GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2007

Legislative Fiscal Note

BILL NUMBER: House Bill 2336 (Second Edition)

SHORT TITLE: Extend Tax Credits & Exempt Disaster Assistance Cards.

SPONSOR(S): Rep. Weiss, Rep. Luebke, Rep. Wainwright, and Rep. Gibson

FISCAL IMPACT

	Yes (x)	No ( )	No Estimate Available ( )		
	FY 2008-09	**FY 2009-10**	**FY 2010-11**	**FY 2011-12**	**FY 2012-13**
REVENUES ($ millions):					
R & D credit	**(1.0)**	**(2.1)**	**(2.3)**	**(2.5)**	**(2.6)**
Low-Income Housing	-	-	-	**(22.1)**	**(45.2)**
Mill Rehabilitation	-	-	**(1.5)**	**(3.4)**	**(4.2)**
Disaster Assistance:					
General Fund	**(0.13)**	**(0.14)**	**(0.14)**	**(0.15)**	**(0.15)**
Local	**(0.07)**	**(0.07)**	**(0.06)**	**(0.06)**	**(0.06)**
EXPENDITURES:					
POSITIONS (cumulative):					

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

EFFECTIVE DATE: See each section for explanation.

BILL SUMMARY:

SECTION 1: EXTEND RESEARCH & DEVELOPMENT TAX CREDIT

Section 1 of this bill would extend for five years, until the year 2014, the sunset on this tax credit. The credit is currently scheduled to expire for taxable years beginning on or after January 1, 2009.

CURRENT LAW: In 2004, the General Assembly enacted a new research and development tax credit as an alternative to the Bill Lee research and development credit, which was set to expire along with the entire Bill Lee Act as of January 1, 2006.

Eligibility. **–** Effective for expenses on or after May 1, 2005, a taxpayer that has qualified North Carolina research expenses or North Carolina University research expenses is allowed a credit. The taxpayer must satisfy Bill Lee Act requirements related to employee wages, the provision of health insurance, the taxpayer's Occupational Safety and Health Act record, and the taxpayer's environmental record. The taxpayer is not required to have no overdue tax debts.

Credit Amount. – For North Carolina university research expenses, the credit amount is equal to 20% of the amount the taxpayer paid to the university for the research and development. For all other qualified research expenses, the credit is equal to a percentage of the expenses as follows:

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

SECTION 2: EXTEND LOW-INCOME HOUSING CREDIT

Section 2 of the proposed committee substitute extends the sunset on the low-income housing tax credit from January 1, 2010, until January 1, 2015. Developers of low-income housing begin their work months in advance and need to know what financing will be available as they secure options on sites.

CURRENT LAW: Congress enacted the federal Low Income Housing Tax Credit in 1986 to fund housing for low- and moderate-income households. Each state receives a limited amount of credit each year. The Internal Revenue Service (IRS) allocates the per capita low-income housing tax credit to state housing agencies such as the North Carolina Housing Financing Agency (HFA), which in turn allocate the credit to project developers who agree to lower project rents for low-income tenants.

In 1999, North Carolina authorized a State income tax credit modeled after the federal housing credit.[2] Under current law, a taxpayer may elect to receive the credit in the form of either a credit against tax liability or a loan generated by transferring the credit to the HFA in return for a 0% interest 30-year balloon loan equal to the credit amount. Historically, project developers have almost always elected the loan option. Neither a tax refund generated by the credit nor a loan received as a result of the transfer of the credit is considered taxable income by the State. Although a State tax refund would be considered taxable income by the IRS if the taxpayer itemizes deductions, a private letter ruling from the IRS provides that the loan proceeds would not.

SECTION 3: EXTEND MILL REHABILITATION CREDIT

Section 3 of the bill extends the sunset for rehabilitation projects for which an application for an eligibility certification is submitted on or after January 1, 2011. The credit is currently set to expire for qualified rehabilitation expenses incurred on or after January 1, 2011. This section also makes clarifying and stylistic changes.

