2009-2010
REVENUE LAWS STUDY COMMITTEE

REPORT TO THE 2011-2012
GENERAL ASSEMBLY OF NORTH CAROLINA
2011 SESSION

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*All of the meeting handouts, including Power Point presentations, may be accessed online in PDF format at the Revenue Laws Study Committee website: http://www.ncleg.net/committees/revenuelaws

REVENUE LAWS STUDY COMMITTEE
State Legislative Building
Raleigh, North Carolina 27603

Senator Daniel Gray Clodfelter, Cochair *Representative Paul Luebke, Cochair*

February 2, 2011

TO THE MEMBERS OF THE 2011 GENERAL ASSEMBLY:

The Revenue Laws Study Committee submits to you for your consideration its report pursuant to G.S. 120-70.106.

Respectfully Submitted,

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Sen. Dan Clodfelter, Co-Chair Rep. Paul Luebke, Co-Chair

2009-2010

REVENUE LAWS STUDY COMMITTEE

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PREFACE

The Revenue Laws Study Committee is established in Article 12L of Chapter 120 of the General Statutes to serve as a permanent legislative commission to review issues relating to taxation and finance. Before it was created as a permanent legislative commission in 1997, the Revenue Laws Study Committee was a subcommittee of the Legislative Research Commission. It has studied the revenue laws every year since 1977. The Committee consists of sixteen members, eight appointed by the President Pro Tempore of the Senate and eight appointed by the Speaker of the House of Representatives.[1] Committee members may be legislators or citizens. The co-chairs for 2009-2010 are Senator Dan Clodfelter and Representative Paul Luebke.

In its study of the revenue laws, G.S. 120-70.106 gives the Committee a very broad scope, stating that the Committee "may review the State's revenue laws to determine which laws need clarification, technical amendment, repeal, or other change to make the laws concise, intelligible, easy to administer, and equitable." A copy of Article 12L of Chapter 120 of the General Statutes is included in Appendix A. A committee notebook containing the Committee minutes and all information presented to the Committee is filed in the Legislative Library and may also be accessed online at the Committee's website: http://www.ncleg.net/committees/revenuelaws.

In 2002, the General Assembly established a permanent subcommittee under the Revenue Laws Study Committee to study and examine the property tax system.[2] The subcommittee consists of eight members, four appointed by the Senate chair of the

[1] The Speaker of the House of Representatives appointed a ninth legislative member, a non-voting advisory member in 2007, and again in 2009.
[2] S.L. 2002-184, s. 8.

Revenue Laws Study Committee and four appointed by the House chair of the Committee. The subcommittee may recommend changes in the property tax system to the full Committee for its consideration in its final report to the General Assembly. The Property Tax Subcommittee has not met since 2004.

COMMITTEE PROCEEDINGS

The 2010 General Assembly enacted seven of the Revenue Laws Study Committee's nine legislative proposals in whole or in part. Appendix B lists the Committee's recommendations to the 2010 General Assembly and the action it took on them. A document entitled "**2010 Finance Law Changes**" summarizes all of the tax legislation enacted in 2010. It is available in the Legislative Library located in the Legislative Office Building. It may also be viewed on the Legislative Library's website[3] and the Revenue Laws Study Committee's website.[4]

The Revenue Laws Study Committee met four times after the adjournment of the 2010 Regular Session of the 2009 General Assembly on July 10, 2010. Appendix C contains a copy of the Committee's agenda for each meeting. All of the materials distributed at the meetings may be viewed on the Committee's website. The Committee considered a number of issues, but it ultimately recommended only three pieces of legislation. Those proposals are discussed below followed by a summary of the Committee's discussion of the other issues for which no legislative proposal was recommended. The Committee considers all proposed tax changes in light of general principles of tax policy and as part of an examination of the existing tax structure as a whole.

LEGISLATIVE PROPOSAL #1:
IRC UPDATE

North Carolina's tax law tracks many provisions of the federal Internal Revenue

[3] http://www.ncleg.net/LegLibrary under 'Publications,' 'Tax and Finance Law Changes'
[4] http://www.ncleg.net/committees/revenuelaws

Code by reference to the Code.[5] The General Assembly determines each year whether to update its reference to the Code.[6] Updating the reference makes recent amendments to the Code applicable to the State to the extent that State law previously tracked federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. Maintaining conformity with federal tax law simplifies tax reporting because a taxpayer will not need to account for differing federal and State treatment of the same asset.

The current reference to the Code is May 1, 2010.[7] Since that time, Congress has enacted two acts that make substantial changes to the tax code: the Small Business Jobs Act of 2010, enacted September 27, 2010, as P. L. 111-240 (2010 Jobs Act), and the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act, enacted December 17, 2010, as P. L. 111-312 (2010 Tax Relief Act). Both acts contain provisions that became effective retroactively on January 1, 2010. Since the General Assembly will not have had an opportunity to enact legislation prior to the end of the 2010 taxable year, taxpayers may have to make adjustments on their 2010 State tax return for items

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[5] North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income. It began basing its calculation of personal income on federal taxable income in 1989.

[6] The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation … shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would … be invalidated as an unconstitutional delegation of legislative power."

[7] Part 31 of S.L. 2010-31 updated the reference to the Internal Revenue Code used in defining and determining certain State tax provisions from May 1, 2009, to May 1, 2010. However, S.L. 2010-31 did not conform to the five year carryback of net operating losses incurred by large businesses.

included in, or excluded from, federal taxable income as a result of one of these two acts. The chart included as Appendix D highlights the differences between North Carolina's current tax law and the changes made by the 2010 Jobs Act and the 2010 Tax Relief Act.

The 2010 Jobs Act enhanced existing business tax incentives and partially offset the associated revenue loss with changes that are expected to increase revenue.[8] The two most noteworthy incentives in the 2010 Jobs Act are the retroactive extension of the 50% bonus depreciation for the 2010 taxable year and the significant expansion of the section 179 deduction for tax years 2010 and 2011. Under the Act, a qualifying business may expense up to $500,000 of section 179 property; without the Act, the expensing limit would have been $250,000 for 2010 and $25,000 for 2011. The $500,000 amount is reduced, but not below zero, if the cost of all section 179 property placed in service during the tax year exceeds $2,000,000; without the Act, the investment limit would have been $800,000 for 2010 and $200,000 for 2011. In addition to the expansion of the section 179 deduction expensing and investment limits, the Act broadens the definition of qualified property to include qualified leasehold improvement property, qualified restaurant property, qualified retail improvement property, and computer software.[9]

The 2010 Tax Relief Act boosts the 50% bonus depreciation extended under the 2010 Jobs Act to 100% for property acquired and placed in service after September 8, 2010, and before January 1, 2012, and it provides 50% bonus depreciation for qualified property placed in service after December 31, 2012, and before January 1, 2013.[10] The

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[8] The 2010 Jobs Act gives taxpayers a greater number of options for their retirement plan dollars. The provisions are treated as revenue raisers because they encourage up-front distributions that are taxable. The majority of the revenue generated by the Act, however, is in the form of increased federal tax penalties. The increased federal penalties would not generate revenue for the State.

[9] Qualified real property is limited to a maximum deduction of $250,000.

[10] Under the 2010 Jobs Act, the bonus depreciation provision would have expired for taxable year 2012. Under the 2010 Tax Relief Act, it does not expire until taxable year 2013.

Act also increases the section 179 deduction expensing and investment limits for the 2012 taxable year from $25,000 and $200,000 to $125,000 and $500,000.[11]

North Carolina has historically decoupled from the bonus depreciation incentives enacted by Congress, but provided that a taxpayer's basis in the property is the same for federal and State purposes. Under State tax law, a taxpayer has had to add back 85% of the accelerated depreciation amount in the year that it is claimed for federal purposes. Then, in subsequent tax years, the taxpayer could deduct from federal taxable income the total amount of the add-back, divided into five equal installments. This adjustment means that for State tax purposes, a taxpayer may deduct a greater depreciation amount in the outlying tax years, which is the normal depreciation amount plus 20% of the accelerated depreciation amount the taxpayer had to add back.

North Carolina has historically conformed to the higher expensing and investment limits of the section 179 deduction. However, the change enacted by Congress in the 2010 Jobs Act represents a substantial increase in these limits and effectively increases the availability of the section 179 deduction to much larger businesses.

The Revenue Laws Study Committee discussed the fiscal impact of these federal tax law investment incentives. Full conformity with the 100% bonus depreciation provisions in the 2010 Tax Relief Act would reduce General Fund revenues by approximately $345 million for fiscal year 2010-2011; full conformity with the 50% bonus depreciation provisions in the 2010 Jobs Act would reduce General Fund revenues by approximately $200 million. Full conformity with the increase in the

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[11] Under the 2010 Jobs Act, the limits would have reverted to the prior levels of $25,000 and $200,000 in taxable year 2012. Under the 2010 Tax Relief Act, the limits will not revert to their prior levels until taxable year 2013.

section 179 deduction expense and investment limits of $500,000 and $2,000,000 would reduce General Fund revenues by approximately $58 million in fiscal year 2010-2011.

Legislative Proposal #1, ***IRC Update***, would take the more cost neutral position, consistent with the State's historical treatment of bonus depreciation and the section 179 deduction. The proposal would decouple from bonus depreciation by requiring the taxpayer to add back 85% of the bonus depreciation in the year it is taken and allowing the taxpayer to deduct that amount over the next five years. For North Carolina's tax purposes, the section 179 deduction expensing limit for 2010 is $250,000 and the investment limit is $800,000. Under current State law, the limits will revert to $25,000 and $200,000 in tax year 2011. The proposal would maintain the section 179 deduction limits of $250,000 and $800,000 for both taxable year 2010 and taxable year 2011 rather than conform to the higher federal limits of $500,000 and $2,000,000 for those tax years. It would conform to the expanded definition of qualifying property for taxable years 2010 and 2011. It would conform to the federal section 179 deduction limits of $125,000 and $500,000 for taxable year 2012 and to the reversion to the original limits of $25,000 and $200,000 for taxable year 2013. The cost of conforming to the Code in the manner recommended by this Proposal is approximately $600,000 for fiscal year 2010-2011.

In addition to the enhancements to the bonus depreciation and to the section 179 deduction provisions, the 2010 Tax Relief Act extends the sunsets of the individual and business tax incentives included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[12] for two years. Those incentives include the repeal of the limitation on itemized deductions, enhanced earned income tax credit provisions, and

[12] Most of the tax provisions in EGTRRA were scheduled to expire in 2010 or 2011 and revert to the provisions as they existed in 2001.

the deduction for higher education tuition expenses and for teachers' classroom expenses. North Carolina conformed to these incentives in 2002. Legislative Proposal 1 would conform to the extension of the sunsets on these incentives.

Under EGTRRA, the federal estate tax rates phased down and the exclusion amount phased up until the tax was repealed for decedents dying on or after January 1, 2010, and before January 1, 2011. During the year of its repeal, property passing through an estate received a modified carryover basis. The estate tax was scheduled to revert to its 2001 exclusion amount of $1,000,000 in 2011 with a maximum tax rate of 55%. The 2010 Tax Relief Act revives the estate tax for decedents dying after December 31, 2009, but at a significantly higher exclusion amount of $5 million[13] and a lower maximum tax rate of 35% than had been scheduled to be revived under EGTRRA. The Act allows estates of decedents dying in 2010 the option of paying the estate tax and receiving a stepped-up basis in the property passing through the estate or not paying the tax and receiving the modified carryover basis.

North Carolina imposes an estate tax on the estate of a decedent when a federal estate tax is imposed on the estate.[14] The amount of the State's estate tax is the amount of the credit allowed on the federal estate tax return for state estate tax paid, as the federal law provided in 2001.[15] Since the federal estate tax did not exist in 2010, North

[13] The Act provides for portability between spouses of the estate tax applicable exclusion amount which means that a married couple may effectively exclude up to $10 million from estate tax.

[14] North Carolina repealed its inheritance tax in 1998 and replaced it with an estate tax that was equivalent to the federal state estate tax credit allowed on a federal estate tax return. This type of state estate tax was known as a "pick up" tax because it picked up for the state the amount of federal estate tax that would otherwise be paid to the federal government.

[15] When Congress phased out the state estate tax credit, beginning in 2002, North Carolina enacted legislation not to conform to the phase-out of the credit. In other words, North Carolina began tying the amount of the State estate tax owed to the federal credit as it existed in 2001 rather than as it currently exists. Georgia, South Carolina, and Tennessee have not had an estate tax since January 1, 2005, because their estate tax equals the amount of the state estate tax credit allowed on the federal estate tax return, which is zero. Virginia repealed its estate tax, effective July 1, 2007.

Carolina's estate tax did not exist for 2010 and the basis of property passing through an estate of a decedent dying in 2010 was determined by the modified carryover basis rules under EGTRRA. With the revival of the federal estate tax in 2001, North Carolina's estate tax is also revived. However, unlike Congress, North Carolina cannot impose the estate tax retroactively on the estates of decedents dying on or after January 1, 2010, and before January 1, 2011. Legislative Proposal #1 would give those estates that chose to pay federal estate tax, and thereby receive the stepped-up basis in the property passing through the estate, the option to elect to receive the stepped-up basis for State tax purposes by paying the State estate tax for 2010. The proposal's conformity on this issue does not result in a revenue impact for fiscal year 2010-2011, but its impact in fiscal year 2011-2012 is a reduction in General Fund revenues of approximately $20 million.

Legislative Proposal #1 would conform to all other provisions in the 2010 Jobs Act and the 2010 Tax Relief Act.

LEGISLATIVE PROPOSAL #2: BUSINESS ENTITY CHANGES FOR PRESENT-USE VALUE TAXATION

At the December 1, 2010, meeting, the Committee voted to recommend legislation to amend the business entity ownership requirements for farmland qualifying for present-use value for property tax purposes. Under current law, farmland[16] may be taxed at its lower present-use value as opposed to market value if the land meets certain ownership, size, and use requirements. The business entity ownership requirements are met when farmland has been owned by a business entity or by one or more of the entity's members for the previous four years. Under this language, ownership is determined on the basis of the name on the deed but does not

[16] Agricultural land, horticultural land, and forestland.

always consider real parties in interest. Recently, counties have received applications in which farmland has been owned by a business entity, such as a partnership, for the past three years. The counties have denied present-use value status in instances where the farmland was previously owned by a different partnership, even though one or more partners of this partnership were the same as the partners of the partnership that currently owns the farmland.

Legislative Proposal #2, ***Business Entity Changes for Present-Use Value Taxation,*** would allow the business entity ownership requirements to be satisfied when the business entity that currently owns farmland shares one or more members in common with the business entity that previously owned farmland. This proposed legislation recognizes that the real parties in interest have not changed.

LEGISLATIVE PROPOSAL #3: TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES

The Revenue Laws Study Committee recommends **Legislative Proposal #3,** ***Revenue Laws Technical, Administrative, and Clarifying Changes.*** This proposal makes several technical and clarifying changes to the revenue laws and related statutes, including changes to the motor fuel tax and property tax laws. Many of the changes were recommendations of the Department of Revenue.

TAX ADMINISTRATION

No Delay of Tax Refunds

In 2009 and 2010, the State delayed the payment of tax refunds to many taxpayers as one of the ways in which it managed the cash flow needs of the State. The hope was that sufficient revenues would be realized in a timely manner so that all refunds could be processed by May 30th without the requirement of paying interest.[17] For the period January 1 through June 30 of 2008, the Department of Revenue issued 172,812 individual income tax refunds with interest.[18] For the same period in 2009, the number of individual income tax refunds issued with interest fell to 115,358; however, that number rose significantly in 2010 to 417,737. The amount of refunds for that period in 2010 equaled $287,574,365 and the amount of interest paid equaled $1,280,002. The Revenue Laws Study Committee asked the Department of Revenue, the Office of State Budget and Management, the State Controller's Office, and the Office of the State Treasurer to address this issue at its November 10th meeting.

North Carolina must constitutionally maintain a balanced budget. The State typically experiences low points in its cash flow during late November through mid-April because of the variance between income and expenditures. Under Article III, Sec. 5(3) of the North Carolina Constitution, the Governor has the authority to "effect the necessary economies in State expenditures" to insure that the State does not incur a deficit for any fiscal period. The two primary tools used by the State government to manage cash flow when revenue is insufficient to meet daily cash requirements have been the reallocation of funds between the General Fund and certain reserve funds on a short-term basis and the scheduling of payments contingent upon sufficient cash being available to meet the requirements.

In 1991, the State Controller's Office, the Office of State Budget and Management, the Department of Revenue, and the Office of the State Treasurer developed cash flow management procedures to pay individual income tax refunds. Appendix E contains two memos from this period. Consistent with the procedures established in March 1991,

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[17] Under G.S. 105-241.21, interest on individual income tax refunds does not begin to accrue until 45 days after the latest of the date the return was filed or due to be filed.

[18] This number does not include amended returns.

the State Controller's Office, the Department of Revenue, and the Office of State Budget and Management began discussions in late February 2010, on managing the payment of tax refunds.

In addition to the tools discussed above to manage cash flow issues, G.S. 142-19 gives the Director of the Budget the authority to borrow money in anticipation of the collection of taxes, by and with the consent of the Council of State. This borrowing would constitute general obligation indebtedness and would be limited to 50% of the taxes anticipated to be collected during the fiscal year. The Office of the State Treasurer noted that borrowing for cash flow purposes may be recognized by rating agencies as an indication of low reserves, but it would not necessarily result in a downgrading of a state's credit rating. Under the current market conditions, the interest rate on short-term borrowing of six months or less would be .60% to 1.00% for a taxable borrowing.[19] With this interest rate, the interest costs per $1 million borrowed would be $500 to $833 per month. The Secretary of Revenue establishes the interest rate that accrues on tax refunds. The rate established by the Secretary may not be less than 5% and may not exceed 16%.

