NORTH CAROLINA GENERAL ASSEMBLY
LEGISLATIVE FISCAL NOTE

BILL NUMBER: SB 748 (Second Edition)

SHORT TITLE: Bill Lee Act Changes

FISCAL IMPACT

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

	($ Million)				
	FY 01-02	**FY 02-03**	**FY 03-04**	**FY 04-05**	**FY 05-06**
REVENUES –					
State General Fund					
Eligible Business Clarification[1]			-.2	-1.1	-2.5
Small County Exception 2[2]			-.2	-.4	-.6
Customer Service Center[3]			-.3	-.6	-.9
Real Property Credit[4]			-4.7	-9.4	-14.3
R&D Carryforward[5]					
Electricity Sales Exempt	-1.9	-1.9	-2.0	-2.0	-2.1
Total	**-1.9**	**-1.9**	**-7.4**	**-13.5**	**-20.4**

PRINCIPAL DEPARTMENTS AFFECTED: The Department of Revenue administers tax credits and the Department of Commerce administers the credit application and certification process.

[1]Maximum impact of -$4.5 million occurs in 2006-07
[2]Maximum impact of -$.9 million occurs in 2006-07.
[3]Maximum impact of -$1.2 million occurs in 2006-07.
[4]Maximum impact of -$18.7 million occurs in 2006-07.
[5]No impact until 2008-09. Maximum impact is -$4.1 million in 2012-13.

ISSUE BACKGROUND: The Bill Lee Act is the package of state tax incentives that was first adopted in 1996 and has been modified in each subsequent year. The incentives are primarily in the form of tax credits for investment in machinery and equipment, job creation, worker training, and research/development. The credits apply to activities undertaken by specifically named industrial classifications. For many of the credits, the counties of the State are divided into five economic distress tiers based on the unemployment rate, per capita income, and population growth. In general, the lower the tier of a county, the more favorable the incentive.

BILL SUMMARY:

Primary Business Classification. Rewrites industry definitions section of Bill Lee Act to make it clear that a taxpayer is not considered to be part of an eligible industry classification

unless the establishment for which the credits are claimed is part of the taxpayer's primary business. This provision is effective when the bill becomes law. In addition, language in the effective date section indicates that this change clarifies existing law and does not represent a change in the law.

Eligible Business Clarification.

a. A taxpayer may be eligible for the warehousing status if the taxpayer has an auxiliary subdivision primarily engaged in warehousing at a site separate from other subdivisions of the taxpayer and serves at least 25 establishments of the taxpayer, with the establishments served located in at least 5 different counties in one or more states from the warehousing subdivision. In addition, the warehouse must be located in a Tier 1, 2, or 3 county.

b. Notwithstanding the taxpayer's primary business, the following activities of an auxiliary subdivision of taxpayer are considered data processing and are eligible for Bill Lee Act credits, regardless of the tier in which the investment is made:

   1. Computer systems design and related services
   2. Software publishers
   3. Software reproducing
   4. Online information services

c. Tightens language to make it clear that only data processing done for third parties for hire is eligible for Lee Act credits.

These provisions are effective for tax years beginning on or after January 1, 2001.

Machinery and Equipment Credit Threshold Tightening. Clarifies that minimum investment threshold applies separately to each site or location of the taxpayer, instead of each tier.

Small County Exception 1. Under current law a county with a population of less than 10,000 and with more than 16% of its population below the poverty level is considered a Tier 1 county regardless of the normal ranking. The bill raises the maximum population threshold to 12,000. The provision is effective when the bill becomes law and applies to designations made on or after that date.

Small County Exception 2. Under current law a county with a population of under 25,000 that would otherwise be designated a Tier 4 or 5 area is designated Tier 3. The bill increases the population threshold to 35,000. The provision is effective when the bill becomes law and applies to designations made on or after that date.

Customer Service Center. A customer service center located in a Tier 1 or 2 county is eligible for the Bill Lee Act credits. The bill extends the eligibility to Tier 3 counties. The provision is effective for tax years beginning on or after January 1, 2002.

