taxes on Business

In evaluating the present license tax structure in North Carolina, attention must be paid to the effect of taxes at all three levels of government. Since the state has placed definite limitations on local taxing power without premeditated consideration of the overall effect on all types or categories of business, the Commission has felt that it was necessary to look at the aggregate impact of all license taxes levied by all three levels of government.

With a few exceptions the county tax is not an important factor in measuring tax impact. It is significant in a few areas, such as service stations and automobile dealers, but for the most part county taxes are small in number and amount.

The city tax, on the other hand, is comprehensive and ties together closely with the state tax. As an examination of Table I discloses, the state taxes are concentrated on financial institutions, amusement activities, service trades, and a few particular types of retail activities. In general Sched-

ule B does not impose a tax on the privilege of engaging in retail and wholesale trades as such. A number of the state taxes, however, are levied on specific activities which are not peculiar to particular categories of business, such as the sale of tobacco, the sale of soft drinks, and the operation of chain stores. Any business selling tobacco and soft drinks whether it be a grocery store, hotel, or manufacturing company operating a canteen for its employees, must pay these taxes, and they are cumulative. The cumulative effect of many small activities taxes can be discriminatory to many small businesses.

Table 1 shows the general businesses affected by Schedule B, but it does not reflect the bases of taxation which are varied in kind and effect. In general the Commission has found that:

1. The taxes levied by the state (and by most local units) have no direct relation to the size or volume of the business.

2. The basis of taxation is often so inexact as to be discriminatory.

3. Rates of taxation in Schedule B have not been periodically changed to reflect economic conditions. As a result the impact of the taxes on businesses has steadily declined in some sections, has remained constant in others, and has increased with economic conditions in others.

4. No provision has been made for avoiding possible discrimination in the accumulation of taxes, on a number of different activities.

Perhaps the best way to demonstrate the variations in impact today is to consider a number of examples. Table 5 on pages 71 and 72 contains examples showing the impact of state, county and city taxes on four types of businesses where the business is located (a) outside a city or incorporated town, (b) in a small town, (c) in a medium-sized city, and (d) in one of our larger cities. All of the cities have been chosen as typical of the cities in their class and the ordinances in effect are also typical.

It is pretty clear from this table that:

1. Small business pays proportionately higher license taxes than large businesses in the same category.

2. License taxes are higher in larger cities than in small cities.

Further examination of license taxes paid in some cities and towns disclosed some small businesses, particularly food stores, pay up to 8/10 of 1% of their gross receipts in license taxes.

This is inequitable and illogical. Small businesses do not require proportionately greater services than do large businesses, nor do they have any better ability to pay. The Commission feels that this result is not necessarily intended, and even if it were, it does not feel that the result is sound. Even if the fact is granted that many of the larger businesses are incorporated and pay franchise taxes in addition to privilege license taxes, the franchise tax is paid for the privilege of doing business in the corporate form with its attendant benefits and protections. As a state with many thousands of marginal businesses, North Carolina cannot afford to put unnecessary obstacles in the face of small enterprises, even when those obstacles are not high in relative dollar amount. In the opinion of this Commission, the system of license taxation should be changed to eliminate this inequity—particularly as between businesses of the same type.

Furthermore, this Commission does not believe that it is fair that some types of business endeavor be required to pay license taxes while others pay small taxes or none at all. Even though this situation is probably not the outgrowth of intentional tax policy, it is inequitable and should be changed.

Finally, the administration of the license tax seems to be outmoded. When it is necessary to issue over 500,000 licenses to no more than 75,000 individual business enterprises in order to raise just $10,000,000 in tax revenue at all three levels of government, it is obvious that something is wrong. Businessmen should not be subjected to the inconvenience and annoyance of having to purchase many licenses from two or more levels of government in order to have permission to engage in business. Neither should government have to issue so many licenses for so many separate activities in order to collect this relatively small amount of revenue.

In summary this Commission believes that the present system of privilege license taxation is outmoded. There is no logic in the selection of businesses paying the tax at the state level; there is no equity when the full impact of license taxation is studied; and there is no reason for such a cumbersome system of administration.

Table 5.

IMPACT OF STATE, COUNTY, AND CITY LICENSE TAXES ON SELECTED BUSINESSES

Business	Gross Sales	State Tax	County Tax	City Tax	Total	% of Gross	Remarks
Grocery Small neighborhood store	$ 80,000						Includes taxes on sale of tobacco and soft drinks
Unincorporated		$ 15.00	......	......	$ 15.00	.02 %	
Small Town		15.00	......	$ 22.50	37.50	.04 %	
Small City		15.00	......	52.50	67.50	.08 %	
Large City		15.00	......	94.10	109.10	.13 %	
Grocery Chain Supermarket	1,000,000						
Unincorporated		80.00	......	......	80.00	.008%	
Small Town		80.00	......	22.50	102.50	.010%	
Small City		80.00	......	102.50	182.50	.018%	
Large City		80.00	......	649.70	729.70	.073%	
Wholesale Mcht.	300,000						Includes sales tax only
Unincorporated		160.00	......	......	160.00	.05 %	
Small Town		160.00	......	50.00	210.00	.07 %	
Small City		160.00	......	50.00	210.00	.07 %	
Large City		160.00	......	150.00	310.00	.10 %	
Wholesale Mcht.	1,000,000						
Unincorporated		510.00	......	......	510.00	.05 %	
Small Town		510.00	......	50.00	560.00	.056%	
Small City		510.00	......	50.00	560.00	.056%	
Large City		510.00	......	360.00	870.00	.087%	
Service Station	60,000						Includes taxes on the sale of soft drinks and tobacco
Unincorporated	(2 pumps)	20.00	2.50	10.00	32.50	.054%	
Small Town		30.00	3.75	16.25	50.00	.083%	
Small City		45.00	7.50	20.00	72.50	.12 %	
Large City		65.00	12.50	25.00	102.50	.17 %	
Service Station	100,000						
Unincorporated	(4 pumps)	30.00	5.00	12.50	47.50	.048%	
Small Town		35.00	5.00	17.50	57.50	.058%	
Small City		45.00	7.50	20.00	72.50	.073%	
Large City		65.00	12.50	25.00	102.50	.103%	

Note: Average population of small town, 3,500; of small city, 15,000; of large city, 75,000.

Business	Gross Tax	State Tax	County Tax	City Tax	Total	% of Gross	Remarks
Automobile Dealer	$ 300,000						Includes taxes
Unincorporated		$ 25.00	$20.00	$20.00	$ 65.00	.02 %	authorized by
Small Town		75.00	20.00	20.00	115.00	.038%	G. S. 105-89 only
Small City		140.00	35.00	35.00	210.00	.07 %	
Large City		200.00	50.00	50.00	300.00	.1 %	
Automobile Dealer	3,000,000						
Unincorporated		25.00	20.00	20.00	65.00	.002%	
Small Town		75.00	20.00	20.00	115.00	.004%	
Small City		140.00	35.00	35.00	210.00	.007%	
Large City		200.00	50.00	50.00	300.00	.01 %	

Note: Average population of small town, 3,500; of small city, 15,000; of large city, 75,000.

FACTORS INFLUENCING REVISION OF THE PRIVILEGE LICENSE TAX

The Commission had no difficulty deciding that its recommendations must include a revision of Schedule B, but it had considerably more difficulty agreeing on the form of the changes. Much attention and thought has been given to this tax levy, and it is important that there be a complete understanding of (1) the assumptions that underlie the recommendations, and (2) the problems that were encountered in attempting to meet the assumptions.

In a state that depends so heavily on sales and income taxes, the question can logically be raised as to whether the state should levy business license taxes of any kind. The first reaction of this Commission was that, with the exception of levies on a few types of business that require special state regulation, the license or occupation tax should not be levied by the state. In fact, it seemed that the license tax has more relation to the local tax structure than to a state's tax structure. Further study indicated that however logical it may be in theory for local units of government, there are problems of tax collection and of tax incidence that lead to serious questions as to the practicality of an across-the-boards occupation tax as a source of revenue for all local governmental units. This point will be discussed in more detail later. In any event, this Commission wishes that it were not necessary to levy a state business license or occupation tax, in view of the other elements in the state's tax structure, and it recommends that future General Assemblies studying modification of the tax structure and re-analyze the state's fiscal picture to determine if in fact the license tax is then needed.

One unassailable fact determined the advisability of retaining the license tax. It is the duty of this Commission to recommend changes in the state's tax structure which will further encourage business enterprise in North Carolina. Changes have been recommended in other tax schedules to meet this legislative mandate and these changes will initially cost the state some revenue. If state services are to be maintained at their present level, and the Commission thinks they should, then the state cannot afford to lose the revenue presently derived from Schedule B. If that revenue is necessary, then the license tax cannot be abolished. It can, however, be made more equitable and easier to administer. Similarly, local units of government cannot afford to lose the revenue presently derived from the license tax.

If the state must continue to derive revenue from the license tax, the Commission next faced this question: Who should pay the tax? In short, should these revenues come from particular types of business which contribute heavily to the problems of government, or should they be derived from every form of business enterprise so that all business would, in some way, make payment for the privilege of doing business. The Commission believes that the latter is the fairest method of levying such a tax. There is no reason why one particular type of business activity should be required to pay taxes not levied on other businesses. If a business requires special regulation, then the cost of regulation should be met from special fees, and the Commission notes that the state's li-

censing boards are supported from special fees, not from the taxes levied on the regulated professions.

Having decided that Schedule B and the license tax powers of local units of government should be revised; that this revision should insure a return to the state of the same amount of revenue now produced; that the revision should insure payment of a tax by all types of business; that the revision should eliminate inequitable taxation insofar as possible (particularly as between competing businesses of the same type) ; that the revision should not result in a decrease in the revenues of local governments; and that revision should permit easier administration and less annoyance to business; the Commission proceeded to a consideration of specific plans. It was soon apparent that there were other, even more difficult, questions to resolve. The first was to determine the measure or basis of taxation to be employed.

Basis of Taxation

The very variety of tax bases in Schedule B of the Revenue Act and the various municipal ordinances seems to the Commission to be a breeding ground of tax inequity. As the examples on pages 71 and 72 show, the use of flat fees (many of them cumulative) and of taxes based on the type of equipment used, the number of fixtures used, and the population of the city where the business is located, can only result in some degree of inequity when the taxes paid by one business are compared with those paid by another business in the same category. The taxes paid by the small groceries and service stations represent accumulation of several small taxes. Furthermore, the basic service station tax is based on city population, not on size of business.

From one theoretical point of view, the best approach to state and local taxation of business is to base the tax on net income, or on average net income in a particular business category. The Commission does not believe that an occupation tax should supplement or be merged into the income tax. Rather, it approves the theory that every business should pay in some measure for the privilege of doing business, that this tax payment should not be based on the value of property owned or on the profitability of doing business in a particular way, and that the tax should be a relatively low tax so constructed that no business will be penalized in relation to other competitive businesses or in relation to all other types of business.

Volume of business has long been considered as an effective basis for taxation, at the state as well as at the local level, and it generally fits the concept of a broadly-levied occupation tax. There are some objections to the idea. Where gross volume is used as a tax measure, it does not affect all businesses equally. The business with the fast turnover and low margin of profit per unit sold will necessarily have a higher volume of gross receipts than the business with a slow turnover and a high margin of profit. Thus the large retailer may pay a higher gross receipts tax while his gross profits, after the cost of goods is subtracted, may be no larger than the gross profits of another retailer having a smaller gross but a larger profit per unit sold. On the other hand, there are legitimate costs of business other than cost of goods purchased, and the business with a high margin of profit per unit sold may have a higher cost of labor, service, repair and other overhead than the large volume retailer.

It has been suggested that volume of business is a particularly appropriate measure of tax at the local level, but while volume undoubtedly has some relation to services provided in retail operations, it cannot easily be linked to the benefit theory of taxation. A bank, for example, may have a large volume of business but not contribute to the need for local or state services in anything like the same proportion that a theater or supermarket may do.

Any effort to consider all the complex factors entering into business operations in devising an occupation tax which will produce a relatively small amount of revenue would be self-defeating. The Commission has concluded that a tax measured by the gross receipts or gross sales of particular businesses would be fair if the rate were low and if the element of cost of goods sold were taken into consideration in fixing rates. Following this conclusion, the Commission divided all business activity in the state into the general categories used for tax research purposes and authorized an intensive study of gross profits in each category—i.e. the ratio of gross receipts minus cost of goods sold to total gross receipts. The results of this study for North Carolina businesses were found to correlate very closely with similar studies made in the State of Kentucky and some Virginia cities.

The Commission has not strictly followed the mathematical relationships established by this study, but these relationships have been used as a guide in arriving at the rates recommended for the levy of occupation taxes (see pages 62 and 63). For example, it was determined that service trades have a gross profits ratio as compared with retail trades of from 3-1 to 5-1. Thus, in fixing rates of taxation, the maximum rate authorized for service trades has been fixed at .3 of 1% of gross receipts while the maximum rate authorized for taxation of retail trades has been fixed at .09 of 1% of gross receipts—a ratio of about 3-1. This general ratio is reflected today in the total license taxes paid by service and retail trades in many of our cities.

A fuller description of this study and the relationships between business categories will be found in the report of the Institute of Government to this Commission.

Some concern has been expressed over the amount of tax for the business having a very large volume. The Commission decided, after careful consideration, that the business with the large volume would be better able to pay a tax based on gross volume than the small business, and that placing a ceiling on the tax as applied to retail and wholesale operations would indirectly discriminate against small business.

