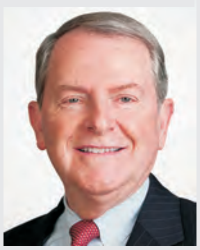
Through the Looking Glass: 'Tax Reform' in the Tar Heel State

by Kay Miller Hobart and Ray N. Stevens

Kay Miller Hobart



Ray N. Stevens

Kay Miller Hobart and Ray N. Stevens are partners with Parker Poe Adams & Bernstein LLP and practice in all areas of state and local taxation. They welcome comments at kayhobart@parkerpoe.com or raystevens@parkerpoe.com.

In the first of this two-part article, Hobart and Stevens review the tax measures recently enacted by the North Carolina General Assembly and discuss broader proposals that were not enacted. The second part will focus on what to expect both during and after the legislative short session that begins in May.

"When I use a word," Humpty Dumpty said, in a rather scornful tone, "it means just what I choose it to mean — neither more nor less."

— Lewis Carroll, *Through the Looking Glass, and What Alice Found There* (1871)

Two words dominated much of the political landscape in North Carolina last year: "tax reform." Those words conjure bold visions of tax code reengineering, including eliminating outmoded taxes, broadening bases, and closing loopholes.

Although there has been some tinkering around the edges over the years, North Carolina's tax system remains largely as it was in the 1930s. There has long been widespread agreement that the state's tax structure is antiquated and in serious need of reform. But the devil is in the details; previous attempts at reform have failed.

With Republicans in control of both the legislative and executive branches, hopes were high last year that tax reform in the Tar Heel State might succeed. Republican leaders in both houses expressed their desire to overhaul the state's tax system, as did Gov. Pat McCrory (R).

"Everybody is talking about tax reform," Senate President Pro Tem Phil Berger (R) said in January 2013.[1] "We intend to move forward this time with a tax reform package."

"There's no question that we'll work on tax reform," House Speaker Thom Tillis (R) said that same month.[2] In his State of the State address in February 2013, McCrory told lawmakers that any tax reform must be revenue neutral and that he wanted to "close loopholes for special interests to make [the] system more fair and transparent."[3]

For months legislative leaders promoted grand proposals to drag North Carolina's tax structure into the 21st century. Entire schedules would be repealed and replaced with forms of taxation that better reflected the modern economy. Bases would be broadened, rates would be lowered, loopholes would be closed, and special preferences would be eliminated.

Ultimately, political reality — or pressure, depending on one's perspective — intruded on the General Assembly's lofty ambitions. When the dust finally settled in July 2013, a far more modest plan emerged. Critics said it was not tax reform at all, but merely a tax cut. The state's leaders nonetheless declared victory, with McCrory calling the bill he signed into law "historic tax reform."[4]

Whether the General Assembly accomplished its goal of tax reform depends, as Humpty Dumpty would say, neither more nor less on what one chooses those words to mean.

An understanding of North Carolina's revenue sources is useful to fully appreciate the breadth of the tax proposals under consideration in 2013. For fiscal 2012, total general fund revenue was $19.5 billion, with total tax revenue accounting for $18.5 billion. Individual income tax revenue was $10.3 billion, 52.59 percent of the general fund. Corporate income tax revenue constituted $1.1 billion, or 5.8 percent, of the fund. Combined, individual and corporate

---

[1]"Tax Reform Agreements and Disagreement," WRAL.com, Jan. 26, 2013.

[2]"Tillis Ready to Take on Big Task of Tax Reform as Session Opens," *Charlotte Business Journal*, Jan. 23, 2013, at 7.

[3]McCrory 2013 State of State address.

[4]"Governor McCrory Signs Tax Reform Into Law," press release (July 23, 2013).

income taxes made up 58.39 percent of the fund. Franchise tax revenue totaled $613 million, or 3.14 percent, and sales tax revenue made up $5.3 billion, or 26.92 percent of the fund.[5]

I. The Initial Plan: Eliminate 60 Percent of the Tax Base

Leading up to 2013, Sen. Bob Rucho (R), co-chair of the Senate Finance Committee, and Berger spearheaded Senate Republican tax reform efforts. "There are good taxes, there are bad taxes," Rucho said.[6] In his view, consumption taxes, like sales taxes, are good taxes because they help the economy. That notion would later prove a significant point of contention between him and other Republican leaders. Rucho also believed that elimination of the income tax would make North Carolina more attractive to employers.