The Committee questioned the Governor's constitutional and statutory authority to delay individual income tax refunds. The issue is whether taxpayer refunds are "expenditures" that are subject to reduction or management by the Governor. The Committee did not receive an answer to this question. The Committee also voiced taxpayers' frustration that the State could delay refunding an overcollected tax payment to a taxpayer to help the State achieve its cash flow needs while the law requires a taxpayer to pay taxes owed to the State by the due date, regardless of the cash position of the taxpayer. Lastly, the Committee noted the cost of short-term financing by the

[19] To qualify as tax exempt borrowing, the General Fund would have to be out of cash.

State is less than the interest the State must pay on delayed tax refunds. At its December 1st meeting, the Committee considered a draft proposal that would prohibit delay in the payment of tax refunds. A copy of the draft is contained in Appendix F.

During the first week of January 2010, Governor Perdue ordered Revenue officials to pay tax refunds within 30 to 45 days after the taxpayer filed the return. According to the press releases, the State may likely borrow short-term to expedite the payment of tax refunds if necessary to manage the cash flow needs of the State. Based upon the Governor's actions, the Committee chose not to recommend legislation.

Department-Initiated Tax Refunds

The Committee spent a great deal of time on the issue of Department-initiated refunds, which was discussed at three of its four meetings. In August of 2010, several newspaper articles reported that the Department of Revenue had a backlog of 230,000 unresolved tax returns, dating back as far as 1994, many of which included overpayments of tax. The articles indicated that, in the past, a longstanding Department policy existed that allowed for overpayments to be refunded as long as the computer system (ITAS) flagged the item as an overpayment within the statute of limitations period. The articles further indicated that a recent change in Department policy resulted in thousands of taxpayer overpayments being withheld. Under the new policy, overpayments are not considered "discovered," the event triggering the Department's obligation to issue a refund, until a departmental employee manually reviews the return after it has been flagged by the computer system. The significance of this change is that taxpayers who would have received a refund under the prior, longstanding policy would not necessarily receive a refund under the new policy. Under the prior policy, taxpayers were assured of eventually receiving a refund because returns are processed by the computer system almost immediately after they are filed and, therefore, discovery was always timely. Under the Department's new interpretation of discovery, a taxpayer will receive a refund only if it is verified by a manual review of the return and that review occurs within three years of the filing of the return. Manual review can take years depending on the Department's resources and workload, as demonstrated by the fact that the current backlog contains returns dating back to the mid-1990s. If employee review occurs more than three years after the filing of the return, then under the Department's new policy, a refund is barred by the statute of limitations.

Under current law, the Department is required to initiate a refund when it knows that a taxpayer has overpaid as long as the Department acquires this knowledge within the statute of limitations period. The central issue is what constitutes knowledge or discovery. At its November meeting, newly appointed Secretary David Hoyle told the Committee that two different interpretations exist within the Department about what constitutes knowledge or discovery. The first interpretation is that the Department has knowledge of an overpayment when a return is processed, and the computer system flags the return as including an overpayment. The return is then placed in a pending status awaiting review to verify that, in fact, a refund is due. This interpretation is supported by emails written by long-time Directors of the Individual Income Tax and Corporate Income Tax Divisions, which were published in the *News & Observer*. The Directors' interpretation is also supported by a long line of North Carolina cases holding that "discovery" occurs when a party is put on notice and could, in the exercise of reasonable diligence, make actual discovery. In his remarks, Secretary Hoyle acknowledged that this practice existed within the Department, but indicated that it was not a written policy and that it was inconsistently applied.

The second interpretation is that the Department has knowledge of an overpayment when a departmental employee manually reviews a "pended" return after it has been flagged by the computer system. In the case of the backlog items, employee review did not occur until several years after the returns were flagged by the computer system, well after the expiration of the three-year statute of limitations period. This interpretation surfaced in 2009 when, as part of its efforts to clean up the backlog items, the Department sought guidance from the Attorney General's Office. According to the Department, the Attorney General opined that discovery occurs when a person actually reviews a return, not when the computer system flags the return for review. Secretary Hoyle informed the Committee that this guidance is now the agency's policy. Neither the Attorney General's opinion nor the agency-wide policy is in writing. Based on the Department's new policy, Secretary Hoyle indicated that a legislative change is required in order to refund the remaining overpayments. The Department has not, however, indicated what specific legislative change needs to be made.

Without further information about which statute the Department was applying to the backlog items or the basis for its interpretation that discovery requires manual review, the Co-Chairs requested more information from the Department before moving forward with any recommendation. Specifically, the Co-Chairs sent a letter to the Secretary asking for a written explanation of the legal basis upon which the Department is relying to support its new policy. A copy of the letter is attached in Appendix G. Although the Department's newly hired General Counsel, Canaan Huie, attended the January meeting and was available to answer questions, no one from the Department provided the requested information to the Committee.

Ultimately, the Committee observed the following:

- There has been no law change requiring a change in the way the statute has historically been applied within the Department.
- The statute may be subject to more than one interpretation, as evidenced by the inconsistent practice cited by the Department.
- The practice described in the emails of former Division Directors is more favorable to taxpayers than the current policy, which makes the refund of an overpayment dependent on the Department's resources and workload.
- The basis for the Attorney General's oral legal opinion that discovery requires employee review within the limitations period is unknown.

Based on these observations, the Committee finds that the Department can issue the refunds without any changes in the law and encourages the Department to do so as soon as possible. The Committee further encourages the Department to adhere to the Directors' longstanding interpretation that the Department has knowledge of an overpayment when the computer system flags a return.

Status of Rulemaking for Forced Combinations

North Carolina is a single entity filing state, meaning that a multistate corporation must determine its State net income as if it filed a separate return for federal income tax purposes. G.S. 105-130.14 prohibits a corporation from filing a consolidated or combined return in North Carolina unless specifically directed to do so by the Secretary of Revenue. Under G.S. 105-130.6, the Secretary can require a corporation to file a combined return with other parent, subsidiary, or affiliated corporations when the Department believes the corporation's net income attributable to this State is not accurately reflected on its separate entity filing return.[20] Section 31.10 of

[20] The Department of Revenue has collected millions of dollars in taxes from forced combinations. The Department generated $424 million through Resolution Initiative in 2009. The Current Operations and

S.L. 2010-31, the Appropriations Act of 2010, created two exceptions to the general rule requiring a corporation to file a single entity return:

- The corporation's facts and circumstances meet the facts and circumstances described in a permanent rule adopted by the Department.
- Pursuant to a written request from the corporation, the Secretary has provided written advice to the corporation stating that the Secretary will require a consolidated or combined return under the facts and circumstances set out in the request.

The act allowed the Secretary to adopt rules that describe facts and circumstances under which the Secretary would require a corporation to file a consolidated or combined return. The Revenue Laws Study Committee asked the Department for an update on the status of its rulemaking for forced combinations. Secretary Hoyle indicated at the December 1st meeting that the Department hoped to have a draft of its rules available before the first of the year. The Committee checked on the status of the rulemaking prior to the conclusion of the Committee's work this biennium. The Department responded that it did not have a draft at this time. It is unclear when a draft may be available. The draft, once submitted to the Rules Review Commission, will be posted on the Office of Administrative Hearings website: http://www.oah.state.nc.us/rules/RRC.

PROPERTY TAX

Present-Use Value Taxation

At the January 5, 2011, meeting, David Baker, Director of the Property Tax Division within the Department of Revenue, gave a presentation on the history and

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Capital Improvements Appropriations Act of 2010 included $110 million in its adjustments to availability attributable to the "Department of Revenue Settlement Initiative."

background of the present-use value program. Mr. Baker explained the recent legislative changes that broadened the business entity ownership requirements to include modern estate planning vehicles such as family limited partnerships and family limited liability companies. The Committee then heard comments from representatives of the North Carolina Farm Bureau, the North Carolina Association of County Commissioners, and the North Carolina tax assessors. Each of these representatives indicated that he or she supported the current present-use program and requested that the Committee make no further changes to broaden the ownership requirements or to make any other changes to the present-use value program at this time other than Legislative Proposal #2 recommended by the Committee.

Central Appraisal of Wireless Companies

At the January 5, 2011, meeting, the Committee reviewed a draft proposal that would authorize the Department of Revenue to add wireless telephone companies and tower aggregate companies to the public service companies that are centrally appraised by the Department for property tax purposes. A copy of the draft is contained in Appendix I. This proposal was recommended by the Department of Revenue in discussions with the wireless companies and tower aggregate companies. Currently, the property of these companies is appraised by each county in which the property is located. The property of public service companies, such as gas companies, electric membership corporations, landline telephone companies, bus line companies, airline companies, and motor freight carrier companies, are centrally appraised by the Department. If these companies are operating both inside and outside the State, then the Department apportions the reasonable share of these companies for taxation in North Carolina using property, business, and mileage factors. In determining the true value of a public service company's property, the Department considers any information that has a bearing on the true value including the market value of the company's capital stock and debt, the book value of the property, replacement value less depreciation, and gross receipts and operating income. The proposal would relieve the wireless providers and tower aggregate companies of listing their property in every county in which their property is located and provide a more accurate determination of the true value of the companies' property. In practice, most counties use only the cost approach to determine true value, since they do not have the capability to consider other approaches such as the gross receipts and operating income of a company.

The Committee decided not to recommend the proposed legislation at this time.

CORPORATE INCOME TAX: INDUSTRY-SPECIFIC APPORTIONMENT FORMULAS

A corporation that does business in more than one state must pay income tax to each of the states in which it has nexus. U.S. Supreme Court cases have upheld the right of states to tax the income of multistate corporations so long as the income is fairly sourced to the taxing state. The conventional method used by states to source income has been the apportionment formula, which is used to derive an apportionment percentage. Generally speaking, a taxpayer multiplies its taxable income by its apportionment percentage to determine the amount of its income sourced to a state. The state's corporate income tax rate is applied to the corporation's income apportionable to that state.

Most states use an apportionment formula based on or substantially similar to the Uniform Division of Income for Tax Purposes Act (UDITPA).[21] The UDITPA formula is a composite of three factors: a property factor, a payroll factor, and a sales factor. The property factor represents the ratio of the taxpayer's real and tangible

[21] UDITPA dates back to 1957.

personal property in the taxing state to its real and tangible personal property everywhere. Likewise, the payroll factor and the sales factor represent a ratio of the taxpayer's payroll and sales in the taxing state to its payroll and sales everywhere. Under UDITPA, the sum of the three factors is divided by three, resulting in a taxpayer's apportionment percentage. North Carolina shifted to a double-weighted sales factor[22] apportionment formula in 1988.[23] Under North Carolina's current apportionment formula, the payroll and property factors are each weighted 25% and the sales factor is weighted at 50%; the sum of the four factors is divided by four.

An industry-specific formula may be used when the general formula does not accurately reflect the income of the corporation derived from North Carolina. North Carolina has an industry-specific formula for railroads[24], telephone companies[25], motor carriers[26], public utilities[27], and air and water carriers[28]. The Department of Revenue brought to the Revenue Laws Study Committee's attention three industries whose income from North Carolina may not be accurately reflected by the general apportionment formula: publishers, broadcasters, and telecommunications service providers.[29] The Department recommended the State consider the Multi-State Tax Commission's (MTC) industry-specific apportionment formulas for these industries. MTC originally proposed model legislation for broadcasters in 1990, and revised it in

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[22] A double-weighted sales factor tends to favor home-state industries that have a concentration of their total facilities in a state but sell their products all over the country.
[23] RJR Nabisco requested the change because it had plans for a large automated bakery in the Garner area. After the change was adopted, RJR Nabisco was bought out and forced to cut back on capital expenditures. The company never built the plant.
[24] Railroad operating revenue.
[25] Operating revenue from local service.
[26] Vehicle miles.
[27] Sales factor only.
[28] Revenue ton miles.
[29] Lennie Collins, the director of the Corporate Income Tax Division, Department of Revenue, made a presentation on this issue at the November 10th, December 1st, and January 5th committee meetings.

1996. Eight states have adopted some version of this model legislation.[30] MTC proposed model legislation for publishers in 1993 and at least four states[31] have adopted some version of this legislation. The MTC proposed model legislation for telecommunications service providers in 2008. North Carolina currently has an industry-specific apportionment formula for telephone companies; however, it only applies to landline companies. The MTC model legislation applies to all telecommunications service providers.[32] The sourcing rules in the model legislation closely mirror the telecommunications service sourcing rules for sales tax purposes under the Streamlined Sales and Use Tax Agreement.

The MTC model legislation would modify the sales factor for each of these industries. Under the general apportionment formula, the numerator includes receipts from the income-producing activity in this State. The issue is whether these receipts accurately reflect the benefit derived from the services received in this State when the income-producing service is performed outside the State. The model legislation moves away from sourcing sales based upon where the revenue generating activity occurs (i.e., where the equipment is located) and towards where the revenue receipts are generated (i.e., where the market for the service is located). The change in the sales tax factor differs for each of the three industries:

- Publishers. – The numerator would include receipts from advertising and from the sale, rental, and other use of its customer lists. The receipts would be sourced based upon a circulation factor.[33]

[30] Alabama, Arizona, California, Colorado, Hawaii, Idaho, New Hampshire, and North Dakota.
[31] Alabama, California, Idaho, and North Dakota.
[32] Illinois has adopted a modified version of the model legislation. Massachusetts has adopted the model legislation.
[33] The circulation factor is the ratio of the corporation's NC purchasers and subscribers of a publication to the corporation's total purchasers and subscribers of the publication.

- Broadcasters. – The numerator would include receipts from video and audio programming. The receipts would be sourced based upon an audience factor.[34]
- Telecommunications service providers. – The numerator would include receipts from telecommunications service, using the same sourcing rules as applied in the sales tax statutes. The denominator would exclude gross receipts from the sale of service that is not taxable in the state to which it would be apportioned.

In all three instances, the Department recommended changing the property factor of the apportionment formula to exclude outer jurisdictional property. Outer jurisdictional property is tangible personal property that is not physically located in any state and, therefore, is not taxable in any state. Examples of outer jurisdictional property include orbiting satellites and undersea transmission cables. Excluding the property from the apportionment formula would prevent the dilution of income sourced to the State.

The Committee briefly discussed a draft proposal that excluded outer jurisdictional property from the property factor for all corporations and created an industry-specific formula for publishers, broadcasters, and telecommunications service providers. Appendix H contains a copy of the draft proposal. The Committee's staff met with interested parties for both the broadcasters and telecommunications service providers to discuss the draft proposal.[35] None of the interested parties supported change at this time. The parties expressed concern about the fiscal impact of a change in

[34] The audience factor is the ratio of the corporation's NC listening or viewing audience to the corporation's total listening or viewing audience.

[35] No one associated with the publishing industry contacted the staff and the staff could not identify a person or lobbyist representative of this industry.

the apportionment formula. Neither the Department nor the fiscal staff could quantify the impact based upon the information they have at this time. The meetings also highlighted other issues of concern:

- Whether the audience factor accurately reflects the benefits derived in a state by a broadcaster.[36]
- Whether wireless telecommunications service providers should be taxed in a similar manner as landline telephone companies.[37]
- Whether the income of all broadcasters is apportioned in a similar manner. And if not, whether they should be apportioned in a similar manner.[38]

Based upon the unknown fiscal impact and the unresolved issues, the Committee chose not to recommend legislation on this issue at this time.

LITIGATION UPDATE

The Revenue Laws Study Committee continues to monitor legal developments potentially affecting the State's tax system or requiring law changes. At its meeting held January 19, 2011, the Committee heard an update on three cases: *Amazon.com LLC v. Lay*[39]; *Amazon.com, LLC v. New York State Dept. of Taxation and Finance*[40]; and *Delhaize America, Inc. v. Lay*.[41]

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[36] The audience factor does not appear to differentiate between the different tiers of service. A better indicator may be a factor based upon subscriber revenue.

[37] Landline telephone companies are subject to an industry-specific apportionment formula. G.S. 105-130.4(n).

[38] Cable companies are considered a regulated public utility under G.S. 105-130.4(r) and as such their income is apportioned under G.S. 105-130.4(l), which is a sales factor only formula.

[39] Kenneth Lay is the former Secretary of the North Carolina Department of Revenue. The cite to this opinion is No. C10-664 MJP (United States District Court, W.D. Washington, Oct. 25, 2010).

[40] 2010 N.Y. Slip Op. 07823 (Supreme Court, Appellate Division, First Department, New York, Nov. 4, 2010).

[41] 06 CVS 08416 (Wake County Superior Court, Jan. 12, 2011).

In *Amazon.com LLC v. Lay*, a federal trial court based in Seattle considered whether the First Amendment of the U.S. Constitution and federal statutes barred the North Carolina Department of Revenue from demanding that Amazon provide customer names where Amazon had already provided to the Department of Revenue the titles of books and movies purchased by North Carolina residents. The American Civil Liberties Union (ACLU) joined the case representing Amazon customers who lived in North Carolina and who did not want the titles of their purchases identified to the Department. The federal court ruled that the First Amendment and federal Video Privacy Protection Act (VPPA) prevented the Department from obtaining customer names and titles of purchases at the same time. This case is important because a federal court found the authority to review actions by a State agency and applied federal law to tax collection activity.