When the gross receipts measure of taxation is employed, the legal question of imposing a burden on interstate commerce is necessarily raised. While the history of gross receipts taxation in the courts is a complicated one, it now seems established that a state or a local political subdivision can levy and collect a gross receipts tax from most types of business without imposing a burden on interstate commerce.

But determination of the basis of taxation did not solve every problem. Those which were found to be most difficult will be more apparent if the basic plans under consideration by the Commission are set forth. The many variations studied can be conveniently grouped into four major types:

PLAN A. A state levied and collected occupation tax with a portion of the proceeds from this tax shared with local governments.

PLAN B. A state levied and collected occupation tax with local governments having the power to levy additional local occupation tax rates which would be collected by the state.

PLAN C. A state levied and collected occupation tax with local governments having a separate power to levy and collect local occupation taxes.

PLAN D. A state levied and collected tax on selected occupations and a local power to levy and collect occupation taxes on all occupations not taxed by the state.

With these plans in mind, the problems can be outlined.

Problems of Administration

Administrative problems are likely to arise in the collection of any taxes based on economic activity. In a day of complex economic operations, small political subdivisions may encounter great difficulty in collecting taxes based on such measures as gross receipts. States, on the other hand, are better equipped to collect such taxes and have been able to do so effectively. There is an understandable preference on the part of local units of government, therefore, for state assistance in the levy and collection of local taxes based on economic activity. This is one of the principal reasons in favor of Plans A and B. Furthermore, while larger cities usually can get the necessary information to collect such taxes, there is an understandable reluctance on the part of business firms in smaller cities and towns to disclose information on gross sales. Also, many businesses—particularly wholesale businesses and repair and other service trades—transact business in many different cities. It is difficult for such businesses to break down their sales according to the cities or communities in which they were made.

There are problems of a different nature. There is the problem of determining into which category or categories a particular business endeavor may fall for tax purposes. An automobile dealer is a good example. In the sale of automobiles, he is engaged in a retail trade. In the servicing of automobiles through repair services, he is engaged in a service. If a different tax rate is employed for service trades than for retail trades, should the dealer be required to allocate his receipts

into retail and service categories? Another such problem arises in determining the proper category for construction trades such as painters, carpenters, and plasterers who may be engaged in business as independent contractors.

Protection of Business — Equity and Certainty

Because of the need to attract industry to this state, and because of the variety of other state taxes already levied, it is desirable that there be as much certainty as possible in the amount of the occupation tax which a particular business may have to pay. Plan A would introduce complete certainty. Plans B, C, and D would provide certainty only if a ceiling were placed on the taxing power of local units of government. The concept of a ceiling runs counter to the theory, to which most of the members of the Commission subscribe, that local units of government should have as much discretion as possible in establishing their tax structures. Good self-government and participation in local government is encouraged when the political process is used responsibly to establish a balance in the sources of local tax revenues. There is, however, some risk incurred by a business if a city has a very broad power of taxation and if at a particular time need for revenue influences the city to levy unusually high taxes on the business community. In attracting new business which is concerned about taxation, there is an advantage in being able to predict in advance the maximum taxes which may have to be paid.

Plan D presents a further complication. If the sources of taxation are divided between the state and local units of government, the state tax levy will be fixed. If equity is to be achieved between those businesses taxed by the state and those taxed at the local level, then there must be some concrete relationship between the state tax rates and those which local governments may levy.

Protection of Business — Mobility

Mention has been made of the administrative problems encountered by local units of government in levying taxes on businesses which can be said to have a tax situs in more than one city, particularly if the tax is based on economic activity. There is, of course, no problem where a firm has established places of business in two or more cities. The problem arises where the firm has just one principal place of business but uses transportation facilities either to sell goods or provide services in a number of cities and towns within easy reach of his principal place of business.

But these local problems are magnified when consideration is given to the whole process of distribution of goods which is developing in the state. Regional distributors are moving into the state with rapidity, many of them being branch sales offices and warehouses for manufacturing concerns. Since their coming facilitates the growth of all economic activity in North Carolina, consideration must be given to whether the levy of taxes on such activities will act as a deterrent to their decisions to settle in the state. Are these activities to be distinguished from domestic wholesale activities in the state?

In choosing between the plans enumerated above, there is a further problem. Distribution activities tend to settle in a few communities, rather than be dispersed throughout the state. Unlimited power in local communities to levy occupation taxes may, without intention, result in such high taxes on these activities that the movement of such distribution centers will be directed to other states.

Protection of Business — Competitive Considerations

Any tax based on economic activity must be carefully drafted so that it will not unfairly affect the competitive situation as between businesses in different states as well as intrastate businesses in the same category. Manufacturing is a case in point. If an occupation tax is imposed on manufacturers in North Carolina, interstate commerce limitations prevent placing a similar tax on competitive goods manufactured in other states and shipped into this state. Similarly many manufactured products go through several manufacturing processes in several different plants before finding their way to the market. Occupation taxes levied on manufacturers at each step in the process may affect the competitive standing of the product. Furthermore, most manufacturers have larger out-of-state sales than intrastate sales. Should these sales be included in a gross receipts

tax? Finally, even though the tax is not large, would not foreign manufacturers consider the tax as a nuisance in making a determination on whether to settle in this state?

On the other hand, there is the problem of overall participation in the costs of government. If all business activity is to be subjected to an occupation tax, what logic demands exemption of manufacturers? This is particularly true where the manufactured product has a purely local market and does not compete with goods manufactured in another state—selected food products being a prime example.

Local Governments — The Problem of Revenue

In considering revision of all parts of the state's tax structure the Commission has been particularly sensitive to the problems and needs of local units of government. Two excellent briefs were filed with the Commission by the representatives of the cities and counties in the state, and careful study has been given to their recommendations.

This Commission has not had the time nor the personnel to study the property tax problems which were emphasized in the brief of the League of Municipalities. While recognizing that there are serious problems connected with the property tax that merit the most intensive study, the Commission believes that that source of revenue should be given further study. At the same time, the Commission has attempted to draft its recommendations so that cities and counties will be strengthened in their ability to meet increasing demands for services.

At a time when a program of industrialization is underway in the state, the cities have the positive duty to provide the services that are required to (1) make urban areas in the state attractive to industry and (2) encourage all forms of economic development. Growing cities face the same demands for increasing revenues that are faced by the state, and some of our cities do not have a tax structure that can easily be adapted to the need for expanded facilities. Furthermore, new development is taking place at an increased pace outside of city boundaries, and the property owners in these suburban fringe areas contribute to the demand for municipal services inside the city boundary without contributing in like measure to the revenues needed to provide those services.

In the growing cities of this state, particularly the cities having a population of more than 10,000, the most pressing service problems seem to be (1) the expansion of water and sewer facilities both inside the city and to service newly-developing areas, (2) the expansion of police and fire and other protective services, and (3) the reconstruction of the city's major street system, apart from the streets constructed and maintained by the State Highway Department. It is becoming abundantly clear, if we assume that the water and sewer expansion can be met from service charges as most cities are doing today, that the problem of revenue is greatest with respect to relieving traffic congestion. Unless our cities can widen and rebuild the streets necessary to take traffic to and from the central business districts, the industrial areas, and other commercial centers, unless these same cities can provide the traffic control and traffic enforcement services necessary to insure effective use of the streets, our growing urban centers may be strangled by the resulting congestion. In order for our cities to finance the work which must be done quickly, either property tax rates must be raised or revenues must be withdrawn from other needed services or new revenue must be made available.

Some of the cities in the state cannot raise property taxes any further. They are already at the statutory limit. Other cities hesitate to increase property taxes to pay for street construction which benefits not only the residents of the city but thousands of persons living outside the city who work and shop in the city. Other cities hesitate to raise property tax rates for fear new industry will be discouraged from settling in the city.

The needs of the counties are not so immediate. There are problems, and the need for further assistance in the construction of new school buildings may become great in the next few years, but at the present time the basic structure at the county level appears to be adequate.

Local Government—The Problem of Local Self-Government

The members of this Commission strongly believe in the wisdom of permitting cities and counties the widest possible latitude in determining what services shall be provided at the local

level and how those services should be supported. The Commission does not regard the variation in tax structures from city to city as inherently bad, so long as there is good administration in each city and so long as the variation represents the considered judgment of the people of the different cities. There is no question that the property tax needs restudy and that property assessment ratios have imposed undesirable limitations on the ability of many cities to raise revenue from the property tax. Apart from the property tax, there would seem to be nothing unsound in permitting cities the choice between a number of sources of non-property tax revenues, for a source that may be acceptable and fair in one city may not be fair in another. A city which has relatively low property taxes and is not in a position to raise property tax rates may choose a different source of revenue for supplementary income than the city which has a high property tax rate. These are matters best left to local political action.

In the last analysis, however, the General Assembly is responsible for the welfare of the entire state, and it must insure that the powers granted all cities or individual cities will not adversely affect the state as a whole. There are situations where the grant of powers to cities may conflict with the larger interests of the state, and this Commission has tried to keep these respective interests in mind in drafting recommendations.

THE RECOMMENDED PLAN

In presenting the plan recommended in this report, the Commission points out that decisions were deliberately made covering each of the problems outlined in the preceding section. In the judgment of the Commission, the plan which we set forth in this section meets more of the objections that have been raised than any other plan.

Plan A was subject to several basic objections. In the first place, experience with the intangible property tax has shown that any tax levied by the state for the benefit of local units of government is considered as a state tax, and the state receives the credit and the blame. At the present time the State of North Carolina is levying a greater variety of taxes at the state level than perhaps any other state, and this Commission is of the opinion that an additional tax at the state level will tend to discourage new industry. Furthermore, it has been determined that no method of distributing state-collected taxes to local governments can be made in a completely equitable manner. The burden of local governmental costs is now distributed in so many ways in so many different cities and counties that the state cannot devise a practical formula which would take all these variables into account. Under Plan A, unless the rates of taxation were fixed so high that the total revenue from the tax would increase as much as 50%, no formula would permit every city to receive as much from occupation taxes as it now receives from its privilege license tax ordinance. Therefore, even though Plan A would meet administrative problems more satisfactorily than any other plan, and even though it would insure more certainty than any other plan, the Commission has determined not to recommend Plan A.

Plan B was devised to make unnecessary the distribution of occupation tax revenues to cities and counties through a formula, and it is based on plans for sales tax levies by local units of government in states such as California. The determination of the rate to be levied in each city would be made by the local governing board, but the tax would be collected by the state and turned over to the local unit. This plan would create terrific administrative problems for the state and businessmen alike, if each of the 400 cities and towns and each of the 100 counties were allowed to levy a separate tax. A variation was suggested whereby the state would share part of its tax proceeds with the cities and towns while the larger cities would be permitted to levy an additional rate to be collected by the state. In the opinion of the Commission, any variation of this plan led to administrative problems and tended to create the impression with businessmen that the tax was a state tax.

Plan C was designed to separate the state and local levies, but it high-lighted problems which were also present to some extent in Plan B. It meant, first of all, that every business would be required to secure a license from both the state and a local government. It meant that the firm doing business in more than one city would have to pay taxes in more than one city at some risk of cumulative taxes and a penalty on mobility that this Commission believes is undesirable. It would

also tend to increase taxes on many types of business more than this Commission believes is desirable.

Plan D seemed to solve some of these problems. By vesting in the state the power to tax those occupations which have mobility, those occupations on which information is most difficult for cities to obtain, and those occupations which seem to have little relationship to local service needs, this plan would assure better administration of the occupation tax and fewer inequities resulting from mobility and cumulative burdens. By vesting in local units of government the power to tax occupations which are basically fixed in location, which call for greater local services, and which can supply information to local tax collectors more easily, the plan would give local governmental units tax sources which could be administered properly on the local level.

Plan D requires that the state and local occupation taxes be considered as a single system in order to measure the total impact of the tax on all business activity, a requirement that is not necessarily present in the other plans. Since the state tax is subject to amendment only during sessions of the General Assembly, and since it is levied at the same rate throughout the state, it was necessary to put a ceiling on the taxing power of cities and counties so that businesses in cities which levied the maximum rate authorized would not be penalized in comparison with businesses paying the state tax. *This ceiling also provides a certainty that is not now present in the city tax structure.* This decision was made in full knowledge of the fact that municipal taxing powers were being curtailed insofar as cities may now levy taxes on businesses other than those taxed in Schedule B of the Revenue Act. On the other hand, the plan suggested will permit every city at least to replace the revenues presently derived from privilege license taxes. Further, this Commission is recommending that cities be granted two additional permissive sources of revenue to supplement their incomes. It is the opinion of this Commission that the state should take every practical step to assure business concerns which may want to settle in North Carolina that they will receive fair treatment, and for this reason, a ceiling on the amount of taxes which may be imposed by both the state and local units of government is desirable.

Table 6 shows in detail how the plan will affect the State of North Carolina.

Table 6

RECOMMENDED PLAN OF OCCUPATION TAXES AT THE *STATE* LEVEL.

Business Category	Estimated Gross Receipts	Tax Rate	Estimated Revenue
Retail Trade			
Vending Machines	$ 25,000,000	.09 of 1%	$ 225,000
Wholesale Trade	2,500,000,000	.075 of 1%	1,875,000
Selected Services (Laundries, Dry Cleaners, Advertising, Collection Agencies, services to dwellings, and a few minor ones)	100,000,000	.3 of 1%	300,000
Selected Amusements:			
Drive-in Theaters	8,300,000	.6 of 1%	50,000
Travelings amusements, football games, races, etc.;	4,500,000	flat fee plus 3% of gross receipts	150,000
Music Machines		$100 operator's license plus $15 per machine	130,000

Manufacturing			
Soft Drink Bottlers	$ 40,000,000	.4 of 1%	$ 160,000
Ice Cream Manufacture	20,000,000	.1 of 1%	20,000
Newspapers	100,000,000	.1 of 1%	100,000
Radio and TV	50,000,000	.1 of 1%	50,000
Contractors and Construction Trades	600,000,000	.1 of 1%	600,000
Professions		$50 per person	630,000
Finance			2,500,000
Miscellaneous			160,000
Total			$6,950,000

NOTES TO TABLE 6.