If one accepts that a basic tenet of tax reform is to broaden the base and lower the rates, the initial proposal by Senate Republicans would qualify as tax reform on steroids. The earliest plan offered by the Senate would have eliminated North Carolina's individual and corporate income taxes, almost 60 percent of general fund revenue, and replaced the lost revenue with a greatly expanded and increased sales tax. Replacing 60 percent of the tax base proved no easy task, however, and when the time came to introduce actual legislation, Senate Republicans had quietly retreated from their ambitious original plan.

II. The Competing Proposals

Three competing legislative proposals emerged in the 2013 General Assembly. There was general consensus among the various sponsors that the proper approach should be to reduce corporate and individual income tax rates and replace the lost revenue with sales tax revenue. Beyond that, the plans sharply diverged both in scope and revenue impact.

A. Senate Republican Plan

Backing away from their initial proposal to eliminate the state's income taxes, Republican leaders in the Senate offered a revised, yet still sweeping, plan. The early legislation took the form of three separate Senate bills. Many of the proposals in those bills would later be incorporated into draft legislation called the North Carolina Fair Tax Act (Fair Tax Act), which was never introduced.

One component of the plan was SB 677, An Act to Reform the Corporate Income Tax and Reduce the Corporate Income Tax Rate by Moving to a Single Sales Factor Apportionment and Eliminating Corporate Tax Expenditures. It would have reduced the 6.9 percent corporate tax rate to 6.5 percent in 2014, 6.25 percent in 2015, and 6 percent in 2016. For tax year 2014, SB 677 would have triple-weighted the sales factor, and in tax year 2015, quintuple-weighted it. Beginning in tax year 2016, all corporations other than public utilities would use the single-sales factor to apportion their income.

SB 677 would also have conformed to the net operating loss provisions of the Internal Revenue Code[7] and would have made other adjustments to the corporate income tax, including the repeal of various credits. According to the fiscal note, when fully implemented in 2016, SB 677 would have resulted in a revenue loss of more than $330 million. In 2017 that loss would have reached $343 million.

A second component of the Senate Republican plan was introduced as SB 669, An Act to Phase-In a Reduction of the Individual Income Tax Rate and to Direct the Revenue Laws Study Committee to Study an Elimination of the Income Tax. It would have eliminated the three individual income tax rates of 6 percent, 7 percent, and 7.75 percent and replaced them with a single rate of 5.25 percent for tax year 2014, 4.75 percent for tax year 2015, and 4 percent for tax years 2016 and beyond. It also directed the Revenue Laws Study Committee to study the elimination of the individual income tax as a revenue source. There was no fiscal note prepared in connection with SB 669.

A third component of the plan was SB 363, An Act to Reduce and Simplify Business Taxes and to Tax All Businesses with Limited Liability Protection the Same. It would have replaced the franchise tax, one of the state's oldest taxes, with a new privilege tax. Since 1933, the franchise tax has been levied at the rate of $1.50 per $1,000 of the total amount of capital stock, surplus, and undivided profits (the capital stock base), subject to some adjustments.[8] It is imposed only on corporations and limited liability companies that elect to be taxed as corporations.[9]

The new privilege tax proposed in SB 363 would have been $1.35 per $1000 of an entity's adjusted net worth base. The new base was intended to better align the existing capital stock base with general accepted accounting principles. The privilege tax would have been imposed on all businesses with limited liability but was capped at $5,000 for all entities other than corporations. The minimum tax would have been raised from $35 to $500.

---

[5] Statistical Abstract of North Carolina Taxes 2012.

[6] "State Sen. Bob Rucho Says North Carolina Tax System Needs an Overhaul," CharlotteObserver.com, Feb. 2, 2013.

[7] North Carolina requires a taxpayer to add back its federal net operating loss and calculate a separate net economic loss. N.C. Gen. Stat. sections 105-130.5(a)(6), 105-130.5(b)(4), and 105-130.8.

