

Basics of North Carolina Local Option Sales Taxes

Overview:

North Carolina counties rely heavily on local sales taxes as an important revenue source within the county general fund to support critical public services. Local sales taxes are the second largest county-levied revenue stream and comprise on average 12 percent of total county revenues.

Per the Tax Foundation's Sales Tax Clearinghouse, North Carolina is one of 38 states that authorize, or provide for, a local sales tax levy; 45 states levy a state sales tax. (Alaska permits a local sales tax but not a state sales tax and California (1%), Utah (1.25%) and Virginia (1%) collect a "local" sales tax that is distributed to local governments.) North Carolina counties are limited in the amount and type of local sales taxes to those specifically authorized by the state legislature.

The General Assembly authorized the first cent of local option sales tax in 1971 "to afford the counties and municipalities...with opportunity to obtain an added source of revenue with which to meeting their growing financial needs" (105-464. Purpose and intent). In comparison, the state initially imposed its first state sales tax in 1933, following a significant restructuring of state v. local government service and funding responsibilities.

While cited statutorily as a local government sales and use tax, the local sales tax levy is imposed solely by the board of county commissioners by resolution following a favorable referendum, if required, or by board resolution. North Carolina's Department of Revenue oversees local sales tax collections from retailers, in concert with state sales tax collections.

The tax is levied within the county as a whole, meaning local sales taxes collected within municipal boundaries and unincorporated areas are credited to the county area. Most, but not all, of the levies are shared with the cities within the county's borders.

A penny of local sales taxes generates roughly \$1.1 billion in revenues, of which 2/3rds of the proceeds on average are distributed to counties. The local sales tax levy generally applies to most tangible goods and closely tracks the state's sales tax base with a few exceptions. Most notably, motor vehicles and utilities are not subject to the local sales tax while food purchases are taxed locally but were phased out of the state sales tax base in 1998.

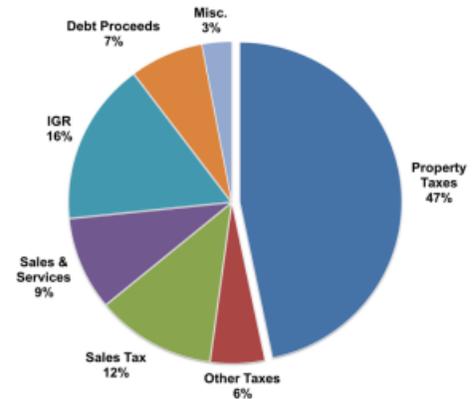
All counties levy at least 2 percent in sales taxes. As of this writing, 27 counties have 2.25 percent, one has 2.5 percent and 2 have 2.75 percent.

Inter-County Local Sales Tax Allocations:

Point of Delivery Allocation

North Carolina maintains two distinct, and unique, inter-county allocation methods for sales taxes collected under the local levy. The point of delivery allocation method credits the county to which the goods are delivered, and all local sales tax levies save a ½ cent tax are allocated in this manner (as of this writing). Generally point of delivery coincides with the point of sale, e.g. where the sales transaction actually occurs and the purchaser walks away with the goods in hand. However, larger items such as appliances and, perhaps more importantly, construction materials may be delivered to the purchaser's home or where the goods are to be used. It is the county area to which the goods are delivered that is credited for the sales tax collected. North Carolina changed its point of sale allocation method to that of

Revenues:



point of delivery in 2001 to become compliant with the *Streamlined Sales Tax Agreement* (see below). This followed a 1987 legislative change in sourcing from destination (point of delivery) to the retailer's location (point of sale).

Some counties report addressing problems by vendors who rely solely on the purchaser's 5-digit zip code to source the sale on goods delivered in a county other than that of the retailer. Since zip codes can cross county lines, the sale could be credited to the incorrect county and the incorrect county sales tax rate could be applied to the sale. This may be particularly acute in developing counties that border urbanized retail centers – the local sales tax on housing construction materials may be sourced to the incorrect county if based only on the 5-digit zip code.

Per Capita Allocation

The second inter-county allocation method is based on the county's population as a percent of the state's total population, according to the most recent state-certified population estimates. Local sales taxes allocated under the per capita method are collected in a statewide pool and then allocated to the county area based on the county's population percentage.

However, a statutory adjustment is made prior to the individual county area distribution that could increase, decrease or retain the actual per capita percentage. This adjustment factor, ranging from 1.49 in Dare County to 0.81 in Columbus County, is thought to correct for the 1987 sourcing change from destination to the retailer's location, and was put in place in conjunction with legislative authority for the second ½ cent per capita local sales tax.