1. **Retail Trade:** While most retail activities would be taxed by the cities and counties, the concentration of vending machine business in the hands of a limited number of operators makes it desirable to have state collection of these taxes.

2. **Wholesale Trade:** Manufacturers' sales branches and brokers who do not take title to merchandise would not be subject to the tax. Petroleum bulk plants and terminals would be subject to the tax except that in computing gross receipts for tax purposes, the state and federal tax on gasoline would not be included.

3. **Services:** The following services would be taxed by the state on the basis of high mobility: all laundry, cleaning and pressing services; all advertising agencies and advertising services (newspaper and radio and television advertising would be taxed under the taxes listed in Manufacturing); mercantile credit and collection agencies; private employment agencies; news syndicates; and services to dwellings such as exterminator services. All other services would be subject to tax by cities and counties under the permissive authority granted those units of government.

4. **Amusements:** The state would tax those amusements now paying a gross receipts tax of 3% under G. S. 105-35,-37.1,-38,-39 (circuses, carnivals, and such amusements as football games, races, etc.), and the same basic rates now levied would be retained. The state would also levy and collect the tax on drive-in theatres at a rate of .6 of 1% of gross receipts and the tax on music machines at the same basic rates now employed in G. S. 105-65.

5. **Manufacturing:** The state would tax soft drink bottlers and manufacturers of ice cream on the basis that these articles of manufacture (now taxed by Schedule B of the Revenue Act) are intended for local consumption, and a new tax on newspapers and cn radio and television stations would be levied in lieu of local taxes. All other manfacturing would not be taxed by the state.

6. **Contractors and Construction Trades:** It would not be feasible for the state to collect this tax from every business engaged in whole or in part in a construction trade. The Commission recommends that the state levy and collect this tax on every business which undertakes or executes a contract for the construction of any item listed in G. S. 105-54, and costing more than $10,000, including both general contractors and subcontractors. In other words, if any business is awarded a contract for either general construction or for installation of plumbing, heating, or electricity or for interior decoration, and the amount of such contract or subcontract is in excess of $10,000, the state will tax that business for all contract or construction work performed during the year. Cities and counties will be given a permissive power to tax businesses doing such contract or construction work where no contract amounting to $10,000 or more is involved.

7. **Professions:** The Commission recommends that the professional tax, which has remained at $25 a year for many years, be increased to $50 a year.

8. **Finance:** Other sections of this report provide for changes in the tax on building and loan associations. All other taxes on financial institutions would remain as they are now found in the Revenue Act.

9. **Miscellaneous:** The following sections of Schedule B would be incorporated in the revision: G. S. 105-41.1; G. S. 105-50; G. S. 105-57; G. S. 105-67; G. S. 105-68; G. S. 105-72; G. S. 105-77; G. S. 105-83; G. S. 105-88; G. S. 105-90; G. S. 105-90.1; G. S. 105-92; G. S. 105-93; G. S. 105-101; G. S. 105-102.1.

Of these sections, the following levy taxes on financial institutions:

G. S. 105-50 Pawnbrokers
G. S. 105-57 Mercantile Agencies
G. S. 105-67 Security Dealers
G. S. 105-68 Cotton buyers and sellers
G. S. 105-83 Installment Paper Dealers
G. S. 105-88 Loan Agencies or Brokers

The following Miscellaneous Taxes would be retained:
G. S. 105-41.1 Bondsmen
G. S. 105-72 Persons, firms or corporations selling certain oils
G. S. 105-77 Tobacco warehouses
G. S. 105-90 Emigrant and Employment Agencies
G. S. 105-90.1 Emigrant and Employment Agencies; States having similar laws.
G. S. 105-92 Trading stamps
G. S. 105-93 Court Process Tax
G. S. 105-101 Tax on seals affixed by officers
G. S. 105-102.1 Certain co-operative associations

A more detailed examination of the plan will be in order when the bill incorporating these recommendations is drafted but a few comments are necessary. The taxes levied by the state will, it is estimated, produce just about the same amount of revenue derived by the state from Schedule B of the Revenue Act.

The recommended tax on wholesale trade would replace both the tax now levied under the sales tax schedule and all taxes now levied by cities.

The only changes recommended in rates for amusement activities are for theatres. For the present the Commission considers it sound to retain the 3% admissions tax on travelling amusements and on special events.

The Commission is aware that there may be a legal question as to the collectibility of the tax on radio and television broadcasting. On the other hand the Commission believes that radio and television broadcasting should not enjoy an exemption not shared by other businesses in the same general category. The recommended tax seems to be a fair tax, and the Commission believes that these business enterprises will cooperate in payment of the tax without raising the legal question.

Local Taxing Powers

To complement the state occupational tax, the Commission recommends that cities and counties be given the power to levy taxes on broad categories of business not taxed by the state under this schedule (except public utilities which would continue to be taxed under the corporation franchise tax). Briefly, cities would be given the following permissive powers:

1. To levy a tax on the gross receipts of all retail trades (except the gross sales of vending machine operators) at a rate of not more than .09 of 1% of total gross receipts attributable to the city or town in which the business is located.

2. To levy a tax on the gross receipts of all establishments where prepared food is sold at a rate of not more than .15% of total gross receipts.

3. To levy a tax on the gross receipts of all service activities (except those taxed by the state) at a rate of not more than .3 of 1% of total gross receipts.

4. To levy a tax on the gross receipts of moving picture theatres (except drive-in theatres) at a rate of not more than .6 of 1% of total gross receipts.

5. To levy a tax on the gross receipts of all bowling alleys, amusement parks, swimming pools, skating rinks and other amusements listed in G. S. 105-66 at a rate of not more than .6 of 1% of total gross receipts.

6. To levy a tax on all billiard and pool tables at rates not more than the aggregate rates levied by the state and cities under G. S. 105-64.

7. To levy a tax on the gross receipts of all contractors and construction trades not taxed by the state at a rate of not more than .1 of 1% of total gross receipts.

8. To levy a tax on all local manufacturing activities of not more than .1 of 1% of the gross sales from goods manufactured in the city and sold to North Carolina concerns, but the maximum tax levied shall not be more than $2,500. Sales to other manufacturers for further processing would be excluded.

9. To establish classifications within retail and service categories and to levy different rates of taxation on businesses in such classifications, so long as the rate for the category is not exceeded and so long as no classification is exempt from taxation.

The Commission recognizes that many cities and towns will have difficulty in collecting taxes based on gross receipts, and accordingly it recommends that cities and towns have the option of levying either a tax based on gross receipts or a tax based on flat fees or some other methods of measurement. In order to insure equity, however, a business in a town which uses the flat fee basis should be allowed to pay on the fee basis or on the gross receipt basis. Before being allowed to pay on the gross receipts basis, the business would be required to exhibit its books before the tax collector to establish the amount of its gross receipts. Thus the records of a business need only be shown when the business decides that it is to its advantage to do so. In other words, if a grocery store is taxed a flat tax of $50, and the owner of the store proves that his gross receipts for the previous year were $40,000, he would pay a tax of just $36 (.09 of 1% x 40,000, see Item 1 above) by exhibiting his books for that year to the tax collector at the time the tax was due.

To assist tax collectors in cities where the gross receipts tax is employed, the Commission recommends that the tax collector in each such city, or his accredited representative, be given authority to check state tax returns in order to insure that businesses in his city are making accurate reports to the city. Without this power, cities will not be able to enforce the tax properly.

Under the powers proposed each city in North Carolina will be able to replace the revenues now derived from privilege license taxation, and, if the powers are exercised to the maximum extent, to derive a small amount of additional revenue. How much additional revenue will depend upon the extent to which each city now relies on the license tax. Under the proposed plan, however, the larger cities would not be able to realize a significant increase in revenues.

The problem of municipal revenue needs has given the Commission great concern. The Commission recommendations do not make it possible for cities to meet needs for additional revenues from business taxation. The Commission believes, however, that those cities where the need is great, and where additional property tax revenues will be difficult or impossible to obtain, should have some additional authority to raise revenue. There is just one authority now granted to cities that is not being widely used—the authority to make charges for the collection of garbage and refuse (G. S. 160-233)—and the Commission recognizes practical difficulties in collecting such a charge. Accordingly, the Commission recommends that cities be given the following authority to levy additional taxes:

1. That G. S. 20-97 be amended to permit each city to levy a tax of up to $10 per year on each motor vehicle resident within the city and to permit each city to levy a tax of up to $25 per year upon vehicles operated in the city as a taxicab.

2. That each city be permitted to levy a tax of up to $10 upon every individual earning salaries and wages in the city. This tax is a variation on the so-called payrolls tax and would insure contribution to governmental expenditures from persons employed in the city wherever they might live. It is anticipated that the bill authorizing such a tax would provide for a minimum wage (such as $2,000 per year) below which the tax would not be levied and would provide suitable administrative powers and procedures.

In addition to the occupation taxes recommended in this report, and the additional permissive taxes recommended, each city would also benefit from the intangible property tax recommendations made by this Commission.

Counties. At the present time counties derive about one-half million dollars a year from license taxes. The Commission recommends that the counties be given authority to levy an occupation tax *on all businesses located outside the corporate limits of municipalities* in the following categories: retail trade; eating establishments; service activities; manufacturing; amusements. In other words, the counties could tax the same types of businesses that cities may tax and the same limitations imposed on cities would apply to counties, but the county would have the power to tax only those businesses outside of cities. The Commission recommends, however, that the maximum county rates be one-half the maximum rates authorized for cities except (1) that the rate for taxation of amusement activities would be equal to the city rates and (2) that the maximum tax which could be collected from manufacturers would be $1,250. Counties would have the same choice between a gross receipts tax and a flat fee tax (with a floor) recommended for cities; they would

have the same classification power with respect to retail trades and services recommended for cities; they could only tax those intrastate manufacturing sales which the cities would have the power to tax.

Counties, if they levy the maximum taxes authorized, would just about replace the revenues derived from the license tax. Some counties would derive a small amount more, and some a small amount less.

It should be emphasized that no business subject to a city or county tax would pay more than one tax—to the city if the business is located in the city and to the county if it is located outside the city.

PROBABLE RESULTS OF THE PLAN

The occupation tax plan proposed by the Commission is a significant change from the system of privilege license taxation now in force; and more information concerning the way in which the plan will operate is desirable.

The plan would go into effect on July 1, 1957, and both the state and local governmental units would use gross receipts information for the business's last fiscal year ending prior to this date. Unless a new business required some sort of special license under some other statute, it would not be required to pay the tax until the year following its establishment. Where a business did not have a full year's operation on which to calculate the tax, the tax would be based on the average monthly gross receipts extended for twelve months.

Impact on Governmental Units

The State. Under the proposed plan the State of North Carolina would derive just about the same amount of revenue presently produced by Schedule B of the Revenue Act. Collection of that revenue would be a much easier task, however, for the state would issue fewer than 25,000 licenses, as compared with over 200,000 at the present time. Greater concentration on fewer businesses, with just one license per business, would probably mean better collections from those businesses. Even so administrative costs should be much lower under the proposed system.

The Cities. Under the proposed plan, precise estimates of the impact on cities cannot be made, for each city would have the authority to fix the rate of taxation applicable to each category of business.

Careful examination of 1954 gross sales information in a sample of more than 30 cities and towns shows that every city but one would derive more revenue from the occupation tax if the maximum rate suggested by the Commission is levied than it derived in 1954 from privilege license taxes. Charlotte, for example, would just about replace the revenue it obtained from license taxes, as would Winston-Salem, Wilmington and Raleigh. Greensboro, Durham, and Asheville would net an increase of as much as 25%. A similar pattern is evident in cities of 10,000 to 25,000 and cities of more than 5,000. While precise sales information in all categories is not available for cities of below 5,000, estimates show that they would generally be able to derive more revenue than they are presently deriving from license taxes.

No city would be bound to levy the maximum rate authorized, and it is the opinion of the Commission that the rate levied would depend on local situations in each city. Each city is going to receive 25% more revenue from intangibles taxes, offset in part by a small property tax loss (the property value of state bank stock now certified to each city by the state as "corporate excess"), and each city would have the power to levy an additional motor vehicle tax and an additional tax on all individual occupations in the city. Thus each city would have more flexibility in determining the source of non-property tax revenue than it has today.

The Counties. Under the proposed plan, counties would be authorized to collect occupation taxes on all retail and selected service activities outside the limits of cities and towns. If all counties levied the maximum rate authorized, the revenue derived would just about equal collections today from privilege license taxes. This result is not necessarily true in individual counties, for some of the larger counties would collect a smaller amount in license taxes. On the other hand each county

would receive 25% more in intangible property taxes offset in part by a loss in property tax valuation from bank stock, and these revenues would insure that each county can increase its present non-property tax revenues.