[8] N.C. Gen. Stat. section 105-122(d). The capital stock base cannot be less than 55 percent of the appraised value of all real and personal property for ad valorem tax purposes nor less than its total actual investment in tangible personal property in the state.

[9] N.C. Gen. Stat. section 105-114(b)(2).

SB 363 would have repealed all state privilege taxes except those on live entertainment, movies, and amusements and would have eliminated the authority of the counties and cities to levy local privilege taxes.[10]

According to the fiscal note, SB 363 would have resulted in a net loss to the state of about $10 million a year. Counties and cities would have lost between $75 million and $79 million a year.

At a May 2013 press conference, Berger outlined the broad guidelines of the Senate leadership's comprehensive tax reform plan, the Fair Tax Act.[11] The plan proposed the most sweeping tax reform since the 1930s, when North Carolina radically transformed the way it financed state and local government. It incorporated the proposals in SB 677 to reform the corporate income tax. Berger said that under the plan, the franchise tax would be reduced by 10 percent.

Under the Fair Tax Act, the individual income tax would have been reduced to 5.5 percent in 2014, 5 percent in 2015, and 4.5 percent for tax years 2016 and beyond. It would have eliminated most deductions, including the deduction for mortgage interest, and would have taxed the Social Security benefits of many retirees the same way the federal government does.[12] The act substituted a 0 percent tax bracket in lieu of the personal exemption and the standard or itemized deduction.

> **Whether the General Assembly accomplished its goal of tax reform depends, as Humpty Dumpty would say, neither more nor less on what one chooses those words to mean.**

The most controversial part of the plan by far was its expansion of the sales tax base. It would have reduced the combined state and local rate from 6.75 percent to 6.5 percent by increasing the state general rate from 4.75 percent to 5 percent but reducing most local rates from 2 percent to 1.5 percent.

To finance the reduction of all the tax rates, the Fair Tax Act would have significantly expanded the sales tax base to cover a vast array of services, including those for personal care; health and dental; repair, installation, and maintenance; landscaping; transportation; business; and construction. By doing so, it would have added many individuals and small businesses to the sales tax rolls. Some observers expressed concern about subjecting small businesses to the additional burden of collecting and remitting sales taxes, while others were skeptical about the level of compliance. Many criticized the regressive nature of the expanded sales tax.

The Fair Tax Act would have eliminated many exemptions and tax preferences, including the popular sales tax exemptions for food and prescription drugs, which cost the state more than $622 million and $464 million a year, respectively.[13] It also would have repealed the $1,500 sales tax cap on the purchase of a plane or boat, a tax preference costing $10 million a year,[14] and would have taxed planes, boats, manufactured homes, and modular homes at the state general rate of 5 percent.

The Fair Tax Act would have capped sales tax refunds at $5 million for nonprofits beginning in July 2014. The cap would have dropped to $1 million in July 2015 and to $100,000 in July 2016. Sales tax refunds to nonprofits cost the state more than $228 million.[15] The act also would have eliminated the sales tax refunds to local governments and repealed some economic incentive refunds.

Overall, the Fair Tax Act would have reduced taxes by $1 billion, the largest tax cut in the state's history. "Our current system cannot be fixed by nibbling around the edges," Berger said. "It's time for our state's leaders to take a courageous stand and implement true tax reform. This is a plan that will get our state headed in the right direction."[16]

Rucho and Berger were so confident in their plan that they asked the University of North Carolina to organize a panel to analyze a draft of it.[17] Faculty members evaluated the plan for adherence to important principles of sound tax policy and effect on economic growth.[18] They concluded that the act met the principles of efficiency, stability, and sufficiency but that its effects on equity and simplicity were harder to gauge. Regarding the plan's economic impact, they said that "while proposed reforms have the potential to contribute positively to future economic growth, the effects are not certain and cannot be quantified with confidence."[19] Therefore, tax reform cannot be viewed "as a panacea to North Carolina's economic ills," but rather "one of several fundamental policy concerns" that affect every citizen of the state, panel members said.[20] They concluded that in the

[10]Counties and cities may levy taxes only as authorized by the state.

[11]"Senate GOP Debuts Far-Reaching Tax Overhaul," NewsObserver.com, May 7, 2013.

