GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2007

Legislative Fiscal Note

BILL NUMBER: Senate Bill 1755 (Third Edition)

SHORT TITLE: Various Tax Law Changes.

SPONSOR(S): Senator Hoyle

	Yes (x)	No ( )	No Estimate Available ( )		
	FY 2008-09	FY 2009-10	FY 2010-11	FY 2011-12	FY 2012-13
REVENUES ($ millions):					
R & D Tax Credit	**(1.0)**	**(2.1)**	**(2.3)**	**(2.5)**	**(2.6)**
Low-Income Housing	**-**	**-**	**-**	**(22.1)**	**(45.2)**
Mill Rehabilitation	**-**	**-**	**(1.5)**	**(3.4)**	**(4.2)**
Ports Tax Credit	**(1.0)**	**(2.0)**	**(2.0)**	**(2.0)**	**(2.0)**
IRC Update	**-**	**(1.2)**	**(0.8)**	**4.3**	**4.0**
Franchise Tax Changes	**** No impact - See Assumptions and Methodology****				
Publicly Traded Partnerships	**** No impact - See Assumptions and Methodology****				
QBV Tax Credit	**-**	**(1.0)**	**(1.0)**	**-**	**-**
EXPENDITURES:					
POSITIONS (cumulative):					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Department of Revenue

EFFECTIVE DATE: See Bill Summary for explanation.

BILL SUMMARY:
The Proposed Committee Substitute for House Bill 1755 makes the following tax law changes:

Extend Credit for Research & Development*:* Section 1 would extend the tax credit for R&D through taxable years beginning on or after January 1, 2014. The credit is currently scheduled to expire for taxable years beginning on or after January 1, 2009. A taxpayer that has qualified North Carolina research expenses or North Carolina University research expenses is allowed a tax credit. For North Carolina university research expenses, the credit amount is equal to 20% of the amount the taxpayer paid to the university for the research and development. For all other qualified research expenses, the credit is equal to a percentage of the expenses as follows:

- For small businesses[1], the rate is 3.25%.
- For research and development conducted in a development tier one area, the rate is 3.25%.
- For other research and development expenditures, the rate ranges from 1.25% to 3.25% as the amount of those expenditures increases.

This section would become effective when it becomes law.

Extend Low-Income Housing Credit*:* Section 2 would extend the low-income housing tax credit through taxable years beginning on or after January 1, 2015. The credit is currently scheduled to expire for taxable years beginning on or after January 1, 2010. [2] North Carolina has a low-income housing tax credit modeled after the federal housing credit. A taxpayer may elect to receive the credit in the form of either a credit against tax liability or a loan generated by transferring the credit to the Housing Finance Authority in return for a 0% interest 30-year balloon loan equal to the credit amount. Historically, project developers have almost always elected the loan option. Neither a tax refund generated by the credit nor a loan received as a result of the transfer of the credit is considered taxable income by the State. Although a State tax refund would be considered taxable income by the IRS if the taxpayer itemizes deductions, a private letter ruling from the IRS provides that the loan proceeds would not.

This section would become effective when it becomes law.

Extend Mill Rehabilitation Tax Credit: Section 3 would extend the mill rehabilitation tax credit to include rehabilitation projects for which an application for an eligibility certification is submitted on or after January 1, 2011. Under current law, the credit sunsets for rehabilitation expenditures incurred on or after January 1, 2011. The provision would also make clarifying and stylistic changes to the statute. North Carolina allows a tax credit for rehabilitating vacant historic manufacturing sites if the taxpayer spends at least $3 million to rehabilitate the site. The credit is a percentage of the qualified rehabilitation expenditures and the percentage varies depending on the enterprise tier location of the site and the eligibility for the federal credit. The credit may be claimed against the franchise tax, the income tax, or the gross premiums tax, but may be taken against only one of these taxes. If the credit is taken for income-producing property, it may be taken in the year the property is placed in service. If the credit is taken for non-income-producing property, the credit must be taken in five equal installments beginning with the taxable year in

[1] A small business is a business whose annual receipts, combined with the annual receipts of all related persons, does not exceed $1,000,000.
[2] Developers of low-income housing begin their work months in advance and need to know what financing will be available as they secure options on sites.

which the property is placed in service. The credit may not exceed the amount of the tax against which the credit is claimed for the taxable year reduced by the sum of all credits allowed, except payment of tax made by the taxpayer. This credit may be taken in place of the credit for historic rehabilitation, not in addition to it.