Local Tax Administration. City and county tax officials would have an easier job in collecting occupation taxes than they now have in collecting license taxes. First of all, within the limits prescribed, governing boards would be able to levy taxes which are equitable as between businesses in the same category, something they have heretofore been unable to do and have wanted to do. Secondly, the governing boards may, if they choose, adopt graduated taxes not strictly based on gross receipts. In small cities and counties such a schedule would make the taxes easier to collect, and no business would suffer because there would be a maximum ceiling on the amount of tax which could be collected from any individual business. Tax collectors would have but one tax to collect from each retail and service activity. Furthermore, if a city levies the tax on the basis of gross receipts, the collector would have the authority to check state tax returns in order to insure that the city was receiving accurate returns. The number of individual taxes collected by cities and towns would be between one quarter and one-half of the number of licenses now issued.

Cost of Administration. The cost of collection, once the details were worked out, should be no more than at present. Theoretically, this cost should be less, at both state and local level. In addition, this type of tax levy is much easier to understand and to explain than the existing system. It is anticipated that all units of government would collect these taxes on the basis of gross receipts for the business fiscal year completed prior to the beginning of the tax year.

Impact on Individual Businesses

Under the proposed plan, some redistribution of the tax load will necessarily result. The pattern would vary from category to category, from location to location, and from small business to large business. Some examination of each category would give a better picture.

Retail Trade. In 1955-56 retail business paid a total of $2,363,834 to the State of North Carolina under Schedule B of the Revenue Act and in excess of 1 million dollars to local units of government. Based on estimated gross sales of 4 billion dollars for all retail businesses in 1956-57, the maximum taxes which could be levied on retail businesses by cities and counties under the proposed plan is $3,150,000, or slightly less than is now being collected. There would, however, be redistribution of this tax load between types of retail businesses.

The most obvious effect of the occupation tax on grocery and food stores would be (1) to give relief to small groceries in the cities and larger towns and (2) to adjust the tax as it affects large as compared to small groceries. Large groceries would pay a higher tax, particularly outside of the larger cities, but the amount of tax would always be proportionate to volume. For example, in one large Piedmont city, levy of the maximum rate by the city would bring tax relief to 142 out of 181 food stores. Some of those 142 businesses are now paying more than .5 of 1% in license taxes while large stores in the same city are paying slightly over .06 of 1%. The Commission believes that it is desirable (1) to have a maximum ceiling for the protection of all businesses and (2) to eliminate this discrepancy in the amount of tax paid by competing businesses.

Most service stations would benefit from the occupation tax levy. At the present time the aggregate amount of license taxes paid by service stations to all three levels of government, particularly when they sell tobacco products and soft drinks, is much higher in proportion to business volume than in any other type of automotive business. Since service stations, like small groceries, are among the numerous marginal businesses in North Carolina (about 5,500 service stations), the Commission believes that it is good tax policy to grant some tax relief to these businesses. Small business should be encouraged in every way consistent with good fiscal policy.

Actually, any business can measure the probable impact of the occupation tax by totalling all license taxes now paid to all units of government and comparing that amount with the amount which would be paid by applying rates of up to .09 of 1% to gross receipts for the last business year. In general large businesses (except in the largest cities) would pay a higher tax, small businesses would pay a lower tax. General merchandise activities would pay a higher tax because their existing

taxes are very low. Automobile dealers (except the smaller dealers) would pay a higher tax because their taxes are now relatively low throughout the state. Small drug and grocery stores, and service stations, would get tax relief. Some cafes and restaurants would get some tax relief.

Two other points are of interest. In 1954-55, the total state taxes on cafes and restaurants, not including tobacco and soft drink taxes paid by these establishments, was $204,205. These same businesses paid approximately $75,000 in taxes to cities and towns. The total tax liability of cafes and restaurants under the proposed plan would be about $200,000 (based on 1954 gross sales) or less than the total taxes presently paid on the basis of a fixed fee per chair.

In 1954-55 total license tax collections under Section 105-89 of the General Statutes (service stations, accessory stores and motor vehicle dealers) were $692,757. In addition these businesses paid approximately $175,000 to local units of government. Under the proposed plan automobile dealers and accessory stores would pay (on the basis of 1954 gross sales) about $550,000 if all cities levied the maximum rate, and service stations would pay about $225,000. In other words there would be a gross savings of over $100,000 for businesses in the automotive category, although most of these savings would be realized by service stations.

Wholesale Trade. At the present time merchant wholesalers pay a sales tax of 1/20 of 1% of their gross receipts and most wholesalers pay an additional tax to cities and towns. This local tax ranges from a flat tax of $10 to $50 in small towns up to 3% of gross receipts in some North Carolina cities. In addition wholesale distributors of motor fuels pay a tax based on the number of gasoline pumps owned or leased by such distributor. Cities and towns cannot levy a tax on these distributors. The Commission proposes that wholesale distributors of all petroleum products would pay the same occupation tax as merchant wholesalers (except that distributors of petroleum products could subtract from gross sales the total gallonage tax paid to the state and federal government).

The impact of this change would not be great on most merchant wholesalers. Wholesalers in the smaller towns may pay a somewhat larger total tax and wholesalers in some large cities may pay a smaller total tax. On the other hand all wholesale businesses would be relieved from determining their tax liability to every city and town in which one of their trucks may be making occasional on-the-spot sales; all wholesale businesses would be paying the same rate of tax as their competitors; and all wholesale businesses would pay just one tax to one unit of government.

Distributors of petroleum products would pay in the aggregate slightly more than is now being paid under the pump tax, but distributors of petroleum products other than motor fuels would pay the occupation tax. This has been an inequity in the present license tax. The 5% gross receipts tax presently contained in Section 105-72 of the General Statutes would be retained in its present form except that the power of cities and towns to tax distributors would be repealed.

Service Activities. Under the proposed plan, a limited number of services, principally laundries and dry cleaning establishments, would pay the state occupation tax, while all other services would be subject to taxation by cities and towns. Some redistribution of the tax load borne by service activities would result, particularly where taxes now levied by Schedule B are either quite high or quite low.

Laundries and dry cleaning establishments would, for example, pay much lower occupation taxes than the present license taxes, but at the same time, changes in the sales tax law would subject laundries to greater sales tax payments. The net saving would be small.

If cities and towns levy the maximum authorized rate on the gross receipts of hotels and motels, those businesses would pay slightly lower taxes. On the other hand barber shops and beauty shops would pay somewhat higher taxes because the present license tax is very low and has remained unchanged since the days of the depression. Automobile repair shops would pay a tax that is now included in G. S. 105-89.

Amusements. Under the proposed plan, cities would have the authority to tax motion picture theaters while the state would tax drive-in theaters. Even if all cities levied the maximum rate of tax authorized, theaters (on the basis of 1954 gross sales) would get relief in the aggregate. An examination of individual theaters indicates that again the small theaters would get more relief

than large theaters (who may pay a higher tax), principally because large theaters pay a smaller proportionate tax today than small theaters. Drive-in theaters as a group would also derive relief from the proposed rate of tax.

No change has been recommended at this time in the method of taxing other amusement activities. In effect an admissions tax is now collected from carnivals, circuses, football games, automobile races, and similar activities. The Commission believes that this is fair since these activities do not have fixed expenses in the same measure that theaters have.

There is a change, however, in that no more than one unit of government would collect a tax from any amusement activity. Where no change in the basis of taxation is suggested, it is proposed that the unit of government levying the tax would have the aggregate powers now possessed by all units of government having authority to tax such businesses. For example, cities and counties would have the authority to tax pool tables in their respective jurisdictions, and the permissible rate of taxation would be as much as the present state tax plus the amount which cities and counties may now levy.

Contractors and Construction Trades. Under the proposed plan, the rate of tax on small contracts would be reduced and the rate of tax on large contracts would be increased, the standard .1 of 1% applying to the gross receipts of all contract activities. No contractor would pay the state tax if he did not, during the year, engage to perform a contract in the amount of $10,000 or more. If a contractor is engaged in both contract work and retail activities, he would pay a tax on his gross receipts from contracting to the state and on his retail activities to his local city government.

Professions. The tax on professions has not been changed since 1925. While the Commission believes that it is impractical to attempt to collect a tax from professional men based on gross receipts, it has recommended that the basic tax be increased from $25 to $50.

Financial Agencies. Other sections of this report list the changes recommended in the method of taxing building and loan associations and of taxing banks. No other change in the method of taxing financial institutions or activities is recommended except that the state would have the responsibility for collecting all taxes on such activities.

Miscellaneous Taxes. The Commission has recommended that a limited number of taxes now contained in Schedule B be retained without change. This is not to say that these taxes cannot in the future be incorporated into the occupation tax. At this time it simply seems advisable to leave them unchanged. The amount of revenue involved is less than $200,000.

Administrative Impact. A discussion of the administrative advantages of the Commission's plan would not be complete without reference to the effect on number of licenses required. Instead of the 500,000 (approximately) licenses now required by the state and cities and counties, only about 75,000 licenses or occupation taxes would be required. No business would have to pay more than one tax unless it engaged in more than one major type of business. No business would have to pay taxes to more than unit of government unless it engaged in two different types of business or had two or more established places of business.

CONCLUSION

The length of this report has been necessary because such fundamental changes in the system of privilege license taxation have been recommended. No suggestion embodying such extensive changes can be perfect. Nevertheless, the Commission believes that the changes are sound and it urges that thorough study be given to the full range of the recommendations. Adoption of this new occupation tax would, in the opinion of this Commission, result in: (1) a more equitable tax; (2) greater protection to business enterprise; (3) reduction of administrative problems for both businesses and the governmental units concerned; and (4) adequate revenue from business taxation for the state and local units of government. Once adopted, it would be easier to make modifications to eliminate still-latent inequities or to improve administrative procedures.

INHERITANCE AND GIFT TAXES

In studying the inheritance tax, the Commission was faced with the necessity of making major policy decisions before any progress could be made. It became necessary to decide whether the interests of the State of North Carolina would be best served by the repeal of the inheritance tax, by the replacement of the inheritance tax with an estate tax patterned after the Federal estate tax, or by giving the present statute a face-lifting.

The first alternative, repeal of the tax, was abandoned due to the pressing need for the revenue derived from this source. Adoption of an estate tax was not considered to be feasible at this time, because, being a major departure from the philosophy of the present statute, more time would be needed for studying the question, for conducting research into the size of exemptions, rate schedules, marital deductions, etc., best suited to the needs of North Carolina, and for drafting the necessary provisions than was available for this purpose. Thus, by the process of elimination it was decided to recommend the retention of the present law with such amendments as are deemed necessary to bring the inheritance tax up-to-date, delete obsolete provisions, make the statute conform to administrative practices, and make certain provisions more workable.

The only change in the Gift Tax Act proposed by this Commission is conformity of the annual exclusion to that in the Federal Code.

SPECIFIC RECOMMENDATIONS

A. IT IS RECOMMENDED *that the words "unless the same be employed in or held or used in connection with some business carried on in whole or in part in this State" be deleted from Subsection Eighth of Section 105-2 of the General Statutes.*

Present Provisions. The law provides that nothing in the inheritance tax laws shall be construed as placing a tax on the transfer of the intangible property of non-residents if the property does not have a business situs in this State merely because of the residence of the trustee "unless the same be employed in or held or used in connection with some business carried on in whole or in part in this State."

This proviso is not being enforced at present. (Citation: G. S. 105-2, Eighth)

Explanation. The Subsection as written is in conflict with the reciprocity requirements of the State of Michigan and, as a result, Michigan assesses North Carolina residents for taxes levied on the transfer of shares of stock of Michigan corporations.

It is believed that this provision should be deleted as such action would result in no loss of revenue to the State of North Carolina but would result in a saving to North Carolina residents of taxes now paid to the State of Michigan.

Effect upon Revenue. None.

B. IT IS RECOMMENDED *that a widow who receives all or substantially all of the estate of the dedecent be permitted to claim at her option an additional exemption of $5,000 for each child under 21 years of age and that whenever such widow elects to claim such additional exemption that the child or children be denied the exemption of $5,000 authorized for minor children.*

Present Provision. Under the present statute "when any person shall die leaving a widow and child or children under twenty-one years of age, and leaving all or substantially all of his property by will to his wife, the wife shall be allowed an additional exemption of Five Thousand Dollars ($5,000) for each child under twenty-one years of age."

The law also provides that each child of the decedent under 21 years of age is entitled to an exemption of $5,000.

The administrative practice is to deny the $5,000 exemption to the child when the mother takes advantage of the additional exemption as described above. (Citation: G. S. 105-4 (b))

Explanation. The above provision of the law may be construed to permit the widow to claim a $5,000 exemption for the child and for the child to claim a $5,000 exemption in its own behalf. It is not believed that this is the intent of the law and, therefore, it is believed that the administrative practice should be written into the law. It is also felt that the law should clearly indicate that the widow may exercise an option in such cases.

Effect upon Revenue. None.

C. IT IS RECOMMENDED *that the words "Federal Internal Revenue Code of 1954" be substituted for the words "Federal Revenue Act of 1926" in Section 105-7 of the General Statutes.*

Present Provision. The present law levies an estate tax in addition to the inheritance tax equal to the difference between the inheritance tax and the amount of the tax credit granted by the Federal government against the estate tax levied by the Federal Revenue Act of 1926. (Citation: G. S. 105-7)

Explanation. The Federal Revenue Act of 1926 has been repealed and the Federal Internal Revenue Code of 1954 enacted in its place. The repeal of the prior act has made the use of the phrase "Federal Revenue Act of 1926" meaningless. The new Federal law provides for a credit against the Federal estate tax for state inheritance or estate taxes paid which is substantially similar in amount to the credit allowed under the prior act.

Effect upon Revenue. None.