[12]The exemption for Social Security benefits in excess of the federal limit costs the state about $363 million a year. *See* Biennial Tax Expenditure Report 2011, at 4. That report analyzes tax expenditures in the Revenue Laws as amended through 2011 for the fiscal 2012.

[13]*Id*. at 4.

[14]*Id*. at 81.

[15]*Id*. at 4.

[16]*Supra* note 11.

[17]The draft analyzed is 2013-Rbx-21c, v4, which does not appear to be publicly available.

[18]University of North Carolina, "The North Carolina Fair Tax Act: A Preliminary Analysis of the Proposal for its Adherence to Sound Tax Principles, Potential Economic Impacts and Role in Economic Recovery" (May 24, 2013).

[19]*Id*. at 51.

[20]*Id*.

proper context, "tax reform is a necessary, significant, but insufficient means to address our state's economic growth challenges."[21]

Rucho said that if the proposal were to become law, "every single soul who pays taxes in North Carolina will have more money in their pockets."[22] Not everyone agreed. The North Carolina chapter of the AARP, for example, sharply criticized the plan's elimination of the exemptions for food, prescription drugs, and Social Security income. The Fiscal Research Division of the General Assembly estimated that when the plan was fully implemented in 2017, the total income and sales tax liability of taxpayers with adjusted gross income under $51,000 would actually be higher than under the tax structure it was designed to replace.[23]

B. Bipartisan Senate Plan

While the Senate leadership offered a radical rewrite of the state's tax code, Sens. Dan Clodfelter (D) and Fletcher Hartsell (R) suggested a more conservative approach. SB 394, Lower Tax Rates for a Stronger NC Economy, would have replaced the three individual income tax rates with a single rate of 6 percent. It would have eliminated most deductions and exemptions; replaced them with a 0 percent tax bracket; and allowed a personal credit, a credit for children, and a credit for charitable contributions.

That bipartisan plan would have reduced the corporate tax rate by tying it to the individual income tax rate. It would have conformed the interest expense deduction for financial institutions to federal law and expanded the royalty reporting option to include interest expense.

Similar to SB 363, SB 394 would have repealed the franchise tax and replaced it with a new privilege tax imposed on all entities with limited liability. That tax would have been $1.00 per $1,000 of the higher of the adjusted net worth tax base or the investment tax base, as defined in the legislation. It also would have eliminated filing fees for filing annual reports with the secretary of state.

SB 394 would have broadened the sales tax base by taxing tangible personal property services, including service contracts, alterations, repairs, maintenance and installation, property care and maintenance, and security. To moderate the effect of those changes, the bill would have provided for an automatic decrease in the sales tax rate if some revenue targets were met.

The bill would have repealed the state sales tax exemption for food and taxed it at the state rate of 1 percent and would have reduced the local tax on food from 2 percent (in most counties) to 1 percent.[24] It also would have taxed sales of manufactured and mobile homes as sales of real property.

SB 394 also would have repealed the privilege taxes on attorneys, installment paper dealers, loan agencies, banks, and newspaper publishers and eliminated the authority of counties and cities to levy local privilege taxes.

C. The House Plan

While the Senate was building and promoting its proposals, the House of Representatives was formulating its own ideas about tax reform. It proposed HB 998, An Act to Reduce Individual and Business Tax Rates and to Expand the Sales Tax Base to Include Services Commonly Taxed by Other States, which it promoted as a simplification of North Carolina's tax system.

HB 998 was ultimately ratified by the General Assembly, but not without significant Senate modifications and a conference process. The legislative history records six iterations of the bill, three with fiscal notes.

1. Proposals in HB 998 That Were Not Enacted

As HB 998 evolved and worked its way through the legislative process, significant points of contention surfaced around the structure of the individual income tax, the future of the corporate income tax, the restructuring of the franchise tax, the elimination of privilege taxes, and the elimination or capping of sales tax refunds. Most of the modifications proposed in those areas did not survive the political process and were not in the ratified bill; however, some may reappear in future legislative sessions.