Eligibility. – To qualify for the credit, the site must satisfy all of the following conditions:

- The site was used as a manufacturing facility or for purposes ancillary to manufacturing, as a warehouse for selling agricultural products, or as a public or private utility.
- The site is a certified historic structure or a State-certified historic structure.
- The site has been at least 80% vacant for a period of at least two years immediately preceding the date the eligibility certification is made.

Amount. – The amount of the credit depends upon the development tier in which the site is located and the eligibility of the site for a federal credit as follows:

- Development tier one or two area – 40% of qualified rehabilitation expenditures or rehabilitation expenses, regardless of whether the taxpayer is allowed a federal credit.
- Development tier three area – 30% of qualified rehabilitation expenditures and the taxpayer is allowed a federal credit. No credit is allowed if the site is located in a development tier three and the taxpayer is not allowed a federal credit.

Cap. – The credit may not exceed the amount of the tax against which it is claimed for the taxable year reduced by the sum of all credits allowed, except payment of tax made by or on behalf of the taxpayer. Any unused portion of the credit may be carried forward for the succeeding nine years.

Allocation. – A pass-through entity may allocate the credit among any of its owners without limitation as long as the owner's adjusted basis in the pass-through entity is at least 40% of the amount of credit allocated to the owner.[3] An owner of a pass–through entity that qualifies for the credit will forfeit a portion of any credit the owner has received if both of the following conditions are met:

- The owner disposed of the interest within five years from the date the eligible site is placed into service.
- The owner's interest in the pass-through entity is reduced to less than two-thirds of the owner's interest in the pass-through entity at the time the eligible site was placed into service.

Forfeiture. – The forfeiture of an owner's interest is not required if the change in ownership is the result of the owner's death or the merger, consolidation, or similar transaction requiring approval by the shareholders, partners, or members of the entity, to the extent the entity does not receive cash or tangible property in the transaction. A taxpayer or owner of a pass-through entity that forfeits a credit is liable for all past taxes avoided as a result of the credit plus interest computed from the date the taxes would have been due if the credit had not been allowed.

Extend Sunset for State Ports Tax Credit *(SB 1723 & 1731)*: Section 4 would extend the State ports tax credit through taxable years beginning on or after January 1, 2014. The credit is currently

[3] A pass-through entity may also allocate the credit for rehabilitating an historic structure among its owners in the same manner as provided in this provision.

scheduled to expire for taxable years beginning on or after January 1, 2009. The General Assembly enacted the State Ports tax credit in 1992 to encourage exporters to use the two State-owned port terminals in Wilmington and Morehead City. The credit is allowed to a taxpayer who loads or unloads waterborne cargo from an ocean carrier at the State-owned port terminal at Wilmington or Morehead City. The amount of the tax credit is equal to the amount of wharfage, handling, and throughput charges paid to the North Carolina State Ports. The credit is limited to 50% of the tax imposed on the taxpayer for the taxable year. The maximum cumulative credit that one taxpayer may claim is $2 million.

This section would become effective when it becomes law.

IRC Update (SB 1939): Section 5 would update from January 1, 2007, to May 1, 2008, the reference to the Internal Revenue Code used in defining and determining certain State tax provisions. By doing so, North Carolina would conform to changes made by three federal acts, except that the bill would delay the impact of the bonus depreciation provision authorized by the Economic Stimulus Act. The bill would become effective for taxable years beginning on or after January 1, 2008.

The proposal would change the reference date to May 1, 2008. By changing the reference date to May 1, 2008, the bill effectively incorporates into our State tax laws changes made by three federal acts, with one exception. The Economic Stimulus Act of 2008 (ESA) has three major components, only two of which impact State revenues: the 50% bonus depreciation provision and the increased expensing limit. The bill conforms to the increased expensing limit but delays the impact of the bonus depreciation provision. Additional detail on the nonconforming provision is provided below. The three federal acts are as follows:

- Economic Stimulus Act of 2008
- Mortgage Forgiveness Debt Relief Act of 2007
- Small Business and Work Opportunity Tax Act of 2007

Economic Stimulus Act of 2008

Enacted on February 13, 2008, the Economic Stimulus Act of 2008 (P.L. 110-185) is a $152 billion package designed to stimulate the economy through rebates for individual taxpayers and incentives for businesses. The rebates, which are technically "advance credit payments," do not impact State revenues and are not discussed in this analysis. The three business incentives are the 50% bonus depreciation provision for qualifying property placed in service in 2008, the increased limits for section 179 expensing of qualified property in 2008, and increased depreciation limits for "luxury" autos predominantly used for business.

