This Bill Analysis reflects the contents of the bill as it was presented in committee.

HOUSE BILL 117: NC Competes Act

2015-2016 General Assembly

Committee:	Senate Appropriations/Base Budget	**Date:**	August 10, 2015
Introduced by:	Reps. S. Martin, Jeter, Collins, Steinburg	**Prepared by:**	Cindy Avrette Dan Ettefagh Committee Counsel
Analysis of:	Fifth Edition		

SUMMARY: ***The Senate committee substitute for House Bill 117 makes changes to the JDIG program, One NC, and the tax laws to incent economic development in the State. The provisions addressed by the bill have been debated this session in House Bill 117 and in the budget bill, House Bill 97.***

PART I. JDIG MODIFICATIONS

JDIG is a discretionary program of the State that provides funds to incentivize new or expanding business to create jobs in the State. The amount that can be committed in JDIG grants has statutorily been capped at $15M per calendar year. Under current law, the period is not based on the calendar year but was based on the 2013-15 biennium (with a $22.5M cap) and a half-year period of 7/1/15 through 12/31/15 (with a $7.5M cap).

Regarding commitment availability, the bill would (i) collapse the prior biennium with the current half-year period, (ii) add $5M of additional capacity for the current period (iii) increase the calendar year statutory cap from $15M to $20M on an on-going basis, and (iv) extend the program three years, allowing JDIG commitments through 1/1/19.

The amount a business receives via JDIG would be changed two ways: (i) the JDIG award calculation is changed from a flat 10-75% the personal income tax withholdings generated by the eligible created positions to a tiered maximum percentage of withholdings (80% of withholdings if the project is in Tier 1 and 75% for all other areas and (ii) the portion of the award diverted to the Utility Account[1] in tier 2 areas is changed from 15% to 10%.

Minimum criteria for participation in the program would be increased. Job creation requirements would increase from 20 jobs to 50 jobs for tier 3.

The bill would create a component for recruitment of megasites or high-yield projects where a business invests at least $750M and creates at least 2,000 jobs. Programmatically, when a high-yield project is landed, the annual JDIG commitment cap for that year increases from $20M to $35M. If the business meets the job creation and investment requirement and meets all performance metrics for three consecutive years, the business' JDIG award is augmented 3 ways: (a) the basis for calculating the award increases to 100% of the withholdings associated with the created, eligible positions; (b) up to 8 years is added to the 12-year term limitation; and (c) any UA diversion is eliminated. In the event the high-yield

[1] Utility account is used to assist local governments in tier 1 and 2 counties to create jobs. Can be used for construction of/improvement to new/existing water, sewer, gas, telecom, high-speed broadband, electrical utility distribution lines/equipment, transportation infrastructure for existing/new/proposed buildings. No local match for top 25 most economically distressed counties. 25% match for remainder of eligible counties.

project fails to meet performance metrics after receiving the augmented award in any year, the augmented benefits expire and the company cannot, thereafter, regain the augmented benefits.

The bill would address concerns that Commerce consumed JDIG availability too quickly each calendar year by splitting the single year $20M basis for commitment caps into 2 equal semiannual installments of $10M. Within the calendar year, amounts not utilized in a period roll over to the next period.

Final miscellaneous changes to JDIG include (i) adding a pre-requisite finding that the local has appropriately participated in recruit efforts and in incentives offered; (ii) strengthening the recapture provision for failure to maintain operations for 150% of the grant term; (iii) modifying the relevant time period against which increases in employment are measured;[2] and (iv) adding to the annual reporting requirement a tier-itemized listing of unaccepted offers and their aggregate value and adding a single-time report requiring the Department to study factors contributing to grant termination in view of other states' efforts with the goal of identifying ways to decrease the incidence of terminations.

PART II. ONE NC MODIFICATIONS

The One NC fund is a discretionary fund by the State to provide money to locals to secure commitments for recruitment, expansion, or retention of new or existing businesses. Part 2 of the bill would modify the local match requirement of the One NC Fund to a tiered requirement: 3 State dollars for 1 local dollar for tier 1, 2 State dollars for 1 local dollar for tier 2, and an even local match for tier 3.