Amazon.com, LLC v. New York addresses when a state has the authority under the U.S. Constitution to require out-of-state retailers to collect state sales tax. New York enacted a statute that became known as the "Amazon Law." This law created a presumption that online retailers, like Amazon, had to collect state sales tax where the online retailer had commissioned affiliates located in the state who maintained web sites with links to the online retailer. Amazon and Overstock.com, Inc. sued New York's Department of Taxation challenging the constitutionality of this law. This case is relevant to North Carolina because North Carolina enacted an Amazon Law similar to the New York law.[42] The New York court, which is a court below the highest court in New York, held that the Amazon Law was constitutional as written but sent the case back to the trial court to develop a factual record before addressing the conduct of the business. This case is widely followed as the first test case of the constitutionality of the

[42] G.S. § 105-164.8(b)(3) [enacted by S.L. 2009-451, § 27A.3.(a)].

Amazon Law. While the case supports the constitutionality of North Carolina's identical statute, the case is the view of an appellate court in New York which is not the highest court in New York and which did not address the actual operations of the online retailers. The New York case will now be retried to determine the operations of the online retailers leaving no final court decision on the Amazon Law. Amazon has terminated all of its affiliates in North Carolina. Litigation on this issue continues because Congress has not exercised its authority under the Commerce Clause of the U.S. Constitution to regulate online retailers' obligations to collect state sales taxes.

Delhaize America, Inc. v. Lay involves a corporate tax shelter where Food Lion (renamed Delhaize America) restructured its operations to achieve tax savings. The Department has challenged corporate tax shelters and offered settlement programs to resolve these cases. The North Carolina Court of Appeals ruled in an earlier case, *Wal-Mart Stores East, Inc. v. Hinton*[43], that the Department could combine a corporate taxpayer's operations to remove the benefit of a tax shelter. In the Delhaize case, the North Carolina Business Court followed the *Wal-Mart* decision and ruled that Food Lion owed the tax as if the tax shelter transaction had not occurred. The Business Court found the tax shelter transaction lacked economic substance. However, the court also ruled that Food Lion did not owe penalties because the U.S. and N.C. Constitutions barred the Department from assessing penalties due to the Department's failure to issue guidance. In 2010, the General Assembly changed the penalty statute[44] to require the Department to issue guidance, which the court discussed favorably. Food Lion has the option to appeal this decision to the North Carolina Court of Appeals. If appealed, this

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[43] 197 N.C. App. 30 (2009).

[44] G.S. § 105-236(a)(5)(f) [enacted by S.L. 2010-31, § 31.10.(b)].

case gives the Court of Appeals an opportunity to apply the *Wal-Mart* decision to the facts in the Delhaize case.

COMMITTEE RECOMMENDATIONS AND LEGISLATIVE PROPOSALS

The Revenue Laws Study Committee makes the following three recommendations to the 2011 General Assembly. Each proposal is followed by an explanation and, if it has a fiscal impact, a fiscal memorandum, indicating any anticipated revenue gain or loss resulting from the proposal.

1. IRC Update
2. Business Entity Changes for Present-Use Value Taxation
3. Revenue Laws Technical, Administrative, and Clarifying Changes

LEGISLATIVE PROPOSAL #1

IRC UPDATE

LEGISLATIVE PROPOSAL #1

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2011 REGULAR SESSION OF THE 2011 GENERAL ASSEMBLY

AN ACT TO UPDATE THE REFERENCE TO THE INTERNAL REVENUE CODE.

SHORT TITLE: IRC Update.

PRIMARY SPONSORS:

BRIEF OVERVIEW: This proposal would update the reference to the Internal Revenue Code used in defining and determining certain State tax provisions from May 1, 2010, to January 1, 2011. By doing so, North Carolina would conform to many of the changes made by the federal Small Business Jobs Act of 2010 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, including part of the estate tax changes, some of the enhanced section 179 expense deduction changes, and the extension of the business and individual income tax incentives set to expire under the Economic Growth and Tax Relief Reconciliation Act of 2001. The proposal would not conform to the bonus depreciation provisions.

FISCAL IMPACT: This proposal would not significantly impact the General Fund for fiscal year 2010-2011. It would reduce General Fund revenues by $57.1 million in fiscal year 2011-2012.

EFFECTIVE DATE: This act would become effective when it becomes law. However, any amendments to the Internal Revenue Code enacted after May 1, 2010, that increase North Carolina taxable income for the 2010 taxable year would become effective for taxable years beginning on or after January 1, 2011.

A copy of the proposed legislation, a bill analysis, and fiscal analysis begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2011

U **D**

BILL DRAFT 2011-RBxz-3A [v.7] (12/01)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/18/2011 5:35:03 PM

Short Title: IRC Update. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO UPDATE THE REFERENCE TO THE INTERNAL REVENUE CODE.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-228.90(b)(1b) reads as rewritten:

"(1b) Code. – The Internal Revenue Code as enacted as of ~~May 1, 2010,~~ January 1, 2011, including any provisions enacted as of that date that become effective either before or after that date."

SECTION 2.(a) G.S. 105-130.5(a) is amended by adding a new subdivision to read:

"(15b) For taxable years 2010 through 2012, eighty-five percent (85%) of the amount allowed as a special accelerated depreciation deduction under section 168(k) or 168(n) of the Code for property placed in service during the taxable year. In addition, for taxable year 2010, a taxpayer who placed property in service during the 2009 taxable year and whose North Carolina taxable income for the 2009 taxable year reflected a special accelerated depreciation deduction allowed for the property under section 168(k) of the Code must add eighty-five percent (85%) of the amount of the special accelerated depreciation deduction. These adjustments do not result in a difference in basis of the affected assets for State and federal income tax purposes."

SECTION 2.(b) G.S. 105-130.5(b) is amended by adding a new subdivision to read:

"(21b) An amount equal to twenty percent (20%) of the amount added to federal taxable income as accelerated depreciation under subdivision (a)(15b) of this section. For the amount added to taxable income in the 2010 taxable year, the deduction allowed by this subdivision applies to the first five taxable years beginning on or after January 1, 2011. For the amount added to taxable income in the 2011 taxable year, the deduction allowed by this subdivision applies to the first five taxable years beginning on or after January 1, 2012. For the amount added to taxable income in the 2012 taxable year, the deduction allowed by this subdivision applies to the first five taxable years beginning on or after January 1, 2013."

SECTION 2.(c) G.S. 105-134.6(c) is amended by adding a new subdivision to read:

"(8b) For taxable years 2010 through 2012, eighty-five percent (85%) of the amount allowed as a special accelerated depreciation deduction under section 168(k) or 168(n) of the Code for property placed in service during the taxable year. In addition, for taxable year 2010, a taxpayer who placed property in service during the 2009 taxable year and whose North Carolina taxable income for the 2009 taxable year reflected a special accelerated depreciation deduction allowed for the property under section 168(k) of the Code must add eighty-five percent (85%) of the amount of the special accelerated depreciation deduction. These adjustments do not result in a difference in basis of the affected assets for State and federal income tax purposes."

SECTION 2.(d) G.S. 105-134.6(b) is amended by adding a new subdivision to read:

"(17b) An amount equal to twenty percent (20%) of the amount added to federal taxable income as accelerated depreciation under subdivision (c)(8b) of this section. For the amount added to taxable income in the 2010 taxable year, the deduction allowed by this subdivision applies to the first five taxable years beginning on or after January 1, 2011. For the amount added to taxable income in the 2011 taxable year, the deduction allowed by this subdivision applies to the first five taxable years beginning on or after January 1, 2012. For the amount added to taxable income in the 2012 taxable year, the deduction allowed by this subdivision applies to the first five taxable years beginning on or after January 1, 2013. "

SECTION 3.(a) G.S. 105-130.5(a) is amended by adding a new subdivision to read:

"(23) For taxable years 2010 and 2011, eighty-five percent (85%) of the amount by which the taxpayer's expense deduction under section 179 of the Code for property placed in service in taxable year 2010 or 2011 exceeds the amount that would have been allowed for the respective taxable year under section 179 of the Code as of May 1, 2010. These adjustments do not result in a difference in basis of the affected assets for State and federal income tax purposes."

SECTION 3.(b) G.S. 105-130.5(b) is amended by adding a new subdivision to read:

"(26) An amount equal to twenty percent (20%) of the amount added to federal taxable income under subdivision (a)(23) of this section. For the amount added to taxable income in the 2010 taxable year, the deduction allowed by this subdivision applies to the first five taxable years beginning on or after January 1, 2011. For the amount added to taxable income in the 2011 taxable year, the deduction allowed by this subdivision applies to the first five taxable years beginning on or after January 1, 2012."

SECTION 3.(c) G.S. 105-134.6(c) is amended by adding a new subdivision to read:

"(15) For taxable years 2010 and 2011, eighty-five percent (85%) of the amount by which the taxpayer's expense deduction under section 179 of the Code for property placed in service in taxable year 2010 or 2011 exceeds the amount that would have been allowed for the respective taxable year under section 179 of the Code as of May 1, 2010. These adjustments do not result in a difference in basis of the affected assets for State and federal income tax purposes."

SECTION 3.(d) G.S. 105-134.6(b) is amended by adding a new subdivision to read:

"(21) An amount equal to twenty percent (20%) of the amount added to federal taxable income under subdivision (c)(15) of this section. For the amount added to taxable income in the 2010 taxable year, the deduction allowed by this subdivision applies to the first five taxable years beginning on or after January 1, 2011. For the amount added to taxable income in the 2011 taxable year, the deduction allowed by this subdivision applies to the first five taxable years beginning on or after January 1, 2012."

SECTION 4. Article 1A of Chapter 105 of the General Statutes is amended by adding a new section to read:

"**§ 105-32.2A. Election to receive stepped-up basis for 2010.**

A personal representative of an estate of a decedent dying in calendar year 2010 for which the federal estate tax is paid may elect to conform the North Carolina basis of the property in the estate to that of the federal stepped-up basis obtained by payment of the federal estate tax by filing an election with the Secretary and paying the amount of tax that would have been payable under this Article had the federal estate tax that was paid been in effect when the decedent died. In the absence of this election and payment, the North Carolina basis of the property differs from the federal basis. To make the election, an executor must file a return with the Secretary within the time allowed for filing the federal estate tax return. "

SECTION 5. This act is effective when it becomes law. Notwithstanding Section 1 of this act, any amendments to the Internal Revenue Code enacted after May 1, 2010, that increase North Carolina taxable income for the 2010 taxable year become effective for taxable years beginning on or after January 1, 2011.

Bill Draft 2011-RBxz-3A:
IRC Update.

2011-2012 General Assembly

Committee:	Revenue Laws Study Committee	**Date:**	January 18, 2011
Introduced by:		**Prepared by:**	Cindy Avrette Committee Counsel
Analysis of:	2011-RBxz-3A		

SUMMARY: This proposal would update the reference to the Internal Revenue Code used in defining and determining certain State tax provisions from May 1, 2010, to January 1, 2011. By doing so, North Carolina would conform to many of the changes made by the federal Small Business Jobs Act of 2010 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, including part of the estate tax changes, some of the enhanced section 179 expense deduction changes, and the extension of the business and individual income tax incentives set to expire under the Economic Growth and Tax Relief Reconciliation Act of 2001. The proposal would not conform to the bonus depreciation provisions.

CURRENT LAW: North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.[1] The General Assembly determines each year whether to update its reference to the Code.[2] Updating the reference makes recent amendments to the Code applicable to the State to the extent that State law previously tracked federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. Maintaining conformity with federal tax law simplifies tax reporting because a taxpayer will not need to account for differing federal and State treatment of the same asset.

BILL ANALYSIS: The current reference to the Code is May 1, 2010.[3] Since that time, Congress has enacted two Acts that make substantial changes to the tax code: the Small Business Jobs Act of 2010, enacted September 27, 2010, as P. L. 111-240 (2010 Jobs Act), and the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act, enacted December 17, 2010, as P. L. 111-312 (2010 Tax Relief Act). Both Acts contain provisions that became effective retroactively on January 1, 2010. Since the General Assembly will not have had an opportunity to enact legislation prior to the end of the 2010 taxable year, taxpayers may

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[1] North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

[2] The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation … shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would … be invalidated as an unconstitutional delegation of legislative power."

[3] Part 31 of S.L. 2010 31 updated the reference to the Internal Revenue Code used in defining and determining certain State tax provisions from May 1, 2009, to May 1, 2010. However, S.L. 2010 31 did not conform to the five year carryback of net operating losses incurred by large businesses.

have to make adjustments on their 2010 State tax return for items included in, or excluded from, federal taxable income as a result of one of these two Acts.

The 2010 Jobs Act enhances existing business tax incentives and partially offsets this revenue loss with changes which are expected to increase revenue.[4] The incentives in the 2010 Jobs Act are not limited to small businesses, and the accelerated deduction for depreciation represents a major benefit to large businesses. The 2010 Tax Relief Act boosts some of the business tax incentives in the 2010 Jobs Act and extends the individual and business tax incentives included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[5] for two years.

Extension of 50% Bonus Depreciation for 2010, 2011, and 2012

Businesses may depreciate the cost of a new asset[6] over a period of time, usually five to 15 years. Bonus depreciation allows a business to claim more of a deduction up front and spread the remainder out over the normal depreciation schedule. The federal Economic Stimulus Act of 2008[7] provided a 50% first year bonus depreciation for qualified property acquired and placed in service in 2008. The federal American Recovery and Reinvestment Act of 2009 extended the 50% bonus depreciation provided to qualified property for an additional year through 2009.

The 2010 Jobs Act extends the bonus depreciation for 2010 and applies retroactively to property acquired and placed in service in 2010.[8] The 2010 Tax Relief Act increases the 50% bonus depreciation extended under the 2010 Jobs Act to 100% for property acquired and placed in service after September 8, 2010, and before January 1, 2012. It also provides 50% bonus depreciation for qualified property placed in service after December 31, 2012, and before January 1, 2013. Under the 2010 Jobs Act, the bonus depreciation would have expired for the 2012 taxable year. Under the 2010 Tax Relief Act, the bonus deprecation expires for the 2013 taxable year.

The 2010 Jobs Act also allows taxpayers using the percentage of completion accounting method to benefit from bonus depreciation at the federal level for assets with a depreciable life of seven years or less. The percentage of completion accounting method might prevent taxpayers from receiving benefit from the bonus depreciation because the accounting method spreads expenses, including depreciation, throughout the life of a long-term contract. Under this accounting method, taxpayers could not deduct the bonus depreciation in the first year. Construction contractors use the percentage of completion accounting method. This provision is new.

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[4] The 2010 Jobs Act gives taxpayers a greater number of options for their retirement plan dollars. The provisions are treated as revenue raisers because they encourage up-front distributions that are taxable. The majority of the revenue generated by the Act, however, is in the form of increased federal tax penalties. The increased federal penalties would not generate revenue for the State.

[5] Most of the tax provisions in EGTRRA were scheduled to expire in 2010 or 2011 and revert to the provisions as they existed in 2001.

[6] There are two notable differences between bonus depreciation and the section 179 expense deduction: bonus depreciation applies only to new equipment, while section 179 may apply to new and used equipment; bonus depreciation may be used to create or increase a loss, while section 179 may not.

[7] Congress has authorized bonus depreciation several times to encourage business investment, specifically after September 11, 2001. The Jobs Creation and Worker Assistance Act of 2002 provided a 30% bonus depreciation allowance. The Jobs and Growth Tax Relief Reconciliation Act of 2003 extended the sunset and increased the amount to 50%.

[8] The property may be placed in service during 2011 for property with a recovery period of 10 years or longer and for transportation property (i.e., tangible personal property used to transport people or property).

North Carolina delayed the impact of the bonus depreciation provisions in 2008 and 2009 in a manner similar to what it has done in the past: a taxpayer adds back 85% of the accelerated depreciation amount[9] in the year that it is claimed for federal purposes; then, in subsequent tax years, the taxpayer deducts from federal taxable income the total amount of the add-back, divided into five equal installments. This adjustment means that for State tax purposes, a taxpayer may deduct a greater depreciation amount in the outlying tax years, which is the normal depreciation amount plus 20% of the accelerated depreciation amount the taxpayer had to add back. The taxpayer's basis in the asset remains the same for federal and state tax purposes, it is just that the timing of the deduction differs.

The proposal would decouple from the bonus depreciation provisions for 2010, 2011, and 2012 in the same manner as it has decoupled from them in the past: A taxpayer would add-back 85% of the accelerated depreciation amount in the year that it is claimed for federal purposes. Then, in subsequent tax years, the taxpayer would deduct from federal taxable income the total amount of the add-back, divided into five equal installments.

Enhanced Section 179 Expensing for 2010, 2011, and 2012

Section 179 of the Code allows the expensing of the purchase price of some business assets[10] in the year of purchase rather than taking depreciation[11] throughout the life of the asset. In other words, expensing trades a smaller yearly deduction over time for a larger deduction in year one.

Prior to the Emergency Economic Stabilization Act of 2008 (EESA), the deduction limit for section 179 expensing was $128,000[12] of the cost of the property with a dollar for dollar phase-out of this amount whenever the total cost of qualifying property placed in service that year exceeded $510,000.[13] EESA increased the deduction limit from $128,000 to $250,000 with a phaseout at $800,000 for the 2008 tax year. The American Recovery and Reinvestment Tax Act of 2009 (ARRTA) extends the temporary increase through 2009. The federal HIRE Act of 2010 extended the 2008 and 2009 increase through 2010. The limits were scheduled to revert to the prior levels of $25,000 and $200,000 in taxable year 2011. North Carolina conformed to those changes.

The 2010 Jobs Act not only delays the reversion to the prior levels until the 2012 taxable year, it also increases the section 179 deduction expensing and investment limits for tax years 2010 and 2011 from $250,000 and $500,000 to $800,000 and $2 million. In addition to the expansion of the limits, the Act broadens the definition of qualified property to include qualified leasehold improvement property, qualified restaurant property, qualified retail improvement property, and computer software.[14] The enhancements made by the 2010 Jobs Act are set to expire for the 2012 taxable year. The 2010 Tax Relief Act does not continue the expansion of the types of property that may qualify for the deduction beyond the 2011 taxable year, but it does increase the limits for the 2012 taxable year from $25,000 and $200,000 to $125,000 and $500,000.

