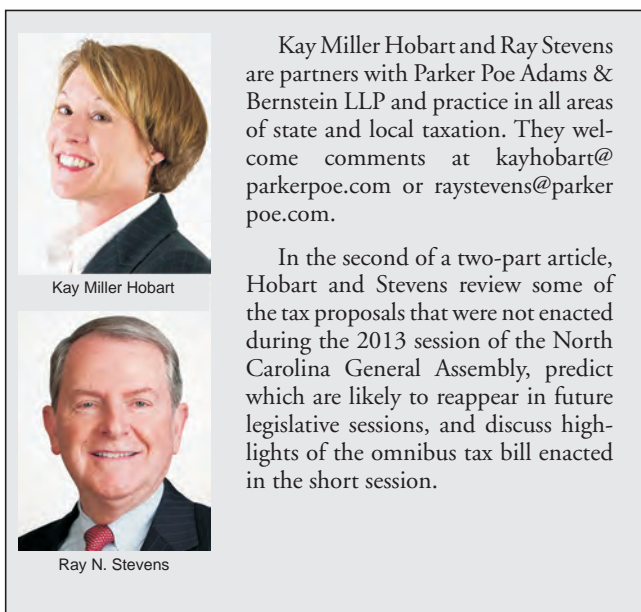


## Tax Reform in the Tar Heel State: Which Way From Here?

by Kay Miller Hobart and Ray N. Stevens



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In the second of a two-part article, Hobart and Stevens review some of the tax proposals that were not enacted during the 2013 session of the North Carolina General Assembly, predict which are likely to reappear in future legislative sessions, and discuss highlights of the omnibus tax bill enacted in the short session.

“Would you tell me, please, which way I ought to go from here?”

“That depends a good deal on where you want to get to,” said the Cat.

“I don’t much care where —” said Alice.

“Then it doesn’t matter which way you go,” said the Cat.

“— so long as I get *somewhere*,” Alice added as an explanation.

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“All right,” said the Cat; and this time it vanished quite slowly, beginning with the end of the tail and ending with the grin, which remained some time after the rest of it had gone.

— Lewis Carroll, *Alice’s Adventures in Wonderland* (1865)

The North Carolina General Assembly returned to Raleigh May 14 for its short session to fine-tune the biennial budget and consider other matters as allowed by the adjournment resolution. At the conclusion of last year’s regular session, some lawmakers expressed frustration about the

scope of the tax reform measures enacted.<sup>1</sup> Many of the proposals, some with seemingly broad and bipartisan support, did not survive the legislative process and remained hanging in the air, not unlike the grin of the Cheshire Cat.

The short session is typically not the time for grand ideas, however, and with the 2014 elections looming, that conventional wisdom will likely hold true. The “April surprise” — that is, the April 15th collections — was not a happy one this year and hamstringing the General Assembly. According to state budget analysts, April’s income tax collections show that North Carolina will face an estimated shortfall of \$445 million when the fiscal year ends June 30.<sup>2</sup> That shortfall has been attributed to the tax cuts enacted last year. Compared with budget predictions prepared last year, revenue projections for fiscal 2015 have been downgraded by \$191 million, signaling a structural deficit that is likely to linger.

With those variables at work, lawmakers may find themselves, like Alice, pondering which direction to go. As the Cheshire Cat said, which way the General Assembly ought to go depends a great deal on where it wants to get. In this article, we will examine the possible paths the General Assembly could take in future legislative sessions and predict where those paths might lead.

We will also discuss highlights of HB 1050, the omnibus tax bill enacted in a flurry of activity early in the current session. On the first day the lawmakers returned to work, HB 1050 was filed, containing the recommendations of the General Assembly’s Revenue Laws Study Committee. The bill rocketed through both the House and Senate, and was signed into law by Gov. Pat McCrory (R) hours after ratification, a mere 15 days after its introduction.

