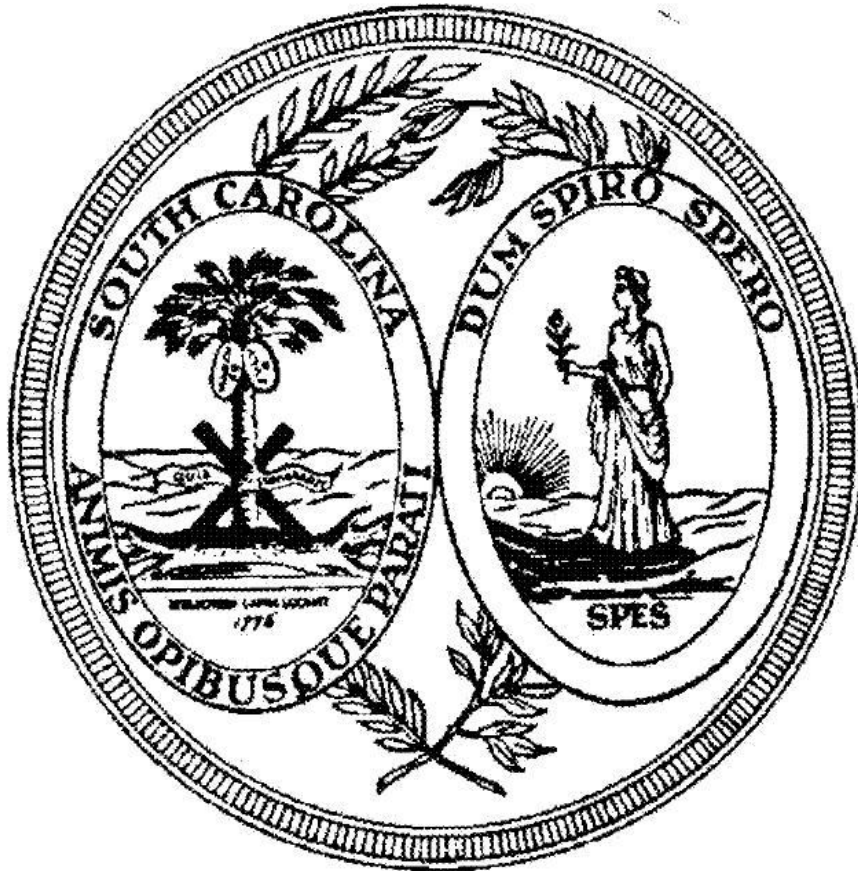


# Final Report of the



## South Carolina Taxation Realignment Commission

*December 2010*

*Note: This report, along with other pertinent TRAC documents, can be found by visiting:  
[www.scstatehouse.gov/citizensinterestpage/TRAC/TRAC.html](http://www.scstatehouse.gov/citizensinterestpage/TRAC/TRAC.html)*

# **South Carolina Taxation Realignment Commission - Final Report**

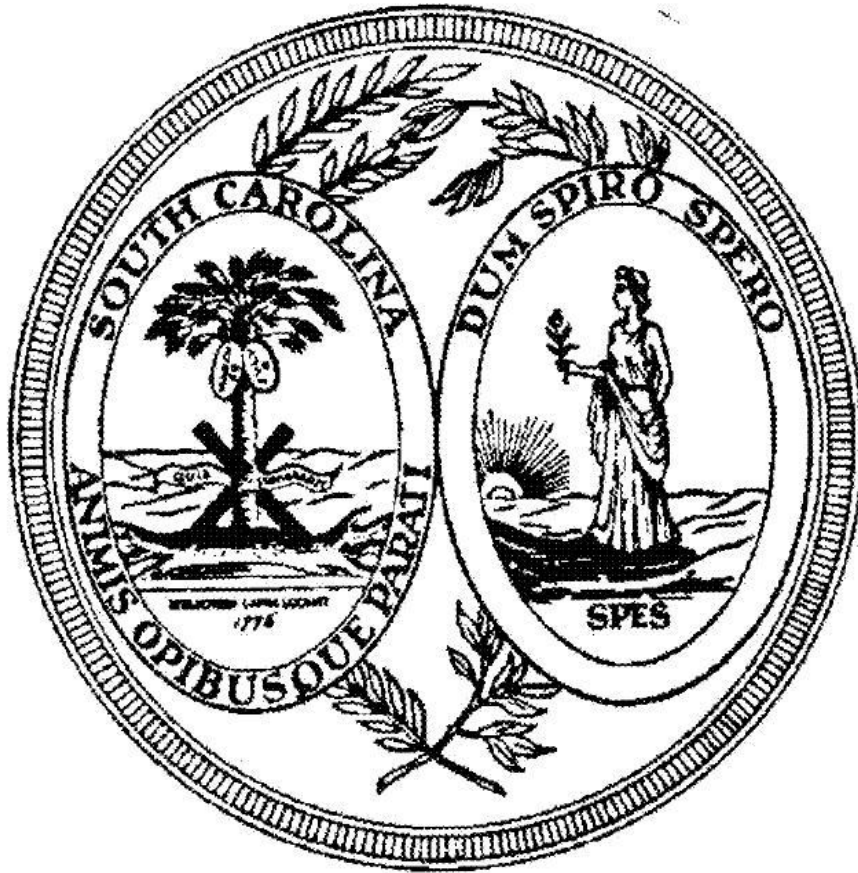
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# Chairman's Letter



## South Carolina Taxation Realignment Commission

December 1, 2010

To the Members of the South Carolina General Assembly:

On behalf of my fellow Commissioners, I am pleased to enclose the final report containing the findings and recommendations of the South Carolina Taxation Realignment Commission (TRAC).

Our report reflects more than a year of work, at no cost to taxpayers, and fulfills the mission you set before us upon passage of Act 81 of 2009; a thorough assessment of the State's current tax structure to determine its "adequacy, fairness, and efficiency" to ensure that our State remains an "optimum competitor in its efforts to attract business and individuals to locate, live, work, and invest" in South Carolina.

After seventeen full commission meetings, numerous subcommittee meetings, input from dozens of citizens, trade associations, and local, state, regional, and national experts on a variety of tax related matters, the report is arguably the most comprehensive and holistic study of our State's tax structure that has been undertaken by any group to date.

A particular note that should be readily apparent to the reader is that our study goes "beyond the theory". It goes deeper than the vague generalities that are often customary of such studies by instead making specific recommendations about how our tax system can be improved.

With few exceptions, TRAC found that South Carolina is a low tax state by almost any honest measure. However, that positive finding should not, for reasons addressed in this report, be misconstrued to suggest that South Carolina's current tax structure is not plagued with structural deficiencies. These deficiencies have challenged both the fairness of the current system and the current system's ability to produce stable revenues over time.

TRAC believes its findings and recommendations go a long way to addressing these important concerns, and we believe provide the General Assembly its most definitive blueprint yet from which to accomplish comprehensive tax reform.

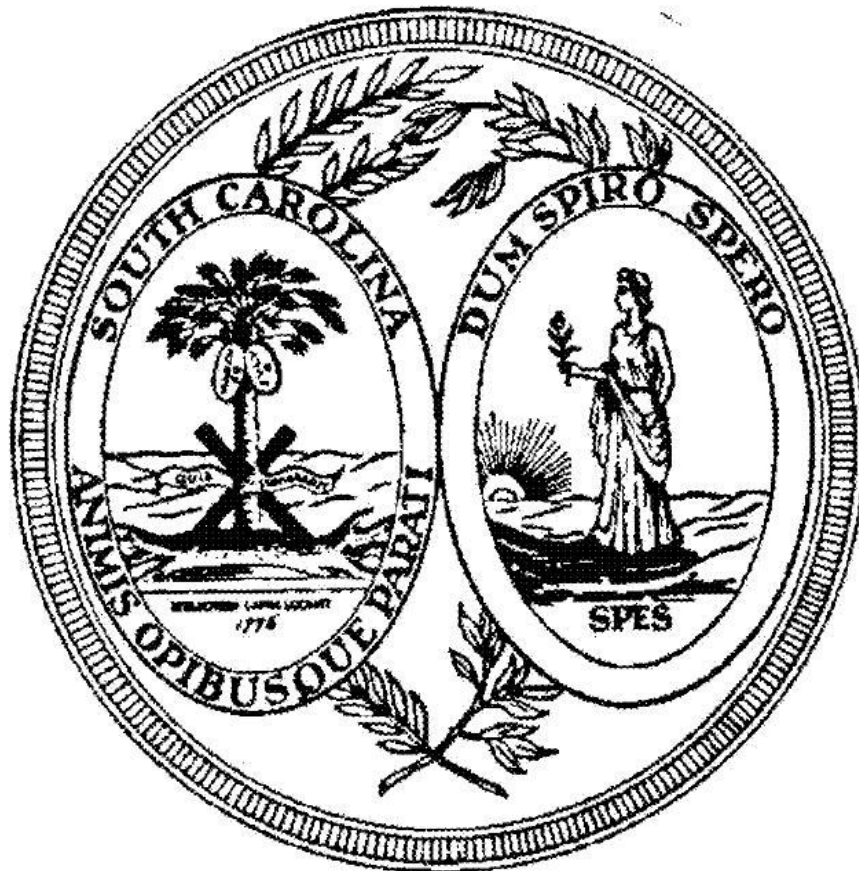
In closing, our Commission would be remiss in failing to thank a number of people, who without their support, this report would not have been possible. First, to Craig Parks, Sr. Research Analyst with the Senate Finance Committee; Rena Grant, Legislative Director with the House Ways and Means Committee; and to Katie Owen, Budget Analyst with the House Ways and Means Committee, each of whose professionalism, analytical abilities, and diligent stewardship guided our often difficult task. And to Kevin Sayed and Campbell Irving, my legal interns, who provided invaluable research assistance through much of this project. To my executive assistant, Cathy Allen, who helped me balance my “day job” with the significant amount of time I, like my fellow Commissioners, dedicated to this important task. And lastly, to several former colleagues at the Department at Revenue, Rick Handel, John McCormack, Sally Major, and Carol Player who throughout this process never failed to respond in offering their ample expertise in a timely manner to the Commission whenever called upon.

Sincerely,

Burnet R. Maybank, III, Chairman  
SC Taxation Realignment Commission

Enclosure: Final TRAC report

# Commission Membership and Staff



## South Carolina Taxation Realignment Commission



Members of the South Carolina Taxation Realignment Commission (TRAC), appointed by the Governor and specific members of the General Assembly, must have substantial academic or professional experience (or specialization) in one or more of the following areas:

1. Public finance,
2. Government budgeting and administration,
3. Tax administration,
4. Economics,
5. Accounting,
6. Business,
7. Tax law.

Furthermore, members of TRAC must have been a resident of South Carolina since January 1, 1997 and cannot be members of the General Assembly. Commissioners will serve without compensation, and are not eligible for the usual mileage, subsistence, and per diem sometimes allowed for members of state boards, committees, and commissions.

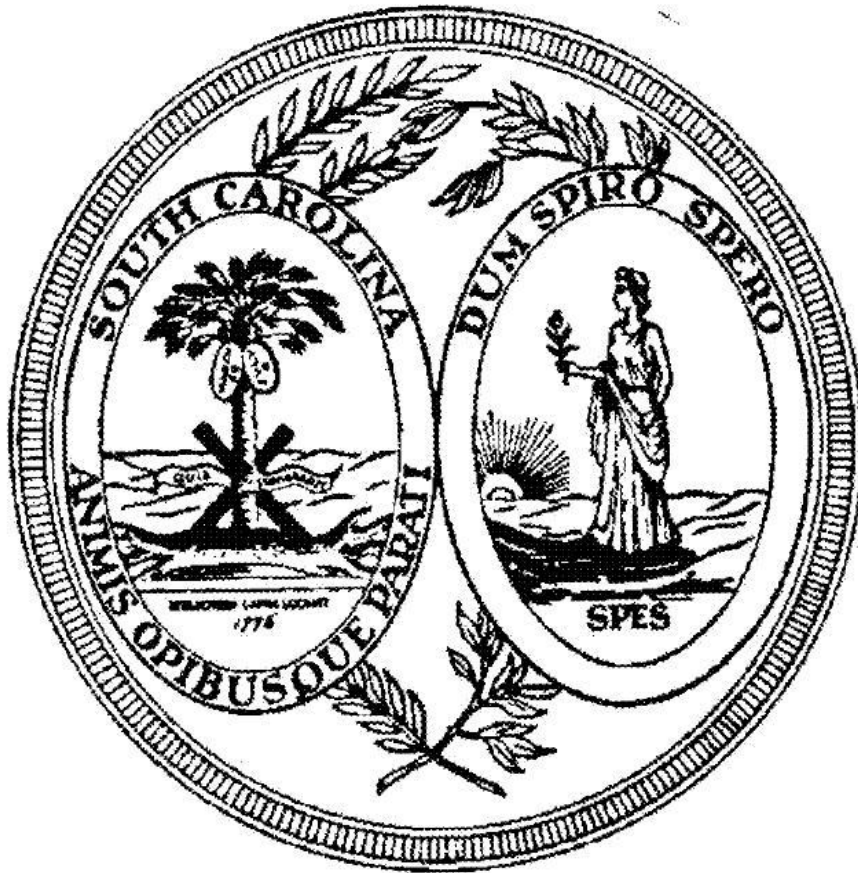
Members of TRAC are as follows:

Burnet Maybank III, JD, Chairman	Appointed by Sen. Leatherman
Bob Steelman, Vice Chairman	Appointed by Rep. Cooper
Ken Wingate, CPA, JD	Appointed by Gov. Sanford
Brian Moody, CPA	Appointed by Gov. Sanford
Don Weaver	Appointed by Sen. McConnell
Ben Kochenower, CPA	Appointed by Sen. Peeler
Charles S. Way, Jr.	Appointed by Sen. Land
Jimmy Addison	Appointed by Rep. Harrell
Jack Shuler	Appointed by Rep. Harrell
Kenneth Cosgrove	Appointed by Rep. Cooper
Ray N. Stevens, Director of DOR	Ex Officio

Staff:

Craig H. Parks, MPA, Sr. Research Analyst, Senate Finance Committee  
Rena Grant, Legislative Director, House Ways and Means Committee  
Katie Owen, Budget Analyst, House Ways and Means Committee  
Kevin M. Sayed, Law Intern for Burnet Maybank, III  
Campbell Irving, Law Intern for Burnet Maybank, III

# Executive Summary



## South Carolina Taxation Realignment Commission

## **Executive Summary**

Created by Act 81 of 2009, the South Carolina Taxation Realignment Commission (TRAC) was charged by the General Assembly to undertake a thorough assessment of the State's current tax structure to determine its "adequacy, fairness, and efficiency" (or lack thereof) to ensure the State remains an "optimum competitor in its efforts to attract business and individuals to locate, live, work, and invest" in South Carolina.

Between late September 2009 and October 2010, TRAC met seventeen separate times as a full commission and numerous times at the subcommittee level studying various tax related topics such as sales and use exemptions, services and intangibles, streamlined sales taxes, individual income taxes, corporate income taxes, fuel taxes, and tourism related taxes. Matters related to e-commerce, the "Fair Tax", tax conformity, property taxes, other funds, and tax administration, just to name a few, were addressed directly at the full commission level.

After careful analysis of issues and concerns related to the above, in addition to other matters, and consideration of important input from dozens of citizens, trade associations, and local, state, regional, and even national experts on a variety of tax related matters, TRAC produced a comprehensive and holistic study of the State's tax structure.

With few exceptions, TRAC found that South Carolina is a low tax state (compared to its neighbors, the region, and nationally) by almost any honest measure. However, that otherwise positive finding does not mean that South Carolina's current tax structure is not significantly hindered by structural deficiencies that will continue to challenge the system's ability to produce stable revenues over time.

And those structural deficiencies, if not addressed, will continue to negatively impact not only the State's ability to provide a tax structure that is adequate in its ability to produce stable revenues for even the most basic of government services, but as important, its ability to produce a system that is fair in its treatment of all taxpayers, not just a growingly select few.

TRAC's recommendations are revenue neutral, and like its name suggests, and in keeping with the clear mission given it by the General Assembly, TRAC "re-aligns" much of the State's

tax structure so that, with little exception, tax bases are “broadened” so that overall tax rates may be “lowered”, bringing greater fairness and stability to the State’s current tax system. And while “broad bases” and “low rates” are not a novel concept in public finance theory, what differentiates TRAC’s recommendations from previous studies is the level of detail and specificity to which TRAC went in not only explaining the “what” and the “why”, but the “how” as well.

The issues, concerns, and findings (e.g. the “what” and the “why”) reported by TRAC will, frankly, be subject to little debate. What will no doubt be subject of considerable debate, and a fact of no surprise to TRAC, will be the “how”; that is, TRAC’s specific recommendations regarding the requisite “fixes” the commission believes are necessary to rectify the very real (and growing) structural deficiencies of the current system.

Indeed, with little exception, all those who provided meaningful input to TRAC agreed that the sustainability of the current tax system was dependent upon a substantial broadening (realigning) of the tax base (and commensurate lowering of the rate), but often many of those same groups did not see wisdom in including their particular interest in that “broadening”. To paraphrase the classic phrase, TRAC heard ample testimony that can be boiled down to “don’t tax you, don’t tax me, tax the man behind that tree”. While not completely certain, TRAC believes it may have heard from the man behind the tree as well.

TRAC realizes the difference (and important interplay) between policy and politics. It has already been suggested by some that TRAC should have produced a report that would be completely “politically palatable”. But that begs the question, if such a report could be devised, why create a “TRAC” in the first place? TRAC’s focus was, as we believe was the intent of the General Assembly, a thorough vetting of sound tax policy, void, to the extent possible, of the customary political pressures that naturally arise when such weighty issues are debated (see the lobbyist protocols put in place by the General Assembly regarding TRAC’s work as evidence of their intent).

That is not to suggest that TRAC’s recommendations are not, or will not be, palatable. In fact, TRAC is hopeful that the General Assembly will receive this report with great foresight, recognizing that TRAC’s recommendations are not only comprehensive, but fair, designed to

ensure South Carolina either remains (or becomes) competitive both regionally and nationally, and are ones that produce a tax system that is more stable than the increasingly narrow and volatile system that exists today.

While we strongly encourage the reader to study this report in its entirety, highlights of but a few of TRAC's findings and recommendations include:

Sales and Use Taxes. One of the few areas where South Carolina does not rank as a low tax state is sales tax. At 6 percent, South Carolina is tied for 13th highest nationally. Due in large part to a tremendous narrowing of the tax base (only 38 percent of gross sales are subject to tax in South Carolina), TRAC recommends a broadening of the base by repealing or amending more than 60 of the State's 80 plus sales and use tax exemptions, exclusions, "max" taxes, and/or discounts. Initial (and unofficial) estimates by TRAC staff indicate these actions impact more than \$600 Million of the State's \$2.7 Billion of sales tax exemptions. In addition, TRAC recommends expanding taxation to additional services reflecting the definitive shift from a goods to a service based economy, and similar recommendations regarding e-commerce vs. brick and mortar, just to name a few. In turn, revenue generated by these reforms should be used for a revenue neutral and commensurate lowering of the overall sales tax rate. TRAC staff unofficially estimates the overall sales and use tax rate could drop to at least 5 percent, and potentially to as low as between 4 and 4.5 percent once its recommendations are fully costed out by the Board of Economic Advisors. It should be noted that a reduction of the sales tax rate to just 5 percent will improve South Carolina's competitive position nationally by a full 18 spots; transitioning the State from one of the highest sales tax states, to one of the lowest, and bringing much needed stability to an otherwise unstable sales and use tax base that continues to narrow. Note: TRAC studied the so-named "Fair Tax", which would replace at least six tax types with a singular sales tax, but did not recommend its adoption in South Carolina. No state has adopted a "Fair Tax" and only four states have, or are, considering its implementation. While no-doubt well intended, TRAC recommends careful consideration by the General Assembly before substituting the relative balance offered by the current system for a pure (and singular) consumption tax.

Individual Income Taxes. South Carolina is a low income tax state by almost every measure. But like the State's sales tax structure, South Carolina's individual income tax system is growing narrower by the year, meaning that fewer and fewer tax "filers" are actually tax "payers",

increasing the overall tax burden on a smaller number of filers each year. TRAC makes a series of revenue neutral recommendations to promote enhanced stability and fairness. Areas include creation of a minimum (and nominal) fee or tax based on size of adjusted gross income, examination of, and recommendations related to, the State's generous level of standard deductions and personal exemptions, adjustments to the capital gains tax exclusion, ensuring South Carolina remains competitive regionally and nationally while offering a greater incentive than currently allowed for investing in South Carolina based companies, a thorough review of the magnitude and impact of the State's "elderly preferences", and for State tax purposes, decoupling from the preferential federal tax treatment of personal injury awards, just to name a few. Any revenue generated by the broadening of the individual income tax structure would be offset by providing broad based tax savings through a combination of expanding the 6 percent tax bracket and lowering of the State's top marginal income tax rate of 7 percent to a commensurately lower rate.

Corporate Income Taxes. South Carolina is one of the lowest corporate income tax states in the region and nation, both in terms of its tax rate and actual tax burden, and is annually ranked by numerous publications as one of the country's most "friendly" states for both large and small companies to "do business". However, these otherwise positive findings do not mean the General Assembly should not undertake other necessary reforms related to the equity, or lack thereof, of the tax treatment between the financial and non-financial sectors, and significant issues surrounding so called "combined reporting" vs. the "separate reporting" that South Carolina follows now. Combined reporting is a way to avoid discrimination against certain businesses, to tax income that would otherwise be shifted out of state, and to deal with the growing complexities of the current corporate climate. If the General Assembly does not adopt combined reporting, TRAC also makes recommendations regarding improvements to the current separate reporting method. TRAC also expresses concern over the growing magnitude of corporate tax credits, particularly the massive amount of credits that are "carried forward" each year, and as such, makes corresponding recommendations. Note: TRAC did not recommend an adjustment to the State's current corporate income tax rate.

Property Taxes. The property tax system in South Carolina is unique compared to the property tax systems in many other states and is, in many cases, a product of extremes. The State has the highest taxes in the nation on manufacturers (not in a fee-in-lieu), a low tax burden on urban

primary residences, very high tax levies on boats and planes, one of the lowest in the country for primary residents over the age of 65 that live in an urban county, and some of the highest national tax rates on commercial and industrial property, and the lowest tax rates on residential property. These extremes are a product of several factors: (1) numerous assessment ratios, (2) a large number of very generous credits and exemptions granted only for primary residences, particularly those owned by persons 65 and over (and more than 60 exemptions overall); and (3) preferential status given to agricultural use properties, just to name a few. Where able, TRAC makes recommendations regarding many of its findings including: manufacturing property, ag-use, legal residence, aircraft, dealer tags, financial institutions and primary vs. secondary residences, just to name a few.

Fuel Taxes. South Carolina has the lowest “gas tax” in the entire Southeast, and the third lowest in the entire country. It is therefore no surprise that South Carolina’s level of road funding (support) per mile is also one of the country’s lowest. Well maintained roads are important not only for the safe mobility of the State’s citizens and visitors, but for commerce and economic development as well. The current 16 cent per gallon flat excise tax is found by TRAC to hinder the stability of revenues requisite to meet these important goals, and that the current “structure” of the tax (flat excise) may be ill-equipped for the long-term to produce stable revenues that keep pace with technological advances in transportation, where cars are more fuel efficient, and in growing cases, rely less and less on fuels that are actually subject to taxation. As such, TRAC recommends two separate options for the General Assembly to consider that would begin to address these issues; a 5 cent per gallon increase, or a revenue neutral structural change, moving our current flat excise tax to a hybrid tax based on one part flat excise, and one part price.

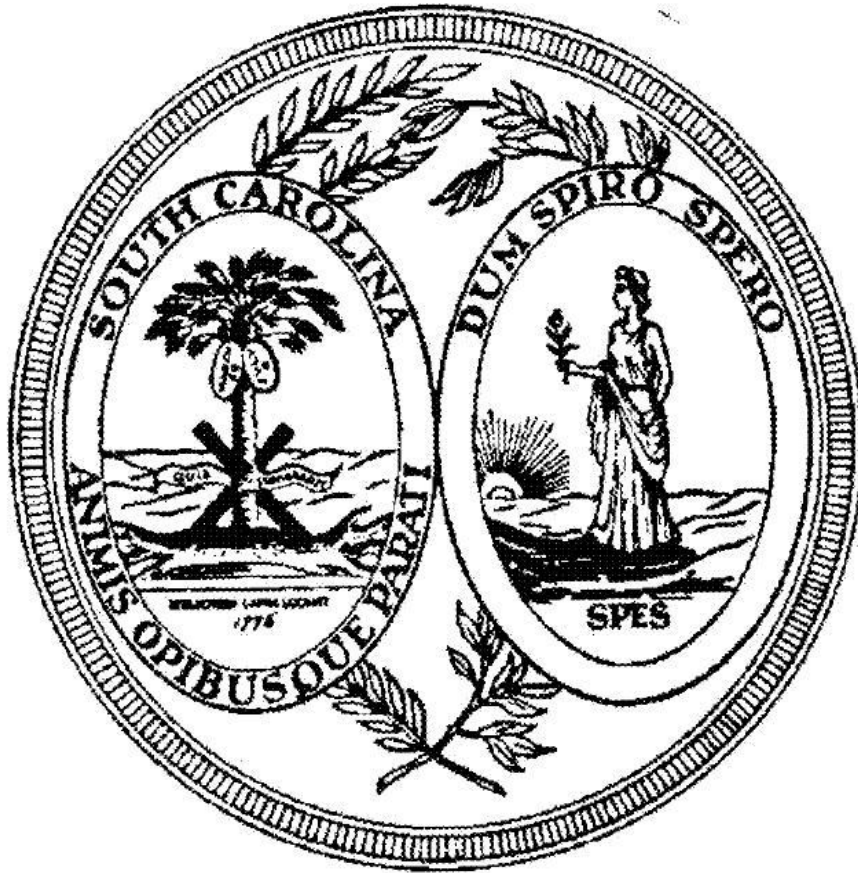
Tourism Taxes. “Tourism taxes” include the state accommodations tax, the local accommodations tax, the local hospitality tax, the local option tourism development fee, and the admissions Tax. TRAC thoroughly reviewed each of the State’s various tourism taxes and made specific recommendations related to extension of the “Tourism Expenditure Review Committee’s (TERC) oversight authority to local tourism taxes, requirement of a “uniform” form relative to both State and local tourism taxes, issues surrounding the preferential tax treatment of time shares, admissions tax exemptions, and film incentives.

Other Funds. TRAC's enabling legislation required it (TRAC) to review "other funds". As General Fund revenue has continued to decline, due in part to issues surrounding the State's tax structure as highlighted throughout TRAC's report, the use of "other funds" has continued to grow. A common misperception is that "other funds" are malleable; that is, that a "dollar is a dollar". However, with little exception, "other funds" are generated for a narrow and/or specific purpose and cannot be "moved" in and between different functional areas of government. That said, the growth in "other funds" demands continual review. TRAC applauds the creation by the General Assembly of the "Other Funds Oversight Committee" (OFOC) and provides specific recommendations to the General Assembly as to parameters it (TRAC) believes OFOC should work within and a process under which it (OFOC) should work.

Tax Administration. Regardless of the types of taxes utilized in any state's revenue system, taxpayers deserve fair, efficient and customer-focused tax administration. While South Carolina scores well in many respects regarding tax administration, TRAC nevertheless makes a series of recommendations to the General Assembly that it believes will improve the laws governing tax administration in South Carolina. These recommendations are detailed in the "Tax Administration" section of this report.



# Enabling Legislation



## South Carolina Taxation Realignment Commission

**South Carolina General Assembly**  
118th Session, 2009-2010

**A81, R121, S12**

**STATUS INFORMATION**

General Bill

Sponsors: Senators Leatherman, Alexander, Ford, Rankin, O'Dell, Cleary, Leventis, Elliott, Lourie, Malloy and Setzler

Document Path: l:\s-res\hkl\001real.dag.docx

Companion/Similar bill(s): 3415

Introduced in the Senate on January 13, 2009

Introduced in the House on February 26, 2009

Last Amended on June 16, 2009

Passed by the General Assembly on June 16, 2009

Governor's Action: June 30, 2009, Signed

Summary: S.C. Taxation Realignment Commission

**HISTORY OF LEGISLATIVE ACTIONS**

Date	Body	Action Description with journal page number
12/10/2008	Senate	Prefiled
12/10/2008	Senate	Referred to Committee on <b>Finance</b>
1/13/2009	Senate	Introduced and read first time <a href="#">SJ-77</a>
1/13/2009	Senate	Referred to Committee on <b>Finance</b> <a href="#">SJ-77</a>
1/14/2009	Senate	Referred to Subcommittee: O'Dell (ch), Peeler, Reese, Fair, Elliott
2/4/2009	Senate	Committee report: Favorable with amendment <b>Finance</b> <a href="#">SJ-2</a>
2/5/2009		Scrivener's error corrected
2/18/2009	Senate	Special order, set for February 18, 2009 <a href="#">SJ-15</a>
2/19/2009	Senate	Debate interrupted <a href="#">SJ-12</a>
2/25/2009	Senate	Committee Amendment Amended and Adopted <a href="#">SJ-48</a>
2/25/2009	Senate	Amended <a href="#">SJ-48</a>
2/25/2009	Senate	Read second time <a href="#">SJ-48</a>
2/26/2009	Senate	Read third time and sent to House <a href="#">SJ-14</a>
2/26/2009		Scrivener's error corrected
2/26/2009	House	Introduced and read first time <a href="#">HJ-114</a>
2/26/2009	House	Referred to Committee on <b>Ways and Means</b> <a href="#">HJ-114</a>
3/31/2009	House	Committee report: Favorable with amendment <b>Ways and Means</b> <a href="#">HJ-17</a>
4/1/2009	House	Requests for debate-Rep(s). Cooper <a href="#">HJ-68</a>
4/2/2009	House	Debate adjourned until Tuesday, April 21, 2009 <a href="#">HJ-41</a>
4/2/2009		Scrivener's error corrected
4/21/2009	House	Debate adjourned until Wednesday, April 22, 2009 <a href="#">HJ-41</a>
4/22/2009	House	Debate adjourned <a href="#">HJ-30</a>
4/22/2009	House	Requests for debate-Rep(s). Ott, White, Rice, Loftis, Cobb-Hunter, Neilson, JR Smith, TR Young, King, Jefferson, GR Smith, JH Neal, Gunn, and Kennedy <a href="#">HJ-67</a>
4/22/2009	House	Debate adjourned until Thursday, April 24, 2009 <a href="#">HJ-94</a>
4/22/2009	House	Roll call Yeas-75 Nays-35 <a href="#">HJ-94</a>
4/29/2009	House	Amended <a href="#">HJ-234</a>

4/29/2009	House	Debate adjourned until Thursday, April 30, 2009 <a href="#">HJ</a> -240
4/30/2009	House	Amended <a href="#">HJ</a> -74
4/30/2009	House	Read second time <a href="#">HJ</a> -87
4/30/2009	House	Roll call Yeas-67 Nays-30 <a href="#">HJ</a> -87
5/1/2009		Scrivener's error corrected
5/12/2009	House	Read third time and returned to Senate with amendments <a href="#">HJ</a> -46
5/13/2009	Senate	Non-concurrence in House amendment <a href="#">SJ</a> -68
5/14/2009	House	House insists upon amendment and conference committee appointed Reps. White, Battle, and Merrill <a href="#">HJ</a> -4
5/14/2009	Senate	Conference committee appointed Setzler, Alexander, and Shoopman <a href="#">SJ</a> -84
6/16/2009	House	Conference report received and adopted <a href="#">HJ</a> -152
6/16/2009	House	Roll call Yeas-86 Nays-20 <a href="#">HJ</a> -152
6/16/2009	Senate	Conference report adopted <a href="#">SJ</a> -90
6/16/2009	Senate	Ordered enrolled for ratification <a href="#">SJ</a> -98
6/24/2009		Ratified R 121
6/30/2009		Signed By Governor
7/7/2009		Effective date 06/30/09
7/7/2009		Act No. 81

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## **VERSIONS OF THIS BILL**

[12/10/2008](#)  
[2/4/2009](#)  
[2/5/2009](#)  
[2/25/2009](#)  
[2/26/2009](#)  
[3/31/2009](#)  
[4/2/2009](#)  
[4/29/2009](#)  
[4/30/2009](#)  
[5/1/2009](#)  
[6/16/2009](#)

(A81, R121, S12)

**AN ACT TO ESTABLISH THE SOUTH CAROLINA TAXATION REALIGNMENT COMMISSION, TO PROVIDE FOR THE COMMISSION'S MEMBERSHIP, POWERS, DUTIES, AND RESPONSIBILITIES, TO PROVIDE THAT THE COMMISSION SHALL CONDUCT A COMPREHENSIVE STUDY OF THE STATE'S TAX SYSTEM AND SUBMIT A REPORT OF ITS RECOMMENDED CHANGES TO FURTHER THE GOAL OF MAINTAINING AND ENHANCING THE STATE AS AN OPTIMUM COMPETITOR IN THE EFFORT TO ATTRACT BUSINESSES AND INDIVIDUALS TO LOCATE, LIVE, WORK, AND INVEST IN THE STATE, TO PROVIDE A SCHEDULE OF REPORTING AND REQUIRE THE COMMISSION TO CONCLUDE ITS BUSINESS BY JANUARY 1, 2011, UNLESS EXTENDED BY LAW, TO PROVIDE FOR PROCEDURES GOVERNING THE CONSIDERATION OF LEGISLATION RESULTING FROM THE COMMISSION'S RECOMMENDATIONS, TO LIMIT RECEIPT BY THE COMMISSION OF INFORMATION FROM LOBBYISTS TO FORMAL PRESENTATIONS TO THE COMMISSION IN A SCHEDULED MEETING AND PROVIDE A PENALTY FOR VIOLATIONS; AND TO AMEND ACT 388 OF 2006, RELATING TO TAXATION, SO AS TO DELETE PROVISIONS ESTABLISHING THE JOINT SALES TAX EXEMPTIONS REVIEW COMMITTEE.**

Be it enacted by the General Assembly of the State of South Carolina:

#### **South Carolina Taxation Realignment Commission created**

SECTION 1.(A) There is created the South Carolina Taxation Realignment Commission to be comprised of eleven members appointed as follows:

- (1) one member each appointed by the President Pro Tempore of the Senate, the Senate Finance Committee Chairman, the Senate Majority Leader, and the Senate Minority Leader;
- (2)(a) two members appointed by the Speaker of the House;
- (b) two members appointed by Chairman of the House Ways and Means Committee;
- (3) two members appointed by the Governor; and
- (4) the Director of the Department of Revenue, to serve ex officio.

Members of the General Assembly may not be appointed to the commission. Members of the commission must have substantial academic or professional experience or specialization in one or more areas of public finance, government budgeting and administration, tax administration, economics, accounting, business, or tax law. Members of the commission must have been a resident of South Carolina since January 1, 1997.

(B) The members of the commission:

(1) must meet as soon as practicable after appointment and organize itself by electing one of its members as chairman and other officers as the commission may consider necessary. Thereafter, the commission must meet as necessary to fulfill the duties required by this act at the call of the chairman or by a majority of the members. A quorum consists of six members. The commission may engage or employ staff or consultants as may be necessary and prudent to assist the commission in the performance of its duties and responsibilities. Any staff or consultants must possess an academic background or substantial career experience in one or more fields including, but not limited to, economics, government budgeting and administration, urban and regional economic development, economic forecasting, state and local public finance, or business;

(2) shall serve without compensation, and are ineligible for the usual mileage, subsistence, and per diem allowed by law for members of state boards, committees, and commissions. Staffs of the Senate Finance Committee and the House Ways and Means Committee shall be available to assist the commission in its work. Any other expenses incurred by the commission shall be paid equally from each

respective house's approved account subject to the approval of the Senate Operations and Management Committee and the Speaker of the House;

(3) unless authorized by a further or subsequent enactment, conclude the commission's business by January 1, 2011, at which time the commission is dissolved. The General Assembly may extend the dates by which the commission shall submit reports required by this act.

(C) The duties of the commission shall be to:

(1) develop criteria for assessing the effectiveness of the current tax system structure, as well as the likely systemic impact of any proposed changes affecting tax revenues and report the criteria to the General Assembly within three months of the effective date of this act, provided that all such criteria must be designed with an emphasis on the systemic balance of the state's revenue structure from the standpoint of adequacy, equity, and efficiency and with the goal of maintaining and enhancing the State as an optimum competitor in efforts to attract businesses and individuals to locate, live, work, and invest in the State; and

(2) no later than March 15, 2010, prepare and deliver a report and recommendation to the Chairman of the Senate Finance Committee and the Chairman of the House Ways and Means Committee, including the text of an amendment that effectuates the recommendations. The commission's report must be a detailed, comprehensive, and careful evaluation of the state's tax system structure. The commission's report shall consider:

(a) sales and use tax exemptions or limitations to be retained, modified, or repealed;

(b) the assessment of state and local taxes levied and other provisions affecting state and local revenue to fund the operation and responsibilities of state and local government, respectively; and

(c) any fee, fine, license, forfeiture, or Other Funds.

After reviewing the adequacy, equity, and efficiency of the state's revenue structure, the commission's report may recommend that no changes are necessary if it determines that such findings are warranted. Following the report and recommendation required by subsection (C)(2), the commission shall continue studying the subjects identified in subsection (C)(2). The commission may make further legislative recommendations at any time. Also, the commission must submit a report to the Chairman of the Senate Finance Committee and the Chairman of the House Ways and Means Committee on August first and February first of each year detailing the commission's progress and points of focus.

For purposes of the scope of the commission's study, local taxes are defined as local levies related to ad valorem taxation, including, but not limited to, assessment ratios, classification and valuation of property, assessable transfers of interest, valuation limitation, local millages, and fee in lieu of taxes agreements; however, local taxes do not include the exemption of owner-occupied residential property as provided in Section 12-37-220(B)(47).

The commission's report may not recommend any action that would nullify any existing agreement entered into by a local government.

The commission must forward its recommendation to the Board of Economic Advisors that must prepare a revenue impact detailing the sources of revenue at the state and local level the commission recommends should be increased or decreased, the projected amount of increase or decrease to each source of revenue, and the net gain or loss of total revenue at both the state and local levels that would result from the recommendation. The report must be attached to any legislative recommendation made by the commission prior to it being submitted to any member of the General Assembly.

(D) The text of any amending language pursuant to subsection (C)(2) must be delivered to the Chairman of the Senate Finance Committee, the Chairman of the House Ways and Means Committee, and upon request, to any member of the General Assembly.

(E) Further legislative recommendations made by the commission must be delivered to the Chairman of the Senate Finance Committee, the Chairman of the House Ways and Means Committee, and upon request, to any member of the General Assembly.

(F) Commission members shall not receive information regarding the business of the commission from a lobbyist except through formal presentation to the commission at a meeting called in compliance with the Freedom of Information Act. Any lobbyist violating the provisions of this subsection is deemed

guilty of a misdemeanor and, upon conviction, must be punished as provided in Section 2-17-130 of the 1976 Code.

(G) In addition to those duties of the commission provided pursuant to subsection (C) of this section, the commission shall study and make recommendations to the General Assembly of the advantages and drawbacks of a revenue neutral replacement of the state individual and corporate income tax, state imposed sales and use tax, estate tax, bank tax, savings and loan association tax, and taxes on beer, wine, and alcoholic beverages with a broadly based consumption tax modeled on the proposed federal Fair Tax as that form of tax would have to be adapted to apply on the state level. In its study, the commission shall specifically consider how such a tax swap would affect jobs creation, savings and investment, and tax compliance costs for South Carolina taxpayers. The result of the study and recommendations required pursuant to this subsection must be made on the schedule provided in subsection (C)(2) of this section.

### **Joint Sales Tax Exemptions Review Committee deleted**

SECTION 2. Act 388 of 2006 is amended by deleting SECTION 1 of Part V, which reads:

“SECTION 1. (A) The sales tax exemptions in Section 12-36-2120 of the 1976 Code shall be reviewed by the General Assembly not later than its 2010 Session and thereafter as the General Assembly deems appropriate but not later than its session every ten years after the first review.

(B)(1) There is established the Joint Sales Tax Exemptions Review Committee composed of seven members; three of whom must be members of the Senate appointed by the Chairman of the Senate Finance Committee, one of whom must be a member of the minority party; three of whom must be members of the House of Representatives appointed by the Chairman of the House Ways and Means Committee, one of whom must be a member of the minority party; and one of whom must be the Governor or the Governor’s appointee who shall serve at the Governor’s pleasure. The committee shall elect a chairman and vice chairman from among its members. All legislative members shall serve ex officio. The committee shall assist the General Assembly in performing its duties under the provisions of subsection (A) in addition to its duties required by this subsection.

(2) In carrying out its responsibilities under this act, the committee shall:

- (a) make a detailed and careful study of the state’s sales tax exemptions, comparing South Carolina laws to other states;
- (b) publish a comparison of the state’s sales tax exemptions to other states’ laws;
- (c) recommend changes, and recommend introduction of legislation when appropriate;
- (d) submit reports and recommendations annually to the Governor and the General Assembly regarding sales tax exemptions.

(3) In carrying out its responsibilities under this act, the committee may:

- (a) hold public hearings;
- (b) receive testimony of any employee of the State or any other witness who may assist the committee in its duties;
- (c) call for assistance in the performance of its duties from any employee or agency of the State.

(4) The committee may adopt by majority vote rules not inconsistent with this act that it considers proper with respect to matters relating to the discharge of its duties under this section. Professional and clerical services for the committee must be made available from the staffs of the General Assembly, the State Budget and Control Board, and the Department of Revenue. The members of the committee may not receive mileage, per diem, subsistence, or any form of compensation for their service on the committee.”

**Time effective**

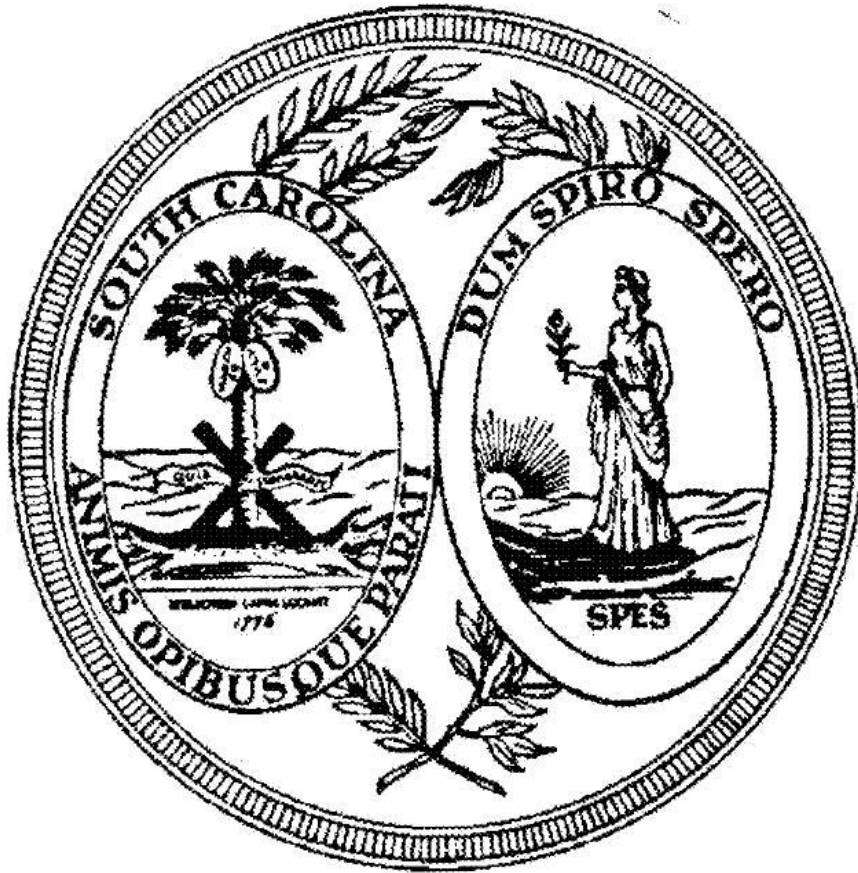
SECTION 3. This act takes effect upon approval by the Governor.

Ratified the 24<sup>th</sup> day of June, 2009.

Approved the 30<sup>th</sup> day of June, 2009.

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# **Enabling Legislation Summary / History**



## **South Carolina Taxation Realignment Commission**



## SENATE FINANCE COMMITTEE BILL SUMMARY

Bill No. **S. 12**

Subject: **S.C. Taxation Realignment Commission**

Primary Sponsor: Sen. Leatherman

Date Introduced: January, 13, 2009

SFC Analyst: Parks/Shealy

Path: L:\S-Financ\Legis\Bills\06-07 SFC Bills\Bill Summaries\cparksS12

### **BILL TITLE**

S. 12 -- Senators Leatherman, Alexander, O'Dell, Cleary, Leventis, Elliott and Lourie: A BILL TO ESTABLISH THE SOUTH CAROLINA TAXATION REALIGNMENT COMMISSION, TO PROVIDE FOR THE COMMISSION'S MEMBERSHIP, POWERS, DUTIES, AND RESPONSIBILITIES, TO PROVIDE THAT THE COMMISSION MUST CONDUCT A COMPREHENSIVE STUDY OF THE STATE'S TAX SYSTEM AND SUBMIT A REPORT OF ITS RECOMMENDED CHANGES TO FURTHER THE GOAL OF MAINTAINING AND ENHANCING THE STATE AS AN OPTIMUM COMPETITOR IN THE EFFORT TO ATTRACT BUSINESSES AND INDIVIDUALS TO LOCATE, LIVE, WORK, AND INVEST IN THE STATE, AND TO PROVIDE FOR PROCEDURES GOVERNING THE CONSIDERATION OF LEGISLATION RESULTING FROM THE COMMISSION'S RECOMMENDATIONS.

**CODE SECTION**      N/A

### **SUMMARY OF BILL AS FILED**

This Joint Resolution creates a temporary commission known as the "Taxation Realignment Commission" (or TRAC) whose purpose is to: 1) assess the effectiveness of the state's current state level tax structure and 2) in doing so, make recommendations to the General Assembly regarding necessary changes, if any, to that structure. In concept, TRAC is modeled after the federal "Base Closure and Realignment Commission" (see brief description of the Base Closure and Realignment Commission (or BRAC) attached)).

Such changes must be designed to ensure that the state's tax structure is "balanced" so that the system is a) adequate, b) equitable, and c) efficient.

The goal of TRAC, and ultimately of the state's tax structure, is creation of a system that enhances the state's reputation as a "...optimum competitor in efforts to attract business and individuals to locate, live, work and invest..." in South Carolina.

TRAC's focus will be on the entire statewide tax code to include individual and business tax rates and structure(s), exemptions, credits and other incentives as well as the state's sales tax rate and bases including comprehensive review and recommendations regarding the state's more than 75 specific sales tax exemptions, the value of which the BEA estimates to total \$2.75 Billion this fiscal year. TRAC will not make recommendations regarding local tax levies or property tax relief provided by the General Assembly.

TRAC must accomplish the following tasks (within a specified timeframe) prior to its termination on January 1, 2011 (unless extended by the General Assembly):

- 1) Within 6 months of passage of this bill (roughly year-end 2009), provide the General Assembly with the criteria it (TRAC) will use to assess the effectiveness of the state's current tax structure,
- 2) By February 25, 2010, provide the Chairmen of the House Ways and Means and Senate Finance Committees a report as to which sales tax exemptions should be kept, modified or repealed, and
- 3) By January 1, 2011, a comprehensive report with recommendations provided to the General Assembly regarding the remainder of the state's tax structure (i.e., everything else other than the sales tax exemptions).

In response, the General Assembly, via the process outlined below, must:

- 1) Enact TRAC's sales tax exemption recommendations in full with their effective date being January 1, 2011 or
- 2) Reject in mass the recommendations; however,
  - 2a) Purely technical amendments can be made to TRAC's recommendations by a simple majority vote while
  - substantive amendments can be made with a two-thirds vote.

As for the additional (i.e., non-sales tax exemption related) recommendations made by TRAC, such recommendations must also be introduced in both houses by the Chairmen of the House Ways and Means and Senate Finance Committees, but their enactment is not required under this bill.

Additional details of TRAC, its membership and qualifications, staffing and reimbursement issues are outlined below:

**MEMBERSHIP:** Eleven members as follows

President Pro Tempore of the Senate to appoint one member  
Speaker of the House to appoint one member  
Chairman of the Senate Finance Committee to appoint one member  
Chairman of the House Ways and Means Committee to appoint one member  
Majority Leader of the Senate to appoint one member  
Majority Leader of the House to appoint one member  
Minority Leader of the Senate to appoint one member  
Minority Leader of the House to appoint one member  
Governor to appoint two members  
Director of the Department of Revenue to serve ex officio

No sitting members of the General Assembly may serve.

**QUALIFICATIONS:** Members must have substantial academic or professional experience or specialization in public finance, government budgeting and administration, tax administration, economics, accounting or tax law.

**CHAIRMANSHIP:** The membership chooses a chairman.

**STAFFING:** The Commission may employ staff or consultants with relevant background and experience. In addition, staffs of the Senate Finance Committee and House Ways and Means Committee are available to assist the Commission.

REIMBURSEMENT: There is no compensation for service on the Commission. Members shall receive per diem and mileage for any travel. Financial responsibility attributed to appointer.

#### **SUMMARY OF BILL AS AMENDED BY FULL COMMITTEE - 01/27/09**

**HOW MANY TRAC COMMISSIONERS?:** 11 - Appointed by respective Speaker/Pres. Pro-Tem, Majority and Minority leaders, Finance chairs and Governor (2 appointments) and DOR ex officio. The membership chooses a Chairman.

**WHO'S ELIGIBLE TO BE A COMMISSIONER?:** First, no *current member* of the General Assembly is eligible. Members must have substantial academic or professional experience or specialization in one or more areas of public finance, government budgeting and administration, tax administration, economics, accounting, tax law or business. Full committee felt it important to require that members file a statement of economic interest with the State Ethics Commission.

**DO MEMBERS GET PAID?:** No. Members shall receive per diem and mileage for any travel. Financial responsibility is attributed to appointer's organization.

**WILL THERE BE A DIRECTOR AND STAFF?:** Yes, if the Commission sees fit. The Executive Director must have a Master's or Bachelor's degree and professional experience. Subject to funding by the General Assembly, the director shall be paid equally from approved accounts of each house of the General Assembly, subject to the approval of the respective Operations and Management Committees. Any staff or consultants must possess an academic background or substantial career experience in one or more fields including economics, government budgeting and administration, urban and regional economic development, economic forecasting, state and local public finance or business.

**WHO CAN'T BE HIRED AS DIRECTOR?:** No member of the General Assembly (existing or previous), nor anyone employed by the General Assembly from January 1, 1997, nor anyone defined as a lobbyist since January 1, 1997.

**HOW LONG WILL THE COMMISSION BE AROUND?:** The Commission is in existence until January 1, 2015. The duration of the Commission may be extended by a subsequent enactment (sunset provision).

**WHAT IS THE COMMISSION'S GOAL?:** The goal of TRAC, and ultimately of the state's tax structure, is creation of a system that enhances the state's reputation as a "...optimum competitor in efforts to attract business and individuals to locate, live, work and invest..." in South Carolina.

**WHAT ARE THEIR DUTIES?:** Develop criteria within the first six months of the effective date of the legislation for assessing the effectiveness of the current tax system and structure.

By February 25, 2011, deliver recommendations to the Chairmen of the Senate Finance Committee and House Ways and Means Committee. In preparing their recommendations the Commission shall consider:

- Sales tax exemptions to be retained, modified or repealed.
- An assessment of STATE and LOCAL taxes levied and other provisions affecting state and local revenue to fund the operation and responsibilities of state and local government.
- At the discretion of the Commission, any state fee, fine or forfeiture.

After the initial TRAC report, the commission continues to work through 2015, providing periodic reports, along with recommendations it feels necessary, to the two money committees.

**SO WHAT IS MEANT BY LOCAL TAXES?:** For purposes of the scope of the commission's study, local taxes are defined as local levies related to ad valorem taxation, including, but not limited to, assessment ratios, classification and valuation of property, assessable transfers of interest, valuation limitation, local millages, and fee in lieu of taxes agreements. NOTE: The commission's report may **not** recommend any action that would nullify any existing agreement entered into by a local government.