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[9] The accelerated depreciation amount for property placed in service in 2008 is 50%.

[10] The business asset must be newly purchased tangible personal property that is used more than 50% for business purposes and is eligible to be depreciated under the Code. The newly purchased property may be new or used equipment.

[11] Generally, taxpayers take the section 179 expense deduction first and claim Section 168(k) depreciation on any remaining basis.

[12] Prior to the EESA, the dollar limits would have been $125,000 with a phase-out beginning at $500,000; both amounts would have been indexed for inflation resulting in the limits of $128,000 and $510,000.

[13] For example, if the taxpayer placed in service during the taxable year one or more items of qualifying property totaling $520,000, the amount that could be expensed under section 179 would be $118,000 -- $128,000 less $10,000, which is the excess of $520,000 over $510,000.

[14] Qualified real property is limited to a maximum deduction of $250,000.

Under the 2010 Tax Relief Act, the deduction limits are set to revert to their prior levels of $25,000 and $200,000 in 2013.

North Carolina has conformed to the enhanced section 179 deduction provisions in the past. However, the enhancements made by the 2010 Jobs Act are the most expansive ever enacted. **The proposal** would conform to the expanded definition of qualified property and it would maintain the 2010 deduction limits of $250,000 and $800,000 for taxable years 2010 and 2011; and it would decouple from the enhanced limits of $500,000 and $2,000,000 for taxable years 2010 and 2011. The proposal would provide that the property's basis would be the same for federal and State purposes and would treat the difference in the same manner as State tax law has historically treated the bonus depreciation: A taxpayer would add-back 85% of the additional expensing taken under federal law in 2010 and 2011 and would deduct 20% of this amount over the succeeding five years. The proposal would conform to the expensing limits of $125,000 and $500,000 for the taxable year 2012 and, like federal law, would revert to the prior expense limits of $25,000 and $200,000 for the tax year 2013.

Estate Tax for 2010 - 2012

EGTRRA gradually reduced the federal estate tax over a period of years and abolished it for decedents dying in 2010. During the year of its repeal, the basis of property passing through an estate was determined by the modified carryover basis rules under EGTRRA. EGTRRA also repealed the state estate tax credit for decedents dying on or after 2004 and replaced the credit with a deduction. The estate tax was scheduled to revert to the 2001 law in 2011.

The 2010 Tax Relief Act revives the estate tax retroactively for decedents dying on or after January 1, 2010, and thereby allows property passing through the estate to acquire a stepped-up basis. The maximum federal estate tax rate is 35% with an applicable exclusion amount of $5 million. The 2010 Tax Relief Act also provides for portability between spouses of the exclusion amount. This portability means that any unused exclusion amount by one spouse is available to the surviving spouse, effectively allowing a married couple to exclude up to $10 million from estate tax.[15] The new estate tax law is scheduled to sunset on December 31, 2012, to the pre-EGTRRA amounts. The 2010 Tax Relief Act gives the estates of decedents dying in 2010 the option to pay no estate tax and assume the modified carryover basis in the property. The 2010 Tax Relief Act did not revive the state estate tax credit.

North Carolina imposes an estate tax on the estate of a decedent when a federal estate tax is imposed on the estate.[16] The amount of the State's estate tax is the amount of the credit allowed on the federal estate tax return for state estate tax paid, as the federal law provided in 2001.[17] Since the federal estate tax did not exist in 2010, North Carolina's estate tax was repealed for 2010 and the basis of property passing through an estate of a decedent dying in 2010 is determined by the modified carryover basis rules under EGTRRA. With the revival of the federal estate tax in 2011, North Carolina’s estate tax is also revived. However, unlike

[15] The portability election is set to sunset December 31, 2012. Therefore the utility of the portability election is limited to situations where both spouses die within the two-year term (2011 and 2012).

[16] North Carolina repealed its inheritance tax in 1998 and replaced it with an estate tax that was equivalent to the federal state estate tax credit allowed on a federal estate tax return. This type of state estate tax was known as a "pick up" tax because it picked up for the state the amount of federal estate tax that would otherwise be paid to the federal government.

[17] When Congress phased out the state estate tax credit, beginning in 2002, North Carolina enacted legislation not to conform to the phase out of the credit. In other words, North Carolina began tying the amount of the State estate tax owed to the federal credit as it existed in 2001 rather than as it currently exists. Georgia, South Carolina, and Tennessee have not had an estate tax since January 1, 2005, because their estate tax equals the amount of the state estate tax credit allowed on the federal estate tax return. Virginia repealed its estate tax, effective July 1, 2007.

Congress, North Carolina cannot impose the estate tax retroactively on the estates of decedents dying on or after January 1, 2010, and before January 1, 2011. **The proposal** would give those estates that chose to pay federal estate tax and receive the stepped-up basis an ability to elect to receive the stepped-up basis for NC purposes by paying the State estate tax for 2010. As under federal law, the estate tax provisions would revert to the pre-EGTRRA exclusion amounts for decedents dying on or after January 1, 2013.

Business Tax Extenders for 2010 and 2011

The 2010 Tax Relief Act extends many of the tax incentives enacted in EGTRRA for two years. The business tax incentives include enhanced deduction and expensing items, charitable deductions, and tax credits. North Carolina conformed to these incentives in 2002[18]; however, under existing North Carolina law, these incentives expired for the 2010 taxable year. **The proposal** would conform to these extensions.

The 2010 Tax Relief Act extends the following business tax incentives that were set to expire for the 2010 taxable year for the 2010 and 2011 taxable years:

- 15-year recovery period for qualified leasehold improvements, restaurant building and improvements, and retail improvements.
- Seven-year recovery period for motor sports entertainment costs recovery.
- Expensing election for certain film and television production costs.
- Brownfields remediation expensing.

The 2010 Tax Relief Act extends the Work Opportunity Tax Credit (WOTC) to include individuals who begin employment after August 31, 2011, and before January 1, 2012. The WOTC is equal to 40% of up to $6,000 of the targeted employee's qualified first year wages. North Carolina's WOTC is equal to 6% of the federal WOTC for wages paid for positions located in this State. The federal WOTC was scheduled to expire September 1, 2011.

The 2010 Tax Relief Act extends the following charitable incentives for taxable years 2010 and 2011:

- Deduction for contributions of food inventory.
- Deduction for contributions by C corporations of books to public schools.
- Deduction for corporate contributions of computer equipment for educational purposes.
- Basis adjustment to stock of S corporations making charitable contributions of property.

Individual Income Tax Extenders for 2010, 2011, and 2012

The 2010 Tax Relief Act extends many of the individual tax incentives enacted in the EGTRRA for two years. Some of the tax incentives expired in 2010 and others were scheduled to expire in 2011. North Carolina conformed to these incentives in 2002[19]; however, under existing North Carolina law, many of these incentives expired for the 2010 taxable year and others are scheduled to expire for the 2011 taxable year. **The proposal** would conform to these extensions.

[18] S.L. 2002-126.
[19] S.L. 2002-126.

The following three individual income tax incentives were scheduled to expire in 2010, but the 2010 Tax Relief Act extends the incentives retroactively for the 2010 tax year and the 2011 tax year:

- Tax deduction for higher education tuition expenses.
- Up to $250 deduction for teacher's classroom expenses.
- Charitable contribution of IRA proceeds.

The following individual income tax incentives were scheduled to expire in 2011, but the 2010 Tax Relief Act extends the incentives for the 2011 and 2012 taxable years:

- *No limitation on itemized deductions.* Section 68 of the Code, first added in 1990, established an overall limitation on itemized deductions. This limitation was gradually repealed starting in 2006, with the phase-out complete in taxable year 2010. The limitation was scheduled to revert in full in 2011. The 2010 Tax Relief Act extends the complete repeal of the limitation for 2011 and 2012.
- *Enhancements to the earned income tax credit (EITC).* The EITC is a refundable tax credit that varies depending on the number of the taxpayer's qualifying children. North Carolina's EITC is equal to 5% of the federal credit amount. EGTRRA increased the EITC from 40% to 45% of a family's first $12,570 of earned income for families with three or more children and increased the beginning point of the phase-out range for married coupled filing a joint return by $1,880. The enhancements were set to expire for the 2011 taxable year. The 2010 Tax Relief Act extends the enhancements through the 2011 and 2012 taxable years.
- *Enhancements to the adoption tax credit.* EGTRRA increased the dollar limitation for the credit and the income exclusion for employer paid expenses to $10,000, indexed for inflation. The Patient Protection and Affordable Care Act increased the credit and exclusion by another $1,000 for 2010 and 2011. The credit cap was scheduled to return to $5,000[20] for taxable years beginning on or after January 1, 2012. North Carolina's adoption tax credit is equal to 50% of the federal credit amount. The 2010 Tax Relief Act extends the enhancements made by EGTRRA for one year. Under the Act, the credit caps will revert to their prior levels in taxable year 2013.
- *Deductibility of mortgage insurance premiums.* Mortgage insurance premiums became deductible in 2007. The insurance must be in connection with home acquisition debt for a first or second home. The deduction is subject to phase-out based on a taxpayer's income. The deductibility of mortgage insurance premiums was set to expire for taxable year 2011. The 2010 Tax Relief Act extends the deduction for one more year, through taxable year 2011.
- *Educational assistance exclusion.* EGTRRA allowed employees to exclude up to $5,250 in employer-provided education assistance from income and employment taxes. The exclusion was set to expire for taxable year 2011. The 2010 Tax Relief Act extends the exclusion for taxable years 2011 and 2012.
- *Student loan interest deduction.* The student loan interest deduction is a deduction from gross income used to determine a taxpayer's adjusted gross income (AGI). The deduction is subject to a phase-out based on the taxpayer's AGI. EGTRRA

[20]The limit is $6,000 for a special needs child.

eliminated the rule that the deduction only applies to payments made during the first 60 months that interest payments were required and it increased significantly the phase-out amounts. These changes were set to expire in 2011, but the 2010 Tax Relief Act extends the changes for taxable years 2011 and 2012.

- *Coverdale education savings accounts.* Coverdale education savings accounts allow a taxpayer to make nondeductible contributions and to withdraw the proceeds tax free if they are used towards educational expenses. EGTRRA increased the amount that may be contributed to an account from $500 to $2,000 and it made elementary and secondary school expenses qualified expenses. The enhancements were set to expire for the 2011 taxable year. The 2010 Tax Relief Act extends the enhancements for taxable years 2011 and 2012.
- *Qualified scholarships.* Qualified scholarships may be excluded from taxable income. EGTRRA provided that the national Health Services Corps Scholarship Program and the Armed Forces Scholarship Program are qualified scholarships for income tax purposes and therefore, may be excluded from taxable income. These scholarships were scheduled to be included in a recipient's income in taxable year 2011. The 2010 Tax Relief Act extends the income exclusion for taxable years 2011 and 2012.

Miscellaneous Business Incentives

The 2010 Jobs Act provides several tax incentives for businesses. **The proposal** would conform to these incentives.

- *Increase in amount allowed as a deduction for start-up expenditures*. The Code allows up to $5,000 of start-up expenses to be deducted. The deduction is reduced by the amount of start-up costs that exceed $50,000. The 2010 Jobs Act increased the deduction to $10,000 for start-up and organization expenses of the taxpayer’s trade or business in 2011 and increased the phase-out threshold to $60,000.
- *Modification to exclusion for gain from certain small business stock.* Fifty percent of the gain realized on qualified small business stock may be excluded from income. To qualify, the stock must be purchased at its original issue and the aggregate gross assets of the issuing corporation may not exceed $50 million and at least 80% of the value of its assets must be used in the active conduct of one or more trades or businesses. The exclusion is capped at the greater of 10 times the taxpayer's basis in the stock or $10 million. ARRTA temporarily increased from 50% to 75% the exclusion for qualified small business stock sold by an individual. The increased exclusion percentage is applicable to stock acquired after February 17, 2009, and before January 1, 2011. North Carolina conformed to ARRTA’s temporary increase of the exclusion. The 2010 Jobs Act increaseed the exclusion percentage to 100% for stock acquired after September 27, 2010, and before January 1, 2011.

Provisions in the 2010 Jobs Act Designed to Increase Revenue

The 2010 Jobs Act contains provisions to increase revenues. The provisions projected to raise the most revenue were related to higher federal tax penalty provisions. These provisions would not apply to North Carolina and would not increase any revenues payable to North Carolina. The Act also contains some retirement-friendly provisions that, if chosen by the taxpayer, would encourage up-front distributions that would be taxable. **The proposal** conforms to these changes.

- *Deduction for health insurance costs in computing self-employment taxes.* The 2010 Jobs Act allows self-employed individuals to deduct the cost of health insurance for the individual and immediate family to determine income subject to federal self-employment taxes. Health insurance costs were already deductible for regular income tax purposes. The reduction in self-employment taxes affects North Carolina taxable income because self-employment taxes were deductible in determining State taxable income. Self-employed taxpayers with health insurance costs will have larger State taxable incomes because less self-employment taxes were imposed and deducted at the federal level.

- *Allow participants in governmental 457 plans to treat elective deferrals as Roth contributions*. The 2010 Jobs Act gives participants the option to move retirement savings from government 457(b) plans to Roth accounts starting in 2011. The conversion will be taxable while the earrings and distributions from Roth accounts are generally tax free.

- *Allow rollovers from elective deferral plans to Roth designated accounts.* The 2010 Jobs Act allows retirement plans to offer participants the option starting September 27, 2010 to rollover distributions into Roth accounts within the same retirement plan. The rollover will be taxable while the earnings and distributions from the Roth account are generally tax free.

- *Permit partial annuitization of a nonqualified annuity contract.* The 2010 Jobs Act allows the owner of an annuity contract to begin receiving benefits based on a portion of the value of the annuity and leaving the balance of the annuity to accumulate earnings tax free. This option starts in 2011.

- *Source rules for income on guarantees.* The 2010 Jobs Act clarifies the federal tax treatment of guarantee fees as income sourced to the United States if connected to the United States by a domestic payer or by the conduct of a trade or business in the United States.

EFFECTIVE DATE: The proposal would become effective when it becomes law. However, any amendments to the Internal Revenue Code enacted after May 1, 2010, that increase North Carolina taxable income for the 2010 taxable year would become effective for taxable years beginning on or after January 1, 2011.

2011-RBxz-3A-SMRB-2 v3

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2009

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: January 19, 2011

TO: Revenue Laws Study Committee

FROM: Jonathan Tart
Fiscal Research Division

RE: 2011 IRC update[1]

FISCAL IMPACT					
	Yes (x)	**No ( )**	**No Estimate Available ( )**		
	FY 2010-11	**FY 2011-12**	**FY 2012-13**	**FY 2013-14**	**FY 2014-15**
REVENUES:					
($ millions)					
Decouple from Bonus depreciation	-.5	-1.1	-.2	1.1	.5
Decouple from Section 179 expensing for 2010 and 2011, keep 250k limit for 2011, conform to fed in 2012 and 2013	-.1	-4	-.3	.3	.4
Increase to capital gain exclusion for small business stock	0	0	0	0	-2
Increased start-up	-2.5	-.8	.1	.2	.2

[1] This memo revises the fiscal impact of the estate tax provisions to reflect more recent analysis. (February 10, 2011.)

expense deduction					
Deduction of health insurance for SE tax	2.8	1.2	.1	0	0
Allow 457 plan deferral to be treated as Roth	.1	.2	.2	.3	.4
Allow rollovers from elective deferral plans to Roth	1.6	4.3	4.7	3.9	4.4
Partial Annuitization of a nonqualified annuity contract	0	.2	.3	.5	.7
Source rules for income on guarantees	1.4	1.9	1.9	1.9	1.9
Tax Relief Act	0	0	0	5.4	3.1
Estate Tax	0	-59	-79	-20	0
Total	2.8	-57.1	-72.2	-6.4	9.6
PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Department of Revenue					
EFFECTIVE DATE: Effective when it becomes law					

BILL SUMMARY: This proposal would update the reference to the Internal Revenue code used in defining and determining certain State tax provisions from May 1, 2010, to January 1, 2011. By doing so, North Carolina would conform to many of the changes made by the federal Small Business Jobs Act of 2010 (2010 Jobs Act) and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act). The proposal would not conform to the following federal tax law provisions:

- Bonus depreciation. – Bonus depreciation allows a business to claim more of a deduction up front and spread the remainder out over the normal deprecation schedule. Over the life of the asset, the taxpayer receives the same benefit. The normal deprecation schedule is usually five to 15 years, depending upon the asset. In the past, Congress has provided 50% bonus depreciation for qualified property to spur economic investment. The bonus depreciation provision was scheduled to expire for property acquired and placed in service in 2010. The 2010 Jobs Act extended the 50% bonus depreciation provision to property placed in service in taxable years 2010 and 2011. The 2010 Tax Relief Act boosted the 50% bonus depreciation to 100% for property acquired and placed in service after September 8, 2010, and before January 1, 2012, and it provided 50% bonus depreciation for property placed in service after December 31, 2012, and before January 1, 2013. Although the proposal decouples from bonus depreciation, it provides that the property's basis is the same for federal and State purposes. The taxpayer must add-back 85% of the accelerated depreciation amount in the year that it is claimed for federal tax purposes, and then deduct 20% of this amount, plus the normal depreciation amount, over the next five years.

