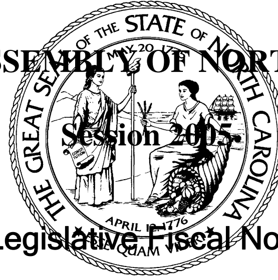
GENERAL ASSEMBLY OF NORTH CAROLINA



Session 2005

Legislative Fiscal Note

BILL NUMBER: House Bill 2170 (Sixth Edition)

SHORT TITLE: Bill Lee Changes.

SPONSOR(S): Representatives Harrell, Daughtridge, Gibson, and Owens

FISCAL IMPACT ($ Million)					
	Yes (X)	**No ( )**	**No Estimate Available ( )**		
	FY 2006-07	**FY 2007-08**	**FY 2008-09**	**FY 2009-10**	**FY 2010-11**
REVENUES: State General Fund	-0-	-$2.0	-$6.4	-$12.0	-$17.0
EXPENDITURES:					
POSITIONS (cumulative):					
PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED:					
EFFECTIVE DATE: Included in "Bill Summary"					

BACKGROUND INFORMATION: The Bill Lee Act was enacted in 1996 and has been modified on numerous occasions. The 1996 legislation included a January 1, 2002 sunset of the full Act. During the 2000 session the sunset was extended to January 1, 2006. Finally, the 2005 General Assembly moved the sunset to January 1, 2008 with the expectation that the 2006 session would overhaul the entire Act. HB 2170 represents that re-write.

The current Bill Lee Act is a package of State tax incentives adopted during the 1996 session. The incentives are primarily in the form of state tax credits for investing in machinery and equipment, acquiring certain real property, creating jobs, establishing a central administrative office, and training workers. The original research and development credit has been re-codified elsewhere.

Under the Act, counties are divided into five enterprise Tiers based on the unemployment rate, per capita income, and population growth of the county. For many of the credits, the lower the Tier of a county, the more favorable the incentive. The Act requires the Department of Commerce and the Department of Revenue to report periodically on the credits allowed by the Act.

BILL SUMMARY: Replaces the existing Bill Lee Act with a new system of more narrowly focused job creation and investment tax credits. The new package generally becomes effective beginning with activity taking place on or after January 1, 2007 and sunsets January 1, 2011. The existing Bill Lee Act is eliminated on January 1, 2007 with one exception: companies currently considering expanding in or relocating to North Carolina would be allowed to claim Bill Lee Act credits for the 2007 tax year under the Act if the taxpayer signs a letter of commitment with the Department of Commerce by December 31, 2006. The letter would require that the specific project be described.

Beginning on the next page is a comparison of the major features of the current Bill Lee Act and the proposed system.

	Current Law	**HB 2170**
Tier Structure (Tier 1 includes most distressed counties)	5 enterprise Tiers: - 10 counties in Tier 1 - 15 counties in Tier 2 - 25 counties each in Tiers 3, 4, and 5 Exceptions may move some counties to more distressed tier level	3 development Tiers: - 40 counties in Tier 1 - 40 counties in Tier 2 - 20 counties in Tier 3 Exceptions may move some counties to a lower tier and some to a higher tier
Tier Rankings	- 3 factors determine initial ranking: unemployment, per capita income, population, growth - Adjustments based on Tier 1 or 2 status, population level, unemployment level, and multi-county parks - Population figures include prisoners	- 4 factors determine initial ranking: unemployment, median household income, population growth, and assessed property value per capita - Same adjustments as under Bill Lee Act except for high high unemployment - Population figures do not include prisoners
Distressed Zones Within a County (Enhanced Credits)	Development zones eligibility: - At least partly within a city of 5,000 or more - Zone population of at least 1,000 - 20% of zone population is below poverty level - Every census tract in zone meets certain poverty guidelines - Area may be in one zone	Urban progress zones eligibility: - Wholly with a city of 10,000 or more - Each track must meet poverty or industrial requirements - Non-residential tracks no more than 35% of zone - Zones no more than 15% of municipality
Taxes to Which Credits Apply	- Credit is taken against either income, franchise, or insurance premiums tax - Credit may not exceed 50% of liability of tax selected - Carryforward period ranges from 5 years to 20 years	- Credit is taken against income, franchise, or insurance premiums taxes or combination of these taxes - Credit may not exceed 50% of combined tax liability - Carryforward period ranges from 5 years to 20 years