**WHAT IS THE PROCESS:** The Code Commissioner must prepare TRAC's findings to be codified and the Chairman of Ways and Means and Senate Finance must file the bill. Full Committee reduced the threshold for substantive amendments from 2/3 to 3/5's and requires that future recommendations made by TRAC after its initial report (remember – TRAC stays around 5 years and is then dissolved) must be introduced by the Chairmen of the money committees.

**WHAT ABOUT THE JOINT SALES TAX EXEMPTIONS REVIEW COMMITTEE?:** Act 388 of 2006 (The "Swap" bill) established a Joint Sales Tax Exemptions Review Committee to review and make recommendations regarding sales tax exemptions no later than the 2010 legislative session. As the TRAC commission would now be charged with this task, it makes little sense to have two potentially competing study committees meeting at the same time. The Full Committee therefore voted to repeal the Joint Committee.

**EFFECTIVE DATE:** The legislation takes effect upon approval by the Governor.

#### **CHANGES TO COMMITTEE AMENDMENT BY FULL SENATE – 2/25/09**

##### P2A – Leatherman, L Martin, Peeler

TRAC can say "no changes" are needed if finds tax code is ok.

\*NOTE: Remainder of P2A rendered moot by Shoopman by P8 below.

##### P9 – Setzler, Knotts and Leatherman

Clarifies that changes to homeowner tax relief under Act 388 can't recommended.

##### P3 – Setzler, Leatherman, Sheheen, Lourie

Moves report date up one year to Feb 2010; plus requires their criteria to be delivered 3 months earlier, in 3 months rather than 6.

##### P4 – Leatherman

Ensures TRAC commissioners have to be SC residents.

##### P7A – Bryant

Requires the BEA to do a Revenue Impact Statement on whatever TRAC recommends.

##### P8 – Shoopman

Deletes Full Committee's recommended 3/5's voting requirement as well as P2A's (previously adopted) simple majority of membership voting requirements when taking action on any TRAC recommendations. Still requires recommendations of TRAC to be delivered to money committees and any member of the GA that requests it.

P10 – Davis and Sheheen

Mandates TRAC to study all OTHER FUNDS which would include tuition, etc.

A5 – Mulvaney

TRAC commissioners can't receive info from Lobbyists unless in a public meeting.

### **CHANGES TO SENATE VERSION BY HOUSE WAYS & MEANS – 3/31/09**

The House Ways & Means Committee proposed a “strike and insert” amendment with only the most significant changes from the Senate version highlighted below:

Commission Membership: Upped from 11 to 17, deleted appointments by the minority party, added six sitting members of the General Assembly (to serve ex officio). Deleted “business” as an eligible experience criteria for service on the commission and made appointments to serve “at the will” of their appointers. Like Senate version, commissioners not eligible for pay, but, unlike the Senate version, also not eligible for mileage/per diems either.

Removed provisions related to hiring of an Executive Director, which was permitted under the Senate version. Language allowing hiring of staff or consultants in a general sense was retained in the bill, but TRAC commissioners have to first get approval of Senate Pres. Pro-tem and House Speaker.

Report timeline(s): Amends language regarding requirement of TRAC to develop criteria for assessing the effectiveness of the current tax system and structure from within the first three months to the first “six months” of the effective date of the legislation (note: this was the original Senate position prior to amendments). Also, divides the required reporting on “all taxes, state and local”, from March 2010 as was required under the Senate bill to 1) Sales tax exemptions by December 2009 and 2) all other state taxes one year later (December 2010).

Note: The version recommended by Ways & Means specifically excluded from TRAC's purview the property tax system of the state.

Unlike the final Senate version, the Ways & Means version did include a requirement that TRAC's recommendations must be introduced as stand-alone legislation in each body. The final Senate version had no such requirement. The Ways & Means version also contained language relating to the amendment process regarding TRAC recommendations introduced.

Lastly, the Ways & Means version did not repeal the Joint Committee charged in Act 388 with reviewing the state's sales tax exemptions by 2010; i.e., the practical effect being two separate bodies studying which exemptions to retain or repeal.

### **VERSION ADOPTED BY THE FULL HOUSE OF REPRESENTATIVES - 4/30/09**

The Full House adopted many of the changes recommended by the Ways & Means committee (noted above) with the following (further) changes:

Adopted the Senate's position regarding the timeline of the initial reports (3 months instead of 6 for the “criteria”; entire report in March 2010 rather than separate reports in December 2009 and 2010).

Adopted Senate version which removed the requirement that TRAC recommendations must be introduced by both bodies.

Adopted Senate version allowing study of local taxes, including property (with exception that TRAC cannot recommending repeal of the homeowner relief from Act 388 - this was in the Senate version as well).

Adopted Senate version regarding lobbyist prohibitions relating to contact with TRAC members, and adding language making such contact by lobbyists a misdemeanor.

Added language requiring TRAC to study the “Fair Tax”.

Adopted the Senate version regarding the repeal of the Joint Committee charged in Act 388 with reviewing the state’s sales tax exemptions by 2010; i.e., meaning only TRAC would be charged with studying the sales tax exemptions.

## **FINAL VERSION ADOPTED BY CONFERENCE COMMITTEE - 6/16/09**

### **Creation of Commission – Appointment Details**

There was a compromise between the Senate and House version about who appoints in each body. There will be 11 total members as in the Senate version (the House called for 17). The appointments will be as in the Senate version for the Senate to include appointments by the Minority. The House will not be required to have an appointer from the Minority.

There will be no sitting legislators on the Commission, ex officio or otherwise. This was the Senate position.

Members must have substantial background in the areas enumerated in the Senate version including business experience, and have to have been SC residents since 1997.

Members will not serve “at the will” of their respective appointers. This was the Senate position.

Appointees will NOT have to file a “Statement of Economic Interest”. House version.

Appointees will NOT receive mileage and per diem. House version.

### **Staffing and Funding Provisions**

Compromise. Language in BOTH versions remains stating that the commission may hire staff or consultants. As does the language that requires these staff or consultants to have experience in a number of areas similar to what commissioners must have.

Staffs of Senate Finance and Ways & Means remain available to assist as in both versions.

Funding subject to approval of Senate O&M and House speaker (compromise) would be paid equally from both bodies.

Qualifications related to Executive Director removed (House version) as no longer needed. Provision remains that Commission “may” hire staff or consultants, and those provisions contain sufficient qualifications.

### **Commission Duration and Other Matters**

House version, i.e., Commission will dissolve in 2011, not 2015 as called for in Senate Bill. However, as was in both bills, the Commission could be extended by the General Assembly.

Senate version remains, i.e., further reports can be made up thru 2011. The House did not provide that.

“Fair Tax” remains. House version. I.e., the Commission will look at, among other things, specifically the Fair Tax concept and report back pros and cons, etc.

Lobbyist misdemeanor remains. House version. The Lobbyist provision requires that lobbyists may only provide information in a public meeting.

### **FISCAL/REVENUE IMPACT**

General Funds: \* See below.

Federal/Other Funds: \$0

\*According to the State Budget Office, based on per diem and travel allowances, the total cost for committee member expenses would be \$2,090 per one-day meeting to be paid by the appointing entity, with all other expenses to be paid equally by the Senate and House of Representatives.

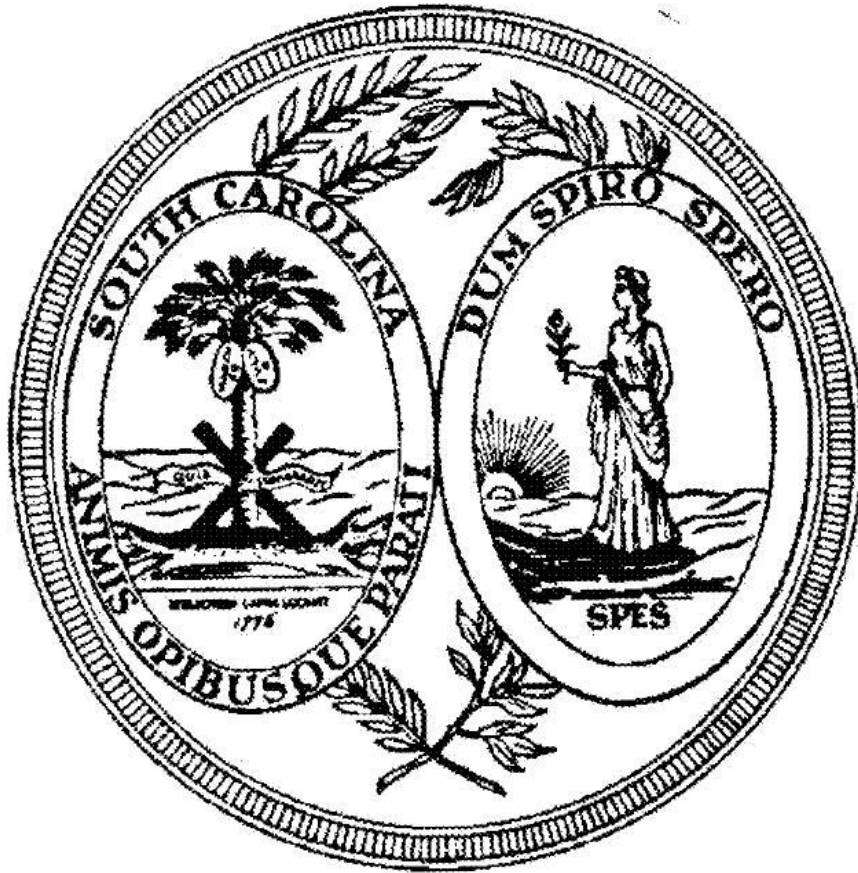
### **SFC SUBCOMMITTEE RECOMMENDATION**

1/22/09 – Favorable to Full

### **ADDITIONAL NOTES**

1/13/09 – SENATE, Introduced, referred to Finance Committee  
1/22/09 – SENATE, Subcommittee reported favorable to Full Committee  
1/27/09 – SENATE, Full committee favorable with amendments  
2/25/09 – SENATE, Full committee amendment adopted with amendments, read 2<sup>nd</sup> time  
2/26/09 – SENATE, Read 3<sup>rd</sup> time, sent to House  
2/26/09 – HOUSE, Introduced, read 1<sup>st</sup> time, referred to Ways & Means  
3/31/09 - HOUSE, Ways and Means, favorable with amendment  
4/29/09 - HOUSE, Amended  
4/30/09 - HOUSE, Amended, read 2<sup>nd</sup> time  
5/12/09 - HOUSE, Read 3<sup>rd</sup> time, returned to Senate with amendments  
5/13/09 - SENATE, Non-concurred in House amendments  
5/14/09 - HOUSE, Insists on amendments, appoints conferees  
5/14/09 - SENATE, Appoints conferees  
6/16/09 - SENATE/HOUSE, Conference report adopted  
6/24/09 - Ratified  
6/30/09 - Signed by Governor (effective date)  
7/7/09 - Given Act number (81)

# Assessment Criteria



## South Carolina Taxation Realignment Commission



## **TRAC's "Assessment Criteria"**

The South Carolina Taxation Realignment Commission's (TRAC) enabling legislation (Act 81 of 2009) required it (TRAC) to provide the General Assembly with the criteria TRAC would use to assess the effectiveness of the state's current tax system structure. The criterion was to be provided to the General Assembly within three months of the act's effective date.

The enabling legislation provided specific guidance regarding the development of such criteria, stating that it (the criteria) "...be designed with an emphasis on the systemic balance of the state's revenue structure from the standpoint of adequacy, equity, and efficiency and with the goal of maintaining and enhancing the State as an optimum competitor in efforts to attract business and individuals to locate, live, work, and invest in the State."

With the understanding that there is no "one size fits all" formula for evaluating any state's tax structure, on September 30, 2009, TRAC submitted to the General Assembly the following criteria it utilized (where able) in its assessment of the effectiveness of the state's current tax system structure.

### **TRAC STATUTORY OBJECTIVE:**

To ensure the State's tax structure enhances "...*the State as an optimum competitor in efforts to attract business and individuals to locate, live, work, and invest in the State.*" (Section 1(C)1 of Act 81 of 2009).

As such, TRAC, where possible to objectively measure, will consider the following criteria when examining the "adequacy, equity, and efficiency" of the State's tax structure, and will do so mindful of the statutory objective referenced above:

### **ADEQUACY:**

In short, "adequacy" examines concepts of "reliability" and "balance". Specifically:

- 1) Does the current tax structure produce revenues that are not highly cyclical relative to the “business cycle”, or does the current mix of revenue sources lead to volatility during up and downturns in the economy?
- 2) Related to the “mix” of revenues, is the state overly reliant on one source of revenue, or is there an appropriate “balance” of sources?
- 3) Likewise, is the current mix (or balance) stable (as understood by the concept of “elasticity”)?
- 4) Regarding “competition” generally, is the state’s tax structure and/or burden (both individual and business) dramatically out of line with other states?
- 5) Regarding the state’s competitive position as it relates to business taxes specifically, understanding that revenue systems are sometimes used as tools of economic development, does the state impose a tax burden far different from that of other states?

### **EQUITY:**

Equity examines the concepts of “fairness” and/or “equal protection” in and/or among various categories or levels of taxpayers. Specifically:

- 1) How is the tax burden distributed among various categories of taxpayers?
- 2) Related to individual/household taxpayers specifically, is the current state tax structure “horizontally equitable”? That is, are taxpayers with the same capacity to pay treated equitably? Generally speaking, it is accepted that the “narrower” the tax base, the more inequitable the system. In contrast, the broader the base, the more equitable the system, generally speaking.
- 3) An additional component to the equity analysis relates to “vertical equity”. Specifically, how do tax burdens compare among taxpayers with different levels of incomes and/or abilities to pay?
- 4) Specifically, does the current tax structure, when examined system wide, minimize “regressivity” as that concept is typically defined?
- 5) Related to business taxpayers in particular, does the tax structure provide similar treatment for all industries and all firms within a particular industry?
- 6) Does the tax structure overly favor new business vs. existing business?

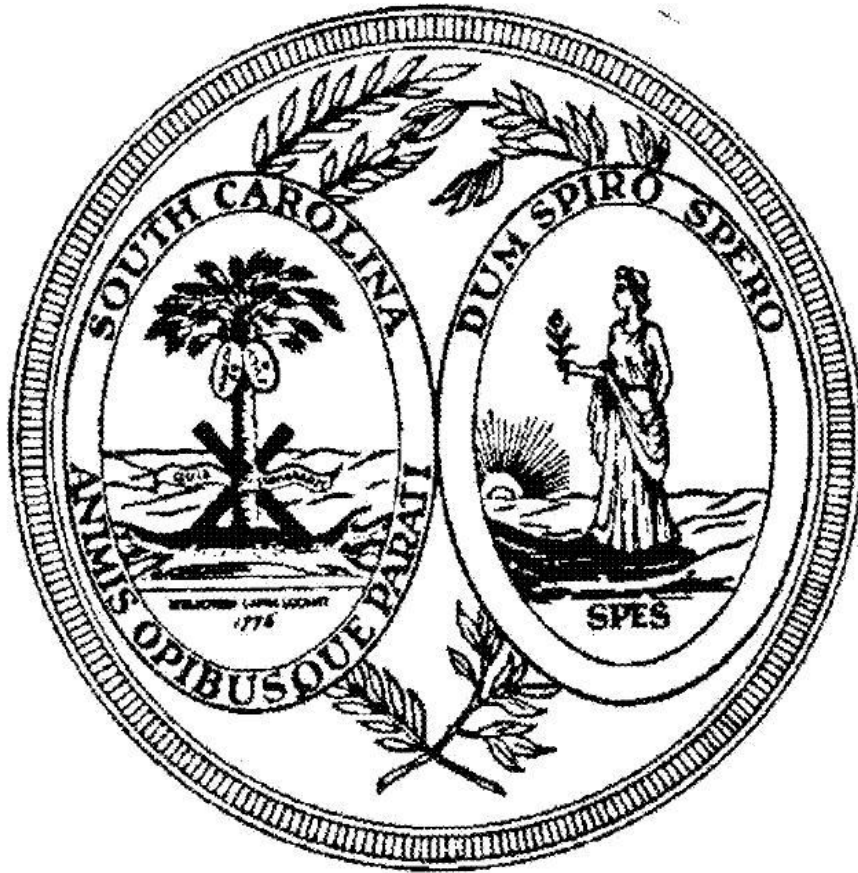
### **EFFICIENCY:**

Efficiency examines the tax structure relative to its “neutrality” in impacting or incentivizing taxpayer decision making. Specifically:

- 1) How efficient is any given state “tax expenditure” (incentive, etc.)? That is, does it accomplish a significant increase in private sector activity with a relatively modest “cost” in terms of lost tax revenue?
- 2) How does the tax expenditure impact the tax structure relative to the concepts of “adequacy” and “equity”? Does it significantly impact a particular revenue stream that supports a public service(s) and/or does it significantly change the distribution of the tax burden from one class of taxpayer to another?
- 3) Related, does the tax expenditure incentivize a new or desired activity or does it “reward” existing behavior, or behavior that would have taken place anyway, in the absence of the incentive?

*The following sources were used to develop TRAC’s “assessment criteria”: “Principles of a High-Quality State Revenue System” - a report by the National Conference of State Legislatures; “The Way We Tax - A 50 State Report”, Governing Magazine, February 2003; “Selected Issues in South Carolina’s Tax and Education System”, a report by Donald Boyd and William Fox, April 23, 2008; “Ensuring a Competitive Revenue System for South Carolina - Findings and Conclusions from an Evaluation of the South Carolina Revenue System”, Holly Ulbrich, Strom Thurmond Institute of Government and Public Affairs, Clemson University, November 18, 2005.*

# **Sales and Use Taxes**



## **South Carolina Taxation Realignment Commission**

## **Sales and Use Taxes, Generally**

Sales and use taxes generally apply to what has been statutorily defined as “tangible personal property” under S.C. Code Ann. 12-36-60:

“‘Tangible personal property’ means personal property which may be seen, weighed, measured, felt, touched, or which is in any other manner perceptible to the senses. It also includes services and intangibles, including communications, laundry and related services, furnishing of accommodations and sales of electricity, the sale or use of which is subject to tax under this chapter and does not include stocks, notes, bonds, mortgages, or other evidences of debt. Tangible personal property does not include the transmission of computer database information by a cooperative service when the database information has been assembled by and for the exclusive use of the members of the cooperative service.”

Sales tax is imposed on the sale of goods and a very limited number of services (to which findings and recommendations are discussed in greater detail in subsequent portions of this section of TRAC’s report) in South Carolina. The sales tax also applies to the fair market value of tangible personal property previously purchased by the retailer at wholesale (for re-sale), but which is used by the retailer or any other person withdrawing tangible personal property to be used and consumed by them instead.

In addition to applying to items one normally thinks of as tangible personal property - furniture, appliances, clothing, etc. - the sales and use tax also applies to some communications like local telephone services, cable television services, satellite programming services, faxing services and paging services, as well as laundry and dry-cleaning services, accommodations and non-residential electricity sales (e.g. business or industrial use unless specifically exempt).

Use tax, like the sales tax, is imposed on goods and certain services purchased out of state and brought into South Carolina, or on which no sales tax has been paid. The statewide use tax rate is identical to the sales tax rate of 6 percent. Local option taxes apply to items subject to the use tax just as they do to the sales tax. Anyone who buys tangible personal property from out-of-state and brings it into South Carolina is responsible for paying a use tax at the rate of 6 percent

plus any applicable local taxes on the sales price. Simply put, a taxpayer is liable for the use tax on goods purchased in another state “as if” the taxpayer had purchased it in South Carolina because he intends to “use it” here. However, a taxpayer is allowed a credit for sales or use tax due and paid to another state against the use tax due this state.<sup>1</sup> Businesses that make non-taxed purchases out-of-state must report and pay the “use tax” on their monthly sales and use reports.

The South Carolina sales and use tax was first enacted in 1951 at a rate of 3 percent for the primary purpose of funding improvements in public education.<sup>2</sup> The sales tax rate has been increased three separate times since 1951; from 3 percent to 4 percent in 1970, from 4 percent to 5 percent in 1984 and most recently, from 5 to 6 percent in 2007.<sup>3</sup> It should be noted that the current sales tax rate of 6 percent, while technically one “rate”, is actually comprised of three different components; a 4 percent “base rate”, commonly referred to as the “General Fund” portion of the sales tax, and the latest two “add-ons” referenced above (1984 and 2007). Revenue from these two additional pennies are segregated from the General Fund portion into two distinct “trust fund” accounts to ensure proceeds are not spent on the general operations of State government, and instead are spent only for the purpose(s) intended by the Legislature at the time of their enactment.

Specifically, the additional one-cent added in 1984 is commonly referred to as the “Education Improvement Act”, or “EIA” penny, and, similar to the intent behind the original three pennies adopted in 1951, revenue from this penny must be used exclusively by the State Department of Education for the support of the State’s elementary and secondary educational system.<sup>4</sup>

Revenue from the latest add-on (the one-cent enacted in 2007) is also, albeit less directly, related to education funding. Commonly referred to as “the swap”, the General Assembly adopted the “sixth cent” of the State’s now 6 cent sales tax, with its revenue also segregated into

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<sup>1</sup> S.C. Code Ann. 12-36-60 (2008).

<sup>2</sup> “Ensuring a Competitive Revenue System for South Carolina - Findings and Conclusions from an Evaluation of the South Carolina Revenue System”, prepared for the Palmetto Institute by Holley H. Ulbrich, November 18, 2005.

<sup>3</sup> “South Carolina Revenue Sources and Fiscal Impacts”, South Carolina Budget and Control Board, Division of Research and Statistical Services, Office of Economic Research (October 21, 2009).

<sup>4</sup> S.C. Code 59-21-1010.

its own trust fund (known as the Homestead Exemption Fund (HEF)), for the purpose of replacing (or “swapping”) revenue derived by school districts from homeowners via the “school operating portion” of their property tax bill, with revenue from the additional penny instead.<sup>5</sup> The trade off was property tax relief for homeowners in exchange for a higher state sales and use tax liability for all consumers of non-exempt retail goods and services purchased or used in South Carolina (hence, “the swap”).

It should be noted that despite the recent (and dramatic) downturn in the economy (and therefore in sales tax collections as discussed in more detail below), the General Assembly ensured school districts that it would fully fund the “swap account” no matter how much sales tax collections actually decline over any given period. As a result, since 2007, the General Assembly’s “open-ended” commitment to school districts has meant a more than \$300 Million transfer from the State’s General Fund to the HEF trust fund, which has, practically speaking, meant \$300 Million less (cumulatively since 2007) in available revenue for the other general operations of State government since that time.

It is important to remind the reader here that a primary charge given to TRAC by the General Assembly was to, in part, (a) assess state taxes levied that (b) “...fund the operation and responsibilities of state...government”.<sup>6</sup> As is clearly demonstrated above, since its institution in 1951, coupled with recent increases to the tax, the State sales tax is a vital State revenue source, particularly for a key operation of state government, namely K-12 education. As such, TRAC took seriously its task of thoroughly examining the structure and stability of the State’s sales and use tax system; for its competitiveness, its fairness, and for its adequacy to produce stable revenues over time.

A critical analysis by TRAC of the State’s sales and use tax structure, imperative for the reasons noted above, was also essential due to the fact that, at 42 percent of total General Fund receipts in the fiscal year just ended (FY2009-10), the sales and use tax is now the single largest component of State General Fund revenue (just slightly ahead of the individual income tax).<sup>7</sup>

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<sup>5</sup> S.C. Code 12-36-1110 and 11-11-155.

<sup>6</sup> S.C. Code 12-3-10(C)(2)(b).

<sup>7</sup> Comptroller General’s year-end (FY2009-10) “Budgetary General Fund Revenue Analysis” released August 20, 2010.

Adding urgency to TRAC's analysis is also the fact that, while certainly the largest source of General Fund revenue, it is also a declining source of revenue, having just completed its third consecutive year of revenue decline. Furthermore, with collections totaling \$2.19 Billion during FY2009-10, sales tax collections today are at the same level of revenue generated in FY2003-04 (6 years ago) and, adjusting for inflation, equates to roughly the same level generated in FY1996-97, 13 years ago.<sup>8</sup>

It should be noted that, while this near term and substantial decline in sales tax revenue is certainly attributable, in part, to the recent and protracted economic downturn, it is also symptomatic of longer term structural issues of great concern to TRAC; issues that are highlighted by several factors including; a) direct legislative actions that have adversely impacted the sales tax base (e.g., sales and use tax exemptions, exclusions and/or maximum tax caps which have increased, not decreased, over time, b) the distinct and dramatic shift away from a goods based to a services based economy, and c) an increasing shift from "brick and mortar" retail transactions to e-commerce purchases, just to name a few. TRAC's findings (and resulting recommendations) in each of these areas of concerns are discussed in greater detail in the sections of this portion of TRAC's report that follow.

It should also be noted that, at 6 percent, South Carolina's State sales and use tax rate is one of the highest in the nation, a fact of some surprise to TRAC and one that should give the Legislature pause before, and if, there are future attempts to increase the State's sales and use tax rate beyond 6 percent. Specifically, excluding so called "local option" sales taxes, South Carolina's current State tax rate of 6 percent ranks in the top quartile (our State imposes the 13<sup>th</sup> highest (tied) sales and use tax rate in the nation).<sup>9</sup> Of equal surprise however, is the fact that, when including local option sales tax(es) into the analysis, our overall national ranking actually improves (though only slightly), from 13<sup>th</sup> to 16<sup>th</sup> highest. That is because, with a statewide average local option sales tax rate of 1.04 percent, our State's local option rate compares more

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<sup>8</sup> In current dollars, sales and use tax revenue was \$2.19 Billion in FY2009-10 vs. \$1.63 Billion in FY1996-97. Adjusting for inflation (based on the CPI-U for SFY10 (216.7) vs. SFY97 (161.7)), collections in FY2009-10 were \$1.63 Billion in constant (real) dollar value terms, which is the same level as FY1996-97. Data points obtained from: "Historical Analyses", South Carolina Budget and Control Board, data through October 31, 2009. [www.budget.sc.gov](http://www.budget.sc.gov); CPI data from the United States Department of Labor, Bureau of Labor Statistics.

<sup>9</sup> "Updated State and Local Option Sales Tax: Combined State and Average Local Rates (50 state analysis), Fiscal Fact No. 196, Padgett, Tax Foundation, October 2009.



favorably nationally than does our State rate, ranking 21<sup>st</sup> instead of 13<sup>th</sup>. Adding our State's 6 percent sales tax rate to an average local option rate of 1.04 percent yields a total average sales tax rate in South Carolina of 7.04 percent, resulting in an overall sales and use tax ranking of 16<sup>th</sup>, meaning that 34 other states impose an overall sales and use tax burden that is lower on their populace compared to South Carolina. The U.S. average state and local sales tax rate is 6.29 percent.<sup>10</sup>

Regarding local option sales taxes, it should not be inferred by the reader that TRAC is suggesting that because our average local option rate compares more favorably nationally than does our State rate, that therefore is "room" for the Legislature to relax the current statutory limits on "how many" local option sales taxes a county may impose upon its residents at any one time. To the contrary, while there are currently nine different local option sales taxes that any given county may impose, it is rare that a county may impose (by statute) more than two at any one time.<sup>11</sup> TRAC also notes the fact that the overwhelming majority of local option taxes must be approved by a voter referendum, though recently the General Assembly, in creating its latest local option tax, allowed the enacting jurisdiction to do so by ordinance in lieu of a referendum.

Lastly, while local option sales taxes were not TRAC's primary focus (with respect to its analysis of the State's sales and use tax structure), it (TRAC) encourages the General Assembly to carefully monitor the proliferation of local option taxes, as 31 counties now impose at least one (and sometimes multiple) local option tax, and at an estimated \$548 Million (in the statewide aggregate) in 2008, use of, and revenue derived from, these local taxes, is a growing and important revenue source for local jurisdictions.<sup>12</sup> As such, the General Assembly should be sensitive to both the needs of local jurisdictions seeking to offset property tax burdens, generate revenue, or a combination of both, but also sensitive to ensuring that local option taxes do not stack "too high" on top of an already high State tax rate to the point where the aggregate sales

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<sup>10</sup> "Updated State and Local Option Sales Tax: Combined State and Average Local Rates (50 state analysis), Fiscal Fact No. 196, Padgitt, Tax Foundation, October 2009.

<sup>11</sup> "Local Option Taxes in South Carolina - A Review", presentation to the Tax Realignment Commission, Craig H. Parks, MPA, Sr. Research Analyst, SC Senate Finance Committee, January 6, 2010.

<sup>12</sup> "Local Option Taxes in South Carolina - A Review", presentation to the Tax Realignment Commission, Craig H. Parks, MPA, Sr. Research Analyst, SC Senate Finance Committee, January 6, 2010.

tax rate is overly burdensome to resident taxpayers (and putting the State at a further competitive disadvantage).

### **Sales and Use Taxes, Issues and Concerns**

As noted above, General Fund revenue derived from the State sales and use tax (the “4 cent”, or “General Fund” portion of the 6 cent sales tax rate) is: 1) the State’s largest source of General Fund revenue, 2) arguably one of the most important sources of General Fund revenue (given one of its primary functions is helping to fund K-12 education), and 3) an increasingly volatile and unstable source of General Fund revenue, a fact highlighted by three consecutive years of revenue decline.

TRAC is concerned that the latter point may be too easily dismissed as a phenomenon solely caused by, and attributable to, the effects of the recent and dramatic economic downturn (caused by what we now refer to as the “Great Recession”). TRAC believes the danger of such a dismissal risks masking the very real and substantial “structural” deficiencies embedded in the State’s sales and use tax statutes, and, as important, it could mask what heretofore has been the State’s inability to recognize (and adapt to) the fundamental and growing shift in the nature of our State’s, the nation’s, and indeed, the global economy.

Simply put (though put in “public finance” jargon), our State’s sales tax base is dangerously narrow; so narrow that our dramatic loss of sales tax revenue over the last several years was certainly exacerbated by this structural deficiency; so narrow that the pace of our recovery (as measured by sales and use tax collections) will be slowed by a tax base that grows smaller by the year.

Consider that a little more than a decade ago, just about 50 percent of all retail sales in South Carolina were subject to sales tax. In isolation that figure might seem surprisingly low to the reader. But by FY2008-09, that figure had dropped to just 38 percent, and that number continues to fall.<sup>13</sup>

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<sup>13</sup> Data from South Carolina Department of Revenue Annual Reports, “Gross and Net Taxable Sales by County”.

As telling is the fact that, during the 10-year period between FY1999-00 and FY2007-08, while “gross” retail sales in South Carolina grew annually at a rate of almost 6 percent, “net” retail sales subject to State sales tax grew at half that annual rate, or just over 3 percent per year.<sup>14</sup> This rate is less than the rate of annual growth in the State’s population plus inflation.<sup>15</sup>

Simply put, even in so called “good years”, when retail sales were growing at a healthy pace, resulting tax collections failed to “keep up”. It is reasonable to expect that sales tax revenue should closely track overall growth in actual sales. When it does not, structural deficiencies are sure culprits.

Consider too, as further evidence of a real and growing structural disconnect between our State’s level of retail activity vs. what it collects in sales tax revenue, that, in years when retail sales are increasing, sales tax revenue has not increased at nearly the same rate (as noted above). But to compound the issue, in years when retail sales have been in decline (as evidenced by the last two recessions), net tax collections actually declined at a much faster pace. Specifically, in FY2003-04, gross retail sales fell by just over 9 percent, but sales tax collections fell by more than 13 percent. In FY2007-08, before the full effects of this latest recession were felt, gross retail sales actually increased by almost 4 percent, but sales tax collections decreased by almost 5 percent. Lastly, as the latest recession became firmly entrenched in FY2008-09, our State’s retailers were suffering, with gross retail sales having fallen compared to the previous year by just over 7 percent; but net sales tax collections fell by almost 12 percent that same year.<sup>16</sup>

Another key measure illustrating the decline in State sales tax revenue relative to economic growth is the correlation between sales tax revenue and personal income. Upon initial observation, sales tax revenue appears to be reasonably stable relative to personal income.<sup>17</sup>

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<sup>14</sup> Data from South Carolina Department of Revenue Annual Reports, “Gross and Net Taxable Sales by County”. Note: Between FY1999-00 and FY2007-08, gross sales grew by 55% while net taxable sales grew by just 32%.

<sup>15</sup> Between FY1999-00 and FY2007-08, the State’s population plus inflation grew at a rate of approximately 4.3% per year based on: a) state population growth between July 1, 2000 and July 1, 2008 of 1.4% per year (US Census Bureau) and b) inflation growth as measured by CPI-U (US Bureau of Labor Statistics) during the same period of 2.8% per year.

<sup>16</sup> Data from South Carolina Department of Revenue Annual Reports, “Gross and Net Taxable Sales by County”.

<sup>17</sup> “Ensuring a Competitive Revenue System for South Carolina - Findings and Conclusions from an Evaluation of the South Carolina Revenue System”, Holley H. Ulbrich, November 18, 2005.

Consider that in 1970 total sales tax revenue equaled roughly 2.5 percent of personal income. By 2008, total sales tax revenue equaled roughly the same percentage of personal income (2.5 percent).

TRAC finds that such apparent stability only occurred because, over time, the General Assembly has increased the State sales and use tax rate to its current rate of 6 percent.<sup>18</sup> Put another way, the only way that total sales tax revenue actually “kept pace” with the State’s growth in personal income over the last 30 years was from periodic tax increases.

But to get a true picture of how our State’s sales tax has actually performed over the last three decades, one must “adjust” for (e.g. “back out”) these rate increases over time. When doing so, what is “unmasked” is not a stable tax, but an unstable sales and use tax system.

Specifically, according to an independent analysis, in 1981, the state sales tax comprised 2.25 percent of personal income. By 2000, that number had fallen to just 2 percent and fell yet again to 1.96 percent by 2004.<sup>19</sup> By 2009, that number is estimated to be just 1.5 percent.<sup>20</sup>

The bottom line, and what we hope serves as a real warning to our Legislature is that, as tax bases narrow (as TRAC has clearly demonstrated has happened in South Carolina), but cost and demand for public services grows (based on population plus inflation alone), upward pressure on a state’s sales and use tax rate naturally results. South Carolina has been no exception. In 1969, South Carolina’s sales and use tax rate was 3 percent. Today it is 6 percent.<sup>21</sup>

Absent recognition of such clear and definitive trends, and ultimately absent requisite structural change (as TRAC recommends herein), state legislators will be faced with inevitable

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<sup>18</sup> “Ensuring a Competitive Revenue System for South Carolina - Findings and Conclusions from an Evaluation of the South Carolina Revenue System”, Holley H. Ulbrich, November 18, 2005.

<sup>19</sup> “Ensuring a Competitive Revenue System for South Carolina - Findings and Conclusions from an Evaluation of the South Carolina Revenue System”, Holley H. Ulbrich, November 18, 2005.

<sup>20</sup> “South Carolina General Fund Sales Tax Collections as a Percentage of Total Personal Income” (1970-2009), prepared for the Tax Realignment Commission by the SC Board of Economic Advisors.

<sup>21</sup> The State’s sales and use tax was first enacted in 1951 at a rate of 3%. It was raised to 4% in 1970, to 5% in 1985 and to 6% in 2007. Source: “South Carolina Revenue Sources and Fiscal Impacts”, South Carolina Budget and Control Board, Division of Research and Statistical Services, Office of Economic Research (October 21, 2009).

pressure to increase the State's sales and use tax rate (e.g. raise taxes), not to raise revenue, but simply maintain revenues instead.

TRAC finds that the Legislature need look no further than to their neighbor to the north (North Carolina) for affirmation of such pressure, where no less than twice during the last 10 years, that state has approved two "temporary" sales tax increases, the first of which became permanent, and the most recent of which, according to news reports, could very well be destined for permanency as well.<sup>22</sup>

TRAC recognizes that such sales and use tax rate increases do not equate to proactive tax reform, but are instead often reactive responses to economic downturns and budgetary pressures. As such, TRAC commends the Legislature for not having raised our State's already high (by comparative measure) 6 percent sales and use tax rate in reaction to recent economic pressures.

In fact, and in contrast to other states, TRAC believes that our Legislature is well positioned to refrain from the foreseeable pressures to increase the tax rate, and instead, is in good position to implement true and long-term structural reform that will actually decrease, not increase, the State's sales and use tax rate, which, as noted above, is currently one of the highest in the country.

TRAC's recommendations, outlined in detail throughout the remainder of this report, are designed to bring stability to an otherwise destabilized tax structure; these are recommendations that are structured to "broaden the base" and "lower the rate" so as to: 1) ensure revenue neutrality, 2) reduce our otherwise high sales tax rate thereby making our state more competitive nationally, 3) making our tax rate and structure fairer to all South Carolinians, not just a narrow few, and 4) modernize the tax structure to reflect the 21<sup>st</sup> century economy; modernization that will bring stability.

And those recommendations will be in three primary areas. They are:

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<sup>22</sup> "NC faces \$3B hole" by Travis Fain, Winston-Salem Journal, August 23, 2010  
<http://www2.journalnow.com/content/2010/aug/23/nc-faces-3b-hole/>

1. Sales and use tax exemptions. Incredible as it may seem, South Carolina now exempts more sales tax than it collects (\$2.7 Billion in exemptions vs. \$2.19 Billion in collections (General Fund portion)). TRAC recognizes that the State's exemptions, exclusions and maximum caps to the sales tax now exceed the amount of General Fund revenue generated from the State's current sales and use tax base not exempt from the tax, thereby making a thorough review of those exemptions of paramount importance when undertaking a comprehensive analysis of the State's tax structure. As noted above, revenue neutrality was a key consideration for TRAC, and as such, 100 percent of any revenue that may be generated by exemptions that TRAC recommends for amendment or repeal should be used by the Legislature (as by TRAC), for dollar for dollar (commensurate) sales tax rate reduction.
2. Taxation of Services. Note: This sub heading could be alternately titled "Lack of Taxation of Services". As noted previously, there has been a distinct and fundamental shift in the nation's (and South Carolina's) personal consumption patterns that have seen our economy move away from a "goods" based to a "services" based economy. Specifically, when measured as a share of the State's portion of Gross Domestic Product (GDP), in 1963, services, as a percentage of private industry output, comprised 48 percent, with the goods sector at 52 percent. By 2008, the certainty of the shift noted above was apparent, with services comprising 75 percent and goods falling to 25 percent.<sup>23</sup> Furthermore, in South Carolina, of the 168 services that the Federation of Tax Administrators has identified as taxable, South Carolina taxes 35, or just 20 percent. The national average is 57.<sup>24</sup> Lastly, a key component of TRAC's "assessment criteria" adopted by the commission involves tax "equity", also known as "fairness". A broader tax base with few(er) exemptions promotes a fairer system and a lower rate. Taxing additional services also helps to offset, but not alleviate, the otherwise regressive nature

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<sup>23</sup> Gross Domestic Product by State (millions of dollars), as a percentage of private industry output. Data compiled by the South Carolina Department of Commerce's Research Division from data from the U.S. Department of Commerce's Bureau of Economic Analysis (US BEA). According to the US BEA, "personal consumption expenditures" is the primary measure of consumer spending on goods and services in the U.S. economy, accounting for roughly two-thirds of "domestic final spending". As such, consumer spending is the primary engine that drives future economic growth. This fact, coupled with the fact that, as noted in the report, there has been a fundamental shift in consumer spending to services and away from goods, creates an imperative for the General Assembly to update the State's tax code to reflect this shift.

<sup>24</sup> 2007 Update, released in July 2008, of the Federation of Tax Administrators survey of "Services Taxation".

of a sales tax structure where few services are generally taxed. Note: As with its exemption recommendations, TRAC recommends that 100 percent of any revenue that may be generated by taxing additional services should be used by the Legislature (as by TRAC), for dollar for dollar (commensurate) rate reduction.

3. E-commerce/Internet Sales. Similar to the fundamental shift in the types of items purchased by consumers (e.g. “goods vs. services”), there is a real and growing shift in “where” and/or “how” consumers purchase those goods and services. Simply put, “e-commerce” (or internet sales) is an ever growing alternative to purchasing the otherwise same good or service from a traditional “brick and mortar” establishment (e.g. your local retailer or “mom and pop”). Two primary issues arise from this phenomenon, both of equal significance and importance. The first, for reasons described in greater detail below, is, in many cases, the State’s inability to collect sales tax on an otherwise taxable item (tax that would have been remitted had the purchase been made a local brick and mortar retailer). According to Bill Fox, Ph.D. from the University of Tennessee and noted expert on internet sales, between 2007 and 2012, South Carolina will have likely lost \$569 Million in state and local sales tax revenue from otherwise taxable e-commerce purchases.<sup>25</sup> The other issue is one of fairness and competitive advantage (or disadvantage). A local vendor selling a book, or a shoe, or some other taxable item in a South Carolina county with a 1 percent local option tax must charge his patron a 7 percent sales tax on those items that the same patron, if willing and able, could very well purchase online, effectively for 7 percent less (assuming the internet vendor does not have “nexus” (term described in greater detail below)) with South Carolina. As such, the local merchant faces a real 7 percent disadvantage; conversely, the internet vendor potentially enjoys a 7 percent advantage. Note: As with its exemption recommendations, TRAC recommends that 100 percent of any revenue that may be generated by adopting statutory changes that facilitate greater sales tax collections from internet purchases should be used by the Legislature (as by TRAC), for dollar for dollar (commensurate) rate reduction.

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<sup>25</sup> State and Local Government Sales Tax Revenue Losses from Electronic Commerce” (summary and revenue tables), Bruce, Fox and Luna, University of Tennessee, April 13, 2009.

## **Sales and Use Tax Exemptions, Generally**

Typically, all retail sales of goods are subject to the sales and use tax. However, the South Carolina sales and use tax laws contain dozens of exemptions (as noted above, exemptions that are now valued at more than \$2.7 Billion annually). Some of the most notable exemptions are for certain items used in farming and manufacturing, medicines sold by prescription, and sales to the federal government. Other excluded items include certain property used in the manufacturing process, materials used to ship manufactured goods for sale and items brought into the state that are for use outside the state. Additional items excluded from the sales and use tax includes sales of goods for resale.

Consider the following “Top Ten” list of sales and use tax exemptions, by “value” (or “cost”) of exemption (per the Board of Economic Advisors exemption estimate matrix for FY2008-09):<sup>26</sup>

1. Prescription Medicine	\$585 Million
2. Motor Fuel	\$500 Million
3. Groceries	\$354 Million*
4. Sales to the Federal Govt.	\$253 Million
5. Residential Electricity/Heating	\$188 Million
6. Cars/Motorcycles/Boats/Planes	\$173 Million
7. Coal/Coke/Fuel sold to Manufacturers, etc.	\$103 Million
8. Electricity sold to Manufacturers, etc.	\$88 Million
9. Toll Charges (Telephone)	\$74 Million

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<sup>26</sup> Sales and Use Tax Exemptions, FY2008-09” (revenue table only), prepared by the SC Board of Economic Advisors, January 14, 2008.



10. Machines used in Manufacturing, etc. \$63 Million

“Top Ten” total: \$2.38 Billion

\*Updated estimate for FY2010-11 provided by the Board of Economic Advisors for “groceries” is \$425 Million.

Note that of the approximately 80 specific sales and use tax exemptions “costed out” by the Board of Economic Advisors, the “top ten” comprise almost 90 percent of the estimated \$2.7 Billion in total exemptions. Furthermore, those “top ten” exemptions represent a staggering \$40 Billion in annual retail sales in South Carolina that go tax free.<sup>27</sup> Compare the value of just those ten exemptions to the net sales that are actually taxable each year in South Carolina (\$55 Billion); that is a difference of just \$14 Billion between every transaction that is subject to tax in South Carolina vs. the value in foregone taxable sales (and therefore revenue) from transactions involving just those ten specific transaction types alone.

It should be noted that if the “top ten” sales tax exemptions noted above were not exempt, and as such, were subject to tax, South Carolina’s sales and use tax rate could drop by almost than half, from 6 percent to just 3.5 percent and generate the same amount of revenue (e.g. be “revenue neutral”) each year.<sup>28</sup>

Based on this illustrative (and definitive) information alone, TRAC could have taken the “easy way out”, and merely adopted the public finance mantra of “broad base, low rates”, thereby simply suggesting the complete and total repeal of not only the “top ten” exemptions, but of the remaining 70 as well, and simply told the Legislature to “lower the rate”.

But instead, TRAC chose the more difficult route of thoroughly, and often painstakingly, examining each of the 80 exemptions in great detail, where in numerous public meetings

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<sup>27</sup> Unofficial TRAC staff calculation which divides the BEA’s exemption estimates by the current State sales and use tax rate of 6 percent.

<sup>28</sup> Unofficial TRAC staff calculation adding back the exemption “top ten” list to the estimated sales tax base and dividing the sum by final FY2008-09 sales and use tax revenue to generate an estimated “revenue neutral” sales tax rate.

including subcommittee work, it (TRAC) took public testimony from dozens of citizens (all sincere, often emotional) and trade associations and testimony from various state, regional and national experts on areas involving sales and use tax generally, and exemptions, exclusions, and exemptions specifically.

TRAC believes what resulted from its deliberative work are a set of recommendations that are: 1) fair, 2) sound tax policy, both in theory and which are workable in “real life”, and 3) responsive in almost all respects to the majority of concerns expressed by those who provided testimony before the commission.

Indeed, rather than take the “easy way out”, TRAC made recommendations that were often not “easy”, but which it (TRAC) believes, if given an honest review conducted in the holistic manner in which the recommendations were themselves developed (as opposed to the isolated “picking apart” that so often happens with such reports), provides a real “blueprint” forward for stabilizing the State’s sales and use tax structure, and as importantly, recommendations that promote a much needed injection of fairness that seems inherently lacking in our tax base that otherwise continues to narrow.

But before examining the exemption recommendations in greater detail, provided below is a brief overview of some the current sales and use tax exemptions (including so called “max taxes”, “exclusions”, and/or “discounts”) in South Carolina statute or by budget proviso.

#### Examples of Sales and Use Tax Exemptions Granted In Chapter 36 of Title 12

1. Promotional maps, brochures, pamphlets of discount coupons for use by nonprofit chambers of commerce or convention and visitor bureaus, which are exempt from income taxation pursuant to Internal Revenue Code Section 501(c), for tax years beginning after 2005.
2. Machines used in research and development. (Effective for tax years beginning after June 30, 2001)

3. Coal, coke, fuel for manufacturers, transportation companies, electric power companies, processors
4. Long-distance telephone calls, access charges and charges for telegraph messages, transactions at automatic teller machines
5. Fuel for ships on high seas
6. Wrapping paper, containers, etc. used incident to sale and delivery of tangible personal property
7. Motor fuel taxed under motor fuel tax law
8. Machines used to manufacture, process, recycle, compound, mine or quarry tangible personal property for sale, prevent and abate pollution
9. Electricity used to manufacture, process, mine, or quarry tangible personal property for sale or used by cotton gins to manufacture tangible personal property for sale
10. Railcars
11. Certain vessels and barges
12. Laundry supplies and machinery (services are taxed under the law)
13. Vacation timeshare leasing plans
14. Partial exemption for modular homes
15. Movies sold or rented to movie theaters (movie theaters are subject to the admissions tax)
16. Tangible personal property delivered outside of the state by South Carolina Retailers
17. Petroleum asphalt products transported and used outside South Carolina

18. Shipping containers used by international shipping lines under contract with the South Carolina State Ports Authority
19. Generally, the sale of all depreciable assets as a result of a sale of the entire business
20. Supplies, equipment, machinery for use in filming/producing motion pictures
21. Material handling systems and equipment used in the operation of a distribution facility or a manufacturing facility
22. Parts and supplies used in the business of repairing or reconditioning aircraft owned by or leased to the federal government or commercial air carriers. (This exemption does not extend to tools and other equipment not attached to or that becomes part of the aircraft)
23. Audio-visual masters, sales price defined, sales tax exemption, waivers
24. Construction materials used in the construction of a new or expanded single manufacturing or distribution facility, or one that serves both purposes
25. Computer Equipment used in connection with a technology intensive facility
26. Transactions prohibited from being taxed by federal or state law or the federal or state constitutions
27. Sales to the federal government
28. Materials necessary to assemble missiles used by the U.S. Armed Forces
29. Sales of motor vehicles and motorcycles to nonresident military personnel
30. Sales by the State General Services Division to other state agencies if the tax was paid on the purchase by General Services
31. Parts and supplies used to repair or recondition aircraft owned by or leased to the federal government

32. Sales to government contractors or someone with a written contract with the federal government
33. Exhibition rentals for museums (for charitable, eleemosynary and government museums – use tax only)
34. Textbooks, books, magazines, periodicals, newspapers and access to on-line information for use in a course of study or for students' use in the school library, sold to public and private schools and colleges and public libraries
35. These items may be in printed form or alternative forms such as audio tapes, videotapes, microfilm, or CD-ROM information
36. Meals sold to students in schools (not for profit)
37. Television, radio and cable TV supplies, equipment, machinery and electricity
38. Zoo plants and animals
39. Newspapers, newsprint paper and the South Carolina Department of Agriculture's Market Bulletin
40. Toll charges, telegraph messages and access charges (long distance)
41. Vacation timeshares
42. Electricity, natural gas, etc. used for residential purposes
43. Hearing aids
44. Festival concession sales by organizations devoted exclusively to public and charitable purposes
45. Sales by certain nonprofit organizations
46. Plants and animals sold to publicly supported zoos

47. Medicines and prosthetic devices sold by prescription and medicines used in the treatment of cancer and other related diseases
48. Prescription medicines and therapeutic radiopharmaceuticals used in the treatment of rheumatoid arthritis and prescription medicines used to relieve the effects of any such treatment.
49. War memorials and monuments honoring U.S. armed services and affixed to public property
50. Meals sold by certain nonprofit organizations to the elderly and disabled
51. Food for the homeless or needy sold to certain nonprofit organizations or food that is subsequently sold or donated by the nonprofit organization to another nonprofit organization
52. Certain trash bags required to be used under a governmental solid waste disposal plan
53. Free samples of prescription medicines distributed by the medicine manufacturer and medicines donated by the manufacturer to a college or university for research or treating indigent patients
54. Goods sold to nonprofit hospitals that primarily treat children at no cost to the Patient
55. Prescription and over-the-counter medicines and medical supplies, including diabetic supplies, diabetic diagnostic equipment and diabetic testing equipment sold to a health care clinic that provides medical and dental care without charge to all patients
56. Sweet grass baskets made by artists of South Carolina with locally grown Sweet grass

Sales Tax Caps (“Max Taxes”) - A comparison between South Carolina, North Carolina Georgia

South Carolina’s “Car Tax Cap”, Generally:

South Carolina has a sales tax “cap”, or “maximum” tax liability regardless of purchase price, on sales of motor vehicles. South Carolina adopted its sales tax cap of \$300 in 1984 to compete with a similar cap that North Carolina had previously enacted. The Legislature acted to adopt the cap as automobile dealers, particularly in border counties, were complaining at that time of lost sales to North Carolina car dealers.

In the subsequent years, South Carolina’s “max tax” statute was amended to pick up other types of personal property (e.g. boats, light constructions equipment, etc). TRAC thoroughly examined the current sales tax structure as it relates to car sales in South Carolina, and particularly compared to the tax structures for similar purchases in both North Carolina and Georgia. Consider the following table comparing the actual and effective tax rates between South Carolina, North Carolina and Georgia for cars bought at various price points. Recommendations, based in part of the findings below, are discussed in more detail in the recommendations portion of this subsection of the report.

