# GENERAL ASSEMBLY OF NORTH CAROLINA

## Session 2009

## Legislative Fiscal Note

**BILL NUMBER**: House Bill 1973 (Fifth Edition)

**SHORT TITLE**: Various Economic Incentives.

**SPONSOR(S)**: Representatives Owens, Gibson, Wainwright, and Brubaker

| **($millions)** | **Yes (X)** | **No ( )** | **No Estimate Available ( )** | | |
|---|---|---|---|---|---|
| **REVENUES:** | **FY 2010-11** | **FY 2011-12** | **FY 2012-13** | **FY 2013-14** | **FY 2014-15** |
| Part 1.–Art. 3J Changes | $0.0 | -$4.6 | -$10.3 | -$20.6 | -$20.6 |
| Part II–Film Credit | $0.0 | -$24.3 | -$56.3 | -$53.8 | -$53.8 |
| Part III–IDM Credits | $0.0 | -$0.5 | -$1.0 | -$1.5 | -$2.0 |
| Part IV – Oyster Shell Tax Credit | $0.0 | -$0.1 | -$0.1 | -$0.1 | $0.0 |
| Part V –Eco-Park | | | *No estimate available* | | |
| Part VI–Woodchipper | | | *No significant impact* | | |
| Part VII – L3C | | | *No estimate available* | | |
| Part VIII–Yadkin River Trust | | | *No estimate available* | | |
| Part IX – DNA Database | $1.24 | $1.65 | $1.65 | $1.65 | $1.65 |
| **TOTAL** | **+$1.24** | **-$27.9** | **-$66.1** | **-$74.4** | **-$74.8** |
| **EXPENDITURES:** | | | | | |
| Part VII – L3C | $30,050 | $0 | $0 | $0 | $0 |

**PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED:** NC DOR; NC Department of Commerce; Judicial Branch

**EFFECTIVE DATE:** Effective when the bill becomes law except where otherwise specified.

**BILL SUMMARY**:
Part I extends the sunset for the Article 3J Credits for Growing Businesses from January 1, 2011 to January 1, 2013. It also lowers the credit rate percentage from 5% to 4% for Tier II business investments and from 3.5% to 2.0% for Tier III business investments. The minimum investment threshold for Tier III investment is increased from $2 million to $3 million.

Part II of the bill makes the following changes to the film production credit:

- Increases the applicable percentage used to calculate the credit from 15% of the amount of qualifying expenses to 25% and eliminates the alternate credit;
- Increases the cap on the amount of credit per feature film from $7.5 million to $20 million;
- Allows employee fringe contributions and per diems to be included as eligible expenses.

- Deletes a provision added in 2006 that clarified that amounts paid to highly compensated individuals are not eligible for the credit regardless of whether paid directly by the production company or indirectly through another entity. It is industry practice in the film business to pay actors indirectly through a contract with a loan-out company. The amendment in 2006 excluded these expenses from the qualifying expenses eligible for the tax credit to the extent those expenses exceeded $1,000,000. Under the bill as amended in Senate Finance, compensation paid to a loan-out company would not be subject to the $1,000,000 cap.

Part III of the bill establishes a tax credit for digital interactive media productions. The credit is equal to 10% of eligible expenses, or 20% if the production is in collaboration with a university. The credit is 15% for certain eligible applications. Taxpayers may take annual credits of up to 50% of tax liability and unused credits can be carried forward for eight years. The minimum cost of an eligible production is $50,000.

Part IV of the bill would extend the tax credit for recycling oyster shells to 2013. The credit amount is $1 per bushel of oyster shells donated to the Division of Marine Fisheries of the NC Department of Environment and Natural Resources.

Part V would create economic development incentives and favorable tax treatment for Eco-Industrial Parks.

Part VI clarifies that companies are not liable for sales and use tax on wood-chipping equipment when said equipment is purchased in conjunction with a vehicle that is not subject to the motor-vehicle use tax. This legislation is designed to aid those who purchase trailers used to haul industrial sized wood chippers. The trailer, because it is a vehicle whose primary use will be in another state, is not subject to North Carolina's motor vehicles tax.