### I. Corporate Income Tax

#### A. Eliminate the Corporate Income Tax

Last session the Senate leadership initially floated the idea of eliminating the corporate income tax altogether but backed off without introducing any legislation. Two versions of the House’s tax package (HB 998) would have

<sup>1</sup>See Hobart and Stevens, “Through the Looking Glass: ‘Tax Reform’ in the Tar Heel State,” *State Tax Notes*, May 5, 2014, p. 265.

<sup>2</sup>Gary D. Robertson, “N.C. Facing \$445M Revenue Shortfall,” Associated Press, May 2, 2014. Revenue is predicted to fall 2.1 percent short of the \$20.6 billion budget for fiscal 2014.

phased out the corporate income tax and repealed it beginning in 2017 and 2018. The tax accounts for approximately \$1.1 billion of total revenue, or about 5.8 percent of the general fund.

According to a December 2013 presentation by Jonathan Tart to the General Assembly Revenue Laws Study Committee, approximately 76,000 corporations file North Carolina corporate income tax returns.<sup>3</sup> Sixty percent of total collections come from between 225 and 250 corporations, while 85 to 90 percent of collections come from 1,500 corporations.

We predict that the General Assembly will make no further reductions in the rate nor eliminate the corporate income tax in the short session but that repeal of the tax will continue to be debated in 2015 and beyond.

## B. Single Sales Factor

One aspect of the corporate income tax that received much attention last year was the apportionment factor. Since 1989, North Carolina has used a double-weighted sales factor to apportion a multistate corporation's income.<sup>4</sup> SB 677 and the North Carolina Fair Tax Act would have moved the state to a single sales factor beginning in 2016. A proposed committee substitute to SB 394, which had bipartisan support, stated that it was the General Assembly's intention to transition to a single sales factor as state revenue increased.

According to Tart, adopting a single sales factor would cost the state \$90 million annually in lost revenue (assuming a 5 percent rate of tax).<sup>5</sup> Of a sample of 9,000 North Carolina corporate income tax returns examined, approximately 6,000 corporations would pay more tax under a single sales factor, and about 3,000 would pay less tax. Even though the number of "winners" was lower, the reduction in their tax bills more than offset the increased tax the "losers" paid.

Arguments against adopting a single sales factor include that it arbitrarily picks winners and losers, ignores why businesses pay tax, and would not benefit most North Carolina corporations because they do not apportion their income. Economic development was a consideration both for and against the single sales factor. Proponents say it encourages investment and job creation, while detractors dispute its effectiveness as an economic development tool.

<sup>3</sup>Tart, "Overview of Corporate Income Tax," General Assembly Fiscal Research Division presentation to Revenue Laws Study Committee (Dec. 10, 2013).

<sup>4</sup>N.C. Gen. Stat. section 105-130.4(i). A corporation is required to use the same apportionment factor to apportion its capital stock base for franchise tax purposes. N.C. Gen. Stat. section 105-122(c1).

<sup>5</sup>*Supra* note 3.

The only other argument for the single sales factor is consistency; North Carolina requires some companies to use a single sales factor.<sup>6</sup>

The wild card in that debate is sourcing income from services. North Carolina uses a proportional cost-of-performance method based on where the income-producing activity occurs.<sup>7</sup> Some states use an all-or-nothing cost-of-performance method, sourcing service revenue to the state where the greatest cost of performance is incurred.

A recent trend has been the move to market-based sourcing, under which revenue is sourced based not on where the service is performed but on where the customer is located or where the service, or the benefit of the service, is received. The North Carolina Department of Revenue has recommended that the state adopt a market-based sourcing model determined by the customer's address.

Tart said market-based sourcing using the customer's address would be easier for the DOR to administer than the proportional cost-of-performance method. Further, moving to a single sales factor would not promote the economic development objective for service companies unless the state also adopted market-based sourcing, according to his report.