	Current Law	**HB 2170**
Activity Eligibility Factors	Depends on a combination of factors including: - Primary activity of a taxpayer as a whole - Primary activity of the special establishment - Enterprise Tier designation of the establishment - Number of new jobs created	- Eligibility depends on the primary activity of the specific establishment - However, company headquarters must create 75 jobs over two years
Eligible Industries	- Air courier services - Central office or aircraft facility - Computer services - Customer service center - Data processing - Electronic mail order house - Manufacturing - Warehousing - Wholesale trade	Same as current law with following exceptions: - Aircraft maintenance and repair is established as a separate category - Central administrative office is changed to company headquarters - Data processing and computer services combined as information technology and services - Motorsports racing team and motorsports racing facilities added - Research and development added
Quality Jobs	- Provision of health insurance - OSHA record - Environmental record - No overdue tax debts	Same As Current Law

Wage Standard	- No wage standard in Tiers 1 and 2 and development zones
	- Wage standard equal to 110% of the lesser of:
	  - County wage
	  - State wage
	  - County wage adjusted by the wage/income factor
		- No wage standard in Tier 1
		- Wage standard equal to the lesser of:
		  - 110% of the State wage
		  - 90% of the county wage
		- Wage standard in Urban Progress zone is 90% of the lower wage

	Current Law	HB 2170
Specific Credits	- Job creation - Investing in machinery & equipment - Technology commercialization - Worker training - Central office or aircraft facility property - Other real property - Development zone projects	- Job creation - Investing in business property - Investing in real property

Job Creation Credit	- Must have 5 full-time employees and create at least one new job
	- Credit amount varies depending on enterprise Tier and development zone:
	  - $12,500 per job in Tier 1
	  - $4,000 per job in Tier 2
	  - $3,000 per job in Tier 3
	  - $1,000 per job in Tier 4
	  - $500 per job in Tier 5
	  - Additional $4,000 for development zone
	- Taken over 4 years
		- Taxpayer must meet a job creation threshold before becoming eligible for the credit:
		  - 5 new jobs in Tier 1
		  - 10 new jobs in Tier 2
		  - 15 new jobs in Tier 3
		- Taken over 4 years
		- Jobs transferred from a related member not included
		- Credit varies depending on Tier and Urban Progress zone:
		  - $12,500 per job in Tier 1
		  - $5,000 per job in Tier 2
		  - $750 per job in Tier 3
		  - Additional $1,000 for Urban Progress zone ($2,000 for hiring a zone resident or long-term unemployed worker in zone)

Machinery & Equipment Credit	- Credit taken in seven installments
	- Credit amount varies depending on enterprise Tier level:
	  - 7% in Tiers 1 and 2
	  - 6% in Tier 3
	  - 5% in Tier 4
	  - 4% in Tier 5
	- Machinery and equipment definition narrowly drawn
		- Credit taken in four installments
		- Credit amount varies depending on development Tier level:
		  - 7% in Tier 1
		  - 5% in Tier 2
		  - 3.5% in Tier 3
		- Business property definition broadly drawn

	Current Law	HB 2170
	- Credit is based on the eligible investment amount above a threshold: - $0 in Tier 1 - $100,000 in Tier 2 - $200,000 in Tier 3 - $1,000,000 in Tier 4 - $2,000,000 in Tier 5	- Credit is based on the eligible investment amount above a threshold: - $0 in Tier 1 - $1,000,000 in Tier 2 - $2,000,000 in Tier 3
Real Property Credit	- Require activity in lower-tiered area - Require 200 new jobs and $10 million investment - Credit equal to 30% of eligible investment amount - Credit taken over 7 years - 20-year carryforward	Same as current law except for 15 year carryforward
Credit Application Fee	- $500 for each type of credit - $1,500 maximum fee per tax year - Proceeds retained as agency receipts - Positions funded by receipts	- $500 for each type of credit - No maximum fee - Proceeds go to General Fund - Positions approved during budget process

The bill also authorizes the creation of agrarian growth (AG) zones and would provide those areas with the same benefits provided to urban progress zones. An AG zone must satisfy the following conditions: (1) it must be composed of contiguous census tracts or block groups located within a single county that does not have any municipality with a population in excess of 10,000; (2) each census tracts or block groups in the zone must have more than 20% of its population below the poverty level; and, (3) the area of the zone, less its smallest census tract, may not exceed 5% of the total area of the county.

A county may have only one agrarian growth zone. Upon request of a local government, the Secretary of Commerce must make a written determination whether an area is an agrarian growth zone.

The bill indicates that for the purposes of the wage standard, the machinery and equipment credit, and the worker training credit, an agrarian growth zone is considered a development tier one area (most distressed counties). For all other purposes, an agrarian growth zone has the same tier designation as the county in which it is located.

