

GENERAL ASSEMBLY OF NORTH CAROLINA



Session 2007

Legislative Fiscal Note

BILL NUMBER: Senate Bill 242 (Second Edition)

SHORT TITLE: Reform Tax Appeals/Close REIT Loophole.

SPONSOR(S): Senator Clodfelter

FISCAL IMPACT					
	Yes (X)	No ()	No Estimate Available ()		
	<u>FY 2007-08</u>	<u>FY 2008-09</u>	<u>FY 2009-10</u>	<u>FY 2010-11</u>	<u>FY 2011-12</u>
REVENUES:	**See Assumptions and Methodology**				
EXPENDITURES:					
Department of Revenue	No impact anticipated				
Office of Administrative Hearings	-	\$145,884	\$145,884	\$145,884	\$145,884
Department of Justice	-	\$526,642	\$526,642	\$526,642	\$526,642
Judicial	-	\$74,211	\$69,912	\$69,912	\$69,912
POSITIONS (cumulative):		8	8	8	8
PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Department of Revenue, Department of Justice, Office of Administrative Hearings, Administrative Office of the Courts					
EFFECTIVE DATE: for taxable years beginning on January 1, 2007					

BILL SUMMARY:

Senate Bill 242 substantially revises the process for the review of disputed tax matters to provide taxpayers with the opportunity for an independent hearing outside the Department prior to paying the tax. These revisions include administrative review by the Office of Administrative Hearings, elimination of the Tax Review Board, and expansion of the Business Court to include tax cases.

This bill addresses two distinct yet related issues. First, the bill substantially revises the overall procedure for disputing tax matters. Second, the bill provides statutory guidance with regard to class actions involving a constitutional challenge to a tax statute. The second issue is a subset of

the first, but it specifically relates to recent judicial interpretations of the 'payment under protest' rule.

Sections 44, 45, and 46 of the bill would limit a corporation's ability to use captive real estate investment trusts (REITs) to avoid State taxes. A REIT is an organization that uses the pooled capital of many investors to purchase and manage real estate. Under current federal and state law, a REIT is taxable only on income that is not distributed to shareholders. The amount of income a REIT distributes is not subject to tax because the REIT is allowed a deduction for the dividends it pays. The amounts received by the shareholders of the REIT are taxable.

The bill directs the Revenue Laws Study Commission to study the use of class action lawsuits under *Dunn v. State of North Carolina*.

ASSUMPTIONS AND METHODOLOGY:

Department of Revenue

This bill changes the manner in which tax cases are heard and appealed. Under this bill, a uniform procedure would exist within the Department of Revenue for handling contested assessments **which would require no additional resources**, and the process after the Secretary's final determination would change, as would the destination for final appeals.

Office of Administrative Hearings

Currently, appeals of the Secretary's final determination in a tax case are heard by the Assistant Secretary for Administrative Services, an employee of the Department of Revenue hired by the Secretary acting as a Hearings Officer. This bill would transfer that responsibility to the Office of Administrative Hearings. OAH has ten Administrative Law Judges who conduct hearings in a broad array of administrative law matters, but none in taxation work. In order to meet the mandates of this bill, OAH would need additional staffing with specific training in taxation matters. Based on current caseloads at OAH, one additional Administrative Law Judge would be required, along with a clerk, to handle the increase in case filings. The salary of an ALJ is \$91,238, and the salary of a clerk would be \$48,546, in addition to \$6,100 in non-recurring start-up expenses, at a total cost of \$145,884. This estimate does not include potential changes to the judicial salaries proposed in this year's budget bill. Because no appeals are likely until after April 15, 2008, there is no impact projected in the first year.

The Senate version of House Bill 1473, the 2007 budget bill, includes a Type I transfer of both positions from Revenue to OAH. This provision is in controversy in the conference committee because the House budget moves the two Revenue positions to the Department of Administration. Both houses remove the two appeals positions from Revenue. The Type I transfer in the Senate budget would transfer the positions, and the current occupants of those positions, at their current levels. The current operation within DOR is handled by one Hearings Officer with one associated support position, at a combined salary of \$167,283. These differences will have to be resolved depending upon which bill passes first.

Administrative Office of the Courts

S 242 makes a change to the process of appeal tax decisions beyond the administrative hearings level. Under current law, these cases can be appealed to Superior Court, but under this bill, these cases would be automatically designated as complex business cases and referred to the Business Court in Wake County. The Business Court is a specialized court process for complex cases designated by the Chief Justice. The judges who hear these complex cases are Special Superior Court Judges appointed by the Governor; they are not resident judges within any district.

Since this bill would establish a new process for handling appeals, AOC does not project how many cases may be appealed from the Office of Administrative Hearings to the Business Court. If the increased formalization of the process through the administrative hearings statutes reduces the number of appeals to court, it is likely that the current Business Court operation could handle all appeals with no expansion. If, however, this bill produces the worst case of increase in Business Court caseload, the AOC projects the need for an additional Business Court Judge and complement of staff, comprising a deputy clerk of court, a law clerk, and a judicial assistant. The cost of an additional Business Court operation is \$313,478; no impact would be expected in the first year, due to the effective date of the bill.

According to the senior Business Court Judge, if the caseload is around ten to twelve complex cases per year, and under 100 routine tax appeals, the court could handle the change with the current number of judges, but would need an additional staff attorney position under any circumstance since their current law clerks turn over each year, and a tax caseload would require specialized knowledge and experience. A staff attorney's position cost would be \$74,211 in the first year.

Department of Justice

The Attorney General's Office provides legal counsel to the Department of Revenue in tax appeals upon request. In recent years, the DOJ has become involved in only two cases per year. Moving the hearings process to OAH will, according to DOJ's understanding, require them to represent the Department in all cases currently heard by the Revenue Hearings Officer. That number of cases varies from year to year: in 2005, 255; in 2006, 160; they currently become involved in about two each year. Providing legal representation in this number of cases would be a significant increase in workload for the DOJ Revenue Section. The most conservative estimate of attorney needs would be five new attorney positions, based on current workload in the section. DOJ requests that new positions be funded at the Attorney III level. The Revenue section is currently staffed mostly with Attorney IIIs; the position cost is \$91,794. To support these positions, DOJ also would require an Office Assistant (\$29,935) and a Paralegal (\$37,737). Because the bill would not be effective until taxes are due in 2008, and it would take several months before any cases reached the point of involving the Department of Justice, no impact is anticipated in the first year.

Close REIT Loophole

Senate Bill 242 includes a provision that disallows a deduction of the dividends paid by captive Real Estate Income Trusts (REIT) from North Carolina taxable income. Captive REITs are defined as entities whose shares or certificates of beneficial interest are not regularly traded on an established securities market and are owned or controlled by a person that is not one of the following entities:

- a. A REIT whose shares or certificates of beneficial interest are regularly traded on an established securities market.
- b. A listed Australian property trust.

Based on the most recent data collected by the Department of Revenue on C-corporation taxpayers, the total captive REIT deductions taken against North Carolina taxable income was an estimated \$9 million. It is the department's position that nearly half of those dollars will be included in taxable income going forward because of the Settlement Initiative. The balance, according to DOR is currently under litigation. Moreover, under current law through forced combined reporting, DOR states it can retain captive REIT dollars when determining a C-corporation's North Carolina taxable income (pending litigation may or may not support the department's position). As such, the captive REIT provisions in S242 will not generate new General Fund revenue.

SOURCES OF DATA: Department of Revenue, Department of Justice, Administrative Office of the Courts.

TECHNICAL CONSIDERATIONS: None

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