For individual income tax purposes, much of the attention focused on whether and how much to limit deductions, including those for home mortgage interest and property taxes. The second edition of HB 998 would have allowed an unlimited itemized deduction for property taxes and mortgage interest. The third edition would have capped the deduction, on a combined basis, at $25,000 for married filing jointly taxpayers and $12,500 for single or married filing separately taxpayers. The fourth edition would have eliminated the standard and itemized deductions and personal exemptions. It also would have eliminated the deduction for Social Security income. The fifth edition would have allowed a taxpayer to choose between a standard deduction and an itemized deduction. The itemized deduction would have been limited to a combined deduction for mortgage interest and property taxes capped at $15,000 for married filing jointly and a charitable contribution deduction of the amount claimed under the IRC.

Action on the corporate income tax focused on the rate and whether the tax itself ultimately would be repealed. The fourth edition of HB 998 would have reduced the corporate income tax rate to 6 percent in 2014, 4 percent in 2015, 2

[21] *Id.*

[22] "Far-reaching Senate Plan Closes Loopholes, Adds Sales Tax," CharlotteObserver.com, May 30, 3013.

[23] *Supra* note 17, at 8.

[24] Food is exempt from the state sales tax but subject to the local sales tax.

percent in 2016, and eliminated the tax altogether beginning in 2017. The fifth edition would have reduced the rate to 6.4 percent in 2014, 5 percent in 2015, 4 percent in 2016, 2 percent in 2017, and repealed the tax in 2018.

North Carolina's franchise tax dates from 1849, when corporations were taxed on their capital stock, and has changed little since then. The House measure would have modernized the tax. The second edition of HB 998 would have reduced the franchise tax from $1.50 per $1,000 to $1.35 per $1,000. The fourth edition would have reduced it from $1.50 per $1,000 to $1.20 per $1,000 for 2015, $0.90 per $1,000 for 2016, and $0.60 per $1,000 for 2017. The tax would have been repealed in 2018.

The fourth and fifth editions would have imposed a new privilege tax on S corporations and other entities with limited liability, except for C corporations, and would have exempted S corporations from the franchise tax. Under the fourth edition, the new privilege tax would have been $400 in 2015, $600 in 2016, and $750 in 2017. Beginning in 2018, C corporations would have been subject to the new privilege tax, instead of the repealed franchise tax, at a flat rate of $5,000. The fifth edition would have reduced the state's franchise tax from $1.50 per $1,000 to $1.25 per $1,000 for 2015, $1 per $1,000 for 2016, and to $0.75 per $1,000 beginning in 2017.

The fourth edition of HB 998 would have repealed all the state privilege taxes in Article 2 and eliminated the authority of counties and cities to impose privilege taxes.

Another controversial aspect of HB 998 was the repeal or limitation of sales tax refunds. The fourth, fifth, and sixth editions would have repealed the sales tax refund to local governments. The fourth edition also would have capped the state portion of sales tax refunds to nonprofits at $7.5 million in 2014, $5 million in 2015, $1 million in 2016, and $100,000 in 2017. The fifth edition would have modified that approach by expanding the proposed cap to $3.5 million in 2016 and $2 million in 2017.

III. The Compromise

Late in the 2013 legislative session, recognizing that the Fair Tax Act did not have the support of either the House or the governor, the Senate revised its plan and adopted a more pragmatic approach. That prompted Rucho to resign as Finance Committee chair in protest, which Berger, as president pro tem, refused to accept. Rucho said there was "a fundamental disagreement on the most effective model of tax reform" and resistance from the governor and key Republican legislative leaders to the underlying premise of the Fair Tax Act: that basing state revenue on consumption taxes would spark economic growth.[25]

Under Berger's leadership, the measure easily passed the Senate. Rucho joined the Democrats in voting against the bill, again saying that nibbling around the edges doesn't work and that the state needed a comprehensive tax reform package.[26] The House remained dissatisfied with the Senate's approach, and the matter went to conference. Behind closed doors, the two chambers attempted to reach a compromise, but the end of the fiscal year came and went with no deal in sight.

Negotiations continued. Although McCrory had earlier taken the position that any tax package must be revenue neutral, both the House and Senate had veto-proof Republican majorities and control of their caucuses, limiting McCrory's leverage. On July 15, 2013, Berger, Tillis, and McCrory announced they had reached a compromise. On July 17 the General Assembly approved HB 998, the Tax Reduction Act, which McCrory signed six days later.

