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## Coates' Canons Blog: Local Sales and Use Tax Changes and New State Revenue Sharing Requirement

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There was a lot of buzz around sales tax reform during the past legislative session. Several different proposals were introduced, ranging from changing the allocation methods of existing local sales taxes to converting local sales taxes to state taxes. Many of the efforts were aimed at providing increased resources to rural areas in the state; some at the expense of more urban areas. The legislature arrived at a compromise of sorts, which is reflected in **Sections 32.18 and 32.19 of S.L. 2015-241** (state budget). The new provisions make a few significant changes including expanding the sales tax base to include certain services; sharing a portion of state sales tax proceeds with counties and municipalities; and reallocating the expected increase in proceeds generated by three of the local sales taxes due to the base expansion to certain counties according to a statutory formula. The third change is being made “to address sales tax leakage that results from the different revenue-raising capacity of local option sales taxes in each taxing jurisdiction.” G.S. 105-524(a).

This post details current local sales and use tax authority, including hold harmless payments and state supplemental payments. It then summarizes the changes to the new local sales and use tax allocation scheme, and it describes the new state supplemental payments. Finally, it briefly analyzes the constitutionality of the new local sales and use tax allocation scheme.

### CURRENT LOCAL SALES AND USE TAX AUTHORITY

Counties levy local sales and use taxes. A local sales and use tax is made up of two separate components—a sales tax on the retail sale or lease of tangible personal property and on the rental of motel and hotel rooms, and an excise tax on the right to use or consume property in North Carolina or elsewhere.

Counties are authorized to levy up to 2.25 percent in general local sales and use taxes. (Mecklenburg County has additional general sales and use tax authority pursuant to local act, and every county has authority to levy sales and use taxes for transportation purposes. See **G.S. Ch. 105, Art. 43**.) The 2.25 percent of general tax authority is comprised of four separate taxes—all counties currently levy three of the four taxes, totaling 2.0 percent. Counties received authorization for the additional 0.25 percent local sales and use tax in 2007. Before levying the additional tax, a county must hold a successful voter referendum. (To date, 30 counties have received voter approval to levy the additional tax.)

### *Local Sales and Use Tax Allocations*

Each of the local sales and use taxes is collected by the state, along with the state's sales and use tax (of 4.75%). After collection costs are subtracted, the net proceeds of the taxes are allocated among the 100 counties. The three taxes are allocated differently and carry different expenditure requirements. They are characterized by the articles in G.S. Chapter 105 under which they are levied:

- **Article 39 one-cent tax.** The net proceeds are returned to the county in which the goods were delivered or services performed (which is usually also the county in which the sale occurred).
- **Article 40 half-cent tax.** The net proceeds of the Article 40 tax are placed in a statewide pool and allocated among the counties on a per capita basis. The per capita amounts due each county are adjusted under a statutory formula set out in **S. 105-486(b)**, which increases or reduces the actual per capita amount for each county.
- **Article 42 half-cent tax.** The net proceeds are returned to the county in which the goods were delivered or

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services performed (which is usually also the county in which the sale occurred). There are some additional administrative costs deducted from the gross proceeds, in accordance with **G.S. 105-501**.

- **Article 46 quarter-cent tax** (only levied by some counties). The net proceeds are returned to the county in which the goods were delivered or services performed (which is usually also the county in which the sale occurred).

### ***Local Sales and Use Tax Distributions***

Once the proceeds are allocated among the counties the proceeds of the Article 39, 40, and 42 taxes are divided among the government units (county and municipalities) in the county by one of two possible distribution formulas—per capita or *ad valorem*. **G.S. 105-472**. The county commissioners select the distribution formula and may change it in April of each year, to take effect in the ensuing fiscal year. The county retains all of the Article 46 tax proceeds. (Click [here](#) for a discussion of the different distribution methods.)