State or Taxing Jurisdiction	Tax Rate	Retail Price Paid For Motor Vehicles			
		\$6,000	\$16,000	\$36,000	\$56,000
<b>South Carolina</b>					
State Tax	5.00%	\$300	\$300	\$300	\$300
Local Tax	0%	\$0	\$0	\$0	\$0
Total Tax	N/A	\$300	\$300	\$300	\$300
Effective Tax Rate (%)		5.00%	1.88%	0.83%	0.54%
<b>North Carolina</b>					
State Tax	3.00%	\$180	\$480	\$1,080	\$1,680
Local Tax	0%	\$0	\$0	\$0	\$0
Total Tax	N/A	\$180	\$480	\$1,080	\$1,680
Effective Tax Rate (%)		3.00%	3.00%	3.00%	3.00%
<b>Georgia</b>					
State Tax	4.00%	\$240	\$640	\$1,440	\$2,240
Local Tax	3%	\$180	\$480	\$1,080	\$1,680
Total Tax	N/A	\$420	\$1,120	\$2,520	\$3,920
Effective Tax Rate (%)		7.00%	7.00%	7.00%	7.00%

Specifically, South Carolina’s “max tax” of \$300 regardless of purchase price applies to the following items, pursuant to SC Code § 12-36-2110”

“The Maximum tax on sale or lease of certain items; calculation of tax on manufactured homes; maximum tax on purchase of certain property by religious organizations; maximum tax on sale or use of machinery for research and development.

(A) The maximum tax imposed by this chapter is three hundred dollars for each sale made after June 30, 1984, or lease executed after August 31, 1985, of each:

(1) aircraft, including unassembled aircraft which is to be assembled by the purchaser, but not items to be added to the unassembled aircraft;

(2) motor vehicle;

(3) motorcycle;

(4) boat;

(5) trailer or semitrailer, pulled by a truck tractor, as defined in Section 56-3-20, and horse trailers, but not including house trailers or campers as defined in Section 56-3-710 or a fire safety education trailer;

(6) recreational vehicle, including tent campers, travel trailer, park model, park trailer, motor home, and fifth wheel; or

(7) self-propelled light construction equipment with compatible attachments limited to a maximum of one hundred sixty net engine horsepower.

In the case of a lease, the total tax rate required by law applies on each payment until the total tax paid equals three hundred dollars. Nothing in this section prohibits a taxpayer from paying the total tax due at the time of execution of the lease, or with any payment under the lease. To qualify for the tax limitation



provided by this section, a lease must be in writing and specifically state the term of, and remain in force for, a period in excess of ninety continuous days.”

Any transaction subject to the maximum tax of \$300 is taxed at a state rate of 5 percent (“max taxes” were exempted from the additional one-cent sales tax increase adopted by the Legislature in 2007 as described above) and is not subject to any local tax administered and collected by the Department of Revenue on behalf of local jurisdictions.

Any transaction not subject to the maximum tax of \$300 is taxed at a state rate of 6 percent and is subject to any local tax administered and collected by the Department of Revenue on behalf of local jurisdictions.

A brief review of North Carolina’s sales tax cap(s):

North Carolina imposes its own particular set tax caps. The caps are defined in GS § 105-164.4. The caps are as follows:

Boats and Aircraft: \$1,500, or alternatively 3 percent of the sales price if that would amount to less than \$1500.

Manufactured Housing: A max tax of \$300 for a one sided home, or \$600 for the sale of a two sided home. If the tax would be less than \$300 or \$600 respectively, then a tax of 2 percent of the sales price applies.

Agricultural Equipment: Generally all sales of agricultural equipment would be exempt based on the current statute. For instance, sales of equipment used in harvesting, planting, or cultivating are exempt. This exemption has applied since 2006.

Manufacturing Machinery: Machinery used in manufacturing has a sales cap tax of \$80, or in the alternative a 1 percent tax applies if that amount would be less than \$80. North Carolina classifies this as a privilege tax.

Class A and B vehicles, and Recreational Vehicles (RV’s): Class A and B vehicles which are generally used in trucking for the transport of goods have a \$1000 sales tax cap. RV’s are treated

similarly. All other vehicles are subject to standard state and local tax rates. For complete definitions for each type of vehicle class please refer to N.C. Gen. Stat. § 20-4.01.<sup>29</sup>

Small Equipment for construction or other similar infrastructure usage: Except as explicitly stated otherwise in N.C. Gen. Stat. § 105-164.4<sup>30</sup>, no caps or exemptions apply. Very few items are subject to these caps and exemptions.

Leased equipment: This equipment is taxed according to state and local tax rates as indicated in the services table. The tax is classified as an “alternative gross receipts tax.”

North Carolina does *not* have a sales tax cap on the sales of motor vehicles because motor vehicle sales are exempt from sales and use tax. However, the state does charge a “highway use tax” under Article 5A of Chapter 105 in lieu of an official sales tax. The highway use tax is applied at a rate of 3 percent, but does *not* apply to; mopeds, tractors, other farming instruments, manufactured homes, mobile offices, road construction, road maintenance equipment or commercial trucks.

#### A brief review of Georgia’s sales tax cap(s):

In 2006 Georgia repealed its specific sales tax caps and the current controlling statute is: O.C.G.A. § 48-3-3 (2010).<sup>31</sup> Georgia offers exemptions only on particular goods if sold for educational, manufacturing, agricultural, or medical purposes. Furthermore, exemptions apply to most sales to the disabled. The standard state and local sales tax rates apply to non-exempt purchases. For a complete list of exemptions reference: O.C.G.A. § 48-3-3 (2010).<sup>32</sup>

#### **Sales and Use Tax Exemptions, Generally (continued)**

##### Examples of Title 12 Exemptions **Outside** Chapter 36 and Non-Title 12 Sales Tax Exemptions

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<sup>29</sup> N.C. Gen. Stat. § 20-4.01 (2010).

<sup>30</sup> N.C. Gen. Stat. § 105-164.4

<sup>31</sup> O.C.G.A. § 48-3-3 (2010).

<sup>32</sup> *Id.*

1. South Carolina Code §58-25-80 (Regional Transportation Authorities) This exemption provides that a regional transportation authority shall not pay any sales tax or use tax. In addition, it provides that a regional transportation authority shall not pay any state or local ad valorem tax, income tax, fuel tax, excise tax or any other use taxes or taxes from which municipalities and counties are exempt.<sup>33</sup>
2. South Carolina Code §56-19-480 (Insurance Companies and Motor Vehicles) This exemption provides that vehicles that have been declared a total loss and are transferred to or from an insurance company in settlement of a claim are exempt from casual excise tax and sales and use taxes.<sup>34</sup>
3. South Carolina Code §44-7-2120 (Regional Health Services Districts) This exemption provides that the gross proceeds of the sale of any property owned by a regional health services district and used in the construction and equipment of any health care facilities for a district is exempt from the sales taxes and all similar excise taxes. In addition, the exemption provision states that it is the intent of the General Assembly that a regional health services district incur no tax liability to the State or any of its political subdivisions except to the extent that sales and use taxes may be payable on the purchases of goods or equipment by the regional health services district.<sup>35</sup>
4. South Carolina Code §38-29-150 (South Carolina Life and Accident and Health Insurance Guaranty Association) This provision exempts the South Carolina Life and Accident and Health Insurance Guaranty Association from payment of all fees and all state, county, and municipal taxes.<sup>36</sup>
5. South Carolina Code §38-31-130 (South Carolina Property and Casualty Insurance Guaranty Association) This provision exempts the South Carolina Property and Casualty Insurance Guaranty Association from payment of all taxes levied by this State or any of its political subdivisions, except taxes levied on real or personal property.<sup>37</sup>

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<sup>33</sup> S.C. Code Ann. § 58-25-80 (2008).

<sup>34</sup> S.C. Code Ann. § 56-19-480 (2008).

<sup>35</sup> 44-7-2120 (2008).

<sup>36</sup> 38-29-150 (2008).

<sup>37</sup> 38-31-130 (2008).

6. South Carolina Code §12-11-30 (Banks) This provision provides that the income tax paid by banks is in lieu of all other taxes on banks, except the use tax, the deed recording fee, and taxes on real property. The real property of a bank is taxed in the place where it is located.<sup>38</sup>
7. South Carolina Code §12-13-50 (Building and Loan Associations) This provision provides that the income tax paid by building and loan associations shall be in lieu of any and all other taxes on such association except use taxes, deed recording fees, and taxes on real property. The real property of any such association shall be taxed in the place where it may be located, the same as the real property of individuals.<sup>39</sup>
8. South Carolina Code §13-17-90 (South Carolina Research Association) This provision states that the South Carolina Research Authority shall pay no taxes or assessments including, but not limited to, income tax, sales and use and property tax upon any of the property acquired by it or upon any of its activities; except that the South Carolina Research Authority is entitled to the above- referenced sales and use tax exemption only in (1) transactions to intangible personal property for the authority's own use or consumption, (2) transactions related to authority contracts with governmental entities and nonprofit entities, and (3) transactions related to authority contracts with private, for-profit entities doing business in South Carolina, where these contracts do not place these entities in competition with other private, for-profit entities in South Carolina.<sup>40</sup>
9. South Carolina Code §§ 12-63-20 and 12-63-30 (Motion Picture Productions Companies) This provision provides a sales and use tax exemption for all qualifying tangible personal property used in connection with the South Carolina filming by a “motion picture production company” that is approved by the South Carolina Film Commission at the South Carolina Department of Parks, Recreation and Tourism.<sup>41</sup>
10. Car Dealership License Plate Tag Sales Tax Exemption Under current sales and use tax laws cars with dealer tags are not subject to paying sales and use taxes in South

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<sup>38</sup> 12-11-30 (2008).

<sup>39</sup> 12-13-50 (2008).

<sup>40</sup> 13-17-90 (2008).

<sup>41</sup> S.C. Code Ann. § 13-63-20 (2008).

Carolina. South Carolina Code § 56-3-2320<sup>42</sup> in conjunction with South Carolina Code § 12-36-90<sup>43</sup> provide for the ability to avoid paying sales tax. Referring to cars with dealer license plate tags, South Carolina Code § 56-3-2320 says: “The license plates, notwithstanding other provisions of this chapter to the contrary, may be used exclusively on motor vehicles owned by, assigned, or loaned for test driving purposes to the dealer when operated on the highways of this State by the dealer, its corporate officers, its employees, or a prospective purchaser of the motor vehicle.”<sup>44</sup>

Under section 12-36-90, the phrase “Gross proceeds of sale” specifically excludes vehicles operated with dealer, transporter, manufacturer, or education license plate tags.<sup>45</sup> Therefore, if someone named a child as a member of a dealership’s board or directors (or even a friend), then that car can be operated with a dealer tag, and if classified under code section 12-36-90 the car can be sold without the revenue being considered sales proceeds.<sup>46</sup> Since no sales proceeds have statutorily accrued, no sales tax can be applied to the sale.

### South Carolina Sales Tax Discounts for “Timely Payment”

#### Retail Vendors

SC Code § 12-36-2610 grants that retailers are given an exemption, better referred to as a “discount”, in the amount of sales tax they must pay if the retailer timely pays its current period sales tax liability.<sup>47</sup> The discount was originally enacted pursuant to Act 612 of 1990. It allows for a 2 percent reduction in total sales tax owed for any timely partial or total prepayment. For instance, if a retailer owes \$100,000 in sales tax, a prepayment for that period would provide for a \$2,000 reduction in liability to \$98,000. The maximum annual discount is 10,000 for voluntarily registered out-of-state retailers and \$3,000 for all other retailers.

#### Tobacco Wholesalers

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<sup>42</sup> S.C. Code Ann. § 56-3-2320 (2008).

<sup>43</sup> 12-36-90 (2008).

<sup>44</sup> 56-3-2320 (2008).

<sup>45</sup> 12-36-90 (2008).

<sup>46</sup> *Id.*

<sup>47</sup> S.C. Code Ann. § 12-36-2640

SC Code. § 12-21-780 grants that tobacco wholesalers are given an exemption, better referred to as a “discount”, in the amount of sales tax they must pay if the wholesaler timely pays its current period sales tax liability.<sup>48</sup> The tax was last amended pursuant to Act 239 of 1996, and at that point in time the cigarette tax was seven cents per pack. From 1996 to the present the wholesalers have had the duty to collect and remit the per pack sales tax. Under the current law, when the distributor or dealer files its return he may deduct there from 3.5 percent of the tax due, with no maximum discount.

### Beer and Wine Wholesalers

SC Code § 12-21-1060 grants that beer and wine wholesalers are given a reduction, in the amount of sales tax they must pay if the wholesaler timely pays its full current period sales tax liability.<sup>49</sup> The tax was originally enacted pursuant to Act 612 of 1990. The tax allows for a 1 percent reduction in total sales tax owed for total payment if paid on or before the due date, with no maximum discount.

### Alcoholic Beverage Wholesalers

SC Code § 12-33-485 grants that retailers are given an exemption, better referred to as a “discount”, in the amount of sales tax they must pay if the retailer timely pays its current period sales tax liability.<sup>50</sup> The tax was originally enacted pursuant to Act 612 of 1990. The tax allows for a 2 percent reduction in total sales tax owed for total payment if paid on or before the due date, with no maximum discount.

### South Carolina Sales Tax Holidays

#### “Back to School Holiday”, General Information

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<sup>48</sup> S.C. Code Ann. § 12-21-780

<sup>49</sup> S.C. Code Ann. § 12-21-1060

<sup>50</sup> S.C. Code Ann. § 12-33-485

Pursuant to SC Code Section 12-36-2120(57), South Carolina offers a so-called “back to school sales tax holiday that takes place annually during a period beginning 12:01 a.m. on the first Friday in August and ending at twelve midnight the following Sunday are exempted. Based on SC Revenue Ruling 10-7 examples of exempt items include:<sup>51</sup>

1. clothing;
2. clothing accessories including, but not limited to, hats, scarves, hosiery, and handbags;
3. footwear;
4. school supplies including, but not limited to, pens, pencils, paper, binders, notebooks, books, book bags, lunchboxes, and calculators; (v) computers, printers and printer supplies, and computer software;
5. bath wash clothes, blankets, bed spreads, bed linens, sheet sets, comforter sets, bath towels, shower curtains, bath rugs and mats, pillows, and pillow cases.

Items Code Section 12-36-2120(57) Does Not Exempt From Sales and Use Tax:

1. sales of jewelry, cosmetics, eyewear, wallets, watches;
2. sales of furniture;
3. a sale of an item placed on layaway or similar deferred payment and delivery plan however described;
4. rental of clothing or footwear.

#### “Second Amendment (Gun) Holiday”, General Information

Budget proviso 89.107 of the FY2010-11 South Carolina appropriations act (e.g. “The Budget”) provides a sales tax holiday on the gross proceeds of sales or sales price of handguns as defined pursuant to Section 16-23-10(1) of the 1976 Code, rifles, and shot guns is exempt from the taxes imposed pursuant to Chapter 36, Title 12 of the 1976 Code and Chapter 10, Title 4 of the 1976 Code for sales occurring from 12:01 a.m., Friday, November 26, 2010, through twelve midnight, Saturday, November 27, 2010. This exemption does not apply to ammunition, archery and related equipment, gun carrying cases, etc.<sup>52</sup>

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<sup>51</sup> SC Rev. Rul. 10-7, #10-7, 1-2.

<sup>52</sup> “Second Amendment Sales Tax Holiday for 2010”, SC Department of Revenue Ruling 10-9.

## **Sales and Use Tax Exemptions, Recommendations**

Pursuant to Act 81 of 2009, which established TRAC, and according to SC Code Title 12, Chapter 3, Section 10(C)(2)(a), the General Assembly specifically mandated that TRAC provide the General Assembly a “detailed, careful, and comprehensive” recommendation regarding which “sales and use tax exemptions or limitations to be retained, modified, or repealed.”

It should be noted that the General Assembly, at least twice during the past decade, has established its own, either joint and/or ad hoc committees, composed of legislators, to undertake a similar review as the one outlined above.<sup>53</sup> However, in neither case did the work of either committee materialize. Simply put, the legislative committees never adopted or published recommendations regarding which sales and use tax exemptions or limitations should be retained, modified, or repealed.

As such, one of the first charges issued by the General Assembly to TRAC was to complete this important, long discussed, but never acted upon task. Acknowledging the significance of this work, the General Assembly did not impose any parameters, restrictions, or limitations on what TRAC could, or could not recommend to the General Assembly in its final analysis regarding which sales and use tax exemptions or limitations to offer for retention, modification, or repeal.

To ensure TRAC’s impartiality and the ultimate integrity of its final product, the General Assembly imposed guidelines for lobbyist interactions with TRAC members outside of public meetings.<sup>54</sup> However, as noted above, TRAC sought, accepted, and carefully deliberated

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<sup>53</sup> In the early 2000’s, the House Ways and Means Committee created an ad hoc committee to study sales and use tax exemptions. The committee met several times, but never issued a report or recommendation(s). In 2006, as part of Act 388, the General Assembly created the “Joint Sales Tax Exemptions Review Committee”. The Committee’s report and recommendations were due by 2010. Because the committee had not met between 2006 and 2009, the committee was dissolved pursuant to Act 81 of 2009 (the same Act that created TRAC).

<sup>54</sup> Pursuant to SC Code 12-3-10(F) “Commission members shall not receive information regarding the business of the commission from a lobbyist except through formal presentation to the commission at a meeting called in compliance with the Freedom of Information Act. Any lobbyist violating the provisions of this subsection is deemed guilty of a misdemeanor and, upon conviction, must be punished as provided in Section 2-17-130 of the 1976 Code.” Note: Pursuant to this code section, the



extensive testimony and information provided publically, or in writing, by citizens, lobbyists, special interest groups, trade associations, and state, regional, and national experts.

The resulting recommendations from TRAC's thorough review and analysis of each of the State's more than 80 sales tax exemptions, exclusions, "max taxes" and/or discounts, are not based on temporary sales tax rates that rise and fall based on short-term budgetary or political pressures, but are based on long-term structural reform that will, by broadening the base and lowering the rate, promote revenue stability and most importantly, promote enhanced fairness for both individuals and businesses, who, absent reform, will otherwise face continued pressure from a tax base that continues to narrow.

A guiding principle for TRAC was creation of a fair and transparent tax system that would tax a broader basket of goods at the lowest rates possible. With little exception, fairness is attained when only final (or "end") retail sales of goods and services are subject to sales tax.

Likewise, sound tax policy suggests that key exceptions (e.g. "exemptions") particularly in regards to "input" transactions be enacted or retained.<sup>55</sup> That is why, with little exception, the majority of TRAC's recommendations retain key exemptions for manufacturing, agricultural and other key business "inputs", while entirely or partially removing many purchases considered to be end or "final" retail sales from their current exempt status.

For example, TRAC recommends retaining the sales and use tax exemption for newsprint "paper", a key process input component necessary in newspaper publication, but recommends taxing the actual retail sale of the newspaper to the end consumer (e.g., the customer).

From a tax policy and fairness standpoint, this recommendation is no different than current law whereby South Carolina exempts from sales tax the rubber used to make a tire, but does not exempt the final product (e.g., "the tire") from retail sales tax. Taxing such business

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TRAC commissioners adopted formal protocols regarding commission/lobbyist interactions, which can be viewed at: [www.sstatehouse.gov/citizensinterestpage/TRAC/CopyOfEthicsCommissionLetterOnCommissioners.pdf](http://www.sstatehouse.gov/citizensinterestpage/TRAC/CopyOfEthicsCommissionLetterOnCommissioners.pdf)

<sup>55</sup> Conceptual attribution to various reports and/or information produced by The Tax Foundation.

inputs, referred to in tax parlance as “pyramiding”, inhibits tax neutrality, transparency and fairness.<sup>56</sup>

TRAC affirms this important policy position and commends the General Assembly for many of the key exemptions it has codified for various manufacturing, agricultural, and key business inputs in industries that are vital to the State’s current and future economic development. TRAC recommends retention of those important exemptions.

In short, in its effort to recommend long-term and sustainable structural reform, TRAC makes thoughtful decisions by continuing full exemptions on certain items, imposing substantially lower rates on others, and fully exempting certain segments of the population from tax liability out of a desire to achieve the difficult balance between a system that is fairer for all South Carolinians on the whole, while not overly burdening the most vulnerable portions of our populace.

### *Key Highlights of Exemption Recommendations*

#### Broaden the Base:

TRAC recommends a significant broadening of the State’s sales and use “tax base” by repealing, amending, or modifying dozens (more than 60 of the State’s 80 plus exemptions) of the State’s sales and use tax exemptions, exclusions, and/or maximum tax caps. With little exception, TRAC repeals or amends almost all true “end” retail sales tax exemptions, leaving mostly only those considered to be true “business inputs” for production of tangible products by some of our State’s most vital industries (including manufacturing and agriculture).

Based on unofficial staff estimates (official Board of Economic Advisors estimate still pending at time of this publication), TRAC’s proposal would “broaden” the State’s sales and use tax base by an estimated \$10.2 Billion, generating an estimated \$614 Million in sales tax revenue

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<sup>56</sup> Conceptual attribution to various reports to include The Tax Foundation, Institute on Taxation and Economic Policy, Michael Mazerov, Holley H. Ulbrich, Jim Eads.

annually.<sup>57</sup> Note: While “unofficial”, TRAC staff believes this estimate could very well be “conservative”, as more than 40 exemptions, or sub items of exemptions, were labeled by staff “to be determined” and therefore not included in their calculations.

#### Lower the Rate:

Further TRAC recommends that the Legislature utilize 100 percent of the estimated revenue to be generated (\$614 Million) for a dollar-for-dollar, commensurate, and permanent reduction in the State’s 6 percent sales and use tax rate, which, at 6 percent, as already noted, is one of the highest state sales and use tax rates in the country.<sup>58</sup>

Based on initial (but unofficial) staff estimates, this proposal would lower the State sales and use tax rate from 6 percent to 5.06 percent. TRAC recommends the General Assembly “round down” to the benefit of taxpayers, and as such, set the rate at 5 percent. As noted above, TRAC staff believes its internal revenue estimate could very well be “conservative”, as more than 40 exemptions, or sub items of exemptions, were labeled “to be determined” and therefore not included in the calculations. As such, it is reasonable to expect that the final sales tax rate could fall below 5 percent.

But even at 5 percent, it is important to note that a rate reduction from 6 percent to 5 percent, which is almost a 20 percent reduction, would vastly improve the State’s national sales tax ranking by almost 18 full spots.<sup>59</sup> As such, South Carolina would move from one of the nation’s highest sales tax states, to one of the lowest, greatly enhancing not only the overall fairness of the current structure, but the competitive position of our State as well.

And because the sales tax (not corporate income and/or license tax) is the second largest tax paid by the average business (trailing only property tax), TRAC believes that an objective of

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<sup>57</sup> “TRAC Sales and Use Tax Exemption Recommendations - Draft Revenue Table (of unofficial estimates)”, prepared by Craig H. Parks, MPA, Sr. Research Analyst, SC Senate Finance Committee, for the Tax Realignment Commission, November 2010.

<sup>58</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/SalesandUseTaxExemptionSubcommittee/SCSalesTaxRatesandRankings.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/SalesandUseTaxExemptionSubcommittee/SCSalesTaxRatesandRankings.pdf)

<sup>59</sup> TRAC staff analysis based on state data on state and local sales and use taxation by state, The Tax Foundation (October 16, 2009).

analysis of its recommendations (in totality) regarding broadening the sales tax base and lowering the overall rate will prove of benefit not just to our residents, but to our business community as a whole, as well.<sup>60</sup>

It should also be noted that this rate reduction, while substantial, should move lower still, given TRAC's adoption of its "Services and Intangibles" recommendations. Like this proposal, TRAC recommends that the General Assembly utilize 100 percent of whatever revenue is estimated to be generated by the services/intangibles recommendations for further dollar-for-dollar rate reduction. Note: While we believe this to be a valid assumption, it nevertheless requires Board of Economic Advisors analysis for verification and/or correction.

#### *Further Explanation of Select Exemption Recommendations*

TRAC understands several of its recommendations, particularly those surrounding the tax treatment of what are commonly referred to as "the necessities" will be met with initial skepticism, and unfortunately, in some quarters, outright dismissal with little or no in depth analysis of what TRAC is actually recommending, and why. That said, TRAC was determined to produce meaningful and impactful recommendations for much needed structural change, and, as such, made the necessary (and "tough") decisions regarding these particular exemptions. And in response to ample public testimony, TRAC actually significantly increased the exemption rate for the taxation of all necessities compared to its initial proposal, thereby lowering the overall proposed effective sales tax rate on these items to no more than 1.25 percent (2.95 percent for groceries).

By incorporating these necessities, which are "end retail" sales (at least partially - remember, most of these items retain a 75 percent exemption) into the overall sales tax base allows for a substantial reduction in the overall State sales tax rate. As such, the commission implores the legislature to make these changes. Without these changes it will not be feasible to make the requisite structural changes to our sales tax system, a system that continues to

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<sup>60</sup>[www.scstatehouse.gov/citizensinterestpage/TRAC/093009Meeting/COST2009StudyBusinessTaxBurdensbyState.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/093009Meeting/COST2009StudyBusinessTaxBurdensbyState.pdf)

destabilize from a continual narrowing of the tax base, nor would a significant lowering of the overall sales tax rate be possible. South Carolina can take a leadership position by implementing the thoughtful and reasonable changes proposed by TRAC regarding the taxation of necessities. In contrast to the path taken by North Carolina, who has raised its sales tax rate twice over the last ten years, these changes in South Carolina would allow the General Assembly to lower the 6 percent base sales tax rate and tax residents and businesses more fairly.

### *Specifics*

#### Residential Electricity/Natural Gas

Currently, residential electricity and natural gas is exempt from sales and use tax liability in South Carolina, while electricity purchased by business and industry (unless used in a manufacturing or similar ‘input’ process) is taxed at 6 percent.\* TRAC recommends expanding the sales and use tax base to include residential electricity and natural gas purchases. However, sensitive to regressivity concerns, especially regarding our State’s most needy and/or elderly residents, TRAC recommends retaining a 75 percent exemption on residential electricity and natural gas for all residents (regardless of income or age). That equates to an effective sales and use tax rate of no more than an estimated 1.25 percent. It should be noted that this rate is 70 percent less than Georgia (4 percent) and 58 percent less than North Carolina (3 percent).<sup>61</sup> In addition to Georgia and North Carolina, more than 20 other states tax residential electricity and natural gas.<sup>62</sup>

How much will this change cost the average South Carolinian? According to the 2008 Consumer Expenditure Survey compiled by the Bureau of Labor Statistics, the average household (called “consumer unit”), which has 2.5 persons, spent \$1,884 on electricity and natural gas combined in 2008. At a sales tax rate of 1.25 percent, that’s a state sales tax liability of \$23.55 per household per year, or \$9.42 per person. That equates to an average sales tax liability of \$0.79 per month, per person. This estimate is similar to data from SCANA. In 2009,

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<sup>61</sup> Based on analysis of data obtained from the Federation of Tax Administrators ([www.taxadmin.org](http://www.taxadmin.org)).

<sup>62</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/SalesandUseTaxExemptionSubcommittee/SalesTaxapplicabilitytoCertainItems50StateComparisonNew.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/SalesandUseTaxExemptionSubcommittee/SalesTaxapplicabilitytoCertainItems50StateComparisonNew.pdf)

the average SCANA customer had an annual natural gas bill of \$647. The average electric bill for the latest “test period” was \$1,551. Summing these two estimates and multiplying by 1.25 percent yields a state sales tax liability of \$27.48 per customer per year, or \$10.99 per person. That equates to \$0.92 per month, per person. (This of course, does not factor any “offset” (e.g. “tax savings”) from lowering the overall tax rate on all other non-exempt purchases)).

\*Note: Because TRAC’s proposal is to lower the State’s overall sales and use tax rate, the current 6 percent sales tax due on business purchases of these commodities would be reduced by almost 20 percent under this proposal, as the overall rate is expected to drop from 6 percent to approximately 5 percent.

### Water

Similar to residential electricity and natural gas, water is currently exempt from sales tax in South Carolina. Currently, 12 states impose a tax on water sales at an average rate of 4.98 percent.<sup>63</sup> Sensitive to regressivity concerns, especially regarding our State’s most needy and/or elderly residents, TRAC recommends retaining a 75 percent exemption on water, yielding an effective sales and use tax rate of no more than an estimated 1.25 percent on such purchases; a rate 75 percent less than the average state currently taxing water.

How much will this change cost the average South Carolinian? According to the 2008 Consumer Expenditure Survey compiled by the Bureau of Labor Statistics, the average household (called “consumer unit”), which has 2.5 persons, spent \$446 on “water and other public services” in 2008. At a sales tax rate of 1.25 percent, that is a state sales tax liability of no more than \$5.58 per household per year, or \$2.23 per person. That equates to \$0.19 per month, per person. (This of course, does not factor any “offset” (e.g. “tax savings”) from lowering the overall tax rate on all other non-exempt purchases)).

### Prescription medicines

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<sup>63</sup>[www.scstatehouse.gov/citizensinterestpage/TRAC/SalesandUseTaxExemptionSubcommittee/SalesTaxapplicabilitytoCertainItems50StateComparisonNew.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/SalesandUseTaxExemptionSubcommittee/SalesTaxapplicabilitytoCertainItems50StateComparisonNew.pdf)

Currently, prescription medicines purchased at a retail pharmacy are exempt from sales tax liability in South Carolina. TRAC recommends:

Retaining the full exemption for prescription medicines bought at a retail pharmacy by Medicaid and Medicare beneficiaries;

Retaining the full exemption for certain medicines sold directly to medical providers for treatment of cancer, lymphoma, leukemia (and related diseases), rheumatoid arthritis, respiratory syncytial virus, viscosupplementation therapies, and medicines sold to Nursing Homes for use by Medicare Part-A patients. The General Assembly specifically enumerated these exemptions and in TRAC's final analysis recommends that they be retained. Note: Medicines sold directly to medical providers but not currently exempt would remain taxable under this proposal but would benefit from an almost 20 percent tax savings compared to current law as the overall sales and use tax rate will drop from 6 percent to approximately 5 percent;

Retaining the full exemption for free samples of prescription medicine distributed by its manufacturer;

Retaining the full exemption for medicine donated by its manufacturer to a public institution of higher education for research or for the treatment of indigent patients;

Retaining the full exemption for prescription medicine sold to health care clinics and/or charitable hospitals where medical care is given free of charge to all its patients (e.g., "free clinics");

Retaining a 75 percent exemption on prescription medicines bought at a retail pharmacy by non Medicaid and Medicare beneficiaries. As such, 25 percent of the gross proceeds of the sale of such prescriptions to non Medicaid/care beneficiaries would be taxable. This equates to an effective sales tax rate of no more than 1.25 percent. In addition to the sensitivity TRAC has shown to issues of regressivity by maintaining full exemption for Medicaid and Medicare beneficiaries, and by imposing an effective sales tax rate that is 80 percent less than the State's current 6 percent sales tax rate, TRAC is still concerned about potential excessive sales tax burdens on residents with chronic and costly conditions. As such, TRAC also recommends a "maximum" sales tax liability on total prescription drug purchases of \$100 per person (\$8.33 month maximum liability) annually. Residents with annual sales tax liability on prescription

drug purchases of more than \$100 would be entitled to, and would receive, a full rebate for any sales tax paid over \$100. The rebate would be in the form of a refundable income tax credit and would be available to all residents regardless of income tax liability. Even residents with no income tax liability would be able to file for, and receive, their refund for sales taxes paid over \$100. Note: At a sales tax rate of 1.25 percent, a resident would have to spend \$8,000 on prescription drugs per year to reach the \$100 cap.

How much will this change cost the average non-Medicare or Medicaid South Carolinian? According to a May 2010 publication by the Henry J. Kaiser Family Foundation titled “Prescription Drug Trends”, the average retail price of prescription drugs was \$71.69 in 2008, but that estimate is before discounts and rebates that, in effect, lower the cost of prescriptions. In 2009, the average number of retail prescriptions purchased per capita was 12.6 per year. At roughly \$70 per month multiplied by a sales tax rate of 1.25 percent yields an average state sales tax liability of just \$0.88 cents per month. For comparative purposes, TRAC staff also analyzed data from the “State Health Plan” (SHP) - the plan which covers 373,000 state government workers and retirees. In 2009, the plan and its participants paid a total of \$575 Million for prescription drug purchases. Based on 373,000 covered lives, that is an average expenditure on prescription drugs of approximately \$1,500 per year. At 1.25 percent sales tax, that equates to roughly \$1.56 per month in sales tax liability for the average SHP beneficiary. (This of course, does not factor any “offset” (e.g. “tax savings”) from lowering the overall tax rate on all other non-exempt purchases)).

TRAC staff also analyzed how many South Carolinians would be impacted by, and therefore benefit from, the proposed maximum tax of \$100 annually. Based on data from both the SHP and the State’s Medicaid program which insures more than 600,000 residents statewide, staff estimates that only between 0.6 percent and 1 percent of the State’s 4.5 Million population would meet or exceed the “cap”. That is between 2,700 and 4,500 South Carolinians that will benefit from the sensitivity of this proposal.

### Groceries



TRAC recommends partial restoration of a “grocery tax”, but sensitive to regressivity concerns, especially regarding our State’s most needy and/or elderly residents, TRAC recommends retaining a 41 percent exemption on grocery sales. Based on an expected sales tax rate of approximately 5 percent yields an effective tax rate on groceries of no more than 2.95 percent, a rate less than the State formally imposed on groceries in the past. In addition, out of deference to concerns for the needy, TRAC recommends that groceries purchased with food stamp benefits (now referred to a “Supplemental Nutrition Assistance Program” (SNAP)) remain fully exempt. It should be noted that of the 14 states that currently tax groceries, the average tax rate in those states is 3.79 percent. Of the 7 states that tax groceries at lower sales tax rates than their state’s general rate, the average is 2.6 percent, making TRAC’s proposal very much in line with tax policy in peer states that tax groceries.<sup>64</sup>

### Car Tax Cap

South Carolina’s \$300 maximum sales tax cap on motor vehicle purchases is truly unique among the 50 states. The cap, entirely appropriate and necessary in 1984, 26 years later, represents one of the most regressive aspects of the State’s entire sales and use tax code today.

As case in point, a resident purchasing a \$6,000 car pays an effective sales tax rate of 5 percent - a rate that is 10 times HIGHER than a resident buying a car that costs \$56,000, whose effective tax rate in South Carolina is just 0.54 percent - a tax rate 10 times less on a car that costs 10 times more.<sup>65</sup> That is the definition of a regressive tax. TRAC therefore recommends repeal of South Carolina’s outdated and regressive sales tax cap on cars. However, sensitive to the current economic climate, and desiring the state’s residents and automobile dealers ample time to adjust to this necessary change, TRAC recommends a gradual increase in the current cap over a period of years, as follows:

July 1, 2011: \$600 cap

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<sup>64</sup> “Which States Tax the Sale of Food for Home Consumption in 2009?”, Center for Budget and Policy Priorities, November 4, 2009.

<sup>65</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/SalesandUseTaxExemptionSubcommittee/CarTaxcomparisonforSCNCGAr elatedinformation.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/SalesandUseTaxExemptionSubcommittee/CarTaxcomparisonforSCNCGAr elatedinformation.pdf)

July 1, 2012: \$1,000 cap

July 1, 2013: \$1,200 cap

July 1, 2014: No cap

### Dealer Tags

TRAC recommends repealing the sales tax exemption for cars with “dealer tags”. Today there are approximately 3,300 dealers in the state, but currently over 18,000 dealer tags; the number of dealer tags has reached nearly as high as 22,000 in the last 5 years. That equates to roughly 5.56 dealer tags per dealership.<sup>66</sup> As more cars are sold, a dealer is allocated new dealer tags to repeat this process. It is interesting to note the ratio of used versus new car dealerships in the state of South Carolina versus the state of California. South Carolina has a ratio of approximately 8.77 used/new car dealerships (2500/285 used/new).<sup>67</sup> Compare that to California which has a ratio 4.61 used/new car dealerships (6785/1470 used/new).<sup>68</sup> This ratio is important because a major area of concern is individuals setting up so called “straw dealerships”, which are used car dealerships that meet minimum legal requirements, but do not have the legitimate intention to competitively enter the business of selling used vehicles (and avoid licensing difficulties of working with new car manufacturers). These straw dealerships are easy to set up because of minimum legal requirements, so the dealerships and the subsequent dealer tags granted provide a great mechanism for creating sales tax shields.

### Banking Exemption

TRAC recommends repealing the sales tax exemption for banks. Banks are defined as any person “engaged in a banking business, whether incorporated under the laws of this State, any other state or the United States or whether unincorporated, except cash depositories.” This definition is generally viewed as being limited to persons who are regulated by federal or state banking regulators. Banks are exempt from South Carolina income taxes, however, SC Code Title 12, Chapter 11, imposes a franchise tax based upon the “entire net income” of banks. The

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<sup>66</sup> South Carolina Dept. of Motor Vehicles: <http://www.scdmvonline.com>.

<sup>67</sup> *Id.*

<sup>68</sup> California Dept. of Motor Vehicles: [www.dmv.ca.gov](http://www.dmv.ca.gov).

tax rate is 4.5 percent of the “entire net income” of the bank doing business in South Carolina or from the sales or rentals of property within South Carolina. Although the chapter is entitled “Income Tax on Banks” and several of its sections refer to it as an income tax, this tax has always been considered a franchise tax based upon net book income. Banks are not subject to any taxes in South Carolina except this tax, use taxes, deed recording fees, and property taxes on real property. The State’s sales tax base should be broadened by removing the sales tax exemption for banks.

#### Savings and Loan Association Exemption

TRAC recommends repealing the sales tax exemption for savings and loans. A savings and loan association includes any mutual or stock-chartered corporation insured by the Federal Savings and Loan Insurance Corporation or any corporation subject to regulatory supervision by the Federal Home Loan Bank, or the Savings and Loan Division of the South Carolina Board of Financial Institutions, other than banks taxed under Chapter 11 of Title 12 of the SC Code, or employees’ credit unions. Associations are exempt from South Carolina’s corporate income tax. However, SC Code Chapter 13 of Title 12 imposes an income tax (not a franchise tax) on associations. The tax rate is 6 percent of the net income from all sources, except for income from municipal, state, or federal bonds or securities exempted by law from the tax, including interest earned on deposits at the Federal Home Loan Bank of Atlanta, or its successors, for those savings and loan associations which meet the qualified thrift lender test set forth in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (Public Law 101-73), as amended. Associations are exempt from this tax for the first three years of their operation. This savings and loan income tax is imposed in lieu of all other taxes on associations, except use taxes, deed recording fees, and property taxes on real property.

#### Vendor discounts for Retailers

While many states no longer allow for this type of tax discount, TRAC does not recommend a total repeal of the discount (as described in greater detail above), but instead recommends lowering the percent discount from 2 percent to 1 percent, and the maximum

discount from \$3,100 per retailer to \$1,000 (or \$1,500 filing electronically).<sup>69</sup> When accounting and funds tracking were done manually as opposed to electronically, this incentive made greater sense so as to encourage and ensure the timely collection of funds. However, due the highly automated nature of data processing available today as compared to even 1990, this tax incentive no longer serves as necessary a purpose.

### Tobacco, Beer and Wine, and Alcoholic Beverages Discounts

While TRAC does not make specific recommendations regarding the repeal or amendment of these specific discounts (described in greater detail above) as it does with the Retailer discount, TRAC nevertheless encourages the Legislature to thoroughly examine these discounts for possible repeal or amendment for reasons similar to those noted above concerning the Retailer discount. Regarding the discount for Tobacco wholesalers specifically, it should be noted that, now that the State's cigarette tax has risen from seven to fifty-seven cents per pack, tobacco wholesalers stand to gain a \$4 million increase in tax discounts (\$4.8 million now versus \$800,000 previously). Wholesalers and distributors get to keep the prepayment discount on the increased tax collections because of what could simply be an oversight of the legislature to correspondingly amend the code relating to tobacco wholesaler tax discounts.<sup>70</sup>

### “Back to School” Sales Tax Holiday

Today, only 18 states, including South Carolina, conduct a “back to school” sales tax holiday.<sup>71</sup> However, TRAC does not seek to eliminate the sales tax holiday as other states like Georgia have done. Instead, TRAC seeks to narrow the current exemption to only items that would be properly used for educational purposes in order to allow the sales tax holiday to be applied in its originally intended form. Under current law, items such as wedding dresses and electronics that could be used for non-educational purposes are exempt. In addition, office supplies were given a blanket exemption that allowed businesses to take advantage of the holiday

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<sup>69</sup> CCH Tax Law Editors, *2010 State Tax Handbook* (2010).

<sup>70</sup> John O'Connor, *New law gives tobacco wholesales extra \$4 million*, The State (South Carolina), June 30<sup>th</sup> 2010 at <http://www.thestate.com/2010/06/30/1357064/new-law-gives-tobacco-wholesalers.html>

<sup>71</sup> “2010 State Sales Tax Holidays (50 state analysis)”, Federation of Tax Administrators, 2010.

despite the fact that purchases were not related to education. Therefore, TRAC recommends that the current sales tax holiday for back to school be amended to only include school supplies and outer wear garments (pants, shorts, shirts) (and not, e.g., wedding dresses or towels) purchased for students in grade K-12 (and not, e.g., law firms).

## **TRAC SALES AND USE TAX EXEMPTION RECOMMENDATIONS - SECTION BY SECTION SUMMARY**

Below is a brief summary of each of the recommended changes by TRAC to the State's numerous sales and use tax exemptions. The draft statutory mark up of the changes can be found in the appendix to the Sales and Use tax section of this report.

### 1. State Vendors

Adds new code section 11-35-XXX.

All affiliates of state vendors must collect and remit sales taxes on sales made (typically through the internet) to state residents.

### 2. Services and Intangibles

Modifies code section 12-36-60.

Adds certain services (see TRAC recommendations regarding services taxation) and data processing, software delivered over the internet, and digital products (e.g., music, books and movies) to the list of intangibles subject to the sales tax.

### 3. Attributional Nexus

Adds new code section 12-36-71.

Adds "Amazon" attributional nexus provision. Any out of state retailer with sales to South Carolina residents in excess of \$10,000 a year, who has a contractual agreement with a South Carolina resident to refer business, is subject to sales tax.

4. Attributional Nexus

Modifies code section 12-36-80.

Requires affiliates of companies with “bricks and mortar” in this state (i.e. stores physically located in South Carolina) to collect sales taxes on sales over the internet.

5. Gross Proceeds

Modifies code section 12-36-90.

Adds installation charges to sales tax base; repeals exemption for motor vehicles with dealer tags.

6. Definition of “Retail Sale”

Modifies code section 12-36-110.

Repeals exemption for automobiles with dealer tags as well as cores, labels and sacks.

7. Definition of “Sales Price”

Modifies code section 12-36-130.

Adds installation charges accompanying the sales of goods to the sales tax base.

8. Advertising Materials

Modifies section 12-36-140.

Repeals exemptions for direct mail promotional advertising materials.

9. Definition of “Computer Software”

Adds new code section 12-36-160.

This section defines the types of computer software are taxable. Eliminates the current distinctions among canned versus custom and other delivery methods. Uses definitions from the Simplified Sales and Use Tax Act (SSUTA).

10. Definition of “Digital Goods”

Adds new code section 12-36-170.

This section details the types of digital goods are taxable. Uses definitions of digital audio-visual works, digital audio works and digital books from the SSUTA.

11. Definition of “Data Processing”

Adds new code section 12-36-180.

This section details the types of digital goods that would be taxable.

12. Sales Tax Rate

Modifies code section 12-36-910.

Repeals 5 cent sales tax rate (new lower rate to be inserted when BEA scores the bill).

Adds computer software, digital goods and data processing. Repeals exemption for data processing.

13. Additional One Cent Sales Tax

Modifies code section 12-36-1110.

Repeals exemption for additional one cent tax for items subject to sales tax cap and for unprepared food.

14. Use Tax

Modifies code section 12-36-1310.

Adds computer software, digital goods, and data processing to general the list of items subject to the use tax. Lowers the use tax rate (lower rate to be determined when BEA scores the bill).

15. Attributional Nexus

Modifies code section 12-36-1340.

Persons soliciting through independent contractors are required to obtain a sales tax license.

16. Sales Tax Cap

Modifies code section 12-36-2110.

In Section 1 the sales tax cap is increased from \$300 to \$600 in 2011; \$1000 in 2012, and \$1,200 in 2013; repeals sales tax cap on sales of light construction equipment, firefighting equipment (included in vehicle no longer under cap) and manufactured housing; imposes cap on railroad cars vessels and barges.

Note: In Section 2 the caps for motor vehicles and motorcycles are repealed in 2014.

17. Exemptions From Sales Tax

Modifies code section 12-36-2120.

(2) Repeals the exemptions for sales to the federal government.

(3) Amends exemption related to publications and on-line access used in a course of study in all schools or for students use in the library to clarify that the exemption also applies to transactions relating to transmission of voice or messages.

(5) The sales tax exemption for feed used for the production of poultry and livestock is deleted in (4) and re-codified in (6).

(6) The agricultural sales tax exemption is amended to add feed (from (4)) and fuel and to clarify the exemption applies to livestock “for sale”.

(7)The sales tax exemption for containers and labels used for agricultural purposes is repealed.

(8) The sales tax exemption for the retail sales of newspapers is repealed.

(9) The sales tax exemption for the sale of fuel to manufacturers is amended to include recycling.

(11) The exemption for toll charges and telegraph messages is repealed except for call centers with 250 or more employees at a single cite.



- (12) The exemptions for water sold by public utilities and certain non-profit corporations are repealed and sales are made subject to the sales tax rate on 25 percent of the gross proceeds of sales. (This will equate to a sales tax rate of roughly 1.25 percent.)
- (14) The exemption for wrapping paper and containers is repealed.
- (17) Obsolete provisions relating to recycling machines are repealed
- (18) The exemption for fuel used to cure agricultural products is repealed (and codified in (6)).
- (19) The exemption for electricity sold to manufacturers is amended to include recyclers and the exemption for cotton gins is repealed (and re-codified in (6)).
- (20) The exemption for locomotives and railroad cars is repealed (and made subject to sales tax cap in 12-6-2110(A)).
- (21) The exemption for barges and vessels of more than fifty tons is repealed (and made subject to sales tax cap).
- (23) The exemption for farm products sold by producers is repealed.
- (25) The exemption for sales of motor vehicles to non-resident members of the armed forces is repealed (and made consistent with sales to members of the armed forces that are actually residents of South Carolina).
- (26) The exemption for sales of supplies, machinery and electricity to television, cable television stations, and radio stations is repealed.
- (27) The exemption for sales of plants and animals to public zoos and gardens is repealed.
- (28) Amends the current exemptions relating to prescription medicines but retains the full exemption for prescription medicines bought at a retail pharmacy by Medicaid and Medicare beneficiaries; medicines used to treat specific diseases such as cancer (and others already enumerated in statute); free samples of prescription medicine distributed by its manufacturer; medicine donated by its manufacturer to a public institution of higher education for research or for the treatment of indigent patients; medicine sold to health care clinics and/or charitable hospitals where medical care is

given free of charge to all its patients and retains a 75 percent exemption on prescription medicines bought at a retail pharmacy by non- Medicaid and Medicare beneficiaries. As such, 25 percent of the gross proceeds of the sale of such prescriptions to non Medicaid/care beneficiaries would be taxable. That equates to an effective sales tax rate of no more than 1.25 percent. For these retail purchases subject to sales tax, TRAC is recommending a maximum liability (cap) of \$100 annually.

(29) This federal government exemption is repealed similar to item 2.

(31) The exemption for vacation time share plans is repealed.

(32) The exemption for fuel and electricity used for agricultural purposes is repealed and re-codified in (6).

(33) The complete exemption for sales of electricity for residential purposes is repealed and is made subject to the sales tax rate on 25 percent of the gross proceeds of sales. (This will equate to a sales tax rate of roughly 1.25 percent)

(34) The fifty percent exemption for modular homes is amended to include manufactured housing.

(38) The exemption for sales of hearing aids is repealed.

(39) The exemption for sales made by certain festivals is repealed.

(40) The exemption for sales of containers made to international shipping lines with contracts with the SCSPA is repealed.

(41) The exemption for sales by non-profit gift shops is repealed.

(43) The exemptions for sales to “motion picture companies” are repealed.

(44) The exemption for electricity used to irrigate crops is repealed (and re-codified in (6)).

(45) The exemption for building supplies used to construct housing for chicken coops and livestock is repealed.

(47) The exemption for all sales of tangible personal property to certain hospitals is repealed.

(48) The exemption for sales of solid waste disposal bags is repealed.

- (49) The exemption for postage purchased by direct mail advertising agencies is repealed.
- (50) The various exemptions for recycling property are repealed (and partially re-codified in (9)).
- (51) The minimum capital investment required for the material handling exemption is clarified to require the minimal capital investment to be made at a single site.
- (53) The exemption for motor vehicle extended service and warranty contracts is repealed.
- (54) The exemption for clothing used in Class 100 clean rooms is repealed.
- (55) The exemption for audiovisual masters is repealed.
- (57) The sales tax holiday for school supplies is amended to only include school supplies and outer wear garments (pants, shorts, shirts) (and not, e.g., wedding dresses or towels) purchased for students in grade K-12 (and not, e.g., law firms).
- (58) The exemption for direct mail promotional materials is repealed.
- (59) An obsolete exemption for facilities for transmitting electricity is repealed.
- (63) The exemption for medicines and supplies sold to healthcare clinics which provide services without charge is broadened to include charitable hospitals.
- (64) The exemption for sales of sweet grass baskets is repealed.
- (68) The exemption for sheriff's sales is repealed.
- (70) The exemption for sales of gold or bullion is repealed.
- (71) The exemption for machinery and equipment for hydrogen fuel cells is repealed.
- (72) The exemption for building materials used in Research Districts is repealed.
- (74) The exemptions for sales of durable medical equipment and prosthetic devices are made subject to the sales tax rate on 50 percent of the gross proceeds of sales. (This will equate to a sales tax rate of roughly 2.5 percent or lower.)
- (75) The exemption for the sales of unprepared food is repealed and is made subject to a sales tax rate on 59 percent of the gross proceeds of sales. Food purchased under the USDA's "Supplemental Nutrition Assistance Program" (SNAP (formerly known as

“food stamps”)) remains fully exempt. (This will equate to a sales tax rate of roughly 2.95 percent on non-SNAP purchases, lower than the effective rate before the exemption was repealed in 2007.)

(76) The sales tax holiday for guns is repealed.

(77) The exemption for energy efficient products which was struck down by the South Carolina Supreme Court is repealed.

18. Discount for timely payment of sales tax by retailers.

Modifies code section 12-36-2610.

Reduces the vendor discount for timely payment of sales taxes from \$3,000 to \$1,000 (mailed returns) and \$3,100 to \$1,500 (electronically filed returns).

19. Sales Tax on Individuals 85 Years or Older

Modifies code section 12-36-2620.

Repeals the general one percent sales tax exemption for persons 85 years and older.

20. ATAX on Persons 85 Years of Age

Modifies code section 12-36-2630.

Repeals the accommodations tax exemption for persons 85 years and older.

21. Sales Tax on Individuals 85 Years or Older

Modifies code section 12-36-2640.

Repeals the casual excise tax exemption for persons 85 years and older.

22. Posting of Sales Tax Discount For Persons 85 and Older

Eliminates code section 12-36-2646.

This provision becomes obsolete with the repeal of the sales tax exemptions for persons 85 and older.

23. Sales Tax on Savings and Loans

Modifies code section 12-11-30.

Repeals the sales tax exemption for savings and loans.

24. Sales Tax on Banks

Modifies code section 12-13-50.

Repeals the sales tax exemption for banks.

25. South Carolina Research Authority

Modifies code section 13-17-90.

Repeals the sales tax exemption for the SCRA (conforms the SCRA to other state and local governments which are required to pay sales taxes).

26. Life and Accident Health Insurance Guaranty Fund

Modifies code section 38-29-150.

Repeals the sales tax exemption for the Life and Accident Health Insurance Guaranty Fund (conforms the Fund to other state agencies).

27. Property and Casualty Insurance Guaranty Fund

Modifies code section 38-31-130.

Repeals the sales tax exemption for Property and Casualty Insurance Guaranty Fund (conforms the fund to other state agencies).

28. Regional Health Service Districts

Modifies code section 44-7-2120.

Repeals the sales tax exemption for Regional Health Services Districts (conforms districts to other hospitals).

**TEMPORARY PROVISOS**

29. 2nd Amendment Sales Tax Holiday

Eliminates House Bill 4567, Part IB, Section 89, Proviso 89.107.

Repeals the Second Amendment Sales Tax Holiday.

30. Private Schools Use Tax Exemption

Eliminates House Bill 4657, Part IB, Section 89, Proviso 89.47.

Repeals the use tax exemption for private schools.

### **Taxation of Services, Generally**

There has been a distinct and fundamental shift in the nation's (and South Carolina's) personal consumption patterns that have seen our economy move away from a "goods" based to a "services" based economy.

