

NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: SB 144 SCS (First Edition)

SHORT TITLE: Streamlined Sales and Use Tax Agreement

SPONSOR(S):

FISCAL IMPACT					
	Yes (X)	No ()	No Estimate Available ()		
	(\$ Millions)				
	<u>FY 2001-02</u>	<u>FY 2002-03</u>	<u>FY 2003-04</u>	<u>FY 2004-05</u>	<u>FY 2005-06</u>
REVENUES					
General Fund					
Prepared Food	\$1.58	3.31	3.47	3.65	3.83
Other Food	* See Assumptions and Methodology *				
Other Provisions	* See Assumptions and Methodology *				
PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.					
EFFECTIVE DATE: Part 1 becomes effective when the bill becomes law and expires on January 1, 2006 unless certain actions occur. Part 2.6 (use tax and distribution) becomes effective July 1, 2001. Section 2.16 (mill machinery) becomes effective January 1, 2006. The remainder of Part 2 becomes effective January 1, 2002.					

BILL SUMMARY: Section One of the bill adds a new Part 7A to Chapter 105 of the General Statutes entitled "Uniform Sales and Use Tax Administration Act." It also authorizes the Secretary of Revenue to enter into the national Streamlined Sales and Use Tax Agreement (the Agreement) and sets out a series of definitions and restrictions that are a part of the agreement. It also clarifies that no provisions of the Agreement will supplant state law unless that provision is specifically enacted by the General Assembly, and authorizes the Department to contract with a special certified service provider to collect remote sales taxes. Section Two of the bill makes several changes in North Carolina's sales tax law to conform to some of the provisions in the national Streamlined Sales Tax project. In particular, the bill alters and adds definitions of food, food ingredients, prepared food, candy, dietary supplements, soft drinks, installation charges, and delivery charges to substantially conform to the definitions proposed for the national Streamlined Sales Tax project. The also changes the state definition of "use" for sales and use tax purposes to include distribution. It clarifies that a retailer who is required to collect the sales and use tax must collect the local use tax if the local sales tax does not apply. This section also changes

the current rules on sourcing sales. The bill changes some tax filing deadlines. The legislation also excludes mill machinery and mill machinery parts and accessories that are currently subject to a 1% sales tax with a maximum tax of \$80 per item from the sales tax and instead shift them to a privilege tax of the same rate that is paid directly to the Department. Section Three states that North Carolina's authority to continue participation in the Streamlined Sales Tax Program sunsets January 1, 2006 unless 15 states sign on to the agreement, or states representing 10% of the U.S. population sign the agreement.

ASSUMPTIONS AND METHODOLOGY: The bill makes several changes that will have a fiscal impact on the General Fund.

Part 1: Framework: Part 1 of the bill provides the framework for future General Assembly action on the streamlined sales tax project and authorizes the Secretary to participate in the Agreement. However, this portion of the bill does not make any substantive changes to existing law. As such, Part 1 has no immediate fiscal impact.

Part 2: Definitions: Part 2 of the bill changes definitions in the sales tax law to conform to those suggested in the national streamline project. Many of these changes related to definitions of food.

Currently, the criteria for determining the state sales tax exemption status for food is based on whether the food item is "intended for home consumption", and whether the item can be purchased with federal food stamps. The result is that the North Carolina definition of a food item is linked to USDA's definition, and changes as USDA alters its list. According to the United States Department of Agriculture, "Households can use food stamp benefits to buy any food or food product for human consumption, and seeds and plants to produce food". (The seed and plant portion does not apply to this discussion). Food stamps can not be used to purchase alcoholic beverages, tobacco, vitamins, medicines, pet food, soaps, paper products, laundry products, grooming items, cosmetics, lunch counter items, food to be eaten in the store, hot foods that are ready to eat, or food marketed to be heated in the store. Food items that are exempt from state sales tax (4%) are still subject to local tax (2%).

Part 2 of the legislation moves the state away from the food stamp definition of food to an alternative set of definitions created by the National Streamlined Sales Tax Project. Some of these definitional changes will have a fiscal impact.

Food: The bill defines food as "substances that are sold for ingestion or chewing by humans and are consumed for their taste or nutritional value". This change in definition, in and of itself, should not have a fiscal impact as the definitions should have the same practical effect. However, unlike with the food stamp definition, the streamline project carves out particular subsets of what would traditionally be considered food and defines those items separately. Those subsets can be classified as taxable or exempt by individual states. Those new subsets are candy, dietary supplements, soft drinks, and prepared food.