The change is effective for taxable years beginning on or after January 1, 2006, and applies to business activities occurring on or after that date.

ASSUMPTIONS AND METHODOLOGY: **2006-07 Year.** The new system is effective for activity taking place on or after January 1, 2007. In general the credits are taken in installments over a four-year period beginning in the tax year following the year of activity. This means that there would be no impact for the 2006-07 fiscal year.

2007-08 and Later Years: General Impact Discussion. It may be helpful to start by looking at some of the ways that the re-write could affect the potential cost of incentives:

(1) The ability of certain taxpayers to choose whether to claim credits under the existing Lee Act or the new system for the 2007 tax year could lead to an increased cost to the extent that the affected taxpayers select the most lucrative option. However, this impact will be limited by the fact that the taxpayer must sign a letter of commitment by December 31, 2006 and must specify the details of the project.

(2) The elimination of the worker training tax credit and the credits for central administrative offices and aircraft facilities will lead to a revenue gain. A March 31, 2006 report of the Department of Revenue indicates that for tax returns processed during the 2005 calendar year, there were $5.8 million of credits generated from the credits that will be eliminated under the bill and that $2.7 million of credits were actually claimed on tax returns.

(3) The impact of the new tier structure on the jobs and investment credits claimed by eligible taxpayers depends on the mix of activity in the new tiers compared to the prior designations. In general, the costs of the investment tax credit will be reduced because current Tier 4 and Tier 5 companies will receive a 3.5% credit instead of 4% or 5% and some current Tier 3 companies will be eligible for a 5% credit instead of 6%. This change is important because the investment tax credit is by far the most expensive of the Lee Act credits ($119.9 million generated and $56.5 million claimed in 2005).

(4) The program savings from the investment tax credit tier changes will be partially offset by higher costs for the jobs credit. For reference purposes, the jobs credit amounts to 30-40% of the investment tax credit total for returns processed during the 2005 calendar year.

(5) The change in the investment tax credit thresholds means that some current Tier 4 taxpayers will have a $2 million threshold to reach instead of $1 million and that many current Tier 3 taxpayers will face a $1 million threshold hurdle of $200,000. This will be offset by the fact that some taxpayers currently located in Tier 2 and 3 counties will have their small thresholds replaced by no threshold.

(6) Under the current system, there is no job creation threshold although a business must have 5 employees to be eligible for the credit for each new job created. The new system does not have a "current job level" threshold but does require a certain number of jobs to be created in order to gain eligibility for the credits. For example, a company located in a new Tier 3 county must create at least 15 jobs to be eligible. Under the existing act a credit could be received for just one new job if the employer already had 5 employees.

(7) The shift from a machinery and equipment investment credit to a general business property credit would in theory add to the cost due to the expanded eligibility (essentially any item that could be depreciated under the Internal Revenue Code). However, discussions with the Department of Revenue staff monitoring the Lee Act indicates this impact will be lessened by the fact that many taxpayers are already claiming the credit for the expanded items.

(8) The conversion of development zones to urban progress zones means that a smaller area will be covered and there will be a lower number of eligible zones. This change could lead to a significant amount of program savings in future years as employers are beginning to discover and take advantage of the enhanced credits.

(9) The ability of taxpayers to use the credit against the combined income, franchise, and insurance premiums tax liability (in lieu of selecting one credit) will add to the cost of the credits by an unknown amount. The impact is especially important in the near term (2008, 2009, etc.) due to the limitation of the credit to 50% of tax liability.

(10) The elimination of the development zone donation credit will have little impact due to its minimal usage.

(11) Under the bill the investment tax credit can be taken over four years instead of seven years. This change will add to the cost in the early years.

2008-09 and Later Years: Fiscal Simulation. The Department of Commerce simulated the impact of the major changes in the re-write using actual data collected over the last five years. This data covered the 1996-2002 experience under the Lee Act. Below are some of the highlights of the simulation:

(1) The analysis indicates that had the new system been in place during the 1996-2002 period, the higher investment threshold for the investment tax credit would have eliminated about 15% of the sites that received the credit and the total credits generated would have declined by 31%. This is important due to the sheer magnitude of the machinery and equipment under the Lee Act (2.5-3.0 times the magnitude of the jobs credit). In addition, these dollar savings were based on a 4% credit for the new Tier 3 counties, not the 3.5% credit in the current version of the bill. The savings at 3.5% would be even larger.

(2) The higher job creation threshold for eligibility of the jobs credit would have reduced the number of sites taking the credit substantially. However, the larger credit amounts would push up the total dollar cost of these credits by over 100%.