As evidence, in 1947, 61 percent of the nation's personal consumption was on tangible goods. By 2007, that percentage had fallen to just 34 percent.<sup>72</sup> In contrast, services share of personal consumption was just 39 percent in 1947. By 2007, that percentage had grown to 66 percent - a complete, and fundamental, "shift" in economic behavior.

Similarly, when measured as a share of the State's portion of Gross Domestic Product (GDP), in 1963, services, as a percentage of private industry output, comprised 48 percent, with the goods sector at 52 percent. By 2008, the certainty of the shift noted above was apparent, with services comprising 75 percent and goods falling to 25 percent, a 50 percentage point swing.<sup>73</sup>

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<sup>72</sup> Data compiled by the South Carolina Department of Commerce's Research Division from data from the U.S. Department of Commerce's Bureau of Economic Analysis (US BEA). According to the US BEA, "personal consumption expenditures" is the primary measure of consumer spending on goods and services in the U.S. economy, accounting for roughly two-thirds of "domestic final spending". As such, consumer spending is the primary engine that drives future economic growth. This fact, coupled with the fact that, as noted in the report, there has been a fundamental shift in consumer spending to services and away from goods, creates an imperative for the General Assembly to update the State's tax code to reflect this shift.

<sup>73</sup> Gross Domestic Product by State (millions of dollars), as a percentage of private industry output. Data compiled by the South Carolina Department of Commerce's Research Division from data from the U.S. Department of Commerce's Bureau of Economic Analysis (US BEA).

However, most states, including South Carolina, have failed to adapt their tax structures to this distinct structural shift in economic activity, and as such, impose their state's sales tax on relatively few services. What results is a narrow tax base with a tax rate that is higher than it otherwise would (and should) be.

Specifically, in South Carolina, of the 168 services that the Federation of Tax Administrators has identified as taxable, South Carolina taxes 35, or just 20 percent of all services that are potentially taxable. The national average is 57.<sup>74</sup>

By category, South Carolina taxes the following services:

Utilities	4
Personal Services	6
Business Services	7
Computer Services	4
Admissions/Amusements	10
Professional Services	0
Fabrication/Repair/Installation	1
"Other" Services	<u>3</u>
SC Total	35
National Average	57

A key component of TRAC's "assessment criteria" adopted by the commission involves tax "equity" (same as fairness). A broader tax base with few(er) exemptions promotes a fairer system and a lower rate. Taxing additional services also helps to offset, but does not completely eliminate, the otherwise regressive nature of a sales tax structure where few services are generally taxed.<sup>75</sup>

It should be noted that South Carolina's inability, not unlike many states, to tax an adequate number of services, is not necessarily a derivative of conscious decisions to exempt services by legislators, rather, a more plausible explanation relates to the "timing" of when states began enacting sales taxes, which began in earnest in the 1930's (South Carolina, as noted above

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<sup>74</sup> 2007 Update, released in July 2008, of the Federation of Tax Administrators survey of "Services Taxation".

<sup>75</sup> "Should Sales Taxes Apply to Services?", Policy Brief #3, Institute on Taxation and Economic Policy, 2008.

enacted its sales tax in 1951).<sup>76</sup> That is to say, as demonstrated above, services as we know them today, simply did not exist 50, 60, and/or 70 years ago.

### **Taxation of Services, Recommendations**

In making the difficult but necessary determinations regarding what additional services TRAC proposes to include in the tax base, a key consideration was to avoid, where possible, taxing “business to business” transactions such as legal and accounting services. Commonly referred to as “tax pyramiding”, taxing such services (or any “business to business” transaction) at the business, or input level, will lead to taxes being stacked upon taxes, where the final retail sale (which is transparent to the taxpayer) may also contain more “hidden” taxes - those taxes that result from imposing the tax at the business level.

While TRAC had a goal to “steer clear” where possible of taxing so called business to business services as described above, that otherwise worthy goal somewhat narrowed the list of what TRAC could consider incorporating into the tax base. Despite this, TRAC still sought to impose the tax on an arrayed number of services to both provide for a sufficient and meaningful broadening of the base to help TRAC’s overall goal of lowering the overall base sales tax rate from 6 percent to a commensurately lower amount (According to Mazerov, South Carolina is potentially exempting almost \$1 Billion of what he refers to as “feasibly-taxable” services; e.g., all services excluding housing, health care, education, legal, insurance, etc.) and to ensure that no one industry was “singled out” for taxation while other and/or similar industries or services remained exempt from tax. This is particularly important given a recent South Carolina Supreme Court case (2003) narrowly decided in the State’s favor regarding how the State currently taxes (and does not tax) services (see the end of this section for a summary of *Ed Robinson Laundry and Dry Cleaning, Inc. v. South Carolina Dept. of Revenue*).

As such, after careful consideration of the above factors, and after a meticulous review of both regional and national state level sales and use taxation of services, TRAC proposes taxing the additional services listed (in summary form) below.

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<sup>76</sup> “Should Sales Taxes Apply to Services?”, Policy Brief #3, Institute on Taxation and Economic Policy, 2008.



Note: For a more detailed description of, or definition for, each proposed change, refer to the appendix attached to the Sales and Use tax portion of TRAC's report. As with its exemption recommendations, TRAC recommends that 100 percent of any revenue that may be generated by taxing additional services should be used by the Legislature (as by TRAC), for dollar for dollar (commensurate) rate reduction.

(a.) Services:

i) Personal Care:

- (1) Salons, Hair Care, and Nail Care Services:
- (2) Day Spa Services – Facials, Makeovers, etc
- (3) Exercise Facility Providers
- (4) Massage
- (5) Tanning Facilities
- (6) Weight Loss Salons and Weight Counselors
- (7) Piercing:
- (8) Tattooing
- (9) Photo Finishing
- (10) Residential and Commercial Cleaning, Maintenance, and Repairs
  - Windows
  - Commercial Janitorial Services
  - Furniture and Upholstery Cleaning, Repair and Refinishing
  - Swimming Pool and Hot Tub Cleaning and Repair
  - Climate Control System or Infrastructure Maintenance and Repair
- (11) Residential and Commercial Property Pest Control and Exterminating
- (12) Professional Security Systems—consulting, installation, and monitoring
- (13) Musical Instrument Repair, Tuning, Refinishing, or Refurbishing
- (14) Pet Grooming and Pet Care
- (15) Garment, Jewelry, or Watch Repairs or Changes
- (16) Sporting Goods Repair, Maintenance, or Custom Fitting and Design (e.g., racket re-stringing, bike, gun repair)

- (17) Transportation or Transport Vehicle Maintenance, Repair, and Towing
- (18) Publishing and Distribution (newspapers and magazines)
- (19) Taxidermy
- (20) Storage
  - Mini-storage
  - Climate Controlled Storage
  - Marina, Aircraft, and Vehicle Storage and Towing
- (21) Commercial Art, Graphic Design, Document Preparation
- (22) Intra-State Transportation
- (23) Miscellaneous Repair, Installation, Labor, and Fabrication
  - Home Appliance Repair
  - Home and commercial entertainment equipment and electronic goods repair
  - Computer repair, hardware upgrading, maintenance
  - Office Equipment

(b.) Intangibles:

i) Digital Goods

The major changes in this area regard taxing digital products and downloadable software. Examples of digital products that would be taxed under this proposal include digital books, music and ringtones. The convenience of purchasing and storing digital media will likely continue to grow at an accelerated pace. This growth will also cannibalize traditional sales of tangible books, music media, and off the shelf software. The taxation of digital forms of these goods will ensure that tax revenues keep pace with changes in the mix of sales of digital and tangible media.

ii) Software

Legislation traditionally limited taxable software on to items that were delivered in tangible form. For instance, computer programs or games bought off of shelves at a brick and mortar retailer would have been one of the few forms of taxable software. Software now comes in an array of different forms, including downloadable software

directly off of the internet. In addition to taxing downloadable software, sales of custom programmed software would be taxable under this proposal.

### iii) Data Processing

Data processing formally means, “the manipulation of information furnished by a customer through all or part of a series of operations involving an interaction of procedures, processes, methods, personnel, and computers.” It also means the electronic transfer of or access to that information. Examples of data processing include, without limitation, summarizing, computing, extracting, storing, retrieving, sorting and sequencing data, and the use of computers to accomplish these tasks. Many of these services have traditionally been exempt. TRAC’s proposal seeks to update current legislation to capture revenue from growth in these service areas.

### iv) Electricity

Electricity, heating oil and natural gas, as well as other fuels for residential use currently receive a full exemption from state and local sales taxes in South Carolina. TRAC proposes a sales tax rate on residential electricity, heating oil natural gas and other energy and heating sources equal to twenty five percent of the new lower base sales tax rate.

### v) Interstate Telephone

Interstate long distance telephone use is currently exempt from sales tax. This proposal seeks to eliminate this sales tax exemption except for commercial “call centers” with more than two hundred and fifty employees.

## Recent Equal Protection Challenge to the Taxation of Services in South Carolina

In an important case appealed in 2003 to the Supreme Court of South Carolina, the court held that particular services could be individually chosen by the state legislature to be required to pay sales taxes on services. *Ed Robinson Laundry and Dry Cleaning, Inc. v. South Carolina Dept. of Revenue*.<sup>77</sup> A taxpayer, a provider of dry cleaning and laundering services, brought action against the State and the Department of Revenue alleging that the Sales and Use Tax Act violated equal protection under the Constitution because the tax on drying cleaning services was not applied equally to all providers of services in South Carolina. The taxpayer argued that exemptions for particular sectors of the service industry had been arbitrarily chosen in favor of some sectors. The taxpayer claimed that as a result of the arbitrary taxation of certain services, drycleaners in particular suffered an unequal and unfair proportion of the sales and use tax burden, violating all drycleaners rights to equal protection under the constitution.<sup>78</sup>

As a result of the business owner's appeal, a majority of the Supreme Court held that because the sales tax applied to drycleaners on a uniform basis, the tax did not violate any equal protection clause. The court further found that although current legislation regarding the taxation of services included 60 *specific* sales tax exemptions, those exemptions did not render the current legislation as arbitrary or discriminatory.

There was a stern dissent by the other two presiding judges, including current Chief Justice Toal. The judges argued that the legislature's ability to arbitrarily impose taxes on hand-chosen service industries was "tyrannical" and "capricious" in nature. The justices agreed with the taxpayer that the *ad hoc* singling out of certain service industries by the legislature violated equal protection, quoting *City of Laurens v. Anderson* which emphasized two tests:

"for a law to be deemed constitutional, it 'must possess two indispensable qualities: first, it must be framed as to so extend to and embrace equally all

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<sup>77</sup> *Ed Robinson Laundry and Dry Cleaning, Inc. v. South Carolina Dept. of Revenue*, 356 S.C. 120, 588 S.E.2d 97 (2003).

<sup>78</sup> *Id.* at 122-4.

persons who are or may be in the like situation and circumstances; and secondly, the classification must be natural and reasonable, not arbitrary and capricious.”<sup>79</sup>

Regarding the first prong of this test the dissent highlighted the fact that 61 other service industries received special, and in their opinion, discriminatory exemptions. The dissent saw no fair reason that dry cleaners as service providers should be taxed when other service providers were not. Regarding the second prong, the court found it equally egregious that the legislature could handpick which service industries to tax without any criteria or guidance.<sup>80</sup> The list of specific exemptions referred to in the *Robinson* case has actually been expanded since the ruling in *Robinson* from 61 to 77 currently.<sup>81</sup>

### **E-commerce/Internet Sales, Findings and Recommendations**

#### **The “Main Street Fairness Act” and South Carolina**

On July 1st, 2010, Federal Legislation commonly known as the “Main Street Fairness Act” was introduced under H.R. 5660. This act is important because it would allow states to tax internet sales by adopting federal congressional law if passed. As previously noted, “e-commerce” is an ever growing preference of commerce by both individuals and businesses alike. But due to reasons described in greater detail below, states (including South Carolina) have not found an effective way to collect sales tax on otherwise taxable items (taxes that would have been remitted had the purchase been made a local brick and mortar retailer). According to Bill Fox, Ph.D. from the University of Tennessee and noted expert on internet sales, between 2007 and 2012, South Carolina will have likely lost \$569 Million in state and local sales tax revenue from otherwise taxable e-commerce purchases. Nationally, that figure is an astonishing \$52 Billion.<sup>82</sup>

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<sup>79</sup> *Id.* at 128-29 (C.J., Toal, dissenting) (quoting [City of Laurens v. Anderson, 75 S.C. 62, 64, 55 S.E. 136, 137 \(1906\)](#))).

<sup>80</sup> *Id.* at 101-02

<sup>81</sup> [S.C. Code Ann. § 12-36-2120](#).

<sup>82</sup> “State and Local Government Sales Tax Revenue Losses from Electronic Commerce” (summary and revenue tables), Bruce, Fox and Luna, University of Tennessee, April 13, 2009.

These revenues go uncollected because of complex sales tax rules. Antiquated laws allow online retailers to avoid collecting sales taxes from out of state consumers, and place retailers on local Main Streets at a competitive disadvantage because Main Street vendors must charge a higher price for their goods because of local sales taxes.

For example, consider that a local vendor selling a book, or a shoe, or some other taxable item in a South Carolina county with a 1 percent local option tax, must charge his patron a 7 percent sales tax on those items that the same patron, if willing and able, could very well purchase online, effectively for 7 percent less (assuming the internet vendor does not have “nexus” (term described in greater detail below) with South Carolina. As such, the local merchant faces a real 7 percent disadvantage; conversely, the internet vendor potentially enjoys a 7 percent advantage. Specifically, according to a study conducted by economists at the University of Tennessee:

“Much of the collection problem arises because states are unable to require remote vendors to remit the tax given the nexus restrictions arising from *Quill v. North Dakota*. Perhaps the biggest consequence is that the US economy is harmed as firms change their best business practices to avoid creating a collection responsibility in certain states. For example, [based on the *Quill* decision] firms choose where to locate their sales or warehousing operations to avoid creating nexus rather than locating where they can operate most efficiently. . . . Also, local vendors face a competitive disadvantage as consumers browse in shops on Main Street but then make their purchases online to evade the tax. . . .”<sup>83</sup>

The Main Street Fairness Act provides Congressional authority for this interstate compact to take effect. This does not compel any state to join, but those that choose to adopt this system would then have the authority to require online retailers to collect and remit sales taxes the same way that businesses on local Main Streets do now.

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<sup>83</sup> Donald Bruce, William F. Fox, William B. Stokely and Lena Luna, “State and Local Government Sales Tax Revenue Losses from Electronic Commerce.” (2009).

TRAC recommends that the General Assembly continue to monitor this bill, and similar bills that may be introduced in the future, and that when this bill likely passes in the future that the General Assembly promptly adopts this legislation.

### Establishing Taxability through Nexus

The concept of nexus addresses what types of links must exist between South Carolina consumers and out of state vendors in order to legally establish the taxability of sales transactions. The power and ability to tax foreign companies, some operating under a complex corporate or geographic structures, causes difficulties in exercising taxing authority against out of state retailers due to legal and practical issues (such as collecting and assessing reasonable tax liabilities). The most common ways to establish nexus are discussed in the following sections.

### Location of an Affiliated Retailer within the State

The premise behind this section provides that if a retailer has a physical presence within this state, commonly referred to as “bricks and mortar”, (e.g. a retail store) then any on-line sales to residents by an affiliated internet or catalogue vendor, or alternative distribution channel should also be taxable. For instance, E-Bay has currently begun to license franchises to agents to open retail consignment establishments using the E-Bay trademark. Because E-Bay has a “bricks and mortar” presence through locally franchised agents, its sales would be subject to sales tax liability.

### “Amazon” Statutes

Under this type of statute, largely originating in New York, a seller would be liable for sales tax for property if it enters into a sales agreement with a resident of a particular state. This particular agreement needs to:

- 1) Directly or indirectly refer potential customers to the on-line seller’s product through an internet link, website, or other means of internet communication.
- 2) Gross receipts should exceed a certain amount, for example \$10,000. Otherwise, taxation would be impractical from a cost administration standpoint for both the retailer and state.

If these two conditions are met then the on-line retailer is presumed to be soliciting business through the in-state person or business contact. Previous court rulings from other states hold that physical presence is constituted by ‘click through’ advertisements on smaller websites with an actual presence in the state. In general, if the internet retailer enters into a business agreement whereby an in-state party will provide means for soliciting business for the internet retailer then a taxable sale has taken place (for example the in-state party has a web-site link to the on-line retailer’s website).

As a point of clarification, despite the fact that this type of statute has picked up the term “Amazon” statute, it does not apply strictly to the company Amazon or its exact business model.

#### Vendors Selling to the State of South Carolina through Direct Sales Contracts

Lastly, under TRAC’s sales and use tax exemption proposal as described in detail above, *all* vendors selling goods or services to the State of South Carolina must register with the South Carolina Department of revenue and submit to an agreement to pay state sales and use taxes, except for those which are specifically granted an exemption by statute. Without this statutory change recommended by TRAC, these organizations would remain exempt due to lack of nexus with the state.

Note: As with its exemption recommendations, TRAC recommends that 100 percent of any revenue that may be generated by adopting statutory changes that facilitate greater sales tax collections from internet purchases should be used by the Legislature (as by TRAC), for dollar for dollar (commensurate) sales tax rate reduction.

#### **STREAMLINED SALES AND USE TAX AGREEMENT (SSUTA)**

A matter related to the “e-commerce” discussion above involves the “Streamlined Sales and Use Tax Agreement” (SSUTA). SSUTA represents a multi-state compact agreement



designed for multiple purposes, including a streamlining of what is in a state's sales tax base (what is taxable vs. what is exempt), tax definitions, number of tax rates, etc.<sup>84</sup>

Simplification is one of the major purposes of the Agreement. There are aspects of the Agreement that provide simplification – for example, the provisions concerning identical state and local tax bases and a single state tax rate (as noted above). Such changes, of course, would be helpful whether or not they are done as part of any agreement. However, there are aspects of the Agreement that are complex. Most of these complex provisions concern definitions and the interpretation of such definitions.

Ultimately, the General Assembly must weigh the potential for increased revenue that may be generated (and used, as TRAC would recommend, for base rate reduction) against the complexities of the Agreement and the potential for an effective loss of sovereignty to the Governing Board of SSUTA. Regardless, simplification of the South Carolina sales and use tax is a worthy goal. The number of full member states will likely increase in the near future.

Lastly, according to a recent note published by the Commerce Clearing House which references the July 1st, 2010, Federal Legislation commonly known as the “Main Street Fairness Act,” compliance with this act would boost state sales tax collections because the bill incorporates issues regarding the taxation of internet sales to residents of other states. Adoption of the “Main Street Fairness Act” would:<sup>85</sup>

- Provide for a uniform threshold for gross sales proceeds that would trigger the state's ability to collect sales taxes from internet vendors located outside the state. For instance, a foreign internet vendor selling less than \$10,000 in gross sales to South Carolina residents would not be forced to collect and remit state sales tax if the SSUTA adopted that proposal.

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<sup>84</sup> “The Streamlined Sales and Use Tax Agreement and South Carolina: A Review of the Requirements to Comply and the Agreement's Possible Impact on South Carolina if the General Assembly Amends the State and Local Sales and Use Tax Laws to Comply”, prepared by Handel and McCormack, SC Department of Revenue, August 20, 2007.

<sup>85</sup> CCH Law Editors, *Streamlined Sales Tax Bill Introduced in House*, 71, State Tax Review, July 15, 2010, at 1.

- Provide for uniform and reasonable vendor collections prepayment discounts to vendor's who timely pay and remit sales tax liabilities owed.

### **“Fair Tax”, Generally**

Implementing a state level ‘Fair Tax’ would require elimination of the following state taxes: Income Taxes (Individual and Corporate), Income Tax Withholding, Income Tax on Banks, Income Tax on Savings and Loans, and the Estate Tax.

According to proponents, the purpose of implementing a Fair Tax System is to make state tax systems more simplified and hospitable to economic development while also taxing individuals at an equal level (in terms of rate/percent).

The taxes eliminated would be replaced with a single-rate personal consumption tax. Essentially, this is a sales tax on goods and services.

All goods and services would be taxed once with absolutely no exemptions, exclusions, or maximum tax caps allowed for purchases by South Carolina’s households.

Rebates (or ‘Pre-bates’) are used within the Fair Tax concept to ensure that no individual or family pays tax up to the poverty level based on household size for low-income taxpayers.<sup>86</sup>

### **‘Fair Tax’ Proponents would say**

Proponents of the ‘Fair Tax’ argue that their preferred tax structure offers a more efficient and fair way to collect taxes by broadening the tax base and removing all exemptions. Fair Tax proponents also claim that tax burdens for individuals would be both minimized and equalized. In addition, proponents claim that there would be no net revenue loss (or gain) for state (e.g. “revenue neutral”), at least in the first year. Fair Tax supporters claim their system prevents

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<sup>86</sup> Americans for Fair Taxation, January 2010. *Fair Tax*, Presentation made January 6<sup>th</sup>, 2010 by Jack Johnson to the South Carolina Taxation Realignment Commission.  
<http://www.scstatehouse.gov/citizensinterestpage/TRAC/TRAC.html>

multiple taxation, removes disincentives for business growth by removing the Corporate Income Tax, and allows individuals to take home the majority of their paycheck (if adopted on a state level) with the exception of federally implemented taxes.<sup>87</sup>

#### ‘Fair Tax’ Opponents would say

Those who question the viability of the ‘Fair Tax’ as an alternative to a traditionally balanced tax structure found in most states (like South Carolina), suggest, that to replace revenue lost from the elimination of other taxes, sales tax rates would have to be higher than they are now and often higher than what is claimed to be needed (by Fair Tax proponents) to be revenue neutral. Opponents, while in agreement that states should and need to broaden their tax base to include a larger variety of services and goods, believe the rate needed to generate a revenue neutral system would be hard to obtain without going beyond what would be considered optimal.

Opponents are also quick to note that goods and services that now go untaxed that would be subject to the new tax include health care services (e.g. doctors visits, medical procedures, etc.), legal and accounting services, child care, school tuition, new home sales (including taxation on lumber, land, etc), etc. They note imposition of a high sales tax on these previously untaxed services could cause technical, economic, and political problems. Opponents are also concerned that such a high “consumption tax” (e.g. “sales tax”) could hurt in-state businesses as residents shift purchases to neighboring states or the internet.

Finally, they note that eliminating all taxes but the sales tax could lock the state into its current levels of revenue which are quite low at this point in the economy and that the proposed elimination of income taxes, while no doubt well intended, will benefit the wealthiest of citizens while the rebate will protect the poorer citizens, inevitably causing the middle class to bear the brunt of these taxation changes.<sup>88</sup>

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<sup>87</sup> Americans for Fair Taxation, 2009. [http://www.fairtax.org/site/PageServer?pagename=about\\_main](http://www.fairtax.org/site/PageServer?pagename=about_main)

<sup>88</sup> McNichol, Elizabeth and Nicholas Johnson, September 7, 2010. “FairTax” *Proposals to Replace State Income and Business Taxes With Expanded Sales Tax Would Create Serious Problems*. Center on Budget Policy Priorities, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3285>.

## **Fair Tax, Findings and Recommendations**

### **Findings**

While the Commission believes that there are some positive aspects to the ‘Fair Tax’ concept, there is very little research for TRAC to study the ramifications and benefits of implementing such a tax structure.

South Carolina currently has a well balanced tax structure between income, sales and property taxes. At roughly 40 percent each, income and sales taxes represent a shared portion of the state’s general fund revenue. Entirely eliminating income taxes significantly disrupts this balance and could be considered questionable public finance policy.

Such significant changes could be volatile especially in the current economic climate. Implementing such a tax structure could potentially make South Carolina more susceptible, not less, to the next economic downturn or recession.

The ‘Fair Tax’ elimination of Income Taxes (Individual and Corporate), Income Tax Withholding, Income Tax on Banks, Income Tax on Savings and Loans, and Estate Taxes could cause South Carolina to raise the current sales tax rate to make up for the lost revenues making South Carolina less competitive as the current sales tax rate is one of the higher in the country.

A main focus of the ‘Fair Tax’ ideal is to eliminate all sales tax exemptions. This is a very admirable concept as not all citizens benefit equally, if at all, from some of the current SC sales tax exemptions.

That is why sales tax exemptions have been one of many primary focuses of TRAC. The TRAC Sales and Use Tax Exemption Report eliminates more than \$600 million of sales and use tax exemptions (using these proceeds to lower the overall base sales tax rate).<sup>89</sup>

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<sup>89</sup> June, 29, 2010. TRAC Sales and Use Tax Exemption Subcommittee - Draft Revenue Table (unofficial estimates).\http://www.scstatehouse.gov/citizensinterestpage/TRAC/SalesandUseTaxExemptionSubcommittee/TRACSalesandUseExemptionSubDraftRevenueTable.pdf

As noted in the recommendations TRAC has adopted regarding the State's sales and use tax exemptions, TRAC's recommendations are based on long-term structural reform that will, by broadening the base and lowering the rate, promote revenue stability and most importantly, promote enhanced fairness for both individuals and businesses, who, absent reform, will otherwise face continued pressure from a tax base that continues to narrow.

In its effort to recommend long-term and sustainable structural reform, TRAC makes thoughtful decisions by continuing full exemptions on certain items, imposing substantially lower rates on others, and fully exempting certain segments of the population from tax liability out of a desire to achieve the difficult balance between a system that is fairer for all South Carolinians on the whole, while not overly burdening the most vulnerable portions of the populace.

TRAC has also recommended increasing the number of services currently subject to sales tax in South Carolina, recognizing the distinct and fundamental shift in the nation's (and South Carolina's) personal consumption patterns that have seen our economy move away from a "goods" based to a "services" based economy.

As already noted, TRAC recommends using 100 percent of any additional revenue that may be generated under its services proposal (which broadens the base) to lower the state sales and use tax rate from its current 6 percent (one of the nation's higher rates) to a commensurately lower level. This action, in concert with TRAC's recommendations regarding sales and use tax exemptions as discussed above, have the real opportunity to substantially lower the State's sales tax rate, thereby promoting a fairer, more stable, and more competitive sales tax base and structure.

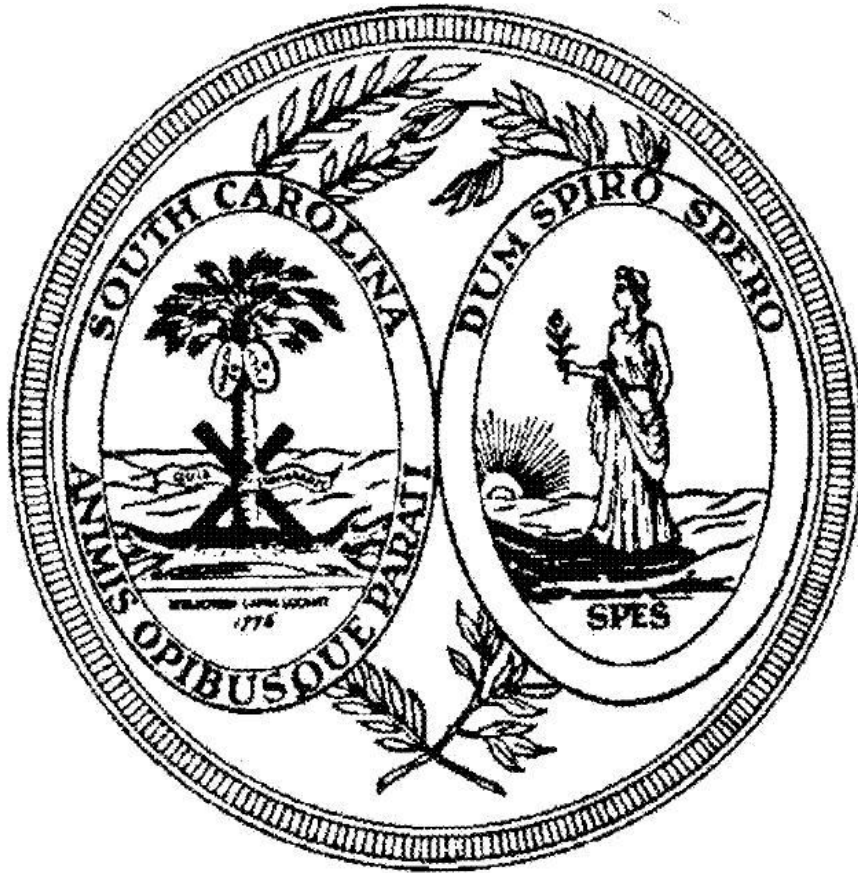
TRAC feels these actions will help make South Carolina's sales tax rate and structure more competitive nationally while also allowing the State to maintain its important balance of revenue streams.

## Recommendation

Simply put, the ‘Fair Tax’ system, while no doubt well intended, has not been adopted by any state and has only been considered by three other states to date (MO, AR, and MI). The lack of research and examples make understanding benefits and drawbacks to the ‘Fair Tax’ problematic and therefore difficult for TRAC to fully recommend during an already unstable economic climate.

As such, The South Carolina Taxation Realignment Commission recommends that the SC Legislature conduct further review and analysis of this concept in order to better understand if this significant structural change would be beneficial to South Carolina, its citizens, and its businesses.

# Individual Income Tax



## South Carolina Taxation Realignment Commission

## **Individual Income Tax, Generally**

Much like the State's sales tax system, South Carolina's individual income tax structure is straining under the burden of a tax base which continues to narrow. As discussed in greater detail below, the ramifications of this reality are not short-lived, but have long-term implications for the ability of the current income tax system to produce sufficient and stable revenues over time.

Enacted in 1921 (in part to replace property tax revenue relinquished to the counties), the individual income tax today is the second largest source of revenue for the State's General Fund, only slightly trailing revenue generated by the State sales and use tax. As such, personal income tax revenue is a crucial component for education as well as health and social services funding.<sup>90</sup> But revenue from this important source is marking its third consecutive year of decline. Individual income tax collections totaled approximately \$2.17 Billion in FY2009-10, an unparalleled drop of more than \$700 Million over the last three years.<sup>91</sup>

This near term and substantial decline in individual income tax revenue, the magnitude of which is attributable, in part, to the recent and protracted economic downturn, is also symptomatic of longer-term structural issues – issues that go deeper than often had cursory discussions about whether a particular rate is too high or too low, or if taxes should be cut or raised.

TRAC is aware that in recent years, policy discussions about the State's individual income tax structure have focused on the State's top marginal individual income tax rate of 7 percent. And while that rate is indeed higher than some states top marginal rates (13 states have higher top marginal rates than South Carolina), TRAC has focused not just on a comparison of top rates, but on "effective" tax rates as well.

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<sup>90</sup> "Personal Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina" prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

<sup>91</sup> Individual income tax collections peaked at \$2.88 Billion in FY2006-07. "Historical Analyses", South Carolina Budget and Control Board, data through October 31, 2009. [www.budget.sc.gov](http://www.budget.sc.gov).



An “effective tax rate” typically refers to the percent of one’s income actually paid in taxes and can differ substantially from “marginal” or “top marginal” rates. According to The Tax Foundation, “Effective rates are typically lower than marginal rates because most tax systems have some forms of deductions, exclusions, credits, (and/or) other adjustments...”.<sup>92</sup> As discussed in greater detail below, South Carolina’s unusually large (as compared to most any other state) level of standard deductions and personal exemptions generally explain why South Carolina has a low tax burden compared to other states (as demonstrated below), even though it has a relatively high top marginal rate.

Ultimately, effective tax rates are what matter most to taxpayers. And in that category South Carolina outperforms almost every other state by comparison. South Carolina’s effective individual income tax rate is 2.8 percent, a rate that is lower than 33 other states.<sup>93</sup>

South Carolina imposes one of the lowest individual income tax burdens on its residents than any state in the nation. Of the 41 states imposing an individual income tax, South Carolina’s average state income tax liability per filer is lower than 35 other states.

Compare that to Georgia whose average tax liability is 46 percent higher than ours. And compare that to North Carolina as well, where the “average” South Carolina taxpayer living in York County, SC pays 70 percent less in income tax than he would as a tax filer living in Mecklenburg County, NC.<sup>94</sup> And that is before factoring into North Carolina’s average tax liability that state’s recent enactment of a 3 percent “surtax” at certain levels of income. A factor

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<sup>92</sup> “Effective tax rate” typically refers to the percent of one’s income actually paid in taxes and can differ substantially from “marginal” or “top marginal” rates. According to The Tax Foundation (as summarized by “Google.com”), “Effective rates are typically lower than marginal rates because most tax systems have some forms of deductions, exclusions, credits, other adjustments, or a progressive marginal tax structure.”

<sup>93</sup> Based on the Board of Economic Advisors (BEA) comprehensive 50 state analysis of individual income tax systems (entitled “State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009”), South Carolina’s effective tax rate is 2.8% (when comparing state individual income tax collections vs. federal adjusted gross income). See page 3 of the above referenced BEA study.

<sup>94</sup> “State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009”, Board of Economic Advisors, August 24, 2009. See Page 10 of full report on TRAC’s website. Note: South Carolina’s average state individual income tax liability is \$1,209 per return. Note: Georgia’s average state individual income tax liability is \$1,763 and North Carolina’s is \$2,057 per return, respectively.

which would undoubtedly enhance South Carolina's distinct tax advantage compared to North Carolina.<sup>95</sup>

As further illustration, at no specific level of income, whether at \$1 or \$1,000,000, do single taxpayers, or married taxpayers, with two children, owe more tax to South Carolina than they would if they earned the same amount of income and lived in North Carolina.<sup>96</sup>

Ten states that have lower top marginal rates than South Carolina actually impose higher average effective rates on taxpayers than South Carolina.<sup>97</sup> Georgia is among those states, with a top marginal rate of 6 percent, but an effective tax rate of 3.5 percent.<sup>98</sup>

In addition, several states with so called "flat taxes" have rates that are lower than South Carolina's top marginal rate, but have effective rates that are higher than South Carolina's. A classic example is Massachusetts, who despite boasting a flat tax, imposes an effective tax rate of 5.3 percent, a rate almost 2 times higher than the effective rate imposed on the average South Carolinian.<sup>99</sup>

Fourteen states impose not only state level income tax, but local income tax as well.<sup>100</sup> Because South Carolina does not permit local income taxes to be levied, our advantage is further enhanced from a competitive national standpoint.

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<sup>95</sup> See [www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/TRACquestionsbearesponse.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/TRACquestionsbearesponse.pdf) for a complete description of the North Carolina surtax referenced in this report.

<sup>96</sup> "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 15 of full report on TRAC's website. As an example, a married couple, filing jointly with two children, and with adjusted gross income of \$1 Million would owe \$75,453 to North Carolina and \$67,504 to South Carolina, a "tax savings" of almost \$8,000 to the South Carolina couple. A South Carolina couple married filing jointly with two children pays less tax than a similarly situated couple from Georgia up until approximately \$150,000 of adjusted gross income. At \$150,000, the South Carolina couple owes just \$128 more in tax than their Georgia counterparts.

<sup>97</sup> "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 3 of full report on TRAC's website.

<sup>98</sup> "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 3 of full report on TRAC's website.

<sup>99</sup> "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 3 of full report on TRAC's website.

<sup>100</sup> "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 4 of full report on TRAC's website.

Based on its thorough and complete analysis, TRAC finds that South Carolina is not a high individual income tax state by any honest and in-depth measure or assessment.

However, our otherwise positive findings do not necessarily suggest certain structural concerns do not exist. These concerns involve the overall fairness of the current income tax system and structure. These concerns relate to the ability of the current system to produce adequate and stable revenues over time. TRAC has identified these concerns and believes that, if addressed, a fairer, more competitive and more stable tax structure for South Carolina will result.

### **Individual Income Tax, Issues, Concerns and Recommendations**

#### **Issue 1: Filers with zero income tax liability.**

TRAC is concerned about the increasing number of South Carolina tax filers with zero individual income tax liability and the issues that surround the sheer magnitude of this reality.

Of the approximately 2.1 million state level individual income tax returns filed in South Carolina each year, more than 870,000, or 41 percent, have zero income tax liability.<sup>101</sup> In fact the growth in the number of South Carolina tax filers with zero individual income tax liability has been dramatic in recent years. Between Tax Year (TY) 1999 and TY2007, the number of total tax returns has grown at a rate of just 1.87 percent per year (a rate roughly mirroring the rate of the State's population growth).<sup>102</sup> That is equivalent to 17 percent growth during that period.

However, growth over that same period of returns filed that owe zero tax increased by 80 percent; a rate of growth of approximately 9 percent per year.<sup>103</sup> That is a ratio of growth between "zero filers" to "total filers" of almost 5 to 1.

It should be noted, however, that, beginning in TY 2007, the bottom income tax bracket (2.5 percent) was eliminated, acting to increase the number of filers with zero individual income

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<sup>101</sup> See [www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/TRACquestionsbearesponse.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/TRACquestionsbearesponse.pdf).

<sup>102</sup> South Carolina Department of Revenue Annual Reports ([www.sctax.org](http://www.sctax.org))

<sup>103</sup> South Carolina Department of Revenue Annual Reports ([www.sctax.org](http://www.sctax.org))

tax liability, thereby increasing the growth rate noted above. Even still, prior to the elimination of the bottom bracket, there was nevertheless a substantial disparity between the growth in number of total returns vs. the growth in zero filers. Specifically, between TY 1999 and TY 2006, the ratio between the growth of zero filers to total filers was almost 3 to 1.

When observed nationally (as based on the volume of federal returns reporting zero income tax liability), South Carolina stands out as well, ranking 6th highest in the country in terms of the number of taxpayers that pay no federal income tax.<sup>104</sup>

This phenomenon has nothing to do with, and is no fault of, taxpayers. Instead, it is a result of the tax system itself. South Carolina, primarily for simplicity, administrative, and taxpayer friendly reasons, adopts “federal taxable income” as its starting point for determining state taxable income.

In contrast, most states use federal “adjusted gross income” as their starting point for determining what income will be taxable at the state level.<sup>105</sup> And while the seemingly subtle difference between the two starting points may not indicate a substantial difference between taxable vs. non-taxable income, the reality is quite the opposite.

Using federal taxable income instead of AGI when computing personal income taxes substantially narrows the tax base, and creates inefficiencies caused by federal exemptions that are not available to everyone. Utilizing federal taxable income, which has, by definition, already had very large (and growing) standard deductions and personal exemptions subtracted from it, helps to erode income that would otherwise be taxable to the State. In short, having a personal income tax tied to the federal tax code can actually provide less stability in times of tax policy changes at the federal level, and therefore provides less revenue stability and predictability for the State.<sup>106</sup>

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<sup>104</sup> “States Vary Widely in Number of Tax Filers with No Income Tax Liability”, Scott A. Hodge, The Tax Foundation, May 24, 2010.

<sup>105</sup> “State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009”, Board of Economic Advisors, August 24, 2009. See Page 2 of full report on TRAC’s website.

<sup>106</sup> “Personal Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina” prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

As noted above, by using a tax basis of federal taxable income, South Carolina automatically adopts the federal level of both standard deductions and personal exemptions. Further compounding this issue is the fact that these deductions and exemptions automatically adjust for inflation each year.

That means, for example, that a family of four, with 2 children over the ages of 6, has the first \$26,000 of income exempt from income tax liability.<sup>107</sup> And that number continues to rise.

Note: TRAC discusses its findings and recommendations regarding the impact of the substantial levels of deductions and exemptions below.

### *Progressivity?*

TRAC supports the concept of a progressive individual income tax structure, which, based on the State's number and level of tax brackets (3 percent, 4 percent, 5 percent, 6 percent and 7 percent) South Carolina appears to have.

However, we worry that while the State's income tax structure may appear appropriately progressive at first glance, the scale may have very well tipped towards "too progressive" based on the fact that more than 40 percent of all tax filers now pay zero individual income tax to the State of South Carolina.

As the "taxable base" (measured by the number of filers liable for at least some amount of tax) continues to erode, additional burden will be felt by the remaining filers who will have to shoulder more responsibility for generating revenue for the basic functions of state government.

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<sup>107</sup> "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 10 of full report on TRAC's website. Note: The standard deduction amount for TY 2009 for a married couple filing jointly was \$11,400. In addition, "personal exemption amounts" for each filer and dependents over the ages of 6 was \$3,650 per person. Dependents under the age of 6 receive double the exemption, or \$7,300 each.

By expanding, not narrowing, the tax base (as TRAC seeks to do), the overall fairness of the system will improve. As noted below, we recommend that any revenue generated by expanding the taxpaying base be applied to structural changes that will improve the overall fairness and stability of the current system.

And while there are various ways to address the narrowing taxpayer base (including moving away from using federal taxable income as the State's starting point for taxation), TRAC believes it has identified a fair, simple, and effective way to ensure that all tax filers can contribute a nominal amount to South Carolina via the individual income tax system.

Recommendation:

TRAC recommends the General Assembly consider the following:

- 1) All tax filers that are residents of South Carolina and have either a minimum level of South Carolina Adjusted Gross Income ("SC AGI" - discussed below) or are required to file a federal return would remit a nominal fee (to be known as "InvestSC" or some like name) depending on their level of SC AGI.
- 2) TRAC recommends that the fee structure be progressive in nature, with fees to be no more than:

SC AGI \$0 to \$4,999=	\$0
SC AGI \$5,000 to \$49,999 =	\$25
SC AGI \$50,000 - \$99,999=	\$50
SC AGI \$100,000+	\$75

This fee would be due by all filers regardless of tax liability and would have the effect of greatly broadening the tax base while ensuring that the fee amount would be minimal for residents with low SC AGI (e.g. no fee would be due on returns with AGI's of less than \$5,000; a return with an AGI of \$5,000 would owe just \$25, a rate of just one half of one percent).

For this proposal, SC AGI would need to be clearly defined in law. If SC AGI was constructed to closely approximate Federal AGI, which would be a reasonable approach, based on the latest available data from the IRS, TRAC's initial (and unofficial) estimate is that the InvestSC fee structure could generate as much as \$74 Million annually.<sup>108</sup>

As with all TRAC recommendations, proceeds from this nominal but broad based fee should be utilized for revenue neutral and long-term structural reform that further enhances the fairness and stability of the current structure (as described below).

Specifically, TRAC recommends that any revenue be used to provide both structural reform and tax relief by expanding the current narrow width of the state's 6 percent tax bracket, which now applies to income between just \$10,960 and \$13,700, to income between \$10,960 and \$21,249 (North Carolina's 7 percent tax bracket "kicks in" at \$21,250 (married filing jointly)).<sup>109</sup>

The practical effect of the narrow width of the current 6 percent bracket means that taxpayers are forced into the State's top 7 percent marginal bracket at a low level of income; a fact that actually works to undermine the progressive nature of the otherwise progressive bracket structure. As noted below, the practical effect of the narrow width of the 6 percent bracket is that South Carolina has two, not five, tiers - effectively 7 percent and 0 percent.<sup>110</sup>

This phenomenon, known as "bracket creep", is an issue of concern for TRAC. Under the current structure, almost all taxpayers "end up" in the top marginal 7 percent bracket.<sup>111</sup> Based on unofficial TRAC staff estimates from TY 2007 individual income tax return data from the South Carolina Department of Revenue, of the approximately 2.07 Million returns filed, just 1.22 Million had at least some tax liability, and of those, approximately 870,000 (or 71 percent) had "state taxable income" of at least \$13,001 or more, essentially putting those returns in the 7

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<sup>108</sup> Unofficial staff draft estimate based on an analysis of the distribution of federal individual income tax returns (TY 2008) at various intervals of adjusted gross income. Source: "Statistics of Income Tax Stats", Internal Revenue Service.

<sup>109</sup> "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 10 of full report on TRAC's website.

<sup>110</sup> "Personal Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina" prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

<sup>111</sup> Unofficial staff estimate based on TY 2007 individual income tax return data from the South Carolina Department of Revenue

percent top marginal rate category (\$13,150 was the level of income subject to the 7 percent top marginal rate in TY 2007).<sup>112</sup>

It should be noted that, according to the Board of Economic Advisors' report "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", South Carolina is one of only 11 states that annually adjusts its tax brackets for inflation (beginning in 1995, South Carolina annually adjusts its tax brackets for one-half of inflation (CPI)). In contrast, 30 states do not adjust their tax brackets for inflation.<sup>113</sup>

As information, full indexation (back to 1995) of tax brackets would have had only a marginal impact on the "bracket creep" as described in this report. Specifically, based on unofficial staff estimates, if fully adjusted for inflation, the top bracket would begin at roughly \$15,100 in TY 2007, not \$13,150, only slightly reducing the number of taxpayers in the top bracket from 71 percent to approximately 67 percent.<sup>114</sup>

To help alleviate this bracket creep, TRAC proposes to expand the 6 percent bracket to at least \$21,249, meaning that all taxpayers with taxable income above just \$13,700 will benefit from a tax savings, as thousands of dollars of their income will move down from the top marginal rate of 7 percent to the lower 6 percent bracket. This structural reform will offer tax relief, will lessen bracket creep, and will improve the overall progressive nature of the current system.

Note: As examples, North Carolina's 7 percent bracket for married filing jointly begins at \$21,250 (as noted above); Arkansas's 7 percent bracket kicks in at \$31,700.<sup>115</sup>

## Issue 2: Standard Deduction and Personal Exemption Amounts

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<sup>112</sup> Unofficial staff estimate based on TY 2007 individual income tax return data from the South Carolina Department of Revenue

<sup>113</sup> "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 4 of full report on TRAC's website.

<sup>114</sup> As information, full indexation of tax brackets would have only a marginal impact on the "bracket creep" as described in the report. Specifically, based on unofficial staff estimates, if fully adjusted for inflation, the top bracket would begin at roughly \$15,100 in TY 2007, not \$13,150, slightly reducing the number of taxpayers in the top bracket from 71% to approximately 67%.

<sup>115</sup> "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 10 of full report on TRAC's website.



As mentioned above, South Carolina, by adopting federal taxable income as its tax base, has some the most generous levels of standard deductions and personal exemptions in the entire country and throughout the Southeast.<sup>116</sup>

And because these amounts are annually adjusted for inflation (South Carolina is the only Southeastern state to do so), they continue to grow each year. The unintended consequence of such high levels of deductions/exemptions is a continual narrowing of the tax base.

Only 9 states have deduction and exemption levels that are as generous as South Carolina's (and that are adjusted for inflation annually). Seven states annually adjust their deduction and exemption amounts, but their base amounts are less than South Carolina's and are less advantageous compared to South Carolina.<sup>117</sup>

We find that the majority of states (24) have deduction and exemption amounts that are: (a) substantially lower than South Carolina's and (b) "fixed" so that they are not annually adjusted for inflation. North Carolina, who, like South Carolina, uses federal taxable income as its starting point for taxation, actually "decouples" from the large federal deduction and exemption amounts, instead choosing to adopt their own fixed (and lower) state level amounts.<sup>118</sup>

The best illustration of the significant disparity between our level of deductions and exemptions and much of the country is seen in the following comparison of deduction and exemption amounts between South Carolina, Georgia and North Carolina:

	<u>SC</u>	<u>GA</u>	<u>NC</u>
<u>Deductions</u>			
Single	\$5,700	\$2,300	\$3,000

<sup>116</sup> "Personal Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina" prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

<sup>117</sup> "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 4 of full report on TRAC's website.

<sup>118</sup> "Personal Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina" prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

Married/Single	\$5,700	\$1,500	\$3,000
Married/Joint	\$11,400	\$3,000	\$6,000
Head of House	\$8,350	\$2,300	\$4,400
65 yrs.+ /Single	\$9,750	\$2,800	\$3,750
65 yrs. +/Joint	\$13,600	\$5,600	\$7,200

#### Exemptions

Per filer/single	\$3,650	\$2,700	\$2,500/\$2,000*
Dependent	\$3,650	\$3,000	\$100 credit
Under 6 yrs. old	\$7,300	\$3,000	\$100 credit

\*NC personal exemption reduced to \$2,000/filer at AGI <\$60K/<\$100 (single/married)

An analysis by the SC Department of Commerce illustrates the magnitude of the gap between deductions and exemptions in South Carolina vs. other states and the impact that the gap ultimately has on the tax base, and therefore, the tax revenue, of South Carolina. By applying Georgia's standard deduction levels to South Carolina's taxable income (for FY2007-08), the total amount of standard deductions otherwise available to taxpayers decreased by \$8.17 Billion.<sup>119</sup> That means that South Carolina's taxable income would increase by that same amount if Georgia's deductions applied here. Applying an average marginal tax rate of approximately 5.5 percent yields more than \$400 Million in additional income tax revenue if South Carolina's standard deduction amounts mirrored Georgia's.

#### Recommendation:

South Carolina's deduction and personal exemption amounts are between 2 and 3 times higher than its neighbors Georgia and North Carolina (and is substantially larger than many other states).

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<sup>119</sup> "Personal Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina" prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

Furthermore, South Carolina's level of deductions and personal exemptions, by mirroring the federal amounts, are significantly inflated when comparing our State level tax rates and brackets to the federal rates and brackets. Consider that the federal top marginal rate is currently 35 percent vs. South Carolina's 7 percent as but one illustration of what could be considered an imbalance in the "scale" of our deduction and exemption amounts compared to the State's actual tax rates and brackets.<sup>120</sup>

As such, and given the significant and continued erosion of the State's tax base as described under "Issue 1" above, TRAC believes South Carolina can no longer afford to adopt the annual inflation adjustments to federal standard deduction and personal exemption amounts.

Therefore, TRAC recommends that the standard deduction and personal exemption amounts be permanently capped at their Tax Year 2009 levels.\*

This recommendation ensures South Carolina retains its competitive advantage over its two neighbors (and most states across the nation). South Carolina's amounts, though capped, would remain between 2 and 3 times higher than both Georgia and North Carolina because their amounts are capped as well.

TRAC recommends that any revenue generated by this change should be used for additional tax relief including either lowering the top marginal rate from 7 percent (see below for related recommendation) or further expansion of the 6 percent bracket, or a combination of both, depending on available revenue (yet to be estimated).

\*Note: Because TRAC recommends the General Assembly consider adopting recommended changes presented in this report in a comprehensive (e.g., as a "package"), it is sufficient that TRAC's recommendation simply caps, but does not reduce, the exemption and deduction levels. However, as clearly demonstrated above, South Carolina's levels of standard deductions and/or personal exemptions are among the most generous both regionally and nationally. As such, there

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<sup>120</sup> "Personal Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina" prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

is certainly “room” for the General Assembly to significantly reduce these deductions and/or amounts while still remaining competitive from a regional and national standpoint. The more adjustment made in this area of the tax code (e.g. adjusting the deduction/exemption amounts to more reasonable, but still fair, levels), the greater the ability the General Assembly has to broaden the tax base, and use the resulting revenue from that broadening for structural reform to include addressing issues of bracket creep (described above) and/or to lower the top marginal rate (as discussed in greater detail below) by an amount commensurate to the revenue raised from these changes.

### Issue 3: Capital Gains

South Carolina is one of only 13 states that provides preferential tax treatment for income from capital gains (held for one year or longer) as compared to the tax treatment of ordinary income (e.g. “wages” from a job).<sup>121</sup>

In contrast, 28 states tax capital gains as ordinary income thereby making gains fully taxable under those states standard tax rates and/or structures.<sup>122</sup>

Of the 13 states providing preferential tax treatment for capital gain income, South Carolina (and 6 others) provides preferential treatment without imposing various restrictions, limitations or caveats. For example, Hawaii provides a lower rate of taxation on capital gains, but only for those incomes greater than \$24,000 (single), \$36,000 (head of household) and \$48,000 (married/joint). Iowa provides preferential treatment, but only for certain gains that are held 10 years or more (Iowa does not exempt stock sales). Mississippi taxes ordinary capital

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<sup>121</sup> Staff analysis of data compiled by the Board of Economic Advisors regarding capital gains tax treatment and presented in “State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009”, Board of Economic Advisors, August 24, 2009.

<sup>122</sup> Staff analysis of data compiled by the Board of Economic Advisors regarding capital gains tax treatment and presented in “State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009”, Board of Economic Advisors, August 24, 2009. Note: According to a January 2010 research report by the Minnesota House of Representative’s Research Department titled “Capital Gains Taxation, Federal and State”, the number of states not providing preferential treatment to capital gains income is 24.

gains at full rates, but provides an exemption only if the gains are associated with certain “in-state” investment.<sup>123</sup>

South Carolina excludes 44 percent of capital gains income from state income tax liability, which equates to an actual tax rate on capital gains of 3.92 percent, below the state’s top marginal rate of 7 percent (the rate at which capital gains would most likely otherwise be taxed at in South Carolina absent this exclusion).