D. IT IS RECOMMENDED *that the provision which permits the deduction of Federal estate taxes assessed under the Federal Revenue Act of 1926 be deleted.*

Present Provision. The present statute permits the deduction of Federal estate taxes assessed under the Federal Revenue Act of 1926 in the determination of the value of property taxed under the Inheritance Tax Act. (The Federal Revenue Act of 1926 levied an estate tax at relatively low rates on the value of estates after allowing an exemption of $100,000). (Citation: G. S. 105-9 (e))

Explanation. The Federal Revenue Act of 1926 has been repealed, consequently, no estate taxes are "finally assessed under" this act and no deductions can be claimed. It is believed that this obsolete provision should be deleted.

Effect upon Revenue. None.

E. IT IS RECOMMENDED *that the section of the Inheritance Tax Act which provides for the exemption of inheritances from taxation whenever a taxable transfer of the same property has occurred during the two years prior to the date of the death of the decedent be repealed, and that a provision be substituted therefor which permits the beneficiaries of an estate to claim a tax credit for taxes paid on a previous transfer of the property occurring two years prior to the date of death of the decedent with the total credit to be prorated among the beneficiaries in the same proportion as the taxable value of the property received by each bears to the total taxable value of the corpus of the estate upon the later transfer, except that such tax credit be granted only with respect to beneficiaries having relationship to the original decedent as provided in Sections 4 and 5 of Chapter 105 of the General Statutes.*

Present Provision. Under the law, property which has been taxed under the inheritance tax shall not be taxed on account of any other transfer occurring within two years of the first transfer. There is a *proviso,* however, that this exemption applies only to Class A and Class B transfers. Class A and Class B beneficiaries include all blood relations of the decedent, husband or wife of the decedent and step-children or adopted children of the decedent. (Citation: G. S. 105-14)

Explanation. The present provision is difficult to administer and it makes no provision for subsequent transfers to beneficiaries of a different degree of relationship from that in the original transfer except that Class C beneficiaries are excluded. It is possible for a taxable transfer to be made to a Class A beneficiary at tax rates ranging from 1 percent to 12 percent with a second

transfer made tax free to Class B beneficiaries where normally rates ranging from 4 percent to 16 percent would be applied. It is even possible for a third transfer to be made tax-free during the two-year period.

Under the proposed provision the property would be valued upon each transfer and the amount of tax computed according to the degree of relationship of the beneficiaries to the person who died possessed of the property being transferred. If the same property should have been taxed under a like transfer which occurred within two years prior to the second transfer, the taxes paid on the first transfer would be deductible from the tax due upon the second transfer. If there were more than one beneficiary upon the second transfer, the credit would be prorated between them.

Thus, if the degree of relationship were different, the total tax upon the two transfers would be determined according to the degree of relationship carrying the highest tax rates.

The present statute excludes Class C beneficiaries from the benefits of the "recurring tax" provision, but it is not clear which transferee's relationship to which decedent operates to negate the exemption from taxation. Under the proposed provision the right to claim a tax credit would be determined by the relationship of the transferee claiming the tax credit to the decedent the transfer of whose property gave rise to the tax liability the payment of which is claimed as a credit.

Effect upon Revenue. Adoption of this recommendation would result in a small increase in revenue over a period of years.

F. IT IS RECOMMENDED *that the provision which specifies that liens against land for inheritance and estate tax obligations shall not constitute a cloud on the title if the lien accrued prior to May 1, 1938, be amended to provide that such general lien shall not be operative against the land for more than 10 years following the date of death of the decedent.*

Present Provision. Under the present law all taxes imposed by the Inheritance Tax Act are a lien upon the property of the estate upon which the tax is imposed and continues to be a lien until the tax is paid except that no lien which accrued prior to May 1, 1938, ". . . shall attach or affect the land." (Citation: G. S. 105-20)

Explanation. The purpose of placing a general lien upon the property is to insure the State of every reasonable opportunity to collect the taxes due upon the transfer of property by will or descent. The limitation upon the time during which the lien is operative against real estate is intended to relieve purchasers of real estate of the necessity of searching for unpaid inheritance tax liabilities from the date of purchase of the property back to the effective date of the provision imposing the lien in order to feel assured of a clear title. Both objectives are considered to be laudatory. It is only with the method of accomplishment that the Commission takes exception. The present statute sets a date beyond which no lien is operative against the land. It has been the policy of the General Assembly in the past to up date this provision from time to time.

It is believed that a permanent provision with a definite period following the date of death of the decedent during which the administration may take such action as is necessary to protect the interest of the State in such property would accomplish both of the objectives of the present law and would eliminate the necessity for periodic revision. A period of 10 years is thought to be sufficient for the purpose of a general lien.

Effect upon Revenue. None.

G. IT IS RECOMMENDED *that Section 105-32 of the General Statutes be repealed.*

Present Provision. Section 105-32 of the General Statutes provides for an agreement between states under which the resident state of a decedent would withhold final settlement of the inheritance tax liabilities until any obligation owing to sister states for inheritance taxes shall have been paid. (Citation: G. S. 105-32)

Explanation. This section was originally enacted as a model law with the expectation that all states would enact similar provisions. This expectation proved to be erroneous as only 2 or 3 states

adopted the model provision. The section, therefore, is non-operative and is surplusage in the General Statutes.

Effect upon Revenue. None.

H. IT IS RECOMMENDED *that the annual exclusion from the amounts of gifts taxed under the Gift Tax Act be increased to $3,000 per donee.*

Present Provision. The present law provides for an annual exclusion of $1,000 per donee from the taxable value of gifts. (Citation: G. S. 105-188)

Explanation. The Federal Code provides for an annual exclusion of $3,000 and it is believed that relatively few of the gifts of less than $3,000 are reported for gift tax purposes due to a general feeling that gifts of less than $3,000 are not taxable.

The policy of conformity to the Federal practice would be served by the adoption of this amendment.

Effect upon Revenue. It is estimated that the loss of revenue from the adoption of this recommendation would be approximately $80,000 during the first year after enactment. As the tax is computed on the basis of the cumulation of taxable gifts to each donee, an increase in the annual exclusion would have a cumulative effect upon revenue collections, i.e., there would be a gradual increase in the revenue loss over a period of years and then the amount of the loss would level out, subject, of course, to changes in giving habits and changes in the number of donors.

TAXES UPON SAVINGS AND LOAN ASSOCIATIONS

The Commission, in its search of the tax laws of North Carolina for inequities, outmoded provisions, and provisions operating unjustly upon any taxpayer, adopted the principle that all taxpayers should pay the same taxes and that the same provisions for the determination of the tax liability should apply to every taxpayer, *except* where, due to the type of business operations, the business practices, or the organization of the businesses, it appeared that the application of the same provisions would result in inequities, would be unworkable, or would not be in the best interest of the State of North Carolina. In such cases separate or different treatment has been recommended.

Savings and loan associations may be placed in the category of businesses for which separate treatment is desirable because of the organization of the associations and because of the methods of operation. The need for separate treatment was recognized by the General Assembly in 1919 by the levy of a privilege license of ten cents a share upon domestic savings and loan associations, and, again, when upon the adoption of the income tax in 1921 these associations were exempted from this tax. Subsequent changes have been made in the share tax base and rate.

It is believed that the original reasons for separate treatment are still sound. The application of the corporation franchise tax and the corporation income tax to these associations would present considerable difficulties. The use of regular business corporation terminology in ascertaining the tax base would either inflict hardship upon such associations or favor them unnecessarily. It was, therefore, decided to recommend that separate treatment of these businesses be continued but that the method be altered so that the taxes levied upon them would produce some revenue from each association without regard to profit, and, in addition, reflect ability to pay by imposing a levy keyed to the fluctuations of the fortunes of business. It is thought that this proposal properly employs the principles of the income and franchise taxes and at the same time reflects the singular organization of savings and loan associations.

IT IS RECOMMENDED *that Section 105-73 of the General Statutes which levies a privilege license measured by the total value of shares upon savings and loan associations be repealed.* IT IS FURTHER RECOMMENDED *that a capital stock tax be enacted to levy a tax of 6¢ per $100 of the capital stock of savings and loan associations as measured by the liability of each association on shares outstanding on December 31st of the preceding year.* IT IS FURTHER RECOMMENDED *that savings and loan associations be subjected to an excise tax measured by net income at the rate of 6 per cent, and that net income be defined as net income for purposes of the corporation income tax except that all dividends and interest paid or credited on shares be deducted in determining net income.*

Present Provision. The present statutes levy an annual license tax upon savings and loan associations of 13¢ per $100 of the book value of shares. In addition savings and loan associations are subjected to the sales and/or use taxes on purchases of office supplies and equipment, intangible property taxes on money in their tills at the end of the year or vaults and on money on deposit in banks, and an annual fee of $25.

Savings and loan associations are specifically exempted from the income tax, from the intangible property tax on accounts receivable, notes receivable, and shares of stock, and are not required to pay the corporation franchise tax. Shares of savings and loan associations are not taxable as intangible property to the shareholder.

The interest or dividends paid on shares is taxable income to the stockholder. (Citation: G. S. 105-73; G. S. 105-138 (2); G. S. 105-203; G. S. 105-212; and G. S. 54-25)

Explanation. The annual privilege license tax of 13¢ per $100 is the only important tax paid to the State by savings and loan associations. This tax is considered as being *in lieu* of the income tax, the franchise tax, and parts of the intangible property tax.

This privilege license has the advantage of being a stable source of revenue, but it has the disadvantage of not reflecting ability to pay as measured by net income.

In any effort to ascertain a workable and satisfactory method of taxing savings and loan associations it must be recognized that these associations are unique in character. They are similar to mutual associations and cooperatives but they are not true cooperatives. They are financial institutions, engaged in assembling or borrowing money and in making loans, primarily mortgage and installment loans, but they differ from banks and other financial institutions both in organization and in function. All money which is available for making loans comes from equity type capital represented by shares. These shares, however, are withdrawable at face value and carry a "dividend" at a more or less fixed rate of interest. Loans are made only to shareholders, but, obviously, shareholders who are also borrowers own only enough stock to qualify for a loan. There are no patronage dividends. After payment of dividends and interest on shares any remaining profits are put in the surplus account: There is no rebate on interest income.

In view of the differences between financial institutions and businesses in general, it is considered to be desirable to treat financial institutions separately in the tax laws. Savings and loan associations are different in organization and operation from other financial institutions, thus it is desirable to treat these associations separately from other financial institutions.

It is thought that the present share tax is, in reality, a franchise tax and should not be labeled an occupational license tax. It is also thought that it is improper for what is virtually the entire contribution of a class of taxpayers to the support of State government to be a rigid tax based on capital. It is believed that the most desirable combination of taxes for this class of taxpayers is a tax measured by the value of capital at a rate lower than the present levy and a tax measured by net income. Under a structure of this type, the State would be assured of some tax payment by each savings and loan association and would have a stable source of revenue while the tax liability of savings and loan associations would fluctuate with the profitability of the operations of these businesses.

A rate of 6¢ per $100 is thought to be proper for a capital stock tax measured by the share liability of each association. The share liability includes the cost of shares plus all interest or dividends credited to each account as of December 31 of each year. An excise tax measured by net income levied at a rate of 6 per cent is believed to be a desirable complement to the proposed capital stock tax. The suggested base of the excise tax is net income as defined in the income tax laws applying to corporations except that all interest and all dividends paid on shares would be deductible.

It is believed that this method of taxing savings and loan associations is fair and equitable both to the associations and to other taxpayers.

It may be noted that the rate of the capital stock tax is lower than the franchise tax rate of $1.50 per $1,000 of capital stock, surplus, etc., but the bases are not comparable although the labels are similar. The capital stock of a savings and loan association is similar to savings deposits of a bank and to the entire deposits of a savings bank or a Hood System or Morris Plan bank, and is, therefore, a larger base than the capital stock of a business corporation. Further, the shares of the associations must be redeemed by the associations upon demand.

The deductibility of interest and dividends paid on shares is considered to be desirable due to the difficulty of separating the portion of such payments which represents true dividends from interest paid for the use of funds, (little if any of the investment in shares in such associations is "risk" capital). In addition, the dividends or interest are taxable in the hands of the shareholder while domestic dividends of corporations are deductible in the hands of the shareholder and the value of domestic shares are exempt from the intangible property tax.

Effect upon Revenue. It is anticipated that there would be no change in the revenue from this class of taxpayer during the 1957-58 fiscal year. In future years a change in the relationship of profits to the value of shares would result in some fluctuation in revenue.

TAXATION OF BANKS

The Commission found that the taxation of banking institutions in North Carolina has evolved on a piecemeal basis without comprehensive treatment and without any consistent policy. National banks pay no income tax, or any direct tax at the State level. The income tax paid by state banks is not measured by real net income. The local property levy on the value of bank shares, which is paid by both national and state banks, produces an inequitable and unequal impact on banks in the same locations and of the same size. It was found that there is no similarity of impact of state and local taxes between banks, by size, by type, by location or any other classification.

After detailed study of the problem it was decided that national banks should no longer be favored over state banks and should pay some tax to the state, that all banks should be treated equally, that banks should be taxed differently from other corporations because of the unique nature of their operations, that the tax laws should not encourage tax avoidance nor should they discourage loans to businesses and individuals. To insure uniformity of treatment of all banks the Commission selected that system which would best equalize the present state and local tax impact between state banks and remove the favoritism shown national banks. In making the choice of tax methods the Commission was limited to those which the Congress permits states to levy on national banks.