No fiscal note accompanied the ratified bill, but according to news reports, it would cost the state about $600 million a year when fully implemented.[27]

HB 998 as ratified flattened North Carolina's individual income tax, eliminating the tiered rate structure of 6 percent, 7 percent, and 7.75 percent and replacing it with a single rate of 5.8 percent for tax year 2014 and 5.75 percent beginning in tax year 2015.

The legislation repealed the personal exemption. It increased the standard deduction to $15,000 for married filing jointly, $12,000 for head of household, and $7,500 for single and married filing separately, allowing a taxpayer to elect either the standard deduction or an itemized deduction. However, it limited that itemized deduction to mortgage interest and property taxes not to exceed $20,000 on a combined basis and the amount allowed as a charitable contribution under the IRC.

While the bill preserved the deduction for Social Security benefits, it eliminated the deductions for retirement benefits, other than those exempt under *Bailey v. State*. The $50,000 business income deduction and the deduction for severance wages were also eliminated.

The enacted legislation also repealed several credits, including for child care and some donations of real property. Surviving credits included the credit for children, which was increased for some taxpayers.[28] Many credits sunset as

[25]"Rucho Resigns as Finance Chairman over Tax Disagreement," WRAL.com, June 13, 2013.

[26]"Senate Tax Reform Passes Key Committee Hurdle," *Carolina Journal Online*, June 13, 2013.

[27]"The Promise-Breaking Ideological Giveaway to the Wealthy," NCPolicyWatch.com, July 7, 2013.

[28]The ratified legislation increased the credit from $100 to $125 for married filed jointly taxpayers with adjusted gross income of less than $40,000 and for single and married filing separately taxpayers with AGI of less than $20,000. It remains $100 for married filing jointly taxpayers with AGI between $40,000 and $100,000 and for single and married filing separately taxpayers with AGI between $20,000 and $50,000. Like the prior law, the credit is not available for taxpayers with AGI above the thresholds.

scheduled on January 1, 2014, including the earned income tax credit and the Article 3J credits.

As enacted, HB 998 significantly lowered the rate of corporate income tax, from 6.9 percent to 6 percent in 2014 and to 5 percent in 2015. Adopting a concept from SB 394, it provided for further reductions in the rate if some revenue triggers were satisfied. If net general fund collections for fiscal 2015 exceed $20.2 billion, the rate will be reduced by an additional 1 percent in 2016. If net general fund collections for fiscal 2016 exceed $20.975 billion, the rate will be reduced by an additional 1 percent in 2017. Thus, beginning with tax year 2017, the rate could be as low as 3 percent.

The bill renamed the state's technology and development tax credit in Article 3F as the research and development tax credit and extended the sunset to January 1, 2016.

North Carolina's method of apportionment remained unchanged under the new law, as does the franchise tax.

Despite early goals of lowering the sales tax rate, under HB 998 the state general rate remained 4.75 percent and the combined state and local rate remained 6.75 percent in most counties.

Although the ratified legislation eliminated some of the preferential sales tax rates, disparities remain. Effective January 1, 2014, the sales tax rate on manufactured homes increased from 2 percent with a $300 cap to the general state rate of 4.75 percent. The rate on modular homes increased from 2.5 percent to the general state rate of 4.75 percent. The $1,500 cap on the sales of boats and planes was not repealed.

The legislation also eliminated some exemptions from the sales tax, but none of the controversial or "big-ticket" items. For example, it repealed the exemptions for nutritional supplements sold by a chiropractor; for meals and food products served to students in dining rooms operated by educational institutions; and for sales of newspapers by street vendors, newspaper carriers, and vending machines. Food and prescription drugs remain exempt, however.

The limitation of sales tax refunds to nonprofits was one of the more contentious items during the session, and the law effectively remains unchanged. Effective July 1, the legislation will limit the aggregate amount of annual refunds of sales and use taxes to nonprofits to $31.7 million (state portion only). As a practical matter, the new limitation will not reduce any refunds to nonprofits because the total amount they pay is less than the capped amount.[29]

HB 998 also limited sales tax exemptions for farmers. It repealed many of the exemptions and replaced them with new ones that are available only to farmers with annual gross income from farming operations of more than $10,000. It repealed the popular sales and use tax holiday, the Energy Star sales tax holiday, and the exemption for bread sold at a bakery thrift store.