Electronic Mail Order House. An electronic mail order house located in a Tier 1 or 2 county is eligible for Bill Lee Act credits. The bill extends the eligibility to Tier 3. The provision is effective for tax years beginning on or after January 1, 2002.

Tax Credit Expiration. Makes it clear that if the number of jobs at a central office or aircraft facility falls below 40, (or falls below 250 at an electronic mail order house), the credit for that location expires and any remaining installments are eliminated In addition, the bill makes it clear that the change in tier designation of the location of a customer service center or electronic mail order house does not result in expiration of credits. These changes are effective when the bill becomes law.

Wage Standard Clarification. Makes it clear that the average wage of all jobs at facility must meet the wage test for which "investment" and R & D credits are claimed. For the jobs and worker training credit, the average wage of jobs for which credit is claimed must exceed wage test and the average wage of all jobs at the facility must meet wage test. These changes are effective when the bill becomes law.

OSHA Citation. Under current law, a taxpayer is not eligible for the Bill Lee Act credits if the taxpayer has no outstanding OSHA citations and no serious OSHA violations within the last three years at the location for which the credit is claimed. The bill changes the language to eliminate tax credit eligibility for OSHA violations that have become a final order within the past three years for "willful serious" or "failure to abate serious" violations. This provision is effective for tax years beginning on or after January 1, 2000.

R & D Credit Carryforward. Extends carryforward for research and development credit from 5 years to 15 years. The change becomes effective for credits first claimed on or after January 1, 2002.

Real Property Credit. Allows a taxpayer who has purchased or leased real property in a Tier 1 or 2 county to receive a credit equal to 30% of the lesser of: (1) the cost of the property, or (2) the amount by which the cost of all real property used by the taxpayer in an eligible business in the state on the last day of the tax year exceeds the cost of all real property used by the taxpayer during a "base year". The base year concept looks back three years and picks the year in which the taxpayer used the most real property in the state. In the case of leased property, the base is equal to lease payments calculated over seven years. The credit may be taken in the year after the investment takes place and is taken in equal installments over seven years. For a taxpayer to be eligible for the credit, the Secretary of Commerce must certify that the taxpayer will purchase or lease, and place in service within three years, at least $10 million of real property at a location and create at least 200 new jobs within two years of the time the property is placed in service. The credit is limited to 50% of tax liability and any unused credit may be carried forward for 20 years. The credit is effective for tax years beginning on or after January 1, 2002 and applies to property placed in service on or after that date.

Credit Applications and Report. Eliminates credit eligibility certification by Department of Commerce. Instead, the taxpayer may request an advisory ruling from Revenue Department.

Electricity Sales Tax Exemption. Exempts from sales tax sales of electricity that are separately metered and used for specific production processes. The exemption is effective for sales occurring on or after November 1, 2001.

Central Office or Aircraft Facility Property Credit. Current law eliminates credit for investing in central office or for aircraft facility real property if total statewide employment drops by 40 or more. The bill eliminates this "clawback" provision, effective for tax years beginning on or after January 1, 2001.

ASSUMPTIONS AND METHODOLOGY:

Eligible Business Clarification. One purpose of this provision is to attract a Lowe's Corporation warehouse to Northampton County. For eligible investments in this Tier 1 county there is no investment threshold. Thus, all of the $36 million of anticipated machinery and equipment acquisition would be eligible for the credit. The expected investment level is based on discussions between the Department of Commerce and Lowe's. It is anticipated that $24 million of the investment will occur in 2002 and $12 million in 2003. The credit must be taken in equal installments over seven years, beginning in the year following the investment. Under current law, these credits sunset on January 1, 2006.

For the jobs credit, it is assumed that Lowe's will hire 425 full-time workers under the following schedule:

2003	150
2004	100
2005	100
2006*	75

**Ineligible due to current sunset on Bill Lee Act credits.*

The credit for Tier 1 counties is $12,500 per job. The credit is taken in equal installments over four years, beginning with the tax year following the year in which the jobs are created. Under current law, these credits sunset on January 1, 2006.