Of the 41 states imposing an individual income tax, only 6 states impose a lower income tax liability on capital gains than South Carolina.<sup>124</sup>

And compared to its neighbors, South Carolina’s tax levy on capital gains is 50 percent less than North Carolina and 35 percent less than Georgia. Both states, unlike South Carolina, fully tax capital gains income.<sup>125</sup>

### Recommendations:

TRAC finds that it is sound tax policy to incentive investment, particularly in South Carolina based businesses. TRAC further finds it imperative for South Carolina to retain its tax advantage with regards to tax treatment of capital gains, particularly compared to its neighbors North Carolina and Georgia.

South Carolina should continue excluding a portion of capital gains held for more than one year from taxation, but should reduce the exclusion from 44 percent to 20 percent. At 20 percent, South Carolina retains its tax advantage both nationally and regionally (most

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<sup>123</sup> Staff analysis of data compiled by the Board of Economic Advisors regarding capital gains tax treatment and presented in “State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009”, Board of Economic Advisors, August 24, 2009.

<sup>124</sup> Staff analysis of data compiled by the Board of Economic Advisors regarding capital gains tax treatment and presented in “State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009”, Board of Economic Advisors, August 24, 2009.

<sup>125</sup> Staff analysis of data compiled by the Board of Economic Advisors regarding capital gains tax treatment and presented in “State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009”, Board of Economic Advisors, August 24, 2009. Note: At 3.92%, South Carolina is 50% more favorable in terms of capital gains tax treatment compared to North Carolina, where capital gains are fully taxable at 7.75%. Likewise, South Carolina is 35 percent less than Georgia, where capital gains are fully taxable at 6%.

importantly over North Carolina and Georgia particularly) with respect to capital gains tax treatment.

And while TRAC recommends a modest reduction in the capital gains tax exclusion (but only to a point where the State still retains competitive advantage), it recommends that the General Assembly give constitutional consideration to increasing the capital gain exclusion for South Carolina based investment gain (not yet defined) from 44 percent to some higher amount (say to 55 percent as an example).

While it is imperative to maintain a competitive advantage regarding capital gains tax treatment regardless of the location of the investment (and TRAC's proposal does that), it seems only proper that policy makers give consideration to offering greater incentive for investment in South Carolina based start-ups and/or other in-state businesses, as opposed to, for example, investment in Dell (Texas) or Hewlett-Packard (California).

Note: TRAC recommends that the General Assembly study states such as Nebraska, Utah, and Mississippi that have some version of this approach to capital gains treatment.

*Perception vs. Reality – Top 7 percent bracket (We Address the Perception).*

Any net revenue generated by reducing the exclusion for capital gains (potentially offset by some amount if the General Assembly was able to increase the exclusion for South Carolina based gains) should be used for a dollar for dollar reduction in the top marginal rate from 7 percent to a commensurately lower amount. It should also be noted that the proposed decrease in the capital gain “exclusion” amount, as noted above, will in reality be partially offset (e.g. mitigated) from the simultaneous reduction in the top marginal rate as recommended herein.

While marginal tax rates matter, and research demonstrates that high marginal rates (particularly at the federal level where the top marginal income tax rate was once as high as 91 percent as recent as 1963 - today it stands at 35 percent) can have negative impacts on certain

economic activities<sup>126</sup>, TRAC’s observations also demonstrate the misleading picture that can be painted by those who limit their critique of a state’s income tax structure to a superficial comparison of only top marginal rates. Nevertheless, we believe that adoption of this recommendation offers the opportunity to lower the state’s top rate below 7 percent. This would help eliminate any misperception that South Carolina is a “high tax state” (it is not) and enhance our competitive advantage among states that have top marginal rates below 7 percent.

But more important than simply improving perception is the tax savings that will be generated for the majority of South Carolinians under this proposal.

#### Issue 4: Tax Preferences for the Elderly.

TRAC finds that the “tax preference” or “bonus” for South Carolina taxpayers age 65 and older is substantial. Consider the following example:

	<u>Senior Couple*</u>	<u>Non-Senior, 2-children**</u>
Standard Deduction	\$13,600	\$11,400
Personal Exemption	\$7,300	\$14,600
Age 65+ Exclusion	\$30,000	\$0
Social Security Exc.	<u>\$25,709</u>	<u>\$0</u>
Total Income Tax Free	<b>\$76,609</b>	<b>\$26,000</b>

\*Example assumes a married couple filing jointly, each 65 or older, both receiving an average monthly Social Security benefit of \$1,071 per month (national average benefit as of July 2010).<sup>127</sup>

<sup>126</sup> “Personal Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina” prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

<sup>127</sup> “Monthly Statistical Snapshot, July 2010 - Table 2”, Average monthly benefit, “all beneficiaries”, U.S. Social Security Administration, Office of Retirement and Disability Policy.

Note: Social Security benefits in South Carolina, as in many states, are tax free for state income tax purposes.<sup>128</sup>

**\*\*Example assumes a married couple filing jointly, both under age 65, with 2 children ages 10 and 12. The example does not factor a maximum tax credit available to working families, the maximum credit which cannot exceed \$210.<sup>129</sup>**

In this example, the “tax preference” offered by the State of South Carolina is more than 3 times higher for the elderly couple with no dependents compared to the working family supporting two children.

While this is a hypothetical example, a 2007 analysis by Georgia State University found that among ten Southeastern states, South Carolina had the highest elderly tax advantage for senior vs. non-senior taxpayers, especially when comparing high income households.<sup>130</sup> Other studies have highlighted South Carolina’s substantial tax preference for senior tax payers to be among the highest nationwide.<sup>131</sup>

#### Recommendation – (Further study and analysis):

TRAC, for reasons of fairness and equity, encourages the General Assembly to study this issue further to determine whether or not the seeming disparity between the current tax treatment of elderly vs. non-elderly taxpayers is appropriate or if the gap should be narrowed.

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<sup>128</sup> Pursuant to SC Code Section 12-6-1120(4), Social Security benefits are not considered “taxable income” to the State of South Carolina (“...South Carolina gross income is determined without application of Internal Revenue Code Sections 78 (Gross-up of Dividends received from Certain Foreign Corporations), 86 (Social Security and Tier 1 Railroad Retirement Benefits), and 87 (Alcohol Fuel Credit”). South Carolina offers a specific deduction for retirement income (such as income from a 401k) of up to \$10,000 per filer age 65 and over and up to \$3,000 per filer up to age 64. For filers age 65 and over, the \$15,000 deduction they are eligible for regardless of the source of income is not in addition to, but in essence, in lieu of, this \$10,000 deduction specific to retirement income. For example, a filer age 65 has \$10,000 of income from a 401k and \$15,000 from wage income. His deduction would not be \$25,000, but would be \$15,000 (\$10,000 retirement deduction and \$5,000 for wage). Also note that senior tax filers also often benefit from the State’s favorable tax treatment of capital gains income (as discussed in the report), further advancing the favorable tax treatment of many seniors compared to the average non-senior taxpayer.

<sup>129</sup> Pursuant to SC Code Section 12-6-3330, married couples filing jointly (when both spouses have earned income) are eligible for a maximum individual income tax credit of \$210.

<sup>130</sup> “Comparing State Income Tax Preferences for the Elderly in the Southeast”, A Policy Brief by the Fiscal Research Center of the Andrew Young School of Policy Studies, Georgia State University, February 2007.

<sup>131</sup> “Ensuring a Competitive Revenue System for South Carolina - Findings and Conclusions from an Evaluation of the South Carolina Revenue System”, Holley H. Ulbrich, November 18, 2005.



TRAC specifically suggests that the General Assembly carefully examine the \$15,000 (\$30,000 married filing jointly) income exclusion for seniors 65 and over allowed under current law. South Carolina offers this level of income exclusion regardless of the source of the income (e.g., the benefit applies whether or not the income is from a pension or is wage income from a job).

This substantial exclusion appears unique compared to other states, where such benefits are often limited specifically to pension or retirement income. The General Assembly should consider, for reasons of equity and fairness among all taxpayers, closely examining the cost and benefits of both the level and structure of this component of the elderly tax preference. Careful review of these deductions is of particular importance given the fact that the number of tax filers claiming them is expected to increase rapidly as the “baby boomer” population reaches retirement age.<sup>132</sup>

However, TRAC affirms the General Assembly’s decision to fully exempt social security benefits from State income tax liability. Regardless of other factors and concerns that TRAC may have regarding the elderly tax preference, we believe that this component of the tax preference should be maintained.

#### Issue 5: Wage and Income Compensation for Personal Injury or Sickness:

As noted above, South Carolina’s income tax laws, with little exception, “piggyback” the federal income tax code. According to S.C. Code Section 12-6-40(B), “All elections made for federal income tax purposes in connection with Internal Revenue Code sections adopted by this State automatically apply for South Carolina income tax purposes unless otherwise provided.”

As such, where states (like South Carolina) conform to the Internal Revenue Code (IRC), the state tax base begins with federal taxable income as the starting point.

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<sup>132</sup> “Personal Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina” prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

The practical effect of this piggybacking is that, unless South Carolina actively “decouples” from federal provisions, South Carolina’s law mirrors federal law when it comes to definitions of what is and is not considered “taxable” income to the State of South Carolina.

For reasons already mentioned (simplicity, administrative ease, and taxpayer friendliness, etc.), South Carolina conforms to the majority of federal definitions of what is considered to be (or not to be) taxable income.

While TRAC does not recommend repealing our conformity to federal tax code as a starting point for taxable income and the definitions contained therein, it does recommend that the General Assembly consider “decoupling” from additional IRC provisions.

One such provision TRAC suggests that the General Assembly give serious consideration to decoupling from involves the federal tax treatment of personal injury and/or sickness lawsuit settlements.

Specifically, federal law 26 USCS Section 104(a)(2), which South Carolina follows, provides an exemption from taxation, “the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness . . .”

The issue of concern expressed here by TRAC is one of equity and fairness. Of specific concern is the fact that personal injury settlements or judgments almost always have as a percentage of the recovery “lost wages”.

However, as noted below, federal law prohibits federal income taxation (and therefore state income taxation because we “piggyback” the feds) of compensatory damages which include provision of past and future wage income that would otherwise be taxable as ordinary income absent the injury.

“An award of damages for personal injuries is not subject to state income taxation. Compensatory damage awards are tax-exempt, and the exemption applies even though such damages often include compensation for the loss of past and estimated future earnings which would have been taxable had the plaintiff not been injured.”<sup>133</sup>

#### Recommendation:

TRAC recommends that South Carolina consider “decoupling” from the federal law which prohibits the taxation of personal injury and sickness benefits. Doing so would make the wages and income components of legal settlements, specifically related to physical injuries, taxable as ordinary income, and would promote equitable and fair treatment of income that would otherwise be taxed absent the injury or sickness.

Note: As a parallel (and potentially counterintuitive ‘tax policy’), unemployment benefits and “sick pay” benefits are taxable under current law, but personal injury and sickness settlements are not.

#### Issue 6: Income Tax Conformity - Findings and Recommendations:

As previously discussed, South Carolina’s income tax laws are modeled after federal income tax laws. According to S.C. Code § 12-6-40(B), “All elections made for federal income tax purposes in connection with Internal Revenue Code sections adopted by this State automatically apply for South Carolina income tax purposes unless otherwise provided.” South Carolina follows the majority of the provisions of the Internal Revenue Code (IRC), with certain exceptions. Where states conform to the IRC, the state tax calculation begins with federal taxable income as the starting point, or states may conform to certain definitions contained in the IRC (e.g. “income”, “deduction”, etc.).<sup>134</sup>

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<sup>133</sup> 71 Am Jur 2d. State and Local Taxation § 426.

<sup>134</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf). Page 2 of link, bullet under “Federal Conformity”.

South Carolina, primarily for simplicity, administrative, and taxpayer friendly reasons, adopts “federal taxable income” as its starting point for determining state taxable income. Related advantages to federal “conformity” include uniformity, the simplicity of a single starting point and reduction of compliance costs.<sup>135</sup> Taxpayers, tax preparers and state administrative personnel may also be able to rely on federal interpretations (IRC rulings, procedures, and pronouncements) when analyzing state tax treatment of issues that arise related to federal conformity.<sup>136</sup>

Disadvantages to federal conformity may include a delegation of policy making power from the state to the federal level and, related, a lessening of control by the state over federal tax policy that could have an adverse impact on state revenue.<sup>137</sup>

The overwhelming majority of states “conform” in some aspect(s) to the IRC. Most of these states utilize one of two methods to conform to the IRC; either “rolling conformity” or “fixed date conformity”. When a state’s tax code is written to automatically adopt federal tax law, and any changes to it, on a continual basis, it is referred to as “rolling conformity”. 21 states currently utilize the “rolling conformity” method.<sup>138</sup>

The primary advantage to rolling conformity is a level of “certainty” it provides both taxpayers and tax preparers. The “rules of the game” (and how they will be applied), are often known well in advance of tax filing deadlines. As a result, rolling conformity, and the certainty that it offers, is generally considered to be less burdensome for taxpayers/prepares from a compliance standpoint.<sup>139</sup> As noted above, disadvantages relate to a greater loss of state policy making power to the federal government and issues related to state revenue concerns resulting from federal tax law changes.

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<sup>135</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf). Page 1 of link, footnote “1”.

<sup>136</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf). Page 1 of link, “A. State Conformity to Federal Provisions in General”.

<sup>137</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf). Page 1 of link, footnote “1”.

<sup>138</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf). Page 2 of link, bullet under “Federal Conformity”.

<sup>139</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf). Page 2 of link, bullet under “Federal Conformity”.

In contrast to rolling conformity, a state's tax code might be written so that it reflects the federal tax code (and changes to it) as of a certain "date". This method of conformity is commonly referred to as "fixed date" conformity. South Carolina and 20 other states follow "fixed date" conformity.<sup>140</sup> It is common practice among most "fixed date" states to routinely "move" their dates forward each year.<sup>141</sup> As such, fixed date conformity requires deliberate legislative action to be taken each year by a state's legislature to update the state income tax laws to changes in the IRC.<sup>142</sup> Currently, South Carolina's "date" through which it has conformed to the IRC is December 31, 2009.<sup>143</sup>

The primary advantage of "fixed date" conformity is the ability it gives states to examine changes made to federal tax law during the prior year to determine whether or not the state should conform to those changes (e.g. "adopt" them) or if it should "opt out" (e.g. "decouple" from) of specific changes due to potential revenue or other tax policy concerns.

A primary disadvantage of fixed date conformity is actually a derivative of its primary advantage, namely, the requirement for deliberate legislative action to be taken each year to conform. Problems arise when delays, sometimes lengthy, in legislative action create uncertainty for taxpayers and tax preparers as to what federal provisions will or will not be adopted by the state, if at all.<sup>144</sup> And while conformity legislation almost always ultimately passes, it is not uncommon that legislative delays force passage well after tax filing deadlines, creating compliance burdens for taxpayers and preparers alike.

South Carolina's General Assembly has not been immune to these concerns, but has in recent years attempted to effectuate a more "timely" passage of the State's annual federal tax conformity bill. TRAC commends the General Assembly for "detangling" conformity provisions from what is commonly referred to as the state's annual "BAT" (Big Annual Tax) bill which historically has been one of the last bills to pass (if it passes) each legislative session.

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<sup>140</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf). Page 2 of link, bullet under "Federal Conformity".

<sup>141</sup> <http://www.cbpp.org/cms/index.cfm?fa=view&id=1051>. Page 3 of link.

<sup>142</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf). Page 2 of link, bullet under "Federal Conformity".

<sup>143</sup> Section [12-6-40](#)(A)(1)(a) of the 1976 Code, as last amended by Act 16 of 2009.

<sup>144</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/Conformity.pdf). Page 1 of link, footnote "1".

Passage of conformity so late in a session means there is no certainty as to what federal changes the State will (or will not) conform to, often as late as May or June, months past both the individual and corporate tax filing deadlines.

In an effort to further prioritize the importance of timely conformity, conformity provisions, usually introduced in the House, were instead introduced in the Senate last session (S. 1174) so that the bill could be debated by that body prior to it receiving the budget from the House, a fact that helped to expedite the process (and the bill's ultimate passage).<sup>145</sup>

### Recommendations:

While TRAC applauds both these recent approaches by the General Assembly to take action on conformity legislation in a more timely manner, it recommends that they (the General Assembly) consider implementation of one (or more) of the following actions to better ensure timely passage of conformity.

1) Thoroughly study the “pros and cons” (as briefly discussed herein) of “rolling conformity” for adoption here in South Carolina. As noted above, “rolling conformity” is the method of conformity used by 21 states. In its analysis of possible implementation, the General Assembly should give consideration to development of a system under which, by a date certain, the General Assembly would be provided a complete list of federal law changes by the Department of Revenue, along with a revenue analysis by the Board of Economic Advisors as to what impact those changes would have on state revenue, if any. If such information is determined to warrant “decoupling” from one or more federal law changes, legislation could then be introduced for expedited passage by the General Assembly (see 2)c) below)).

2) Fixed-date conformity. If the General Assembly determines that rolling conformity is not a viable option for the State, TRAC recommends the following amendments to the current process to ensure timely passage:

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<sup>145</sup> Act 142 of 2010.

a) Continue recent practice of introducing conformity as free-standing legislation and prohibit amendments unrelated to conformity (bobtailing). Such non-germane amendments inevitably slow down conformity's passage.

b) Add a statutory requirement that the Department of Revenue, in conjunction with the Board of Economic Advisors, provide a detailed analysis (include revenue impacts, if any) to the General Assembly of federal law changes to the IRC by a date certain.

c) Pass a "rule". Both bodies of the General Assembly should add to their respective "rules" a requirement that conformity legislation must pass each body by a date certain. There is precedent in current House and Senate rules regarding actions being taken by certain dates.<sup>146</sup> TRAC recommends that, whatever the respective dates are, ultimate passage allow for an effective date of no later than March 1 of any given year. Annual passage of conformity no later than March 1 will provide both taxpayers and tax preparers' ample time to "know the rules of the game". Such certainty will reduce taxpayer/preparer burden while increasing compliance.

**Additional "Options for Consideration" for the General Assembly regarding the Individual Income Tax:**

*Note: Any and all "savings" generated by the options below could be used to lower the State's top marginal rate from 7 percent to a commensurately lower amount, thereby providing broad based, rather than targeted, tax relief.*

**Internal Revenue Code Section 179 "Business Expensing"**

- Consider amending Code Section 12-6-50 to limit IRC Section 179 to \$25,000 (or some amount). IRC Section 179 allows certain taxpayers to immediately expense, rather than depreciate over time, business equipment purchases. Initially the amount that could be expensed was \$25,000. Prior to 2010, the deduction had risen to \$250,000. The

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<sup>146</sup> See Senate Rule 10, Senate Rule 47, and House Rule 5.12 as examples.

deduction was reduced by the amount that the cost of the equipment exceeded \$800,000 (phase-out level). Under the Small Business Act of 2010 signed into law on September 27, 2010, for tax years beginning in 2010 and 2011, the maximum amount a taxpayer can expense is increased to \$500,000 and the phase-out level is increased to \$2 million. Also, some depreciable real property now qualifies for the Section 179 deduction. If the State did not adopt (decouples from) the new federal law or lowers the amount of the Section 179 expense, the taxpayer would still be able to depreciate the property over time rather than receiving the larger deduction in the year of the purchase.

### South Carolina Research Credit

- Consider amending the South Carolina research credit to make it more in line with the federal research credit. Both the South Carolina and federal research credits are for research and development costs in the experimental or laboratory sense, including costs incident to the development or improvement of a product. The federal research credit, Section 41 of the Internal Revenue Code, is 20 percent of **the increase** in qualified research expenses incurred by the company for the tax year over a base year amount calculated pursuant to the statute. South Carolina's research credit (SC Code Section 12-6-3415) is equal to 5 percent of the taxpayer's **total** qualified research expenses. To claim the South Carolina research credit, a taxpayer must claim the federal increased research expenditures credit, so the taxpayer must have some increase in eligible research expenses to claim the South Carolina research credit, but because South Carolina's credit is not limited to increases in research costs, the South Carolina credit may be much larger than the credit allowed under federal law, which is an unusual, and probably unintended, outcome.

### Modifications to federal gross or taxable income

- Consider bringing back the requirement that for exchanges of real property IRC §1031, like-kind exchanges, be limited to an exchange for real property located in South Carolina. (Former SC Code §12-6-1120(3)). Gains or losses from exchanges of property



are generally recognized for tax purposes. However, under Internal Revenue Code Section 1031, the exchange of qualifying real property does not result in recognized gain (or deductible loss). For example, assume a taxpayer exchanges his South Carolina beach condominium for a North Carolina mountain house. The gain from the exchange is not recognized for federal or South Carolina purposes. When the North Carolina house is later sold, the taxpayer will recognize gain for federal income tax purposes, but not for South Carolina income tax purposes since the house is located in North Carolina. Prior to 2000, property in South Carolina could only receive like-kind exchange treatment if it was exchanged for other property in South Carolina. (Former SC Code § 12-6-1120(3)).

- Consider repealing the portion of SC Code §12-6-1120(7) pertaining to the exclusion of retirement income from the US Reserves or National Guard inactive and training duty, since after age 65 the \$15,000/\$30,000 deduction will apply to this income.
- Consider modifying SC Code §12-6-1160, dependent deduction for residents. Specifically, current law allows taxpayers with children under 6 yrs. of age to essentially “double” the personal exemption deduction they could otherwise claim if their dependents were over the age of 6. Consider limiting the exemption to the new capped personal exemption amount(s) recommended in the body of the report (“Issue 2” above) or consider “phasing out” this special exemption in the same manner that the current benefit was “phased in” (in 1994, the dependent deduction was an additional 25 percent of the federal personal exemption amount; 50 percent in 1995; 75 percent in 1996; and 100 percent in 1997 and thereafter).
- Consider amending Article 11 of Chapter 6, Catastrophe Savings Account (CSA), to eliminate the deduction for up to \$250,000 for those who self insure. Under the law, an individual can self-insure losses up to the value of the taxpayer’s legal residence or \$250,000, whichever is less, and place the self-insured amount in a CSA. In general, contributions to the account are deducted for South Carolina income tax purposes; interest on the account is not included in South Carolina income; and distributions for qualified catastrophe expenses are not included in South Carolina income. This can be a

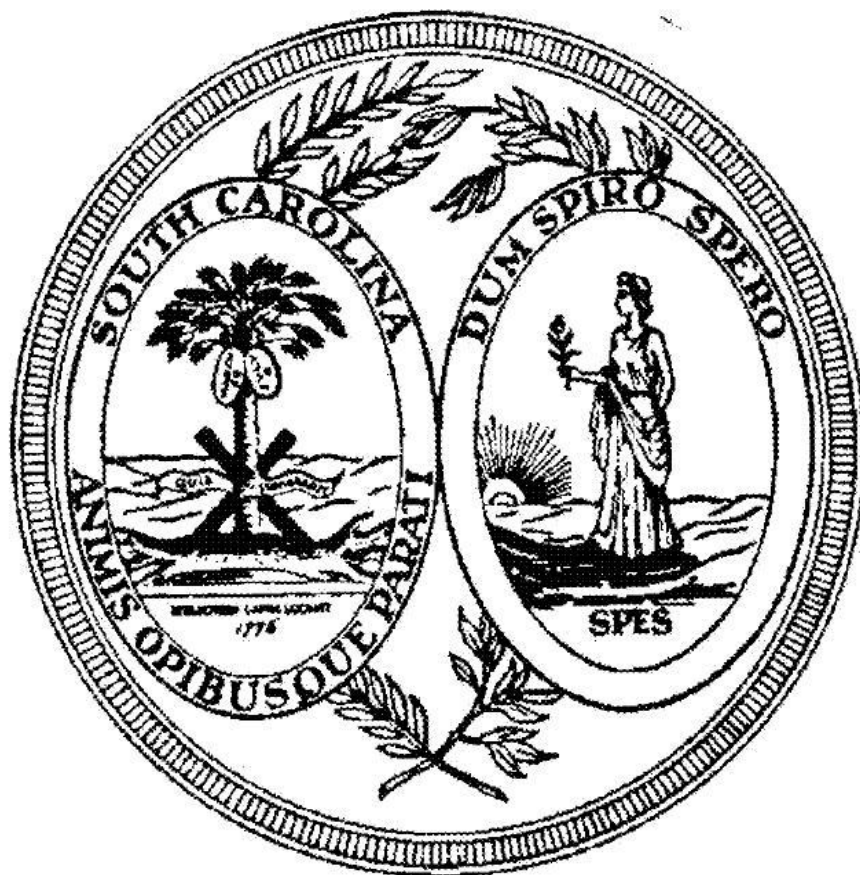
very large South Carolina deduction. The account is also not subject to collection by legal creditors. Additionally, if a taxpayer had a catastrophic loss, he could receive money from this account without paying taxes and receive a casualty loss deduction on his income tax return. As such, the General Assembly may want to consider eliminating this self-insurance provision.

### Credits

- Generally speaking, sound tax policy suggests broad based taxes with low rates are preferable to higher rates that are offset for (some) taxpayers through either special exemptions or targeted tax credits. As such, TRAC recommends the General Assembly give serious consideration to a thorough review of each of the State's almost 40 specific targeted income tax credits provided in statute today; credits that totaled more than \$250 Million in TY 2007 alone and have been steadily increasing since TY 2002. TRAC finds that the sheer number of credits likely makes our income tax system more complex than it otherwise needs to be. In addition, while no doubt well intended, most tax credits, like exemptions and deductions, create "loopholes" in the tax group and have the effect of pitting one group against another (the one receiving the tax advantage vs. the one not receiving the advantage). The end result conjures questions of fairness and lowers taxable income thereby further narrowing the tax base and, as such, decreasing state revenue.
- In undertaking this important review, TRAC recommends that the General Assembly consider:
- Review of both "individual" income tax credits and "business" tax credits as many business credits affect individual income tax returns because the businesses are sole proprietorships, S corporations, or partnerships, or limited liability companies taxed as sole proprietorships, S corporations, or partnerships.

- Repeal of credits that are rarely used. Rare use may indicate that they are not influencing behavior, but may instead only serve to provide windfalls for those that happen to come within the credit's terms.
- Repeal of credits that cost the state more than the value of the activities they are otherwise intended to encourage.

# Corporate Income Tax



## South Carolina Taxation Realignment Commission

## **Corporate Income Taxes, Generally**

South Carolina imposes one of the lowest corporate income tax rates (and tax burdens) and has one of the most “business and tax friendly” climates of any state in the nation.

First introduced in 1927, and today levied at a rate of 5 percent (the corporate tax was reduced from 6 percent to 5 percent in 1989), South Carolina’s corporate tax rate ranks tenth best nationally (overall) and is tied with Utah for the third lowest corporate tax rate among the 32 states imposing a flat tax, only slightly trailing Colorado (4.63 percent) and Michigan (4.95 percent) for the top spot.<sup>147</sup> However, it is important to note that while Michigan’s corporate tax rate “appears” to be lower than ours, hidden just beneath the surface are additional business tax burdens which act to increase that state’s effective corporate tax rate. Specifically, Michigan imposes a 21.99 percent “surtax” on a corporation’s tax liability (capped at \$6 Million per year) as well as a modified version of a “gross receipts tax” at a rate of 0.8 percent.<sup>148</sup>

South Carolina’s low corporate tax rate and tax burden leads the way (e.g. are low) closer to home as well. Of the seven Southeastern states that impose flat taxes, South Carolina imposes the lowest corporate tax rate.<sup>149</sup>

South Carolina’s corporate tax rate is 20 percent lower than Georgia’s (6 percent) and 38 percent lower than North Carolina’s (6.9 percent - and that calculation is before factoring North Carolina’s recent tax increase (via a “surtax”) on corporate income over a certain threshold)).<sup>150</sup> Mississippi’s tax rate is slightly lower because it does not impose its 5 percent top marginal tax

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<sup>147</sup> “Corporate Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina” prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

<sup>148</sup> “Corporate Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina” prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

<sup>149</sup> The Tax Foundation [http://www.taxfoundation.org/files/state\\_corp\\_income\\_rates-20100325.pdf](http://www.taxfoundation.org/files/state_corp_income_rates-20100325.pdf).

<sup>150</sup> See [www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/TRACquestionsbearesponse.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/TRACquestionsbearesponse.pdf) for a complete description of the North Carolina surtax referenced in this report. Specifically, from NC DOR’s website regarding the Corporate Surtax: “Corporations subject to corporate income tax must pay an income tax surcharge of 3 percent on its North Carolina income tax due before deducting any tax credits or payments. S corporations filing composite income tax returns on behalf of shareholders who live outside North Carolina must calculate the amount of North Carolina income tax due separately for each nonresident shareholder. That calculation must include the amount of individual income surtax based on the Surtax Percentage Table for individuals with a filing status of single. Note: there is no penalty (interest) for underpayment of estimated tax if the underpayment is because of the surtax.”

rate until corporate income reaches \$10,000.<sup>151</sup> Likewise, Louisiana taxes income less than \$200,000 at 4 percent compared to South Carolina's 5 percent, but at income of \$201,000 and above, Louisiana's tax rate jumps all the way to 8 percent, giving South Carolina the clear advantage at corporate incomes above that level.<sup>152</sup>

As important as a state's corporate tax rate, is its "tax burden" (as sometimes measured on a "per capita" basis). Here too, South Carolina performs well, and actually improves its national standing, ranking sixth best nationally (at \$72 per capita).<sup>153</sup> Georgia ranks ninth (\$98 per capita), imposing a tax burden 36 percent higher than South Carolina's.<sup>154</sup> At \$132 per capita, North Carolina ranks 24<sup>th</sup>, imposing an average tax burden that is more than 80 percent higher than South Carolina's.<sup>155</sup> Note: TRAC did not recommend an adjustment to the State's current corporate income tax rate.

South Carolina's low corporate tax rate, coupled with its expansive list of corporate tax "credits" (South Carolina had over 20 types of credits against corporate income tax in FY 2007-2008, a fact which is discussed in greater detail below) helps to explain the State's competitive tax advantage both regionally and nationally as well.

Not only does South Carolina rank well when comparing baseline tax statistics between states as outlined above, but it also annually ranks as one of the nation's most "business friendly" states among a host of prominent annual "business climate" reports each year. Consider only a sampling of the State's most recent achievements in this category: 1) South Carolina ranked 1<sup>st</sup> for the nation's lowest business costs according to "Area Development" magazine's annual report "Top 10 States for Business"; 2) 1<sup>st</sup> for "economic growth potential" by "Business

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<sup>151</sup> The Tax Foundation [http://www.taxfoundation.org/files/state\\_corp\\_income\\_rates-20100325.pdf](http://www.taxfoundation.org/files/state_corp_income_rates-20100325.pdf).

<sup>152</sup> The Tax Foundation [http://www.taxfoundation.org/files/state\\_corp\\_income\\_rates-20100325.pdf](http://www.taxfoundation.org/files/state_corp_income_rates-20100325.pdf). Note: SC is tied with Mississippi for the lowest top rate of 5%. However, Mississippi (and several other states) has a marginal rate structure with lower rates. SE states/rates are as follows: SC=Flat 5%, FL=Flat 5.5%, WV=Flat 8.5%, NC=Flat 6.9% (does not factor increase due to temporary "surtax"), KY=Marginal Rates of 4%, 5% and 6%, with top rate kicking in at \$50K+, AR=Marginal Rates from 1% to 6.5% with top rate kicking in at \$100K+, TN=Flat 6.5%, AL=Flat 6.5%, GA=Flat 6%, LA=Marginal Rates from 4% to 8% with top rate kicking in at \$200K+, VA=Flat 6%, MS=Marginal Rates from 3% to 5%, with top rate kicking in at \$10K+.

<sup>153</sup> The Tax Foundation "The Facts on South Carolina's Tax Climate" <http://www.taxfoundation.org/research/topic/57.html>.

<sup>154</sup> <http://www.taxfoundation.org/research/topic/22.html>

<sup>155</sup> <http://www.taxfoundation.org/research/topic/47.html>.

Facilities Magazine”, and 3) in the common category of “best business climate”, South Carolina ranked fourth, sixth and sixth by “Business Facilities Magazine”, “Site Selection Magazine” and “Development Counselors International” respectively.<sup>156</sup>

And while South Carolina’s corporate tax rate is low (and therefore very competitive) nationally, and its per capita tax burden modest, the revenue it generates is not insignificant. Averaging approximately \$200 Million per year over the last ten years, corporate income tax revenue is the third largest source of “General Fund” revenue for the State of South Carolina.<sup>157</sup>

Historically, corporate tax revenue fluctuates from year to year, particularly relative to the business cycle. Following the 2001 recession, corporate tax collections fell three consecutive years, bottoming out at approximately \$108 Million in 2003. Similar to other revenue sources during the same period, corporate tax collections rebounded sharply along with the economy after 2003, averaging almost \$250 Million per year between the last two recessions (2001 and 2008). Not surprisingly, the “Great Recession” led to a familiar pattern, one seen earlier in the decade, with corporate tax revenue now back to its 2003 level (\$110 Million in FY2009-10).<sup>158</sup>

It is also of interest (and importance) to examine who “actually pays” (e.g. “who owes”) corporate income taxes in South Carolina. Specifically, of the approximately 98,000 “corporate filers”, only 11 percent (roughly 11,000) actually end up owing South Carolina corporate income tax each year.<sup>159</sup> That means that almost 90 percent (87,000) of corporate filers owe “zero tax” to South Carolina.

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<sup>156</sup> “South Carolina’s Corporate and Business Tax Climate Rates and Rankings”, a presentation to the South Carolina Taxation Realignment Commission, by Craig H. Parks, MPA, Sr. Research Analyst, Senate Finance Committee, October, 22, 2010.

<sup>157</sup> SC’s Corporate Tax Collections: FY10 from Comptroller General’s Year End report for FY10, dated August 20, 2010. Other Years indicated taken from the SC Budget and Control Board’s “Historical Analysis” report dated October 31, 2009.

<sup>158</sup> SC’s Corporate Tax Collections: FY10 from Comptroller General’s Year End report for FY10, dated August 20, 2010. Other Years indicated taken from the SC Budget and Control Board’s “Historical Analysis” report dated October 31, 2009.

<sup>159</sup> Information regarding corporate tax liability in SC from data provided by the SC Department of Revenue for Tax Year 2008.

Dissecting further, of the 11,000 corporate filers that actually owe tax, more than 40 percent are actually not South Carolina based corporations at all, but are instead what are known as “foreign” corporations, which means that the corporations are chartered (incorporated) outside of South Carolina. Furthermore, the average tax liability of foreign corporations owing tax to South Carolina is actually three times higher than South Carolina based corporations owing tax (\$32,000 for foreign corporations vs. \$10,000 for South Carolina based corporations).<sup>160</sup>

Generally speaking, corporate filers comprise a wide array of industries, representing 96 different industrial sectors in 2008. But while corporate filers represent the a large variety of industry, their geographic diversity across the State is not as diverse, with more than half of all corporate filers concentrated in one of just seven counties. Those counties are (in order of magnitude greatest to least): Greenville, Charleston, Horry, Richland, Beaufort, Lexington and Spartanburg.<sup>161</sup>

### **Federal Tax Conformity and Taxable Income**

As noted above, South Carolina corporate income tax is imposed upon the South Carolina taxable income of domestic and foreign corporations. Once a business has determined its South Carolina taxable income, it must apply the South Carolina corporate income tax rate (5 percent) to determine the amount of South Carolina corporate income tax due.

South Carolina corporate (and individual) income tax laws conform substantially to the federal income tax laws. Each year, South Carolina’s income tax laws have been amended to conform to the Internal Revenue Code of 1986 as amended through the immediately preceding December 31st, with the exception of Internal Revenue Code Section provisions listed in South Carolina Code §12-6-50 that are specifically not adopted by South Carolina.

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<sup>160</sup> Information regarding corporate tax liability in SC from data provided by the SC Department of Revenue for Tax Year 2008. Domestic corporation, per DOR is a corporation that is chartered/incorporated in SC. Foreign corporation, per DOR is a corporation that is chartered/incorporated outside of SC.

<sup>161</sup> “Corporate Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina” prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.



This conformity simplifies the filing of returns by adopting federal taxable income as a starting point for South Carolina income tax purposes. With some exceptions, South Carolina income tax liability is determined in accordance with the same set of statutes and rules used in determining federal income tax liability. Subject to certain modifications, the South Carolina gross income and taxable income of a business is the business's gross income and taxable income as determined under the Internal Revenue Code.

Note: Refer to TRAC's "Individual Income Tax" component of this report for a more detailed analysis of TRAC's "findings and recommendations" regarding conformity.

### **Corporate License Fees, Generally**

South Carolina, like a number of other states, imposes a corporate license fee. South Carolina Code §12-20-50 imposes this annual license fee on the capital and paid-in surplus of a corporation. The license fee is \$15 plus \$1 for each \$1,000, or fraction, of capital stock and paid-in or capital surplus shown on the corporate records on the first day of the tax year. The minimum license fee is \$25. The license fee is computed in advance of the taxpayer's income tax year.

If a "consolidated" return is filed, then the license fee is measured by the capital stock and paid-in or capital surplus of each corporation considered separately without offset for investment of one corporation in the capital or surplus of another corporation in the consolidated group. The minimum license fee applies to each corporation in the consolidated group.

South Carolina Code §12-20-60 provides that the license fee imposed by South Carolina Code §12-20-50 must be apportioned in accordance with the ratio prescribed for income tax purposes. However, a taxpayer using the reduction percentage allowed during the phase in of the single sales factor apportionment method in Code §12-6-2250(B) for income tax purposes, may use either the "phased in" factor for license fee purposes or the original four factor apportionment factor, whichever results in the lower license fee. The \$25 minimum license fee,

however, may not be apportioned. A business using an alternative method to apportion income must also use that alternative method to compute the South Carolina corporate license fee.

License fee revenue has historically been more stable compared to corporate income tax collections, having ranged between approximately \$65 Million and \$75 Million annually between 2001 and 2010.<sup>162</sup>

Note: Even when factoring (“adding in”) South Carolina’s per capita corporate license fee burden (approximately \$16 per capita in 2008) into its per capita corporate tax burden (\$72 per capita), South Carolina’s total average per capita corporate tax and license fee burden combined is still lower than both Georgia’s (\$98) and North Carolina’s (\$132) corporate tax burden (per capita) alone.

### **Taxation of Other Corporate and/or Business Entities**

South Carolina Code §12-6-550 exempts a number of corporations from South Carolina income tax. Exempt corporations include insurance companies, certain nonprofit corporations organized for the purpose of providing water supply and/or sewer disposal, banks, building and loan associations, and certain electric cooperatives. Some of these entities may be subject to other types of South Carolina tax. Also, South Carolina does not generally tax the income of a tax-exempt organization qualifying under Internal Revenue Code §§501 through 528, although the unrelated business income of such an entity is taxed. The taxation of pass through entities and limited liability companies generally conforms to the federal income tax laws. The South Carolina taxation of pass-through entities and withholding requirements are discussed below, as is the tax treatment of various financial institutions.

### **Pass Through Entities**

#### **S Corporations\***

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<sup>162</sup> “Corporate Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina” prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

South Carolina recognizes a valid federal Subchapter S election. South Carolina Code §12-6-590 provides that a corporation having a valid election under Subchapter S of the Internal Revenue Code is not subject to South Carolina income tax to the extent it is exempt from federal corporate income tax. Further, a termination or revocation of an “S” election for federal purposes automatically terminates or revokes the election for South Carolina income tax purposes.

#### Partnerships\*

Partnerships are not subject to South Carolina income tax under South Carolina Code §12-6-600. The gross income, adjusted gross income, and taxable income of a partnership and its partners are determined in accordance with applicable provisions of the Internal Revenue Code. Partners include in their South Carolina taxable incomes their proportionate share of the partnership’s South Carolina taxable income. See South Carolina Revenue Ruling #97-7 for information on a resident partner reporting personal service income received from South Carolina and one or more states.

#### Limited Liability Companies\*

South Carolina follows the federal tax treatment of limited liability companies. If a limited liability company is treated as a corporation for federal income tax purposes it is treated as a corporation for South Carolina income tax purposes and is subject to a corporate license fee. South Carolina Code §12-2-25 provides that a partnership includes a limited liability company taxed for all South Carolina income tax purposes as a partnership. Accordingly, a limited liability company that is treated as a partnership for federal income tax purposes is not subject to South Carolina income tax or the corporate license fee.

\*Note: As “pass through entities”, S Corporations, Partnerships and Limited Liability Companies are taxed, not at the entity level, but at the individual level through the individual income tax structure. In 2006, the General Assembly, in an effort to “level the playing field between “C-corps” (typically considered to be larger businesses that pay the “corporate tax” described above) and smaller businesses who traditionally are more likely to be S Corporations,

Partnerships, or Limited Liability Companies, reduced the top marginal rate from 7 percent to a flat 5 percent for income passed through from these businesses. Furthermore, as some businesses would owe less under the former marginal rate structure, the General Assembly went the extra “business friendly” step by allowing these firms to choose each year which tax structure would provide them the lowest tax burden.

As an aside, it is important to note, that similar to our State’s positive rankings regarding “business friendliness” for larger corporations, South Carolina also ranks well as a place for small businesses too, having ranked seventh best “small business climate” in the US according to the “2009 Small Business Survival Index” published by Small Business and Entrepreneurial Council.<sup>163</sup>

## Financial Institutions

### Banks

Banks are defined as any person “engaged in a banking business, whether incorporated under the laws of this State, any other state or the United States or whether unincorporated, except cash depositories.”<sup>164</sup> This definition is generally viewed as being limited to persons who are regulated by federal or state banking regulators.

Banks are exempt from South Carolina income taxes,<sup>165</sup> however, SC Code Title 12, Chapter 11, imposes a franchise tax based upon the “entire net income” of banks. The tax rate is 4.5 percent of the “entire net income” of the bank doing business in South Carolina or from the sales or rentals of property within South Carolina.<sup>166</sup> Although the chapter is entitled “Income Tax on Banks” and several of its sections refer to it as an income tax,<sup>167</sup> this tax has always been

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<sup>163</sup> The Small Business and Entrepreneurial Council’s “Small Business Survival Index 2009” - <http://www.sbecouncil.org/uploads/SBSI2009.pdf>.

<sup>164</sup> SC Code §12-11-10.

<sup>165</sup> SC Code §12-6-550(1).

<sup>166</sup> SC Code §12-11-20.

<sup>167</sup> SC Code §§12-11-30, 12-11-50, and 12-11-60.

considered a franchise tax based upon net book income.<sup>168</sup> Banks are not subject to any taxes in South Carolina except this tax, use taxes, deed recording fees, and property taxes on real property.<sup>169</sup>

For purposes of administration, allocation and apportionment, enforcement, collection, liens, penalties, and other similar provisions, all provisions of the South Carolina's income tax<sup>170</sup> that may be appropriate or applicable are adopted and made a part of the bank franchise tax for the purposes of enforcement and administration, including the requirement to make declarations of estimated tax and make estimated tax payments.<sup>171</sup>

### Savings and Loan Associations

A savings and loan association includes any mutual or stock-chartered corporation insured by the Federal Savings and Loan Insurance Corporation or any corporation subject to regulatory supervision by the Federal Home Loan Bank, or the Savings and Loan Division of the South Carolina Board of Financial Institutions, other than banks taxed under Chapter 11 of Title 12 of the SC Code, or employees' credit unions.<sup>172</sup>

Associations are exempt from South Carolina's corporate income tax,<sup>173</sup> however, SC Code Chapter 13 of Title 12 imposes an income tax (not a franchise tax) on associations. The tax rate is 6 percent of the net income from all sources, except for income from municipal, state, or federal bonds or securities exempted by law from the tax, including interest earned on deposits at the Federal Home Loan Bank of Atlanta, or its successors, for those savings and loan associations which meet the qualified thrift lender test set forth in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (Public Law 101-73), as amended.<sup>174</sup>

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<sup>168</sup> See South Carolina Attorney General's Opinion dated March 12, 1948, Commission Decision I-D-189 (1975), and SC Form 1101B and instructions.

<sup>169</sup> SC Code §12-11-30.

<sup>170</sup> Chapter 6 of Title 12 of the SC Code.

<sup>171</sup> SC Code §12-11-40 and Commission Decision I-D-189 (1975).

<sup>172</sup> SC Code §§12-13-10 and 12-13-40.

<sup>173</sup> SC Code §12-6-550(2).

<sup>174</sup> SC Code §12-13-30.

Associations are exempt from this tax for the first three years of their operation.<sup>175</sup> This savings and loan income tax is imposed in lieu of all other taxes on associations, except use taxes, deed recording fees, and property taxes on real property.

### Other Financial Institutions

Other financially related corporations like finance companies, credit card companies, securities brokers and dealers, are taxed under the corporate income tax provisions in SC Code Chapter 6 of Title 12.

### **Recommendations Regarding Financial Institutions**

#### 1. Conform the Bank Corporate Income Tax Rate to Those Paid by Other Businesses

As a result of legislation passed in the 1940s, banks, savings and loans and certain credit unions pay an income tax in lieu of all other taxes except deed recording fees, real property and use taxes. As such, these institutions pay no sales taxes, personal property taxes or local business license taxes. One would surmise that such financial institutions would therefore pay an income tax at a higher rate than other businesses. In fact, the converse is true; the income tax rate for banks is lower than virtually every other business enterprise tax rate (4.5 percent versus 5 percent for C Corporations and 7 or 5 percent for individuals, LLCs, S Corporations and the like.) In addition, federally chartered credit unions pay no income taxes.

Banks paid \$15,672,134 and savings and loans \$3,421,963 in taxes in FY 2009 – 2010 – (By contrast, insurers paid \$158 million, along with numerous other state and local taxes.)

As such, the General Assembly should consider raising the income tax rates on banks, savings and loans and credit unions to a level commiserate with their other tax savings.

#### 2. Conform the Tax Treatment of Credit Unions and Savings and Loans to Banks

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<sup>175</sup> SC Code §12-13-40.

There is little economic difference today between a credit union, savings & loan and a bank, and yet federally chartered credit unions pay no income taxes. Therefore, the General Assembly should conform the tax treatment of credit unions and savings and loans to other financial institutions.

### 3. Allocation and Apportionment of Income of Multi-State Banks

There is little guidance for the allocation and apportionment of income for multi-state banks. The General Assembly should enact legislation to provide clarity in this area. (The MTC has a model Banking Regulation for apportioning income for multi-state banks.)

#### **A Note about Nexus and Public Law 86-272**

Nexus is a sufficient connection between a person and a state, and a sufficient connection between an activity, property, or transaction and a state, that allows the state to subject the person, and the activity, property, or transaction to its taxing jurisdiction. The Due Process and Commerce Clauses of the United States Constitution, 15 U.S.C. §381 (Public Law 86-272), and other federal statutes provide limitations on states' powers to tax out-of-state corporations.

Public Law 86-272 prohibits a state from taxing the income of a taxpayer if the taxpayer's only business activities within the state consist of the solicitation of orders for sales of tangible personal property that are sent outside the state for approval and are filled and shipped from outside the state.

#### **Allocation and Apportionment of Income, Generally**

South Carolina Code §12-6-2210 provides for the determination of taxable income of a business. A taxpayer whose entire business is transacted or conducted in South Carolina is subject to income tax based on the entire taxable income of the business for the taxable year. A taxpayer that transacts or conducts its business partly within and partly outside of South Carolina

is subject to income tax based on the portion of its business carried on in South Carolina. This portion is determined through allocation and apportionment of income. The sum of these amounts is South Carolina taxable income.

South Carolina Code §§12-6-2220 and 12-6-2230 provide that certain classes of income, less related expenses, are allocated. Items directly allocated include non-business interest, non-business dividends, non-business rents and royalties from the lease or rental of real estate or tangible personal property, gains and losses from the sale of real property, and non-business gains and losses from sales of intangible property.

The income remaining after allocation is apportioned in accordance with South Carolina Code §12-6-2240. South Carolina generally requires the use of one of the following apportionment methods:

- 2) A “four factor” apportionment method (based on property, payroll, and double-weighted sales) or a “phased in” single factor apportionment method (based on sales) for taxpayers whose principal business in South Carolina is dealing in tangible personal property. This method is typically used by businesses that manufacture, sell, or rent tangible personal property.

**NOTE:** The “single sales factor” apportionment method is being phased in for tax years beginning in 2007 – 2010. The “single sales factor” apportionment method will replace the “four factor” apportionment method for tax years beginning in 2011 for businesses dealing in tangible personal property. See South Carolina Code §§12-6-2250, 12-6-2252, and 12-6-2295.



- 3) A “gross receipts” apportionment method for taxpayers not dealing in tangible personal property. This method is typically used by financial businesses and service businesses, including businesses that install or repair tangible personal property, and contractors. See South Carolina Code §§12-6-2290 and 12-6-2295.
- 4) A “special” apportionment method provided in South Carolina Code §12-6-2310 for certain companies, such as railroad companies, telephone companies, pipeline companies, airline companies, and shipping lines.
- 5) An individualized apportionment method tailored to a particular taxpayer (a) because the standard method for that taxpayer does not fairly represent the extent of the taxpayer’s business in South Carolina, or (b) as an economic incentive allowed the taxpayer. See subsections (b) and (c) below for more information on alternative apportionment provisions.

#### **Four Factor Apportionment Method/ New Single Sales Factor Apportionment Method**

##### **Phase-In Rules for Tax Year Beginning 2007-2010**

- a. Original Four Factor Apportionment Method. South Carolina Code §12-6-2250 contains the “four factor” formula and provides:

A taxpayer whose principal business in this State is (a) manufacturing or any form of collecting, buying, assembling, or processing goods and materials within this State, or (b) selling, distributing, or dealing in tangible personal property within this State, shall make returns and pay annually an income tax which includes its income apportioned to this State. Its income apportioned to this State is determined by multiplying the net income remaining after allocation under South Carolina Code §§12-6- 2220 and 12-6-2230 by a fraction, the numerator of which is the property ratio, plus the payroll ratio, plus twice the sales ratio, and the denominator of which is four. However, where the sales ratio does not exist [*i.e.*, there is zero sales everywhere], the denominator of the fraction is the number of existing ratios, and where the sales ratio exists but the payroll ratio or the property ratio does not exist, the denominator of the fraction is the number of existing ratios plus one. The property, payroll, and sales ratios must be determined in accordance with South Carolina Code §§12-6-2260, 12-6- 2270, and 12-6-2280, respectively.

b. New Single Sales Factor Apportionment Method.

For tax years beginning after 2010, South Carolina Code §12-6-2252 (*i.e.*, the new single sales factor apportionment method) provides that the above taxpayer's income is apportioned to South Carolina by multiplying the net income remaining after allocation under South Carolina Code §§12-6-2220 and 12-6-2230 by the sales factor defined in South Carolina Code §12-6-2280. However, if a sales factor does not exist, the remaining net income is apportioned to the business's principal place of business.

c. Phase In of Single Sales Factor Apportionment Method, As Applicable, for Tax Years Beginning 2007 - 2010.

For taxable years beginning in 2007 through 2010 only, South Carolina Code §12-6-2250(B) provides that a taxpayer apportioning income pursuant to South Carolina Code §12-6-2250(A) (*e.g.*, one whose principal business in South Carolina is dealing in tangible personal property) shall apportion income by using the method provided in South Carolina Code §12-6-2250 (*i.e.*, original four factor apportionment method) and, if applicable, the method provided in South Carolina Code §12-6-2252 (*i.e.*, new single sales factor apportionment method). If the calculation under South Carolina Code §12-6-2252 (single sales factor apportionment method) results in a reduction in income apportioned to South Carolina, the reduction is allowed as follows:

<b>Taxable Year Beginning in</b>	<b>Percentage of Reduction</b>
2007	20 percent
2008	40 percent
2009	60 percent
2010	80 percent

#### **Gross Receipts Apportionment Method**

South Carolina Code §12-6-2290 provides for the “gross receipts” formula and states: “If the principal profits or income of a taxpayer are derived from sources other than those described in South Carolina Code §12-6-2250 or §12-6-2310, the taxpayer shall apportion its remaining net income using a fraction in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year. For purposes of this section, items included in gross receipts are as provided in South Carolina Code §12-6-2295.” The “gross receipts” ratio is most commonly used by service businesses. The proper sourcing of gross receipts was reviewed in *Lockwood Greene Engineers v. South Carolina Tax Commission*, 361 S.E.2d 346 (1987). The court held that in sourcing income of a multistate engineering firm, “gross receipts from within this State” were to be determined according to where the services were performed rather than according to where the customers were located.