There are several states that allocate a portion of their state-levied sales taxes on a per capita basis but we know of no other state that allocates locally-levied sales taxes via the per capita method. There has been discussion regarding the constitutionality of having a locally-levied tax whose proceeds are used outside of the tax levying jurisdiction.

Intra-County Local Sales Tax Allocations:

Counties may choose one of two methods to share the proceeds of qualifying county area sales tax levies with their municipalities—by ad valorem or per capita (not to be confused with the inter-county per capita allocation). Generally, the ad valorem method favors counties. Counties must designate the method by adopting a board resolution in April and providing a certified copy of the resolution within 15 days following its adoption to N.C. DoR, to become effective the next fiscal year. Should a county not adopt a distribution method each year, the current distribution method in effect remains as is. As of this writing, 47 counties have elected to use the ad valorem method while 53 counties have chosen the per capita allocation.

Ad Valorem Method

This method allocates qualifying intra-county sales taxes in proportion to the property tax levied by a county and its municipalities in the previous fiscal year. For example, if Carolina County levied \$50 million in property taxes and Dogwood City levied \$25 million in property taxes, Carolina County would receive 66.6% of total proceeds (\$50 mil / (\$50 mil + \$25 mil)). The N.C. DoR collects property tax levy information annually to set the distribution.

Included in the property tax levy, if applicable, are any special district property taxes levied by either the county or city on behalf of the special district. If these levies are included, then the county or city levying the tax on behalf of the special district must share its proceeds in proportion to the amount of property taxes levied. School districts with a supplemental tax would likewise receive a share of the county's allocation.

Per Capita Method

This method allocates qualifying intra-county sales taxes based on a unit's population to the total county population plus the populations of all eligible municipalities. For example, if Carolina County's population was 100,000 and the populations for its three municipalities totaled 75,000, Carolina County would

receive 57.1% of the total proceeds ($100,000 / (100,000 + 75,000)$). Population figures reflect the most recent state-certified population estimate.

Special district populations are not included in the tally and no distribution is made to special districts under the per capita method.

Hybrid Method?

Onslow County received special legislative authority to combine the ad valorem and per capita inter-county method, but has since elected to use the ad valorem method alone.

Specific Local Sales Tax Levy Authority:

Several local option sales taxes have been authorized since the initial local sales tax in 1971. Below is a description of each local sales tax as referenced by its statutory citation in General Statute Chapter 105. Largely, any local sales tax authorized prior to 2000 included unprepared food sales in the local sales tax base. After the state phased out food sales in the state sales tax base in 1998, the General Assembly has not permitted any new local sales tax levies to be applied to unprepared food.

In keeping with the *Streamlined Sales Tax Agreement* (see below) and following the state's phase out of state sales taxes on unprepared food, the 2 percent local sales tax on food—its administration and accounting—is now treated as if it is a state sales tax (beginning with fiscal year 2003 collections). For allocation purposes, one-half of the food sales tax is distributed on a per capita basis while the other half is distributed proportional to the 1997-98 Article 39 tax on food. Overall, food accounted for nearly \$140 million per penny in 2012-13, or 12.5 percent of the total.

Article 39

Article 39 was the original local option sales tax and authorized in 1971. It was set at one percent of eligible sales, the highest individual levy authorized, and is allocated on a point of delivery basis. All counties impose Article 39, which may be levied via a referendum or by board resolution (if no referendum failed with 5 years of board action).

Since Article 39 was the original local sales tax, all subsequent local sales tax articles refer back to Article 39 for administrative purposes. For example, Article 39 outlines the steps for repealing a local sales tax and allows for a petition of 15% of qualified voters to force a referendum on the levy's repeal. (Dare County's levy of a 1 percent sales tax for beach re-nourishment, as allowed under a local bill, was repealed in this manner).

Article 40

Article 40 was authorized in 1983 to provide "an added source of revenue with which to meet their (counties and cities) growing financial needs, and to reduce their reliance on other revenues, such as the property tax" (105-481. Purpose and intent). Set at one-half percent, Article 40 is allocated on a per capita basis. All counties impose Article 40, which may be levied similarly to Article 39.