There is no way to predict how many other major companies will take advantage of the eligibility change. For the purpose of this analysis, it is assumed that one warehouse investment equal in size to the Lowe's project will take place in 2003/2004, one in 2004/2005, and a final investment in 2005/2006. For the future investments, it is assumed that the investment and jobs creation schedule will accelerate in order that a larger portion of the credit activity will occur prior to the January 1, 2006 sunset of Bill Lee Act credits. Even with the acceleration, a substantial portion of the 2005/2006 project and a small portion of 2004/2005 investment will not receive credits due to the existing sunset.

Small County Exception 1. Under the current tier ranking, only Alleghany and Jones County would be affected. The activity levels in those counties is small enough that the revenue impact of the change would be insignificant.

Small County Exception 2. The impact of the bill could vary from year to year depending on which counties are affected and the specific capital investment and job creation activities for that county. For the purpose of this analysis, the 2001 county population data and tier ranking are used. This data indicates that **the enactment of the bill would affect the following counties: Alexander, Dare, Davie, Macon, and Transylvania**.

If the bill is enacted, the credits for the three counties would change as follows:

	Dare, Macon	Alexander, Davie, Transylvania
Investment tax credit:		
Current threshold*	$500,000	$1,000,000
New threshold*	$200,000	$200,000
Jobs credit:		
Current credit	$1,000	$500
New credit	$3,000	$3,000

**Credit applies to investment in machinery and credit that exceeds the threshold. The effect of the threshold change is to allow more projects to qualify for the credit. For those investments already qualifying, the credit amount would increase.*

Targeted Investment Tax Credit: The steps used in the analysis of the investment tax credit follow the methodology used in 1996 under the original Bill Lee Act. The first step was a review of job announcements compiled by the Department of Commerce. From the list of projects for the five affected counties, nonmanufacturing announcement data was eliminated because a review of the Standard Industrial Classification (SIC) indicated that none of these projects were eligible under the Bill Lee Act guidelines.

Next, it was assumed that that the machinery and equipment portion of each project was 66 2/3%. This assumption was based on the experience of the Department of Commerce and various governmental surveys.

The third step was to determine the credit base under the old law and compare it to the base that would apply if the bill were approved. This difference was then multiplied by the 1% annual credit for each year in which the credit is taken (credit is taken in seven installments). Since the credit cannot be taken until the tax year after the year in which the investment takes place, the first impact would be in the 2003 tax year (2003-04 fiscal year).

Finally, the impact estimate was averaged over the eight years represented by the announcements data (1993-2000), resulting in an "average impact" per year.

Jobs Credit: The steps in this analysis use the same source as the investment tax credit (announcements data). The basic methodology is that the difference in credit amounts under the old law and the proposed amounts are multiplied by the job announcements. The difference is then allocated over the four-year period for which the credit is taken. Like the investment tax credit, the "average year" impact is calculated by dividing the total impact by the number of years included in the database (8). An implicit assumption in the analysis is that all of the jobs meet the wage test in the Bill Lee Act.

Technical Considerations: The estimates are conservative due to the fact that many "announcements" do not come to fruition. The credits are generally limited to 50% of the taxpayer's liability, with a five-year carryforward. Since we have no specific data on the liability for individual companies, we have assumed that all of the potential credits for a given tax year will be used (i.e., the 50% cap does not come into play).

Customer Service Center/Electronic Mail Order House. Discussions with an economic developer in Eden indicated that the intent of the provision is to attract one or two customer call centers to currently vacant manufacturing facilities in Eden. When the 1999 provision was added for customer service centers in Tiers 1 and 2, the fiscal estimate (consensus between Fiscal Research Division and Commerce) was in the form of a simulation based on one new facility per year in each tier. The assumed investment level was $2 million and the assumed new jobs per facility amounted to 200.

For the purpose of this proposal, it was assumed that one project per year would take place at an average machinery and equipment acquisition of $500,000 and 400 jobs. These numbers may be more in line with the potential for the Eden situation.

Investment Tax Credit: The ITC is equal to 7% of the eligible investment in machinery and must be taken in equal installments over seven years beginning in the year after the investment takes place. This means that the first fiscal year impacted would be 2003-04. The current Bill Lee Act credits sunset on January 1, 2006. Thus, beginning in 2007-08 the only cost will be the later installments from investments made prior to the sunset.

