NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: House Bill 1414 (Fourth Edition)

SHORT TITLE: Create New Jobs/Recruit New Industry

SPONSOR(S):

FISCAL IMPACT ($MILLION)

Yes (x**)** **No ( )** **No Estimate Available ( )**

($ Millions)

	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09
REVENUES					
General Fund					
Reduce Corporate Tax	(13.7)	(28.3)	(28.8)	(29.5)	(30.0)
Sales Tax Ref. & Exempt.	(4.7)	(7.4)	(7.5)	(7.6)	(7.8)
Qual. Bus. Invest. Credit	-	(3.0)	(3.0)	(3.0)	(9.0)
Research & Development	(7.3)	(18.5)	(22.0)	(23.4)	(24.7)
Escheats Fund Investments	* No General Fund Impact – See Assumptions *				
Insurable Interest	* See Assumptions *				
TOTAL General Fund	**(25.7)**	**(57.2)**	**(61.3)**	**(63.5)**	**(71.5)**
Local Governments	(2.2)	(3.7)	(3.9)	(3.9)	(4.1)

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue, North Carolina Department of Commerce, Department of the State Treasurer, and the University System.

EFFECTIVE DATE: Sections 1.1 and 1.3 (Corporate tax exemption) become effective for taxable years beginning on or after January 1, 2005. In Part 3 (Sales tax), the amendment to G.S. 105-164(j)(2) in Section 3.1 becomes effective January 1, 2004 and applies to sales made on or after that date. Sections 3.2, 3.3, and 3.4 become effective October 1, 2004. The remainder of Part 3 becomes effective July 1, 2004. Part 4 (Qualified Business Investment) becomes effective for investments made on or after January 1, 2004. Part 5 (Research and Development Credit) becomes effective for taxable years beginning on or after January 1, 2005. Part 6 (Escheat Fund) becomes effective when law. Section 7 (Insurable Interest) and the remainder of the bill becomes effective when law.

BILL SUMMARY: The bill makes numerous changes to the state's taxation and economic development related laws and programs.

Part 1 institutes a corporate income tax exemption program. The **corporate income tax** is levied at the rate of 6.9% of taxable income (income after allowable deductions), with 7.25% of the proceeds allocated to school facilities assistance. The legislation allows corporations with state net income of $100,000 or less to claim a $25,000 corporate income tax exemption. If the corporation's state net income is between $100,000 and $200,000, the taxpayer can receive a $15,000 exemption. In order to hold harmless the dollar amount of school facilities assistance, the earmarking formula is raised from 7.25% to 7.44% of net collections.

Part 2 is reserved.

Part 3 addresses **sales tax refunds and exemptions**. During the 2003 Special Session, the General Assembly authorized sales tax refunds of sales tax paid on building materials, building supplies, fixtures, and equipment that become part of the real property of an eligible facility. Facilities are considered eligible if at least $100 million will be invested in constructing the facility, as certified by the Department of Commerce, and the primary industry for which the facility will be used is bioprocessing or pharmaceutical manufacturing. Section 3.1 expands the definition of eligible facilities to include those with only $50 million of investment, provided the facility is located in a tier 1, 2, or 3 county. (The $100 million minimum investment requirement continues for tiers 4 and 5). In addition, the legislation expands the list of eligible industries to include aircraft manufacturing motor vehicle manufacturing (including military vehicle manufacturing), and semiconductor manufacturing. Section 3.2 creates a sales tax exemption for plastic mulch and plant bed covers when they are sold to farmers. It also exempts from sales tax delivery charges for delivery of direct mail, if the charges are separately stated, and the sale of tangible personal property on which aerial survey data is stored, if it is sold to a professional land surveyor. Finally, Sections 3.2 and 3.3, in total, provide a sales tax exemption for sales of aircraft parts and lubricants if they become component parts, or are dispensed, during the repair, maintenance, or overhaul of a commercial aircraft.

Part 4 deals with the **Qualified Business Investment Credit** (QBIV). Section 4.1 raises the annual credit limit from $6 million to $9 million, effective beginning with the 2004 tax year. Section 4.2 extends the sunset on this credit from January 1, 2007 to January 1, 2009.