Arguments against market-based sourcing include that North Carolina's proportional approach is more equitable than an all-or-nothing market approach; that sourcing based on the customer's address is subject to manipulation; that market-based sourcing is difficult to apply, requires extensive rulemaking, and ignores where the services are performed; and that most states use some form of cost-of-performance. In particular, Tart reported that states adjoining North Carolina have not moved to market-based sourcing.

And the price tag for adopting market-based sourcing? According to the Fiscal Research Division, the cost can't be estimated.

A move to a quadruple-weighted sales factor appeared briefly in the current session as part of HB 1050. It was removed from the bill by the House Finance Committee. We predict that the single sales factor will resurface in future sessions and that it will ultimately be adopted. Moving to market-based sourcing is a harder call. Because no state adjoining North Carolina uses that method, and more importantly, because the fiscal impact can't be determined, we expect that the General Assembly will tread cautiously in that area.

<sup>6</sup>Public utilities and excluded corporations, defined as building or construction contractors; securities dealers; loan companies; and any corporation that receives more than 50 percent of its ordinary gross income from intangible property are required to use the single sales factor. N.C. Gen. Stat. section 105-130.4(a)(4) and (r).

<sup>7</sup>N.C. Gen. Stat. section 105-130.4(l)(3)c.

### C. Conform Net Economic Loss

The net economic loss provision is another aspect of the corporate income tax that received attention last session. SB 677 would have conformed the state net operating loss rules to the federal ones. The state's NOL provision is more limited than the federal provision. It is intended to "grant some measure of relief to the corporation that has incurred economic misfortune."<sup>8</sup> While the federal provision allows an NOL when deductions exceed taxable income, North Carolina's statute allows a loss only if deductions are greater than all revenue, including nontaxable income.<sup>9</sup>

As expected, legislation was introduced in the current session as part of HB 1050 that will more closely conform North Carolina to the federal provision. Under HB 1050, a state net loss is created when allowable deductions exceed gross income under the Internal Revenue Code. The legislation instructs the secretary of revenue to apply the standards in IRC sections 381 and 382 in determining whether a loss survives a merger or acquisition. The North Carolina Supreme Court has held that in order for a surviving corporation to claim pre-merger losses, there must be "a continuity of business enterprise."<sup>10</sup> Replacing North Carolina's net economic loss with a calculation more comparable to that in the federal rules is projected to cost the state \$5 million a year according to the fiscal note.

### II. Modernize the Franchise Tax

The franchise tax is one of the state's oldest taxes. All three of last year's competing legislative proposals attempted to modernize that tax. North Carolina's franchise tax is imposed only on corporations and limited liability companies that elect to be taxed as corporations.<sup>11</sup>

SB 363 would have repealed the franchise tax and replaced it with a new privilege tax on all businesses with limited liability. The new tax would have been imposed on an entity's adjusted net worth base and would have been reduced and capped for all entities other than corporations. SB 394 also would have replaced the franchise tax with a new privilege tax on all entities with limited liability. The privilege tax would have been imposed on the higher of the adjusted net worth tax base or the investment tax base. Under SB 394, the tax also would have been reduced. One version of HB 998 would have replaced the franchise tax with a new privilege tax imposed at a flat rate on all entities with limited liabilities.

Despite apparent agreement that the franchise tax needed to be reformed and the similarity of the proposals, no legislation was enacted last session.

<sup>8</sup>N.C. Gen. Stat. section 105-130.8(a)(1).

<sup>9</sup>N.C. Gen. Stat. section 105-130.8(a)(2).

<sup>10</sup>*Fieldcrest Mills Inc. v. Coble*, 290 N.C. 586, 227 S.E.2d 562 (1976).

<sup>11</sup>N.C. Gen. Stat. section 105-114(b)(2).

According to a January presentation by Tart to the Revenue Laws Study Committee, the franchise tax generates about \$520 million a year.<sup>12</sup> About 220,000 franchise tax returns are filed each year. Taxpayers with a franchise tax base of more than \$20 million account for less than 1 percent of the returns but pay 75 percent of the tax. Taxpayers that pay the \$35 minimum tax account for more than half the returns filed.