- Section 179 expensing. – Section 179 expensing allows the expensing of the purchase price of some business assets in the year of purchase rather than taking depreciation over the life of the asset. Section 179 has a deduction limit that begins to phase out on a dollar for dollar scale once an investment limit is reached. The deduction limit is $25,000 and the investment limit is $200,000. In the past, Congress has increased both the deduction limit and the investment limit to spur economic investment. For the 2010 taxable year, the deduction limit was $250,000 and the investment limit was $800,000. The expensing limits were scheduled to revert to their prior levels in 2011. The 2010 Jobs Act expanded the section 179 deduction limits from $250,000 to $500,000 for the 2010 taxable year and from $25,000 to $500,000 for the 2011 taxable year; it expanded the investment limits from $800,000 to $2,000,000 for the 2010 taxable year and from $200,000 to $2,000,000 for the 2011 taxable year; the expensing limits were scheduled to revert to their prior levels in 2012. It also broadened the definition of qualified property to include certain real property investments for the 2010 and 2011 taxable years. The 2010 Tax Relief Act expanded the section 179 deduction limits for the 2012 taxable year from $25,000/$200,000 to $125,000/$500,000; the expensing limits are scheduled to revert to their prior levels of $25,000/$200,000 in 2013. The proposal would maintain the 2010 deduction limits of $250,000 and $800,000 for taxable years 2010 and 2011. It would decouple from the enhanced limits of $500,000 and $2,000,000 for taxable years 2010 and 2011 but provide that the property's basis would be the same for federal and State purposes. The proposal provides that a taxpayer must add-back 85% of the additional expensing taken under federal law in 2010 and 2011 and may deduct 20% of this amount over the succeeding five years. The proposal would conform to the expensing limits of $125,000/$500,000 for the 2012 taxable year.

- Estate tax. – The federal estate tax expired for decedents dying in 2010. The estate tax had been scheduled to reemerge in 2011 at the 2001 exclusion amount of $1 million and the maximum estate tax rate of 55%. The 2010 Tax Relief Act revived the federal estate tax retroactively to January 1, 2010, with an exclusion amount of $5 million (the portability provision effectively provides an exclusion amount of $10 million for married couples) and a maximum estate tax rate of 35%. The estate of a decedent dying in 2010 may elect not to pay estate tax, and receive a modified carryover basis in the property passing through the estate. The estate tax provisions are scheduled to return to the 2001 rates and exclusion amounts for decedents dying on or after January 1, 2013. The proposal would conform to the higher exclusion amounts and give estates that chose to pay federal estate tax and receive the stepped-up basis in the property passing through the estate to elect to receive the stepped-up basis for NC purposes by paying the State estate tax for 2010.

The proposal would conform to all other provisions in the 2010 Jobs Act and the 2010 Tax Relief Act. The other provisions in the 2010 Jobs Act include the following:

- An increased exclusion amount of the gain realized on qualified small business stock. The exclusion amount is increased from 50% to 75% for stock acquired after February 17, 2009, and before January 1, 2011, and held for more than five years.
- An increased deduction limit for start-up expenses. The deduction is reduced by the amount of start-up costs that exceed a certain amount. The deduction limit is increased from $5,000 to $10,000 and the phase-out threshold is increased from $50,000 to $60,000.

- Various other small provisions that are intended to generate revenue. – Deduction for health insurance costs, 457 plans, 401(k) rollovers to Roth accounts, annuitization of a nonqualified annuity contract, sources rules for income on guarantees.

The 2010 Tax Relief Act extended many of the tax incentives enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 for two years. North Carolina conformed to these incentives in 2002; however, under existing North Carolina law, several of these incentives expired for the 2010 taxable year and many others are scheduled to expire for the 2011 taxable year. The proposal would conform to the federal effective date extensions.

The 2010 Tax Relief Act extended the following business tax incentives that were set to expire for the 2010 taxable year for the 2010 and 2011 taxable years:

- 15-year recovery period for qualified leasehold improvements, restaurant building and improvements, and retail improvements
- Seven-year recovery period for motor sports entertainment costs recovery
- Expensing election for certain film and television production costs
- Brownfields remediation expensing

The 2010 Tax Relief Act extended the Work Opportunity Tax Credit (WOTC) to include individuals who begin employment after August 31, 2011, and before January 1, 2012. North Carolina's WOTC is equal to 6% of the federal WOTC for wages paid for positions located in this State. The federal WOTC was scheduled to expire September 1, 2011.

The 2010 Tax Relief Act extended the following charitable incentives for taxable years 2010 and 2011:

- Deduction for contributions of food inventory
- Deduction for contributions by C corporations of books to public schools
- Deduction for corporate contributions of computer equipment for educational purposes
- Basis adjustment to stock of S corporations making charitable contributions of property

The 2010 Tax Relief Act extended the following individual income tax incentives retroactively for the 2010 taxable year and the 2011 taxable year:

- Tax deduction for higher education tuition expenses
- Up to $250 deduction for teacher's classroom expenses
- Charitable contribution of IRA proceeds

The following individual income tax incentives were scheduled to expire in 2011, but 2010 Tax Relief Act extends the incentives for the 2011 and 2012 taxable years:

- No limitation on itemized deductions.
- Enhancements to the earned income tax credit (EITC). North Carolina's EITC is equal to 5% of the federal credit amount.
- Enhancements to the adoption tax credit. North Carolina's adoption tax credit is equal to 50% of the federal credit amount.
- Deductibility of mortgage insurance premiums.
- Educational assistance exclusion.

- Student loan interest deduction.
- Increased amount that may be contributed to Coverdale education savings accounts and expansion of qualified expenses to include elementary and secondary school expenses.
- Exclusion of scholarships received from the national Health Services Corps Scholarship Program and the Armed Forces Scholarship Program from income.

For a more detailed explanation of the federal tax provisions, please see the summary of the proposal prepared by the Research Division.

ASSUMPTIONS AND METHODOLOGY:
Except as outlined below, The fiscal impact to the General Fund from partial conformity with the IRC update is based on JCT estimates on changes to federal taxes from the update. The methodology used begins with these JCT estimates, which are calculated by federal fiscal year. Fiscal Research adjusts these numbers back to an approximate calendar year tax impact. Then the next step was to prorate the national numbers to the state impact. This adjustment involved two steps: accounting for the relative size of the state based on federal tax collections and then adjusting for the difference in federal and state marginal tax rates. Once North Carolina's share of the JCT estimates were determined, state tax liability changes were estimated and allocated to the appropriate fiscal year.

The estimate of the bonus depreciation provision is based on data obtained from the Department of Revenue from the 2004 and 2008 tax returns. The estimate is derived from the tax that would not have been paid had North Carolina not required an add-back for bonus depreciation in computing State taxable income for both of those years. In order to assess the impact of the 85% add-back of the bonus depreciation and the Section 179 deduction, a depreciation schedule was developed. The depreciation simulation was used to determine the impact of the bonus depreciation and the Section 179 deduction with the adoption of an 85 percent add-back rule and a 5 year deduction for each fiscal year.

The estimate to conform to the estate tax provision of the Tax Relief Act was prepared based on tax return data obtained from the Department of Revenue for the 2007, 2008, and 2009 tax years. The impact is estimated from the tax that would not have been received as a result of the increase in the federal exclusion amount.

The Tax Relief Act of 2010 included multiple extensions of tax credits and deductions which were first enacted under the Economic Growth and Tax Relief Reconciliation Act of 2001. Because the changes were extensive and the Act was in place for ten years, the revenue base was adjusted to include the impacts from the Act. If the Tax Relief Act had not been enacted, then the result would have been an increase in General Fund revenue as result of the various federal tax law changes expiring for the 2011 tax year. Because they were extended for two years, there is no impact for FY 2011-12 and FY 2012-13. In the out years, after the latest extensions expire there will be a net gain to General Fund revenues. As with other calculations related to federal tax changes, analysis from the JCT was used to determine state tax liability. General Fund revenue changes would occur in FY 2013-14 and FY 2014-15.

SOURCES OF DATA: US Joint Committee on Taxation, US Bureau of Economic Analysis, NC Department of Revenue

TECHNICAL CONSIDERATIONS: None

LEGISLATIVE PROPOSAL #2

BUSINESS ENTITY CHANGES FOR PRESENT-USE VALUE TAXATION

LEGISLATIVE PROPOSAL #2

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2011 REGULAR SESSION OF THE 2011 GENERAL ASSEMBLY

AN ACT TO REVISE THE BUSINESS ENTITY OWNERSHIP REQUIREMENTS OF LAND AT PRESENT-USE VALUE

SHORT TITLE: Business Entity Changes

PRIMARY SPONSORS:

BRIEF OVERVIEW: This Legislative Proposal makes changes to the business entity ownership requirements for qualification of land at its present-use value so that the requirements are met when the current owner of the land shares members in common with the prior owner of the land.

FISCAL IMPACT:

EFFECTIVE DATE: This act becomes effective for taxable years beginning on or after July 1, 2011. However, applications filed beyond the listing period (January 1-January 31) would be accepted up to and through September 1, 2011, so that an owner may benefit from the property tax relief during the July 1, 2011 tax year.

A copy of the proposed legislation and a bill analysis begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2011

U **D**

BILL DRAFT 2011-LAz-3 [v.3] (11/29)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
11/29/2010 5:26:05 PM

Short Title: Business Entity Changes. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO REVISE THE BUSINESS ENTITY OWNERSHIP REQUIREMENTS OF LAND AT PRESENT-USE VALUE.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-277.3(b1) reads as rewritten:

"**§ 105-277.3. Agricultural, horticultural, and forestland – Classifications.**

…

(b1) **(Effective for taxes imposed for taxable years beginning on or after July 1, 2008)** Entity Ownership Requirements. – In order to come within a classification described in subsection (a) of this section, land owned by a business entity ~~or trust must have been owned by the business entity or trust or by one or more of its members or creators, respectively,~~ must meet the requirements of subdivision (1) of this subsection and land owned by a trust must meet the requirements of subdivision (2) of this subsection.

(1) Land owned by a business entity must have been owned by one or more of the following for the four years immediately preceding January 1 of the year for which the benefit of this section is claimed:

a. The business entity.

b. A member of the business entity.

c. Another business entity whose members include a member of the business entity that currently owns the land.

(2) Land owned by a trust must have been owned by the trust or by one or more of its creators for the four years immediately preceding January 1 of the year for which the benefit of this section is claimed."

SECTION 2. This act becomes effective for taxable years beginning on or after July 1, 2011. An application for property tax relief provided by this act may be filed and must be accepted at any time up to and through September 1 for the July 1, 2011 taxable year.

DRAFT 2011-LAz-3:
Business Entity Changes

2011-2012 General Assembly

Committee:	Revenue Laws Study Committee	**Date:**	December 1, 2010
Introduced by:		**Prepared by:**	Martha Walston Committee Counsel
Analysis of:	Draft Proposal 2011-LAz-3		

SUMMARY: This legislative proposal makes changes to the business entity ownership requirements for qualification of land at its present-use value so that the requirements are met when the current owner of the land shares members in common with the prior owner of the land.[1]

CURRENT LAW: Since 1973, farmland (agricultural land, horticultural land, and forestland) has been appraised and assessed at its present-use value as opposed to fair market value for property tax purposes if the farmland meets certain ownership, size, and use requirements. Farmland owned by a business entity meets the ownership requirements if the land was owned by the business entity or one of its members for the four years immediately preceding January 1 of the year for which the benefit is claimed. Prior to 2008, the members of the business entity had to be individuals. In 2008, the Revenue Laws Study Committee proposed legislation to broaden the ownership requirements so that farmland could be owned by a business entity whose membership includes modern estate planning vehicles such as a family limited partnership, a family limited liability company, or a trust.[2] S.L. 2008-146 alleviated problems tax assessors were having with recognizing these types of ownership. Now, for example, if the farmland is owned by a business entity, the members of the business entity are no longer restricted to individuals but can include trusts and other business entities.

BILL ANALYSIS: The 2008 changes to the present-use value (PUV) statutes focus on problems the tax assessors were having with recognizing types of ownership. Ownership is determined on the basis of the name on the deed but does not always consider real parties in interest.

Recently, counties have received applications where farmland has been owned as follows:

- Farmland owned by ABC Partnership for past four years applies for PUV status.
- The partners of ABC Partnership are Tom, Dick, and Harry.
- The previous owner of the farmland was XYZ Partnership.
- The partners of XYZ Partnership were also Tom, Dick, and Harry.

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[1] A "business entity" is defined as a corporation, general partnership, limited partnership, or limited liability company. A "member" is defined as a shareholder of a corporation, a partner of a general or limited partnership, or a member of a limited liability company.

[2] When the membership of a business entity includes a business entity or trust, then the individual members of the business entity and the individual beneficiaries of the trust are deemed to be indirect members of the qualified business entity.

- Counties have denied PUV status to the farmland based upon the language in G.S 105-277. 3(b1): The farmland had not been owned by its current owner, ABC Partnership, for four years immediately preceding the application, nor was the land owned by a partner of ABC Partnership.

The proposal would allow the business entity ownership requirements to be satisfied when the business entity that currently owns the farmland shares one or more members in common with the business entity that previously owned the farmland. For example, because one or more partners of the partnership that currently owns the farmland are the same partners of the partnership that previously owned the farmland, the ownership requirement would be met. In this example, the real parties in interest have not changed.

EFFECTIVE DATE: This act becomes effective for taxable years beginning on or after July 1, 2011. However, applications filed beyond the listing period (January 1-January 31) would be accepted up to and through September 1, 2011, so that an owner may benefit from the property tax relief during the July 1, 2011 tax year.

Unknown-SMLA-1(e1) v10

LEGISLATIVE PROPOSAL #3

REVENUE LAWS TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES

LEGISLATIVE PROPOSAL #3

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2011 REGULAR SESSION OF THE 2011 GENERAL ASSEMBLY

AN ACT TO MAKE TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES TO THE REVENUE LAWS AND RELATED STATUTES

SHORT TITLE: Revenue Laws Technical, Clarifying, & Administrative Changes.

PRIMARY SPONSORS:

BRIEF OVERVIEW: This proposal includes several technical, administrative, and clarifying changes to the revenue laws and related statutes.

FISCAL IMPACT:

EFFECTIVE DATE: This act would become effective when it becomes law.

A copy of the proposed legislation and a bill analysis begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2011

U **D**

BILL DRAFT 2011-RBxz-1B [v.2] (11/29)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/19/2011 7:38:04 AM

Short Title: Rev Laws Tech, Clarify., & Admin. Chngs. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO MAKE TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES TO THE REVENUE LAWS AND RELATED STATUTES.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-120.2(f) is repealed.

SECTION 2. G.S. 105-129.50 is amended by adding a new subdivision to read:

"§ 105-129.50. Definitions.

The definitions in section 41 of the Code apply in this Article. In addition, the following definitions apply in this Article:

(1) Development tier one area. – Defined in G.S. 143B-437.08.

…".

SECTION 3. G.S. 105-130.4(t2) is repealed.

SECTION 4. G.S. 105-164.4C(h)(5) reads as rewritten:

"(h) Definitions. – The following definitions apply in this section:

…

(5) Postpaid calling service. – A telecommunications service that is charged on a call-by-call basis and is obtained by making payment at the time of the call either through the use of a credit or payment mechanism, such as a bank card, travel card, credit card, or debit card, or by charging the call to a telephone number that is not associated with the origination or termination of the telecommunications service. A postpaid calling service includes a service that meets all the requirements of a prepaid ~~wireline~~ telephone calling service, except the exclusive use requirement.

…".

SECTION 5. G.S. 105-164.13(12) and (26a) reads as rewritten:

"§ 105-164.13. Retail sales and use tax.

The sale at retail and the use, storage, or consumption in this State of the following tangible personal property, digital property, and services are specifically exempted from the tax imposed by this Article:

…

(12) Sales of any of the following items:

a. Prosthetic ~~devices.~~devices for human use.

b. Mobility enhancing equipment sold on a prescription.

c. Durable medical equipment sold on prescription.

d. Durable medical supplies sold on prescription.

…

(26a) Food sold not for profit by a public school cafeteria to a child care center that participates in the Child and Adult Care Food Program of the Department of ~~Public Instruction.~~Health and Human Services."

SECTION 6. G.S. 105-164.13D(a) reads as rewritten:

"(a) The taxes imposed by this Article do not apply to the Energy Star qualified products listed in this section if sold between 12:01 A.M. on the first Friday of November and 11:59 P.M. the following Sunday. The qualified products are:

(1) Clothes washers.

(2) Freezers and refrigerators.

(3) Central air conditioners and room air conditioners.

(4) Air-source heat ~~pumps and geothermal heat~~ pumps.

(5) Ceiling fans.

(6) Dehumidifiers.

(7) Programmable thermostats."

SECTION 7. G.S. 105-164.14A(a)(1) and (4) read as rewritten:

"**§ 105-164.14A. Economic incentive refunds.**

(a) Refund. – The following taxpayers are allowed an annual refund of sales and use taxes paid under this Article:

(1) Passenger air carrier. – An interstate passenger air carrier is allowed a refund of the sales and use tax paid by it on fuel in excess of two million five hundred thousand dollars ($2,500,000). The amount of sales and use tax paid does not include a refund allowed to the interstate passenger air carrier under G.S. 105-164.14(a). This subdivision is repealed for purchases made on or after ~~January 1, 2011.~~January 1, 2013.

…

(4) Motorsports team or sanctioning body. – A professional motorsports racing team or a motorsports sanctioning body is allowed a refund of the sales and use tax paid by it in this State on aviation fuel that is used to travel to or from a motorsports event in this State, to travel to a motorsports event in another state from a location in this State, or to travel to this State from a motorsports event in another state. For purposes of this subdivision, a "motorsports event" includes a motorsports race, a motorsports sponsor event, and motorsports testing. This subdivision is repealed for purchases made on or after ~~January 1, 2011.~~January 1, 2013.