Candy: Under current law almost all candy can be purchased with food stamps, and is therefore exempt from state tax if it is purchased for home consumption. These items are subject to local tax. The legislation defines candy as "a preparation of sugar, honey, or

other natural or artificial sweeteners in combination with chocolate, fruits, nuts, or other ingredients or flavorings, in the form of bars, drops, or pieces that do not require refrigeration”. Candy that includes flour is still considered food and is not a part of the special subset candy.

According to the National Confectioners Association, national per capita expenditures on candy have been as follows:

Per Capita Consumption	
Year	Amount (in \$)
1995	44.7
1996	46.6
1997	51.4
1998	51.6
1999	50.1

Extending this growth trend and applying it to the decennial census population estimate for North Carolina (8,049,313) suggests that in 2000 North Carolinians purchased \$428.3 (\$53.2 x 8.0 million people) million worth of what is commonly considered candy. Based on data provided by Confectioner Magazine and joint analysis with Tax Research, Fiscal Research believes about 25.5% (\$109.2 million) of candy is currently taxed because it is not sold for home consumption. Therefore, approximately 74.5% or \$319.1 million is currently exempt.

Under the new definition all candy made with flour will continue to be classified as food and will be exempt from state sales tax. This represents approximately \$51.4 million in sales. In addition, most of the non-flour candy that is currently exempt will remain exempt because of the home consumption language. However, there may be some movement at the margins since the food stamp definition and the streamline definition are not identical. Because there is no way to determine how the Department and the Streamline project will rule on any marginal products no formal estimate is possible. However, any change is expected to be slight.

Dietary Supplements: Currently most dietary supplements, except vitamin capsules, are exempt from state tax as they can be purchased with food stamps. (Vitamin capsules cannot be purchased with food stamps). Adding this definition to the statutes effectively maintains the exemption for dietary supplements. It also continues the taxability of vitamins. As a result, the Department does not expect a significant revenue change as a result of this provision. Fiscal Research is unable to estimate the potential revenue change as it is unclear how this term will be interpreted over time. (It should be noted that the vast majority of “clarifications” issued by the federal food stamp program related to determining if dietary supplement type products are a food (eligible) or a vitamin (ineligible)).

Soft Drinks: Because soft drinks can be purchased with food stamps these items are exempt from state tax if they are purchased for home consumption. The legislation sets out a special class of food called “soft drinks”. Soft drinks are defined as “a nonalcoholic

beverage that contains natural or artificial sweeteners”. The term does not include beverages that contain one or more of the following: (a) milk or milk products, (b) soy, rice, or similar milk substitutes, (c) more than 50% vegetable or fruit juice. Under the bill these items are exempt from state sales tax if they are purchased for home consumption. According to the 2000 beverage market index prepared by Beverage World magazine, the 1998 per capita consumption of items that might qualify as soft drinks under the bill was approximately 60.59 gallons or 228.7 liters. Applying these numbers to the 2000 census population estimate for North Carolina suggests that approximately 1.84 billion liters of soft drinks are consumed in the state each year. Assuming that all vending and fountain drinks, as well as 60% of all other soft drink purchases are currently taxed by the state suggests that the state now collects approximately \$50.2 million from soft drink sales. Neither the Department nor Fiscal Research expects this bill will significantly increase or decrease the \$50.2 million.

Prepared Food: The bill defines a new group as “prepared food” and makes that food taxable. The bill defines prepared food as items that meet one of the following criteria:

- Sold in a heated state or is heated by the retailer,
- Consists of two or more foods mixed or combined by the retailer for sale as a single item,
- Sold with eating utensils provided by the retailer.

If the product is merely sliced, repackaged, or pasteurized it is not considered “prepared” for purposes of this definition.

Fiscal Research believes the definitions in the bill expand the state sales tax base to include much of the prepared food sold at bakeries and supermarkets.