Jobs Credit: The credit is equal to $3,000 per job. The credit is taken over four years, beginning in the year after the job is added. Thus, the first fiscal year impacted would be 2003-04. The Bill Lee Act credits sunset on January 1, 2006. This means that for 2007-08 and later years the only cost will be the later installments from jobs created prior to the sunset.

Technical Considerations: This fiscal estimate is in the form of a simulation based on prior consensus methodology developed with the Department of Commerce and discussions with a person familiar with textile/apparel building conversion possibilities in the Town of Eden. No one is able to predict the number of call centers that could be established in other Tier 3 counties. For the 2001 calendar year, there are 21 counties that are in Tier 3.

The "simulation" methodology used in this analysis is the same used in the 1999 legislation authorizing Bill Lee Act credits for customer call centers.

R & D Credit Carryforward. The estimate for this provision is based on a Department of Commerce simulation of R&D activity. The specifics of the analysis are outlined below:

Additional companies claiming credit (small companies)

- Average company size is assumed to be $30 million of gross receipts, with R&D spending equal to $3 million, or 10% of revenue.
- Assume these companies increase R&D by 10% in first year, or $300,000. With a 5% credit, this amounts to $15,000 in credit base for the typical manufacturer. If 50 additional companies use this credit, total additional credit base is $750,000.
- For future years, it is assumed that the reduction in the credit for each company due to the increase in the four-year average would be offset by additional companies claiming the credit.
- The actual experience for 1997-99 indicated that companies claiming the credit are able to use 29%, with the remainder being carried forward. The credit usage is less than 100% because credits may not exceed 50% of tax liability.

- Due to the existing five-year carryforward option and the 2002 effective date, the change would have no impact until the 2008-09 fiscal year. In addition, the 2006 sunset on the credit means that the total cost of the provision begins declining in 2012-13.

Increased Credit Usage By Existing Companies

- The June 2001 report on the effectiveness of the Bill Lee Act credits shows 1999 tax year R & D credits claimed of $22.9 million. For the purpose of this analysis the Department of Commerce assumed that the existing company credit usage tops out at $25 million. This would be equal to $100 million in new credits over the last 4 years before the credit sunset.
- The analysis assumes that the current credit users, who are mostly large manufacturers, would be able to take 80% of the credits during the year in which the additional spending takes place and the current carryforward period (5 years). This assumption converts to $20 million of potential credits that could be used if the carryforward period were extended.
- The next step is the assumption that 75% of these extended carryforward credits will be used (the other 25% is unused due to companies going out of business, etc.). This converts to $15 million of usable credits for the extended period, or $3.75 million per year (the original calculations were based on the remaining 4 years of the credit).
- Since the provision is not effective until the 2002 tax year and claimants are already eligible for a 5-year carryforward, the first year in which the additional credits will be used in 2008 tax year. The application of the 2006 sunset on the credit means that the peak cost of the provision occurs in 2001-12.

Real Property Credit. The cost estimates for this section of the bill are based on an analysis by the Department of Commerce using 1997-99 actual experience. This analysis was modified by the Fiscal Research Division to reflect 2000 data.

Methodology

- Obtained business and industry database information on projects that created 200 jobs and made a minimum $10 million real property investment (or based on the 65% real property investment assumption, approximately a $15 million total investment) in Tier 1 and Tier 2 counties over the last four years (1997-2000).
- Obtained Bill Lee Act applications information on projects that created 200 jobs in Tier 1 and Tier 2 counties over the last four years (1997-2000). Compared machinery and equipment investment information from W.S. Lee Act applications data to total investment from Business and Industry data. Based on this comparison, used 65% of the total investment as the portion spent on real property.
- The number of projects created from the 1997-2000 database in Tier 1 and Tier 2 counties that created 200 or more jobs and met the minimum $10 million real property investment requirement was seven (two in 1997, two in 1998, two in 1999, and one in 2000). This data includes one very large project (NUCOR) that was based on targeted incentives, but excludes a $378 million announcement for 2000 that is still uncertain. The basic method for calculating foregone revenue estimates in the past has been to use the average of the relevant data (e.g., jobs, investment, projects, etc.) for the preceding years. For the purpose of this analysis, it is assumed that one new project per year involving $15 million real property investment occurs. Therefore, the foregone revenue estimates are based on the average (over four years) assumed real property investment (65% of total investment) for 12 projects.