### **Fairness Based Alternative Apportionment Provisions**

South Carolina Code §12-6-2320 provides for alternative methods to fairly apportion income for companies who do business in more than one state. Any taxpayer who believes that the statutory apportionment formula does not represent the extent of the taxpayer's business within this State may apply to the Department for approval of an alternative method.

Under South Carolina Code §12-6-2320(A), a taxpayer may petition for, or the Department may require, with respect to all or any part of the taxpayer's business activity, one of the following alternatives for reporting:

- a. Separate Accounting;
- b. The exclusion of one or more factors;
- c. The inclusion of one or more factors; or
- d. The use of another allocation and apportionment method.

### **Unitary Business Doctrine, Generally**

Apportionment is tied to the unitary business concept. Before an apportionment formula can be applied by a state to ascertain the taxable income of a multistate corporation, or an affiliated group of corporations, a determination must be made that the divisions of the corporation, or the members of the controlled corporate group, constitute one unitary business. "The linchpin of apportionability in the field of state income taxation is the unitary business principle."<sup>176</sup>

A state cannot tax value earned outside of the state,<sup>177</sup> but a state may look beyond its borders to get the true value of taxed property or privileges within its borders, when in-state activities are an integral part of an organic interstate system that gives an enhanced value to the property or privileges which are taxed.

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<sup>176</sup> Exxon Corp v. Dept of Revenue, 447 U.S. 207, 223 (1980).

<sup>177</sup> Conn. General Life Ins. Co. v. Johnson, 303 U.S. 77 (1938).

“In a unitary enterprise, property outside the state, when correlated in use with property within the state, necessarily affects the worth of the privilege within the state.”<sup>178</sup> Thus, the privilege of doing business within a state may be made more valuable owing to its being an integral part of a multistate operation.

Therefore, to determine the amount a state can tax, first the unitary business is determined. A corporation can have income which is not connected with a trade or business, and a corporation can conduct more than one unitary business. The income and apportionment must be computed separately for each unitary business. On the other hand, one unitary business can encompass a group of related corporations<sup>179</sup> and the income from the unitary business, which is not otherwise allocated, is apportioned between the taxing state and everywhere else.

There is no objective and easy definition of unitary business. Rick Pomp and Oliver Oldman explain:<sup>180</sup>

The unitary business concept is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach.<sup>181</sup> Instead it [US Supreme Court] has identified some of the indicia of a unitary business: unity of use and management;<sup>182</sup> a concrete relationship between the out-of-state and the in-state activities;<sup>183</sup> functional integration, centralization of management, economies of scale;<sup>184</sup> substantial mutual interdependence;<sup>185</sup> and some sharing or exchange of value not capable of precise identification of measurement — beyond the mere flow of funds arising out of a passive investment or a distinct business

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<sup>178</sup> Ford Motor Co. v. Beauchamp, 308 U.S. 331 at 336 (1939) (franchise tax case).

<sup>179</sup> See Mobil Oil v. Vermont, 445 U.S. 425 (1980).

<sup>180</sup> State & Local Taxation, Richard D. Pomp and Oliver Oldman (3d ed. 2000) at 10-20 to 10-21. See also the draft of the Public Participation Working Group - Uniformity Committee Liaison Group on Definitions of Unitary Businesses on the Multistate Tax Commission website; [www.mtc.gov](http://www.mtc.gov).

<sup>181</sup> Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983).

<sup>182</sup> Butler Bros. v. McCollan, 315 U.S. 501 (1942).

<sup>183</sup> Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983).

<sup>184</sup> Mobil Oil Corp. v. Vermont, 445 U.S. 425 (1980).

<sup>185</sup> F.W. Woolworth Co. v. New Mexico, 458 U.S. 354 (1982).

operation.<sup>186</sup> The Court has recognized that in a unitary business, it is exceedingly difficult to determine the profits earned by the processes conducted within a state's borders.<sup>187</sup>

In a unitary multistate business, no method of assigning net income can precisely determine the exact amount of income attributable to any geographic area or to any given part of a series of multistate business operations. States have devised statutory apportionment formulas for multistate income designed to arrive at a portion of income reasonably attributable to the state. The formula method provides a rough approximation of a company's income that is reasonably related to the activities conducted within the taxing state; it does not identify the precise geographical source of a company's income.

### **Unitary Business Doctrine, Issues**

There are really two separate unitary business issues:

Are two (or more) entities or segments unitary so that their apportionment factors and incomes should be combined and used in determining income subject to income tax in a state? A segment for this purpose is a subdivision of an entity consisting of any grouping of business activities, functions, or transactions.

If the answer to the first issue is no, then is the income in question part of apportionable income? A yes answer to the second issue means that the income is apportionable, but that the apportionment factors of the payer are not included in the apportionment formula.

The first issue is the traditional unitary business issue for corporate income tax. Are the entities or segments not separate businesses, but an integral part of a multi-state unitary operation, such that the income from the operations within each state cannot accurately be

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<sup>186</sup> Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983).

<sup>187</sup> Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920).

attributed to a given state by the separate accounting method?<sup>188</sup> The underlying rationale is that there is but one business and the apportionment factors and income are really the apportionment factors and income of one business which should be allocated and apportioned together.<sup>189</sup>

The second issue is a determination of whether income is apportionable. In South Carolina that is the same as determining whether it is business income or non-business income,<sup>190</sup> and in some cases where a corporation is carrying on more than one unitary business, determining to which unitary business the income relates.<sup>191</sup>

### **South Carolina Overview, a Separate Entity State**

South Carolina is a separate entity state, and generally treats related corporations as if they were unrelated. South Carolina does not normally apportion the income of related corporations together, even when they are part of one unitary business.<sup>192</sup> Single member limited liability companies and QSubs that are disregarded for all South Carolina tax purposes are exceptions to this rule. Another possible exception is provided by SC Code §12-6-2320(A) which provides that if South Carolina's statutory allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in South Carolina, the taxpayer may petition for, or the Department may require, in respect to all or any part of the taxpayer's business activity a

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<sup>188</sup> The Supreme Court has declared the "principal virtue of the unitary business principle of taxation is that it does a better job of accounting for 'the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise' than, for example, geographical or transactional accounting." *Allied Signal, Inc. v. New Jersey*, 504 U.S. 768, 783 (1992) quoting from *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 164-165 (1983).

<sup>189</sup> See e.g., *Exxon Corp. v. Wisconsin*, 447 U.S. 207 (1980); *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980); *F.W. Woolworth, Co. v. New Mexico*, 458 U.S. 354 (1962); *ASSARCO, Inc. v. Idaho State Tax Comm.*, 458 U.S. 307 (1982); *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983); and see BNA Multistate Tax Portfolio #1110, *Income Taxes: Definition of a Unitary Business*.

<sup>190</sup> In South Carolina, all apportionable income is business income.

<sup>191</sup> The payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment. What is required instead is that the transaction serve an operational rather than an investment function. For example, interest earned on short-term deposits in a bank located in another state where that income forms part of the working capital of the corporation's unitary business, is part of that corporation's apportionable income, notwithstanding the absence of a unitary relationship (issue 1) between the corporation and the bank.

In order to exclude certain income from the apportionment formula, the company must prove that the income was earned in the course of activities unrelated to those carried out in the taxing state. See *Allied Signal, Inc. v. New Jersey*, 504 U.S. 768 (1992); and *Eastman Kodak Company v. SC Tax Comm.*, 418 S.E.2d 542 (SC 1992); and see BNA Multistate Tax Portfolio #1110, *Income Taxes: Definition of a Unitary Business*.

<sup>192</sup> The South Carolina Supreme Court held in *Emerson Elec. Co. v. Wasson*, 287 S.C. 394, 339 S.E.2d 118 (1986), that parent and subsidiary corporations are not to be considered a single entity for apportionment purposes.

different method. It is possible that in certain circumstances the taxpayer may request, or the Department may require, combined reporting; *i.e.*, the apportionment of multiple related corporations together. Although this type of alternative combined apportionment has been discussed, the Department has, to date, never attempted to impose it over a taxpayer's objection.

South Carolina does allow what it refers to as consolidated returns.<sup>193</sup> They are nothing like what federal tax practitioners consider consolidated returns.

South Carolina recognizes that it is possible that one corporation can carry on two or more separate unitary businesses. When that is the case, each unitary business is apportioned separately.<sup>194</sup>

### **Separate Reporting System for Corporate Income Tax, Generally**

South Carolina currently operates under a separate reporting system for corporate income tax. This means that the state generally “treats related corporations as if they were unrelated.” The following example offers some insight for how the separate entity reporting works on an individual basis.

Corporation A operates within South Carolina, and because of these in-state activities, A has nexus with the state. A is therefore liable to pay corporate income tax. Corporation B is a trademark holding firm in another state, and a subsidiary of A. B owns and holds A's trademark,

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<sup>193</sup> SC Code §12-6-5020 and *Emerson Elec. Co. v. Wasson*, 287 S.C. 394, 339 S.E.2d 118 (1986).

<sup>194</sup> *Exxon Corporation v. South Carolina Tax Commission*, 273 S.C. 594, 258 S.E.2d 93 (1979). See also SC Reg. §117-710.1 Proper Allocation and Apportionment of Income:

The phrase “transacting or conducting his business partly within and partly without this State” ... is applicable to a single business operation, which is unitary or homogenous and is carried on both within and without the State. A taxpayer operating two or more unrelated businesses, each of which is entirely within and without the State, is not subject to the provisions of this section, but each business determines its South Carolina net income separately. A taxpayer operating a unitary or homogenous business within and without the State and an unrelated business either entirely within or without is subject to the [apportionment] formulas with respect to the unitary or homogenous business but not with respect to the unrelated business. The income from the unrelated business is allocated and apportioned separately as appropriate to the State where such business is conducted.

A review of South Carolina cases below will attest, this possibility is not a common occurrence in South Carolina.



and, as part of A's business within South Carolina, licenses the use of this trademark to A in exchange for a royalty fee.<sup>195</sup> Corporation B has no officers within South Carolina, nor does it do any business within the state beyond this licensing agreement with Corporation A.<sup>196</sup>

Under the separate entity system, Corporation B is an unrelated operation to Corporation A in South Carolina. A and B are separate companies entirely for the purpose of assessing tax liability. Even if the state were to utilize the unitary business principle and define A's operation so broadly as to include its transactions with B, and even though B is a subsidiary A, a corporation liable to pay corporate income tax, the state would still not be able to reach B and its activities with A to tax the income it receives from A's operations in South Carolina. With separate entity reporting, the two companies would be distant from each other, and since B has no nexus with the state, it would avoid liability.

Similarly, since the state treats A and B as strangers, A's operations would have no impact in B's tax liability, since there would be no liability to begin with. More striking however, B's income from its operations with A would not be held against A when apportioning A's income for tax liability.<sup>197</sup> The money Corporation A pays to its subsidiary, Corporation B, would only serve to negate A's liability since it would only be calculated as an expense against A's income for its in-state activities.<sup>198</sup>

Separate entity reporting creates a potentially massive tax loophole for corporations capable of taking advantage. While the system is very attractive to those companies, it creates a number of problems for the state, as well as for those corporations incapable of seizing its benefits.

### **Separate Reporting, Issues and Concerns**

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<sup>195</sup> Under this hypothetical, Corporation B could be referred to as a "Passive Investment Company" or "Delaware holding companies." See Sheldon H. Laskin, *Only a Name? Trademark Royalties, Nexus, and Taxing That Which Enriches*, 22 AKRON TAX J. 1, 4 (2007).

<sup>196</sup> See, e.g., *Geoffrey, Inc. v. South Carolina Tax Com'n*, 437 S.E.2d 13 (S.C. 1993).

<sup>197</sup> See RICHARD POMP, *STATE & LOCAL TAXATION* 10-30 (4th ed. 2001); see also HELLERSTEIN & HELLERSTEIN, *STATE TAXATION* §9.15 (3rd ed. 2010).

<sup>198</sup> See PENNSYLVANIA BUDGET AND POLICY CENTER, *ENSURING ALL CORPORATIONS PAY THEIR FARE SHARE* (2010).

There are numerous potential issues associated with separate reporting for both the state and the private sector. What follows is a point-by-point breakdown of these problems.

*1. Separate Entity Reporting Creates a Tax Loophole for Corporations to Avoid Tax Liability.*

The most obvious concern with separate entity reporting is the potential tax loophole the system leaves open for certain businesses to utilize. Using the example from above, consider a scenario in which Corporation A creates Corporation B as its subsidiary, and that Corporation B files its articles of incorporation in a state that has no corporate income tax.<sup>199</sup> Corporation B would then have no tax liability in South Carolina or in the state in which it is incorporated. A can then pay B extremely high rates and fees for the use of its trademark, thereby reducing its taxable income to a point where its liability within South Carolina would be either minimal or none at all.<sup>200</sup> Tax expert Richard Pomp refers to this form of income maneuvering as the “Delaware loophole” given the high number of corporations who establish subsidiaries in the tax-free state of Delaware and thereby avoid tax liability in separate entity states where they have sufficient nexus.<sup>201</sup>

The implications for South Carolina include significant losses in tax revenue. Pomp recently estimated that Pennsylvania’s separate entity system has so far cost that state \$615 million.<sup>202</sup>

*2. Separate Entity Reporting is Discriminatory Against Smaller Businesses.*

A second issue with separate entity reporting is that the system provides an unfair competitive advantage for typically large multi-state corporations. The holding company tax loophole, as exemplified in the A and B example, offers a potentially beneficial option for

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<sup>199</sup> See Delaware or Wyoming as examples.

<sup>200</sup> PENNSYLVANIA BUDGET AND POLICY CENTER, ENSURING ALL CORPORATIONS PAY THEIR FARE SHARE (2010).

<sup>201</sup> *Id.*

<sup>202</sup> *Id.*

certain businesses capable of setting up subsidiaries in tax-free states. This benefit, however, is felt by only certain corporations, while many others, including small businesses, are left out.

Multi-state corporations operating within South Carolina benefit from state and locally-funded public services. They benefit, like all businesses, from doing business within the state. The difference, however, for these multi-state corporations is that while they accept and use these benefits, they are able to avoid paying their fair share of taxes, which are then used to fund these services. The income they collect can be sent, under the current law, to their holding subsidiary in Delaware.

Other, usually smaller, businesses are not so fortunate. Corporations that do all of their business within South Carolina, for example, are liable to pay their 5 percent income tax.<sup>203</sup> Since they are not capable or sophisticated enough to establish holding companies as tax haven subsidiaries, they operate within their own state at a competitive disadvantage with these multi-state corporations.<sup>204</sup>

### *3. Separate Entity Reporting Leads to Year-by-Year Inconsistencies in State Tax Revenue.*

The tax loopholes created by South Carolina's separate reporting structure also lead to inconsistencies with the state's tax revenues. Looking at South Carolina's year-by-year tax revenues from fiscal year 2000-01 to the present shows that over the past nine years, ending in fiscal year 2008-09, revenues have jumped as high as 47 percent in fiscal year 2003-04, but have likewise dropped in 2001-02 at -38 percent and -23 percent in 2008-09.<sup>205</sup>

There are numerous explanations for these inconsistencies, including changes in the economic climate and other areas of legislation, but the ability of corporations to manipulate

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<sup>203</sup> S.C. CODE ANN. § 12-6-530 (2010).

<sup>204</sup> See Andrew Haile, *A Time For Action: Reforming the North Carolina Tax Code*, 2010 N.C. L. REV. ADDENDUM 1 (2010).

<sup>205</sup> See *supra* chart on pp. 4.

their multi-state tax liabilities through holding company loopholes only exacerbates the state's problem in enforcing a consistent, dependable tax structure.<sup>206</sup>

### Overcoming Separate Reporting – Geoffrey

#### The Case

*Geoffrey, Inc. v. South Carolina Tax Commission*<sup>207</sup> involved a corporate structure identical to the A and B hypothetical discussed above. Geoffrey, Inc. was a subsidiary of Toys R Us, incorporated in Delaware, and held various Toys R Us trademarks. Geoffrey then issued licensing agreements with Toys R Us so that Toys R Us could then use these marks in various states across the United States, including South Carolina, where they sold their products. Toys R Us used the licensed marks on their buildings and on the tags of their products within South Carolina. Much like Corporation B in the hypothetical, Geoffrey had no officers within South Carolina, nor anything else, such as tangible property, that would have created a sufficient nexus with the state to generate tax liability.<sup>208</sup>

As expected, Toys R Us used the expense associated with its licensing agreements with Geoffrey to limit their in-state tax liability by taking a deduction on their income. Under South Carolina's separate entity structure, the income derived from Toys R Us' activities within the state, as well as Geoffrey's income from its licensing agreements arising from Toys R Us' activities within the state, could not be reached by the South Carolina Department of Revenue. Toys R Us' income had been diminished by their deductions paid to Geoffrey, and Geoffrey's income suffered no liability since the subsidiary had no nexus with the state.

Despite these facts, the Department of Revenue still forced Geoffrey to pay income tax under the concept that it was doing business in South Carolina through its licensing agreements, which was sufficient activity to trigger nexus with the state.

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<sup>206</sup> See Andrew Haile, *A Time For Action: Reforming the North Carolina Tax Code*, 2010 N.C. L. REV. ADDENDUM 1 (2010).

<sup>207</sup> *Geoffrey, Inc. v. South Carolina Tax Com'n*, 437 S.E.2d 13 (S.C. 1993).

<sup>208</sup> *Id.*

## Supreme Court's Ruling

Geoffrey challenged the tax on Due Process and Commerce Clause grounds, but to no avail. The South Carolina Supreme Court upheld the tax and held that Geoffrey had nexus with the state for two reasons.<sup>209</sup> First, Geoffrey had intangible property in the state through an account receivable set up by Toys R Us through which Toys R Us paid Geoffrey for the use of the trademarks.<sup>210</sup> The Court ignored a long-held assumption that physical, tangible, presence within the state was necessary for nexus.<sup>211</sup>

Second, the Court held that Geoffrey willingly sought to do business within South Carolina through its agreements with Toys R Us.<sup>212</sup> These agreements read that the trademarks were licensed for Toys R Us' use in all states *except for Massachusetts, Pennsylvania, New Jersey, Texas, and New York*.<sup>213</sup> The Court reasoned that Geoffrey set up the agreements with sufficient specificity such that Geoffrey was on notice of the use of the marks in South Carolina, one of the states unlisted in the exception, and could have prevented Toys R Us from doing so.<sup>214</sup>

Once the Court determined that Geoffrey had nexus with South Carolina, the tax survived both the Due Process and Commerce Clause challenges.<sup>215</sup>

## Problems with *Geoffrey*

Despite the Court's success in overcoming the parent-subsidary structure<sup>216</sup> for taxing within a separate entity jurisdiction, relying on the *Geoffrey* ruling to deal with the numerous problems posed by separate reporting only leads to more issues for the state.

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<sup>209</sup> *Id.*

<sup>210</sup> *Id.*

<sup>211</sup> *See* Quill Corp. v. North Dakota, 112 S.Ct. 1904 (1992).

<sup>212</sup> *Geoffrey*, 437 S.E.2d 13 (S.C. 1993).

<sup>213</sup> Emphasis added.

<sup>214</sup> *Geoffrey*, 437 S.E.2d 13 (S.C. 1993). The Court further held that the tax imposed was rationally related to the benefits Geoffrey received from the state for Due Process purposes. The benefit received were Toys R Us' customers, through whom Geoffrey received its income. Geoffrey also received protection, benefits, and opportunities in accordance with doing business in the state, from which it also derived its income.

<sup>215</sup> For further discussion of the Due Process and Commerce Clause holdings by the Court, *see supra* pp. 16-18.

Listed are a few of the difficulties in using *Geoffrey* as the de facto law for overriding multi-state tax structures taking advantage of separate entity loopholes.

### *Litigation is Not the Best Answer*

From a practical perspective, using *Geoffrey* as the method of overcoming loophole structures means that the only way for the state to gain access to some of the lost revenue is through more litigation. This is an expensive way of dealing with the separate entity problem. Other states, including North Carolina, have already recognized that the use of litigation in dealing with the shortcomings and inefficiencies of separate reporting is not the ideal answer.<sup>217</sup>

### *Geoffrey is Not Entirely Definitive for All Holding Company Loophole Structures*

The *Geoffrey* ruling offers a mechanism for dealing with loophole structures that is very fact specific. In a separate entity jurisdiction, a multi-state corporation could still conceivably take advantage of the loophole without facing a successful *Geoffrey* challenge.

For example, a parent and subsidiary could execute less specific licensing agreements than those between Geoffrey and Toys R Us. Those agreements listed specific states as being exempted locations for the use of the trademarks, and this degree of specificity was a crucial factor in the Court's determination that Geoffrey willfully did business within South Carolina. All a post-Geoffrey multi-state corporation has to do is be less specific with their agreements.

A second crucial factor in *Geoffrey* for finding nexus within the state was the presence of an account receivable within South Carolina that Toys R Us used to pay Geoffrey. A post-Geoffrey corporation could simply avoid this type of intangible presence within the state and the parent could simply pay the subsidiary directly to its Delaware (or out of state) address.

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<sup>216</sup> Also referred to as piercing the corporate veil.

<sup>217</sup> See Andrew Haile, *A Time For Action: Reforming the North Carolina Tax Code*, 2010 N.C. L. REV. ADDENDUM 1 (2010)..

The case is helpful, then, in only specific circumstances that are easily overcome. Relying on the courts to use the ruling as a way to overcome every loophole structure is a gamble that need not be taken.

### *Legislation is the Better Way*

The most definitive way for dealing with separate entity reporting is through new legislation that will change South Carolina's tax structure to a combined reporting system. Legislation would be definitive and not subject to corporations altering their corporate structure to constantly fit within the shifting or narrowing allowable loophole as determined by cases like *Geoffrey*. Other states have also recognized the need to enact legislation to move from a separate entity system to combined reporting when the alternative would be relying strictly on case law.<sup>218</sup>

### **Combined Reporting for Corporate Income Tax, Generally**

Combined reporting represents another mechanism for taxing corporate income in South Carolina. Under a combined reporting system, a parent company and all of its subsidiaries file as a single unified or *combined* company, eliminating shifting mechanisms where profits and costs can be funneled disproportionately based on where each was incurred.

In a separate entity reporting structure, the relationship between a parent and subsidiary is ignored, even when both operate within the same unitary business. In a combined reporting structure, on the other hand, the state treats a subsidiary as if it is a division of the parent corporation, operating within the same unitary business. The income of the subsidiary and the parent would be calculated together, with all allocable income removed, and the remaining, taxable income would be determined by the state's apportionment formula from this overall number. Returning to the Corporation A/ Corporation B scenario offers some insight into how combined reporting works.

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<sup>218</sup> See Andrew Haile, *A Time For Action: Reforming the North Carolina Tax Code*, 2010 N.C. L. REV. ADDENDUM 1 (2010).

Corporation A sells its products in South Carolina, where it has nexus with the state. Corporation B, a subsidiary of A, is incorporated in Delaware, where it leases the use of A's trademark to A in South Carolina. Normally, as established above, B would not have nexus with South Carolina, and thus could not be taxed in a separate entity structure. In combined reporting, however, A and B would both be taxed as one entity. Since A has nexus with South Carolina, and part of A's business in the state included the use of the trademarks it leased from B, both would be included in the same unitary business. For tax purposes, both A and B's income would be combined, and then the state would determine the taxable portion of that income to them by their apportionment formula.<sup>219</sup>

Combined reporting states impose numerous conditions on when multi-state corporations qualify for combined reporting. First, the parent and subsidiaries must be part of the same unitary business.<sup>220</sup> Second, states normally require that a common corporation own the subsidiaries and parent, measured by a minimum ownership of stock.<sup>221</sup> This minimum ownership requirement usually entails that one corporation own more than 50 percent of common stock<sup>222</sup> in the parent and subsidiaries involved in the unitary business.<sup>223</sup>

In 2008, 21 states applied combined reporting methods to corporate income tax. Combined reporting requires that companies combine profits from all related subsidiaries, including captive real-estate investment trusts (REITs) and passive investment companies (PICs), before determining what portion of their profits are taxable in that state.<sup>224</sup>

For the four states that did not levy corporate income tax in 2008, this issue was irrelevant. (Texas has since instituted a 0 percent corporate tax rate.)

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<sup>219</sup> For a discussion of South Carolina's apportionment formula, *see supra* pp. 7-15.

<sup>220</sup> *See supra* pp. 22-25.

<sup>221</sup> *See* RICHARD POMP, *STATE & LOCAL TAXATION* 10-31 (4th ed. 2001).

<sup>222</sup> Some states require 80 percent share of common stock over the corporations. *See* HELLERSTEIN & HELLERSTEIN, *STATE TAXATION* §8.11 (3rd ed. 2010).

<sup>223</sup> *See* RICHARD POMP, *STATE & LOCAL TAXATION* 10-31 (4th ed. 2001).

<sup>224</sup> These states are: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Texas, Utah, Vermont, and West Virginia.



Besides D.C., South Carolina is one of the remaining 25 states that still uses a separate reporting method. Separate reporting methods can facilitate a company's ability to shelter corporate income from taxes, typically through PICs and REITs.

No other southeastern states apply combined reporting mechanisms, however. Commissions in Kentucky, Pennsylvania, and North Carolina have also recommended the adoption of combined reporting.

### **Forms of Combined Reporting**

Combined reporting serves numerous purposes for the state, and most important of which, it prevents the use of holding companies and subsidiaries in tax-free states that can be used as tax havens. Despite the general usefulness of combined reporting in bolstering the state's corporate income tax revenue, there are various forms of combined reporting that need to be explored.

#### **1. "Pure" Combined Reporting<sup>225</sup>**

The most basic method used by combined reporting states entails requiring all corporations to file combined returns. This "pure" combined reporting involves, first, that a subsidiary or parent company have nexus with the state. Second, the state must determine the unitary business of the corporation. Then, this unitary business must satisfy the more than 50 percent common ownership requirement. Once all of this satisfied, then the parent and subsidiaries file a combined report that includes all of their income, whether some of these subsidiaries have nexus with the state or not. The state then uses its apportionment formula to calculate the tax liability of this unitary business operation.

#### **2. Forced Combined Reporting**

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<sup>225</sup> See RICHARD POMP, STATE & LOCAL TAXATION 10-31 (4th ed. 2001).

A second method in which a state enforces combined reporting is by authorizing the Department of Revenue to compel a corporation to file a combined return. This would entail the South Carolina DOR determining that a unitary business includes subsidiaries that do not have nexus with the state, and then forcing the corporate entity that does have nexus with the state to file a report that includes the income of its parent and subsidiaries, whether they have nexus with the state or not, so long as they are considered part of the unitary business. A very recent South Carolina Supreme Court decision, *Media General v. SCDOR*, arguably authorizes forced combined returns.

Kansas, North Carolina, and Tennessee utilize a forced combined reporting mechanism. In Kansas, Kan. Stat. Ann. § 79-32.141 empowers the department of revenue director to require a unitary business to file a combined report even though corporations are not otherwise required to do so under state law.<sup>226</sup> Once the director decides that a corporation must file a combined report in a given year, that business must continue to do so for as long as combined reporting is allowed in the state.<sup>227</sup>

In North Carolina, the tax administrator may require a unitary business to file a combined return if a separate entity report does not effectively determine the taxable income for the state.<sup>228</sup> Similarly, in Tennessee, the state tax commissioner can compel “two or more entities owned or controlled” by the same person or corporation to file a combined report when filing separate reports would fail to properly reflect taxable income.<sup>229</sup>

### 3. “Water’s Edge” Combined Reporting

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<sup>226</sup> See *State by State Analysis of Income Taxes: Consolidated Returns and Combined Reporting*, BNA Tax Management Portfolios (2010).

<sup>227</sup> See *State by State Analysis of Income Taxes: Consolidated Returns and Combined Reporting*, BNA Tax Management Portfolios (2010).

<sup>228</sup> See *State by State Analysis of Income Taxes: Consolidated Returns and Combined Reporting*, BNA Tax Management Portfolios (2010).

<sup>229</sup> See *State by State Analysis of Income Taxes: Consolidated Returns and Combined Reporting*, BNA Tax Management Portfolios (2010).

One of the most controversial issues affecting combined schemes is what states should do with unitary business operations that include foreign corporations or subsidiaries. While some states, most notably California, initially included these foreign entities in a combined report, concerns over foreign affairs eventually led most states with worldwide reporting to adopt “water’s edge” combined reporting. Water’s edge reporting adheres to the policy that combined reporting should only concern united corporations or corporate entities within the United States.

### **Benefits of Combined Reporting**

Combined reporting prevents the use of tax loopholes linked to corporate structure. In a separate entity tax system, multi-state corporations are able to control their tax liability through their own structures. Using out of state subsidiaries, for example, provides a tax haven from which the state cannot reach because the subsidiary does not have nexus. Under a pure combined reporting scheme, corporations within a unitary business are required to file a combined report, thus eliminating the usefulness of holding companies and other subsidiaries. In a forced combined reporting scheme, corporations are similarly forced to file as a unitary business when the department of revenue determines doing so better reflects their taxable corporate income.

Additional advantages to combined reporting are:

- Combined reporting discourages corporations from creating out of state subsidiaries.
- In combined reporting, corporations are no longer incentivized to establish out of state subsidiaries. If these subsidiaries, typically holding companies, are deemed to be part of the same unitary business as the parent company, which has nexus with the state, then any income that is shifted to them will be taxed. Subsidiaries whose sole purpose is to take advantage of the loopholes created by separate entity reporting will cease to serve that purpose, and corporations will no longer feel the need to shift income out of the state.
- Combined reporting leads to increased tax revenue for South Carolina. Since companies can no longer shield themselves from liability through the restructuring

loopholes created by separate entity reporting, the state will be much more successful at capturing taxable income in a combined system.

- Combined reporting is a more equitable tax system for all taxpaying businesses. In a separate entity system, intrastate companies are at a disadvantage since they cannot take advantage of holding company loopholes like multi-state corporations. Combined reporting prevents those loopholes, meaning that all taxpaying companies within South Carolina are on equal footing.
- Combined reporting better reflects the economic realities of present day corporations. Companies operating in multiple states are often part of a group of companies controlled by a parent. Merging these related companies for tax purposes better represents their true economic activity as decisions are made by the parent company.

More specifically, combined reporting better captures the true income of a multi-state corporation. In a separate entity system, the state is limited in determining and taxing corporate income for business activities that take place within its jurisdiction. The only corporate entities with tax liability in a separate system are those with nexus within the state. This eliminates transfers of income, “flows of value,” “sharing of knowledge,” and experience that contribute to the earnings and income of multi-state corporations. In a separate system, these and other intangible elements of a business operation are eliminated from consideration and all that remains to be allocated and apportioned is the sales income of the one or two corporate entities within the state. The reality, however, is that what a corporation earns from its activities in South Carolina reach beyond just what can be seen or experienced within the state’s borders. Combined reporting states recognize the complexity of the current corporate culture, and in certain cases, even in South Carolina, corporations themselves have recognized the need for combined reporting as a way to properly determine tax liability.

Case Note – *Media General Communications v. South Carolina Department of Revenue*.

In *Media General Communications v. South Carolina Department of Revenue*, the taxpaying corporation challenged the Department of Revenue’s use of the separate entity accounting procedures authorized by the state on the grounds that it did not correctly reflect the

unitary business's corporate income.<sup>230</sup> The parent corporation, Media General, Inc., was domiciled in Virginia and owned Media General Communications, incorporated in Delaware. Media General Communications in turn owned Media General Options, who then owned a subsidiary named Media General Broadcasting of South Carolina Holdings, Inc. This corporate structure, indicative of the complexities of the current corporate climate, comprised a unitary business of shared ownership and management.

The Department of Revenue performed an audit of Media General, Media General Communication, and Media General Broadcasting and issued tax assessments on each of them individually for income earned through licensing intangible assets within South Carolina. Media General challenged these individual assessments performed under the separate entity accounting formula on the grounds that they resulted in a distortion of the income and business activities of the unitary business within the state. Media General instead argued that a combined accounting better represented their taxable income.

The administrative court sided with Media General, holding that S.C.C. § 12-6-2320 (A)(4) allows for combined reporting. That specific code section reads:

If the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.<sup>231</sup>

The South Carolina Supreme Court upheld the administrative court's ruling. The Court held that the code section authorizing the use of "any other method to effectuate an

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<sup>230</sup> Media General Communications, Inc. v. South Carolina Department of Revenue, 2010 WL 2347037 (S.C. June 14, 2010).

<sup>231</sup> S.C. CODE ANN. § 12-6-2320 (A)(4) (2010).

equitable allocation and apportionment of the taxpayer's income" included the use of combined reporting as a possible mechanism in South Carolina.

The Court's ruling in *Media General* recognized that combined reporting is preferential to separate entity reporting in certain circumstances. What is also of note is the fact that while separate entity reporting has been the common method in South Carolina, there is case law recognition within the state that combined reporting is better equipped to handle the complexities of multi-state corporate structures, particularly when such structures impact the ability of the state to properly tax corporate income.

Additional advantages to combined reporting are (continued):

- Combined reporting does not necessarily mean increased tax liability for corporations. Tax expert Richard Pomp argues that while some businesses may fear that combined reporting increases the tax liability for multi-state corporations, this is not always or necessarily the case.<sup>232</sup> *Media General* offers a clear example of when multiple parts of a unitary business have nexus with the state, and each are taxed separately, shifting to a combined reporting system may actually lessen the tax liability while also giving corporations a much easier and cost-effective way of filing income tax.
- Combined reporting does not inhibit economic growth. Economist Robert Lynch found that combined reporting has not interfered with the economic progress of states that employ it.<sup>233</sup>
- Combined reporting is now the corporate income tax system followed by 23 of 45 states. One of the most pressing concerns for shifting from a separate entity reporting structure to a combined system is that it would encourage multi-state corporations to leave South Carolina for more tax-friendly states. The reality, however, is that 23 of the 45 states that impose corporate income tax now use combined reporting as their tax structure. In many of the 22 states without pure

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<sup>232</sup> See RICHARD POMP, STATE & LOCAL TAXATION 10-31 (4th ed. 2001).

<sup>233</sup> PENNSYLVANIA BUDGET AND POLICY CENTER, ENSURING ALL CORPORATIONS PAY THEIR FARE SHARE (2010).

or forced combined reporting, legislation allows for the elective use of combined reporting by either administrative agencies or taxpayers.

In short, keeping with the current separate entity reporting system places South Carolina at a disadvantage with these other states and prevents the state from joining a movement by most jurisdictions to utilizing combined reporting, particularly when complex corporate structures require the use of a more comprehensive tax system to better reflect income tax liability.

### **Criticisms of Combined Reporting**<sup>234</sup>

Mandatory unitary combined reporting (MUCR)—is touted by proponents as a “loophole closer” and as a way to stop “income shifting” to low tax jurisdictions. In actuality, however, mandatory unitary combined reporting carries severe economic consequences: 1) it arbitrarily assigns income to a state, 2) negatively impacts the real economy, and 3) imposes significant administrative burdens on both the taxpayer and state.<sup>235</sup>

1. Arbitrarily Assigns Income – Although proponents of MUCR argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under MUCR create new distortions in assigning income to different states. The MUCR assumption that all corporations in an affiliated unitary group have the same level of profitability is not consistent with either economic theory or business experience. Consequently, MUCR may reduce the link between income tax liabilities and where income is actually earned. Many corporate taxpayers may conclude that there is a significant risk that MUCR will arbitrarily attribute more income to a state than is justified by the level of a corporation’s real economic activity in the state.

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<sup>234</sup> Testimony of Committee on State Taxation (COST) before TRAC.

<sup>235</sup> A thorough discussion of the problems associated with MUCR can be found in the study prepared for COST by Ernst & Young LLP, “*Understanding the Revenue and Competitive Effects of Mandatory Unitary Combined Reporting*” (<http://www.cost.org/WorkArea/DownloadAsset.aspx?id=70000>).

2. Negatively Impacts the Real Economy – Proponents of MUCR have focused on the benefits in terms of reducing tax planning opportunities, but they fail to acknowledge that MUCR may result in higher effective corporate income tax rates. Economic theory suggests that these higher effective tax rates will ultimately be borne by labor in the state through fewer jobs (or lower wages over time) or by in-state consumers through higher prices for goods and services.
3. Significant Administrative Burden - Determining the Unitary Group: The concept of a “unitary business” is uniquely factual and universally poorly-defined. It is a constitutional (Due Process) concept that looks at the business as a whole rather than individual separate entities or separate geographic locations. In order to evaluate the taxpayer’s determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine how a taxpayer and its affiliates operate at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation’s operational and tax staff to gather this operational information. In practice, however, auditors routinely refuse to make a determination regarding a unitary relationship on operational information and instead wait to determine unitary relationships until after they have performed tax computations. In other words, the tax result of the finding that a unitary relationship exists (or does not exist) often significantly influences, or in fact controls the auditor’s finding. Determining the scope of the unitary group is a complicated, subjective, and costly process that is not required in separate filing states and often results in expensive, time-consuming litigation.

*Calculating Combined Income* – Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most MUCR states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In addition to variations in apportionment formulas among the states that apply to all



corporate taxpayers, further compliance costs related to MUCR result from variations across states in the methods used to calculate the apportionment factors.

Mandating unitary combined reporting exacerbates the problems with the corporate income tax. In light of the underlying conceptual flaws in the state corporate income tax, the TRAC should support either elimination of the corporate income tax or adoption of a New Mexico-style election that allows corporations to choose to file on a separate, combined or consolidated basis.

### **Combined Reporting, Recommendations**

For the reasons articulated above, the General Assembly should examine requiring the use of combined reporting for corporate income tax. Ideally, such legislation would recognize the benefits of the combined system over the current separate entity reporting structure. Combined reporting is a way to avoid discrimination against certain businesses, to tax income that would otherwise be shifted out of state, and to deal with the growing complexities of the current corporate climate.

The two best methods for enforcing combined reporting include pure combined reporting, which means an across the board requirement that all corporations and unitary businesses with nexus with the state file a combined report, and forced combined reporting, which authorizes the Department of Revenue to compel corporations to file combined reports should it be determined that doing so better reflects the income of a corporation.

### **Separate Reporting, Recommendations**

In the event the General Assembly retains South Carolina as a separate reporting state (see prior discussion) the General Assembly should consider adopting the following reforms.

#### **Adopt State Law Counterpart to IRC §482**

Regardless of whether their statutes or case law authorize combined reporting for affiliated corporate entities, many states have adopted provisions identical or analogous to Section 481 of the Internal Revenue Code, which authorizes the Secretary of the Treasury to “distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among” commonly controlled entities “in order to prevent evasion of taxes or clearly to reflect income.” For example Alaska, California, and Hawaii have expressly incorporated Section 482 into their own tax codes. Other state legislatures have adopted their own statutes based on Section 482, and still other states provide their respective taxing authorities with broad power to prevent distortions of net income and evasion of taxes.

#### Adopt Economic Substance Doctrine

The General Assembly should consider adopting the federal income tax requirement for economic substance. This would allow the SCDOR to better challenge unlawful tax shelters.

#### Disallow Deduction for Related Party REITs

REITs are a creature of federal tax law. Deductions for payments to related party REITs should be disallowed.

#### Require Forced Combinations

The DOR has the authority to require forced combinations under the recent *Media General* ruling. The DOR should issue regulations providing the ground rules for forced combinations.

#### Apply the Throwback Rule

The “throwback rule” is used to rectify the loss of corporate income tax revenue caused by the conflict between state apportionment formulas and Public Law 86-272. When a corporation produces and/or sells goods in more than one state, each state requires the business

to pay tax on just a portion of its nationwide profit. That taxable share is calculated by an apportionment formula in each state's corporate income tax law. The most commonly used formula assigns some of the profit to the state(s) in which the corporation produces goods, some to state(s) in which employees are based, and some to the state(s) in which the corporation makes sales.

However, Public Law 86-272, establishes a threshold level of presence or "nexus" a corporation must have in a state before it can be subjected to a corporate income tax on profit earned in that state. Public Law 86-272 frequently blocks states in which a corporation merely makes sales from imposing an income tax on the states' respective shares of the corporation's profit (as calculated by the formula).

The throwback rule effectively allows a state in which a corporation produces goods or services to tax the profit on any sales made by the corporation into states in which the corporation has insufficient presence to be subjected to a tax on its profit from those sales. Including D.C., 31 states in the nation issue the "throwback rule" to avoid such loss of corporate income tax. Alabama and Mississippi are the only two southeastern states that apply the "throwback rule".<sup>236</sup>

### **Corporate Tax Recommendations Relative to Ethical Issues**

Most illegal tax shelters historically have resulted from contingency fee tax planning wherein the tax professional charges for a portion of the tax savings. (Such changes are sometimes contingency fees and other times are large flat fees with no relationship to the amount of professional time spent on the matter.) Contingency fees are barred by IRS Circular 230, which only applies to original filed returns. Circular 230 does not apply to amended returns. The General Assembly should consider the following reforms:

#### **Adopt all of Circular 230**

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<sup>236</sup> The Department of Commerce, A Report to the SC Taxation Realignment Commission.

South Carolina has adopted most, but not all of IRS Circular 230. The General Assembly should consider adopting Circular 230 in its entirety.

### Amended Returns

As stated above, Circular 230 does not prohibit contingency fees on amended returns. South Carolina should consider: (1) going beyond Circular 230 and barring contingency fees on amended returns; or (2) requiring a statement on any return prepared on the basis of contingency fees.

### Corporate Income Tax Credits, Generally

South Carolina had over 20 different types of credits against corporate income tax in FY 2007-2008. During that year, \$708.9 million in credits were claimed by only 454 filers. South Carolina allows credits to be carried forward up to 15 years. As noted below, in 2008, \$645.7 million in credits were carried forward by 279 filers.<sup>237</sup>

### Corporate Tax Credit Carry-forwards (2001-2009)\*

2001	\$84 Million
2002	\$99 Million
2003	\$87 Million
2004	\$191 Million
2005	\$261 Million
2006	\$274 Million
2007	\$627 Million
2008	\$646 Million
2009	\$708 Million

\*Source: South Carolina Department of Revenue Annual Reports 2001-2009

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<sup>237</sup> “Corporate Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina” prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

Apart from carry-forwards from previous years, the New Jobs tax credit and the Economic Impact Zone (EIZ) credit are the largest credits. In 2008, credits carried over from previous years accounted for 89 percent of total credits, New Jobs credits account for 5 percent, and EIZ credits accounted for 3 percent.<sup>238</sup>

#### Year-by-Year Comparison of Corporate Income Tax Credits

Credit Claimed	FY 06-07 No. of Returns	FY 06-07 Amount	FY 07-08 No. of Returns	FY 07-08 Amount	FY 08-09 No. of Returns <sup>239</sup>	FY 08-09 Amount <sup>240</sup>
TC Column A Carry Over from Previous Year	161	\$574,948,328	175	\$631,714,509	248	\$664,735,750
TC 1 Drip/Trickle Irrigation Systems	-	-	3	\$1,295,285	1	\$97,500
TC 2 Socio/Econ Disadvantage Small Business	5	\$100,068	3	\$56,742	-	-
TC 3 Water Resources	1	\$2,500	1	\$82,500	3	\$1,042,344
TC 4 New Jobs Credit	93	\$72,059,902	102	\$36,581,029	124	\$41,479,523
TC 5 Scenic River	-	-	-	-	-	-
TC 6 Infrastructure	5	\$673,570	8	\$1,519,781	9	\$3,043,408
TC 7 Palmetto Seed Capital	-	-	-	-	-	-
TC 8 Corporate	2	\$434,737	1	\$434,736	5	\$9,287,269

<sup>238</sup> “Corporate Income Tax: Statewide Economic Growth and Taxation Issues in South Carolina” prepared by Dr. Rebecca Gunnlaugsson, Ph.D., Director, Research Division, SC Department of Commerce, October 28, 2010.

<sup>239</sup> These numbers are preliminary and not yet finalized.

<sup>240</sup> These numbers are preliminary and not yet finalized.

Headquarters						
TC 9 Employer Child Care	-	-	-	-	-	-
TC 10 Base Closure	1	\$4,186	1	\$482	-	-
TC 11 Economic Impact Zone	62	\$9,070,623	84	\$20,772,039	69	\$23,190,705
TC 12 Family Independenc e Payments	16	\$381,202	12	\$71,739	17	\$136,697
TC 12A Add. AFDC	6	\$35,987	6	\$17,262	6	\$25,561
TC 17 Recycling Property Tax	1	\$12,187,836	1	\$7,026,056	3	\$7,877,996
TC 18 Research Expenses	33	\$4,142,805	47	\$7,425,132	88	\$15,753,004
TC 19 Qualified Conservation Contribution	1	\$2,557	1	\$469	2	\$24,499
TC 21 Certified Historic Structure	2	\$242,876	1	\$77,477	1	\$235,155
TC 28 SC Quality Forum	-	-	3	\$1,158,981	-	-
TC 30 Increased Port Cargo	-	-	2	\$53,144	6	\$1,702,268
TC 34 Corporate Tax Moratorium	2	\$922,428	-	-	-	-
TC 36 Industry Partnership Fund	1	\$5,300	1	\$500,000	-	-
TC 37 Toxicity Testing	-	-	2	\$142,200	-	-

Credit						
Health Insurance Pool Credit <sup>241</sup>	-	-	-	-	1	\$795,484
Unidentified Taken <sup>242</sup>	1	\$2,500	-	-	14	\$926,833
<b>Total</b>	<b>393</b>	<b>\$675,217,405</b>	<b>454</b>	<b>\$708,929,563</b>	<b>597</b>	<b>\$770,353,996</b>
Expired Credits	4	\$742,572	5	\$589,273	5	\$2,740,273
Total Carry forwards	154	\$626,509,297	279	\$645,733,375	253	\$708,376,217

### **The “Jobs Tax Credit”, Issues and Concerns**

South Carolina has a host of tax credits. Most have relatively little revenue impact. The one tax credit with a major revenue impact is the Job Tax Credit. This revenue impact is a function of several factors. First, the credit is relatively rich, ranging from \$1,500 to \$8,000 per job depending upon the wage scale and the county in which the job is located. Second, the carry forward for the credit is 15 years. Third, new jobs – even retail and service (mostly in poorer counties) now qualify for the credit. Lastly, the General Assembly has steadily increased the types of jobs which qualify even in richer counties. When originally enacted, the minimum number of jobs which had to be created was ten, and only manufacturers, warehouse and distribution qualified. Currently, only 2 new jobs need to be created and such entities as banks and general contractors qualify.

### **The “Jobs Tax Credit”, Recommendations**

1. The General Assembly should consider reducing the maximum credit amount from \$8,000 to \$6,000.
2. The Carry forward should be reduced

<sup>241</sup> There is no form for this credit.

<sup>242</sup> Previously these were not broken out.

Corporate income tax credits carried forward to the future have been increasing since 2003. The amount of carryover credits from previous years increased dramatically in 2007, rising \$353 million or 129 percent over 2006. The level remained high in 2008. This increasing use of tax credits and carry-forwards over time not only reduces state corporate revenues, but also increases year-over-year variability. South Carolina has a staggering \$650 million plus in tax credit carry forwards, many of which relate to the Job Tax Credit. The carry forward on new hires should be reduced from 15 to 5 or 3 years. Three years is the typical carry forward period for most state and federal tax credits. South Carolina's fifteen year carry forward is likely the longest in the country. The General Assembly should, however, reduce the carry forward prospectively (i.e. only on jobs created after the effective date of the Act.)

### 3. Tax credits for retail and service jobs should be eliminated

When the economy improves, the General Assembly should consider eliminating the creation of retail and service jobs from the Job Tax Credit.

## **R&D Credit, Issues, Concerns and Recommendation**

Amend the South Carolina research credit to make it more in line with the federal research credit. Both the South Carolina federal research credits are for research and development costs in the experimental or laboratory sense, including costs incident to the development or improvement of a product. The federal research credit, Section 41 of the Internal Revenue Code, is 20 percent of the increase in qualified research expenses incurred by the company for the tax year over a base year amount calculated pursuant to the statute. South Carolina's research credit (SC Code Section 12-6-3415) is equal to 5 percent of the taxpayer's total qualified research expenses. To claim the South Carolina research credit, a taxpayer must claim the federal increased research expenditures credit, so the taxpayer must claim the federal increased research expenditures credit, so the taxpayer must have some increase in eligible research expenses to claim the South Carolina research credit, but because South Carolina's credit research expenses to claim the South Carolina research credit, but because South Carolina's credit is not limited to increases in research costs, the South Carolina credit may be



much larger than the credit allowed under federal law, which is an unusual, and probably unintended, outcome.

### **Brief Summary of Corporate Income Tax Credits**

**DRIP/TRICKLE IRRIGATION SYSTEMS CREDIT:** For purchasing and installing conservation tillage equipment, drip/trickle irrigation system or dual purpose combination truck and crane equipment. (TC-1)

**CREDIT FOR STATE CONTRACTORS SUBCONTRACTING WITH SOCIALLY AND ECONOMICALLY DISADVANTAGED SMALL BUSINESSES:** For state contractors that subcontract with socially and economically disadvantaged small businesses. (TC-2)

**WATER RESOURCES CREDIT:** For investing in the construction of water storage and control structures for soil and water conservation, wildlife management, agriculture and aquaculture purpose.

