GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2007

Legislative Fiscal Note

BILL NUMBER: Senate Bill 1171 (First Edition)

SHORT TITLE: Privilege Tax For Info. Tech. & Serv. Company.

SPONSOR(S): Senator Cowell

FISCAL IMPACT (Mil.)

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11	FY 2011-12
REVENUES					
State General Fund	**-24.3**	**-26.0**	**-26.3**	**-26.5**	**-26.8**
Local Government	**-13.4**	**-18.1**	**-18.2**	**-18.4**	**-18.6**

EXPENDITURES

POSITIONS (cumulative):

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: The tax is collected by the Department of Revenue. The enactment of the bill is not expected to affect the budget requirement of the Department.

EFFECTIVE DATE: July 1, 2007.

BILL SUMMARY: In recent years the State, in order to comply with the Streamlined Sales Tax Project (collect sales tax on remote vendors), has shifted the taxation of manufacturing machinery and selected other capital expenditures from a 1%, ($80 limit) sales tax to a separate privilege license tax levied at the same rate.

During the 2006 legislative session, the 1% ($80 limit) tax treatment on capital equipment was extended to certain equipment purchases by research and development companies in the physical, engineering, and life sciences.

SB 1171 would extend the 1% ($80 limit) tax treatment to certain equipment purchased by information technology and services companies that perform research and development.

ASSUMPTIONS AND METHODOLOGY: The analysis of the impact of this proposal is similar to the steps used for an identical change approved by the 2006 General Assembly for research and development companies. One research problem is a lack of specific North Carolina R & D spending data for affected industry groups. As a proxy, a ratio of R & D spending to employment was developed for the 2006 fiscal note.

In 2005 the North Carolina Biosciences Organization (NCBio), in conjunction with Fiscal Research, surveyed selected members of their organization concerning their level of employment and their expenditures on research and development equipment. The results of the survey indicate that these businesses spent an average of $15,065 per employee on potentially qualifying equipment in 2004.

This 2004 ratio is out of date due to the normal rise in the dollar amount of research per employee over the last 3 years. At the same time, during the 2006 discussions industry representatives indicated that their experience indicated that the $15,065 ratio may be too high. Since these adjustments are somewhat offsetting, it was decided to continue to use the $15,065 assumption for the 2007-08 fiscal year.

The next step was to pull data from the Employment Security Commission website for 2004, 2005 and 2006 on the number of employees from the three NAICS codes affected by the bill: We then applied 75% of the two-year growth rate between 2004 and 2006 to the actual 2006 level to get to the mid-point value for the 2007-08 fiscal year. The NAICS codes affected, as well as the estimated 2007-08 employment levels, are shown below:

NAICS Code	Description	Employment
518	ISPs, Search Portals, & Data Processing	11,707
5112	Software Publishers	7,216
5415	Computer Systems Design and Related Services	28,546

The employment counts were multiplied by the ratio of R & D equipment to employment to derive an estimate of the expenditures that would qualify for the new tax rate. This spending level was then multiplied by the tax rate under existing law and the proposed 1% rate under the bill. The difference between these rate calculations is the dollar savings between the current law rate on July 1, 2007 (4.0% state, 2.5% local) and the 1% rate.

The next step is to try to determine the impact of the $80 "per article" tax limit. The effect of the limit is to cap the sales price to which the tax applies at $8,000. This limit has been part of the sales tax law, and now the license tax law, for many decades. On numerous occasions during this period Fiscal Research, working with the Department of Revenue, has tried to get estimate of the impact of the $80 limit. Unfortunately, the distribution of capital purchases by dollar amount exists nowhere in the marketplace and is not reported on sales tax returns.

Given the expensive nature of the specialized equipment used in R & D activities we felt that the cap would substantially lower revenue from the straight 1% rate. For the purpose of this analysis, it was assumed that the $80 limit lowers the 1% yield by 60%.

The new 1% tax ($80 limit) would represent would be a State tax with no local tax levied. Under current law the local 2.5% sales tax applies to these transactions in addition to the state tax. In addition, the impact estimate for the State portion of the tax incorporates the current law reduction from 4.25% to 4.0% on 7/01/07.

For future years the impact of the bill is estimated to increase by 1% per year. This rate is substantially below the growth of the economy or R & D expenditures because of the impact of the $80 cap. The effect of the cap is to shift much of the growth to “units” instead of dollars. The 1% assumption is in line with historical sales tax experience on manufacturing machinery and other items that were subject to the 1%, $80 cap treatment.

The estimate for the 2007-08 fiscal year is less than 100% of the annual effect for timing reasons. For example, the state portion of the tax, a Fiscal Research model, based on sales tax collection data by size of retail merchant, indicates that for a tax change effective date of July 1, 2007 the 2007-08 impact will be 94.3% of the annual impact. The reason has to do with the time lag between the levy of the tax on a purchase and the remittance of tax proceeds by merchants. For the local portion of the tax, the 2007-08 impact is 75% of the annual amount.

SOURCES OF DATA:

TECHNICAL CONSIDERATIONS:

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