50% Bonus Depreciation Provision. – Depreciation is an income tax deduction that allows a taxpayer to recover the cost or other basis of certain property over several years. It is an annual allowance for the wear and tear, deterioration, or obsolescence of the property. Bonus depreciation allows a business to claim more of a deduction up front and spread the remainder out over the normal depreciation schedule. In other words, a taxpayer will recover the basis in the asset sooner than under prior law. However, over the life of the asset the taxpayer still receives the same benefit. Congress has used 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%.

Under the ESA, a taxpayer is entitled to depreciate in the first year 50% of the adjusted basis of certain qualified property placed in service during the 2008 calendar year.[4] To be eligible to claim bonus depreciation, property must be (1) eligible for the modified accelerated cost recovery system (MACRS) with a depreciation of 20 years or less; (2) water utility property; (3) off-the-shelf computer software; or (4) qualified leasehold property. Bonus depreciation is available for every item of tangible personal property, except inventory, property used outside the U.S., and property depreciated under the alternative depreciation system. Other than the computer software mentioned, it is not available for intangibles. If property is sold in the same year it is placed in service, no bonus depreciation is allowed.

The bill does not conform State law to the accelerated depreciation schedule allowed under the ESA. Over the life of an asset placed in service during 2008, taxpayers will be able to deduct the same amount of the asset's basis under both federal and State law; it is just that the timing of the deduction will differ. To accomplish this "decoupling" from the federal accelerated depreciation provision, the bill does two things:

- The taxpayer must add back to federal taxable income 85% of the accelerated depreciation amount (50%) in the year the accelerated depreciation is claimed for federal purposes. The add-back means that for State tax purposes, a taxpayer would deduct less in that tax year than the taxpayer would have deducted if the State conformed to the accelerated depreciation law.
- In tax years beginning on or after January 1, 2009, the taxpayer may deduct from federal taxable income the total amount of the add-back required for either the 2007 or 2008 tax year, divided into five equal installments. This means that for State tax purposes, a taxpayer would be allowed to deduct a greater depreciation amount in the outlying tax years – the normal depreciation amount plus 20% of the accelerated depreciation amount the taxpayer had to add back. The purpose of this recovery provision is to enable the taxpayer to have the same basis in assets for federal and State purposes. Without this deduction provision, a taxpayer would have a different basis in the depreciable asset for State and federal purposes and would have to keep separate books and records for State and federal purposes until the disposal of the asset. In effect, the add-back and subsequent deduction will affect the timing of the impact of bonus depreciation on the State but it will not increase or decrease the total amount of revenue the State receives over the affected years.

Increased Section 179 Expensing Limits - In general, a qualifying taxpayer may elect to treat the cost of certain property as an expense and deduct it in the year the property is placed in service instead of depreciating it over several years. This property is frequently referred to as section 179 property, after the relevant section in the Internal Revenue Code. To be eligible, the property must be tangible personal property which is actively used in the taxpayer's business for which a depreciation deduction would be allowed. The property must be used more than 50% for business and must be newly purchased property. Generally, taxpayers take expensing first and claim section 168(k) depreciation on any remaining basis.

Last year, Congress increased the annual expensing limitation to $125,000 with a phase-out beginning at $500,000. Both of these limitations are indexed for inflation. Thus, prior to the ESA,

[4] The placed-in-service date is extended one year, through December 31, 2009, for property with a recovery period of 10 years or longer, for transportation property, and for certain aircraft.

the deduction was limited to $128,000 of the cost of the property with a phase-out at $510,000 for 2008. Because the deduction is completely phased out for qualifying purchases exceeding $638,000, the deduction is confined generally to the relatively small business.

The new law temporarily doubles the limitation to $250,000.[5] The threshold for reducing the deduction is also increased to $800,000 with a complete phase-out once qualifying purchases exceed $1.05 million. These limitations apply only to property purchased and placed in service in tax years beginning in 2008. The limitations will return to the lower levels for tax years beginning in 2009.