The legislation also changed taxation of electricity and piped natural gas. Effective July 1, it will repeal the state's franchise tax on electricity and eliminate the preferential sales tax rate on sales of electricity. It also will repeal the excise tax on sales of piped natural gas in Article 5E. Sales of electricity and piped natural gas will be taxed at the combined general rate of 6.75 percent in most counties.

The taxation of entertainment was also altered under the bill. The bill repealed the privilege tax on live entertainment, movies, and amusements, and subjected admission charges to live entertainment, movies, and attractions to the sales tax.[30]

And all that talk of expanding the sales tax base? It ended not with a bang but with a whimper — the sales tax in North Carolina is now imposed on service contracts, with some exemptions. A service contract is defined as "a warranty agreement, a maintenance agreement, a repair contract, or similar agreement or contract by which the seller agrees to maintain or repair tangible personal property."

Finally, the law repealed the estate tax for the estates of decedents dying on or after January 1, 2013.

IV. By the Numbers

Every other year, by statute, the North Carolina Department of Revenue publishes a report of tax expenditures. According to the report, "the listing of expenditures and measurements of their respective costs will allow legislative review of their impact on the State's economy and on government revenues."[31]

A review of the expenditures in the report for fiscal 2012 provides some insight into the various legislative proposals, especially those designed to broaden the bases and eliminate tax preferences. Ultimately, however, the rationale for retaining or eliminating many of the expenditures remains unclear. Rep. Paul Luebke (D) was just one to criticize the "piecemeal" approach of the legislation, saying, "I feel an explanation was lacking."[32]

The single largest expenditure identified was the standard or itemized deduction, which cost the state an estimated $2.3 billion a year. HB 998 scaled that expenditure back. The second largest expenditure was the personal exemption, which cost about $1.23 billion before HB 998 eliminated it.

[29]"Update: Income, Corporate Taxes Lower under N.C. Budget Deal; Nonprofit Refund Cap Removed," Journalnow.com, July 16, 2013.

[30]The tax is generally effective for admissions purchased on or after January 1, except there are special rules relating to admissions for live entertainment. The legislation exempts elementary or secondary school events, agricultural fairs, events by nonprofits (limited to two a year), and youth athletic contests.

[31]*Supra* note 22, at 1.

[32]"NC Bill Closes Some Loopholes While Preserving and Extending Many Others," CharlotteObserver.com, July, 18, 2013.

The third and fourth largest expenditures were the sales tax exemptions for food and prescription drugs, which cost $622 million and $465 million a year, respectively. The exemption for Social Security benefits in excess of the federal limit ranks seventh and cost $363 million. Sales tax refunds to nonprofits were next at $228 million. All those tax preferences were considered for elimination in the 2013 legislative session but remain on the books. Collectively, they total more than $16.7 billion.

The preferential sales tax rate for electricity, which was repealed, ranks ninth on the list and cost $180 million. The preferential rate and cap on manufactured homes cost $6.9 million and the preferential rate on modular homes cost $2.9 million, both also repealed. The sales tax cap on airplanes and boats cost $10 million and remains on the books.

The tax credit for children was the 11th highest expenditure, costing $151 million. That credit was slightly increased for some taxpayers, but the credit for child care and some employment-related expenses, number 27 on the list at $51.2 million, was repealed. The earned income tax credit, which sunset as scheduled, ranked 19th on the list and cost $102.5 million.

The business income deduction, which has been repealed, was number 13, costing $131.6 million. The exemption for food sold in dining halls operated by educational institutions, also repealed, was number 34 on the list and cost $33 million. The sales and use tax holiday cost $14.5 million and the Energy Star sales tax holiday cost $1.7 million; both were repealed. Also repealed were the sales tax exemptions for sales of some newspapers ($7.2 million), nutritional supplements sold by chiropractors ($400,000), and bread sold at a bakery thrift store ($100,000).

