Coates' Canons Blog: Impending Local Sales and Use Tax Changes: The Final Phase of Medicaid Funding Reform Legislation

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The General Assembly enacted Medicaid funding reform legislation in 2007. The cornerstone of the legislation was the state assuming the counties' Medicaid costs, but it contained several other provisions that impact counties, municipalities, and local school administrative units—including the repeal of a one-half cent local sales and use tax and the change in allocation method of another one-half cent local sales and use tax. Many of the legislation's provisions were implemented in phases, over a three-year period. The final provisions become effective as of October 1, 2009. This post briefly summarizes the changes that will occur on that date. (Note that a detailed description of the entire Medicaid funding reform legislation and its impact on local units is available here.)

Repeal of Article 44 Local Sales and Use Tax

As of October 1, 2009, the authorization for counties to levy the Article 44 one-quarter cent local sales and use tax is repealed. (Recall that one-quarter cent of the Article 44 tax was repealed on October 1, 2008.)

Change in Distribution Method of Article 42 Local Sales and Use Tax

Also as of October 1, 2009, the method for allocating the proceeds of the Article 42 one-half cent tax among the counties switches from per capita (whereby the proceeds are placed in a statewide pool and allocated among the counties based on relative populations) to point-of-origin (whereby the proceeds are returned to the counties in which the goods were delivered).

Municipal Hold Harmless

Each county is required to hold all municipalities located within the county, and incorporated as of October 1, 2008, harmless for the loss in revenue from the repeal of the Article 44 local sales and use tax. The hold harmless payment is calculated in two steps:

First, the base hold harmless payment is calculated as an amount equivalent to the local sales and use tax revenue a municipality receives from the Article 40 local sales and use tax.

Second, the hold harmless calculation must factor in any increase or decrease in municipal revenue due to the change in allocation method of the Article 42 local sales and use tax proceeds from per capita to point-of-origin. To calculate the revised hold harmless amount, subtract the amount determined by taking 25 percent of the amount of local sales and use tax revenue a municipality receives from the Article 39 tax from the amount determined by taking 50 percent of the amount of local sales and use tax revenue a municipality receives from the Article 40 tax (50% of Article 40 tax proceeds minus 25% of Article 39 tax proceeds). The difference, positive or negative, is added to the base hold harmless amount to determine the revised hold harmless amount (Article 40 tax proceeds plus (50% of Article 40 tax proceeds minus 25% of Article 39 tax proceeds)). Therefore, the municipal hold harmless amount is increased if a municipality loses revenue because of the switch of the Article 42 tax revenue allocation method from per capita to point-of-origin. Alternatively, the hold harmless amount is decreased if a municipality gains revenue because of the switch in the allocation method.

The municipal hold harmless proceeds are distributed directly to each eligible municipality by the Department of Revenue. Each county's Article 39 local sales and use tax distribution is reduced by the total amount of municipal hold harmless funds due to eligible municipalities located within the county.

County Supplemental Payments

If you are keeping track so far, as of October 1, 2009, counties will lose local sales and use tax revenue because of the repeal of the Article 44 tax and because of the reduction in Article 39 tax proceeds due to the municipal hold harmless payments. Some counties also may lose local sales and use tax revenue because of the change in allocation method of the Article 42 tax proceeds.

These revenue losses must be viewed in the context of the other provisions of the Medicaid funding reform legislation—specifically, the gains to counties from the State assuming the counties' Medicaid payments. The legislation guarantees that each county experience a *financial gain* of at least $500,000 each year as a result of the Medicaid funding reform. Financial gain does not necessarily translate into additional revenue, though. The guarantee requires that the difference between the "gain" a county experiences from the state assuming its Medicaid costs and the "loss" it experiences from the loss of its projected share of the local sales tax proceeds (including the repeal of the Article 44 tax, any loss due to the change in allocation method of the Article 42 tax proceeds, and any loss in Article 39 tax proceeds due to the municipal hold harmless payments) is at least $500,000. The State will make a supplemental payment to a county for the difference if the amount is less than $500,000. (See page 15 of Local Finance Bulletin No. 38 for a detailed breakdown of the calculation.)

The state supplemental payments are made semiannually. The Secretary of Revenue estimates the hold harmless amount and sends each county 90 percent of the estimated amount with the March local sales and use tax distribution. The Secretary of Revenue determines the actual amount at the end of the fiscal year and remits the balance to each county by August 15.

Capital Outlay Earmark for Public Schools

A county also is required to hold its local school administrative unit harmless for the loss of any Article 42 tax revenue earmarked for public school capital outlay, or debt service on county borrowing for school projects, due to the change in allocation method of the Article 42 tax proceeds from per capita to point-of-origin. Recall that until October 1, 2009, 60 percent of the amount a county receives from the Article 42 tax is specifically earmarked for these purposes. After that date, when the allocation method of the Article 42 tax proceeds changes, G.S. 105-502 directs a county to earmark 60 percent of the following:

- The amount of revenue the county receives from the Article 42 tax, *plus*
- If the amount allocated to the county under G.S. 105-486 (Article 40 tax) is greater than the amount allocated to the county under G.S. 105-501(a) (Article 42 tax), the different between the two amounts.

(It appears that the General Assembly intended that the phrase "amount allocated to the county" be interpreted to refer to the amount a county receives from both the Article 40 and Article 42 taxes—after the full amount of the proceeds due to the county from these taxes are distributed among the county and any eligible municipalities.)

Note that any amounts a county must expend to hold local school administrative units harmless for the loss of earmarked Article 42 tax revenue are not factored into the county supplemental payment calculation.

Local Units Likely Do Not Experience Impact of Changes Until January 2010

Although counties and municipalities receive monthly distributions of local sales and use tax proceeds, the distributions tend to run about three months behind. Because of this, local units should not begin to experience changes in local sales and use tax revenue distributions due to the repeal of the Article 44 local sales and use tax or the change in allocation method of the Article 42 local sales and use tax until January 2010. (The January 2010 distributions reflect the October 2009 local sales and use tax collections.)s

Links

- www.sog.unc.edu/pubs/electronicversions/pdfs/lfb38.pdf

- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-501.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_105/Article_40.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_105/Article_42.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_105/Article_39.html
- www.sog.unc.edu/publications/bulletins/phased-implementation-2007-and-2008-medicaid-funding-reform
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-502.html
- www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-486.html