Increased Depreciation Limits for "Luxury" Autos. – Since the new law permits taxpayers to claim bonus depreciation, it also increases section 280F depreciation limits on luxury vehicles.[6] A luxury vehicle is one that costs more than the "luxury auto price floor," which is adjusted annually for inflation along with the depreciation limits. The first-year limit on depreciation for passenger vehicles placed in service in 2008 is projected to be $2,960 for automobiles and $3,160 for vans and trucks. The new law raises the cap by $8,000 for a maximum first-year depreciation of $10,960 for autos and $11,160 for vans and trucks.

Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142)

Enacted on December 20, 2007, the Mortgage Forgiveness Debt Relief Act was Congress's response to the problems generated by the subprime crisis, short sales, and rising foreclosure rates.

Income Exclusion for Discharged Indebtedness on Principal Residence. - When a lender forecloses on property, sells the home for less than the borrower's outstanding mortgage and forgives all or part of the unpaid mortgage debt, the canceled debt is considered income under the Code.

This act provides an exclusion from income for this discharged indebtedness related to a principal residence for the three-year period beginning January 1, 2007 and ending December 31, 2009. There is no income limitation but no more than $2 million in mortgage debt is eligible for exclusion.

Extension of Deduction for Mortgage Insurance Premiums. - The act temporarily extends for three years, through tax year 2010, the deduction for qualified mortgage insurance premiums. Qualified mortgage insurance is mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, the Rural Housing Administration, or private mortgage insurance.

Surviving Spouse Home Sale Exclusion. **–** The new law extends the period of time during which a surviving spouse may use the joint return filers' $500,000 home sale gain exclusion before being treated as a single individual, who is entitled only to a $250,000. Previously, a surviving spouse was entitled to the $500,000 exclusion only to the extent he or she could file a joint return with the deceased spouse's estate, which only occurs for the tax year in which the spouse dies. Starting January 1, 2008, the sale of a residence that had been jointly owned and occupied by the surviving

[5] The new law does not alter the section 179 limitation imposed on sport utility vehicles, which have an expense limit of $25,000.
[6] These limits were increased when bonus depreciation was previously available.

and deceased spouse is entitled to the $500,000 gain exclusion provided the sale occurs no later than two years after the date of death of the individual spouse.

Income Exclusion for Volunteer Emergency Responders. - The act also allows volunteer emergency responders to exclude from income state and local tax benefits of up to $360 for tax years beginning after December 31, 2007. The benefit expires in 2010. Last year, the General Assembly established a $250 income tax deduction for certain volunteer emergency responders who attend at least 36 hours of annual training.

Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28)

Enacted on May 25, 2007, the Small Business and Work Opportunity Act of 2007 (SBWOA) was part of the larger U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007. It includes nearly $5 billion in tax incentives primarily for small businesses to help businesses absorb the cost of complying with the increase in the federal minimum wage as well as a package of S corporation reforms. It includes the following provisions:

Increased Small Business Expensing Limit – The dollar and investment limitations for expensing were increased retroactively to January 1, 2007, and were extended through 2010. The prior base limit of $100,000 was increased to $125,000 and the investment limitation was increased from $450,000 to $500,000 for tax years beginning in 2007. Both limits are indexed for inflation. However, this provision is effectively superseded by the newly increased expensing provision in the ESA.

Extension of Work Opportunity Tax Credit – Created in 1996 by the Small Business Job Protection Act, this tax credit is designed to encourage employers to hire individuals from economically-challenged populations. There are nine "target" groups, including public assistance recipients, ex-felons, veterans, high-risk youth, individuals who reside in certain economically depressed areas, and individuals referred to the employer as part of a vocational rehabilitation plan. The amount of the credit is a percentage of qualified wages paid during each of the first two years of employment. Prior to this act, the credit was scheduled to expire for employees hired after December 31, 2007.

This act extends the sunset for three and a half years, until August 31, 2011, and expands the scope of the credit. It expands the targeted veterans' population to include veterans with service-connected disabilities who have been unemployed for six months or more during a one-year period ending on the hire date and are hired within one year after having been discharged form the military or released from active duty. It also increases from $6,000 to $12,000 in the case of individuals who qualify under the newly expanded veterans' group. The high-risk youth and vocational rehabilitation referral groups are also expanded.