Other large expenditures that were not considered for elimination include the sales tax exemption for motor vehicles, the sixth largest item. Motor vehicles are subject to the 3 percent highway use tax instead of the 4.75 percent state rate of sales tax. The difference costs the state $424.7 million each year. Another large preference not considered is the exemption from the sales tax of items taxed by Article 5F, which imposes a 1 percent privilege tax with a cap of $80 per article. It was the 10th largest item on the list and costs $178.4 million.

V. Blame the Lobbyists

In any tax reform effort, most would agree that closing loopholes is a good idea. Unless, of course, it's your loophole that's about to be closed.

"Members of the audience, would you just raise your hands if you're lobbyists," Rucho asked at a crowded Finance Committee meeting. Nearly every hand in the room went up. "Members of the committee, I just want you to remember, those are the folks that are in the process of trying to be sure that this tax system stays complicated and loopholes are maintained."[33]

Early in the process, Rucho predicted that tax reform efforts "could turn into the lobbyist full-employment act."[34] Some would say his predictions came true. Berger said, "Reforming a state's tax code is no easy task in the face of a barrage of special interests fighting to preserve the special treatment they receive at the expense of all taxpayers."[35]

> **In any tax reform effort, most would agree that closing loopholes is a good idea. Unless, of course, it's your loophole that's about to be closed.**

Frustrated that his tax reform efforts were being derailed by special interest groups, Rucho didn't blame Berger for abandoning their ambitious Fair Tax Act, but instead faulted McCrory and the House leadership. "Ultimately, McCrory and Tillis felt more pressure than they could withstand," he said.[36] He later wrote that he was disappointed that they "did not provide the leadership or have the political backbone to fight the special-interest groups, who favor loopholes over a fair tax system."[37]

VI. The Controversy Continues

McCrory called the tax compromise measure a huge success, saying, "Our tax reform plan is not just a tax cut here and there but meaningful tax reform, historic tax reform, that will spur economic development, create jobs and put more money in the pockets of hard working North Carolinians."[38]

But economists disagree that tax reform, in and of itself, is sufficient to solve economic growth challenges. Others have disputed the governor's claim that everyone would benefit from the plan. According to an analysis by the Fiscal Research Division of the General Assembly, a married couple with two children making $20,000 a year would see their tax bill increase from a $222 rebate to owing tax of $40,

[33] "Tax Reform Remains Up in the Air," WRAL.com, June 21, 2013.

[34] "Closing Tax 'Loopholes' Could Be Painful for All," WRAL.com, Dec. 14, 2012.

[35] "Governor, Senate, House Reach Historic Deal on Tax Reform," press release (July 15, 2013).

[36] "Senate Gives Tax Reform Initial Approval," *Carolina Journal Online*, June 14, 2013.

[37] *Supra* note 25.

[38] "Gov. McCrory, GOP Legislative Leaders Tout Tax Plan as Job Creator," NewsObserver.com, July 15, 2013.

for a $262 net tax increase. On the other hand, a married couple with two children making $250,000 a year would see a tax decrease of $2,318.[39]

Rucho minimized the significance of the legislation, calling it "the first itsy-bitsy step toward tax reform."[40] Other Republicans acknowledged the legislation did not go as far as they wanted. "This is a step in getting our fiscal house in order," said Rep. David Lewis (R), one of HB 998's original sponsors.[41]

Some of the most biting criticism came from those who refused to credit the legislation with the label of tax reform, calling it simply a tax break instead. "If you are grading this as tax reform, it doesn't get there," said Roby Sawyers, a tax professor at North Carolina State University. "At the end of the day, it probably looks more like a tax cut."[42] Rep. Rick Glazier (D) said, "This is a tax cut and a tax shift but not major tax reform."[43]

In the end, much like Alice and Humpty Dumpty, whether the compromise ultimately enacted lived up to the Republican pledge of historic and comprehensive tax reform probably depends on which side of the looking glass you find yourself. Only time will tell whether the ambitious proposals discarded in 2013 will find a more receptive audience in future legislative sessions. ✰

[39] "AP Factcheck: Many Pay More Under New N.C. Tax Laws," News-record.com, Dec. 30, 2013.

[40] *Supra* note 38.

[41] "Tax Plan Heading to McCrory," WRAL.com, July 17, 2013.

[42] *Supra* note 38.

[43] *Supra* note 41.