NORTH CAROLINA GENERAL ASSEMBLY
LEGISLATIVE FISCAL NOTE

BILL NUMBER: House Bill 1157 (Second Edition)

SHORT TITLE: Enforce Tax Collection and Equality/No Fraud

FISCAL IMPACT ($MILL.)

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

	FY 2001-02	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06
REVENUES: State General Fund					
LLC's	+$10.5	+$11.0	+$11.4	+$11.7	+$12.2
Royalty Provision	20.0	21.0	21.8	22.4	23.3
Subsidiary Dividends	30.8	32.3	33.6	34.5	35.9
Total	**$61.3**	**$64.3**	**$66.8**	**$68.6**	**$71.4**

PRINCIPAL DEPARTMENT AFFECTED: The corporate income tax is collected by the Department of Revenue. The enactment of the bill should not affect the Department's budget Requirements.

EFFECTIVE DATE: The LLC provision is effective for **taxes due** on or after January 1, 2002. The other two changes are effective for tax years beginning on or after January 1, 2001.

BILL SUMMARY: (1) **Royalty Income.** Clarifies that royalty payments received for the use of trademarks in North Carolina are income derived from doing business in this state. To accomplish this objective, the bill allows related corporations an option: (a) the payer deducts the N.C. royalty payments on its N.C. return and the recipient includes the royalty income on its N.C. return; or (b) the payer adds the payments to its N.C. income and the recipient deducts them on its N.C. return. (2) **Limited Liability Corporations (LLC's).** Requires a corporation to include a LLC's assets in its franchise tax base if the corporation is entitled to receive 70% or more of the assets of the LLC upon dissolution of the LLC. (3) **Subsidiary Dividends.** Piggybacks the federal dividends received deduction for State corporate income tax purposes and to the treatment used in most states.

ASSUMPTIONS AND METHODOLOGY:

(1) **Royalty Income.** The first step in this estimate was a review of the Department of Revenue's analysis, as set out below:

> The Department used data on outstanding assessments, data from accounting firms, and data from other states to develop this estimate. The Department assumes that, in the absence of a statutory change that reinforces the Departments' rule, most of the companies that have been assessed will wait for a decision of the North Carolina Supreme Court before complying. Since the Loophole Commission estimate, the Department has contacted accounting firms and other states. Information from accounting firms indicates that there are between 50 and 75 companies that have liabilities and have not been assessed by the Department. The Department assumes that the liabilities of the group of companies known to the accounting firms are similar to those of the companies currently under assessment. The estimated annual increase from 50 of these companies is $25 million, the estimated annual increase from 60 of these companies is $30 million, and the estimated annual increase from 75 of these companies is $37.5 million. When added to the Department's assessments, the estimated increase ranges from $40 to $52.5 million.

In addition to reviewing the Department of Revenue methodology, Fiscal Research considered impact data from similar laws in two other states. The scope of the proposed North Carolina change is in line with a 1998 Connecticut change, which was estimated at the time to generate $14 million once fully implemented. In addition, the Revenue Department memorandum indicated that Ohio legislation was generating $50 million per year.

In order to use this data, adjustments must be made for the relative size of the 3 states and the different tax rates. In addition, it is necessary to factor in the fact the Ohio encompasses more types of intangible income than the proposed change.

Using data from other states is difficult due to differences in corporate practices regarding intangible property and the composition of each state's economy. To be conservative we have used a $20 million estimate for this provision.

(2) Limited Liability Corporations (LLC's). The Fiscal Research estimate is based on an analysis by the Department of Revenue contained in a June 15 memorandum. The language below sets out the Department's methodology:

> The Department of Revenue (DOR) received a list from the Secretary of State's Office of the 42,000 LLCs formed since 1997 when the law was changed to allow LLCs to be single-member LLCs. The Department sampled this list to determine how many of these LLCs are single-member LLCs. Based on the sampling, the Department estimates that 50% of the 42,000 are single-member LLCs. The Department then tried to determine how many of the 21,000 single-member LLCs would be affected by the change made and what that change would be. Based on information received from accounting firms and on reviewing the articles of organization of the single-member LLCs, the Department estimates that 10% of the

single-member LLCs, or 2,100 LLCs, are affected. The Department determined the before and after franchise tax liability of a handful of corporations that have created single member LLCs. The tax benefit ranges from $5,000 to $250,00 annually. Information from accounting firms indicates that the average benefit is $5,000 to $20,000. Applying the $5,000 benefit to the 2,100 single-member LLCs affected by Section 34.5 gives a total of $10.5 million. Using a higher average liability would result in a higher estimate. The Department does not have enough data to determine the proper average, however, and is therefore applying the low end of the range.

Fiscal Research is using the $10.5 million estimate, which is at the bottom of the Revenue Department forecast range.

(3) **Subsidiary Dividends.** The first step in this estimate was a review of the Department of Revenue's analysis, as set out below:

> The Department started with an estimate done in 1997 when the General Assembly was considering requiring all corporations to attribute expenses to subsidiary dividends. For that 1997 estimate, the Department reviewed returns for tax year 1994 to determine the amount of subsidiary dividends claimed and the effect of a 15% attribution requirement on these dividends. The estimated effect was $30 million. The Department used the $30 million from the 1997 estimate as the starting figure for this estimate. The Department recalculated the 1997 estimate to apply the reduced tax rate and to take into account the growth in collections since 1997. The Department then made two adjustments to this amount. First, it increased the amount to reflect the gain in the reduction from 100% to 80% of the deductible percentage of dividends received from companies that are not affiliates. In making this adjustment, the Department assumed that 10% of the dividends deductible under current law are received from non-affiliates. Second, it decreased the amount to reflect the loss on dividends received from less than 50%-owned companies.

Fiscal Research is using the Department of Revenue methodology for this provision.

TECHNICAL CONSIDERATIONS: The impact estimate of all 3 provisions was increased in future years by the growth in calendar year nationwide corporate pretax profits as estimated by DRI/WEFA, the consulting firm used by the Office of State Budget, Planning, and Management. The annual growth rates range from 2.9% to 4.8%.

FISCAL RESEARCH DIVISION 733-4910
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Signed Copy Located in the NCGA Principal Clerk's Offices