…".

SECTION 8.(a) G.S. 105-164.14B(a) reads as rewritten:

"(a) Definitions. – The following definitions apply in this section:

…

(12) Owner. – The term includes a lessee under a lease-purchase contract.

(13) Paper-from-pulp manufacturing. – An industry primarily engaged in manufacturing or converting paper, other than newsprint or uncoated groundwood paper, from pulp or pulp products, or in converting purchased sanitary paper stock or wadding into sanitary paper products.

…

(21) Reserved.

(22) Turbine manufacturing. – An industry primarily engaged in manufacturing turbines or complete turbine generator set units, such as steam, hydraulic, gas, and wind. The term does not include the manufacturing of aircraft turbines."

SECTION 8.(b) G.S. 105-164.14B(b)(1) reads as rewritten:

"(1) Business requirement. – The facility is primarily engaged in one or more of the following:

a. Air courier services.

b. Aircraft manufacturing.

c. Bioprocessing.

d. Financial services, securities operations, and related systems development.

e. Motor vehicle manufacturing.

f. Paper-from-pulp manufacturing.

g. Pharmaceutical and medicine manufacturing and distribution of pharmaceuticals and medicines.

~~g.~~h. Semiconductor manufacturing.

~~h.~~i. Solar electricity generating materials manufacturing.

j. Turbine manufacturing."

SECTION 9. G.S. 105-187.51C(c) reads as rewritten:

"(c) Forfeiture. – If the required level of investment to qualify as an eligible datacenter is not timely made, then the rate provided under this section is forfeited. If the required level of investment is timely made but any eligible machinery and equipment is not located and used at an eligible datacenter, then the rate provided for that machinery and equipment under this section is forfeited. A taxpayer that forfeits a rate under this section is liable for all past sales and use taxes avoided as a result of the forfeiture, computed ~~at the combined general rate~~ from the date the taxes would otherwise have been due, plus interest at the rate established under G.S. 105-241.21. If the forfeiture is triggered due to the lack of a timely investment required by this section, then interest is computed from the date the sales or use tax would otherwise have been due. For all other forfeitures, interest is computed ~~at the combined general rate~~ from the time as of which the machinery or equipment was put to a disqualifying use. A credit is allowed against the sales or use tax owed as a result of the forfeiture provisions of this subsection for privilege taxes paid pursuant to this section. For purposes of applying this credit, the fact that payment of the privilege tax occurred in a period outside the statute of limitations provided under G.S. 105-241.6 is not considered. The credit reduces the amount forfeited, and interest applies only to the reduced amount. The past taxes and interest are due 30 days after the date of forfeiture. A taxpayer that fails to pay the past taxes and interest by the due date is subject to the provisions of G.S. 105-236."

SECTION 10.(a) G.S. 105-228.37 reads as rewritten:

"**§ 105-228.37. Refund of overpayment of tax.**

(a) Refund Request. – A taxpayer who pays more tax than is due under this Article may request a refund of the overpayment by filing a written request for a refund with the board of county commissioners of the county where the tax was paid. The request must be filed within six months after the date the tax was paid and must explain why the taxpayer believes a refund is due.

(b) Hearing by County. – A board of county commissioners must conduct a hearing on a request for ~~refund in accordance with the procedures that apply to a hearing held by a board of equalization and review on an appeal concerning the listing or appraisal of property. If~~ <u>refund. Within 60 days after a timely request for a refund has been filed and at least 10 days before the date set for the hearing, the board must notify the taxpayer in writing of the time and place at which the hearing will be conducted. The date set for the hearing must be within 90 days after the timely request for a hearing was filed or at a later date mutually agreed upon by the taxpayer and the board. The board must make a decision on the requested refund within 90 days after conducting a hearing under this subsection.</u> ~~the board decides that a refund is due, it must refund the county's portion of the overpayment, together with any applicable interest, to the taxpayer. If the board finds that no refund is due, the written decision of the board must inform the taxpayer that the taxpayer may appeal the decision to the Property Tax Commission.~~

(c) ~~Review by Commission.~~ <u>Process if Refund Granted.</u> – <u>If the board of commissioners decides that a refund is due, it must refund the overpayment, together with any applicable interest, to the taxpayer and inform the Department of the refund. The Department may assess the taxpayer for the amunt of the refund in accordance with G.S. 105-241.9 if the Department disagrees with the board's decision.</u> ~~The procedure in G.S. 105-290 for the appeal to the Property Tax Commission of a decision of a board of equalization and review concerning the listing or appraisal of property applies to the appeal of a denial by a board of county commissioners of a request for a refund of tax paid under this Article. If the Commission determines that a refund is due, the board of county commissioners must refund the county's portion of the overpayment, together with any applicable interest, to the taxpayer. A decision of the Commission is binding on the Secretary and on a board of county commissioners.~~

(d) ~~Judicial Review.~~ <u>Process if Refund Denied.</u> – ~~A decision of the Property Tax Commission is subject to judicial review in accordance with G.S. 7A-29.~~<u>If the board of commissioners finds that no refund is due, the written decision of the board must inform the taxpayer that the taxpayer may request a Departmental review of the denial of the refund in accordance with the procedures set out in G.S. 105-241.11.</u>

(e) Recording Correct Deed. – Before a tax is refunded, the taxpayer must record a new instrument reflecting the correct amount of tax due. If no tax is due because an instrument was recorded in the wrong county, then the taxpayer must record a document stating that no tax was owed because the instrument being corrected was recorded in the wrong county. The taxpayer must include in the document the names of the grantors and grantees and the deed book and page number of the instrument being corrected.

When a taxpayer records a corrected instrument, the taxpayer must inform the register of deeds that the instrument being recorded is a correcting instrument. The taxpayer must give the register of deeds a copy of the decision granting the refund that shows the correct amount of tax due. The correcting instrument must include the deed book and page number of the instrument being corrected. The register of deeds must notify the county finance officer and the Secretary when the correcting instrument has been recorded.

(f) Interest. – An overpayment of tax bears interest at the rate established in G.S. 105-241.21 from the date that interest begins to accrue. Interest begins to accrue on an overpayment 30 days after the request for a refund is filed by the taxpayer with the board of county commissioners."

SECTION 10.(b) G.S. 105-228.30(b) reads as rewritten:

"(b) The register of deeds of each county must remit the proceeds of the tax levied by this section to the county finance officer. The finance officer of each county must credit one-half of the proceeds to the county's general fund and remit the remaining one-half of the proceeds, less taxes refunded and the county's allowance for administrative expenses, to the Department of Revenue on a monthly basis. A county may retain two percent (2%) of the amount of tax proceeds allocated for remittance to the Department of Revenue as compensation for the county's cost in collecting and remitting the State's share of the tax. Of the funds remitted to it pursuant to this section, the Department of Revenue must credit seventy-five percent (75%) to the Parks and Recreation Trust Fund established under G.S. 113-44.15 and twenty-five percent (25%) to the Natural Heritage Trust Fund established under G.S. 113-77.7."

SECTION 11.(a) G.S. 105-228.90(b) is amended by adding a new subdivision to read:

"(b) Definitions. – The following definitions apply in this Article:

…

(4b) NAICS. – The North American Industry Classification System adopted by the United States Office of Management and Budget as of December 31, 2007.

…"

SECTION 11.(b) G.S. 105-129.81(13) and (18) read as rewritten:

"**§ 105-129.81. Definitions.**

The following definitions apply in this Article:

…

(13) Information technology and services. – An industry in one of the ~~following:~~following, as defined by NAICS:

a. ~~Internet service providers, Web search portals, and data processing subsector 518 as defined by NAICS.~~Data processing industry group 518.

b. Software publishers industry group ~~5112 as defined by NAICS.~~5112.

c. Computer systems design and related services industry group ~~5415 as defined by NAICS.~~5415.

d. An internet activity included in industry group 519130.

…

(18) NAICS. – ~~The North American Industry Classification System adopted by the United States Office of Management and Budget as of December 31, 2002.~~Defined in G.S. 105-228.90.

…"

SECTION 11.(c) G.S. 105-164.3(23a) reads as rewritten:

"(23a) NAICS. ~~– The North American Industry Classification System adopted by the United States Office of Management and Budget as of December 31, 2007.~~Defined in G.S. 105-228.90."

SECTION 12. G.S. 105-236(a)(2) reads as rewritten:

"(a) Penalties. – The following civil penalties and criminal offenses apply:

…

(2) Failure to Obtain a License. – For failure to obtain a license before engaging in a business, trade or profession for which a license is required, the Secretary shall assess a penalty equal to five percent (5%) of the amount prescribed for the license per month or fraction thereof until paid, not to exceed twenty-five percent (25%) of the amount so prescribed, but in any event shall not be less than five dollars ($5.00). In cases in which the ~~taxpayer~~ taxpayer, after written notification by the Department, fails to obtain a license as required under G.S. 105-449.65 or G.S. 105-449.131, the Secretary may assess a penalty of one thousand dollars ($1,000).

…".

SECTION 13.(a) G.S. 105-256(a)(9) reads as rewritten:

"(a) Publications. – The Secretary shall prepare and publish the following:

…

(9) A final decision of the Secretary in a contested tax case. ~~The Secretary must redact identifying taxpayer information from a final decision prior to publication.~~"

SECTION 13.(b) G.S. 105-259(b)(27) reads as rewritten:

"(b) Disclosure Prohibited. – An officer, an employee, or an agent of the State who has access to tax information in the course of service to or employment by the State may not disclose the information to any other person except as provided in this subsection. Standards used or to be used for the selection of returns for examination and data used or to be used for determining the standards may not be disclosed for any purpose. All other tax information may be disclosed only if the disclosure is made for one of the following purposes:

…

(27) To provide a ~~report~~ publication required under this Chapter."

SECTION 13.(c) G.S. 150B-21.17(a)(5) is repealed.

SECTION 14. G.S. 105-467(a) reads as rewritten:

"(a) Sales Tax. – The sales tax that may be imposed under this Article is limited to a tax at the rate of one percent (1%) of the ~~transactions listed in this subsection. The~~

~~sales tax authorized by this Article does not apply to sales that are taxable by the State under G.S. 105-164.4 but are not specifically included in this subsection.~~following:

(1) A retailer's net taxable sales and gross receipts that are ~~The sales price of tangible personal property~~ subject to the general rate of sales tax imposed by the State under ~~G.S. 105-164.4(a)(1) and (a)(4b).~~G.S. 105-164.4.

~~(2) The gross receipts derived from the lease or rental of tangible personal property when the lease or rental of the property is subject to the general rate of sales tax imposed by the State under G.S. 105-164.4(a)(2).~~

~~(3) The gross receipts derived from the rental of any room or other accommodations subject to the general rate of sales tax imposed by the State under G.S. 105-164.4(a)(3).~~

~~(4) The gross receipts derived from services rendered by laundries, dry cleaners, and other businesses subject to the general rate of sales tax imposed by the State under G.S. 105-164.4(a)(4).~~

(5) The sales price of food that is not otherwise exempt from tax pursuant to G.S. 105-164.13 but is exempt from the State sales and use tax pursuant to G.S. 105-164.13B.

(5a) The sales price of a bundled transaction that includes food subject to tax under subdivision (5) of this subsection, if the price of the food exceeds ten percent (10%) of the price of the bundle. A retailer must determine the price of food in a bundled transaction in accordance with G.S. 105-164.4D.

(5b) The sales price of bread, rolls, and buns that are sold at a bakery thrift store and are exempt from State tax under G.S.105-164.13(27a).

~~(6) The sales price of prepaid telephone calling service taxed as tangible personal property under G.S. 105-164.4(a)(4d).~~

~~(7) The gross receipts derived from providing satellite digital audio radio service subject to the general rate of tax under G.S. 105-164.4(a)(6a).~~"

SECTION 15. Section 24.18(g) of S.L. 2006-66 reads as rewritten:

"**SECTION 24.18.(g)** This section is effective for taxable years beginning on or after January 1, 2006, and expires for taxable years beginning on or after ~~January 1, 2011.~~January 1, 2013."

SECTION 16. Section 31.7(e) of S.L. 2010-31 reads as rewritten:

"**SECTION 31.7.(e)** G.S. 105-37.1(a)(1), as amended by subsection (a) of this section, becomes effective ~~August 1, 2010,~~February 1, 2009, and applies to charges for admission received before that date or on or after that date. G.S. 105-37.1(a)(2), as amended by subsection (a) of this section, becomes effective January 1, 2011, and applies to admission tickets sold on or after that date. The remainder of this section is effective when it becomes law."

SECTION 17. Section 8 of S.L. 2006-209 reads as rewritten:

"**SECTION 8.** As applied to G.S. 20-79.4, the authority in G.S. 164-10 for the Division of Legislative Drafting and Codification to reletter or renumber section subdivisions includes the authority to renumber all the subdivisions in G.S. 20-79.4(b) in sequential and alphabetical order and to eliminate mixed number-letter subdivision designations. ~~This section expires July 1, 2011.~~"

SECTION 18. A facilitator is not liable for an overcollection or undercollection of sales tax or local occupancy tax if the facilitator has made a good faith effort to comply with the law and collect the proper amount of tax as the result of the change under Section 31.6 of S.L. 2010-31 regarding a facilitator's collection and remittance obligations imposed under G.S. 105-164.4(a)(3), G.S. 153A-155(c), and G.S. 160A-215(c). This applies only to the period beginning January 1, 2011, and ending April 1, 2011.

SECTION 19. G.S. 105-164.16(d) reads as rewritten:

"(d) Use Tax on Out-of-State Purchases. – Use tax payable by an individual who purchases the items listed in this subsection~~tangible personal property other than a boat or an aircraft, digital property, or a service~~ outside the State for a nonbusiness purpose is due on an annual basis. For an individual who is not required to file an individual income tax return under Part 2 of Article 4 of this Chapter, the annual reporting period ends on the last day of the calendar year and a use tax return is due by the following April 15. For an individual who is required to file an individual income tax return, the annual reporting period ends on the last day of the individual's income tax year, and the use tax must be paid on the income tax return as provided in G.S. 105-269.14. The items are:

(1) Tangible personal property other than a boat or an aircraft.

(2) Digital property.

(3) A service."

SECTION 20. G.S. 105-133(14) reads as rewritten"

"§ 105-333. Definitions.

The following definitions apply in this Article unless the context requires a different meaning:

…

(14) Public service company. – A railroad company, a pipeline company, a gas company, an electric power company, an electric membership corporation, a telephone company, a telegraph company, a bus line company, an airline company, or a motor freight carrier company. The term also includes any company performing a public service that is regulated by the United States Department of Energy, the United States Department of Transportation, the Federal Communications Commission, the Federal Aviation Agency, or the North Carolina Utilities Commission, except that the term does not include a water company, mobile telecommunications service as defined in G.S. 105-164.3, a cable television company, or a radio or television broadcasting company."

SECTION 21. G.S. 105-241.9(b) reads as rewritten:

"(b) Time Limit. – The Secretary must propose an assessment within the statute of limitations for proposed assessments unless the taxpayer waives the limitations period ~~in writing.~~ before it expires by agreeing in writing to extend the period. A taxpayer may waive the limitations period for either a definite or an indefinite time. If the taxpayer waives the limitations period, the Secretary may propose an assessment at any time within the time extended by the waiver."

SECTION 22. This act is effective when it becomes law.

Bill Draft 2011-RBxz-1B: Rev Laws Tech, Clarify., & Admin. Chngs.

2011-2012 General Assembly

Committee:	Revenue Laws Study Committee	**Date:**	January 18, 2011
Introduced by:		**Prepared by:**	Finance Team
Analysis of:	2011-RBxz-1B		

***SUMMARY:* This proposal includes several technical, administrative, and clarifying changes to the revenue laws and related statutes.**

EFFECTIVE DATE: This act would become effective when it becomes law.