Family Business Tax Simplification - Effective for tax years beginning on and after December 31, 2006, the act allows a married couple who jointly operates an unincorporated business and who files a joint return to elect not to be treated as a partnership for federal tax purposes.

Katrina Recovery Tax Incentives. – The act also extends and enhances some of the tax incentives in the Gulf Opportunity Zone Act of 2005 and Katrina Emergency Tax Relief Act of 2005. These include the extension of special expensing for qualified property, an enhanced low-income housing credit, and flexible tax-exempt bond financing rules.

S Corporation Changes – Generally speaking, these provisions are designed to make it easier for small business to retain S corp status. They also encourage use of the S corp business entity by effectively reducing the taxes owed by shareholders.

1. Passive investment income. – An S corporation that has accumulated C corporation earnings and profits and has gross receipts of which more than 25% are passive investment income may lose its Subchapter S status and will be subject to a tax on the excess passive investment income. Effective for tax years beginning after May 25, 2007, capital gain from the sale or exchange of stock or securities is no longer treated as an item of passive investment income. These gains are still counted as gross receipts but not as passive investment income.
2. Banks as S corps. - Effective for tax years beginning after December 31, 2006, the new law eliminates the treatment of restricted bank director stock as outstanding stock that threatened S corp status under the single-class-of-stock rule. It also alters the treatment of accounting adjustments caused by a bank changing its method of accounting.
3. Partial sale of QSubs. – A qualified Subchapter S subsidiary (QSub) is a wholly owned subsidiary that an S corp elects to treat as a QSub. Under the new law, a sale of QSub stock that terminates the QSub election and creates a deemed new corporation is now treated as a sale of an undivided interest in the assets of the QSub. This treatment eliminates the danger of an avalanche of gain being recognized by a sale of only a partial, but substantial (i.e. more than 20%), interest in the subsidiary.
4. ESBT interest. – Effective for tax years beginning after December 31, 2006, the new law allows an electing small business trust (ESBT) to deduct interest paid on money borrowed to acquire S corporation stock. Although Treasury regulations allocated the interest to the S corporation portion of the ESBT, they did not allow a deduction.
5. E&P reduction. – Effective for tax years beginning after May 15, 2007, the new law allows a corporation that was an S corp before 1983, but was not an S corp for its first tax year that began after December 31, 1996, to eliminate its pre-1983 earnings and profits from the corporations accumulated E&P balance. This benefit had previously been available only to a corporation that was an S corp for its first taxable year after 1996. The result is that S corps to which this new provision applies may be able to reduce the amount of distributions treated as taxable dividends.

Close Franchise Tax Loopholes *(HB 2508)*: Section 6 would provide that limited liability companies (LLC) that elect to be taxed as S corporations are subject to the franchise tax in the same manner as other S corporations. In 2006, the General Assembly amended the definition of 'corporation', as it applies to the franchise tax statutes, to include a LLC that elects to be taxed as a C corporation for federal income tax purposes. The Department of Revenue began to receive questions from S corporations as to whether they could convert to an LLC and elect to be treated as S corporations for income tax purposes, thereby becoming exempt from franchise tax. In 2005, S corporations paid more than $50 million in franchise tax. This section of the bill would provide that an LLC that elects to be treated as a corporation for income tax purposes, either a C corporation or a S corporation, is also considered a corporation for franchise tax purposes.

This section would also provide that captive REITS are subject to the franchise tax in the same manner as a corporation. In 2007, the General Assembly limited a corporation's ability to use captive real estate investment trusts (REITs) to avoid State taxes by disallowing the dividend paid deduction when a REIT is a captive REIT. The effect of this change is that a captive REIT is treated as a regular corporation for income tax purposes. A REIT is an organization that uses the pooled capital of many investors to purchase and mange real estate. [7] A REIT that is owned or controlled by a single entity is commonly referred to as a captive REIT.[8] This section of the bill would provide that a captive REIT is also treated as a regular corporation for franchise tax purposes.

This section would become effective for taxable years beginning on or after January 1, 2009.