**NEW JOBS CREDIT:** For qualifying employers that create ten or more jobs. (TC-4)

**SMALL BUSINESS ALTERNATIVE JOB CREDIT:** For qualifying small businesses that create 2 or more full-time jobs. (TC-4SA)

**SMALL BUSINESS JOB CREDIT:** For qualifying small businesses that create and maintain 2 or more full-time jobs. (TC-4SB)

**SCENIC RIVER CREDIT:** For donating certain lands adjacent to designated rivers or sections of a river. (TC-5)

**INFRASTRUCTURE CREDIT:** For construction or improvements of water lines, sewer lines and road projects eventually dedicated to public use or qualifying private entity. (TC-6)

**CORPORATE HEADQUARTERS CREDIT:** For qualifying costs related to establishing a corporate headquarters in South Carolina or expanding or adding to an existing headquarters. (TC-8)

**EMPLOYER CHILD CARE CREDIT:** For employers that establish child care programs to benefit employees or donate to a non-profit corporation providing child care. (TC-9)

**BASE CLOSURE CREDIT:** For hiring employees who lost their jobs because of federal military installation closure or Realignment. (TC-10)

**ECONOMIC IMPACT ZONE CREDIT:** For placing qualifying property in service in an economic impact zone. (TC-11)

FAMILY INDEPENDENCE PAYMENTS CREDIT: For employers hiring qualifying recipients of Family Independence Payments. (TC-12)

ADDITIONAL FAMILY INDEPENDENCE PAYMENTS CREDIT: For employers hiring qualified Family Independence Payment recipients in a least developed county. (TC-12A)

COMMUNITY DEVELOPMENT CREDIT: For investing amounts not claimed as charitable deductions in qualifying development corporations or financial institutions. (TC-14)

RECYCLING PROPERTY CREDIT: For taxpayers constructing or operating a qualified recycling facility when investing in recycling property. (TC-17)

RESEARCH EXPENSES CREDIT: For taxpayers claiming a federal research expenses credit. (TC-18)

QUALIFIED CONSERVATION CONTRIBUTION CREDIT: For donating a qualifying gift of land for conservation or a qualified conservation contribution of a real property interest. (TC-19)

BROWNFIELD VOLUNTARY CLEANUP PROGRAM CREDIT: For costs of voluntary cleanup activity by a non-responsible party. (TC-20)

CERTIFIED HISTORIC STRUCTURE CREDIT: For rehabilitation projects that qualify for the federal credit. (TC-21)

TEXTILES REHABILITATION CREDIT: For rehabilitating an abandoned textile manufacturing facility. (TC-23)

COMMERCIALS CREDIT: For production companies producing commercials in South Carolina. (TC-24)

MOTION PICTURES CREDITS: For investing in motion picture projects or motion picture production or post-production facilities in South Carolina after June 30, 2004. (TC-25)

VENTURE CAPITAL INVESTMENT CREDIT: For lending money to the SC Venture Capital Authority (TC-26)

SC QUALITY FORUM CREDIT: For participating in quality programs of the SC Quality Forum. (TC-28)

PORT CARGO CREDIT: For increasing usage by volume at state ports. (TC-30)

RETAIL FACILITIES REHABILITATION CREDIT: For revitalizing abandoned retail facilities. (TC-31)

MERCURY SWITCH DISPOSAL CREDIT: For vehicle recycler or scrap recycling facility participating in End-of-Life Vehicle Solution (ELVS) Program for each mercury switch collected and admitted for disposal. (TC-33)

CORPORATE TAX MORATORIUM: For qualifying taxpayers that make a substantial investment and creates at least 100 new, full-time jobs, a 10 year, or in some cases, a 15 year moratorium on corporate income taxes. (TC-34)

ALTERNATIVE MOTOR VEHICLE CREDIT: Taxpayers with federal credit allowed under Internal Revenue Code 30B, will receive SC Credit. (TC-35)

INDUSTRY PARTNERSHIP FUND CREDIT: For contributing to the SC Research Authority's Industry Partnership Fund. (TC-36)

WHOLE EFFLUENT TOXICITY TESTING CREDIT: For a manufacturing facility incurring costs in complying with whole effluent toxicity testing. (TC-37)

SOLAR ENERGY OR SMALL HYDROPOWER SYSTEM CREDIT: For installing a solar energy system or small hydropower system in a South Carolina facility. (TC-38)

ETHANOL OR BIODIESEL PRODUCTION CREDIT: For producers of corn-based or non-corn-based ethanol or soy-based or non-soy-based biodiesel. (TC-40)

RENEWABLE FUEL FACILITY CREDIT: For constructing a renewable fuel production or distribution facility in South Carolina. (TC-41)

APPRENTICESHIP CREDIT: For employing an apprentice. (TC-45)

HYDROGEN INFRASTRUCTURE DEVELOPMENT FUND CREDIT: For contributions to the South Carolina Hydrogen Infrastructure Development Fund. (TC-47)

PLUG-IN HYBRID VEHICLE CREDIT: For in-State purchase or lease of a plug-in hybrid vehicle. (TC-48)

CELLULOSIC ETHANOL OR ALGAE-DERIVED BIODIESEL RESEARCH AND DEVELOPMENT CREDIT: For qualified expenditures for research into and development of feedstock's and processes for cellulosic ethanol and for algae-derived biodiesel. (TC-49)

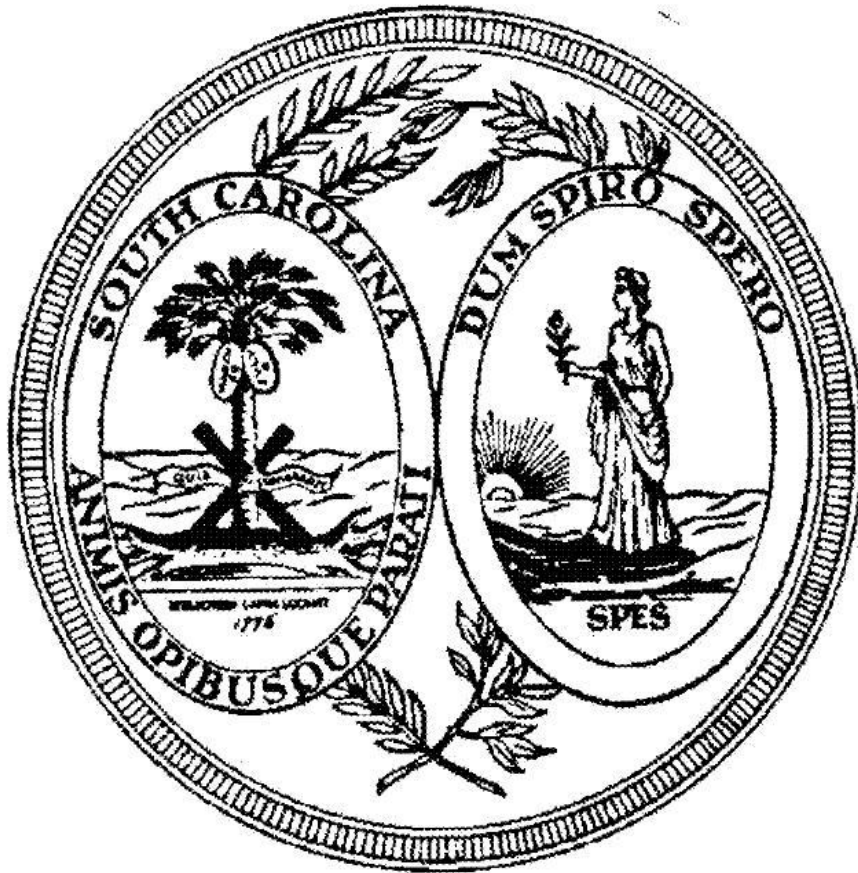
BIOMASS RESOURCE CREDIT: For costs incurred by corporation for purchases and installation of equipment used to create power, etc. for commercial use. (TC-50)

VENISON FOR CHARITY CREDIT: For processing deer meat for charity. (TC-51)

SPRINKLER SYSTEM CREDIT: For installing a fire sprinkler system. (TC-52)

ENERGY EFFICIENT MANUFACTURED HOME CREDIT: \$750 credit for new purchase of an Energy Star manufactured home. (TC-53)

# Property Tax



## South Carolina Taxation Realignment Commission

## **Property Taxes, Generally**

The property tax system in South Carolina is unique compared to the property tax systems in many other states. For example, seventeen states have assessment systems that differentiate tax treatment by various classes of property, but South Carolina has the most (ten) individual categories. In addition, South Carolina is one of the only states in the Southeast that applies a different assessment rate to primary residential real property (4 percent) and other real property types (e.g. 6 percent for rental and/or second home properties).<sup>243</sup>

In short, South Carolina's property tax system is a product of extremes. The State has the highest taxes in the nation on manufacturers (not in a fee-in-lieu), a low tax burden on urban primary residences, very high tax levies on boats and planes, one of the lowest in the country for primary residents over the age of 65 that live in an urban county, and some of the highest national tax rates on commercial and industrial property, and the lowest tax rates on residential property.<sup>244</sup>

Consider the data below compiled by the Minnesota Taxpayers Association as illustration of the extremes indicated above. Note: higher numbers indicate lower tax rates, while lower numbers indicate higher tax rates.

### **Property Taxes Payable 2009**

#### **Urban Homestead**

<b><u>\$150,000 PROPERTY</u></b>			<b><u>\$300,000 PROPERTY</u></b>		
<b>STATE</b>	<b>CITY</b>	<b>RANK</b>	<b>STATE</b>	<b>CITY</b>	<b>RANK</b>
South Carolina	Columbia	49	South Carolina	Columbia	50
Georgia	Atlanta	9	Georgia	Atlanta	18
North Carolina	Charlotte	35	North Carolina	Charlotte	35

<sup>243</sup> South Carolina Department of Commerce, *Property Tax, A Review of Issues in South Carolina* (Bert Shuler).

<sup>244</sup> South Carolina Department of Commerce, *Property Tax, A Review of Issues in South Carolina* (Bert Shuler).

Urban Apartment  
\$600,000 Valued Property  
\$30,000 Fixtures

<b>STATE</b>	<b>CITY</b>	<b>RANK</b>
South Carolina	Columbia	19
Georgia	Atlanta	24
North Carolina	Charlotte	42

Urban Commercial

<u>\$100,000 PROPERTY &amp; \$20,000 FIXTURES</u>			<u>\$1 MILLION PROPERTY &amp; \$200,000 FIXTURES</u>			<u>\$25 MILLION PROPERTY &amp; \$5,000,000 FIXTURES</u>		
<u>State</u>	<u>City</u>	<u>Rank</u>	<u>State</u>	<u>City</u>	<u>Rank</u>	<u>State</u>	<u>City</u>	<u>Rank</u>
South Carolina	Columbia	18	South Carolina	Columbia	19	South Carolina	Columbia	19
Georgia	Atlanta	29	Georgia	Atlanta	30	Georgia	Atlanta	31
North Carolina	Charlotte	48	North Carolina	Charlotte	48	North Carolina	Charlotte	48

Urban Industrial (50 percent Personal Property):

<u>\$100,000 VALUED PROPERTY \$50,000 Machinery and Equipment \$40,000 Inventories \$10,000 Fixtures</u>			<u>\$25 MILLION VALUED PROPERTY \$12,500,000 Machinery and Equipment \$10,000,000 Inventories \$2,500,000 Fixtures</u>		
<u>STATE</u>	<u>CITY</u>	<u>RANK</u>	<u>STATE</u>	<u>CITY</u>	<u>RANK</u>
South Carolina	Columbia	1	South Carolina	Columbia	1

Georgia	Atlanta	7	Georgia	Atlanta	20
North Carolina	Charlotte	42	North Carolina	Charlotte	43

Rural Homestead

<u>\$70,000 PROPERTY</u>			<u>\$150,000 PROPERTY</u>			<u>\$300,000 PROPERTY</u>		
<u>STATE</u>	<u>CITY</u>	<u>RANK</u>	<u>STATE</u>	<u>CITY</u>	<u>RANK</u>	<u>STATE</u>	<u>CITY</u>	<u>RANK</u>
South Carolina	Mullins	30	South Carolina	Mullins	32	South Carolina	Mullins	32
Georgia	Fitzgerald	21	Georgia	Fitzgerald	20	Georgia	Fitzgerald	18
North Carolina	Edenton	32	North Carolina	Edenton	34	North Carolina	Edenton	34

Rural Commercial

<u>\$100,000 PROPERTY &amp; \$20,000 Fixtures</u>			<u>\$1 MILLION PROPERTY &amp; \$200,000 Fixtures</u>			<u>\$25 MILLION PROPERTY &amp; \$5,000,000 Fixtures</u>		
<u>STATE</u>	<u>CITY</u>	<u>RANK</u>	<u>STATE</u>	<u>CITY</u>	<u>RANK</u>	<u>STATE</u>	<u>CITY</u>	<u>RANK</u>
South Carolina	Mullins	5	South Carolina	Mullins	5	South Carolina	Mullins	5
Georgia	Fitzgerald	26	Georgia	Fitzgerald	27	Georgia	Fitzgerald	27
North Carolina	Edenton	41	North Carolina	Edenton	41	North Carolina	Edenton	41

Rural Industrial (50 percent Personal Property):

<u>\$100,000 PROPERTY</u>	<u>\$1 MILLION PROPERTY</u>	<u>\$25 MILLION PROPERTY</u>
<u>\$50,000 Machinery and Equipment</u>	<u>\$500,000 Machinery and Equipment</u>	<u>\$12,500,000 Machinery and Equipment</u>
<u>\$40,000 Inventories</u>	<u>\$400,000 Inventories</u>	<u>\$10,000,000 Inventories</u>



<u>\$10,000 Fixtures</u>			<u>\$100,000 Fixtures</u>			<u>\$2,500,000 Fixtures</u>		
STATE	CITY	RANK	STATE	CITY	RANK	STATE	CITY	RANK
South Carolina	Mullins	1	South Carolina	Mullins	1	South Carolina	Mullins	1
Georgia	Fitzgerald	17	Georgia	Fitzgerald	19	Georgia	Fitzgerald	19
North Carolina	Edenton	44	North Carolina	Edenton	44	North Carolina	Edenton	44

These extremes are a product of several factors: (1) numerous assessment ratios, (2) a large number of very generous credits and exemptions granted only for primary residences, particularly those owned by persons 65 and over; and (3) preferential status given to ag-use properties, just to name a few.

The effect of these extremes is to significantly reduce the property tax base of some types of property (e.g. primary residences and farms) with the remaining property tax base being shifted, via assessment ratios, to everyone else. The shift hits non fee-in-lieu manufacturers (as well as boats and planes) particularly hard as they have a 10.5 percent assessment ratio.

### **Property Taxes, History of Recent Changes**

Like other states, South Carolina has been under considerable pressure over time to provide property tax relief to certain categories of taxpayers and as such, these extremes were not created overnight. Many of the more detailed property tax provisions have been amended in recent years. Consider the following summary of a timeline of some of the most noteworthy changes over the last thirty years.<sup>245</sup>

1975 - Act 208 required all real property to be valued at fair market value (FMV) for tax purposes. FMV approximates the price at which a given piece of property would sell between a

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<sup>245</sup> South Carolina Department of Commerce, *Property Tax, A Review of Issues in South Carolina* (Bert Shuler).

willing buyer and a willing seller. Act 208 also required the classification of real property for assessment purposes.

1984 - Business inventories were gradually exempted from property taxation with the phase-in of the merchant's inventory tax exemption (fully exempt by 1987). However, the value of this exemption was shifted from the taxpayer at the county level to the State as a whole, as the exemption required reimbursement from South Carolina (e.g. the State's "General Fund") to the counties annually in the amount of the revenue not collected as a result of the exemption. In 2008, the South Carolina Board of Economic Advisors estimated the annual fiscal impact of the merchant's inventory exemption to be approximately \$40.6 million.

1994 - The General Assembly established the school property tax relief trust fund. This provision exempted the first \$100,000 of all owner occupied property from the portion of the total millage applied for school operating purposes.<sup>246</sup>

1996 - The General Assembly altered (through a phased approach) the allowances for the depreciation of manufacturing personal property for property tax purposes. Under the amended provision, the maximum allowed depreciation percentage for this category was increased from 80 percent in years prior to 1997 to 83.3 percent in 1997, 86.6 percent in 1998, and 90 percent in 1999 and subsequent years. Similar to the merchant's inventory exemption, these changes created two special purpose funds, the state property tax relief and the depreciation property tax reimbursement funds, to reimburse the counties for lost revenue as a result of the amended legislation. In 2008, South Carolina counties received reimbursements of \$40.1 million for the manufacturers' depreciation allowance.

2000 - In 2000, the State's Constitution was amended to reduce the assessment rate for personal motor vehicles from 10.5 percent to 6 percent over a seven year period. As such, by 2007, the assessment ratio on personal motor vehicles was 6 percent.

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<sup>246</sup> After the passage of Act 388 in 2006, the \$100,000 residential homeowners exemption is referred to as tier 1 property tax relief.

2006 – Act 388. Known as “The Swap”, Act 388 brought about several significant policy changes, the most notable of which was “swapping” 100 percent of the school operating portion (except for general obligation debt) of a primary homeowners property tax bill for a 1 cent increase in the State sales and use tax (raising it from 5 to 6 percent). However, the sales and use tax on “groceries” was reduced from 5 to 3 percent (and has since been further reduced from 3 percent to 0 percent). Furthermore, Act 388 limited the amount by which the fair market value of real property could increase resulting from a general reassessment program to 15 percent over a five-year period. However, the limits imposed by the act do not apply to increases in value as a result of an assessable transfer of interest (a topic of growing debate as noted below). Finally, Act 388 established a tiered structure for state level reimbursements from the trust fund for tax relief to counties for certain property tax exemption categories. Tier 1 items include reimbursements for property tax relief related to the \$100,000 residential homeowners exemption established in 1994. Tier 2 items include reimbursements for the homestead exemption, and tier 3 items generally include additional reimbursements for the elimination of the property taxes assessed for school operating purposes under Act 388. Tier 3 items also include a \$2.5 million minimum state level disbursement to each county annually.

In concert with Act 388, the General Assembly also passed the “South Carolina Real Property Valuation Reform Act of 2006”. This act requires real property to be appraised after an assessable transfer of interest, which includes conveyance by deed, by land contract, to a trust, by distribution from a trust or under a will, and by lease as well as a change of use of agricultural property subject to rollback taxes. As a result of an appraisal that is triggered by an assessable transfer of interest, real property sold between years of general reassessment is appraised for property tax purposes at fair market value at the time of sale. Property owners and local governments are strongly divided over the assessable transfer of interest provisions and during the 2009-10 session of the General Assembly, legislation was strongly debated as to how to resolve this issue.

It should also be noted that, in 1990, the General Assembly established the local option sales tax in South Carolina. The local option sales tax is an optional 1 percent general sales and use tax on nearly all taxable retail sales in a given county imposed to reduce the property tax

burden on property owners in that county. Specifically, the General Assembly requires at least 71 percent of the proceeds from the local option sales tax to be used to offset property tax burdens. However, thirteen of the thirty counties imposing the local option sales tax applied 100 percent of receipts to offset property tax collections. The property tax relief provided by the local option sales tax is distributed to property owners in proportion to the market value of their property. Therefore, it is important to note that primary residential owners receive more relief proportionally than owners of other property types, since this category of property receives the lowest possible assessment rate. For participating counties, In 2008, the local options sales tax accounted for approximately \$238.9 million of local government revenue across all counties in South Carolina.

### **Property Taxes, Calculating**

Property tax, which is mostly administered, assessed and collected by local governments (with assistance from the South Carolina Department of Revenue), is generally calculated as follows:

Property value (typically fair market)

X Assessment Ratio (depending on class of property)

X Millage Rate\* (equal to one-thousandth of a dollar (\$0.001))

Yields Tax Due

\*In 2008, the average millage rate in South Carolina was 297.6 mills.

### **Determining the Taxable Value for Property**

Article X, Section 1, of the South Carolina Constitution provides for taxation by classification, but also states that within each classification “fair market value” is to be used. Article III, Section 29 of the South Carolina Constitution provides that:

“[a]ll taxes upon property, real and personal, shall be laid upon the actual value of the property taxed, as the same shall be ascertained by an assessment made for the purpose of laying such tax.”

In addition, SC Code §12-37-930 provides that:

All property is to be valued “at its true value in money that is the price that the property would bring following reasonable exposure to the market where both seller and buyer are willing.”<sup>247</sup>

### Assessment Ratios

The following assessment ratios are applied to the value of the property to determine the assessed value for purposes of taxation:

#### **Assessment Ratios by Property Type**

<b>Primary Residence</b>	4.0 percent
<b>Agricultural (Private)</b>	4.0 percent
<b>Agricultural (Corporate)</b>	6.0 percent
<b>Other Real Property</b> <sup>248</sup>	6.0 percent
<b>Motor Vehicles</b>	6.0 percent
<b>Other Personal</b>	10.5 percent
<b>Manufacturing</b>	10.5 percent
<b>Utility</b>	10.5 percent
<b>Business Personal</b>	10.5 percent
<b>Motor Carrier</b>	9.5 percent

### Business Personal Property

All furniture, fixtures and equipment are to be reported at acquisition cost with a deduction allowed for depreciation. This category does not include inventory.

<sup>247</sup> See *Lindsey v. S.C. Tax Comm’n*, 302 S.C. 504, 397 S.E.2d 95 (1990); *Smith v. Newberry County Assessor*, 350 S.C. 572, 567 S.E.2d 501 (Ct. App. 2002).

<sup>248</sup> The other real property category encompasses all real property other than owner occupied primary residential real property, including secondary residences and commercial and rental real property.

## Fee-in-Lieu of Property Taxes

Industries investing at least \$2.5 million (\$1 million in some counties) in South Carolina may negotiate for a fee-in-lieu of taxes, resulting in a savings of about 40 percent of property taxes otherwise due.

The project may be financed with industrial revenue bonds and structured as a purchase-leaseback. The county may hold title to the fee assets. Under certain fee agreements, the title remains with the company.

A company must make the minimum investment over a period of five years to qualify. A county may grant up to an additional 5 years to complete a project. An additional minimum investment may be required to be met within a certain period of time. In addition, the fee agreements may be negotiated as a fixed millage rate for the term of the fee agreement or a millage rate that varies every five years in accordance with the prior five-year average millage for the site.

The following example shows the savings from reducing the assessment ratio from 10.5 percent to 6 percent. Savings are also available from freezing the millage rate and the value of real property.

	<b>Normal Calculation</b>	<b>Fee-in-Lieu</b>
Total Investment		
In Equipment	\$100,000,000	\$100,000,000
Investment Less		
Depreciation	\$89,000,000	\$89,000,000
Assessment Ratio	x 10.5%	x 6%
Assessed Value	\$9,345,000	\$5,340,000
Millage	x 0.250	x 0.250
Tax Due	<u>\$2,336,250</u>	<u>\$1,335,000</u>
Savings		\$1,335,000

## Property Tax Revenues, Generally

The property tax is the primary source of revenue for local governments in South Carolina. In 2008, property tax revenue represented 53 percent of all tax collections in South Carolina at the local government level (excluding state and federal aid).

In 2008, approximately 62.6 percent of the total revenue received by local governments in the state of South Carolina went to school districts, 20 percent to municipalities, and 13.4 percent to county governments.<sup>249</sup>

### **Property Tax, a Detailed View of Revenues**

The composition of revenue from the property tax changed significantly between 1993 and 2008. In 1993, approximately 20.4 percent of property tax revenue was collected from primary residences; 1.3 percent from private and corporate owned agricultural property; 28.6 percent from second residences and other real property; 14.6 percent from motor vehicles; and 35.1 percent from business and other categories of personal property, including fee in lieu of taxes agreements.<sup>250</sup> However, by 2008, approximately 23.4 percent of property tax revenue was collected from primary residences; 0.7 percent from private and corporate agricultural property; 41.1 percent from second residences and other real property; 10.5 percent from motor vehicles; and 24.3 percent from business and other personal property.<sup>251</sup>

Furthermore, the distribution of taxable values across property tax categories changed between 1993 and 2008. However, changes in the distribution of revenues and values did not always occur together or even in the same direction. For example, owner occupied primary residences represented 33 percent of all taxable property in 1993 and 42.3 percent in 2008. However, this property category only paid 20.4 percent and 23.4 percent of all property taxes in 1993 and 2008, respectively. In contrast, the other real property category, which include secondary residences and commercial and rental real property, accounted for 29.5 percent and 34.7 percent of all taxable property in 1993 and 2008 but paid 28.6 percent and 41.1 percent of

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<sup>249</sup> South Carolina Department of Commerce, *Property Tax, A Review of Issues in South Carolina* (Bert Shuler).

<sup>250</sup> Since property tax revenue from agricultural property has historically been small, the private and corporate agricultural real property categories are combined in figures 12 and 13.

<sup>251</sup> South Carolina Department of Commerce, *Property Tax, A Review of Issues in South Carolina* (Bert Shuler).

all property taxes in these years. Business and other personal property accounted for 20.6 percent and 13.4 percent of all taxable property in 1993 and 2008 but paid 35.2 percent and 24.3 percent of all property taxes. The share of property taxes and values for motor vehicles has been roughly in proportion, and in terms of both measures, agricultural property as a percentage of the total has been in decline. Historical differences between the tax revenues and fair market values across property tax categories raise important issues of equity in the property tax system in South Carolina.<sup>252</sup>

### **Property Tax Exemptions, Generally**

State law provides over 60 property tax exemptions, as detailed below.

#### **The property of all:**

- 1) Libraries
- 2) Churches
- 3) Parsonages
- 4) Burial grounds

#### **Exemptions as they relate to institutions of learning or medical services:**

All property of:

- 5) Schools
- 6) Colleges and other institutions of learning except where the profits of the institutions are applied to private use the property of all charitable institutions
- 7) The infirmed, the disabled, the aged, children
- 8) Indigent persons except where the profits of the institutions are applied to private use

#### **Exemptions as they relate to certain individuals:**

The dwelling house and up to one acre of surrounding land is exempt for:

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<sup>252</sup> South Carolina Department of Commerce, *Property Tax, A Review of Issues in South Carolina* (Bert Shuler).



- 9) A Veteran who is permanently and totally disabled from a service-connected Disability
- 10) A former law enforcement officer who is permanently and totally disabled from a service connected disability in this State as defined in Section 23-23-10 (E)(1).
- 11) A former firefighter, including a volunteer firefighter who is permanently and totally disabled from a service connected disability in this State as defined in Chapter 80 of Title 40.
- 12) The exemption is passed to the surviving spouse of a member of the armed forces of the United States who meet the qualifications of a veteran, law enforcement officer or firefighter.
- 13) Qualified surviving spouse also means the surviving spouse of a member of the armed forces of the United States who was killed in action who at the time of death owned the dwelling in fee or jointly with the now surviving spouse. All criteria must be met to qualify for the exemption.
- 14) The law enforcement officer and firefighter must have been employed in the State of South Carolina when declared permanently and totally disabled as a result of a service connected disability.

Exemptions as they relate to organizations:

Nonprofit organizations involved in the following:

- 15) Water supply
- 16) Sewage disposal
- 17) A combination of both water supply and sewage disposal
- 18) American Legion
- 19) Veterans of Foreign Wars
- 20) Disabled American Veterans
- 21) Fleet Reserve Association
- 22) Marine Corps League
- 23) Other similar veterans' organizations
- 24) YMCA and YWCA
- 25) Salvation Army

- 26) Boy Scouts
- 27) Girl Scouts
- 28) Palmetto Junior Homemaker Association
- 29) New Homemakers of South Carolina
- 30) South Carolina Association of Future Farmers of America
- 31) New Farmers of South Carolina
- 32) Religious, charitable, eleemosynary, educational or literary society, corporation
- 33) association, when the property is held primarily for holding meetings and
- 34) conducting business
- 35) Property owned by religious, charitable, eleemosynary, educational or literary society, corporation or association, if property is acquired to construct or renovate a residential structure for sale to economically disadvantaged persons.
- 36) The exemption will not exceed fifty (50) acres per county and the sale *cannot* be for profit
- 37) Property owned by religious, charitable, eleemosynary, educational or literary society, corporation or association, extends to the real property that is held for a future use by the organization that would qualify for the exemption or held for investment by the organization in sole pursuit of the organization's exempt purposes and while held this property is not rented or leased for a purpose unrelated to the exempt purposes as defined in SC Code Section 12-37-220 (B)(16)(c).
- 38) Real property leased on a nonprofit basis to a(n):
- 39) State agency
- 40) County
- 41) Municipality or other political subdivision used for public purposes
- 42) the exemption does not apply to property used for office space or warehousing
- 43) Volunteer fire departments and rescue squads when property is used exclusively for that purpose or property leased to a department or squad by an entity itself exempt from property taxes
- 44) Nonprofit museums used exclusively for such purpose

- 45) Property of nonprofit or eleemosynary community theater companies, symphony orchestras, county and community arts councils and other similar companies, which is used exclusively for promotion of the “arts”
- 46) Charitable trusts and foundations if property is used for charitable purposes

The following exemptions as they relate to personal effects and the home:

- 47) Household goods and furniture used in the owner’s primary home
- 48) Household goods and furniture used in a timeshare residential units
- 49) Clothing
- 50) A homestead exemption of \$50,000 is available to residents who are 65 years of age, who are totally disabled or who are totally blind

The following exemptions pertain to the farm:

- 51) All agricultural products owned by the producer
- 52) Livestock and poultry
- 53) Farm machinery and equipment
- 54) Greenhouses

The following exemptions pertain to businesses:

- 55) New manufacturing facilities and additions costing at least \$50,000 to existing manufacturing facilities which are not in a fee-in-lieu are exempt from the ordinary county taxes for a period of five years
- 56) Corporate headquarters, corporate office facilities and distribution facilities are exempt from ordinary county taxes for five years if the cost of new construction or additions is \$50,000 or more and 75 or more full-time jobs are created
- 57) Manufacturers’ inventories
- 58) Merchants’ inventories

- 59) Personal property of an air carrier operating a hub in South Carolina is exempt for 10 years
- 60) Water, air or noise pollution equipment and facilities

Miscellaneous property tax exemptions:

- 61) Real property leased on a nonprofit basis to a state agency, county, municipality or other political subdivision used for a public purpose other than office space or warehousing
- 62) Property leased to and operated by the S.C. Public Service Authority for generating or transmitting electricity
- 63) Personal property used for public display loaned or leased on a nonprofit basis to:
  - a) State agencies
  - b) Counties
  - c) Municipalities
  - d) Other political subdivisions
- 64) Carnival equipment owned, leased or used by a foreign corporation or nonresident for a period of not more than six months if property tax has been paid in another state
- 65) Other property owned by churches if no income producing ventures are located on the property and no profit or benefit is derived by any individual
- 66) Nonprofit community-owned recreation facilities open to the general public
- 67) Personal property in transit with 'no situs' status
- 68) Intangible personal property

**Property Tax Recommendations, Section by Section Summary**

Note: See appendix for draft of legislation corresponding to the recommendations below.

**Section 12-11-30** Repeals personal property exemption for banks.

**Section 12-13-50** Repeals the personal property exemption for savings and loans.

**Section 12-37-220** Exemptions.

**A(2)** Limits hospital property tax exemption to hospital purposes (i.e. not office complexes.)

**A(4)** Charitable Trusts and Foundations must be exempt under IRC §501(c)(3).

**A(7)** Under current law a new manufacturing establishment (not in a fee-in-lieu) receives an automatic abatement of the county's portion of the property taxes (typically 40 percent of the tax bill.) There is no automatic abatement of the city or school district millage, meaning only the county receives no tax payments. The amendment abates 40 percent of the total tax bill.

**B(10)** Repeals property taxation exemption for telephone cooperatives. (Electric cooperatives pay property taxes.)

**B(16)(a)** Requires charitable organizations to be exempt under IRC §501(c)(3).

**B(32)** R&D exemption. See (A)(7).

**B(35)** Repeals personal property tax exemption for timeshares.

**B(39)** R&D exemption. Municipalities may exempt R&D under this provision. (The exemption is automatic for counties.) The amendment under B(32) would also make this automatic for municipalities.

**B(45)** Repeals exemption for vehicles leased to out-of-state armed service members. (There is no exemption for resident members.)

**Sections 12-37-230, -235 and -240.** These statutes provide that cities and counties may contract with exempt nonprofit housing corporations for payment for services. The sections are silent on how such contracts are negotiated or executed and the sections are amended to delete the contract requirement.

**Section 12-37-670** New Structures. This section clarifies that new structures are subject to taxation when they are substantially completed and fit for use.

**Section 12-37-712** Conforms aircraft with boats. Taxes on private passenger aircraft are amongst the highest in the United States and as a result there is substantial non-compliance and evasion in this area. This section explicitly gives the auditor authority to access airport hanger and fuel sale records to determine if taxes are owing.

**Section 12-37-714.** Conforms aircraft with boats. Several years ago the General Assembly provided for the proration of property taxes on boats which are here for less than a full calendar year. (Previously it was an all or nothing test.) This amendment adds aircraft.

**Section 12-37-930.** Historically the taxation on vehicles, watercraft and aircraft was based upon true FMV. The General Assembly, as a result of a very rare increase in value in certain SUVs

enacted a 95 percent rule. This results in considerable administrative complexities. The amendment deletes it.

**Section 12-37-950.** Leases of exempt property by the private sector. South Carolina has since the 1950s required a private sector lessee of exempt property to pay the same property taxes as its competitors who lease private property. The section for a variety of reasons has never been enforced and it has accordingly been amended to include a filing requirement by a private sector entity who leases exempt property.

**Section 12-37-2720.** Dealer tags. This section exempts from property taxation vehicles used by a dealer's officers, employees, children and spouses for both business and personal use. The section is repealed.

**Section 12-43-220(a)(c)(1)** "One percent holders." TRAC received testimony that a family which owned a second home (which typically is taxed with a 6 percent assessment ratio) could have the home taxed as a primary residence (with a 4 percent assessment ratio) merely by transferring a one percent interest to, e.g., a child. This amendment would prorate the taxes in such scenario.

**Section 12-43-220(E)** Property taxed as agriculture use is subject to rollback taxes when the property is converted to other use (e.g., residential, commercial, etc.) The law is unclear, however, when such property is converted. This amendment requires the DOR to issue Regulations to provide guidance to assessors on this issue.

**Section 12-43-220(6)** Rollback taxes. The only exception to rollback taxes is when property is put into a fee-in-lieu. This amendment repeals the exception.

**Section 43-232 Ag use.** There has been considerable media attention regarding the misuse of Ag use (e.g. lot on front beach at Kiawah.) By way of background, there are two types of ag use qualifications: (1) timber; and (2) crops. The amendments increase the minimum acreage for timber and row crop ag use from five to ten acres and the exception for parcels of less than ten acres is tightened. The assessor can also consider whether legal restrictions would prevent commercial timbering. For cropland, the minimum income test is increased from one to two thousand five hundred dollars and taxpayers are required to file a Schedule F with their federal income tax return.

**Section 12-43-233** Ag use, Agri-tourism. Two years ago the General Assembly added a very loose exemption for “agri-tourism.” This amendment clarifies that property exempt under the agri-tourism provision must meet the traditional ag-use tests.

**Section 12-43-340** Ag use. The criminal penalties for making a false statement on an ag use application is increased from two hundred to one thousand dollars.

### **Property Tax Recommendations, Detail of Select Recommendations**

#### **Manufacturers, Generally**

For non-fee-in-lieu manufacturers, property tax rates in South Carolina are the highest in the United States. Of the 19 rankings for industrial property compiled by Minnesota Association of Taxpayer's Study, including rural and urban; small, medium and large buildings; and small, medium and large machinery and equipment, South Carolina had the highest taxes in all 19 categories.

From an economic development and competitiveness standpoint, while counties have the ability to lower the tax rates for new manufacturing facilities with fee-in-lieu, so do other competing states. In addition, older facilities which predated the enactment of fee-in-lieu, many smaller manufacturing facilities, and many expansions are not in, or eligible for, a fee-in-lieu. As measured in terms of revenue generated, non-fee-in-lieu revenue (\$329 million in FY 08) still significantly exceeds fee-in-lieu revenue (\$192 million).

#### **Recommendation:**

The General Assembly should consider a constitutional amendment lowering the assessment ratio for manufacturers or amend the fee statutes to allow existing facilities not in a fee-in-lieu to enter into one. Such changes could be implemented on a phased-in basis.

#### **Second Homes and Rental Property (e.g. Commercial/Rental)**

The taxes on second homes (non-primary residences owned by residents or visitors) and apartments (which are classified as commercial) are significantly higher than primary residences.

This results from (1) a higher assessment ratio (6 percent vs. 4 percent); and (2) various credits which apply only to primary residences.

This differential is amongst the highest in the country. The Minnesota Association of Taxpayers Study showed that only 5 states subsidized homeowner's rates by commercial property owners more than South Carolina (The Minnesota Association of Taxpayers April 2010 Study). South Carolina had the highest ratio to homestead rates.

In fact, only three states in the Southeastern region, Alabama, Mississippi, and Virginia, assess these two property types differently.<sup>253</sup>, <sup>254</sup>

These differences, combined with other recent tax changes, have significantly impacted the South Carolina real estate market. South Carolinians shopping for a second home have been chilled by the "sticker shock" of the annual taxes which would be due on a second home. REITs and other institutional investors in apartment complexes have left the South Carolina market out of concern they can no longer pass annual real property tax increases onto tenants. All of this has created the perfect storm for the South Carolina real estate market, which is depressed because of numerous other economic factors.

#### Recommendation:

The General Assembly should equalize the tax preferences for primary residences versus other residences (second homes and apartments).

#### Agricultural Real Property, Generally

#### Current Law

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<sup>253</sup> Louisiana also assesses owner occupied primary residential real property and other real property differently; however, the differences are small in comparison to the assessment rates in Alabama, Mississippi, and Virginia. All land in Louisiana, both residential and commercial, is assessed at a rate of 10 percent of fair market value. Residential buildings are assessed at a rate of 10 percent, and commercial buildings are assessed at a rate of 15 percent.

<sup>254</sup> South Carolina Department of Commerce, *Property Tax, A Review of Issues in South Carolina* (Bert Shuler).



Real property that is used for agricultural purposes (and meets the other requirements for agricultural real property) is classified as agricultural real property and taxed on an assessment equal to:

a. 4 percent of the fair market value for agricultural purposes for owners or lessees who are individuals or partnerships, and for corporations that do not have one or more of the following: (1) more than 10 shareholders; (2) a shareholder (other than an estate) that is not an individual; (3) a nonresident alien as a shareholder; and (4) more than 1 class of stock.

b. 6 percent of the fair market value for agricultural purposes for corporate owners or lessees, except for certain closely held corporations specified in (a) above.

In addition, SC Code §12-43-220(d) grants a special valuation, known as fair market value for agricultural purposes, for real property that is “actually used for agricultural purposes.”

c. Application for Classification of Property as Agricultural Real Property:

Each new owner must apply to the county assessor for classification as agricultural real property on or before the first date taxes are due without penalty. An owner who has obtained such classification must notify the assessor of a change in use within 6 months.

(ii) Penalty for Falsifying Application:

SC Code §12-43-340 provides that it is unlawful for a person to knowingly and willfully make a false statement on the application for agricultural real property. A person making such a false statement is guilty of a misdemeanor and, upon conviction, must be fined not more than \$200.

iii) Change in Use - Rollback Taxes:

When agricultural real property is applied to a use other than agricultural, it is subject to additional taxes, referred to as rollback taxes. The amount of the rollback taxes is equal to the sum of the differences, if any, between the taxes paid or payable on the basis of the fair market value for agricultural purposes and the taxes that would have been paid or payable if the real

property had been valued, assessed, and taxed as other real property in the taxing district (except the value of standing timber is excluded), for the current tax year (the year of change in use) and each of the immediately preceding 5 tax years. SC Code §12-43-220(d) and 27 SC Code Regs. 117-1780.3.

Any property that becomes exempt from property taxes under SC Code §12-37-220(A)(1) (property owned by the state or a local taxing authority and used exclusively for public purposes) or SC Code §12-37-220(B)(41) (economic development property during the exemption period as provided in Chapter 44, Title 12 of the SC Code) is not subject to rollback taxes.

“Fair market value for agricultural purposes” is a special valuation that applies to real property that qualifies as “agricultural real property.” The special valuation is governed by statute and by Department regulations.

(iv) Method of Valuation:

SC Code §12-43-220(d)(2)(A) defines “fair market value for agricultural purposes” as the productive earning power based on soil capability to be determined by capitalization of typical cash rents or typical net income from timber and non-timber crops.

The fair market value for agricultural purposes determined for the 1991 tax year is effective for all subsequent years. SC Code §12-43-220(d)(2)(B)(i). Values derived before 1992 and based on the soil capacity of the various regions of the state are provided in Department regulations for current use.

When the use of agricultural real property changes, the property is subject to “roll back taxes” that cause a recapture of the difference in tax on the property as agricultural real property and the tax that would have been assessed if the property had not qualified as agricultural real property. The value of standing timber is not included in calculating the roll back recapture.

(v) Definition of Agricultural Real Property:

To qualify as agricultural real property, real property must be “actually used for agricultural purposes.” SC Code §12-43-220(d). See also SC Commission Decision 92-77. This means that the property must be currently used for bona fide agricultural purposes. Intended or future use is not determinative. 27 SC Code Regs. 117-1780.1; SC Tax Commission Decision 92-77.

Agricultural real property is defined as “any tract of real property which is used to raise, harvest or store crops, feed, breed or manage livestock, or to produce plants, trees, fowl or animals useful to man, including the preparation of the products raised thereon for man’s use and disposed of by marketing or other means.” SC Code §12-43-230(a). Agricultural real property also includes a dockside facility whose primary use is the landing and processing of seafood. SC Code §12-43-220(d)(5).

27 SC Code Regs. 117-1780.1 further defines agricultural real property. It provides 6 non-exclusive factors to be considered by county assessors in determining whether the tract in question is bona fide agricultural real property: (1) the nature of the terrain; (2) the density of the marketable product (timber, etc.) on the land; (3) the past usage of the land; (4) the economic merchantability of the agricultural product; (5) the use or not of recognized care, cultivation, harvesting and like practices applicable to the product involved, and any implemented plans thereof; and (6) the business or occupation of the landowner or lessee, provided that purchase for investment purposes does not disqualify a tract if it is actually used for agricultural purposes.

The following uses of real property do not qualify as agricultural: (1) recreation; (2) hunting clubs; (3) fishing clubs; (4) vacant land lying dormant; or (5) any other similar use. *Id.* It is often difficult to ascertain whether a particular parcel of land is being used for a bona fide agricultural purpose. In such instances, no single factor is determinative of the issue. Rather, all the factors listed in Regulation 117-1780.1 and all relevant facts must be viewed together to determine the classification. *Id.*

Except as provided in SC Code §12-43-232, the size of a parcel can be considered in conjunction with other factors in reaching an overall determination. The location of property in a residential subdivision or an area zoned for residential use is also a factor. SC Tax Commission Decision 93-37.

In cases in which the real property is committed to more than one use, one use being agricultural and the other use or uses being unrelated to agriculture, the agricultural activity must comprise the most significant use of the property for the property to be classified as agricultural real property. 27 SC Code Regs. 117-1780.1.

Agricultural real property may be used for agri-tourism, provided agri-tourism is supplemental and incidental to a primary use for agricultural purposes. SC Code §12-43-233. A lengthy, non-exclusive list of agri-tourism uses set forth in the statute includes such diverse uses as wineries, educational tours, on-farm food sales, farm vacations, bird watching, and crop art. The term “agricultural real property” includes real property used to provide free housing for farm laborers provided such housing is located on a tract of land that qualifies as agricultural real property. SC Code §12-43-230(a).

(vi) Additional Requirements for Agricultural Real Property

SC Code §12-43-232 provides additional requirements that must be met in order for real property to qualify as agricultural real property. The requirements are as follows:

a. Timberland:

If the tract is used to grow timber, the tract must be 5 acres or more. Tracts of timberland of fewer than 5 acres qualify if they are contiguous to, or are under the same management system as, a tract of timberland that meets the minimum acreage requirement. Tracts of timberland of fewer than 5 acres are eligible to be agricultural real property if they are owned in combination with other tracts of agricultural real property that are not timberland but qualify as agricultural real property. Tracts of timberland must be devoted actively to growing trees for commercial use.

b. Christmas Trees:

A tract devoted to growing Christmas trees must be 5 acres or more. If the tract is fewer than 5 acres, it will qualify as agricultural real property if at least \$1,000 of gross farm income was reported for at least 3 of the last 5 tax years.

c. Other Acreage:

All other tracts must be at least 10 acres or more. Tracts of fewer than 10 acres qualify as agricultural real property if they are contiguous to other tracts that total at least 10 acres when combined. Tracts that do not meet this requirement will qualify if at least \$1,000 of gross farm income was reported for at least 3 of the last 5 tax years.

d. New Ownership:

A new owner may qualify a non-timberland tract of fewer than 10 acres if he earns at least \$1,000 of gross farm income in at least 3 of the first 5 years of ownership. If the new owner fails this requirement, the tract is not considered agricultural real property and is subject to the rollback tax.

e. Grandfather Clause:

If neither the acreage nor the income requirements are met, the property will qualify as agricultural real property if the current owner or an immediate family member owned the property for at least the 10 years ending January 1, 1994, and the property was classified as agricultural real property for property tax year 1994. Such property must continue to be classified as agricultural real property until the property is applied to some other use or until the property is transferred to someone other than an immediate family member, whichever occurs first. "Immediate family" is defined in SC Code §12-43-232(3)(e).

f. Idle Land:

Real property idle under a federal or state land retirement program or property idle pursuant to accepted agricultural practices will be classified as agricultural real property if the property otherwise would have qualified, subject to satisfactory proof to the assessor.

g. Leased Agricultural Real Property:

In the case of rented or leased agricultural real property, the property will qualify if either the lessor or the lessee meets the above requirements.

#### Recommendations:

TRAC recommends the General Assembly:

1. Increase the minimum acreage size for both timber and row crops from 5 to 10 acres; According to the United States Department of Agriculture, the average tract of timber property in South Carolina was approximately fifty six acres in 2008;
2. Require assessors to consider deed and other legal restrictions on timbering in determining whether land is being used for timber production.
3. Increase the minimum income test for crops from \$1,000 to \$2,500;
4. Require non-contiguous tracts to directly support timber or crop use;
5. Require the SCDOR to issue regulations to clarify when rollback taxes are assessed;
6. Increase the criminal penalties for false statements on an ag use application from \$200 to \$1,000;
7. Require assessors to determine the current status every five years of ag use property which is valued at 20 percent or less of FMV.

#### Legal Residence, Generally

The legal residence and not more than 5 contiguous acres, when owned totally or in part in fee simple or by life estate and occupied by the owner of the interest, is taxed based on an assessment ratio of 4 percent. The residence must be the domicile of the owner at some time during the tax year. Additional dwellings located on the same property (not more than 5 acres) and occupied by immediate family members of the owner will also qualify for the 4 percent ratio.

An individual is considered the owner of the property if he has an interest in it pursuant to an installment contract for sale with the U.S. Department of Veterans Affairs. If residential real property is held in trust and the income beneficiary of the trust occupies the property as his legal residence, the 4 percent ratio applies if the trustee certifies to the assessor that the income beneficiary occupies the property as a residence.

When the legal residence, including a mobile home, is located on leased or rented property, and the residence is owned and occupied by the owner, the 4 percent assessment ratio applies for the residence (the assessment ratio for the land is 6 percent). If the lessee of property upon which he has located his legal residence is liable, by law, for taxes on the leased property, then the property upon which he is liable for taxes, not to exceed 5 acres contiguous to his legal residence, will be assessed at the 4 percent ratio. The 4 percent assessment ratio does not apply to any mobile home or residence that is rented, or to any business for profit located on the residential property.

A motor home, boat or watercraft, or trailer used for camping and recreational travel that is pulled by a motor vehicle may qualify as a legal residence if it meets the requirements set forth in SC Code §12-37-224.

A purchaser who purchases residential property with the intent that it will become his primary residence, but the property is subject to vacation rentals as provided in SC Code Title 27, Chapter 50, Article 2, for no more than 90 days, may apply for the 4 percent assessment ratio once the purchaser occupies the property. If the owner actually occupies the property within 90 days of acquiring ownership and otherwise qualifies, the 4 percent ratio will apply retroactively to the date of ownership. A taxpayer is not disqualified from receiving the 4 percent legal residence assessment ratio just because he rents out his legal residence for not more than 14 days during the tax year.

Generally, the residential classification is not available unless the owner of the property applies to the county assessor before the first penalty date for taxes due (January 16). As part of the application, the taxpayer must certify that neither he nor any other member of his family

(which includes his spouse, unless legally separated, and his dependent children under age 18) is residing in or occupying any other residence in South Carolina that has been qualified for the 4 percent assessment ratio by the taxpayer or a member of his family. He must also certify that he does not claim to be a legal resident of a jurisdiction other than South Carolina for any purpose. The application may be extended by the local taxing authority for reasonable cause. A new application does not have to be filed unless there is a change in ownership. A residence that is qualified as a legal residence for any part of a year is entitled to the 4 percent assessment ratio for the entire year.

A motor home, boat or watercraft, or trailer used for camping and recreational travel that is pulled by a motor vehicle may qualify as a primary or secondary residence for property tax purposes if it qualifies for deduction of the interest portion of indebtedness on a qualified primary or secondary residence under the Internal Revenue Code. SC Code §12-37-224. Requirements for the relevant deduction under the Internal Revenue Code include on-board sleeping, cooking and toilet facilities. A primary residence is taxed based on a 4 percent assessment ratio, and secondary residence is taxed based on a 6 percent assessment ratio.

Property that qualifies under SC Code §12-37-224 is valued in the same manner as motor vehicles.

#### Recommendation:

The owners of a primary residence (with a 4 percent assessment ratio) can have a second home (with a 6 percent assessment ratio) taxed as a primary residence merely by deeding a 1 percent interest to a child. TRAC recommends the General Assembly prorate the taxes (e.g. 1 percent taxed with a 4 percent assessment ratio and 99 percent with a 6 percent ratio.)

#### Dealer Tags, Generally

South Carolina Code § 56-3-2320 provides for an exemption for vehicles with a dealer tag: “The license plates, notwithstanding other provisions of this chapter to the contrary, may be



used exclusively on motor vehicles owned by, assigned, or loaned for test driving purposes to the dealer when operated on the highways of this State by the dealer, its corporate officers, its employees, or a prospective purchaser of the motor vehicle.”<sup>255</sup>

In South Carolina a dealer earns two dealer tags for the first twenty cars sold during the preceding year, and an additional dealer tag for each fifteen cars sold during that same preceding year. A vehicle with a dealer tag is *completely* exempted from property tax if the owner is the dealership, a corporate officer, or employee. There are less than 3,300 dealers in the state, but over 18,000 dealer tags. That equates to roughly 5.56 dealer tags per dealership.<sup>256</sup> Consider the following table:

<u>Dealer Size</u>	<u>Sales Volume</u>	<u># of Dealers (Percent Tot.)</u>	<u>Number of Plates (Percent Tot.)</u>	<u>Percent Max Plates</u>
<u>Allowed</u>				
Mega	> 3,000	18 (0.5%)	476 (3%)	4.3%
Large	1,000-2,999	128 (4%)	2,972 (16%)	9.68%
Medium	500-999	169 (5%)	3,027 (16%)	19.03%
Average	100-499	1,087 (37%)	6,786 (37%)	28.08%
Small	<100	1,901 (58%)	5,106 (28%)	85.87%

An interesting comparison is the ratio of used versus new car dealerships in the state of South Carolina versus the state of California. South Carolina has a ratio of approximately 8.77 used/new car dealerships (2500/285 used/new).<sup>257</sup> Compare that to California which has a ratio 4.61 used/new car dealerships (6785/1470 used/new).<sup>258</sup>

Another interesting fact is that California has more than nine times the population of South Carolina, but only about three times as many dealerships. This disproportionate number of dealerships per person shows that an some important incentive exists for opening dealerships in South Carolina. This ratio is important because a major area of abuse concerns individuals setting up straw dealerships, which are used car dealerships that meet minimum legal

<sup>255</sup> S.C. Code Ann. § 56-3-2320 (2008).

<sup>256</sup> South Carolina Dept. of Motor Vehicles: <http://www.scdmvonline.com>.

<sup>257</sup> *Id.*

<sup>258</sup> California Dept. of Motor Vehicles: [www.dmv.ca.gov](http://www.dmv.ca.gov).

requirements, but do not have the legitimate intention to competitively enter the business of selling used vehicles (and avoid licensing difficulties of working with new car manufacturers). These “straw” dealerships are easy to set up because of minimum legal requirements, so the dealerships and the subsequent dealer tags granted provide a great mechanism for creating sales tax shields.

Based on estimates from the department of revenue, the average property tax liability avoided by dealers per car is between \$240 and \$250. Contrast that with the DMV’s figures where motor vehicle owned by the average consumer pays \$140 annually.

The South Carolina Department of Motor Vehicles estimates that this tax exemption costs the state between \$4 and \$5 million annually.

Recommendation:

Repeal the property tax exemption for dealer tags.

### Aircraft, Generally

Property taxes on private passenger airplanes are amongst the highest in the nation. As a result, there is considerable evasion of the taxes.

Recommendation:

The General Assembly should consider lowering the Assessment Ratio on private passenger aircraft.

The General Assembly should conform the tax treatment of aircraft to boats, thus allowing a proration of the taxes.

### Time Share Units, Generally

Time shares enjoy a unique tax status, including an exemption for sales and accommodation taxes. For purposes of property taxation, a time share unit operating under a vacation time sharing ownership plan, as defined in SC Code §27-32-10(7) (purchaser receives an ownership interest as well as right of use), must be valued as if the unit were owned by a single owner. However, a time share unit operating under a vacation time sharing lease plan, as defined in SC Code §27-32-10(8) (purchaser receives right of use but not ownership interest), may be valued as other income producing investment property is valued. Furniture and fixtures are exempt from personal property taxes and sales of time shares are exempt from the ATI provisions, meaning they are not revalued for tax purposes on re-sales.

#### Recommendation:

Repeal the personal property exemption for furniture and fixtures.