Assumptions

- The tax credit will be taken in equal installments over seven years with a 10-year carry forward.
- The project information obtained from the Business and Industry database is based on 2000 tiers. However, only one of the counties on the list was not a Tier 1 or Tier 2 in that particular year (Rutherford in 1997 was in Tier 3). Still, using 2000 tiers for 1997, 1998, and 1999 should not skew the foregone revenue estimate results.
- While one of the 1997 projects only met the minimum $10 million real property investment requirement based on the "confidential" investment figures, the project was not excluded from the calculations for the "announced" investment estimates.

- Tax credit will be effective beginning with the 2002 tax year. However, the credit may not be taken for the taxable year in which the real property investment is made, but can be taken in equal installments over the seven years following the taxable year in which the investment in real property investment is made.
- To calculate maximum potential costs, assumed 100% of companies will begin to use all of the credit potential over the next seven years. Actual use will be limited by the fact that tax credits can only be applied to 50% of a company's tax liability. Therefore, this methodology potentially overstates actual costs.

Electricity Sales Tax Exemption. At the present time, this legislation will only provide a sales tax exemption for electricity used in the manufacturing of aluminum at Alcoa's Yadkin/Badin Works. The plant began paying sales tax on its manufacturing electricity in March 2000. The fiscal officer for this plant provided Fiscal Research with actual tax payments from September 1999 to February 2001. Operating 1.5 of its 2 production lines at 91% capacity and under a new energy contract that began in October 2000, the plant paid an average of $68,779 per month in sales taxes from October 2000 to February 2001. If the current production rate continues, it is

expected that the plant will pay $825,357 in sales tax in a 12-month period. Of the sales taxes paid, $4,300 a month is for general plant energy such as plant lighting and auxiliary power to run cranes, furnaces, crushing equipment, etc. Twelve months of tax on general plant energy equals $51,600. By subtracting the general plant energy from the manufacturing energy leaves $773,757 in tax that would be exempt under this bill.

Oct 2000 tax	$	72,301.04
Nov 2000 tax	$	71,248.02
Dec 2000 tax	$	67,648.04
Jan 2001 tax	$	64,852.56
Feb 2001 tax	$	67,849.32
Five months of tax payments	$	343,898.98
Average monthly tax payment	$	68,779.80
Annualized tax payment	$	825,357.55
General plant energy use	$	4,300.00
Annualized tax payment	$	51,600.00

Manufacturing use only	$ 773,757.55

This fiscal note assumes that the plant will increase operations to utilize 100% of its capacity on the 1.5 lines it has open and will restart the mothballed .5 line at 100% capacity in FY 2001-02. The electrolytic process to make aluminum is done in "pots". The plant is currently running 171 pots that pay an average of $4,525 a year in sales taxes. The plant's fiscal officer states that two lines of operation can equal 244 pots. Operating the plant at full capacity at current energy prices can produce state sales tax revenue equal to $1,104,100 per year. (244 pots X $4,525/year). No growth is included in the five-year period of this fiscal note because the Alcoa plant has a long-term electricity contract. An employee with Duke Energy Corporation said long-term contracts range from 5 to 15 years.

In addition, the language for the exemption will likely affect other taxpayers. The Department of Revenue, based on a review of the language and an analysis of sales tax returns of certain taxpayers, indicates that the additional annual revenue loss from the companies other than Alcoa would be $.8 million for 2001-02. For future years this amount was grown by 5% per year.

Note: Yadkin, a division of Alcoa Power Generating Inc., supplies much of the electricity used by Badin Works. Yadkin operates four reservoirs, dams, and powerhouses on the Yadkin River to supply hydroelectric power to the Badin Works. Rainfall and stream flow will affect the amount of hydroelectric power produced by Yadkin and thus the amount of electricity purchased by Badin Works from an outside source.

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