Part 5 handles the **Research and Development Tax Credit**. Under the current Bill Lee Act (tax incentives for industry recruitment) there is a credit for research and development expenditures. There are two alternative credits available to taxpayers: (1) a credit of 5% of the increase in research and development expenses that are apportioned to North Carolina and (2) a credit of 25% of the State's apportioned share of the federal alternative incremental credit (helps start-up companies).

The legislation moves the State research and development credit out of the Bill Lee Act and allows taxpayers the option of using the existing credit system (incremental credit or alternative credit) or a new restructured credit. The new credit contains the following features:

- The credit is no longer limited to just certain types of businesses.
- The taxpayer must still satisfy requirements relating to wage standard, health insurance, environmental impact, and safety and health programs.
- The credit may not exceed 50% of tax, with a 15-year carry forward.
- The new credit is a flat rate for qualified North Carolina research expenses, based on federal definitions of this term.

The structure for the new credit is as follows:

- Small business (annual gross receipts below $1 million) - 3%.
- Research conducted in Tier 1, 2, or 3 (distress tiers under Bill Lee Act) - 3%.
- Other research costs - 1% for expenses up to $50 million, 2% for expenses between $50 million and $200 million, and 3% for expenses above $200 million.
- Research payments to N.C. research universities - additional credit of 15%.

Part 6 deals with Escheat Fund investments. It broadens the array of instruments and investments the Treasurer can make with Escheat Fund dollars.

Part 7 addresses insurable interest of charitable organizations. Specifically, it allows nonprofits and other entities to purchase life insurance interests on the behalf of an individual with the individual's approval.

ASSUMPTIONS AND METHODOLOGY: The bill makes several changes to the State's tax laws.

Part 1: Corporate Income Tax Exemption. The starting point for the analysis is a tabulation of 2001 tax year corporate income tax returns by the Department of Revenue. The tabulation was based on a grouping of tax returns by taxable income amount. For each statistical reporting bracket, data on the number of returns, taxable income, and tax liability was shown. This data allowed for the determination of "average taxable income" and "average tax liability" for each bracket.

The next step was to grow the 2001 data to 2005. This process is complicated because during a period of economic recovery the growth rates for the number of returns and the average taxable income per return differ by statistical reporting bracket. For example, the typical experience is for the number of smaller returns to decline slightly while the largest reporting bracket ($1 million and over) rises exponentially. The average taxable income per bracket is relatively stable over time for smaller and medium-sized taxpayers but the amount for the highest brackets will increase at a very high rate.

The forecast of number of returns and average return size was accomplished by a review of the experience of three other states (Wisconsin, Utah, Virginia) for the mid-1990's period in addition to the 1990-94 North Carolina data. The other states were selected because of the availability of distribution data and the absence of major tax changes. The mid-1990's data was used because of the feeling that overall economic conditions during 2001-05 would be similar to the earlier period.

In addition, a projection of overall corporate income tax liability for 2005 was developed using the national forecasts of pre-tax corporate profits by Global Insight (used by Office of State Budget and Management) and Economy.com (used by Fiscal Research Division). The national outlook firms indicated that corporate profits should expand by 78-96% from 2001 to 2005. However, historical data indicates that federal and state tax bases have not kept up with the improvement in profitability over time due to a multitude of factors including the shift of business organizations to S corporation tax status and other types of corporate organizations, as well as efforts to minimize tax liability.

For this reason this analysis assumes that the state tax base will increase by 45% during this period. The original projection of the number of returns and average liabilities was then fine tuned to reconcile the total tax base using the distribution analysis to the amount using the tax base growth estimate. This adjustment took place largely in the upper statistical reporting brackets because of the sensitivity of these taxpayers to economic conditions. The adjustment had little practical impact on the estimate of the impact of this bill because, under the bill, the relief applies exclusively to corporations with the smallest taxable incomes.

The result of the analysis is that the projected 2005 statistical reporting bracket data can be used as a tax calculator to determine the impact of a policy change. The first step of this methodology is to determine the impact of the change on the average tax return in each bracket is calculated. This calculation is repeated for each statistical reporting bracket. The results for each bracket are then weighted by the number of returns in each bracket to come up with the total impact.