### Banks and Other Financial Institutions, Generally

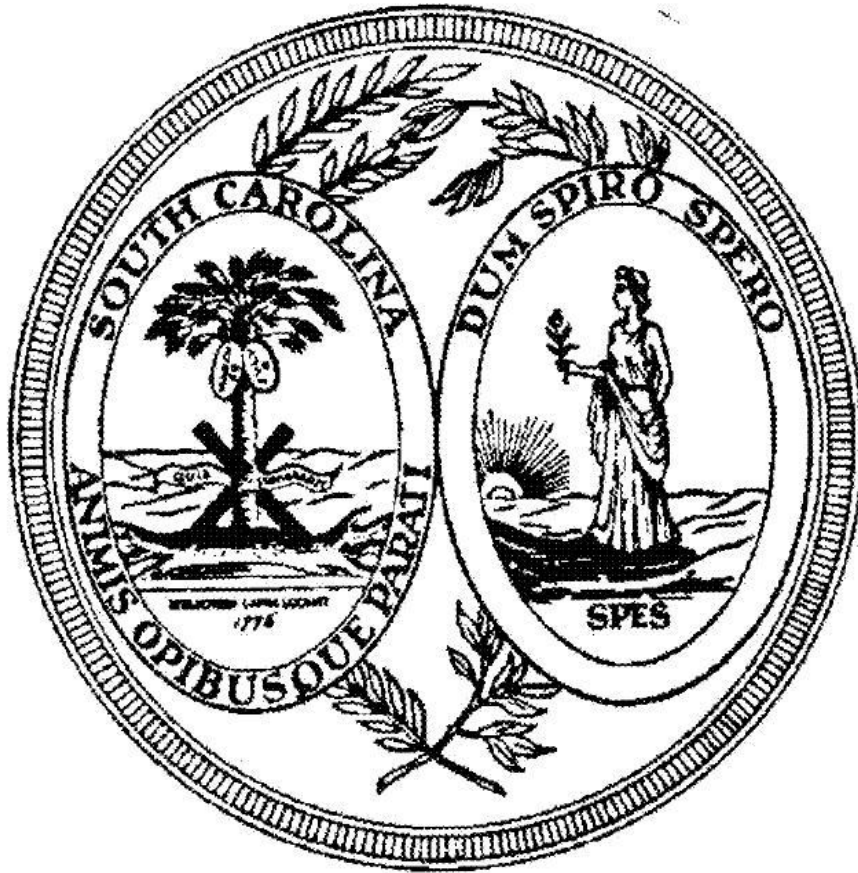
Banks and savings and loans pay an income tax in lieu of other forms of taxes, including sales, local business license taxes and taxes on personal property. Savings and loans pay an income tax of six percent but are exempted from it for a three-year period. Many credit unions pay no income taxes. The income tax rate on banks is the lowest for any business entity. (Corps pay 5 percent, LLCs, partnerships and individuals pay either 5 percent or 7 percent.) Banks paid \$15,672,134 and Savings & Loans paid \$3,421,963 in taxes in FY 09-10. Credit Unions organized under federal law paid no income taxes. By contrast, insurers paid \$158,647,299 as well as local taxes.

#### Recommendation:

Repeal the personal property tax exemption for banks, S&Ls and credit unions.

Equalize the property taxation of banks, S&Ls and credit unions.

# Fuel Tax



## South Carolina Taxation Realignment Commission

## **Fuel Tax, Generally**

TRAC studied issues related to the State's road funding pertaining to the adequacy of both the amount of revenue currently generated and specifically related to the adequacy and effectiveness of the State's current motor fuel excise tax (in terms of both its rate and structure) and how that tax and/or structure impacts the amount of revenue generated.

## **Fuel Tax, Findings**

TRAC finds that adequate funding by the State for road and/or transportation related infrastructure projects is of paramount importance for both the mobility and safety of the State's citizens and is an important aspect of the State's long term economic development.

The majority of State road funding for the Department of Transportation to construct or maintain the State's transportation related infrastructure is the motor fuel excise tax, referred to by statute as a "user fee", which generates approximately \$500 Million annually.<sup>259</sup>

An excise tax is a "fixed rate tax" which remains unchanged regardless of changes in the price of motor fuel and/or changes in the price of oil. The current motor fuel excise tax rate is 16 cents per gallon of gasoline or diesel fuel sold, excluding 0.75 cents per gallon for inspection and/or environmental fees. Including those additional fees, the total motor fuel user fee is 16.75 cents per gallon "at the pump".<sup>260</sup> This rate of tax (16 cents per gallon) has remained unchanged since 1987.<sup>261</sup>

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<sup>259</sup> Source: "Highway Funding 2008 - Ranked by Net State Funds per Mile", a 50-state comparison compiled by the South Carolina Department of Transportation from various federal and other sources. In 2008, total State funding for State roads (excluding SIB) was \$839.9 Million, of which approximately \$521.2 Million (62%) was from motor fuel revenue. Note: A small percentage of road funding from motor fuel revenue is made available to counties to fund locally maintained roads.

<sup>260</sup> "South Carolina Revenue Sources and Fiscal Impacts", South Carolina Budget and Control Board, Division of Research and Statistical Services, Office of Economic Research (October 21, 2009).

<sup>261</sup> "South Carolina Revenue Sources and Fiscal Impacts", South Carolina Budget and Control Board, Division of Research and Statistical Services, Office of Economic Research (October 21, 2009).

South Carolina's current rate of tax is the lowest of the 12 states that comprise the Southeast and is the 3<sup>rd</sup> lowest in the entire country.<sup>262</sup> Compared to our neighbors, South Carolina's excise tax rate is 7.25 cents per gallon lower (or 30 percent less) than Georgia's (approximately 24 cents per gallon) and is 13.15 cents per gallon lower (or 45 percent less) than North Carolina's (29.9 cents per gallon).

Due to the current structure of South Carolina's tax (fixed rate excise), road funding is, in essence, completely tied to consumption, which has been trending flat or downward as a result of several factors including the increasing fuel efficiency of motor vehicles and a gradual switch by consumers to hybrid and/or alternative fueled vehicles.

As a result, and absent a fuel tax increase or structural change, the only significant way to increase motor fuel revenues is to increase the number of vehicles on the state's roads and/or burn more gallons of motor fuel within our state. However, this actually puts more strain on the State's roadways, requiring more maintenance and therefore seemingly compounding the issues at hand.

As evidence of this trend, over the last 13 years (FY97 to FY09), motor fuel revenue has grown at a rate of 2 percent per year.<sup>263</sup> In contrast, the growth of population plus inflation has averaged approximately 4 percent per year during that period and the growth of a price of a barrel of oil (a primary "ingredient" in road construction cost) has grown at 10 percent per year (Note: In 1987, it cost approximately \$26,000 to pave 1 mile of 2 lane roadway. Today that same cost is \$180,000 (a 9 percent per year increase)).<sup>264</sup> Taking a more near term snapshot

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<sup>262</sup> [www.scstatehouse.gov/citizensinterestpage/TRAC/093009Meeting/TableofGasolineTaxesintheSoutheast.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/093009Meeting/TableofGasolineTaxesintheSoutheast.pdf)  
[www.taxadmin.org/fta/rate/mf.pdf](http://www.taxadmin.org/fta/rate/mf.pdf). Of the "lower 48" states, South Carolina has the 3<sup>rd</sup> lowest motor fuel tax behind New Jersey (14.5 cents/gallon - gasoline only) and Wyoming at 14 cents/gallon. Florida has a base state rate of 16 cents/gallon, but consumers must pay at least 12.6 cents/gallon more in county level fuel tax. When factoring in Alaska at 8 cents/gallon, South Carolina ranks as the 4<sup>th</sup> lowest motor fuel (gasoline and diesel) tax levy in the country.

<sup>263</sup> "South Carolina Gasoline, Special Fuel, and Highway Use Fee Revenue by Type and Allocation", a report compiled by the South Carolina Board of Economic Advisors from State Treasurer and Department of Transportation year-end reports and reported in the "South Carolina Revenue Sources and Fiscal Impacts", South Carolina Budget and Control Board, Division of Research and Statistical Services, Office of Economic Research (October 21, 2009).

<sup>264</sup> According to the U.S. Energy Information Administration, the 1997 "Weekly All Countries Spot Price FOB Weighted by Estimated Export Volume" annual average cost for a barrel of oil was \$18.28. By 2009, that figure was \$60.07, a 10% per year increase in the price of a barrel of oil. Also see: [www.scstatehouse.gov/citizensinterestpage/TRAC/DOT%20Presentation%20Materials%20to%20TRAC%20Fuel%20Tax%20Subcommittee.pdf](http://www.scstatehouse.gov/citizensinterestpage/TRAC/DOT%20Presentation%20Materials%20to%20TRAC%20Fuel%20Tax%20Subcommittee.pdf) (see Page 1 of link).

(FY05 to FY09) motor fuel revenue has grown at just 0.58 percent per year and revenues declined by 3.6 percent in FY09.<sup>265</sup>

As a result of these and other factors, South Carolina road funding/support from state sources (as measured by “net state funds per mile” (excluding SIB\* funds)) ranks 49<sup>th</sup>, at \$20,000 per mile. The US average of net state support is \$89,000 per mile.<sup>266</sup> \*Note: If SIB funds were included, South Carolina’s per mile total would increase by approximately \$3,000/mile, potentially improving the State’s ranking by roughly 3 to 4 spots.

As such, and based in part on the findings above and other factors, TRAC finds the current level of road funding invested by the State to be inadequate.

And while TRAC further finds that the State may be overly reliant on one primary source of road funding (motor fuel excise tax), as evidenced by the fact that a relatively small portion of DOT’s funding comes from any source other than the motor fuel excise tax, TRAC believes it is outside of its authority to make budgetary/appropriation recommendations to the General Assembly.

As such, TRAC cannot make a recommendation that the General Assembly simply increase General Fund appropriations for road funding which would have the effect of necessitating a shift of funding from one functional area of state government to another. That is the prerogative of the General Assembly, not TRAC.

Instead, as TRAC’s primary purpose is an examination of the State’s tax rates and structures, a component of which is certainly the motor fuel excise tax or “user fee”, TRAC has limited its principal recommendation(s) to issues surrounding the State’s current motor fuel excise tax.

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<sup>265</sup> “South Carolina Gasoline, Special Fuel, and Highway Use Fee Revenue by Type and Allocation”, a report compiled by the South Carolina Board of Economic Advisors from State Treasurer and Department of Transportation year-end reports and reported in the “South Carolina Revenue Sources and Fiscal Impacts”, South Carolina Budget and Control Board, Division of Research and Statistical Services, Office of Economic Research (October 21, 2009).

<sup>266</sup> “Highway Funding 2008 - Ranked by Net State Funds per Mile”, a 50-state comparison compiled by the South Carolina Department of Transportation from various federal and other sources.



### **Fuel Tax, Primary Recommendations**

Based on the findings above, TRAC recommends that **BOTH** of the following proposals (in their entirety) be provided to the General Assembly so that it (the General Assembly) may determine which proposal is best to implement in South Carolina.

Note: TRAC finds that both proposals have merit and therefore determines that the General Assembly should have the opportunity to study each.

#### **Recommendation 1:**

Increase the current 16 cent/gallon motor fuel excise tax on gasoline and diesel fuel by 5.5 cents per gallon, bringing the total state excise tax including fees to 22.25 cents per gallon.

Note: The half cent increase over and above the base 5 cent increase proposed will be temporary, with proceeds dedicated to the SUPERB fund, and will be repealed immediately upon the fund returning to solvency.

TRAC approximates that this would generate an additional \$150 Million in revenue for the Department of Transportation annually, depending on consumption and related issues (as discussed above). Note: This estimate requires verification (or correction) by the Board of Economic Advisors and/or the Department of Transportation and as such is for informational purposes only.

This increase would provide needed revenue for roads while keeping the tax rate competitive with Georgia and North Carolina.

#### **Recommendation 2:**

TRAC reviewed, and is advancing, a proposal to modify the current fixed rate excise tax to a “hybrid” tax based on a combination of a price component and flat excise tax component. Similar structures currently exist in both Georgia and North Carolina.<sup>267</sup>

Specifically, the proposal:

- Ensures that the price component is an excise tax, rather than a sales tax, to ensure the money continues to be dedicated to roads and is not unintentionally diverted to the General Fund for other uses.
- So as to ensure no burden or cost to retailers and distributors in implementing this new structure, continue the tax collection and remittance point at the terminal rack level.
- Recommends adjusting the price component at least annually, or semi-annually (every 6 months) to capture a tax rate that more accurately reflects fuel prices in a timely manner.
- Ensures a “floor”, or minimum tax rate regarding the variable rate so that road funding is stabilized to the extent possible.
- Recommends a “ceiling”, or maximum tax rate, that cannot be exceeded. An appropriate ceiling to consider would be NC’s “floor” (that is, the total tax rate could not exceed 29.9 cents per gallon as that is NC’s current “floor”).
- Ensures that any fuel structure change should account for the current distribution of portions of the gas tax revenue as required under current law, so that those distributions are not unintentionally and adversely affected (this is a

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<sup>267</sup> Both NC and GA base their motor fuel tax rates on a combination, or a “hybrid” of: 1) a fixed rate/flat “per gallon” excise tax and a 2) variable rate based on some price component (similar to a sales tax) of fuel (either wholesale or retail). The two rates are summed to a final “cents per gallon” figure, providing a total tax rate for a period as described below. These rates are recomputed every 6 months based on a retrospective look at fuel prices over the previous period and are implemented prospectively during the following 6 months. Neither tax structure places additional cost or burden on the states’ retailers and/or gas station operators by requiring them to collect, remit, or re-compute the tax. Instead, the tax is collected and remitted as it is here, at the terminal rack level (In NC; in GA it is at the distributor level).

technical/mathematical exercise that can easily be incorporated into any final recommendation as necessary).

- Recommends that in the transition to the hybrid tax structure, that the DOR has adequate resources to properly and timely implement the new structure.
- This recommendation is “revenue neutral”\* the first year when the current 16 cent/gallon excise tax is reduced by 9-cents (to 7 cents per gallon) and it is combined with a price component of 4.65 percent (x the current weighted average wholesale price (\$1.935 x 4.65 percent = 9-cents per gallon)).

Note: In addition to the 7 cents per gallon referenced above, the recommendation adds an additional half cent increase and will be temporary, with proceeds dedicated to the SUPERB fund, and will be repealed immediately upon the fund returning to solvency.

#### **Fuel Tax, Additional Options for Consideration**

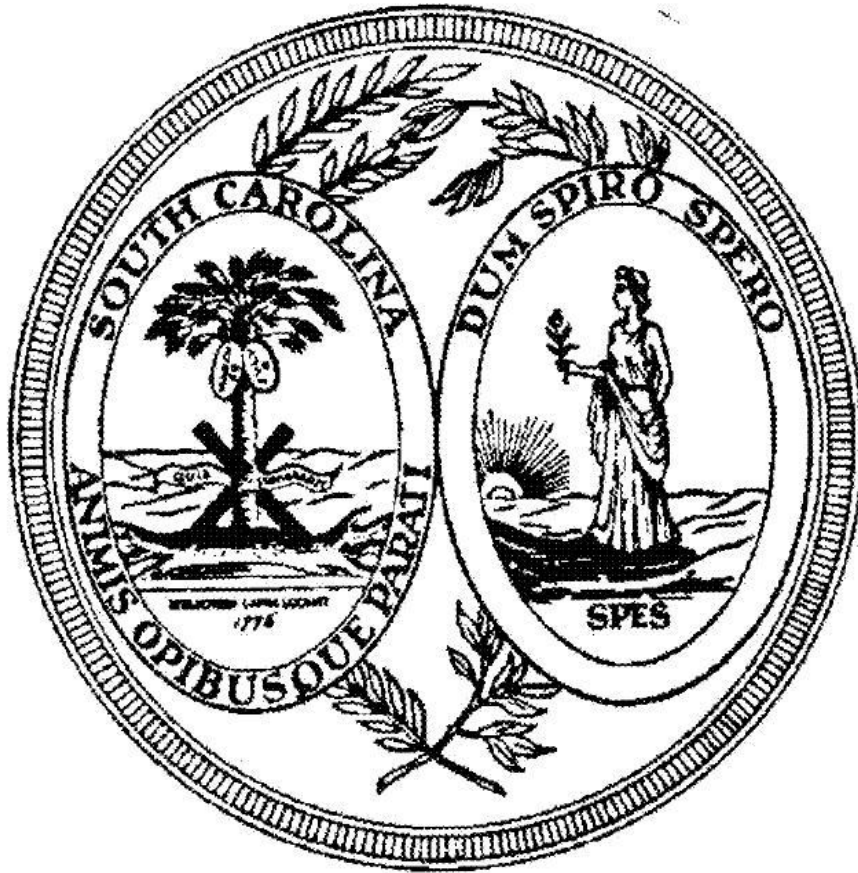
TRAC further recommends that the General Assembly consider adoption of a modified version of Arkansas’s innovative approach regarding ad valorem taxation of out of state trucks based on the amount miles driven by those trucks in state and other factors. This new revenue stream would help to diversify the State’s funding portfolio without putting additional burden on our State’s drivers or our in-state trucking companies. Such a diversification is important as South Carolina has an inordinate amount of State maintained roads compared to the average state (see attached for the Arkansas statute referenced above).

Alternative Fuel Vehicles. As noted above, the nation and state is experiencing a gradual trend to use of not only more fossil fuel vehicles which are more fuel efficient, but a shift towards vehicles that do not use fossil fuels (gasoline/diesel) at all. Because State funding for roads comes almost exclusively from taxes imposed on gasoline/diesel consumption, as this trend continues, it will naturally lead to less road revenue as drivers of such vehicles have no mechanism by which to contribute to road maintenance under the current system/structure. Simply put, alternative fuel vehicles, and the normal wear and tear that

results from them, as with any vehicle, needs to be accounted for. As such, TRAC recommends that the General Assembly accept with foresight this gradual but long term trend and begin planning accordingly.

Note: TRAC also reviewed other recommendations that could increase road funding, including removal of the sales tax exemption on motor fuel and elimination of the \$300 car tax cap, and possibly using the resulting revenues for roads, but such recommendations would be in conflict with the TRAC recommendation that any revenue generated by changes to the current sales and use tax exemptions should be used to lower the overall sales tax rate (“broad base / low rate”).

# Tourism Taxes



## South Carolina Taxation Realignment Commission

## **TOURISM TAXES, GENERALLY**

By way of background, "tourism taxes" include the state accommodations taxes;<sup>268</sup> the local accommodations taxes;<sup>269</sup> local hospitality tax;<sup>270</sup>; and the local option tourism development fee.<sup>271</sup> Also included in this category is the Admissions Tax.<sup>272</sup>

Local accommodations businesses (hotels, motels, inns, and Bed & Breakfasts with more than 6 rooms) must collect a 2 percent tax on every room rented. These funds are remitted to SCDOR and are disbursed back to local governments through a formula. The formula contains a provision known as "Robin Hood".<sup>273</sup> Through Robin Hood, counties where more than \$400,000 in Accommodations Tax revenues is collected in a fiscal year must donate a portion of their Accommodations Tax collections during the following FY to counties where less than \$400,000 was collected. There were thirteen donor counties in South Carolina in 08-09: Beaufort, Berkeley, Charleston, Colleton, Florence, Georgetown, Greenville, Horry, Lexington, Orangeburg, Richland, Spartanburg, and York. This list changes annually depending upon the economy.

The chart below shows the current distribution of funds after local governments receive their Accommodations Tax *allocations*, which, in many cases, are considerably greater than their actual *collections* of Accommodations Tax. A fictional government, which is allocated \$125,000 in a given year, is mandated to distribute the funds thusly:

- By current Accommodations Tax law, the first \$25,000 allocated to the local government goes into its General Fund.
- Of the remaining allocation, 5 percent of the remaining funds are also placed into the General Fund. The remaining funds are "labeled" 30 percent Fund and 65 percent Fund, since 95 percent of the funds after removal of the first \$25,000 remain.

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<sup>268</sup> Imposed by S.C. Code § 12-36-920 and allocated in Section 6-4-5.

<sup>269</sup> S.C. Code § 6-1-500, et. seq.

<sup>270</sup> S.C. Code § 6-1-700, et seq.

<sup>271</sup> S.C. Code § 4-10-910, et seq.

<sup>272</sup> S.C. Code § 12-21-2410, et seq.

<sup>273</sup> Referred to by one Mayor as "Jesse James."

- The 30 percent Fund is disbursed to a Designated Marketing Organization (also known as Destination Marketing Organization or DMO).
- The final 65 percent Tourism-Related Fund is allocated by the Local Government for promotion of the arts or for “tourism related” expenditures.

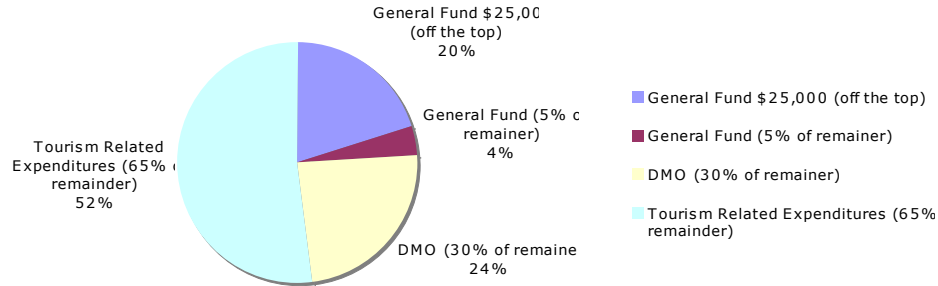
A Local Government receiving an allocation of more than \$50,000 must set up an Accommodation Tax Advisory Committee to make *recommendations* on how the 65 percent funds should be spent. This Advisory Committee is made up of seven (7) tourism-related individuals from within the area where the tax is collected.

- It must include a majority of persons (4) representing the hospitality sector (lodging and dining)
- A minimum of two (2) from the lodging sector when applicable, and
- A minimum of one (1) from the arts and cultural sector.

This Advisory Committee reviews applications for the 65 percent Funds and makes recommendations to the Local Government concerning distribution. However, the Committee’s recommendations are not binding. By October 1 each year, a report must be submitted to the Tourism Expenditure Review Committee regarding the projects funded through the 65 percent Tourism-Related Fund.

The following chart shows the distribution currently mandated for a local government receiving a \$125,000 allocation:

Distribution of Current Local Government Allocation (Fictional \$125,000 All

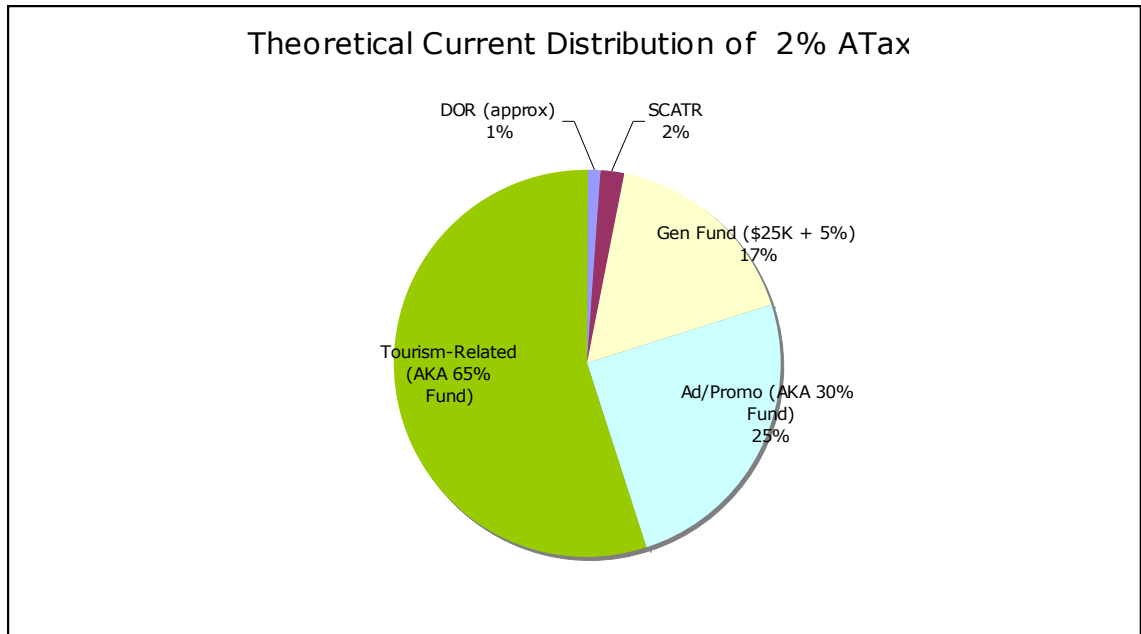


In theory, the 2 percent Accommodation Tax funds collected statewide are now distributed to local governments by SCDOR in the following manner:

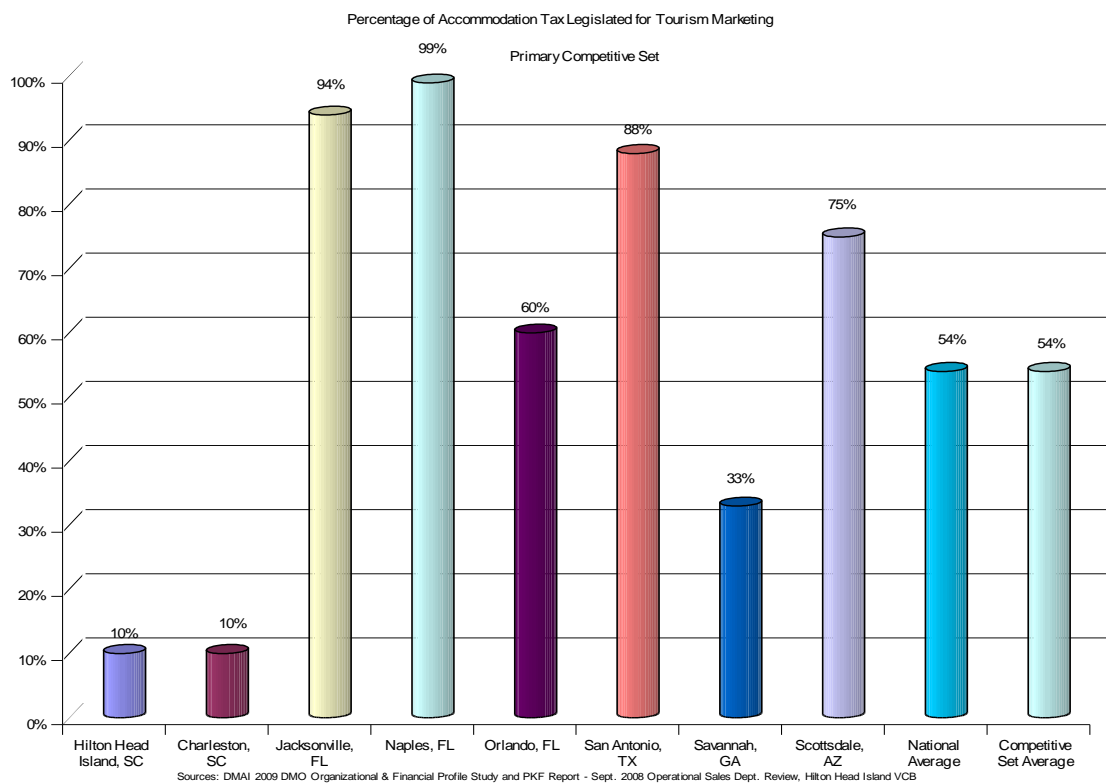
1. A fee is paid to SCDOR for administration and management.
2. 2 percent is disbursed to the 11 SC Tourism Regions
3. Remaining funds are allocated to local governments and divided in the manner shown in the chart above.

This chart shows the theoretical expenditure of the 2 percent State-mandated Accommodations Tax under current law:

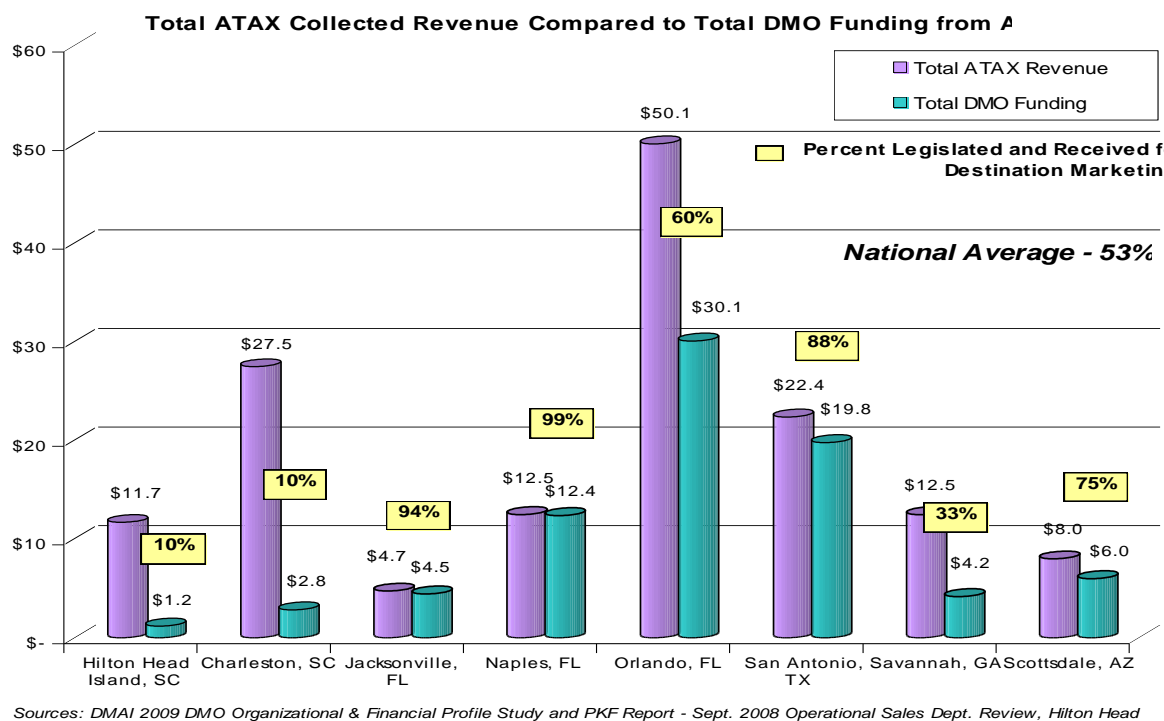




The following charts show disbursement of tourism-related taxes in some of South Carolina's destinations as compared with competitors:



And DMO funding compared to Accommodations Tax collections:



## Tourism Taxes, Recommendations

### Allocation of Tourism Tax Revenue

TRAC received considerable testimony and published media reports that the percentage of state and local accommodations taxes (ATAX) spent on direct support of tourism (either through advertising or direct grants (e.g. to Spoleto or CVBs), as opposed to local government general fund use, considerably lagged both our neighboring states as well as the US average. The Committee felt, nevertheless, that its jurisdiction did not extend to spending decisions. The Committee does encourage the General Assembly to review the formulas for spending of state and local ATAX dollars (tourism vs. general fund) as well as the considerable increase in “Robin Hood” funds taken from the tourism counties (who both raise the funds as well as bear the burden of supplying services to tourists.)

### Tourism Expenditures Review Committee (TERC)

The General Assembly established TERC to oversee expenditures of state ATAX. The Committee recommends that it have oversight responsibility over local ATAX and hospitality taxes as well. Local ATAX and hospitality taxes are statutorily limited to promoting tourism. There have been considerable media reports that local governments have nevertheless been using local ATAX and hospitality taxes to balance their budgets and other non-tourism uses.

The Committee, responding to criticism that TERC fails to provide written guidance, recommends that TERC be required to issue regulations subject to General Assembly approval.

### “Uniform” Form

The Committee recommends that the DOR be given the responsibility to promulgate a Uniform Sales and Use Tax form for all state and local tourism taxes (ATAXs and hospitality) together with the duty to collect and remit the taxes to local government, preferably on a monthly basis.

### Timeshares

Timeshares enjoy a unique range of tax exemptions and preferences. These range from exemptions of state and local ATAXs and personal property taxes, an exemption from the Assessable Transfer in Interest (ATI) provisions which require other properties to be revalued upon sale; and a unique statute valuing time share real property. The subcommittee felt this represented unfair competition to other service providers (hotel, motel, campground and owners of second homes). The time share industry also benefits from ATAX expenditures including advertising and general fund services paid for by ATAX dollars. As the Hawaii Department of Taxation stated in Bulletin 98-4:

#### *1. Why is the occupancy of resort time share vacation units being taxed?*

The Legislature found that time share interval owners are similar to transient individuals occupying hotels for tax purposes. Act 156 quotes the following language from The Law and Business of Time-Share Resorts: "The

purchaser is essentially purchasing tomorrow's vacation at today's prices and dollars. The contract price is paid or financed all at once and there is no worry about skyrocketing hotel rentals or inflation." Transient individuals occupying a resort time share vacation unit utilize State and county facilities in a manner similar to transient individuals occupying hotels. Act 156, therefore, taxes the transient occupancy of resort time share vacation units under the transient accommodations tax in a manner similar to hotels being taxed on their hotel rental.

Accordingly the Committee recommends the General Assembly repeal the ATAX exemption for timeshares and impose state and local ATAX based upon gross daily maintenance fees. The time share plan manager should be responsible for collecting the taxes, filing tax returns, and paying the tax to the Department of Revenue. A plan manager is a person who undertakes the duties, responsibilities, and obligations of managing a resort time share vacation plan or is required to act for a resort time share vacation plan under the Accommodations Tax Law.

#### ATAX Exemption for Persons Over the Age of 85

The burdens to small business of administering the current ATAX exemption for persons over 85 far outweigh the benefits and the Committee recommends that the exemption be abolished.

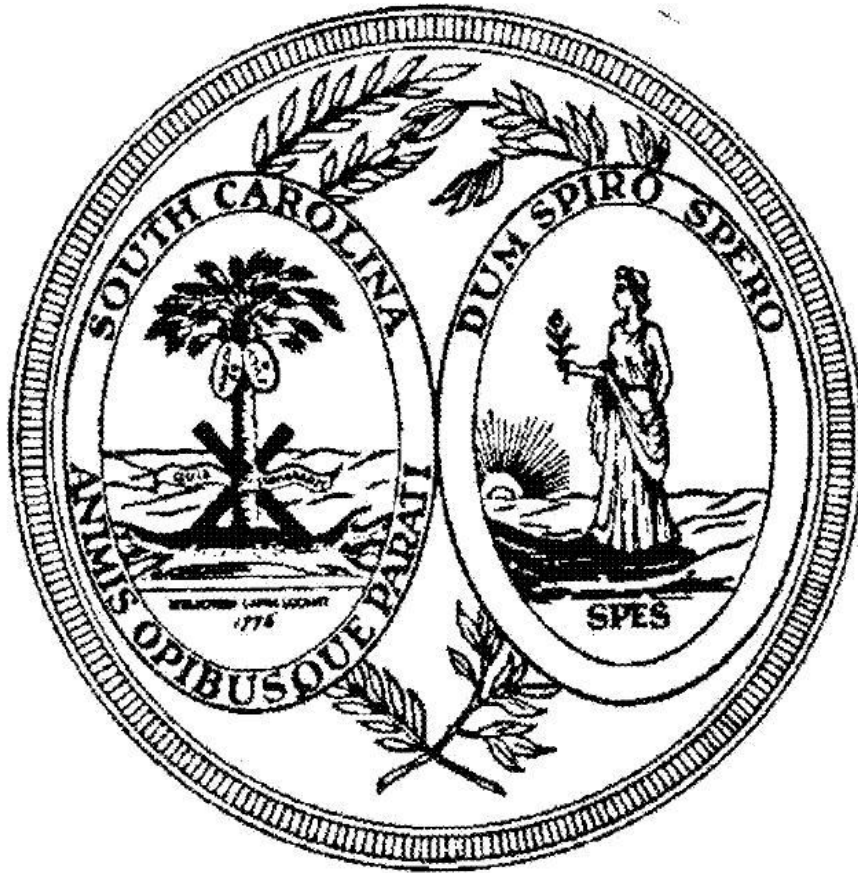
#### Admissions Tax Exemptions

The Admissions Tax Act is replete with exemptions. The Committee recommends the General Assembly examine each one both with regards to unfair competition and equal protection.

#### Film Incentives

The Committee recommends that the General Assembly codify the film budget provisos which has been carried forward in the budget for the past several years contrary to Senate Budget Rules. These three provisos are Film Marketing (Proviso 39.7 - FY 2010-11 Appropriations Bill, Part 1B); Film Motion Picture Rebate Percentage (Proviso 39.15 but using the language contained in Proviso 39.10 – FY 2009-10 Appropriations Bill, Part 1B); and Motion Picture Administration Application Fee (Proviso 39.9 – FY 2010-11 Appropriations Bill, Part 1B).

## Other Funds



## South Carolina Taxation Realignment Commission

## **Other Funds, TRAC's Statutory Charge**

Pursuant to SC Code Section 12-3-10(C)(2)(c), TRAC's report "...shall consider...any fee, fine, license, or Other Funds."

## **Other Funds, Findings**

State appropriations are comprised of three primary types of funds: 1) General Funds, 2) Federal Funds and 3) Other Funds.<sup>274</sup>

**General Funds** are just that - general - because they can be appropriated to any functional area of state government and typically have the fewest "strings attached" related to their use.<sup>275</sup> More than 80 percent of the State's general funds are derived from two primary sources; the State sales and use tax and the State individual income tax. General Fund revenue just completed its third consecutive year of decline, with a recurring base for the current year (FY2010-11) of approximately \$5.08 Billion. That is down from roughly \$6.74 Billion just three years ago (FY2008-09) and is the same level of general fund revenue collected in FY2000-01, not adjusted for inflation or population growth.<sup>276</sup>

**Federal Funds** are usually categorical programs by the Federal government that often require matching State dollars first be "put up" so that the Federal funds may be "drawn down" (examples are Medicaid and Transportation, just to name a few). With little exception, Federal funds come with "strings attached" requiring compliance with federal regulations regarding how the money may and/or may not be spent. Failure to comply with those regulations often result in penalties and other sanctions for those found in non-

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<sup>274</sup> Slide 2 - "Tax Realignment Commission - Other Funds Presentation", September 10, 2010, by Mike Shealy, Budget Director, South Carolina Senate Finance Committee.

<sup>275</sup> Slide 6 - "Tax Realignment Commission - Other Funds Presentation", September 10, 2010, by Mike Shealy, Budget Director, South Carolina Senate Finance Committee.

<sup>276</sup> FY2010-11 recurring general fund base figure from the Office of State Budget after vetoes sustained. FY2000-01 and FY2008-08 general fund revenue levels from the Office of State Budget's "Historical Analysis" published in 2009.

compliance.<sup>277</sup> Federal funds expended by State agencies in FY2008-09 totaled \$7.37 Billion.<sup>278</sup>

**Other Funds** are State funds derived from non-general and/or non-federal fund sources. In short, when a State appropriation cannot be classified as “general” or “federal”, it is categorized as “other”. Unlike general funds, other funds are almost always “earmarked” or “restricted”, and as such, much like federal funds, are usually allocated for expenditure on a specific program or activity (e.g. “strings are attached”). Interest from “earmarked” funds accrues to the State’s General Fund while interest from “restructured” funds accrues to that specific fund.<sup>279</sup>

Examples of “other funds” are lottery proceeds, revenue from the State’s 16 cent/gallon gasoline and diesel “user fee”, and tuition and fee revenue from colleges and universities, just to name a few. In each case, revenue from these specific sources, as with most other funds are either earmarked or restricted and, as such, cannot be transferred among and between the general operations of State government. Lottery revenue must be spent on K-12 and/or higher education and cannot be spent on public safety or State parks. Gasoline and diesel user fee revenue must be spent on roads, not teacher salaries. Tuition revenue accrues to the benefit of the colleges that collect it and to the students that pay it, and not to upkeep of prisons or lakes and rivers, etc.

As illustrated above, other funds, which are often derived from various “fees for service”, are characterized by a relationship between the cost borne by the individual purchasing the good or service and the benefit obtained by the individual using the good or service.

As such, TRAC finds that, with little exception, “other funds” are not malleable, and while other funds are a significant and growing component of State government expenditures, “other funds” growth in one functional area of government will not necessarily offset the

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<sup>277</sup> Slide 10 - “Tax Realignment Commission - Other Funds Presentation”, September 10, 2010, by Mike Shealy, Budget Director, South Carolina Senate Finance Committee.

<sup>278</sup> Office of State Budget’s “Historical Analysis” published in 2009.

<sup>279</sup> Slide 21 - “Tax Realignment Commission - Other Funds Presentation”, September 10, 2010, by Mike Shealy, Budget Director, South Carolina Senate Finance Committee.



sometimes dramatic decreases in other areas of State government because, as discussed above, those funds cannot be “shifted” from one functional area of State government to another.

TRAC finds that other fund expenditures were the single largest category of expenditure by State government in FY2008-09, at \$7.44 Billion, slightly ahead of Federal funds (\$7.37 Billion) as noted above.<sup>280</sup>

TRAC finds that there has been a gradual and definitive shift from State general fund revenue (primarily sales and individual income tax revenue) to “other” and “federal” funds over the past fifteen years. Specifically, in FY1994-95, general fund expenditures comprised 40 percent of total State expenditures, with federal and other funds representing approximately 30 percent each. By 2008-09, general fund expenditures had fallen to just 28 percent, with federal and other funds rising to roughly 36 percent each.<sup>281</sup> This noticeable shift in funding sources for State government is due, in part, to a combination of external factors (the economy) and internal factors (State tax policy).

As such, TRAC finds that these three major funding sources are interrelated. Specifically, as economic externalities combined with State tax policy impact general fund revenue collections, and as federal program expansions create demand for requisite state matching dollars, pressure for “other” funds (fees, fines, etc.) will only continue to grow.

Compounding the pressure on “other funds” is the fact that the State’s Board of Economic Advisors projects long-term general fund revenue growth at just 1.5 percent per year for the foreseeable future, forcing agencies and special interests to seek fee and fine revenue in place of general fund dollars - dollars that may not materialize.

Furthermore, TRAC finds it likely that federal spending available for the states seems destined for retraction in the near term as well. Such will likely result from the exhaustion by the states of funds the federal funds they received from the various federal stimulus programs over

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<sup>280</sup> Office of State Budget’s “Historical Analysis” published in 2009.

<sup>281</sup> Office of State Budget’s “Historical Analysis” published in 2009.

the last several years, coupled with the reality of the fiscal condition of the federal government as it relates to current and projected levels of both deficits and debt at the federal level.

Lastly, TRAC finds that the General Assembly appears cognizant of the findings that TRAC has considered with regards to “other funds” (as noted above), and, as a result, has created by temporary budget proviso in the current year’s (FY2010-11) appropriation act, an “Other Funds Oversight Committee” (OFOC).<sup>282</sup>

OFOC will be a “joint committee” comprised of eight members, four from the South Carolina House of Representatives and four from the South Carolina Senate. OFOC’s charge is to “review and examine the source of other funds in this State and recommend to the General Assembly the appropriate policy for the receipt, appropriation, expenditure, and reporting of other funds.”<sup>283</sup>

TRAC applauds the General Assembly for its creation of OFOC given the reality of the long-term trend away from State general fund revenue to the use of other funds to operate certain functions of State government.

Given this reality, TRAC finds it imperative that the General Assembly take a more proactive review and oversight of other funds. TRAC finds that OFOC gives the General Assembly an appropriate template by which to begin such a proactive role in “other funds” budgeting.

TRAC finds that the General Assembly is to be commended for creation of OFOC and encourages the committee to vigorously pursue other funds oversight and review.

### **Other Funds, General Recommendations**

Rather than relying on a temporary budget proviso that may or may not be adopted in a given year, TRAC recommends that the General Assembly should codify, or make permanent,

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<sup>282</sup> Proviso 70.27 of the FY2010-11 Appropriations Act (H.B. 4657 of 2010).

<sup>283</sup> Proviso 70.27 of the FY2010-11 Appropriations Act (H.B. 4657 of 2010).

OFOC, to ensure that other funds oversight and analysis receives the proper long-term attention required of such an important undertaking.

Given the sheer magnitude of the task set before OFOC as measured by the literally hundreds of fees and/or fines charged by the more than 100 agencies or departments of the State, (a fact that highlights the need for a long-term approach by OFOC), TRAC recommends that OFOC undertake a very detailed review of other funds at only a few State agencies over a longer period of time, rather than a more cursory review of all State agencies over a shorter period of time. In short, TRAC encourages OFOC to develop a process that is manageable, so that its product is meaningful. Utilizing such a process would allow OFOC to properly review other funds at all State agencies over a reasonable period of time.

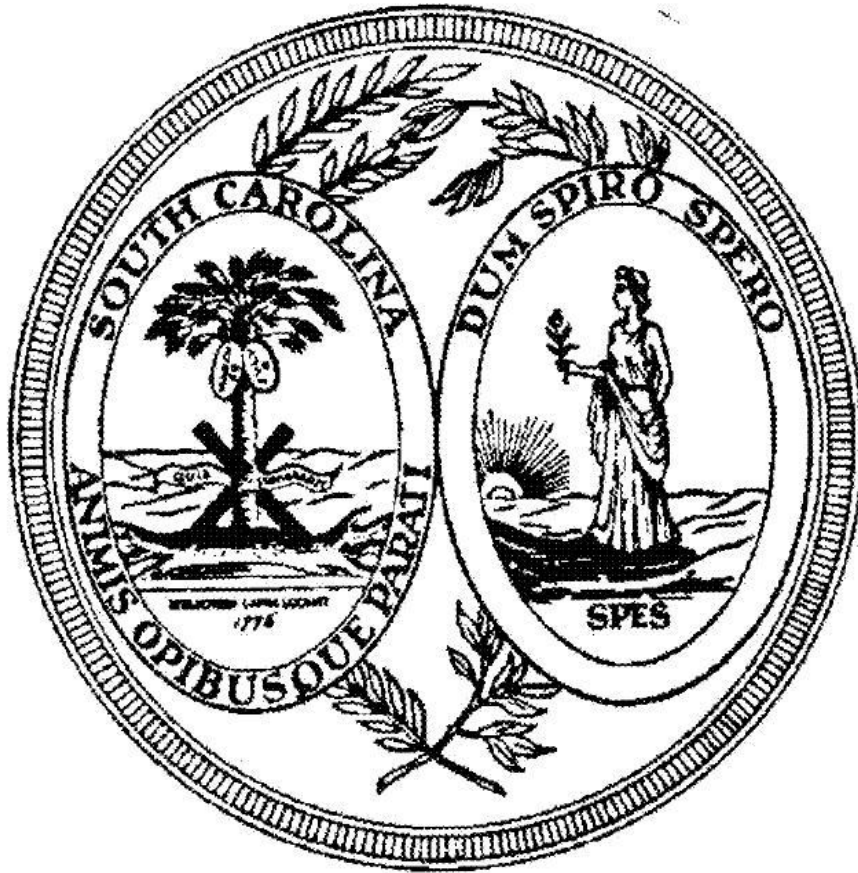
### **Other Funds, Specific Recommendations**

When examining the fees and fines that generate the other funds of State agencies, TRAC specifically recommends that OFOC consider, at minimum:

1. What is the relative price of the good or service compared to the cost of providing the good or service?
2. Related, does the fee charged to the individual consuming the good or service: cover, fall below, or exceed the cost to the agency for providing the good or service?
3. Are other fund revenues properly accounted for by State agencies (based on the generally accepted principles of “Fund Accounting”) and are the amounts and uses of those funds readily available to members of the General Assembly and to the public for review?
4. Statutory authority. Does the ability for an agency to levy, increase, retain, expend, and/or carry forward a fee relate back to a specific statutory or budgetary authority? If yes, which statute or budget proviso? If no, under what authority does the agency assess the fee?

5. How does the fee compare to fees charged by similar agencies for similar purposes in neighboring states, states within the Southeast, and states nationwide (as applicable)?

# **Tax Administration**



## **South Carolina Taxation Realignment Commission**

## **Tax Administration, Generally, and Recommendations**

Regardless of the types of taxes utilized in any state's revenue system, taxpayers deserve fair, efficient and customer-focused tax administration. In Council On State Taxation's most recent survey of state tax administration systems, South Carolina scored a respectable B grade.<sup>284</sup> However, the General Assembly should consider the following changes to improve the laws governing tax administration in South Carolina:

- Require ALJs hearing tax disputes at the ALJ Division to have tax expertise prior to appointment;
- Eliminate the requirement forcing taxpayers to pay a disputed tax prior to appeal to Circuit Court and Court of Appeals;
- Equalize the rate of interest applicable to refunds and assessments (currently 2 percent disparity);
- Extend the state income tax due date to 30 days beyond the federal return due date; and
- Define "final determination" for purposes of reporting federal tax changes to South Carolina.

Foremost in good tax administration is a fair and efficient tax appeals system. A state's ability to recognize the potential for error or bias in its tax department determinations and to provide taxpayers access to an independent appeals tribunal is the most important indicator of the state's treatment of its tax customers, and South Carolina has been commended for the independence of the ALJ Division. States with fair and efficient tax appeal systems, however, share two additional elements: 1) the tribunal's judges should be specifically trained in tax law; and 2) taxpayers should not be required to prepay a disputed tax or post a bond before final resolution of the issue.

## **Tax Administration, Additional Recommendations**

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<sup>284</sup> Lindholm, Douglas L. and Fredrick J. Nicely, *"The Best and Worst of State Tax Administration: COST Scorecard on Tax Appeals and Procedural Requirements,"* February 2010, <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=75910>.

**Trained Judges:** One or more of the ALJs should be specifically trained as tax attorneys. (The ALJs previously had 2 tax attorneys with LLMs in Taxation. Currently there are none.) The tremendous growth and complexity in the body of tax law and the nature of our multi-jurisdictional economy makes this consideration paramount. ALJs not trained in tax law are less able to decide complex corporate tax cases on their merit, and a perception exists (rightly or wrongly) that the *revenue impact* of these complex cases too often helps guide decision-makers through the fog of complicated tax statutes, regulations, and precedent. That perception reflects poorly on a state's business climate and reputation as a fair and competitive place to do business.

**Equalized Interest Rates:** Interest rates should apply equally to both assessments and refund claims. South Carolina previously had equalized interest rates but it no longer does. Failure to equalize interest rates diminishes the value of the taxpayer's remedy of recovering tax monies to which it is legally entitled. Interest rates are meant to compensate for the lost time-value of money and should apply equally to both parties.

**Return Due Date and Automatic Extensions:** The state's corporate income tax return due date should be at least 30 days after the federal tax return due date, or the state's extended due date should be at least 30 days after the federal extended due date. Further, the state's corporate income tax return due date should be automatically extended simply by obtaining a federal extension. By extending state due dates to this point, state tax administrators allow taxpayers to file correct returns based on complete federal return information. Although corporate taxpayers often file a single consolidated federal return, the adjustments necessary to generate the multitude of state tax returns are complex and time-consuming. A minimum of 30 days beyond the extended federal due date is needed to complete these adjustments. To ease administrative burdens, an automatic state extension should only require attaching a copy of the extended federal return with the state return to qualify.

**Final Determination:** All states imposing a corporate income tax require a taxpayer to report changes in federal taxable income to the state. In the majority of states the requirement is triggered by when a "final determination" is made regarding the federal income tax return (*e.g.*,

issuance of a Revenue Agent's Report). However, some states have no such definition. Although the Multistate Tax Commission promulgated a model uniform statute for reporting federal tax adjustments in August, 2003, the states are not using a uniform definition as to when a federal tax change constitutes a "final determination" to be reported to the state. This is unfortunate because it unnecessarily creates compliance problems and wrongfully subjects taxpayers to concomitant penalties and interest for unintentional noncompliance. COST suggests the following "best practice" as a workable definition, primarily based on the statutory definition of "final determination" used by New Hampshire. "A 'final determination' is deemed to occur when the latest of any of the following activities occurs with respect to a federal taxable year: (1) The taxpayer has made a payment of any additional income tax liability resulting from a federal audit, the taxpayer has not filed a petition for redetermination or claim for refund for the portions of the audit for which payment was made and the time in which to file such petition or claim has lapsed. (2) The taxpayer has received a refund from the U.S. Treasury that resulted from a federal audit. (3) The taxpayer has signed a federal Form 870-AD or other IRS form consenting to the deficiency or consenting to any over-assessment. (4) The taxpayer's time for filing a petition for redetermination with the U.S. Tax Court has expired. (5) The taxpayer and the IRS enter into a closing agreement. (6) A decision from the U.S. Tax Court, district court, court of appeals, Court of Claims, or Supreme Court becomes final."

**- - - End of Report - - -**

**Appendices Separately Attached from this Report as Follows:**

Sales and Use Taxes  
Individual Income Tax  
Corporate Income Tax  
Property Tax  
Fuel Tax  
Votes on Proposals  
Commissioner Comments