Article 40's statutory language requires counties to set aside 30 percent of its proceeds for public school capital outlay purposes, including school indebtedness. When originally enacted, counties were required to set aside 40 percent for the first 5 years of the levy, and then 30 percent for the next 5 years. Cities sharing in the distribution had similar set aside requirements for water and sewer capital outlays. The General Assembly enacted legislation to extend the county-required set aside indefinitely while the city set aside was allowed to sunset.

A county may petition the Local Government Commission to allow the county to use part or all of its required set aside for purposes other than school capital needs, if it can demonstrate that it is able to meet its public school capital needs without Article 40 proceeds. Informal discussions with the LGC indicate that the local board of education would need to sign off on the county's petition prior to the LGC approving the set aside release. **As of this writing, the LGC has only approved one release to allow the set aside to be used in part for local public school current expense purposes.**

Since the local sales tax on food was converted to a “state” sales tax and decoupled from Article 40, the school capital set-aside is not required for the food portion of proceeds.

NCACC has developed a methodology to assist counties in calculating their set aside requirements.

Article 42

Article 42, authorized in 1986 at one-half percent, was originally allocated like Article 40 on a per capita basis. It too was enacted as an added source of local revenue and to reduce reliance on other revenues such as the property tax but also for the loss of “federal revenue sharing” (105-496. Purpose and intent).

After its enactment, counties could levy a total of 2 percent in sales taxes, with 50% allocated on a point of sale basis and 50% allocated on a per capita basis. All counties levy Article 42, which may be imposed similarly to Article 39.

In 2009, and as a part of the historic county Medicaid Relief Swap of 2007, Article 42 was converted from a per capita to a point-of-delivery basis. This change was made to reduce the state’s financial exposure to a state-funded hold harmless for those counties whose loss of Article 44 sales taxes as a part of the swap exceeded their gain from Medicaid relief.

The food sales tax receipts originally levied under Article 42, now levied under Article 5, the state’s sales tax legislation, remain distributed on a per capita basis.

Article 42, like Article 40, also has set aside requirements--current law requires counties to use 60 percent of Article 42 receipts for public school capital outlay purposes. As originally enacted, the required set aside stepped down and phased out after 11 years but subsequent legislation removed the step down and mandated the 60 percent set aside indefinitely. The General Assembly further modified the set aside to require counties whose Article 42 receipts are less under the point of delivery allocation to earmark enough revenue to make up for the loss of school construction funding.

Article 44

Article 44, set at one-half percent, was authorized in 2001 to replace state reimbursements for local tax base losses legislatively repealed in the 1980s. The state was facing a fiscal crisis at that time, and chose to withhold and repeal the local reimbursement distribution of \$333 million. All counties immediately took action to impose Article 44, which permitted an accelerated levy and collections schedule to replace lost state reimbursements within the 2001-2002 fiscal year.

As a part of the 2007 Medicaid Relief Swap, Article 44 was ceded to the state to offset the state’s increased Medicaid costs for assuming the county Medicaid cost share. Counties continue to see Article 44 adjustments as refund requests are processed and sales tax discoveries are made.

As originally enacted, Article 44 followed the then established local sales tax allocation of 50% per capita and 50% point of delivery, the first levy to have a dual allocation method. Legislation authorizing Article 44 provided for a 10-year hold harmless provision for those local governments whose expected Article 44 receipts did not replace their repealed state reimbursements. After several extensions, the Article 44 hold harmless sunset in 2013.

Article 46

Article 46, at one-quarter percent and allocated by point of delivery, was also authorized as a part of the 2007 Medicaid Relief swap, whereby legislators acknowledged the substantial infrastructure and operating demands facing county governments.

Unlike the previous local sales tax options, the county’s voters must approve its levy via an advisory referendum prior to board enactment. As of this writing, 29 counties have been successful in having Article 46 approved by their voters.

Article 46 Sales Tax Referendum



Article 46 is the only statewide local sales tax levy not shared with municipalities.

Article 43

Article 43 began in 1997 as a one-half percent public transportation tax available only to Mecklenburg County. In 2007, the General Assembly extended the local sales tax authority under Article 43 to all counties, but continued to limit the tax proceeds for public transportation purposes only. A favorable advisory referendum must be held prior to imposition of Article 43.

The General Assembly also set stipulations on the amount of the levy. Mecklenburg, the Triangle Transit Authority (Durham, Orange, Wake), and the Triad Transit Authority (Forsyth and Guilford) may levy one-half percent for public transportation systems. All other counties may levy one-quarter percent if they or another local government within the county operates a public transportation system. If more than one local government operates a public transportation system within the county, Article 43 proceeds are allocated within the county on a per capita basis.