The purchase of the trailer is often accompanied by the purchase of a wood chipper. The wood chipper, because it is not considered a motor vehicle and not subject to the motor vehicles tax, is, under current law, subject to the North Carolina sales tax. This legislative change clarifies that neither the wood chipper nor the trailer used to haul the wood chipper is subject to the North Carolina motor vehicle or sales tax. Part VI of the bill is retroactive with an effective date of July 1, 2009.

Part VII would recognize a new type of corporate designation known as a low-profit limited liability company (L3C).

Part VIII creates the Yadkin River Trust as a public agency and instrumentality of the State with a three-member board of directors. The Trust is given several powers and directed to report to three legislative commissions by January 15, 2011 regarding the Federal Energy Regulatory Commission's license renewal for the Yadkin Project No. 2197.

Part IX changes the funding for the DNA database.

**ASSUMPTIONS AND METHODOLOGY**:

**Part I** extends the Article 3J credits from January 1, 2011 to January 1, 2013. The Article 3J Credits for Growing Businesses replaced the William S. Lee Act credits effective January 1, 2007 and includes credits for creating jobs, investing in business property and investing in real property. The credits can be used to offset up to 50 percent of the taxpayer's state income and/or franchise tax liability and must be taken in four (jobs and business property) or seven (real property) annual installments. Unused credits can be carried forward for five years for the jobs and business investment credits. The real property investment credits can be carried forward for fifteen years.

The annual impact of Article 3J is based on the two annual reports available from the Department of Revenue. The 2009 report provides credits generated and taken for the first year of Article 3J. The amount of activity for the first year is assumed to be relatively low because taxpayers were allowed for that year only to elect to take either Bill Lee or Article 3J credits. Therefore, the credits generated from the 2010 report are considered to be more reflective of future activity.

For purposes of this analysis, a simulation was developed to estimate the potential impact of the Article 3J extension. The simulation assumes that credits continue to be generated each year at the same level as in the 2010 report. The assumption for the percentage of credits taken each year is based on the percentage taken in the 2009 report (data for credits taken in the 2010 report is not yet available). Credits taken represented 10.7% of credits generated for that year; thus, the installments for each tax year are calculated by multiplying the credits generated (based on the 2010 report) by the percentage taken ($112,579,981 * 10.7% = $12,082,452). The annual impacts for each fiscal year of the credit extension are calculated by adding the credit installments that would be taken each year as shown in Table 1.

The Article 3J extension would have no impact on revenues in FY 2010-11 because taxpayers cannot take any credits until the tax year following the year they are generated. Credits would be generated beginning in calendar year 2011 and would be taken for tax year 2012. FY 2011-12 revenues would be impacted by taxpayers who reduce April and June estimated payments in 2012. This impact is estimated to be 45% of the full-year impact of the credit extension.

**Table 1. Fiscal Impact of Art. 3J Credit Extension by Fiscal Year ($millions)**

| | **FY 2010-11** | **FY 2011-12** | **FY 2012-13** | **FY 2013-14** | **FY 2014-15** |
|---|---:|---:|---:|---:|---:|
| Tax Year | | | | | |
| 2012 | $0.0 | $5.4 | $12.1 | $12.1 | $12.1 |
| 2013 | $0.0 | $0.0 | $0.0 | $12.1 | $12.1 |
| **Total Impact** | **$0.0** | **$5.4** | **$12.1** | **$24.2** | **$24.2** |

Finally, the fiscal impacts are adjusted to reflect the change in credit percentage for Tier II and III business investments and the threshold for Tier III investments. Department of Revenue Article 3J reports were used to determine the impact of the threshold adjustment. Any projects less than $3 million were removed from the list of eligible Tier III projects. Furthermore, because the amount of the threshold is not included as an eligible expense, the investment amount for each remaining project was reduced by $1 million to reflect the $1 million increase in the amount of the threshold

($2 million to $3 million). When the new credit rate percentage of 2% is applied to the Tier III investments meeting the $3 million threshold and the 4% rate is applied to Tier II investments, the result is a 15% reduction in Article 3J costs. The final step in the fiscal analysis is to apply this percentage reduction to the impacts in Table 1. The results are shown in Table 2 below:

**Table 2. Fiscal Impact of Credit Rate Reduction and Threshold Increase on Article 3J Impacts ($millions)**

| | FY 2010-11 | FY 2011-12 | FY 2012-13 | FY 2013-14 | FY 2014-15 |
|---|---|---|---|---|---|
| Current Law w/ Sunset Extension | $0.0 | -$5.4 | -$12.1 | -$24.2 | -$24.2 |
| 4% Credit Rate for Tier II; 2% Credit Rate and $3 million Threshold for Tier III | $0.0 | -$4.6 | -$10.3 | -$20.6 | -$20.6 |

**Part II:** Currently, the film production credit is 15% of eligible expenses, with an alternate credit equal to 25% of eligible expenses, less the difference between the amount of tax paid on purchases subject to the privilege tax on mill machinery and the amount of tax that would be paid if the purchases had been subject to the combined general rate of sales tax. The bill eliminates this alternate credit and increases the credit from 15% to 25%. This portion of the bill has an insignificant impact because eligible expenses are already subject to the 25% rate under the alternate credit, and the add-back of the sales tax differential has a minimal effect.

The fiscal impact of the remaining film credit changes was determined based on an analysis provided by the Department of Commerce. The Department used actual studio budgets to estimate the impact of projected changes based on the number and size of additional film productions resulting from the bill. The analysis assumes that without the proposed expansion, baseline film production activity would include one episodic television production with $22 million in-state spending and five $10-million film productions with $6 million in-state spending.

The estimates for film production activity under the proposed expansion assume the same current film activity, plus one $40-million film and one $100-million film impacting the General Fund in FY 11-12. Beginning in FY 12-13, the fiscal estimate assumes annual impact from two $25-million productions, four $50-million productions and one $75-million production.

Table 1 provides the projected annual number and cost of films resulting from the expanded credit. Due to production cycles, the film credit is not expected to reach this level of activity and impact until FY 12-13. No fiscal impact is anticipated in FY 10-11.

| Table 1. Projected Film Production Spending ($millions) | | | |
|---|---|---|---|
| Total Production Spending | Total Qualified Spending | Number of Productions | Total Cost of Film Credit |
| $75 | $49.8 | 1 | $12.5 |
| $50 | $38.6 | 4 | $38.6 |
| $25 | $13.2 | 2 | $6.6 |
| $10 | $4.7 | 5 | $5.8 |
| $44 | $23.5 | 1 | $5.9 |
| **Total Cost** | | | **$69.4** |
| Source: NC Department of Commerce | | | |

Table 2 provides the projected fiscal year impacts of the credit expansion based on the expected production cycles. Total costs reach a peak of $72 million in FY 2012-13 and level off to the annual amount of $69.4 shown in Table 1 in FY 2013-14. The net fiscal impact factors in the credit add-back; North Carolina requires the value of the tax credit to be added back to taxable income. The analysis assumes that the add-back will be taxed at an average rate of 7 percent.

| Table 2. Net Fiscal Impact of Film Production Credit Changes by Fiscal Year ($millions) | | | | | |
|---|---|---|---|---|---|
| | **FY 2010-11** | **FY 2011-12** | **FY 2012-13** | **FY 2013-14** | **FY 2014-15** |
| Total Projected Impact of Credit | -$11.5 | -$35.8 | -$72.0 | -$69.4 | -$69.4 |
| Less Existing Cost under Current Law | $11.5 | $11.5 | $11.5 | $11.5 | $11.5 |
| Additional Cost of Credit | $0.0 | -$24.3 | -$60.5 | -$57.9 | -$57.9 |
| Credit Add-back | $0.0 | $1.7 | $4.2 | $4.1 | $4.1 |
| Net Fiscal Impact of Film Credit Expansion | **$0.0** | **-$22.6** | **-$56.3** | **-$53.8** | **-$53.8** |

**Part III:** This section would provide a 10% to 20% tax credit for eligible expenses related to the production of digital interactive media productions. The credit is taken against the income or franchise tax; the maximum credit for a single production is $7.5 million. IDM credits may not exceed 50% of tax liability and unused credit can be carried forward for 8 years.

Based on discussions with industry representatives, there are approximately thirty companies in North Carolina that would potentially qualify for the credit. Production cycles average from one to three years and expenses range from $200,000 to several million per production.