Publicly Traded Partnership ***(HB 2508):*** Section 7 would change the reporting and payment requirements that apply to a PTP that is described in section 7704(c) of the Internal Revenue Code. It would require a qualifying PTP to report annually to the Department the partners in the PTP who received more than $500 of income rather than report the income received by every partner. It would also exempt qualifying PTPs from the requirement to pay tax on the partnership income received by a nonresident. In making these changes, the provision seeks to strike a balance between the costs and burden of compliance with the reporting requirements for both the PTPs and the Department and the benefits gained by compliance. The provision is substantially the same as the model legislation recommended by the Multi-State Tax Commission. A PTP is a limited partnership the interests in which are traded on stock exchanges such as the New York, American, and NASDAQ exchanges. Unlike a traditional partnership, a PTP has tens of thousands, and sometimes hundreds of thousands, of unitholders.[9] A PTP's unitholders can change daily in trades on public exchanges. There are approximately 90 PTPs in the country that meet the description in section 7704(c) of the Code, and 10 of these PTPS are located in North Carolina.[10]

This section would become effective for taxable years beginning on or after January 1, 2008.

Qualified Business Venture Tax Credit: The proposed committee substitute increases the cap on the Qualified Business Venture (QBV) tax credit from $7 million to $8 million. The tax credit is set to sunset on January 1, 2011. The QBV tax credit provides a 25% credit against personal income tax for individual investments in qualifying small businesses. Credits are capped at $50,000 per individual investor per year, and currently is capped at $7 million per year for all investments statewide. To qualify for the credit, businesses must have less than $5 million in revenues annually and be engaged primarily in manufacturing, processing, warehousing, wholesaling, or research and development.

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[7] Under federal and State law, a REIT is taxable only on income that is not distributed to shareholders. The amount of income a REIT distributes is not subject to tax because the REIT is allowed a deduction for the dividends it pays. The amounts received by the shareholders of the REIT are taxable.

[8] Two common types of captive REITs are rental REITs and mortgage REITs.

[9] Many of the units are held in 'street names' by brokerage houses.

[10] The ten PTPs in N.C. are involved in pipelines (1), terminal facilities (2), propane gas (5), and real estate (2). N.C. PTPs include Magellan Midstream Partners, Spectra Energy Partners, AmeriGas, and Ferrell Gas.

ASSUMPTIONS AND METHODOLOGY:

SECTION 1: EXTEND RESEARCH & DEVELOPMENT TAX CREDIT

The methodology used to estimate the fiscal impact of extending the tax credits through 2013 was to examine the level of credits currently taken and estimate future growth based on current trends in the credit combined with a forecast of economy-based growth. Since this credit is relatively new and has seen only modest use since its inception in 2005. It is expected to grow moderately over the next several years... With recent enhancements to the credit and a noticeable increase in credits taken, the credits could reach $2 million for FY 2008-09 and future growth is anticipated at nearly 7 percent per year. Because tax credits are typically taken based on tax years, which do not coincide with the State's fiscal year, FY 2008-09 losses represent a partial year's credits.

SECTION 2: EXTEND LOW-INCOME HOUSING CREDIT

This section of the bill extends the low-income housing credit until January 1, 2015. The credit was set to expire January 1, 2010. The estimated impact of extending this credit is based on historical tax credit data provided by the North Carolina Housing Finance Agency and the Department of Revenue's 2005 and 2007 Tax Expenditure Report. This data indicates that FY 2008-09 revenue losses will be nearly $40 million. Future growth is determined in part by per capita federal allocations, which are based on population growth and inflation as measured by the Consumer Price Index for all urban consumers (CPI-U). The per capita amount of the federal credit is used to estimate the eligible basis and HFA staff have estimated the State tax credit will be 20% of the basis amount with a utilization rate of 96%. The table below shows the calculations for estimating the fiscal impact by first estimating the annual dollar amounts credited.

Award Year	Federal Tax Credit[1]	NC Population	Federal Tax Credit	Basis Amount (8.5%)	Average Credit (96% utilization)	Annual Impact
2008	$2.00	9,356,630	$18,713,260	$220,156,000.000	19.2%	$42,269,952
2009	$2.05	9,547,450	$19,572,273	$230,262,029.412	19.2%	$44,210,310
2010	$2.10	9,742,480	$20,459,208	$240,696,564.706	19.2%	$46,213,740
2011	$2.15	9,937,120	$21,364,808	$251,350,682.353	19.2%	$48,259,331
2012	$2.20	10,133,900	$22,294,580	$262,289,176.471	19.2%	$50,359,522
2013	$2.25	10,336,510	$23,257,148	$273,613,500.000	19.2%	$52,533,792
2014	$2.30	10,543,880	$24,250,924	$285,304,988.235	19.2%	$54,778,558