PART III. PHASE-IN SINGLE SALES FACTOR

Corporate income and franchise tax apportionment of taxable income for multi-state corporations is based on three factors: property, payroll, sales. The sales factor is double-weighted. Part IV would phase-in single sales factor apportionment (SSF) over three years:

- 2016: three times sales
- 2017: four times sales
- 2018: single sales factor

SSF is an increasing trend among states. More than 21 states currently use SSF. Among the State's neighboring states: SC and GA use SSF; TN just amended its formula to move from double-weighted to triple-weighted sales; and VA uses SSF for manufacturing and retail.

The Senate budget (H97, V7) contained this provision. In addition to phasing-in SSF, the Senate budget made many other changes to the corporate income and franchise tax statutes. Those changes are not included in this Part. The House has not passed legislation this session that would change the general apportionment formula.

PART IV. DATACENTER INFRASTRUCTURE ACT

Under current law, an eligible Internet datacenter may receive a sales tax exemption for electricity and certain business property that is located and used at the datacenter. An eligible Internet datacenter is one that is used primarily by a business engaged in software publishing or an Internet activity, that is comprised of structures located on contiguous parcels of land that are commonly owned by the operator of the facility, is located in a development tier one or two area, and has a written determination provided by the Secretary of Commerce that at least $250 million in private funds has been or will be invested in the property. To be eligible for the exemption, the business property must be capitalized for tax purposes under the Code and must be used for the provision of services related to the business of the primary user

[2] Under current law, the business must maintain employment levels at the level of the year immediately preceding the base period. The bill would change the relevant comparison point for employment levels from immediately preceding the base period to the greater of the employment levels at the date of application or date of award.

of the datacenter; used for the generation, transmission, transformation, distribution, or management of electricity; or used to provide related computer engineering or computer science research.

There were two other tax benefits available to certain datacenters, but those benefits have expired.[3]

Section 4 would create a similar, but not identical, sales tax exemption for datacenter equipment and electricity. There are slight differences in the requirements that would need to be met to qualify for the exemption, and there appears to be more flexibility in the types of business property that would qualify for the sales tax exemption. To qualify for the sales tax exemption, the taxpayer would need to meet wage standard and health insurance requirements, and would need to have a written certification from the Secretary of Commerce that at least $75 million in private funds has been or will be invested by one or more owners, users, or tenants of the datacenter within five years of the date the initial investment is made. Initial investments made on or after January 1, 2012, may be included to meet the investment threshold. This section becomes effective for purchases made on or after October 1, 2015. The House passed this identical provision, with a July 1st effective date, in HB 117. The Senate has not considered this provision.

PART V. SALES TAX RELATIVE TO AVIATION

Part V addresses several sales tax issues related to aviation.

Expiring sales tax refund for interstate passenger air carrier with a hub in NC

An interstate passenger air carrier with a hub in the State is allowed a sales tax refund of State and local sales tax paid on fuel in excess of $2.5 million. The General Assembly enacted the refund provision in 2004, effective January 1, 2005, with a sunset that has been extended several times. The refund tax benefit is repealed for purchases made on or after January 1, 2016.

Section 5.1(c) would address the expiration of the sales tax refund by exempting aviation gasoline and jet fuel sold to an interstate air business for use in a commercial aircraft. The exemption is effective for sales made on or after January 1, 2016. It expires for sales made on or after January 1, 2020. The Senate has not considered this issue this session. The House extended the refund provision for four years in House Bill 117, V4.

The exemption is broader than the current refund provision; it is available to all interstate air businesses at all airports in the State. The exemption provided in this bill for fuel mirrors the existing sales tax exemption for tangible personal property sold to an interstate air business that becomes a component part of a commercial aircraft during its maintenance, repair, or overhaul. For purposes of these two exemptions, a commercial aircraft is defined as one that has a certified maximum take-off weight of more than 12,500 pounds and is regularly used to carry for compensation passengers, commercial freight, or individual addressed letters and packages. An interstate air business is one or more of the following:

- An interstate air courier. – A person whose primary business is the furnishing of air delivery of individually addressed letters and packages for compensation, in interstate commerce, except by the United States Postal Service.
- An interstate freight air carrier. – A person whose primary business is <u>scheduled</u> freight air transportation, as defined in the North American Industry Classification System adopted by the United States Office of Management and Budget, in interstate commerce.

[3] G.S. 105-164.14A(a)(3) provided a sales tax refund for information technology companies in a tier one area for machinery and equipment. This preference expired January 1, 2014. G.S. 105-187.51C imposed a 1% excise tax, in lieu of a State and local sales tax, on certain equipment and machinery. This preference expired July 1, 2015.