A simulation was developed to explore the potential fiscal impact of the credit. Because of the duration of the production cycle, it is unexpected that any productions would qualify for the credit in FY 2010-11. The simulation assumes a total of $30 million annually (an average of $1 million per company) in qualified expenditures beginning in FY 2011-12 with credits taken evenly over a period of nine years (initial tax year, plus eight carryforward years). The average credit rate percentage is assumed to be 15%

Based on these assumptions, the following fiscal impacts result:

| **Interactive Digital Media Fiscal Impacts Based on Simulation** | | | | |
|---|---|---|---|---|
| **FY 2010-11** | **FY 2011-12** | **FY 2012-13** | **FY 2013-14** | **FY 2014-15** |
| $0.0 | -$0.5 | -$1.0 | -$1.5 | -$2.0 |

**Part IV:** The fiscal impact for extending the credit for recycling oyster shells is based on estimates in the 2009 Department of Revenue Tax Expenditure Report. Based on past experience, the credit costs less than $100,000 per year.

**Part V:** Section 5.1 would designate certain Eco-Industrial Parks as Tier One economic development projects. If such a Park were located in a Tier Two or Three County, this new designation would change their status and requirements for grants from the Job Development Investment Grant (JDIG), the Industrial Fund, the Utility Fund, and the Article 3J Tax Credits for Growing Businesses. At this point, it is not known how many parks exist or where they are located, so Fiscal Research cannot provide an estimate as to the potential impact. It is expected that there would be no impact in FY 2010-11 and FY 2011-12.

Section 5.2 requires that the Green Business Fund give priority to projects in an Eco-Industrial Park. Additionally, it allows Commerce to create a cap on the grant size and allows Commerce to require matching funds for the grant, except for those grants given to Eco-Industrial Parks. This section would change the way Green Business Fund grants are prioritized; however the Fund did not receive an appropriation for FY 2010-11 or future years. This section will have no impact until such time as the Green Business Fund receives an appropriation.

Section 5.3 gives priority for JDIG awards to projects that are Eco-Industrial Parks. This section would change the way JDIG grants are prioritized but will not have an impact on appropriations.

Section 5.4 would give Eco-Industrial Parks a ceiling of $5 million for renewable energy tax credits per installation for renewable energy property that is placed in service in a certified Eco-Industrial Park for non-residential purposes. Fiscal Research does not have an estimate as to how many Eco-Industrial Parks might qualify and for what amount of credit.

Section 5.5 increases the credit for qualified research expenses at an Eco-Industrial Park to 35% of the expenses. Current law allows a credit equal to the percentage of expenses ranging from 1.25% to 3.25%; North Carolina university research qualifies for a 20% credit. Because the amount of qualified research that will occur in an Eco-Industrial Park is unknown, Fiscal Research is not able to estimate the impact.

**Part VI:** Although some fiscal impact would result if assessments for wood-chipping equipment are pending, the amount is expected to be minimal.

**Part VII:** The legislation provides that a low-profit limited liability (L3C) company is a limited liability company (LLC) under North Carolina law. Low-profit limited liability companies (L3Cs) have been proposed as a means for encouraging investment in struggling business enterprises. Under this theory, non-profit organizations that are required to spend a certain percentage of their assets each year to maintain their non-profit status would invest in L3Cs that have some social purpose.

If structured correctly, it is possible that the IRS could treat this investment as a program-related investment that would count towards the percentage that must be spent in order to maintain non-profit status. Because non-profits do not face the same pressures as for-profit investors, the theory states that non-profits would be willing to accept a lower rate of return than would be required for a for-profit investor. Struggling businesses might then be able to stay in business, providing jobs to employees and other community benefits, because the pressure to produce market-rate profit levels had been removed. One of the benefits of L3Cs is that no special legal structure, other than the LLC structure, is needed to establish an L3C.