The second step of this analysis by Commerce was to perform a simulation using the most recent three tax years. After taking into account the elimination of the worker training tax credit and the central administrative office credit, the shift to the new system would lead to a slight revenue gain (under $1 million) in the first year in which the credits are actually taken, **when compared to the potential costs of the existing Bill Lee Act.** However, the Department admits that the analysis is not 100% complete. For example, it does not take into account the revisions to the data that will take place after the results of the extensive Department of Revenue audits are factored in. In

addition, the analysis does not consider the impact on the 2008 tax year of the provision allowing "letter of commitment" companies to choose between the existing Bill Lee Act and the new system for the 2007 tax years.

Discussions with the Department of Revenue indicate that their preliminary analysis shows that the new system could lead to additional credits generated of $12 million, **when compared to the potential costs of the existing Bill Lee Act.** However, as in the case of the Department of Commerce's simulation, the analysis does not consider all of the features of the new system. In addition the $12 million is calculated on a "claims generated" basis. This is important because the Department of Revenue has indicated that the limitation of the credits to 50% of tax liability means that only a handful of companies are able to use the full amount of the credit in the first couple of years. Thus, a substantial portion of the potential credits will be carried forward to future years.

There is another issue to be considered when analyzing the fiscal impact of the overhaul. Up to this point our analysis has focused on how the costs of the new system compares to the existing Bill Lee Act. On this issue, we can say that the new system is approximately revenue neutral.

However, the primary focus of a fiscal estimate for state budget purposes is how the system envisioned under the bill compares to current law, which includes a January 1, 2008 sunset to the Bill Lee Act. This means that the meaningful comparison beginning with the 2008 calendar year is the absolute cost of the new system.

Based on the analysis of the Department of Revenue and Department of Commerce, we estimate that the incremental annual impact of shifting from the current Act to the new system at $1.2 million each year. This means that the second year impact is $2.4 million, the third year is $3.6 million, and so forth. These costs would continue to pyramid until the 2011 sunset.

Since the new system is effective beginning with 2007 tax year activity and taxpayers take the credit in the year following the activity year, the first effects would be felt in the 2008 tax year. We bumped up the potential 2008 tax year cost to $2.2 million due to the fact that certain taxpayers may be able to choose between the existing credits and the new system for the 2007 activity year.

After calculating the tax year impact, we adjusted the numbers to the state fiscal year by assuming that 55% of the relief is taken in the fiscal year ending in the tax year for which the credit is claimed and the remainder would be taken in the following fiscal year.

These costs apply to the difference between the new system and the current Lee Act. In addition, there is a baseline cost associated with removing the January 1, 2008 sunset of the incentives. Based on a review of the historical experience of the Bill Lee Act from 1996-2005 and discussions with the Department of Revenue (which has access to actual tax returns), we estimate the fiscal year cost for the combination of the jobs and investment credits at $2.3 million for 2008-09, $6.7 million for 2009-10, and $11.2 million for 2010-11. These costs would be added to the incremental costs under the new system, when compared to current Bill Lee Act.

Agrarian Growth Zones. Under current law the Bill Lee Act sunsets on January 1, 2008. In addition, the enhanced Lee Act tax credits that will apply to companies locating in eligible zones are taken in the year following the activity year. Thus, the practical effect of the bill is to allow additional investment and worker training tax credits for the 2007 and 2008 tax year.

Another consideration is the fact that the credits that may be claimed in a given tax year may not exceed 50% of the taxpayer's liability. Discussions with the Department of Revenue indicate that this limit restricts the amount of credits that may be claimed in the first few years following the activity year. This means that much of the cost of the enhanced credits will come through carryforwards in future years.

A final issue is that the experience under the Bill Lee Act since 1996 would indicate that the large majority of investment tax credits go to counties that would not be affected by this legislation.

For these reasons we feel that the impact of the bill on General Fund tax revenue will be minimal.

Administrative Costs. The Department of Revenue is charged with reporting on the credits claimed and credit used under both the existing Bill Lee Act and the new system. The addition of the reporting requirements for the new system will mean that the Department will be faced with reviewing tax returns and tabulating credit usage for both the old system and the new. This will lead to additional personnel requirements and other costs. Preliminary data formatting work will begin during the 2006-07 fiscal year.

SOURCES OF DATA: Numerous discussions with the research staff of Department of Revenue and Department of Commerce and tax impact simulations run by the staff.

TECHNICAL CONSIDERATIONS: None

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Signed Copy Located in the NCGA Principal Clerk's Offices