We predict that efforts to reform the franchise tax will resurface, but not until 2015.

### III. Eliminate the Individual Income Tax

The individual income tax accounts for 53 percent of general fund revenue. As a result of last year's tax law changes, the state is facing a \$445 million revenue shortfall for this fiscal year and has lowered revenue projections for the next fiscal year by \$191 million.

Although discussion of eliminating North Carolina's individual income tax continues, the practicalities of doing so will prevent its repeal any time in the foreseeable future.

### IV. Expand the Sales Tax Base

The Fair Tax Act would have subjected many services to the sales tax. SB 394 also would have broadened the sales tax base by taxing more services. Ultimately, what was enacted was a far cry from those initial proposals.

There was more nibbling around the edges of sales tax reform during the short session. For example, the General Assembly has begun to tackle how to distinguish between retail sales plus installation and performance contracts. The distinction is important because the customer pays sales tax on retail sales, and the contractor pays use tax on performance contracts. HB 1050 provides some clarity regarding who is responsible for the tax and provide that a "retailer-contractor" is the consumer of tangible personal property used in performing a contract for the improvement of real property. Technically, that is not base broadening, but merely a clarification of who is liable for the tax and whether the tax is a sales or use tax. Nevertheless, legislation on that topic has been needed, and that is a good start.

Expect to see more efforts to broaden the sales tax base in the 2015 session. In particular, increased local revenue from further expansion of the sales tax base has been suggested as a means to offset revenue losses from the repeal of local privilege taxes, discussed below.

### V. Tax Expenditures and Preferences

Capping refunds of sales taxes to nonprofits, including nonprofit hospitals, was one of the most hotly contested topics in last year's legislative session. The Fair Tax Act and various editions of HB 998 would have significantly limited

<sup>12</sup>Tart, "Overview of Franchise and State Privilege Taxes," General Assembly Fiscal Research Division presentation to the Revenue Laws Study Committee (Jan. 14, 2014).



sales tax refunds to nonprofits. Although a cap was ultimately enacted, it is essentially meaningless because the compromise legislation set the cap at a higher amount than any nonprofit pays.

Sales tax refunds to nonprofits cost the state \$221 million a year.<sup>13</sup> That is the ninth costliest tax expenditure overall and the fifth costliest sales tax expenditure.<sup>14</sup> Most of the refunds go to nonprofit hospitals.<sup>15</sup> North Carolina Senate leaders have questioned whether nonprofit hospitals deserve the sales tax refund at all. After last year's compromise (HB 998), a spokesperson for Sen. Phil Berger (R) said, "We are also pleased it protects taxpayers from further subsidizing large and profitable businesses organized as nonprofits."<sup>16</sup>

Other controversial large tax preference items that were considered for elimination last year included the sales tax exemption for food and prescription drugs and the income tax exemption for Social Security benefits in excess of the federal limit.

**Perhaps the General Assembly will heed the advice of Winston Churchill to 'never let a good crisis go to waste.'**

In February Gov. Pat McCrory (R) and Republican legislative leaders promised to increase the pay for new North Carolina teachers, a promise that will cost about \$200 million over the next two years. "We know we have the resources to do that" without raising taxes, Berger said, adding that the pay raise "will pass without any difficulty whatsoever."<sup>17</sup>

In early April the Fiscal Research Division of the General Assembly announced that personal income tax collections were \$221 million below projections because of the tax measures enacted last year. According to the report, the 2013 tax legislation resulted in more changes to the withholding schedules than anticipated. Now, after accounting for the April surprise, that shortfall has doubled to \$445 million.