Low Profit Limit Liability Companies will be a new category of business entity in North Carolina. The Department of Secretary of State estimates that it will incur $30,000 in one-time start-up costs for programming. This programming will require a month of work and include the following technical changes that are necessary to include this category in the agency's system: 1) amend the LLC profile to include the low profit corporate ending (L3C) that will be able to be queried; 2) write a document to include certification statement that the entity's purpose satisfies the requirements of 57C-1-03(12a); 3) create a document to be available within agency's Knowledge Base, with all examination/rejection parameters; 4) create a document for placement on the schedule of fees/documents for LLC's online; and 5) provide documents that will be searchable and viewable online under the profile. Additionally, two weeks are required for text development of document at a cost of $50. The agency estimates total one time costs of $30,050 and no additional personnel or recurring funding is required.

As with the Limited Liability Companies (LLC), revenue is anticipated from fees charged to the L3Cs in the amount of $125 per entity upon organization, and $200 per entity for the annual reporting fee. However, these fees will be deposited into the General Fund and not into the agency's budget as a receipt. Therefore, an appropriation would be required to provide the $30,050 in one time costs. However, as this is a new category of business entity, neither the Department of the Secretary of State nor the Fiscal Research Division (FRD) has been able to determine the number of business entities that may be established.

**Part VIII:** This section creates the Yadkin River Trust as a public agency and instrumentality of the State. The Trust would have a Board of Directors consisting of three members: the Secretary of Commerce, one member appointed by the Speaker of the House of Representatives, and one member appointed by the President Pro Tempore of the Senate.

The bill also requires that the Trust monitor the proceedings before the Federal Energy Regulatory Commission concerning the license for the Yadkin Project No. 2197 and report to three legislative commissions on that matter before January 15, 2011.

*Expenses of the Board*
The Trust would have a three-member Board of Directors who would be entitled to per diem and allowances per G.S. 138-5. Fiscal Research estimates that the Board would meet monthly and thus incur annual costs of $7,058 to cover subsistence and travel. Subsistence is comprised of $101.50 plus $15 daily per GS 138-5. It is assumed that one member of the Commission would need to travel such a distance so as to require two days of subsistence. Total annual subsistence costs are $4,178. Travel costs are estimated at $2,880 which assumes a round trip of 230 miles per member reimbursed at $0.33 per mile.

G.S. 77-142 provides the Trust with several Powers, including the ability to:

- develop the Yadkin River in Stanly, Davidson, Montgomery, and Rowan Counties as an instrumentality of intrastate, interstate, and foreign commerce and navigation;
- pursue efforts directed at the equitable distribution of water for public purposes;
- seek enforcement of environmental laws and contribution to environmental cleanup costs, and
- fulfill the purpose and intent of S.L. 1885-212, which set forth certain requirements to erect and maintain dams and other obstructions in the Yadkin River.

At this time, it is not known what exactly the Trust would do with regards to existing dams and obstructions located on the Yadkin River and what expenses they might incur. Thus, Fiscal Research cannot provide an estimate of those expenses.

**Part IX:** Modifies the DNA database. The Administrative Office of the Courts (AOC) reports that based on the current number and rate of offender compliance in criminal judgments, the new $3.00 fee on criminal cases upon conviction for all felonies and misdemeanors could be expected to yield approximately $1.24 million in the first year and $1.65 million in subsequent years. A majority of this revenue would be generated by Chapter 20 (traffic) misdemeanors. The revenue from felony convictions would be minimal in the first year due to the priority order of costs due the State and the number of probationers who take more than one year to pay all fees owed or who are revoked prior to paying all fees. Revenue from felony convictions would increase slightly in the second and subsequent years.

**SOURCES OF DATA:**
North Carolina Department of Revenue, "Tax Credits for Growing Businesses," Available at: http://www.dornc.com/publications/growing_businesses.html

2009 Tax Expenditure Report, North Carolina Department of Revenue; Moody's Economy.com

NC Department of Commerce

NC Department of Secretary of State

2007 Economic Census. Sector 31: EC0731A1: Manufacturing: Geographic Area Series: Industry Statistics for the States. 2) Oregon Environmental Quality Commission Meeting. August 2008. Attachment F, “Certified Wood Chipper Report, January 1, 2008 through June 30, 2008.”

Available at: http://www.deq.state.or.us/about/eqc/agendas/attachments/2008aug/K-AttAEF-TaxCreditWorksheets.pdf

Judicial Branch

**TECHNICAL CONSIDERATIONS**: None

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