SPECIFIC RECOMMENDATIONS

IT IS RECOMMENDED *that Section 105-436 of the General Statutes which provides for the assessment and taxation of the shares of stocks of banks be repealed, and that banks be exempted from the income tax and payment of ad valorem taxes upon personal property.* IT IS FURTHER RECOMMENDED *that, in lieu of the income tax, the franchise tax and taxes on personal property, banks be subjected to an excise tax measured by the entire net income of each bank at a rate of 4½ per cent, and that the definition of "entire net income" be similar to the definition of the net taxable income of corporations for income tax purposes except that interest income from obligations of the Federal government, or of its instrumentalities, be included in entire net income.*

Present Provision. All banks in North Carolina are required to pay ad valorem taxes to the counties and municipalities at general property tax rates on the assessed value of all real estate, tangible personal property, *and* the shares of stock of the banks. The counties assess the real estate and tangible personal property and the State Board of Assessment assesses the shares of stock and certifies the assessed value to local taxing authorities.

The assessed value of the shares of stock of a bank is determined by taking the capital stock, surplus and undivided profits, and from this base deducting the assessed value of real estate and tangible personal property assessed locally, and from the surplus and undivided profits deducting a reserve for bad debts of five per cent of all bills and notes receivable and the cost value of North Carolina State bonds, Federal bonds, and land bank bonds; the remainder of the value of the shares is the assessed value of such shares. If any bank has one or more branches, the assessed value of the shares is allocated between the parent and the branches in proportion to the deposits of the parent and the branches.

In addition to ad valorem taxes, banks chartered by the State of North Carolina are subject to the corporation income tax. Such state banks are exempt from the corporation franchise tax, the intangible property tax and the privilege license on dealers in installment paper secured by personal property.

National banks are exempt from the income tax and the sales and use taxes in addition to the taxes from which state banks are exempt. (Citation: G. S. 105-346; G. S. 105-83 (d); G. S. 105-125; and G. S. 105-212)

Explanation. Banks organized under the national banking laws may be taxed by the states only in the manner prescribed by the United States Congress. Congress has prescribed four alternate methods of taxing national banks. The method in use in this State is the levy of an ad valorem

tax on the value of the shares of stock of such banks. Use of this tax precludes the levy of any other tax on National banks except the general property tax on real estate.

The prohibition against the levy of both a share tax and an income tax on national banks results in a major differentiation or inequity between national and state banks and between national banks and other taxpayers who are required to pay the income tax. *Under the existing laws national banks are required to pay no tax for the support of state government in North Carolina.*

The share tax is the only remaining vestige of an archiac form of taxation referred to as a corporate excess tax which was in common usage prior to the general adoption of the net income tax. A corporate excess tax is levied on the intangible value of the shares of stock corporations determined by deducting the assessed value of property assessed locally from the book value of the shares. The introduction of the net income tax and the difficulty of applying the corporate excess tax to multi-state corporations resulted in the disappearance of this form of taxation from general use.

The bank share tax is not a true corporate excess tax, however, for in addition to the deduction of all liabilities in determining the book value of shares and the deduction of the assessed value of real estate and tangible personal property, banks are permitted to deduct 5 per cent of all loans as anticipated losses and all North Carolina State and Federal bonds from surplus and undivided profits. These deductions reduce the base below that of the usual corporate excess tax. In fact, all of the banks in the State except a few industrial banks have enough Federal bonds to more than offset the entire surplus account. If these deductions were not permitted, the liability of banks as a group for share taxes would be approximately five times the present amount.

It is these deductions from surplus, particularly of Federal bonds owned, which cause the greatest inequalities in the application of the share tax. Inequalities have developed from differences in capital structure. At the time many of the banks in North Carolina were organized, Federal bonds were an insignificant consideration in tax matters, and the capital structures of banks were determined under existing laws and conditions. During the past twenty years, however, the importance of Federal securities in the portfolios of banks has increased until such holdings amount to approximately one-third of all securities, loans and discounts held by North Carolina State banks (one-fourth of total assets).

The effect of this development upon the tax liability of a bank is far from insignificant and it is understood that it has become a major consideration in the management of the capital accounts. The temptation to avoid the impact of this tax by building up surplus rather than capital is one that a businessman cannot be expected to forego.

As was stated above, virtually all banks in the State have their entire surplus accounts offset by Federal bonds, consequently, the assessed values of the shares correspond to the capital stock account less the assessed value of the real estate and tangible property listed locally. During recent years few banks have obtained additional capital needed for expansion by issuing new stock, the needed funds have come from earnings which have been retained in the surplus account rather than being distributed to the shareholders in dividends. The declaration of stock dividends is infrequent. There can be little doubt that the tax laws influenced these decisions by the boards of directors. In over half of the state banks, the capital stock account is less than one-fourth of the total of the capital accounts and in a number of cases the capital stock is less than 10 per cent of the total of the capital accounts. In one extreme case the ratio is less than 4 per cent. Since government bonds may offset surplus and undivided profits, and since the assessed value of real estate and tangible property is deducted from capital stock, the lower the amount of capital stock, proportionally, the smaller the remainder which is the assessed value of the shares. For this reason a number of banks are not assessed anything on shares, and for many more the assessment is extremely low in comparison with the book value of the shares. .

As the ratio of the total assessed value of the property of banks, including the assessed value of shares, varies from less than 4 per cent to over 60 per cent for those banks studied, it is obvious that gross inequities between banks result from the levy of this tax. In addition, there is a wide variation in the rates levied in different localities and these rates are strongly influenced by the

prevailing assessment practices of the counties. Low assessments result in high rates and vice versa, but there is no relationship between the assessment ratios used in the counties and the ratios resulting from the application of the bank share tax. A bank in a locality with low rates may have an extremely low assessment and a bank in a locality with high tax rates may also have a relatively high assessment.

It may also be pointed out that the counties and cities have no justifiable claim upon revenue from the share tax which is the only tax on intangible property levied at local tax rates.

The corporation income tax as applied to banks also results in major inequities. The exemption of national banks from the income tax was noted above. There are, however, differences almost as great between state banks. These differences result largely from the exemption of the interest on Federal obligations from taxation. Non-taxable interest accounted for 21.7 per cent of the gross income of all state banks in 1955. The impact of this tax-exempt income upon the income tax is even more startling, for 67.6 per cent of the *entire* net income of state banks was represented by non-taxable interest. Thus, the taxable net income of state banks was, on the average, less than one-third of their net income before income taxes. The principal objection to this situation is that the total impact of the tax is not spread evenly between banks on the basis of real net income. The greatest differences occur between industrial and commercial banks, but there are differences between large banks and small banks and between banks in larger cities and those in towns and small cities. In addition to the differences between classes of banks, there are notable differences between banks in substantially the same situations. Among the causes of these differences in the impact of the income tax banks is the degree to which the bank performs the function in the community of making short-term commercial loans to local businessmen to tide them over periods when cash is short, and to enable them to hold inventories in the expectation of sales as during the pre-Christmas period.

Another cause of differences between banks in the impact of the income tax is the variation in the relative importance of demand deposits as a source of lendable funds of each bank. Demand deposits represent money left in trust with a bank for the convenience of the depositor and, of course, the bank makes no payment for the use of these funds. Although the amount of any one account fluctuates from day to day, the total of all deposits in any one bank is reasonably constant, thereby furnishing the bank with funds which may be used for investment, subject to liquidity requirements and requirements of investment quality.

As demand deposits furnish a relatively cost-free source of funds for making investments, it is possible for banks to hold low return Federal bonds and notes with such funds, while it would not be feasible to hold Federal obligations with savings deposits. The relationship of the amount of demand deposits which a bank can attract to total funds available for investment is not entirely subject to the control of the bank. Also a large portion of the total holdings of Federal bonds are held with funds which would, otherwise, have to be maintained in cash to conform to the liquidity requirements of the State and of the Board of Governors of the Federal Reserve System.

The deductions of tax-exempt interest render some banks non-taxable, which, in reality have large net earnings after all taxes. The proportion of the entire net income of banks which is represented by tax-exempt interest varies from 100 per cent to zero per cent.

If the ratio that all state and local taxes paid other than on real estate* bear to entire net income before income taxes is computed for each state bank, it is found that the burden of taxation in some cases is more than 4 times as great as in others.

It cannot be claimed that these differences result from different local conditions as the following two examples show.

Two banks in the same city with assets, assessed valuation of real and tangible personal property, and book value of capital stock being roughly comparable, have assessed values of shares grossly different as is shown below. The differences in assessed values of shares is caused by differences in make-up of the capital accounts.

*Real estate taxes are omitted as all banks do not own their banking houses and the inclusion would distort the results.

		Bank A		Bank B
Total Assets		$11,345,588		$11,122,638
Capital Account:				
Common stock	$225,000		$150,000	
Surplus and Undivided profits	412,341	637,341	624,441	774,441
Assessed value:				
Real estate and tangible personal property		152,380		151,045
Shares or corporate excess		72,620		None
Total assessed value		$ 225,000		$ 151,045

NOTE: Figures were altered to avoid disclosure of identity of individual banks.

Both banks had enough government bonds to offset their surplus and undivided profits but Bank A has $225,000 capital stock and Bank B has $150,000 capital stock. The capital stock almost exactly coincides with the total assessed value in each case, resulting in a 49 per cent greater propery tax liability for Bank A than for Bank B. Bank A had as assessed value of stock of $72,620 while no assessment was made on the stock of Bank B.

This is by no means an extreme case. These two banks were chosen as they are of approximately the same size, have no out-of-town branches, and are located in the same municipality. Examples could be cited of banks which are roughly comparable except that they are located in different towns with the total assessed value of all property of one bank being as much as 10 times as great as the other. It should be remembered that this difference is caused by the varying ratios of capital stock to *book value* of capital stock which were noted above.

A comparison of two other banks illustrates the results of the application of the state income tax to state banks. The two banks in the following illustration are located in the same city and have approximately the same amount of capital stock, surplus, and undivided profits. The total net incomes before income taxes of these two banks are not greatly dissimilar as Bank B exceeds Bank A in income by only 13 per cent, but there is a great difference in the *taxable* net income of these two banks due to the exemption of interest on governmental obligations. Bank A with the *smaller* net income paid almost 3½ times as much in corporate income taxes to the State as did Bank B.

	Bank A	Bank B
Capital account	$ 650,663	$ 579,401
Total deposits	5,463,759	10,028,695
Entire net income before income taxes	68,905	88,689
Non-taxable interest	20,043	74,048
State income tax paid	2,949	878

NOTE: Figures adjusted to avoid disclosure of individual banks.

It should be noted that, although the investment by the stockholders in each bank is approximately the same, there is a disparity in deposits. This same disparity is accentuated in the amounts of non-taxable interest received by each of the banks. It is interesting to note that Bank B with the largest amount of non-taxable interest has *demand* deposits five times as great as does Bank A.

After making a careful study of the effects upon different banks of the present method of taxation, this Commission became concerned with the extreme gravity of the differentiation in treatment of banks. The Commission was restricted in its search for an equitable solution to the problem to those methods of taxation which the states are authorized by the United States Congress to apply to national banks. Any other course would be substituting one injustice for another.

The United States Congress has enacted permissive legislation establishing four methods under which the states may tax national banks. Property taxes may be levied on all real estate at the same rates levied upon all other real estate. In addition, national banks may be taxed in one of the four following ways:

1. A property tax may be levied on bank shares, subject to certain limitations, under a general property tax or a classified property tax (depending upon which the state uses).

2. The dividends on national bank shares may be taxed to the stockholders as personal income if the dividends of other domestic corporations are so taxed.

3. The net income of national banks may be taxed under a corporation income tax law which is applicable to other corporations.

4. A franchise or excise tax measured by net income may be used by states which tax other corporations either by an income tax or a franchise tax or both.

If the first method is used the others are prohibited. The second method may be used jointly with either of the last two methods.

The first method is now used by North Carolina, if any change is to be made in the method of taxing national banks this method must be discarded.

The second method, that of taxing the dividends of banks as income to the stockholders, cannot be used in this State unless we are ready to tax all dividends of domestic corporations. Therefore, it may be discarded.

If the third method, taxation of the net income of national banks, were adopted, the share tax on national banks would have to be repealed, and equity would indicate that state banks should receive the same treatment. Such action would remove some of the inequities between banks but would accentuate the inequities resulting from the non-taxability of Federal interest. Further, it would increase the present differential in the impact of taxation upon the banking community and upon business corporations by further reducing the total tax liability of banks as a group. State banks would pay approximately 50 per cent less in state and local taxes and national banks would pay slightly less with a shift of payments from local governments to the State. Adoption of the third alternate method is not considered to be in the best interest of the State as a whole.

The fourth method is believed to offer a solution which will equalize the tax burden between banks while not altering the position of state banks with regard to other types of taxpayers. The adoption of this method would entail the enactment of an excise tax upon banks and the exemption of national banks from all taxes except the general property tax on *real estate*. The base of the excise tax would be net income as defined for this purpose. Any tax rate may be used provided the total state and local tax liability of national banks is not more burdensome than the total state and local taxes paid by other corporations. For this purpose taxes are usually compared to net income. A choice of bases and rates is, therefore, available. It is believed, however, that the most desirable definition of net income for purposes of a bank excise tax would be net income as defined for corporation income tax purposes, *except* that the interest from Federal obligations should be included in the tax base. If this tax base were used, a tax rate of 4½ per cent could be adopted and *state* banks as a group would have approximately the same total tax liability as under the current law as was revealed by a study of the income tax returns for 1955. National banks would pay approximately $105 thousand more each year in state and local taxes.