1. Per capita amount adjusted by the CPI-U as forecast by Moody's economy.com rounded down to the nearest $0.05

This bill extends the state low-income housing tax credit five additional years – tax years 2010 through 2014. However, the tax year impacts shown above must be distributed by fiscal years. This analysis assumes that the project developers take the 30-year no interest loans. This means each tax year's credit amount will be transferred to the HFA in two annual installment payments. For example, the 2010 tax year credit amount will be paid in July 2011 (FY 2011-12) and July

2012 (FY 2012-13). The following chart shows the fiscal year impact of the tax credit program until its sunset date.

Tax Year	FY 2011-12	FY 2012-13	FY 2013-14	FY 2014-15	FY 2015-16
2010	$22,105,155	$22,105,155			
2011		$23,106,870	$23,106,870		
2012			$24,129,666	$24,129,666	
2013				$25,179,761	$25,179,761
2014					$26,266,896
Total	**$22,105,155**	**$45,212,025**	**$47,236,536**	**$49,309,426**	**$51,446,657**

SECTION 3: EXTEND MILL REHABILITATION CREDIT

By extending the sunset for mill rehabilitation projects, which is currently set to expire on January 1, 2011, the State of North Carolina is providing incentives for restoring and reusing large vacant industrial, agricultural, and utilities buildings. There are approximately 200 eligible properties throughout North Carolina. Many of the properties that have already been renovated with this credit are located in urban areas or Tier 3 counties. The current ongoing projects are more evenly spread out among all three tiers. The majority of the future projects are likely to help rehabilitation of properties in lower economic tiers since most of the upper tier projects have already been completed. The national register typically does not add any new properties to the list of historic places due to the fact that historic buildings are defined as being at least 50 years old and "significant".

Since July 1, 2006, there have been eight completed Mill Tax Credit projects in North Carolina and ten additional projects have requested and received preliminary determinations of site eligibility from the State Historic Preservation for the Mill Tax Credit program. All of these projects have an income-producing component. Since the properties are income-producing, the credit is assumed to be taken in the year it is placed in service. Nine of the ten projects proposed or underway anticipate a total rehabilitation cost of $149,477,148 or approximately $16.6 million per project. Beyond the ten projects that are proposed or underway, the North Carolina Department of Cultural Resources State Historic Preservation Office estimates three new mill rehabilitation projects will begin or be completed in the next five years. Based on past projects they believe that the private investment per project in the future will most likely continue to average approximately $17 million per project.

The time it takes for a mill rehabilitation project to secure financing to the time that property is completed can take on anywhere from 3 to 5 years. The State Historic Preservation Office notes that mill projects are complex in nature and have longer construction time horizons in order to complete all phases of the project. There are 10 current projects expected to be completed over the next 4 years (7 in 2008) and 3 future projects, which are expected to be placed in service within the next 10 years. There is existing legislation that allows for a Historic Rehabilitation Tax Credit under Article 3D. G.S. 105-129.35 and 105-129.36 allow 20% credit for income-producing rehabilitation project and 30% for nonincome-producing rehabilitation project. All of these calculations are based upon income-producing properties. The tax year impacts must be

distributed by fiscal years. To do this fiscal year impacts were estimated by assuming 45% of the tax year credit will be taken in the year prior to the tax year the credit is taken. This is because of taxpayer adjustments to their estimated payments, which will be paid in September and December.

Projected Impact of Extending Credit on the General Fund ($ Millions)				
Tax Year	**TY 2011**	**TY 2012**	**TY 2013**	**TY 2014**
Average Project Costs (millions)	$17.0	$17.0	$17.0	$17.0
Number of Projects in Tier 3 Counties (estimated)	0	0	1	0
Amount of Credit for Tier 3 Counties	30%	30%	30%	30%
Total Tier 3 Credits	0	0	$5.1	0
Number of Projects in Tier 1 & 2 Counties	1	1	1	1
Amount of Credit for Tier 1 & 2 Counties	40%	40%	40%	40%
Total Tier 1 & 2 Credits	$6.8	$6.8	$6.8	$6.8
Available Article 3D (20%)	$3.4	$3.4	$6.8	$3.4
Total Net Credits Taken	**$3.4**	**$3.4**	**$5.1**	**$3.4**

SECTION 4: EXTEND NC PORT CREDITS

From FY 1994-95 through FY 2006-07 credits have ranged from $200,000 to $2.2 million. The average over this time period is just under $1 million. Because in any given year the total potential credits taken are close to $2 million (which has occurred on 2 occasions), the fiscal estimate reflects this potential level of credits taken.