In addition to these distributions, some counties are also required to make a hold harmless payment to their incorporated municipalities. Specifically, a county must hold any municipalities incorporated as of October 1, 2008, harmless for the loss of a half-cent local sales tax that occurred pursuant to Medicaid Reform legislation enacted in 2007 (formerly the Article 44 tax). A county's Article 39 distribution is reduced by the amount of the hold harmless payment. The hold harmless payment is calculated according to the following formula:

$$\text{Article 40 tax proceeds due to municipality} + ((.50 * \text{Article 40 tax proceeds due to municipality}) - (.25 * \text{Article 39 tax proceeds due to municipality}))$$

### ***Earmarked Local Sales and Use Tax Proceeds***

A municipality may expend its local sales and use tax proceeds for any authorized public purpose. A portion of a county's Article 40 and Article 42 local sales and use tax revenue is earmarked for public school capital outlay purposes or to retire any indebtedness incurred by the county for public school capital outlay.

## **CHANGES TO LOCAL SALES AND USE TAX AUTHORITY**

As stated above, the state budget makes changes to sales tax authority by expanding the base, reallocating some local tax proceeds among local governments, and sharing some state tax proceeds with local governments.

### ***Expanding State and Local Sales and Use Tax Base***

Effective March 1, 2016, **Section 32.18 of S.L. 2015-241** expands the state and local sales and use tax base to include repair, maintenance, and installation services to tangible personal property and motor vehicles. There is an exception for tangible personal property "installed or applied by a real property contractor pursuant to a real property contract." G.S. 105-164.3(33d). There is also an exemption for repair maintenance, and installation services done pursuant to a service contract that is exempt under G.S. 105-164.4l, and for repair, maintenance, and installation services purchased for resale. See G.S. 105-164.13(61a) and (61b).

This change is expected to generate an aggregate increase in local sales and use tax revenue for the last four months of FY2015-2016 of \$18.7 million. This revenue will be allocated among counties according to the current allocation methods through June 30, 2015. Local units will see this increase reflected in their June-September distributions.

### ***Allocating Certain Sales Tax Proceeds According to Statutory Formula***

However, effective July 1, 2016, **Section 32.19 of S.L. 2015-241** makes changes to the local sales and use tax allocation formulas. A portion of the Articles 39, 40, and 42 proceeds that would have been allocated to each county according to the current allocation methods (described above), instead will be placed in a statewide pool and allocated according to a statutory formula. (Any amounts attributable to the local sales and use tax on food will not be included in the new allocation method. See **Section 10.1.(e1) of S.L. 2015-268**.)

The total amount diverted from the Articles 39, 40, and 42 tax proceeds for FY2016-17 is \$84,800,000 (1/12 of this amount each month). That amount is projected to derive from the increase in local sales and use tax proceeds from expanding the

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tax base. The amount will be adjusted each year as sales and use tax revenue increases or decreases. See G.S. 105-524(c).

Under the new allocation formula, some counties will receive more money from the base expansion than they would have under the current allocation methods, while others will receive less. Twenty-one counties will not receive any of the diverted proceeds. The legislative intent, however, is that no local government will be worse off as a result of the base expansion plus new allocation method than it would have been under the current allocation method (without the base expansion). Click [here](#) for allocation projections from Fiscal Research for each county over the next few fiscal years.

Note that the changes will not impact a county's allocation from the Article 46 proceeds. Counties that levy an Article 46 local sales and use tax should receive the full amount of the increase in proceeds due to the base expansion. The same is true for those counties that levy an Article 43 transportation sales and use tax.

### ***Distributing Newly Allocated Sales and Use Tax Proceeds***

A county that receives an allocation under this new formula is required to distribute a portion of the proceeds with its incorporated municipalities according to the same distribution method used for the county's Articles 39, 40, and 42 sales and use taxes.

However, when calculating the hold harmless payment due to a municipality (according to the formula specified above), a county may not consider the reallocations made pursuant to G.S. 105-524. That means that in plugging in the numbers to the hold harmless formula a county must use the amounts that would have been allocated to it under Articles 39, 40, and 42, if the new allocation formula were not applied and if the county did not receive any distributions of state sales tax proceeds. See **Section 10.1.(e3) of S.L. 2015-268**.