There would, however, be some shift in revenue receipts between levels of government as a result of the repeal of the share tax and the exemption of banks from personal property taxes, both of which would be necessitated by the adoption of the excise tax. The State would gain $283,000 from national banks and $385,000 from state banks, or a total gain of $668,000 per year. Local governments would receive $573,000 less in property taxes. Almost $500,000 of this loss would be from the share tax to which local governments have no valid claim. (Other recommendations of this Commission more than offset this loss to local governmental units.)

It may be noted that there is no suggestion to include North Carolina state and local bonds in the base of the bank excise tax. The large amount of outstanding obligations of this type all of which were issued with the contractual understanding that no state or local taxes, direct *or indirect*, would be levied upon them, combined with the general desire to do nothing which might render the sale of local bonds more difficult caused this Commission to decide to recommend that only Federal interest be included in the tax base.

It is recognized that the exclusion of State and local interest from the tax base may result in some inequities similar to those resulting from the exclusion of all governmental interest under the present statute. There is, however, a marked difference in degree. Interest from North Carolina state and local bonds amounted to only 16 per cent of all non-taxable interest received by state banks in 1955. Should such interest be included, however, the tax rate could be reduced and still bring in the same revenue.

Although the methods of taxation of bonds in other states were surveyed by the Commission, no general comparison will be included in this report, but a brief summary of the methods of taxation used by our neighboring states is considered to be appropriate.

Virginia uses a share tax under a classified property tax system which subjects bank shares to a tax at a rate of $1 per $100 of valuation and includes in the base thereof all governmental obligations including Federal bonds and Virginia state and local bonds. Tennessee employs a share tax under the general property tax applying the aggregate of local rates against a base which includes all government obligations including Federal bonds and Tennessee state and local bonds. Georgia uses a share tax under the general property tax applying the aggregate of state and local rates against a base including all government obligations including Federal bonds and Georgia state and local bonds. South Carolina uses the excise method including in the base thereof interest from all government obligations including that from Federal government bonds and South Carolina state and local bonds. The rate in South Carolina is 4½ per cent, the same rate which was formerly applied under the corporate income tax. The corporate rate has since been raised to 5 per cent but the bank rate has remained at 4½ per cent. In addition, bank dividends are taxable income to the recipient.

It should be noted that the excise tax is in lieu of all other taxes except ad valorem taxes on real estate and sales and use taxes on purchases of supplies and equipment by state banks. All banks are now exempt from the corporation franchise tax and the intangible property tax. Under the proposal they would be exempted from the corporation income tax and the ad valorem tax on tangible personal property. Stockholders would still be permitted to deduct dividends received on bank shares from their gross income in computing their net income for income tax purposes.

Effect upon Revenue. It is estimated that the adoption of the recommendation relative to banks would result in an increase in revenue of $668,000 during the 1957-58 fiscal year. National banks would pay approximately $105,000 more in taxes than under the present law while state banks would pay approximately the same amount. The major increase in State revenue would result from a redistribution of revenue from local governments to the State. (Other changes recommended by the Commission more than offset this revenue loss of the local governmental units.)

MISCELLANEOUS

Although the Commission did not study the area of administration and tax collection methods from an organizational or broad procedural point of view, there are certain changes of an administrative nature deemed advisable. These recommendations do not affect the base of the taxes or the rates. Some are designed to facilitate collection. Others more clearly outline present relief provisions or provide new procedures for redress of the taxpayer from the State. The Commission herein attempts to outline changes to provide greater protection of the rights of the taxpayer without jeopardizing the State's position.

SPECIFIC RECOMMENDATIONS

A. IT IS RECOMMENDED *that where the Commissioner of Revenue has determined that an assessment should be made for additional taxes a letter notifying the taxpayer of the intention of making the assessment be sent by certified letter, or by any means whereby the Commissioner receives proof of delivery, at least thirty days prior to actual assessment; that taxpayers who have been assessed for additional taxes be permitted to petition the Tax Review Board for administrative review of the assessment provided such taxpayers give notive of the intent to petition the Board within thirty days of assessment and provided that completion of the petition for review is made within ninety days of the date of the assessment, and that the provisions in the present law for appeal to the Superior Courts from the decision of the Board and for making jeopardy assessments be retained.*

Present Provision. Under the present statute the Commissioner of Revenue may notify a taxpayer of the assessment of taxes or additional taxes whereupon such tax ". . . shall become due and collectible. . ."

A taxpayer is entitled to a hearing before the Commissioner of Revenue if he makes application within thirty days after the receipt of notice of the assessment from which he is appealing. If no application for hearing is made within thirty days the assessment is final.

A taxpayer may petition the Tax Review Board for review of the Commissioner's decision provided he files the petition within thirty days from the time the Commissioner notifies the taxpayer of his decision following the hearing before the Commissioner. (Citation: G. S. 105-241.1, G. S. 105-241.2 and G. S. 105-241.3)

Explanation. There are two major differences between the proposed law and the present law. The first difference is that the proposed law contains no provision for appeal to the Commissioner of Revenue from an assessment by the Commissioner. There is a thirty-day period between the notice of the *intent* to make an assessment and the actual assessment. During this period the taxpayer would be able to confer with the Commissioner and point out any errors in the assessment. The Commissioner would be able to make any corrections in the data giving rise to the assessment or to postpone the date of actual assessment during the period before assessment, but after making an assessment the assessment would be final as far as the Commissioner is concerned.

The second difference is that the proposed law provides for notice of appeal to the Tax Review Board from the assessment within thirty days of the assessment instead of completing the appeal within thirty days as is required under the present law, and provides for a ninety-day period following assessment during which the appeal can be completed and filed with the Tax Review Board.

It is believed that the proposed method of handling assessments is more orderly than the present method. The taxpayer is given ample time to prepare an appeal but only one hearing is required and the final settlement will not be delayed through repeating the time consuming process of appeal, scheduling hearings, holding hearings and reaching decisions. It is believed that the interests of both the taxpayer and the State would be served by adoption of this recommendation.

Effect upon Revenue. **None.**

B. IT IS RECOMMENDED *that the statute of limitations applicable to the assessment of additional taxes by the Commissioner of Revenue when a proper application for a license or a return has been filed be three years from the date the return is actually filed or the filing date of the return whichever date is the later.*

Present Provision. The present law provides that the Commissioner of Revenue may assess any tax or additional tax within three years ". . . of the date the tax or additional tax was due to be paid, where a proper application for a license or a return has been filed. . .". (Citation: G. S. 105-241.1; G. S. 105-160; and G. S. 105-124)

Explanation. Under the present statute there is a shorter period of time during which a delinquent return may be audited and an assessment made than is the case for a return filed within the proper time. In numerous instances returns are filed only a short time prior to the termination of the period during which assessments can be made. It is believed, therefore, that the limitation upon the period during which assessments can be made should be changed to allow assessments within three years of the actual date the return is filed, but to prevent the necessity of keeping records on each return filed the provision should be qualified to permit assessment within three years of the filing date for all returns filed on, or prior to, the due date.

Effect upon Revenue. None.

C. IT IS RECOMMENDED *that the penalties for fraudulent understatement of income taxes, of sales taxes, or of intangible property taxes be 50 per cent of the tax or additional tax due and that the Commissioner of Revenue be denied authorization to reduce or forgive the penalty.*

Present Provision. The Income Tax Act, the Sales Tax Act, and the Intangible Personal Property Tax Act provide that where an understatement of tax is found by the Commissioner of Revenue to be fraudulent the tax or the additional tax shall be doubled. The Commissioner is given the authority to reduce or waive any penalties provided for in the Revenue Act. (Citation: G. S. 105-158 (4); G. S. 105-174 (c); G. S. 105-237; and G. S. 105-208)

Explanation. It is felt by the Commission that in tax matters there are no degrees of fraud and that penalties for fraudulent evasion of taxes should be uniformly applied. It is believed, however, that penalties of 100 per cent are excessive and that there might well be a reluctance to assess such a heavy penalty. It is the understanding of the membership of the Commission that in many cases penalties are reduced to 50 per cent. As a policy of amelioration of penalties could well favor the outspoken and well informed tax evader, it is believed that there should be no administrative discretion in the application of penalties for fraud.

Effect upon Revenue. It is believed that the effect upon revenue of adoption of this proposal would be negligible.

D. IT IS RECOMMENDED *that, whenever an overpayment of the correct amount of tax due under any tax schedule is ascertained whether by routine administrative examination or by examination resulting from a demand for a refund, the overpayment be refunded to the taxpayer within sixty days if the amount of the overpayment is $10 or more, that where such overpayment is less than $10 the overpayment be refunded upon receipt of a written demand for such refund from the taxpayer, but that no overpayment be refunded upon discovery or receipt of written demand if such discovery is not made or such demand is not received within three years from the filing date of the return or within six months of the payment of the tax alleged to be an overpayment, whichever date is the later.*

Present Provision. The sections of the statutes which provide for general administration of the tax laws include a section which provides that the Commissioner of Revenue shall make refunds of overpayments of tax within sixty days of discovery, provided that demand for the refund is made by the taxpayer within three years of the date of the overpayment.

The income tax laws provide that an overpayment of tax shall be returned within thirty days after it is discovered, and certain of the other tax schedules provide for refund with no reference to demand by the taxpayer.

The administrative practice is to make refunds for overpayments of $1 or more upon discovery without requiring demand by the taxpayer. (Citation: G. S. 105-266; G. S. 105-158 (1); G. S. 105-29 (a); G. S. 105-174; G. S. 105-184; G. S. 105-191; G. S. 105-208; and G. S. 105-228.2 (8))

Explanation. It is believed that an overpayment of tax due to error, misunderstanding, or wrongful assessment should be made when the overpayment is discovered regardless of whether the taxpayer is aware of the overpayment or not. Although this is the administrative practice, the statutes should be clarified. As the administrative cost involved in making a refund is not insignificant, it appears desirable to withhold refunds when the amount of the overpayment is less than $10 unless the taxpayer makes a request for the refund. The auditors might well be engaged in more urgent work than making such small refunds. It is also thought that the limitation upon the time within which a refund may be made should be retained, except that where payment is made near or after three years from the filing date (as under an assessment), the taxpayer should have six months in which to request a refund.

Effect upon Revenue. A small increase in revenue would result from the withholding of such small refunds as would otherwise be made.

E. IT IS RECOMMENDED *that in all cases where refunds of overpayements of taxes are made that interest be paid at the rate of three per cent per annum on the amount of the overpayment, that the interest be computed from a date ninety days after the date the overpayment was originally paid by the taxpayer but that this provision not apply to interest required under Section 105-267 of the General Statutes.*

Present Provision. The law provides that interest shall be paid on refunds for overpayment of tax at the rate of six per cent per annum, provided that the interest shall be computed from a date ninety days after the date the tax was paid. (Citation: G. S. 105-266 and G. S. 105-159)

Explanation. It is believed by this Commission that payment of interest at the rate of six per cent on refunds for overpayment of taxes may very well encourage taxpayers to make overpayments with the purpose of later requesting a refund with interest. Such practice should be discouraged and this can best be done by reducing the rate of such interest payments to approximately the rate paid on Federal bonds and on savings deposits, i.e., three per cent.

Effect upon Revenue. Adoption of this proposal would result in some increase in revenue as the amount of interest paid on refunds would be reduced by one-half.

F. IT IS RECOMMENDED *that a taxpayer be permitted to petition the Tax Review Board for review of the decision of the Commissioner of Revenue to withhold a refund of taxes alleged by the taxpayer to constitute an overpayment, but that the petition of the taxpayer be considered by the Board only* WHERE *the taxpayer has filed a demand in writing for such refund within the time required for filing such demand and the Commissioner has issued a decision in the case or where the refund has not been made within six months of the date of filing such demand;* WHERE *notice of the impending petition has been filed by the taxpayer within thirty days of the expiration of the six-month period or the issuance of an adverse decision by the Commissioner, whichever date is the earlier; and* WHERE *the petition has been completed within ninety days of the expiration of the six-month period or the issuance of an adverse decision by the Commissioner, whichever date is the earlier.* IT IS FURTHER RECOMMENDED *that, in the event the taxpayer is aggrieved by the decision of the Board, he be permitted to appeal to the Superior Court for recovery of such taxes.*

Present Provision. Under the present statute a taxpayer is permitted to petition the Tax Review Board for review of the Commissioner's decision "... with respect to his asserted tax liability...". This provision is interpreted to apply only to assessments of additional tax plus any penalties and interest. There is no specific authorization for petition for relief from the Commissioner's decision to deny a refund, nor is the Commissioner required to give notice of his decision. (Citation: G. S. 105-241.2)

Explanation. It appears to be no more than fair that a taxpayer who believes that he has made an overpayment of taxes through error, misunderstanding or for any other reason, should be permitted to appeal to the Tax Review Board for administrative review if the Commissioner of Revenue finds that no refunds is due, and to appeal to the Superior Courts if the decision of the Board is unfavorable. The recommendations contained herein are designed to provide for such appeals.

Effect upon Revenue. The loss of revenue from such administrative review cannot be estimated, but it is believed that the loss would be small.

G. IT IS RECOMMENDED *that the provision of the law which requires that a taxpayer post bond at the time of filing a petition for review of an assessment asserted by the Commissioner of Revenue be deleted and that the Tax Review Board be authorized to impose a penalty of $100 or less in addition to the costs of the proceedings in cases of frivolous petitions to the Board wherein it is the apparent purpose of the taxpayer to delay the payment of taxes.*

Present Provision. The law provides that where a taxpayer has been assessed additional taxes, the taxpayer may petition the Tax Review Board for review of the assessment without having to pay the tax but he is required to give a bond at the time of filing of the petition sufficient to cover the amount of the assessment. (Citation: G. S. 105-241.2)

Effect upon Revenue. None.