CURRENT LAW: North Carolina allows a tax credit for rehabilitating vacant historic manufacturing sites if the taxpayer spends at least $3 million to rehabilitate the site. The credit is a

[1] A small business is a business whose annual receipts, combined with the annual receipts of all related persons, does not exceed $1,000,000.

[2] Under the original version of the State credit, a project developer had to sell the tax credits to receive funds to finance the project. Developers indicated that the process of selling the credits was complex and that they sold for no more than 45 cents on the dollar. In 2002, the General Assembly modified the way in which developers benefited from the credit to promote efficiency and cost savings while providing the same level of incentives.

percentage of the qualified rehabilitation expenditures and the percentage varies depending on the enterprise tier location of the site and the eligibility for the federal credit. The credit may be claimed against the franchise tax, the income tax, or the gross premiums tax, but may be taken against only one of these taxes. If the credit is taken for income-producing property, it may be taken in the year the property is placed in service. If the credit is taken for non-income-producing property, the credit must be taken in five equal installments beginning with the taxable year in which the property is placed in service. The credit may not exceed the amount of the tax against which the credit is claimed for the taxable year reduced by the sum of all credits allowed, except payment of tax made by the taxpayer. This credit may be taken in place of the credit for historic rehabilitation, not in addition to it.

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

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

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

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

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

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

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

Forfeiture. – The forfeiture of an owner's interest is not required if the change in ownership is the result of the owner's death or the merger, consolidation, or similar transaction requiring approval by the shareholders, partners, or members of the entity, to the extent the entity does not receive

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

cash or tangible property in the transaction. A taxpayer or owner of a pass-through entity that forfeits a credit is liable for all past taxes avoided as a result of the credit plus interest computed from the date the taxes would have been due if the credit had not been allowed.

SECTION 4: EXEMPT DISASTER ASSISTANCE DEBIT CARD SALES FROM SALES TAX

CURRENT LAW: The State may not impose its sales tax on purchases made by the federal government or an instrumentality of the federal government. G.S. 105-164.13(17) specifically exempts 'sales which a state would be without power to tax under the limitations of the Constitution or laws of the United States or under the Constitution of this State.' The American Red Cross (ARC) is an instrumentality of a federal agency. Therefore, sales made pursuant to a disbursing order issued by the ARC are considered a sale to the ARC that is exempt from taxation.

In the past, the ARC provided disaster assistance relief by giving disaster victims a disbursing order to purchase items that the victim needed. Over the last few years, the ARC has begun giving disaster victims debit cards to use to purchase these same items. The ARC began using debit cards because it believes they are more efficient, effective, and less bureaucratic for the victim and less administrative effort and expense for the organization. However, for purposes of the sales tax exemption, there is a significant difference between a debit card and a disbursing order: the purchaser, for purposes of the sales tax exemption, is the disaster victim when a debit card is used and it is the ARC when the disbursing order is used. Therefore, purchases made with a disaster assistance debit card are subject to sales tax.

ANALYSIS: Section 4 of the proposed committee substitute would exempt from sales tax tangible personal property purchased with a client assistant debit card issued for disaster assistance relief by a State agency or a federal agency or instrumentality. The ARC is an instrumentality of a federal agency. Another example of a federal agency or instrumentality that may utilize this exemption would be FEMA.

Section 4 of this proposed committee substitute would extend the sales tax exemption that exists for purchases made through a disbursing order issued by a State or federal agency or instrumentality to purchases made with a client assistance debit card issued by it. In 2007, the total disaster victim assistance purchases were $3 million across all North Carolina chapters of the ARC.

BACKGROUND: The ARC client assistance card clearly identifies itself as one issued by the ARC. The ARC has the ability to see from its reports of the card's use the amount purchased and the store from which the goods were purchased. Unlike the old disbursing order system, the ARC does not have a cash register receipt describing the specific items purchased. The client assistance card authorization form is a contract between the ARC and the disaster victim. The contract stipulates the types of items the card may be used to purchase. In the event of inappropriate purchases, the card can be suspended.