The projected 2005 data by size of income indicates that the exemption will completely eliminate the tax on 15,470 corporate returns, or 53% of the total of 28,952 returns. Another 9,273 returns (32%) will receive partial relief.

The calculation of the impact on the State General Fund includes the additional cost of 2.4% of the gross amount of the relief in order to hold harmless the dollar amount of the school facilities finance fund.

Part 2: Reserved

Part 3: Sales Tax Refunds and Exemptions

This part of the bill makes numerous changes to the State's sales and use tax laws, particularly as they relate to economic development.

Section 3.1 modifies and expands the sales tax refund provisions for major projects approved by the General Assembly during the 2003 Special Session. During that session, the General Assembly passed HB 2, which authorized sales tax refunds for projects representing at least $100 million in facility investment. This special tax treatment was extended only to the bioprocessing and pharmaceutical manufacturing industries. This bill expands that provision in two ways. First, it extends this sales tax incentive to aircraft manufacturing, motor vehicle manufacturing, and semiconductor manufacturing. Estimates for this provision were produced by the North Carolina Department of Commerce, based on their past experience with this type of project. Their estimate assumes that 1) North Carolina would have no more than one $100 million investment per year, 2) construction materials make up 40% of the typical construction cost and 3) the refund accounts for the state portion of the sales tax at 4.5%. The second change relates to the minimum investment provisions. The bill lowers the minimum investment to receive the refund from $100 million to $50 million. This provision applies only to projects in tiers 1, 2, and 3 (the $100 million minimum continues to apply in tiers 4 and 5). The previous estimate was increased by 25% to account for this change. Adjustments were made to the final number in the fiscal estimate box to account for the sunset of the most recent State one-half percent and the effective date. A local loss estimate is also included, based on the previous methodology.

Sections 3.2 and 3.3 create several sales and use tax exemptions. First, it exempts plastic mulch and plant bed covers sold to farmers from the sales and use tax. Under current law, these items are taxable at the full rate. According to Dr. Doug Sanders, a professor of Horticultural Science at N.C. State University, plastic mulch is used on approximately 20,000 acres in the State at a cost of approximately $300 per acre, suggesting total purchases of $6.0 million annually. Applying the State sales tax rate of 4.5% (4.0% after July 1, 2005) provides a state estimated annual cost of $270,000 ($240,000 after the rate drops to 4.0%). The local loss is approximately $120,000. No good data is currently available on the plant bed covers. However, antidotal information suggests it is approximately equal to plastic mulch, for a total State cost of $540,000 ($480,000 at 4.0%), and a local cost of $240,000. Adjustments are made in the fiscal estimate box to reflect the October 1, 2004 effective date.

The second change relates to aircraft maintenance. Under current law, sales of aircraft lubricants, aircraft repair parts, and aircraft accessories to an interstate air courier or a passenger air carrier at the courier's or carrier's hub are exempt. The legislation expands the current exemption by eliminating the requirement that the sale take place at a hub, by allowing the exemption for sales to an interstate freight carrier, and by allowing the exemption for sales to a person who leases commercial aircraft to an interstate air business. This expanded exemption is limited exclusively to commercial aircraft that have a maximum certified take-off weight of more than 12,500 pounds. In December 2003, Tax Research estimated that exempting all aircraft parts and accessories would cost the state two to six million dollars annually. Because this estimate did not include lubricants, a number slightly above the mid-point (five million) was used as a proxy for the total cost of exempting all parts, accessories and lubricants. Conversations with state pilots and military personnel, and their review of aircraft documents, suggest the 12,500-pound weight limit effectively excludes most general aviation aircraft from the exemption. According to the Federal Aviation Administration's (FAA) Administrator's most recent Fact Book (March 2004), approximately 79.8% of all licensed aircraft in the state are non-general aviation. Using this number as a proxy for the proportion of total sales that would be covered by the new exemption suggests an annual State cost of $3.99 million. The state estimate is reduced in the out years to reflect the expected reduction of the state sales tax rate in 2005, and both State and local costs are increased in the out years to reflect the Air Force's procurement annual inflation index of 2%.