### ***New Earmarks on Local Sales and Use Tax Proceeds***

The revenue that is distributed to counties under the new statutory formula in G.S. 105-524 contains an earmark. It must be used for expenditures related to economic development, public schools, or community colleges. There is no non-supplant language associated with the new provisions, though. That means that a county is free to use this revenue to substitute for other revenue that it would have appropriated for one or more of these purposes.

The portion of the new allocation distributed to municipalities is not earmarked; it may be used for any lawful purpose.

### ***Supplemental State Appropriations***

#### **Medicaid Reform Supplemental Payments**

As part of the Medicaid reform legislation enacted in 2007, counties lost the authority to levy a half-cent sales and use tax (Article 44 tax) in exchange for the state taking over the majority of Medicaid expenses that were previously borne by counties. At that time, the state guaranteed that each county would benefit by at least \$500,000 as a result of the "Medicaid swap." In other words, if a county's gain from not having to pay Medicaid expenses did not exceed its loss from the half-cent sales and use tax by at least \$500,000, the state would make a supplemental payment to the county to make up the difference.

In 2014, the legislature modified the supplemental payment formula to reduce the state payments over time. Effective for FY2015-16, the guaranteed benefit to each county is reduced to \$250,000. It is then reduced to \$125,000 for FY2016-17. And starting in FY 2017-18, the state will only make a supplemental payment if the loss in revenue to a county from the repealed local sales and use tax would have exceeded the gain to the county from the reduction in Medicaid expenses that year. See **G.S. 105-523**.

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Note that in calculating whether or not a supplemental payment is due to the county, the state may not consider the reallocations made pursuant to G.S. 105-524. That means that in plugging in the numbers to the hold harmless formula the state must use the amounts that would have been allocated to the county under Articles 39, 40, and 42, if the new allocation formula were not applied and if the county did not receive any distributions of state sales tax proceeds. See **Section 10.1.(e4) of S.L. 2015-268**.

### **Base Expansion Supplemental Payments**

Under the new law, all counties will also receive additional appropriations from the state beginning in FY2016-17. Specifically, **Section 32.19 of S.L. 2015-241** directs the Department of Revenue to withhold \$17,600,000 from state sales and use tax collections each year (1/12<sup>th</sup> of this amount each month). This amount will be allocated *among all counties* (the law directs the Department of Revenue to allocate a proportional share of the amount to the “taxing counties,” which are defined to include all counties that levy the Articles 39, 40, and 42 taxes) according to the following methods:

- 50 percent will be allocated by the same method as the Article 39 local sales and use tax proceeds (minus the portion attributable to food);
- 25 percent will be allocated by the same method as the Article 40 local sales and use tax proceeds (not including the statutory adjustments in G.S. 105-486(b)); and
- 25 percent will be allocated by the same method as the Article 42 local sales and use tax proceeds.

Because these allocations will be reflected in the local sales and use tax distributions, each county must share a portion of the additional revenue with its incorporated municipalities according to the same distribution method (per capita or ad valorem) that it uses to distribute its Articles 39, 40, and 42 local sales and uses taxes.

The state supplemental payment revenue must be used by counties for expenditures related to economic development, public schools, or community colleges. There is no non-supplant language associated with the new provisions, though. That means that a county is free to use this revenue to substitute for other revenue that it would have appropriated for one or more of these purposes.

The portion of the supplemental payment distributed to municipalities is not earmarked; it may be used for any lawful purpose.

### **CONSTITUTIONALITY OF NEW LOCAL SALES AND USE TAX ALLOCATION SCHEME**

Questions have been raised about the constitutionality of the new local sales and use tax allocation scheme. Specifically, some have argued that distributing local sales and use taxes levied and collected in one county to other counties violates the Law of the Land clause of the North Carolina Constitution. The following is a cursory review of the argument. (A more detailed analysis will follow in a future blog post.)