- An interstate passenger air carrier. – A person whose primary business is scheduled passenger air transportation, as defined in the North American Industry Classification System adopted by the United States Office of Management and Budget, in interstate commerce. Charter flights, by definition, do not appear to be an interstate passenger air carrier.

FAA policy that revenue from tax on aviation fuel must be used for aviation purposes

On November 7, 2014, the Federal Aviation Administration (FAA) adopted an amendment to its policy on Federal requirements for the use of proceeds from taxes on aviation fuel.[4] The action confirmed the FAA's long-standing policy that airport operators that have accepted Federal assistance generally may use airport revenue only for airport related purposes.[5] Failure to do so could result in a loss of federal funds. States must have an action plan as to how it plans to comply with the FAA policy by December 8, 2015; and the State must be in compliance with the policy by December 8, 2017.

North Carolina has included fuel in its State and local sales and use tax base for decades without restricting its use to aviation purposes. Of the State sales tax rate of 4.75%, 3% is grandfathered but the remaining 1.75% must be in compliance with the FAA policy. Of the local sales tax rate, 2% is grandfathered but any local option sales taxes imposed since 1987 are not. Rather than trying to administratively account for the tax revenue derived from the grandfathered rates and the revenue derived from the remainder of the sales tax levies, this section simplifies the process by imposing the combined general rate of sales tax on aviation gasoline and jet fuel[6] and using all of the proceeds from the tax for aviation purposes. Most of the sales tax on aviation gasoline and jet fuel is attributable to purchases made by interstate air businesses, and those purchases would be exempt from sales tax under Section 5(c).

This change means there will not be a local tax rate on aviation gasoline and jet fuel.[7] All of the revenue derived from the sales tax on aviation gasoline and jet fuel must be transferred to the Highway Fund within 75 days after the end of the fiscal year and is appropriated to the Division of Aviation of the Department of Transportation for prioritized capital improvements to public airports and time-sensitive aviation capital improvement projects for economic develop purposes. This change becomes effective January 1, 2016. This issue has not been addressed to date in either the Senate or the House.

Sales tax exemptions for qualified aircraft and qualified jet engines

S.L. 2013-316 expanded the sales tax base to include the sales price of a service contract. A service contract is defined as a warranty agreement, a maintenance agreement, a repair contract, or a similar agreement or contract by which the seller agrees to maintain or repair tangible personal property. Service contracts on the following items are exempt:

- An item exempt from tax under the sales tax Article, other than a motor vehicle exempt from tax.
- A transmission, distribution, or other network asset contained on utility-owned land, right-of-way, or easement.

[4] Federal Register at 64 FR 7696 on February 16, 1999 ("Revenue Use Policy")
[5] Taxes enacted prior to 1987 are grandfathered and are not subject to the use restriction.
[6] Section 5.1(b) would impose the combined general rate of tax on the gross receipts derived from aviation gasoline and jet fuel. The combined general rate of 7% is the general rate (4.75%) plus the highest authorized local option sales tax rate available to all counties (2.25%).
[7] Under the Streamlined Sales Tax Agreement, the tax base must be uniform in the taxing jurisdiction. To maintain a local uniform tax base, and meet the FAA use restrictions, would be administratively difficult. There is also some uncertainty how the FAA use restrictions would apply to local sales tax levies. The elevation of the tax to a State tax, and the use of all the proceeds from the tax for aviation-related purposes, eliminates many of these issues.

- An item purchased by a professional motorsports racing team for which the team may receive a sales tax refund under G.S. 105-164.14A(5).
- An item subject to tax under Article 5F of Chapter 105 of the General Statutes

Section 5.2(c) would exempt from sales tax service contracts on a qualified aircraft or qualified jet engine. A qualified aircraft is defined as an aircraft with a maximum take-off weight of more than 9,000 pounds but not in excess of 15,000 pounds; a qualified jet engine is an engine certified under Part 33 of Title 14 of the Code of Federal Regulations. In addition, Section 5.2(d) would exempt parts and accessories for use in the repair or maintenance of a qualified aircraft or a qualified jet engine.

This section becomes effective October 1, 2015. Both the House and the Senate budgets (HB 97, V4 and V7) provided an exemption for service contracts of a qualified aircraft and a qualified jet engine.