BILL ANALYSIS:

Section	Explanation
1	Repeals an obsolete provision. When the General Assembly enacted the qualified business venture tax credits in 1987, they applied to investments in North Carolina companies and to both corporations and individuals. In 1996, the General Assembly revised the tax credit to apply to all investments because the restriction to North Carolina companies was unconstitutional. In the same act, S.L. 1996-14, ES2, the General Assembly also restricted the tax credit to individuals and pass-through entities. The subsection being repealed is a carry-over from the original law as it applied to holding companies.
2	Provides a definition for development tier one area in the tax credit for research and development. The tax credit amount for research performed in a development tier one area is 3.25%.
3	Repeals an obsolete provision. In S.L. 2010-89, the General Assembly provided an alternative apportionment formula for a corporation that signed a letter of commitment by September 15, 2010, certifying that it planned to invest at least $500 million in private funds to construct a facility in a development tier one area. No company signed such a letter. The General Assembly enacted the provision at the request of Microsoft; Microsoft announced in August that it would be locating in Virginia.
4	Removes the word "wireline" at the request of the Streamlined Sales Tax Compliance Review and Interpretations Committee. It makes no substantive change in the law.
5	Clarifies that the sales tax exemption for prosthetic devices is for human use and corrects the name of the agency where the Child and Adult Care Food Program is located.
6	Removes geothermal heat pumps from the Energy Star sales tax holiday because consumers are not able to purchase them. Only contractors can

	purchase geothermal heat pumps and they are not entitled to the exemption. The presence of the item in the list raises many questions and frustrates consumers.
7	Corrects the sunset dates of the sales tax refunds for fuel sold to passenger air carriers and motorsports teams. The General Assembly extended these sunsets from January 1, 2011, to January 1, 2013, in S.L. 2010-31. In a subsequent piece of legislation recommended by the Revenue Laws Study Committee, S.L. 2010-166, these refund provisions were reenacted in a new statute dedicated to economic incentive refunds. The later legislation failed to conform to the extended sunset dates.
8	Includes the two new sales tax refunds for paper from pulp manufacturing and turbine manufacturing in the correct statute. The General Assembly enacted the refunds in S.L. 2010-31. The rewrite of the economic incentive refunds, enacted in S.L. 2010-166, failed to include this conforming change. Gives effect to the sales tax refund for paper from pulp manufacturing by defining the term "owner" to include a lessee in a lease-to-purchase contract. The Department of Commerce requested this change.
9	Removes unnecessary and confusing words. If a datacenter fails to maintain its required levels of investments, it forfeits its incentive and must pay sales tax on its purchases. The statute stated that the sales tax would be calculated "*at the combined general rate*". The words are not necessary and may not correctly reference the right tax rate since the term "combined general rate" does not include the ¼ ¢ local sales tax applicable in some counties.
10	Clarifies the refund process for the deed stamp tax.
11	Updates the reference to NAICS and places the definition in the statute applicable to most of Chapter 105. NAICS is the North American Industry Classification System adopted by the US Office of Management and Budget. It is updated every five years. Makes a conforming change to the term "information technology and services" to reflect the changes from the 2002 NAICS to the 2007 NAICS.
12	Clarifies that the higher penalty for failure to obtain a license under the motor fuel statutes only applies after the taxpayer has received written notification from the Department of Revenue to obtain the requisite license.
13	Reconciles two current conflicting provisions concerning whether the identity of certain taxpayers is public information. This section also makes conforming changes. The taxpayers affected are those who bring a contested case action at the Office of Administrative Hearings to obtain a review of an assessment or a denial of a refund by the Department of Revenue. Currently, G.S. 150B-31.1(e) states that the record, proceedings, and decision in a contested case are confidential until the final decision is issued. The Secretary of Revenue makes the final decision and, once that decision issued, the records with the

	taxpayer name is public. G.S. 105-256(a)(9) requires the Secretary of Revenue to publish the final decision in a contested case in a format that redacts identifying information. The requirement to redact the identifying information serves no purposes, however, because once the decision is published, the record in the contested case proceeding becomes public in an unredacted form under G.S. 150B-31.1. Subsection (a) reconciles these provisions by amending G.S. 105-269(a)(9) to delete the requirement that the Secretary redact identifying taxpayer information when publishing final decisions. Subsection (b) makes a conforming change to the secrecy statute, G.S. 105-259, to change the word "report" to "publication" to ensure that the final decisions are included within the current exception for reports. G.S. 150B-31.1 and G.S. 105-256(a)(9) were both enacted in 2007 in Senate Bill 242, S.L. 2007-491. Under prior law, the Tax Review Board reviewed administrative decisions of the Secretary and made a decision, called an order, after the review. Orders of the Tax Review Board were published in the North Carolina Register, as required by G.S. 150B-21.17(a)(5),and were not redacted. S.L. 2007-491 revised the procedure for the review of contested tax cases and, as part of the revisions, eliminated the Tax Review Board. Subsection (c) makes a conforming change and repeals the obsolete requirement in G.S. 150B-21.17(a)(5) to publish orders of the Tax Review Board in the North Carolina Register.
14	Modernizes the local sales tax base to conform to the State sales tax base for items taxed at the general rate of tax. This change will remove the need to amend the local sales tax statute whenever an item is added to the State sales tax base and taxed at the general rate of tax. It effectively includes digital products in the local sales tax base, as intended by the General Assembly.
15	Conforms the sunset provisions of miscellaneous provisions associated with the tax credit for recycling oyster shells. The General Assembly extended the sunset on this credit from January 1, 2011, to January 1, 2013, in S.L. 2010-147.
16	Changes the effective date for the exclusion of amenities from general admissions receipts. Prior to February 1, 2009, amenities were excluded from admissions receipts. Effective February 1, 2009, with one day's notice, the Department of Revenue issued a directive providing that amenities would be included in admissions receipts. The Revenue Laws Study Committee recommended, and the General Assembly enacted, a restoration of the prior understanding. The effective date of the legislation was August 1, 2010. Companies that paid the tax with amenities included in the admissions receipts sought a refund of the excess tax paid. The Department denied the refund request because the effective date of the legislative change was August 1, 2010, not February 1, 2009 (the day the directive took effect).

17	Removes the sunset from the provision that allows the Codifier of Statutes to renumber the subdivisions in the special license plates statute in sequential and alphabetical order.
18	Provides that a facilitator would not be liable for an overcollection or an undercollection of sales tax or local occupancy tax during the period of January 1, 2011, through April 1, 2011, as the result of the new collection and remittance obligations imposed under Section 31.6 of S.L. 2010-31 as long as the facilitator made a good faith effort to comply with the law and collect the proper amount of tax. During the 2010 Session, the General Assembly established new sales and use tax reporting and remittance obligations on "facilitators," which are entities that enter into a contract with the providers of accommodations to market and collect payment for accommodation rentals. An example of a facilitator is an online travel company, such as Expedia or Travelocity.
19	Clarifies that use tax is payable by an individual on an annual basis for purchases made outside the State for a nonbusiness purpose of digital property and certain services. In 2009, the General Assembly imposed the State and local general rate of sales tax on certain digital goods, such as downloaded music and books. The legislation also made several conforming changes by adding the term "digital property" to a number of other sales tax statutes. Among them, the term "digital property" was added to the statute that sets out when an individual is required to pay use tax on out-of-State purchases. Since digital property was being subjected to sales tax, a corresponding change was made to subject it to use tax if it is purchased out of State. The Department of Revenue is interpreting the statute to exclude digital property and services from the annual use tax reporting requirement. This section clarifies that the "other than" phrase applies only to boats and aircraft. All other tangible personal property, digital property, and taxable services purchased outside the State for a nonbusiness use are subject to the annual reporting requirement for use tax.
20	Clarifies that the definition of "public service company" in the property tax statutes does not include mobile telecommunication service.
21	Clarifies that a waiver of a statute of limitations must be executed before the statute of limitations expires.

2011-RBxz-1B-SMSV-2 v2

APPENDIX A

AUTHORIZING LEGISLATION
ARTICLE 12L OF CHAPTER 120
OF THE
GENERAL STATUTES

ALL MATERIALS DISTRIBUTED AT MEETINGS MAY BE VIEWED ON THE COMMITTEE'S WEBSITE:
http://www.ncleg.net/committees/

ARTICLE 12L

Revenue Laws Study Committee

§ 120-70.105. Creation and membership of the Revenue Laws Study Committee.

(a) Membership. -- The Revenue Laws Study Committee is established. The Committee consists of 16 members as follows:

(1) Eight members appointed by the President Pro Tempore of the Senate; the persons appointed may be members of the Senate or public members.

(2) Eight members appointed by the Speaker of the House of Representatives; the persons appointed may be members of the House of Representatives or public members.

(b) Terms. -- Terms on the Committee are for two years and begin on January 15 of each odd-numbered year, except the terms of the initial members, which begin on appointment. Legislative members may complete a term of service on the Committee even if they do not seek reelection or are not reelected to the General Assembly, but resignation or removal from service in the General Assembly constitutes resignation or removal from service on the Committee.

A member continues to serve until a successor is appointed. A vacancy shall be filled within 30 days by the officer who made the original appointment. (1997-483, s. 14.1; 1998-98, s. 39.)

§ 120-70.106. Purpose and powers of Committee.

(a) The Revenue Laws Study Committee may:

(1) Study the revenue laws of North Carolina and the administration of those laws.

(2) Review the State's revenue laws to determine which laws need clarification, technical amendment, repeal, or other change to make the laws concise, intelligible, easy to administer, and equitable.

(3) Call upon the Department of Revenue to cooperate with it in the study of the revenue laws.

(4) Report to the General Assembly at the beginning of each regular session concerning its determinations of needed changes in the State's revenue laws.

These powers, which are enumerated by way of illustration, shall be liberally construed to provide for the maximum review by the Committee of all revenue law matters in this State.

(b) The Committee may make interim reports to the General Assembly on matters for which it may report to a regular session of the General Assembly. A report to the General Assembly may contain any legislation needed to implement a recommendation of the Committee. When a recommendation of the Committee, if enacted, would result in an increase or decrease in State revenues, the report of the Committee must include an estimate of the amount of the increase or decrease. (1997-483, s. 14.1.)

§ 120-70.107. Organization of Committee.

(a) The President Pro Tempore of the Senate and the Speaker of the House of Representatives shall each designate a cochair of the Revenue Laws Study Committee. The Committee shall meet upon the joint call of the cochairs.

(b) A quorum of the Committee is nine members. No action may be taken except by a majority vote at a meeting at which a quorum is present. While in the discharge of its official duties, the Committee has the powers of a joint committee under G.S. 120-19 and G.S. 120-19.1 through G.S. 120-19.4.

(c) The Committee shall be funded by the Legislative Services Commission from appropriations made to the General Assembly for that purpose. Members of the Committee receive subsistence and travel expenses as provided in G.S. 120-3.1 and G.S. 138-5. The Committee may contract for consultants or hire employees in accordance with G.S. 120-32.02. Upon approval of the Legislative Services Commission, the Legislative Services Officer shall assign professional staff to assist the Committee in its work. Upon the direction of the Legislative Services Commission, the Supervisors of Clerks of the Senate and of the House of Representatives shall assign clerical staff to the Committee. The expenses for clerical employees shall be borne by the Committee. (1997-483, s. 14.1.)

APPENDIX B

DISPOSITION OF COMMITTEE'S RECOMMENDATIONS TO THE 2010 REGULAR SESSION OF THE 2009 GENERAL ASSEMBLY

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http://www.ncleg.net/committees/

DISPOSITION OF REVENUE LAWS STUDY COMMITTEE RECOMMENDATIONS TO THE 2010 REGULAR SESSION OF THE 2009 GENERAL ASSEMBLY

SHORT TITLE	SENATE SPONSORS	HOUSE SPONSORS	BILL #	FINAL STATUS*
IRC Update	Stein	Luebke	HB 1829 SB 1183	Enacted* SL 2010-31, Sec. 31.1 [Budget Bill]
Construction of Wills and Trusts	Clodfelter	Carney	HB 1865 ►SB 1176	Enacted* SL 2010-126, [SB 1176]
Economic Incentives Alignment & Changes	Jenkins	McComas	HB 1880 ►SB 1215	Enacted* SL 2010-166, [SB 1215]
Modernize Admissions Tax/Restore Amenities Exclusion	Hartsell	Gibson	HB 1911 SB 1186	Enacted* SL 2010-31, Sec. 31.7 [Budget Bill]
Modernize Sales Tax on Accommodations	Hartsell	Luebke	HB 1828 SB 1185	Enacted* SL 2010-31, Sec. 31.6 [Budget Bill]
Improve Tax & Debt Collection Process	Brunstetter	McGee, Luebke, Brubaker, Carney	HB 1881 SB 1188	Enacted* SL 2010-31, Sec. 31.8 [Budget Bill]
Expand Exception to PUV Ownership Requirements	Tillman	Brubaker, Luebke, Carney, Gibson	HB 1909 SB 1187	*Not Enacted*
No Nonvoted Local Debt for Competing System	Hoyle	n/a	SB 1209	Included* SL 2010-152, Sec. 7.5(a)(b) [Studies Bill]
Revenue Laws Technical & Administrative Changes	Clodfelter	Wainwright	HB 1810 ►SB 1177	Enacted* SL 2010-95, [SB 1177]

* Bills were modified prior to enactment.

APPENDIX C

MEETING AGENDAS

ALL MATERIALS DISTRIBUTED AT MEETINGS MAY BE VIEWED ON THE COMMITTEE'S WEBSITE:
http://www.ncleg.net/committees/

Sen. Daniel Clodfelter Rep. Paul Luebke

Wednesday, November 10, 2010
Room 643, Legislative Office Building
9:30 a.m.

I. **Welcome and Introductions**

II. **Budget Outlook**

– *Barry Boardman, Fiscal Research Division*

III. **Department-Initiated Tax Refunds**

– *Jonathan Tart, Fiscal Research Division*

– *David Hoyle, Secretary, Department of Revenue*

IV. **Delay of Tax Refunds: Current Status, Effect, and Alternatives**

– *Cindy Avrette, Research Division*

– *David Hoyle, Secretary, Department of Revenue*

– *Vance Holloman and Tony Solari, State Treasurer's Office*

– *David McCoy, Office of State Controller*

– *Charlie Perusse, Office of State Budget and Management*

V. **Industry-Specific Apportionment Formulas: Publishers**

– *Lennie Collins, Director of Corporate Income Tax, Department of Revenue*

VI. **Overview of 2010 Finance Law Changes**

– *Trina Griffin, Research Division*

VII. **IRC Update**

– *Jonathan Tart, Fiscal Research Division*

VIII. **Adjournment**

REVENUE LAWS STUDY COMMITTEE AGENDA

Sen. Daniel Clodfelter Rep. Paul Luebke

Wednesday, December 1, 2010
Room 544, Legislative Office Building
9:30 a.m.

I. Approval of Minutes from November 10, 2010 Meeting

II. Industry-Specific Apportionment Formulas: Broadcasters

– *Lennie Collins, Director of Corporate, Excise, and Insurance Tax, Department of Revenue*

III. Status of Rulemaking for Forced Combinations

– *Department of Revenue*

IV. IRC Update Follow-Up

– *Jonathan Tart, Fiscal Research Division*

V. Department-Initiated Tax Refunds Follow-Up

– *Trina Griffin, Research Division*

VI. Business Entity Changes for Present-Use Value Taxation

– *Martha Walston, Fiscal Research Division*

VII. Delay of Tax Refunds Follow Up: Distribution of Proposed Legislation

– *Rodney Bizzell, Fiscal Research Division*

VIII. Revenue Laws Technical, Clarifying, and Administrative Changes: Part I

– *Cindy Avrette, Research Division*

IX. Adjournment

REVENUE LAWS STUDY COMMITTEE AGENDA

Sen. Daniel Clodfelter Rep. Paul Luebke

Wednesday, January 5, 2011
Room 544, Legislative Office Building
9:30 a.m.

I. Approval of Minutes from December 1, 2010 Meeting

II. Overview of the Unemployment Trust Fund
– Kevin Carlson, Assistant Chairman for Finance and Administration, Employment Security Commission

III. Federal Tax Law Changes Update & Distribution of IRC Update Draft
– Cindy Avrette, Research Division

IV. Central Appraisal of Wireless Companies
– Martha Walston, Fiscal Research Division

V. Industry-Specific Apportionment Formulas: Telephone
– Lennie Collins, Director of Corporate, Excise, and Insurance Tax, Department of Revenue

VI. History and Background of Present-Use Value Program
– David Baker, Director of Property Tax Division, Department of Revenue
– Comments from Interested Parties: NC Farm Bureau, NC Association of County Commissioners, Tax Assessors

VII. Department-Initiated Tax Refunds: Follow Up
– Canaan Huie, General Counsel, Department of Revenue

VIII. Technical, Clarifying, and Administrative Changes – Part II
– Trina Griffin, Research Division

IX. Adjournment

Sen. Daniel Clodfelter Rep. Paul Luebke

Wednesday, January 19, 2011
Room 544, Legislative Office Building
9:30 a.m.

I. Approval of Minutes from January 5, 2011 Meeting

II. Briefing on Recent Cases

- ***Amazon.com v. NC Dept. of Revenue*** ***(October, 2010)***
- ***Amazon.com v. New York State Dept. of Taxation & Finance*** ***(November, 2010)***
- ***Delhaize America, Inc. v. NC Dept. of Revenue*** ***(January 2011)***

  – Greg Roney, Research Division

III. Legislative Proposals

- **#1: IRC Update**
  Cindy Avrette, Research Division
  Jonathan Tart, Fiscal Research Division
- **#2: Business Entity Changes for Present-Use Value Taxation**
  Martha Walston, Fiscal Research Division
- **#3: Revenue Laws Technical, Clarifying, and Administrative Changes**
  Trina Griffin, Research Division

IV. Approval of Committee Proceedings (no legislative proposals)

- **No Delay of Tax Refunds**
- **Department-Initiated Tax Refunds**
- **Status of Rulemaking for Forced Combinations**
- **Central Appraisal of Wireless Companies**
- **Industry-Specific Apportionment Formulas**

V. Approval of Draft Report

VI. Adjournment

APPENDIX D

IRC CHART

ALL MATERIALS DISTRIBUTED AT MEETINGS MAY BE VIEWED ON THE COMMITTEE'S WEBSITE: http://www.ncleg.net/committees/

IRC Update Chart

	IRC as of May 1, 2010	North Carolina's current tax law *references the IRC as of May 1, 2010*	Small Business Jobs act of 2010 *Enacted September 27, 2010*	Tax Relief and Job Creation Act of 2010 *Enacted December 17, 2010*
Bonus Depreciation *allows a business to claim more of a deduction up front and spread the remainder out over the normal depreciation schedule. Over the life of the asset, the taxpayer receives the same benefit. The normal depreciation schedule is usually 5 years or 15 years, depending upon the asset.*	50% bonus depreciation for qualified property acquired and placed in service in 2009.	DECOUPLED but provided that the property's basis is the same for federal and State purposes. Taxpayer must add-back 85% of the accelerated depreciation amount in the year that it is claimed for federal tax purposes. The taxpayer may deduct 20% of this amount, plus the normal depreciation amount, over the next five years. *The extension of the bonus depreciation for tax years 2010, 2011, and 2012 are not included in the current NC tax law.*	50% bonus depreciation extended to property acquired and placed in service after December 31, 2009, in taxable years ending after such date, and before January 1, 2012 (2010 and 2011 taxable years).	Boosts 50% bonus depreciation to 100% bonus depreciation for property acquired and placed in service after September 8, 2010, in taxable years ending after such date, and before January 1, 2012 (2010 and 2011 taxable years). Provides 50% bonus depreciation for qualified property placed in service after December 31, 2012, and before January 1, 2013 (2012 taxable year).