Although there are no North Carolina cases directly on point, the North Carolina Supreme Court has held that “[t]he taxing district through which the tax is to be apportioned must be the district which is to be benefitted by its collection and expenditure.” *Commissioners of Johnston County v. Lacy*, 174 N.C. 141, 146 (1917). In that case, the court struck down a law requiring a county to issue county bonds on behalf of a township in the county. According to the court,

It is a fundamental principle in the law of taxation that taxes may only be levied for public purposes and for the benefit of the public on whom they are imposed, and to lay these burdens upon one district for benefits appertaining solely to another is in clear violation of established principals of right, and contrary to the express provisions of our Constitution, article I, Sect. 17, which forbids that any person shall be dispossessed of his freehold liberties and privileges, or in any manner deprived of his life, liberty, or property, but by the law of the land.

*Id.* at 484.

Similarly, in *Commissioners of Bladen County v. Boring*, 175 N.C. 105, 108 (1918), the court held unconstitutional a law that required a county to guarantee road bonds on behalf of a township because “it is not within the legislative power to tax one community or local taxing district for the exclusive benefit of another....” The court went on to state that “[t]he

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constitutional requirement of uniformity of taxation forbids the imposition of a tax on one municipality, or part of the State, for the purpose of benefiting or raising money for another.” *Id.* at 119.

The court also struck down an act of the General Assembly authorizing a city to issue bonds to fully fund a city-county building. *Wilson v. High Point*, 238 N.C. 14 (1953). The court held that:

[t]he purpose to be accomplished by a tax must pertain to the district taxes, as the constitutional requirement of uniformity in taxation forbids the imposition of a tax on one municipality or part of the State for the purpose of benefiting or raising money for another.

*Id.* at 21 (internal quotations omitted).

Given this line of cases, the constitutionality of both the per capita allocation of local sales and use taxes under Article 40, as well as the new allocation method under Article 44, is questionable. That said, the court often affords great deference to legislative enactments. See, e.g., *Briggs v. City of Raleigh*, 195 N.C. 223 (1923) (exercising deference to General Assembly in rejecting challenge that appropriations by the City of Raleigh to the State Fair violated the constitution). The court might look for ways to differentiate the local sales and use tax allocation schemes from the expenditures at issue in the cases discussed above. For example, it might interpret the precedent as limited to prohibiting a law that requires one taxing entity to raise revenue *solely* for the benefit of another unit of government. In the case of the local sales and use tax allocations, each of the counties benefits at least partially from the revenue it levies and collects from the Article 39, 40, and 42 taxes. Some counties are merely required to share a portion of this revenue with other jurisdictions. Alternatively, a court might find the existing precedent limited to the levy and distribution of property taxes and other taxes that are only paid by a particular unit’s property owners, residents, or citizens. Sales taxes are paid by anyone who purchases goods, or has certain services performed, in the county. In other words, the taxes are not only paid by a county’s residents, citizens, or property owners.

To date no county has challenged the constitutionality of the per capita allocation under Article 40. It is yet to be seen if one or more counties will raise this issue in light of the new allocation scheme under Article 44.

## Links

- [www.ncleg.net/Sessions/2015/Bills/House/PDF/H97v9.pdf](http://www.ncleg.net/Sessions/2015/Bills/House/PDF/H97v9.pdf)
- [www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter\\_105/Article\\_39.html](http://www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_105/Article_39.html)
- [www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter\\_105/Article\\_40.html](http://www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_105/Article_40.html)
- [www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter\\_105/GS\\_105-486.html](http://www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-486.html)
- [www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter\\_105/Article\\_42.html](http://www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_105/Article_42.html)
- [www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter\\_105/GS\\_105-501.html](http://www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-501.html)
- [www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter\\_105/Article\\_46.html](http://www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_105/Article_46.html)
- [www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter\\_105/GS\\_105-472.html](http://www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-472.html)
- [canons.sog.unc.edu/?p=6219](http://canons.sog.unc.edu/?p=6219)
- [canons.sog.unc.edu/wp-content/uploads/2015/10/Sales\\_Tax\\_Change\\_Multi\\_Year\\_FRD\\_091720153.pdf](http://canons.sog.unc.edu/wp-content/uploads/2015/10/Sales_Tax_Change_Multi_Year_FRD_091720153.pdf)
- [www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter\\_105/GS\\_105-523.html](http://www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-523.html)