Generally, budget writers try to underestimate revenue in the second year of the biennial budget. Last year the legisla-

ture left about \$360 million unspent for this year, which it planned to use for teacher raises. The shortfall eliminated that cushion. Even after news of the \$445 million shortfall, Rep. Nelson Dollar (R), senior co-chair of the House Appropriations Committee, said, "I anticipate that we will be able to follow through on having a general increase for teachers and state employees."<sup>18</sup>

The governor's budget includes \$262.9 million in raises for teachers and state employees, \$108 million of which is earmarked for teachers. The Senate's budget is more ambitious and includes \$468 million to increase teacher pay.

Perhaps the General Assembly will heed the advice of Winston Churchill to "never let a good crisis go to waste." With revenue shortfalls, recurring Medicaid overruns, and a continuing structural deficit, the legislature may be tempted to revisit some of the larger tax expenditures it left on the books last session.

## V. Privilege Taxes

### A. Repeal Remaining State Privilege Taxes

Last session the fourth edition of HB 998 would have repealed all the state privilege taxes in article 2. SB 363 and SB 394 would have repealed the state privilege taxes except those on live entertainment, movies, and amusements (which after HB 998 are subject to the sales tax and not the privilege tax). The remaining privilege taxes in article 2 are on attorneys and other professionals, installment paper dealers, loan agencies, banks, and newspaper publishers. Those taxes are frequently criticized as arbitrary and antiquated. Over the years, many of them have been repealed.

We predict that the trend will continue and that the remaining privilege taxes will be repealed in future legislative sessions.

### B. Repeal or Reform Local Privilege Taxes

As expected, a hotly debated part of HB 1050 was the repeal and potential reform of the local privilege taxes. In an interesting and ironic twist, the authority of cities to levy the tax was apparently repealed last session by a drafting error. HB 1050 reenacts that authority, at least temporarily.

There has long been agreement that reform of the local privilege tax was needed. Cities have broad authority to levy privilege taxes.<sup>19</sup> Counties, by contrast, have very limited authority to impose local privilege taxes and raised only about \$500,000 collectively in fiscal 2012.<sup>20</sup> SB 363, SB 394, and the fourth edition of HB 998 would have all repealed the authority of cities and counties to impose local privilege taxes. According to a presentation to the Revenue Laws Study Committee, more than 300 cities levy privilege taxes, and in fiscal 2012 they collected a total of \$62 million

<sup>13</sup>North Carolina DOR, "2013 Biennial Tax Expenditure Report" (Dec. 2012), at 4.

<sup>14</sup>The sales tax exemption for food for home consumption is the single costliest sales tax expenditure, at \$720.5 million, and the second highest tax expenditure overall. The exemption for prescription drugs is the second most expensive sales tax expenditure. Given the overwhelming opposition to proposals to repeal those two popular exemptions last session, those proposals are unlikely to reappear any time soon.

<sup>15</sup>Ames Alexander, "Senate Proposal Would Require N.C. Hospitals to Pay Sales Taxes," *The Charlotte Observer*, May 31, 2013.

<sup>16</sup>Richard Craver, "Nonprofits Still Nervous About Sales Tax Refund Cap," *Winston-Salem Journal*, July 17, 2013.

<sup>17</sup>Emery P. Dalesio, "McCrory, N.C. Lawmakers Pledge New Teacher Pay Raise," Associated Press, Feb. 10, 2014.

<sup>18</sup>*Supra* note 2.

<sup>19</sup>N.C. Gen. Stat. section 160A-211.

<sup>20</sup>N.C. Gen. Stat. section 153A-152.

in local revenue.<sup>21</sup> Those taxes are a significant source of revenue for some North Carolina cities; for example, they provide \$16.9 million for Charlotte and \$7.6 million for Raleigh.

Cities may levy privilege taxes on all businesses except as restricted by statute. Cities can't impose privilege taxes on some businesses, including lawyers and banks (which are subject to a state privilege tax). The amount of tax that cities may impose on other types of businesses is capped. For example, privilege taxes on car dealerships and contractors are capped at \$25 and \$10, respectively.