	IRC as of May 1, 2010	North Carolina's current tax law *references the IRC as of May 1, 2010*	Small Business Jobs act of 2010 *Enacted September 27, 2010*	Tax Relief and Job Creation Act of 2010 *Enacted December 17, 2010*
Section 179 expensing *allows the expensing of the purchase price of some business assets in the year of purchase rather than taking depreciation over the life of the asset. Section 179 has a deduction limit that begins to phase out on a dollar for dollar scale once an investment limit is reached. The deduction limit is $25,000 and the investment limit is $200,000; neither is indexed for inflation.*	The deduction limit is $250,000 for 2010 and the investment limit is $800,000. The expensing limits are scheduled to revert to prior levels in 2011.	Conforms. Deduction limit is $250,000 with an investment limit of $800,000; reverts to $25,000/$200,000 in 2011.	The limits expanded to $500,000 and $2,000,000 for 2010 and 2011; reverts back to prior levels in 2012 with no indexing ($25,000/$200,000). Expands definition of qualified property to include certain real property up to $250,000 for 2010 and 2011.	The limits expanded in 2012 to $125,000 and $500,000, indexed for inflation. Reverts to prior levels in 2013 ($25,000/$200,000).

	IRC as of May 1, 2010	North Carolina's current tax law *references the IRC as of May 1, 2010*	Small Business Jobs act of 2010 *Enacted September 27, 2010*	Tax Relief and Job Creation Act of 2010 *Enacted December 17, 2010*
50% of the gain realized on qualified small business stock *may be excluded from income. To qualify, the stock must be purchased at its original issue and the aggregate gross assets of the issuing corporation may not exceed $50 million and at least 80% of the value of its assets must be used in the active conduct of one or more trades or business. The exclusion is capped at the greater of 10 times the taxpayer's basis in the stock or $10 million.*	Exclusion increased from 50% to 75% for stock acquired after February 17, 2009, and before January 1, 2011, and held for more than 5 years.	Conforms *with 75% exclusion*	Exclusion increased to 100% for stock acquired after September 27, 2010, and before January 1, 2011.	
Up to $5,000 of start-up expenses may be deducted*. The deduction is reduced by the amount of start-up costs that exceed $50,000.*	The deduction limit is $5,000 and the phase-out threshold is $50,000.	Conforms. Deduction limit of $5,000 and a phase-out threshold of $50,000	Increases the deduction limit to $10,000 and the phase-out threshold to $60,000.	

	IRC as of May 1, 2010	North Carolina's current tax law *references the IRC as of May 1, 2010*	Small Business Jobs act of 2010 *Enacted September 27, 2010*	Tax Relief and Job Creation Act of 2010 *Enacted December 17, 2010*
Other provisions of the Small Business Jobs Act of 2010: • Deduction for health insurance costs • 457 plans • 401(k) rollovers to Roth accounts • Annuitization of a nonqualified annuity contract • Source rules for income on guarantees	N/A		These items generated a minimum amount of revenues.	
Various business tax extenders: • Longer recovery periods • Charitable incentive deductions	Incentives expired for tax year 2010.	Conforms. Incentives expired at the end of 2009.		Extends business incentives for two more taxable years: 2010 and 2011.
Various tax credits: • WOTC • EITC • Adoption	Enhancements set to expire for the 2011 tax year.	Conforms. Enhancements set to expire for the 2011 tax year.		Enhancements extended for two more tax years: 2011 and 2012.

	IRC as of May 1, 2010	North Carolina's current tax law *references the IRC as of May 1, 2010*	Small Business Jobs act of 2010 *Enacted September 27, 2010*	Tax Relief and Job Creation Act of 2010 *Enacted December 17, 2010*
Various individual tax extenders: • Full repeal of phase-out of itemized deductions • Deductibility of mortgage insurance premiums • Educational assistance exclusion • Student loan interest deduction • Coverdale education savings accounts • Exclusion of qualified scholarships • Deduction for higher education tuition • Expense deduction for teacher's classroom supplies • Charitable contribution of IRA proceeds	Incentives and enhancements expired for the 2010 taxable year and others set to expire for the 2011 taxable year.	Conforms. Incentives and enhancements expired or will expire in 2011.		Incentives and enhancements extended two more taxable years, through either 2011 or 2012.

	IRC as of May 1, 2010	North Carolina's current tax law *references the IRC as of May 1, 2010*	Small Business Jobs act of 2010 *Enacted September 27, 2010*	Tax Relief and Job Creation Act of 2010 *Enacted December 17, 2010*
Estate tax *gradually reduced over a period of years and then abolished for decedents dying in 2010. EGTRRA repealed the state estate tax credit for decedents dying after 2004 and replaced it with a deduction.*	Scheduled to revert to pre-EGTRRA estate tax maximum tax rate of 55% and a $1 million applicable exclusion amount. The state estate tax credit, as it existed in 2001, is revived for decedents dying after 2010.	Conforms. NC does not have an estate tax for decedents dying in 2010 and the basis of the property passing through an estate of a decedent dying in 2010 is the modified carryover basis rules under EGTRRA. Beginning in 2011, the state estate tax is equal to the state estate tax credit as it existed in 2001 and the exclusion amount is $1 million		Revives the estate tax at significantly higher applicable exclusion amount and lower tax rate than had been scheduled under EGTRRA: the maximum estate tax rate is 35% with an applicable exclusion amount of $5 million. Gives estates of decedents dying in 2010 the option to (1) pay the estate tax based on the new 35% rate and $5 million exclusion, with stepped-up basis, or (2) no estate tax and modified carryover basis. Extends the state estate tax deduction. These provisions scheduled to sunset on December 31, 2012. Unless modified or extended, the estate tax law will revert to pre-EGTRRA rates and exclusion amounts.

APPENDIX E

MEMORANDUMS

1) Office of the State Controller, January 25, 1991

2) Office of the State Controller, March 5, 1991

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APPENDIX F

DRAFT LEGISLATION
NO DELAY OF TAX REFUNDS
2011-RBxz-2

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GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2011

U **D**

BILL DRAFT 2011-RBz-2 [v.1] (11/29)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
11/30/2010 2:39:19 PM

Short Title: No Delay of Tax Refunds. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO PROHIBIT DELAY IN THE PAYMENT OF TAX REFUNDS.

Whereas, in both 2009 and 2010 the Governor delayed the payment of tax refunds owed to the taxpayers of this State; and

Whereas, interest does not begin to accrue on an individual income tax refund unless the State pays the refund after May 30; and

Whereas, delaying the payment of tax refunds due North Carolina's taxpayers forces the taxpayers to make involuntary short-term interest-free loans to the State; and

Whereas, tax refunds should not be considered assets of the State but should instead be considered funds held in trust; and

Whereas, the State Constitution and the General Statutes give the Governor the tools needed to avoid a deficit in an economic downturn; and

Whereas, these tools do not include the delay of tax refunds because tax refunds are not "expenditures" that are subject to reduction or management by the Governor; and

Whereas, the cost of short-term financing by the State is less than the interest the State must pay on delayed tax refunds; and

Whereas, delaying the payment of tax refunds due North Carolina's taxpayers shifts the stress of an economic downturn from the State's budget to the State's taxpayers; and

Whereas, the law requires a taxpayer to pay taxes owed by the due date, regardless of the cash position of the taxpayer on the due date; and

Whereas, taxpayers have a right to expect prompt payment of their refunds; Now, therefore,

The General Assembly of North Carolina enacts:

SECTION 1. Article 9 of Chapter 105 of the General Statutes is amended by adding a new section to read:

"**§ 105-258.3. Taxpayer refunds.**

An overpayment of tax belongs to the taxpayer who made the overpayment and is not an expenditure that is subject to management by the Director of the Budget. When the Department approves a refund for payment and submits a requisition to the State Controller for the funds needed to make the refund, the State Controller may not withhold approval of the requisition."

SECTION 2. G.S. 143C-6-2(b) reads as rewritten:

"(b) Revenue Collections. – The Director, with the assistance of the Secretary of Revenue and other officials collecting or receiving appropriated State revenue, shall continuously survey the revenue collections. If the Director finds that revenues to any fund, when added to the beginning unreserved fund balance in that fund, will be insufficient to support appropriations from that fund, the Director shall immediately notify the General Assembly that a deficit is anticipated. The Director shall consult with the Chief Justice to identify expenditure reductions and other lawful measures the Chief Justice and Judicial Branch can implement to reduce expenditures. The Director shall report in a timely manner to the General Assembly a plan containing the expenditure reductions and other lawful measures as the Director is implementing in order to avert the deficit. This section does not authorize the Director to delay the payment of tax refunds in violation of G.S. 105-258.3."

SECTION 3. This act is effective when it becomes law.

APPENDIX G

LETTER
CO-CHAIRS TO SECRETARY OF REVENUE
DECEMBER 21, 2010

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REVENUE LAWS STUDY COMMITTEE
State Legislative Building
Raleigh, North Carolina 27603

Senator Daniel Clodfelter, Cochair ***Representative Paul Luebke, Cochair***

December 21, 2010

Mr. David Hoyle, Secretary
Department of Revenue
PO Box 25000
Raleigh, NC 27640

Dear David,

This is a request for a written explanation of the legal basis on which the Department is relying to hold taxpayer refunds. We make this request as a result of your presentation to the Revenue Laws Study Committee. You informed the Committee that the Department obtained an oral legal opinion from the Attorney General's Office that supports the Department's actions on this subject and that the Department cannot issue the refunds without a law change.

Without the benefit of the legal opinion, we do not understand why or how the law needs to be changed. We also do not understand how the Department's new policy is compatible with a long line of North Carolina cases that establish that, for statute of limitations purposes, discovery occurs when a party is on notice and could, in the exercise of reasonable diligence, make actual discovery. When the automated processing of a return identifies an overpayment, the Department is on notice of the potential refund.

The Revenue Laws Committee's next meeting is January 5, 2011. We ask that you provide the written explanation by January 3 so that we have time to review it before the meeting. Please send a copy electronically to Ms. Trina Griffin, Committee Counsel, as well.

Sincerely,

Rep. Paul Luebke, Co-Chair

Sen. Dan Clodfelter, Co-Chair

APPENDIX H

DRAFT LEGISLATION
UPDATE CORPORATE APPORTIONMENT FORMULA
2011-RBxz-4

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GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2011

U **D**

BILL DRAFT 2011-RBxz-4 [v.5] (01/04)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
1/29/2011 11:07:20 AM

Short Title:	Update Corporate Tax Apportionment Formula.	(Public)
Sponsors:	.	
Referred to:		

A BILL TO BE ENTITLED

AN ACT TO ADJUST THE APPORTIONMENT FORMULA SALES FACTOR FOR TELECOMMUNICATIONS SERVICE PROVIDERS, BROADCASTERS, AND PUBLISHERS AND TO UPDATE THE APPORTIONMENT FORMULA PROPERTY FACTOR FOR ALL CORPORATIONS BY EXCLUDING OUTER-JURISDICTIONAL PROPERTY FROM THAT FACTOR.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-130.4 reads as rewritten:

"**§ 105-130.4. Allocation and apportionment of income for corporations.**

(a) As used in this section, unless the context otherwise requires:

(1) "Apportionable income" means all income that is apportionable under the United States Constitution.

(1b) "Broadcast programming" means video programming as defined in G.S. 105-164.3 or audio programming. Each episode of a series is considered a separate broadcast.

(2) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(3) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(4) "Excluded corporation" means any corporation engaged in business as a building or construction contractor, a securities dealer, or a loan company or a corporation that receives more than fifty percent (50%) of its ordinary gross income from intangible property.

(4c) "General formula" means a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four. If the sales factor does not exist, the denominator of the fraction is the number of existing factors. If the sales factor exists but the payroll factor or the property factor does not exist, the denominator of the fraction is the number of existing factors plus one.

(5) "Nonapportionable income" means all income other than apportionable income.

(5b) 'Outer-jurisdictional property' means tangible personal property that is not physically located in any state. The term includes orbiting satellites and undersea transmission cables.

(6) "Public utility" means any corporation that is subject to control of one or more of the following entities: the North Carolina Utilities Commission, the Federal Communications Commission, the Interstate Commerce Commission, the Federal Energy Regulatory Commission, or the Federal Aviation Agency; and that owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, the transportation of goods or persons, or the production, storage, transmission, sale, delivery or furnishing of electricity, water, steam, oil, oil products, or gas. The term also includes a motor carrier of property whose principal business activity is transporting property by motor vehicle for hire over the public highways of this State. The term does not include a corporation engaged in the business of broadcasting.

(7) "Sales" means all gross receipts of the corporation except for the following receipts:

a. Receipts from a casual sale of property.

b. Receipts allocated under subsections (c) through (h) of this section.

c. Receipts exempt from taxation.

d. The portion of receipts realized from the sale or maturity of securities or other obligations that represents a return of principal.

(8) "Casual sale of property" means the sale of any property which was not purchased, produced or acquired primarily for sale in the corporation's regular trade or business.

(9) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

…

(i) All apportionable income of ~~corporations other than public utilities, excluded corporations, and qualified capital intensive corporations shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four. If the sales factor does not exist, the denominator of the fraction is the number of existing factors and if the sales factor exists but the payroll factor or the property factor does not exist, the denominator of the fraction is the number of existing factors plus one.~~ corporations, other than those corporations that are required to apportion income under one of the special formulas provided in subsections (m) through (s3) of this section, is apportioned to this State by multiplying the income by the general factor.

(j) (1) The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned or rented and used in this State during the income year and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used during the income year. Neither the numerator nor the denominator includes outer-jurisdictional property.

(2) Property owned by the corporation is valued at its original cost. Property rented by the corporation is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the corporation less any annual rental rate received by the corporation from subrentals except that subrentals shall not be deducted when they constitute apportionable income. Any property under construction and any property the income from which constitutes nonapportionable income shall be excluded in the computation of the property factor.

(3) The average value of property shall be determined by averaging the values at the beginning and end of the income year, but in all cases the Secretary of Revenue may require the averaging of monthly or other periodic values during the income year if reasonably required to reflect properly the average value of the corporation's property. A corporation that ceases its operations in this State before the end of its income year because of its intention to dissolve or to relinquish its certificate of authority, or because of a merger, conversion, or consolidation, or for any other reason whatsoever shall use the real estate and tangible personal property values as of the first day of the income year and the last day of its operations in this State in determining the average value of property, but the Secretary may require averaging of monthly or other periodic values during the income year if reasonably required to reflect properly the average value of the corporation's property.

…

(n) All apportionable income of a ~~telephone company shall be apportioned to this State~~ telecommunications service provider is apportioned by multiplying the income by ~~a fraction, the numerator of which is 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 the company plus the gross operating revenue in North Carolina from other service less the uncollectible revenue in this State, and the denominator of which is the total gross operating revenue from all business done by the company everywhere less total uncollectible revenue. Provided, that where a telephone company is required to keep its records in accordance with the standard classification of accounts prescribed by the Federal Communications Commission the amounts in such accounts shall be used in computing the apportionment fraction as provided in this~~

~~subsection.~~the general formula, after modifying the numerator and denominator of the sales factor in accordance with this subsection. The numerator includes gross receipts derived from providing telecommunications service or ancillary service that is sourced to this State under G.S. 105-164.4C and a portion of the gross receipts derived from sales of telecommunications service to other telecommunications service providers for resale. The portion of the gross receipts derived from sales of service to other providers for resale is determined by multiplying the total gross receipts derived from sales of service to other providers for resale by a fraction, the numerator of which is the provider's total carrier service revenues for this State and the denominator of which is the sum of the provider's total carrier service revenues, as reported by the Federal Communications Commission for the most recent year for which data is available. The denominator does not include gross receipts from the sale of telecommunications service that is not taxable in the state to which it would be apportioned under this subsection. The definitions in G.S. 105-164.3 and G.S. 105-164.4C apply in this subsection.

…

(s2) All apportionable income of a corporation engaged in the business of broadcast programming is apportioned by multiplying the income by the general formula, after modifying the numerator of the sales factor in accordance with this subsection. The numerator includes all receipts from broadcast programming multiplied by an audience factor. The audience factor is the ratio of the corporation's North Carolina listening or viewing audience to the corporation's total listening or viewing audience. A corporation may use published rating or subscription statistics, as appropriate, to determine its audience factor.

(s3) All apportionable income of a corporation engaged in the business of publishing, selling, licensing, or distributing a book, a magazine, a newspaper, a newsletter, a report, or another publication is apportioned by multiplying the income by the general formula, after modifying the numerator of the sales factor in accordance with this subsection. The numerator includes all of the corporation's receipts from advertising and from the sale, rental, or other use of its customer lists multiplied by a circulation factor. The circulation factor is the ratio of the corporation's North Carolina purchasers and subscribers of a publication to the corporation's total purchasers and subscribers of the publication. A purchaser or subscriber of a publication is the final recipient of the publication. A separate circulation factor applies to each publication. If advertising in a publication is included only in copies of the publication distributed to a limited geographic area, the circulation factor is determined on the basis of the circulation within the limited geographic area. A corporation may use rating statistics published by the Audit Bureau of Circulations or other comparable statistics to determine the circulation factor for a publication.

…."

SECTION 2. This act is effective for taxable years beginning on or after January 1, 2011.