As of this writing, Mecklenburg, Durham and Orange have adopted the Article 43 half-cent sales tax for public transportation purposes.

Summary of Local Option Sales Taxes

G.S. & Year	Amount	Referendum?	Allocation— PD or PC?	Restricted Use?	Applies to Food?
Art. 39; 1971	1 penny	Optional	PD	No	Yes
Art. 40; 1983	½ penny	Optional	PC	30% for school capital	Yes
Art. 42; 1986	½ penny	Optional	PD (Originally PC)	60% for school capital	Yes
Art. 44; 2001 <i>2007-ceded to state via Medicaid swap</i>	½ penny	Optional	½ PD; ½ PC	No, but replaced repealed reimbursements	No
Art. 43; 2007 for all counties	½ or ¼ penny	Required	PD	Yes—public transit only	No
Art. 46; 2007	¼ penny	Required	PD	No, & no city share	No

Mechanics of Local Option Sales Taxes

N.C. DoR oversees the monthly disbursement of local option sales taxes to the eligible local government unit, both counties and cities, via electronic transfer. It is important to define the sequencing of sales, collections, allocation and distribution to understand the timing of local sales tax revenues. While large retailers must remit proceeds twice during the sales month, they generally have until the 20th day of the following month to submit the sales tax allocation report to show what county area is to be credited with the sales tax collections.

N.C. DoR takes the month thereafter to calculate the distribution, make any changes based on amended returns, and arrange for the disbursement. Therefore, local government sales tax distributions in any

given month reflect actual sales made up to three months prior. For example, August “collections” reflect July vendor “sales,” which are processed and “allocated” in September, with a local government “distribution” made on or before Oct. 15. The October payment is the first month’s sales tax distribution allocated to the July-June fiscal year.

Sequencing of Local Sales Tax Collections & Receipt



If a county board enacts a new sales tax levy, it becomes effective, e.g. collections start, on the first day of the next calendar quarter, provided that 90 days advance notice is given to N.C. DoR. Recent election law changes limit a county’s special election for a proposed sales tax levy increase to those election cycles in which all county precincts are open. Generally, this limits a special election to either the primary or general election in even-numbered years. A favorable local sales tax referendum in November would permit collections to begin the following April 1.

Local Sales Tax Exemptions and Refunds

While the state exempted its purchases from state and local sales taxes in 2004, all other eligible entities, largely local government units and non-profits, must apply for sales tax refunds in the fiscal year following the purchase. Given the burdensome nature of refund tracking and report filing, counties have long sought equal sales tax treatment with state agencies, namely to be exempted from paying state and local sales taxes at the onset. But because an exemption and its resulting \$90 million loss of state sales tax dollars would occur within the same fiscal year as the final \$90 million refund paid out of state funds, the General Assembly has balked at exempting local governments from state sales taxes.

Local school districts became eligible to seek sales tax refunds in 1998, and promptly lost that ability for state sales tax refunds in 2005. Consequently, counties file refunds for sales tax paid on county-funded school capital purchases. Community colleges are not eligible to receive sales tax refunds.

Counties are encouraged to monitor closely the sales tax refunds debited from their county area distribution, given the growth and expansion of these refunds. Overall, these refunds were \$187 million in 2012-13 for the local share alone. Much of the refund amount is attributed to hospitals and other non-profits. While the General Assembly did consider repealing non-profit and local government access to sales tax refunds, the final 2013 tax reform legislation limited non-profits to a total of \$13.3 million per local government refund paid, effective for purchases made on or after July 1, 2014.

Per G.S. 105-164.14 (f), counties may request in writing to DoR the refund detail for the previous 12 months, and the sales tax distribution report lists the total refunds month by month.

Local Sales Taxes on Remote (On-Line) Sales

Unless a company has a physical presence in the state—a nexus—the U.S. Supreme Court has ruled that the company is not required to collect sales taxes on purchases made by mail order, Internet, telephone, etc. Current N.C. state law requires the purchaser to pay the “use tax” on the purchase, although the State Department of Revenue reports that compliance is minimal and enforcement difficult.

Remote sellers have voiced concerns over managing sales tax collections for the 45 states and their localities that levy sales taxes, given disparate and changing rates and jurisdictions, differences in items subject to tax, and potential audit and reporting requirements for more than 7,000 governmental units. Working with the business community, the Streamlined Sales Tax Project (SSTP), whose membership