H. IT IS RECOMMENDED *that an overall "transferee liability" provision be enacted which is similar to the Federal Code.*

(Under the Federal Internal Revenue Code of 1954, the Commissioner of Internal Revenue is authorized to assess and collect any income, estate, or gift tax liability from a person who is a "transferee" of a taxpayer who is initially responsible for the tax liability. In the application of the Federal law a transferee includes a donee, heir, legatee, devisee, distributee, stockholders of a liquidated corporation, or any other person who receives property from the taxpayer for an inadequate consideration. The Federal law requires that the transfer (for an inadequate consideration) be made after the tax liability accrues and that the transfer be made at a time when the taxpayer (transferor) is insolvent or that he be rendered insolvent by reason of the transfer.)

Present Provision. Under the present statute, the purchaser of a business or of the stock of goods of a business is held liable for any unpaid sales tax for which the former owner of the business is liable; inheritance taxes are a lien upon the property of the estate the transfer of which gave rise to the liability; and all taxes are a general lien upon the property of the taxpayer. (Citation: G. S. 105-176; G. S. 105-20; G. S. 105-241)

Explanation. The purpose of a "transferee liability" provision is to permit the collection of taxes owed by a decedent or an insolvent person from a person to whom the taxpayer has transferred property for the apparent purpose of evading the tax. Under the common law a creditor is permitted to pursue the assets of his debtor when the assets were transferred for the purpose of defeating and defrauding the creditor's claim. The Commissioner of Revenue now has the authority to pursue the assets of a taxpayer under this common law principle, but he must bring suit in the courts of the State to do so.

The proposed provision would merely eliminate the necessity of court action in these cases. Under the Federal Code the rights of the taxpayers are protected as the Commissioner must bear the burden of proof that the person in possession of the property and against whom the Commissioner is assessing the tax is a "transferee." The person alleged to be a "transferee" can contest the liability on the basis of not being a "transferee" and on the basis of denial that the original taxpayer was liable for the tax.

It should be clearly noted that a bona fide purchaser of property for value would be not liable for taxes owed by the seller of the property should the proposed provision be enacted.

Effect upon Revenue. It is believed that some additional taxes would be collected if this provision were enacted which might otherwise be lost.

I. IT IS RECOMMENDED *that the Commissioner of Revenue be authorized to compromise the amount of tax liability in cases where the taxpayer is insolvent, in cases of doubtful liability, and in cases where the collectibility of the entire amount is in doubt; that such compromise be made only with the approval of the Attorney General; and that such provisions be similar to the provisions in the Federal Code.* IT IS FURTHER RECOMMENDED *that the Commissioner of Revenue be authorized to conclude a written agreement with the taxing officials of another state or states and with the taxpayer in cases of disputes as to the state of domicile of a decedent; and that such agreements be made only with the approval of the Attorney General.*

Present Provision. The law provides that the Commissioner of Revenue may, with the approval of the Attorney General, agree upon the amount of taxes due from a fiduciary and that such agreement shall be full satisfaction of the taxes to which the agreement relates. The statutes are silent as to compromises in other situations. The Commissioner, with the advice and agreement of the Attorney General, makes such compromises as are necessary to protect the State from loss. (Citation: G. S. 105-240)

Explanation. It is believed to be in the best interest of the State to authorize the Commissioner of Revenue to make a compromise settlement of the tax liability of taxpayers in cases of litigation where there is reasonable doubt concerning liability, in cases where there is doubt as to collectibility of the entire amount, and in cases of insolvency where it is necessary to reach an agreement with the taxpayer before any part of the tax can be collected. It is thought that such provisions should conform to those in the Federal Code.

The proposal for giving the Commissioner the authority to make agreements with the taxing officials of other states and with taxpayers in cases of disputes as to the domicile of a decedent is considered to be desirable to facilitate the settlement of estates.

Effect upon Revenue. None.

J. IT IS RECOMMENDED *that all requirements that taxes be paid* UNDER PROTEST *as a condition to bringing civil action for judicial determination of the correct tax liability be deleted; and that a taxpayer be permitted to sue the Commissioner of Revenue in the courts of the State for the recovery of any overpayment of taxes alleged by the taxpayer whether due to erroneous self-assessment or to assessment by the Commissioner of Revenue, plus any penalty and/or interest upon any alleged wrongful assessment; but that such suit be authorized only where the taxpayer has paid the tax, has filed a demand in writing for refund with the Commissioner of Revenue within the time provided for filing such demands, and such demand has been denied by the Commissioner of Revenue, or the refund of such taxes has not been made within six months after the date such demand was filed.* IT IS FURTHER RECOMMENDED *that any payment of taxes, penalties or interest whether paid under protest, duress, or otherwise be without prejudice to any defense of rights the taxpayer may have.*

Present Provision. Under the law a taxpayer who believes the levy or the asssesment of any tax is unlawful or excessive may not bring suit in the courts for judicial determination of the proper amount of such tax unless the tax *is paid,* unless it is paid *under protest,* unless a demand for refund is filed within thirty days of such payment, and unless the tax has not been refunded within ninety days of the filing of such demand. (Citation: G. S. 105-241.4 and G. S. 105-267)

Explanation. It is believed that the requirement that taxes must be paid under protest as a condition to bringing suit in the courts of the State is obsolete and should be taken out of the statutes. Any taxpayer who has overpaid his taxes whether due to an error on his part, or due to a change in the interpretation of the law which occurred after his return has been filed, or for whatever reason is entitled to the opportunity to obtain a ruling by the courts in his case if he has exhausted other remedies.

Effect upon Revenue. The effect upon revenue of any provision for administrative or judicial review cannot be estimated with any reasonable accuracy, but it is believed that in this case the loss of revenue would be small.

APPENDIX

SUGGESTED PROVISIONS FOR ALLOCATION AND APPORTIONMENT OF THE INCOME OF INTERSTATE CORPORATIONS OTHER THAN PUBLIC SERVICE CORPORATIONS

APPENDIX

PROPOSED STATUTORY PROVISIONS FOR ALLOCATION OF INCOME OF INTERSTATE CORPORATIONS OTHER THAN PUBLIC SERVICE CORPORATIONS

(Not Intended as a Bill)

A corporation engaged in doing business in this State shall pay annually an income tax equivalent to six per cent of its net taxable income. The net taxable income of such corporation shall be determined as provided in this Article.

If the entire business of the corporation is transacted or conducted within the State, the tax shall be measured by the entire net income of the corporation for the income year. The entire business of a corporation shall be deemed to have been transacted and conducted within this State if such corporation is not subject to a net income tax or a franchise tax measured by net income in any other state, the District of Columbia, a territory or possession of the United States or any foreign country, or would not be subject to a net income tax in any other such taxing jurisdiction if such other taxing jurisdiction adopted the net income tax laws of this State. If the corporation is transacting or conducting its business partly within and partly without North Carolina, the tax shall be imposed upon a base which reasonably represents the proportion of the trade or business carried on within the State. A corporation subject to taxation under this article shall be deemed to have been transacting or conducting its business partly within and partly without this State if such corporation is subject to a net income tax or a franchise tax measured by net income in any other state, the District of Columbia, a territory or possession of the United States, or any foreign country, or would be subject to a net income tax in any other such taxing jurisdiction if such other taxing jurisdiction adopted the net income tax laws of this State. *Provided,* that nothing in this paragraph shall be construed as denying the rights of allocation and apportionment as provided in this section to corporations suffering a net loss, but that for purpose of determining the taxable portion of stock under the intangible property tax, of determining the deductible portion of dividends under the income tax, and of the apportionment of net economic losses carried forward the provisions apply as if the corporation had a net income. The allocation or apportionment of the entire net income of the corporation shall be made in accordance with the following provisions.

1. Interest received from intangible property held for non-unitary investment purposes less all related expenses shall be allocated to the state in which the principal place of business of the corporation is located.

2. Dividends received from, and gains or losses from the sale or other disposition of corporate stocks owned other than stocks of a subsidiary corporation having business transactions with or being engaged in the same business as the taxpayer less all related expenses shall be allocated to the state in which the principal place of business of the corporation is located. For purposes of this paragraph a corporation shall be considered to be a subsidiary if the parent corporation owns in excess of 50 per cent of the voting stock of such subsidiary.

3. Royalties or similar income received from the use of patents, trademarks, copyrights, secret processes and other similar intangible rights less all related expenses shall be allocated to the state in which the principal place of business of the corporation is located (or to the state in which such rights were used).

4. Rents received from the lease or rental of real estate or tangible personal property, royalties received from tangible property, and gains or losses from the sale or other disposition of real estate or tangible personal property where the property leased, rented or sold is or was not used in or connected with the trade or business of the taxpayer during the income year less all related expenses allowable as deductions under this act shall be allocated to the state in which the property was located at the time the income was derived.

5. The income less all related expenses from any other investments, the net income from which is not properly includable in the net apportionable income of corporations engaged in interstate commerce under the Constitution of the United States because it is unrelated to the business activity of the corporation conducted partly within and partly without North Carolina shall be allocated to the state in which the business situs of the investment is located, provided that if the business situs of such investment is partly within and partly without North Carolina it shall be apportioned by use of the same formula as the net apportionable income of the corporation.

6. The net income of the above classes having been separately allocated and deducted, the remainder of the net income of the corporation shall be apportioned as follows:

(a) Where the income is derived principally from the manufacture, production or sale of tangible personal property the corporation shall apportion its net apportionable income to North Carolina on the basis of the ratio obtained by taking the arithmetic average of the following three ratios:

(1) Property. The ratio of the value of real estate and tangible personal property used by such corporation in this State at the close of the income year of such corporation, to the value of the entire real estate and tangible personal property used by it everywhere at the close of the income year of such corporation, except that inventories of goods, wares and merchandise shall be valued on the basis of a monthly or other periodic average during the income year of such corporation. If the taxpayer does not take or keep records of monthly or other periodic inventories, or, if in the opinion of the Commissioner of Revenue the method and time of taking such inventories does not accurately reflect the true average inventory, the Commissioner shall determine the proper amount from such information as may be available.
As used in this Paragraph:

(i) The words 'tangible personal property' shall mean corporeal property such as machinery, tools, implements, goods, wares and merchandise, and shall not mean cash on hand or in bank, shares of stock, bonds, notes, accounts receivable, credits, special privileges, franchises, good will, evidence of an interest in property or evidences of debt.

(ii) The word 'value' as applied to property owned other than inventories shall mean original cost plus additions and improvements less reserve for depreciation, unless in the opinion of the Commissioner of Revenue as peculiar circumstances in any case justify a different basis, in which event the Commissioner may construe 'value' to mean fair market value. Inventories shall be valued in accordance with the accounting practice of the corporation, unless in the opinion of the Commissioner of Revenue a different method is required in order to better reflect the net income of the corporation. In determining the value of property no deductions shall be made for encumbrances thereon.

(iii) The words 'property used' shall include all real estate and all tangible personal property owned, leased or rented by the corporation at the close of the income year, except that any property the income from which is excluded from the net apportionable income shall be excluded in the computation of the property ratio.

(iv) The word 'value' as applied to real estate rented or leased shall mean the net annual rental rate multiplied by 8, and as applied to tangible personal property rented or leased the word 'value' shall mean the net annual rental rate multiplied by such figure for each type of property as the Commissioner shall direct. The net annual rental rate shall mean the gross annual rental rate paid by the taxpayer less the gross annual rental rate received by the taxpayer for subrentals of real estate.

(2) Payrolls. The ratio of all salaries, wages, commissions and other personal service compensation paid or incurred by the taxpayer in connection with the trade or business of the taxpayer in this state during the income year to the total salaries, wages, commissions and other personal service compensation paid or incurred by the taxpayer in connection with the entire trade or business of the taxpayer wherever conducted during the income year. For the purposes of this section, all such compensation to employees chiefly working at, sent out from or chiefly connected with an office, agency or place of business of the taxpayer in this State shall be deemed to be in connection with the trade or business of the taxpayer in this State; all such compensation to general executive officers shall be excluded from the numerator and the denominator of the ratio, and all such compensation in connection with income separately allocated under the provisions of this article shall be excluded from the numerator and the denominator of the ratio.

(3) Sales. The ratio of sales made by such corporation during the income year which are attributable to North Carolina to the total sales made by such corporation everywhere during the income year.

For purposes of this subsection sales attributable to North Carolina shall be all sales where the goods, merchandise or property is received in this State by the purchaser. In the case of delivery of goods by common carrier or by other means of transportation, including transportation by the purchaser, the place at which the goods are ultimately received after all transportation has been completed shall be considered as the place at which the goods are received by the purchaser. Provided that direct delivery into this State by the taxpayer to a person or firm designated by a purchaser from within or without the State shall constitute delivery to the purchaser in this State. The word 'sales' as used in this subsection shall be construed to include rentals of tangible personal property the rentals from which are not separately allocated under part 4 of this section. Such rentals to be attributed to North Carolina if the property is located in North Carolina.

(b) Where the income is derived principally from business other than that described in Subsection (a) above the corporation shall apportion its net apportionable income to North Carolina on the basis of the ratio of its gross receipts in North Carolina to its gross receipts everywhere. Gross receipts as used in this paragraph shall mean the entire receipts of the corporation except that it shall exclude receipts from sources separately allocated under Subsections 1 through 5 of this section.

Note: The above contains proposed provisions for the allocation of the net income of corporations other than those public service corporations filing under Section 105-136 of the General Statutes, it is not intended to supersede, repeal or amend the provisions of G. S. 105-134 relating to remedies of the taxpayer.