Unless the taxes are capped or include exemptions, cities may levy them using any reasonable method, including a flat rate or a tax on gross receipts. There is no restriction, for example, on how cities may tax grocery stores, home improvement stores, or manufacturers. Wide disparities exist not only in the taxation of different types of businesses, but also in how different municipalities tax the same type of business.

One of the more controversial proposals considered and ultimately approved by the Revenue Laws Study Committee was the reform of the local privilege tax. Under that proposal, the authority of the cities and counties to levy local privilege taxes would have been repealed. In lieu of the existing privilege tax, cities would be authorized to levy a flat tax not to exceed \$100 on each business operating in the city. The legislation would not have replaced the county privilege tax. Some members of the committee did not like the idea of any privilege tax at all on businesses. Others expressed concern about the fiscal impact on the cities and thought they should be held harmless.

Sen. Bob Rucho (R) suggested that if the sales tax were further expanded, the increased local revenue would alleviate some of the adverse fiscal impact to the municipalities. According to the Fiscal Research Division, cities will gain an additional \$15 million in new sales tax revenue under the tax measures enacted last year.

The North Carolina League of Municipalities asked the committee to postpone the proposal until the 2015 session and to consider it along with any expansion of the sales tax base. According to the league, privilege tax reform efforts should be combined with efforts to replace any lost revenue. Otherwise, cities may be forced to raise property taxes.

Although HB 1050 originally included the proposal recommended by the Revenue Laws Study Committee, the Senate removed the provision which would have authorized cities to levy a tax of \$100 or less. As enacted, HB 1050 repeals the authority of cities and counties to levy privilege

taxes effective for tax years on or after July 1, 2015. And, it locks in the tax in effect for fiscal 2014, preventing a city from increasing it for fiscal 2015. HB 1050 also requires a business to be physically located within the city in order for the tax to apply. Currently, the business must be "carried on" in the city.

The legislation did not adopt any replacement for the privilege tax, nor did it include any measures to alleviate the \$62 million fiscal hit to the cities. Those efforts will have to wait until 2015.

## VII. Fine-Tuning and Other Adjustments

There was also some fine-tuning of last year's tax legislation in HB 1050, including the sales tax exemption for farmers and the sales tax treatment of prepaid meal plans, admission charges, and service contracts.

Also, unhappy with a change in interpretation by the DOR regarding the taxation of accommodations, the General Assembly enacted legislation to reinstate the earlier interpretation. Prior to 2012, the DOR took the position that the sales tax exemption for accommodations rented for 15 days or less did not apply if rented by a broker. In 2012 it reversed course and applied the exemption without regard to whether a broker was involved. HB 1050 included a measure to restore the earlier interpretation. This seemingly trivial issue was a driving force behind the speed with which HB 1050 passed both chambers. The U.S. Open will be held in Pinehurst in June, and legislative leaders wanted this question resolved before then.<sup>22</sup>

Finally, another controversial measure was the adoption of an excise tax on e-cigarettes. In a rather unusual move, the industry approached the General Assembly asking to be taxed. There was considerable debate over whether and how to tax these products, but the General Assembly adopted a tax of 5 cents per fluid milliliter of consumable product as part of HB 1050. By comparison, cigarettes are taxed at 45 cents per pack.

## VIII. Conclusion

Last year, when the General Assembly adjourned, there was a sense of unfinished business. Comprehensive tax reform, like the Cheshire Cat, had vanished. Instead, the legislature enacted a series of tax reductions and other modest adjustments. Those cuts have left the state with a structural budget deficit. Many of the more ambitious and controversial proposals, including ones that could potentially eliminate the deficit, remain hanging in the air like the Cheshire Cat's grin. ☆

<sup>21</sup>Chris McLaughlin, "Local Privilege License Taxes," University of North Carolina School of Government presentation to the Revenue Laws Study Committee (Jan. 14, 2014).

<sup>22</sup>During the U.S. Open, many private homes in Moore County, especially near the golf course, are rented to spectators, providing a significant source of revenue for residents and the local government.