ASSUMPTIONS AND METHODOLOGY:

SECTION 1: EXTEND RESEARCH & DEVELOPMENT TAX CREDIT

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

SECTION 2: EXTEND LOW-INCOME HOUSING CREDIT

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

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

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

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

For example, the 2010 tax year credit amount will be paid in July 2011 (FY 2011-12) and July 2012 (FY 2012-13). The following chart shows the fiscal year impact of the tax credit program until its sunset date.

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

SECTION 3: EXTEND MILL REHABILITATION CREDIT

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

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

The time it takes for a mill rehabilitation project to secure financing to the time that property is completed can take on anywhere from 3 to 5 years. The State Historic Preservation Office notes that mill projects are complex in nature and have longer construction time horizons in order to complete all phases of the project. There are 10 current projects expected to be completed over the next 4 years (7 in 2008) and 3 future projects, which are expected to be placed in service within the next 10 years. There is existing legislation that allows for a Historic Rehabilitation Tax Credit under Article 3D. G.S. 105-129.35 and 105-129.36 allow 20% credit for income-producing rehabilitation project and 30% for non income-producing rehabilitation project. All of these calculations are based upon income-producing properties. The tax year impacts must be distributed by fiscal years. To do this fiscal year impacts were estimated by assuming 45% of the tax year credit will be taken in the year prior to the tax year the credit is taken. This is because of taxpayer adjustments to their estimated payments, which will be paid in September and December.

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

SECTION 4: EXEMPT DISASTER ASSISTANCE DEBIT CARD SALES FROM SALES TAX

The fiscal impact of exempting client assistance cards from state and local sales and use tax is based on data provided by the Triangle ARC. During the 2006-07 fiscal year, North Carolina American Red Cross chapters provided an estimated $3.9 million dollars in disaster relief assistance with approximately 70 percent of the $3.9 million ($2.8 million) in the form of client assistance cards.

Based on Moody’s Economy.com inflation rates, Fiscal Research estimates that ARC will provide roughly three million dollars in disaster relief assistance via debit cards in FY2008-09. Should client assistance cards receive a tax exemption, state and local sales tax revenues would decline by approximately $196,000 during this same period (Table1).

Table 1 provides information on the projected sales tax revenue forgone by exempting disaster relief assistance debit cards from state and local sales and use taxes. The table also accounts for state and local sales and use tax changes occurring on October 2008 and October 2009.

Table 1: Revenue Impact of Exempting Disaster Relief Client Assistance Card Disbursements from Sales Tax, by Fiscal Year (in millions)

	*FY 2008-09	**FY 2009-10	FY 2010-11	FY 2011-12	FY 2012-13
Disaster Relief via Debit Card	2.9	3.0	3.0	3.1	3.2
General Fund Impact	(0.13)	(0.14)	(0.14)	(0.15)	(0.15)
Local Impact	(0.07)	(0.06)	(0.06)	(0.06)	(0.06)
State and Local Impact (6.75% sales tax)	(0.20)	(0.20)	(0.20)	(0.21)	(0.21)

* FY2008-09 estimates incorporate local and state sales tax rate changes occurring on October 1, 2008; Assumes local sales tax rate of 2.5% for three months and 2.25% for nine months; Also assumes state sales tax rate of 4.25% for three months and 4.5% for nine months

* *FY2009-10 estimates incorporate local and state sales tax rate changes occurring on October 1, 2009; Assumes local sales tax rate of 2.25% for three months and 2% for nine months; Also assumes state sales tax rate of 4.5% for three months and 4.75% for nine months

Source: Triangle American Red Cross Documentation of FY07 Financial & Material Assistance

SOURCES OF DATA: Department of Revenue, Moody's economy.com, North Carolina Housing Finance Agency, State Historic Preservation Office, Triangle American Red Cross

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

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