Sales tax rate and cap on boats, aircraft, and qualified jet engines

The State sales tax rate on boats and aircraft is 3%, with a cap of $1,500. There is no local sales tax on boats or aircraft. Section 5.2(b) would increase the rate to the general rate, which is currently 4.75%. It would also increase the cap on the sales tax on aircraft to $2,500. Section 5.2(f) is a conforming change to remove boats and aircraft from the local sales tax base, even though they would be subject to the State general rate. It also removes qualified jet engines from the local sales tax base.

Under the Streamlined Sales Tax Agreement, a taxing jurisdiction must have uniform tax rates and may not have caps or thresholds. Aircraft and boats are two exceptions to that provision. A qualified jet engine does not fall within one of the exceptions. To afford similar tax treatment for qualified aircraft and qualified jet engines, Section 5.2(e) would allow the purchaser of a qualified jet engine to pay the use tax through a direct pay permit in lieu of the sales tax, and provide that the maximum use tax would be $2,500.

This section would become effective October 1, 2015. The Senate budget (HB 97, V7) increased the sales tax rate for boats and aircraft; and it increased the cap on aircraft to $5,000. Neither the House nor the Senate has considered a different use tax rate on qualified jet engines.

PART VI. FAIR DISTRIBUTION OF SALES TAX REVENUE TO LOCAL GOVERNMENTS

In 1971, the General Assembly authorized counties to impose a 1¢ local option sales tax, distributed to the taxing counties based on the point of collection.[8] In 1983, the General Assembly authorized counties to impose a ½¢ local option sales tax, distributed to the taxing counties on a per capita basis.[9] In 1985, the General Assembly authorized counties to impose a second ½¢ local option sales tax, distributed to the taxing counties on a per capita basis.[10] In 2001, the General Assembly authorized counties to impose a third ½¢ local option sales tax, distributed to the taxing counties as follows: ½ point of collection, ½ per capita.[11]

The 50/50 point of collection/per capita distribution of local option sales taxes remained in place until 2007. In 2007, as part of the Medicaid Swap, the third ½¢ local tax rate was reduced to 0 and the State sales tax rate was increased ½¢. Also as part of that swap, the second ½¢ local sales tax distribution among the counties was changed from per capita to point of collection.[12]

[8] S.L. 1971-77.
[9] S.L. 1983-908.
[10] S.L. 1985-906.
[11] S.L. 2001-424, Section 34.14.
[12] S.L. 2007-323, Section 31.16.

Food has always been part of the 2% local sales tax base. In 2003, as part of many sales tax changes the State made to adhere to the Streamlined Sales Tax Agreement, the taxation of food was moved to the State level for administrative purposes and the following distribution formula was adopted:[13]

- ½ of the net proceeds are distributed on a per capita basis, after adjusting the allocated amount by the appropriate adjustment factor.
- ½ of the net proceeds are distributed proportionately to each taxing county based upon the amount of sales tax on food collected in the taxing county in the 1997-1998 fiscal year.

Section 6 provides that all of the local sale tax revenues under Articles 39, 40, and 42, including the net proceeds from the sales tax on food, are distributed the same: 50% on a point of collection and 50% on a per capita basis. Section 6(h) removes the current restrictions on how the two ½¢ local option sales taxes must be used: 30% for public school capital outlay and 60% for public school capital outlay, respectively. Section 6(c) replaces this use provision with a similar, but more expansive use provision: the net proceeds of the revenue received by a county on a per capita basis must be used for public education and community college purposes.

Section 6(d) removes the adjustment factor that has been applied to the per capita distributions since 1988. Effective March 1, 1988, the General Assembly provided that the situs of a sale was considered to be the county of the retailer's place of business rather than the purchaser's county when the property was sold in one county and delivered to the purchaser in another county. This change in situs would have resulted in some counties gaining revenue and others losing revenue. To hold counties harmless, the per capita local option sales tax distributions were adjusted up or down by the adjustment percentage in G.S. 105-486.[14] In 2001, to comply with the uniform sourcing rules of the Streamlined Sales Tax Agreement, the sourcing rules for both the State and local sales and use taxes were changed back to destination sourcing.[15]

This section becomes effective July 1, 2016, and applies to sales made on or after that date. The Senate budget bill (H97, V7) would have phased the 75% point of collection/25% per capita local sales tax distribution to 20% point of collection/80% per capita over five years.

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[13] S.L. 2003-284; S.L. 2003-416.
[14] S.L. 1987-832.
[15] S.L. 2001-347.