Under North Carolina law four (4) counties and two (2) municipalities are authorized to levy a 1% tax on prepared food and beverages. While the definition of prepared food used in the appropriate session laws is different than that in the streamline bill, both Fiscal Research and the Sales Tax Division believe the net effect will be similar. One of the counties that levy the tax, Wake County, can manipulate their prepared meals tax database. According to the Wake County Revenue Director, during FY 1999-00 84 stores collected approximately \$80,000 in prepared food taxes. This equates to \$952.38 per store, per penny of tax. The national Food Marketing Institute indicates that there were 31,500 supermarkets nationally in 2000. According to the 2000 census North Carolina is home to 2.86% of the U.S. population. Using population as a proxy for supermarket distribution suggests that there are approximately 900 supermarkets in the state. Applying the Wake County estimate of \$952.38 to these stores creates an upper end estimate of \$857,142 per penny or \$3,428,568 at a rate of 4%. However, because Wake County has a disproportionate share of homes with high incomes and two working professionals, Fiscal Research believes this is an over estimate. Seventy-percent of the number, or \$2.4 million is used as the estimate for the fiscal note.

As mentioned previously this bill also makes taxable some sales by bakeries that are currently exempt. Under current law bakery items for home consumption are exempt from state sales tax. Items sold for something other than home consumption – carry out, weddings, etc. – are taxable. In 1996-97, when all food was taxed by the state, North

Carolina collected \$3.7 million in sales taxes from bakeries. This was an all time high. In 1999-00, when food for home consumption was completely exempt, the Department collected \$2.5 million in sales tax from bakeries. This is the same amount collected in 1998-99. Therefore the maximum gain from reinstating the sales tax on bakeries would be \$1.2 million. However, Fiscal Research believes this is an overestimate given the market trend away from bakeries towards supermarkets. Therefore an estimate of \$0.75 million is used in the fiscal analysis.

All of the prepared food estimates are grown by 5% annually.

One non-food related definition change could have a fiscal impact on the state.

Delivery Charges: At present most delivery charges are subject to state and local sales tax or use tax. Under current law, only in-state purchases with point of sale title transfers are exempt. In practical terms this means items sold in-state, but delivered by a third party carrier, such as a trucking company or the U.S. Postal service, are exempt. As a part of the bill, these delivery charges become taxable. The Department believes the fiscal impact of this change will be a small revenue gain. However, no data is available to create an accurate fiscal estimate.

Part 2: Sourcing: Currently a sale is assumed to take place at the retailer's place of business, regardless of delivery. The bill shifts the state from this sourcing rule to a multi-tier rule that addresses many areas where the appropriate source could be unclear. If the purchase is a traditional "over-the-counter" transaction the sale is sourced to the purchase location. This is similar to current law. However, under the bill if a product is delivered to another location (i.e. a job site or a home in another county) the sale is sourced to the point of delivery. If the seller does not know the delivery address the sale is sourced to the first of the following addresses known by the seller: business or home address of the purchaser, billing address of the purchaser, address of the seller. This change will likely result in a small revenue shift between counties and cities. However, the overall amount of revenue available to local governments will not change.

Part 2: Mill Machinery: The bill also shifts manufacturing items that are currently taxed at a rate of 1% to a maximum tax of \$80 from the sales tax to a use tax, effective 2006. This is expected to make it easier for manufacturers to remit the tax. The Department of Revenue reports that this class of taxpayer tends to pay the use taxes owed. Therefore, the Department does not expect a change in revenue as a result of this change. (The delayed effective date of January 1, 2006 will also limit the immediate fiscal impact of this change).

Part 2: Use and Distributed Items: Under current North Carolina law items that are printed out of state for in state companies are exempt from sales and use tax if those items are mailed directly from the out of state supplier to North Carolina consumers. The most often used example is catalogs printed but out of state printers, paid for by North Carolina retailers, and mailed directly from the printer to a North Carolina resident. This section of the bill clarifies that when the item is distributed from an out of state organization to North Carolina consumers and is paid for by a North Carolina company that transaction is subject

to North Carolina use tax. While this is expected to create a small revenue gain for the state no data is available to produce a reasonable fiscal estimate.

Part 2: Administration of Returns: Currently taxpayers who are consistently liable for at least \$20,000 a month in sales and use taxes must pay the tax and file a return two times a month. Under the bill the taxpayer is still responsible for twice monthly payments, but is only required to file a return once a month. Since this is not changing the payment no fiscal impact is expected.

FISCAL RESEARCH DIVISION 733-4910

PREPARED BY: Linda Struyk Millsaps

APPROVED BY: James D. Johnson

DATE: May 17, 2001



Signed Copy Located in the NCGA Principal Clerk's Offices