The third change deals with delivery charges for delivery of direct mail. Under current law, postage that is embedded in a direct mail item is subject to sales tax, as are any other delivery charges. This provision would make that embedded postage exempt from sales tax if the postage were separated from printing charges when the client is billed. It would also exempt the remaining delivery charges for direct mail from sales tax, if the charges were separately stated. In May and June 2004, Fiscal Research surveyed the largest printers of direct mail in North Carolina, based on an industry association provided list of their largest members. These printers were asked to examine their 2002 records and identify the amount of postage that would have been subject to sales tax in 2002, but would not be under the legislation. The four printers that responded with data indicated that their change in tax liability for 2002, in total, would have been $46,409.

According to the Print Market Atlas, in 2002 there were $1,096,280,000 in North Carolina shipments of the category, “general commercial printing”. All these shipments are assumed to be direct mail printing. The atlas also listed $99,640,000 in “quick printing”, a portion of which was likely direct mail. Using the total amount for “general commercial printing” and 25% of the amount for “quick printing” creates a proxy for the total North Carolina direct mail market of $1.121 billion. Industry data suggests that the four responding printing companies, in total, represent approximately 15.52% of the direct mail market. Using this number as a proxy for tax liability suggests total industry tax liability of $299,027 in 2002. Adjustments are made in the fiscal impact box for inflation and the October 1, 2004 effective date.

The legislation also affects the taxability of shipments of printed material for later direct mail mailings. The four responding companies indicated that they did not deliver their product in this manner. However, industry representatives indicate that at least some direct mail printers deliver their products in this manner. As such, the estimate has been increased by 10% to account for this type of delivery.

The fourth change addresses aerial surveying. Currently, sales to a professional land surveyor of tangible personal property on which custom aerial data is stored in digital form or is depicted in graphic form are taxable. The bill makes these sales exempt. Aerial photography professionals are represented by the North Carolina Society of Surveyors and the North Carolina Association of Photogrammetry and Remote Sensing Professionals. According to these industry representatives, there are approximately twenty-one (21) firms that do aerial surveying work. In May and June 2004, Fiscal Research attempted to survey the fifteen companies for which address and telephone information was available. These organizations were given a copy of the language eventually included in this bill, and were asked to estimate the dollar value of their qualifying sales for the most recent year. Of these fifteen companies, six (6) provided data indicating, in total, $374,558 of taxable sales. Assuming these six companies are proportionally representative of the industry suggests potential annual taxable sales of $1.3 million. Applying a 4.5% state sales tax rate to the $1.3 millions suggests a State revenue loss of $58,997, and a local loss of $26,221.

The total revenue impact of the sales and use tax changes in Part 3 is as follows:

	2004-05	2005-06	2006-07	2007-08	2008-09
TOTAL					
State	4.7	7.4	7.5	7.6	7.8
Local	2.2	3.7	3.9	3.9	4.1

Part 4: Research and Development Tax Credit Data compiled by the Department of Revenue from a review of the tax returns of taxpayers taking the existing credit indicates usage of $7.0 million per year. There were 216 applications for the credit in 2000 and 141 in 2001. These numbers may differ from the number of taxpayers taking the credit because the credit can be taken against either the franchise or the income tax.

The Department of Commerce staff, in conjunction with the Department of Revenue, has reviewed the tax returns for the largest 25 taxpayers taking the current R & D credit. These companies generated 77% of the R & D credit for 1999-2001. From the tax return detail supplied by these companies, Commerce was able to simulate the impact of the new credit.

For other potential users, the starting point in developing a simulation was a National Science Foundation survey of R & D spending for 1988. The data is compiled by state but is not broken down in enough detail to allow an industry-specific calculation of the impact of the credit. To achieve this end, Commerce "sensitized" the NSF data by using information from the 1997 Economic Census of the Census Bureau (U.S. Department of Commerce) and wage data from the N.C. Employment Security Commission. This enabled the creation of industry average of research and development spending. In addition, Commerce discussed research activity with universities across the state.