Because tax credits are typically taken based on tax years, which do not coincide with the State's fiscal year, FY 2008-09 losses represent a partial year's credits.

SECTION 5: IRC UPDATE

Based on the analysis of the Joint Committee on Taxation (JCT), there are three sections of this bill that would impact the State's General Fund revenues. They are the Sec. 179 expensing increases and the 50% bonus depreciation, which were both part of the Economic Stimulus Act, plus the Mortgage Debt Forgiveness Act. According to JCT analysis, the other sections of the IRC update are expected to have minimal or no impact on the General Fund.

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. The tax year estimates were compared with estimates produced by the Center for Budget and Policy Priorities and were found to be comparable in magnitude.

Once North Carolina's share of the JCT estimates were determined, state tax liability changes were estimated and allocated to the appropriate fiscal year. Then in order to assess the impact of the 85% addback of the bonus depreciation, a series of depreciation schedules were developed. These depreciation simulations were used to determine the impact of the bonus depreciation with the adoption of an 85 percent addback rule and a 5 year carryforward for each fiscal year.

To estimate the impact of the Mortgage Debt Forgiveness Act, similar methodology as described above was used. The share of North Carolina's fiscal impact was calculated with a slight difference. Rather than use tax collection, real estate activity was used as a means to determine the State's share of the JCT estimated revenue changes.

SECTION 6: CORPORATE TAX LAW CHANGES

Sections 6 closes a potential loophole that could impact franchise tax collections. This could occur if an existing corporation (C or S) reorganized itself as a limited liability company and then elected S corporation status for federal tax purposes. This will impact any entities that have been able to take advantage of the loophole and avoid franchise tax liability. It is not possible, however, to calculate the number of companies that have reorganized themselves as a limited liability company to take advantage of this loophole or any companies that were avoided the tax regardless of the intent to avoid franchise tax liability. It is estimated that the impact of this bill is to increase franchise tax collections, however the amount is not anticipated to be significant.

This section also closes a loophole that allows corporations to create captive REITs and shift assets to the REIT that then become exempt from franchise tax. A similar loophole was closed for income tax purposes last year and the Department did not think any significant changes to collections would result. Again, this may affect some taxpayers but the amount is not expected to be significant.

SECTION 7: PUBLICLY TRADED PARTNERSHIP

Section 7 would change the reporting and payment requirements that apply to a Publicly Traded Partnership (PTP) that is described in section 7704(c) of the Internal Revenue Code. It would require a qualifying PTP to report annually to the Department of Revenue the partners in the PTP who received more than $500 of income rather than report the income received by every partner. According to the Department of Revenue this section of the bill will not have a fiscal impact. It may effect who has a tax liability, but not the overall amount of tax liability generated by the PTP.

SECTION 8: QUALIFIED BUSINESS VENTURE TAX CREDIT

Section 8 increases the cap on the QBV tax credit by $1 million each fiscal year. Demand for the credit has fluctuated since its inception, but often has reached or exceeded the cap. In 2006, QBV tax credit claims exceeded the $7 million cap. Demand for the credit is expected to continue to increase and is estimated to be equal to, or greater, than the cap in future tax years. Therefore, the impact of the bill from increasing the cap on the tax credit through tax year 2010 would be equal to the difference between the previous $7 million cap and the new $8 million cap for each fiscal year.

SOURCES OF DATA: Department of Revenue, Moody's economy.com, North Carolina Housing Finance Agency, State Historic Preservation Office, The Joint Committee on Taxation, The Center for Budget and Policy Priorities

TECHNICAL CONSIDERATIONS: Section 3 Mill Rehabilitation: At the time the program was established the Department of Commerce had five tier designations. Subsequent revisions have reduced the number of tiers to three.

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Signed Copy Located in the NCGA Principal Clerk's Offices