The Department of Commerce, in cooperation with the Department of Revenue, determined from a review of tax returns that companies applying for the R & D credit, on average, are able to use 32% of the credit. This usage rate was applied to the categories of the new credit.

After the potential credits were calculated under the new system, it was determined that the additional annual revenue loss would be $13.2 million for the 2005 tax year if all taxpayers were able to use the new credit. However, the ability of a taxpayer to choose between the existing credit system and the new credit adds $3.0 million to the cost of the bill.

The new credit is effective for eligible research expenditures made on or after January 1, 2005. The first fiscal impact will be for the 2004-05 fiscal year, based on April and June 2005 estimated tax payments for the 2005 tax returns. For the purpose of this analysis, we have assumed that 45% of the annualized amount of the 2005 credit would be taken during the April-June 2005 period based on the "safe harbor" provision requiring estimated payments of at least 90% of annual liability during the tax year (for four payments).

For future years, the annual impact of the credit overhaul is expected to grow at a rate of 6%. This assumption ties closely to the forecast of North Carolina personal income growth as projected by Global Insight (forecasting firm used by Office of State Budget and Management) and Economy.com (forecast used by Fiscal Research Division). The future fiscal year estimates are based on the assumption that 45% of the annual tax year impact will occur during the April-June period of the tax year and the remainder during the July-March period (subsequent fiscal year).

Finally, the estimates have been adjusted for the fact that under current law the Bill Lee Act credits for research and development sunset on January 1, 2006.

Section 5: Qualified Business Investments Tax Credit The bill raises the cap from $6 million to $9 million for the General Fund revenue loss from the tax credit. This fiscal analysis assumes the credit maximum will be reached based on program history. The amount of credits applied for exceeded the current $6 million cap five out of seven years between 1997 and 2003 (see the following chart). The amount of tax credit applications has exceeded the proposed $9 million cap twice in the last seven years.

Year Credit Claimed	Individuals	Corporations/ Pass-Throughs	Total
1997	2,322,317	3,677,683	6,000,000 *
1998	4,235,771	1,108,870	5,344,641
1999	4,714,892	1,285,108	6,000,000 *
2000	4,221,732	1,778,268	6,000,000 *
2001	3,612,777	2,387,223	6,000,000 *
2002	$4,179,918	$1,820,082	$6,000,000 *
2003	$4,064,764	$1,530,349	$5,595,113
	$45,696,368	**$17,779,425**	**$63,475,793**
*In these years, total credits requested exceeded $6 million. Actual requests were as follows:			
	1997	$9,250,000	
	1999	6,450,000	
	2000	7,000,000	
	2001	19,000,000	
	2002	$7,825,000	

The $3 million increase in the QBV credit in 2004 will have a revenue impact in FY 2005-06. The revenue loss from tax year 2004 is delayed because investments are made in 2004, applications for the tax credit on the 2004 investments are made in 2005, the Department of Revenue notifies taxpayers in November/December of 2005 of the amount of credit they will receive, then the taxpayers file their tax returns in spring 2006.

This section of the bill also extends the sunset of the Qualified Business tax credit from 2007 to 2009. Since the General Fund revenue forecast for future fiscal years assumes an end to the Qualified Business tax credit program, extension of the sunset to 2009 means there will be a General Fund revenue loss in FY 2008-09 and FY 2009-10. As explained above, the 2007 tax year credits are a revenue loss to the state in FY 2008-09 and the 2008 tax year credits are a revenue loss in FY 2009-10. It is assumed that the full $9 million cap will be reached each fiscal year.

Part 6: Escheat Fund Investments

This part of the bill expands the instruments the State Treasurer can use when investing proceeds of the Escheat Fund and has no fiscal impact.

Part 7: Insurable Interest of Charitable Organizations

The part adds an additional fundraising tool for nonprofits and other entities, including the university system. No fiscal analysis of this provision is possible at this time.

SOURCES OF DATA:

TECHNICAL CONSIDERATIONS: None

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Signed Copy Located in the NCGA Principal Clerk's Offices