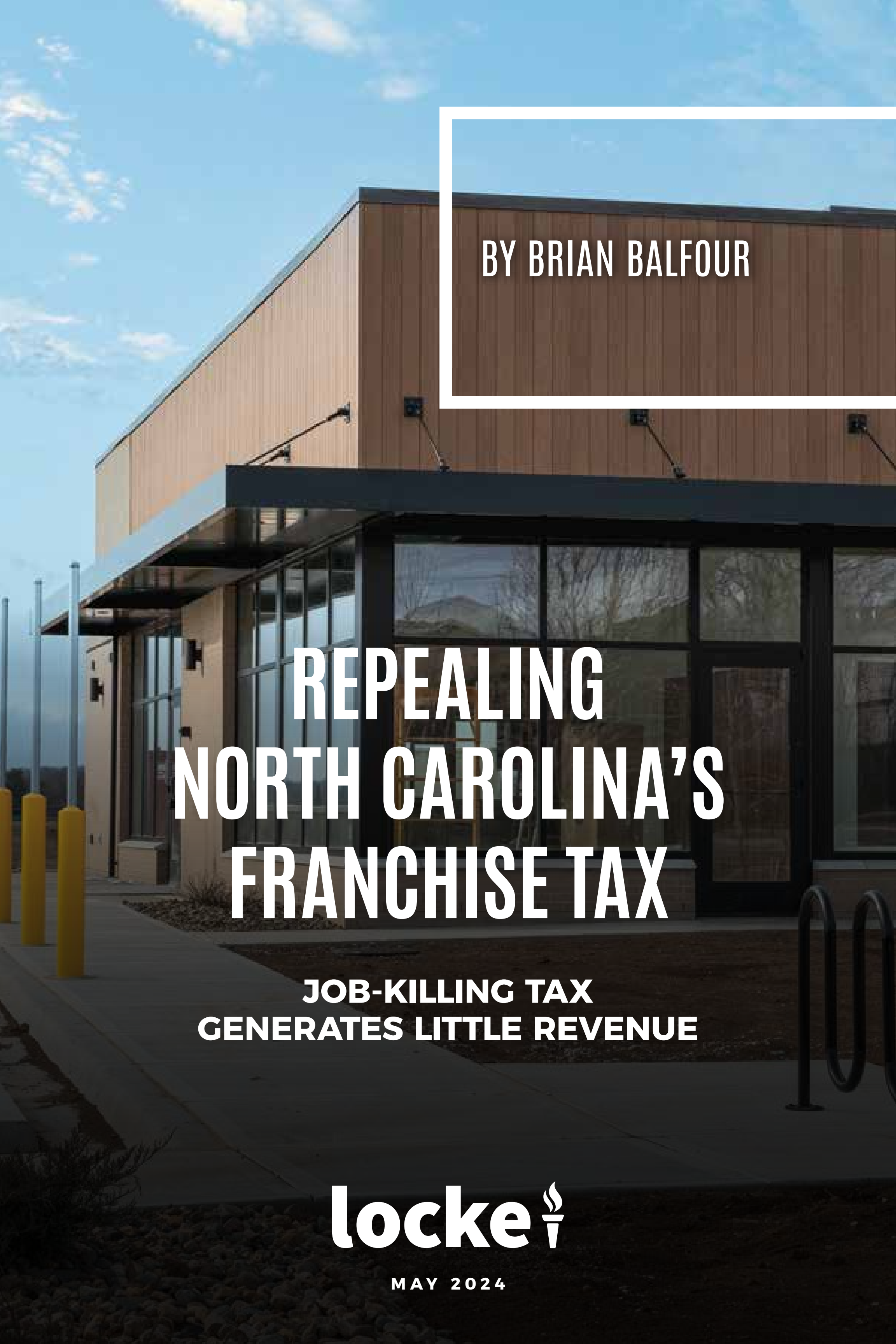

BY BRIAN BALFOUR

REPEALING NORTH CAROLINA'S FRANCHISE TAX

JOB-KILLING TAX GENERATES LITTLE REVENUE

locke

MAY 2024

Repealing North Carolina's Franchise Tax

Job-Killing Tax Generates Little Revenue

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Executive Summary

North Carolina has a lot to brag about when it comes to its tax climate. Over the past dozen years, state legislators have transformed it from one of the least competitive states to one of the most competitive. It is recognized by national outlets as the best state to do business.

But now is not the time to rest on our laurels. There's still more room for improvement. Other states have followed North Carolina's lead and are catching up.

Repealing the onerous and destructive franchise tax would be a great next step.

NC Chamber leadership described the tax as "a major impediment to new investments" and urged its immediate repeal, calling it in 2021 an even higher priority than lowering the corporate income tax. The complexity of the franchise tax not only places steep compliance costs on businesses, even those with no physical presence in the state, but also is used by the state Department of Revenue as a source for punishing honest mistakes and oversights with fines.

Making matters worse, businesses must pay the tax every year, even in those in which they lose money, punishing job creators when they can least afford it. Even independent contractors — depending on how they file — must pay an annual minimum despite having no employees or assets.

"The reasons for eliminating the franchise tax are numerous, and repeal would continue our state's positive momentum and make North Carolina more competitive for investment vital to economic growth and the jobs that come with it."

In spite of all of these disruptive effects, the franchise tax generates just a small fraction of state revenue. Numerous states over the past several years have recognized the harmful impact of a franchise tax and have repealed theirs, leaving North Carolina in a minority of states still imposing one.

The reasons for eliminating the franchise tax are numerous, and repeal would continue our state's positive momentum and make North Carolina more competitive for investment vital to economic growth and the jobs that come with it.

Introduction

In 2011, the North Carolina General Assembly passed a budget that allowed a "temporary" 1-cent statewide sales tax to expire. The tax had been passed in 2009 with a 2011 expiration date. The General Assembly successfully overrode then-Gov. Bev Perdue's veto of the budget, a veto motivated by her desire to keep three-quarters of that penny sales tax increase in place in spite of the original intent being its 2011 expiration. Extending the "temporary" tax increase would have cost taxpayers nearly $1 billion per year.

Thus began over a decade of sweeping tax reforms that transformed North Carolina from one of the highest-taxed states in the nation to one of the most competitive tax climates in the country.

The largest step on this journey occurred in 2013 with the passage of a comprehensive tax reform package that significantly transformed the personal income tax from a multitiered progressive rate structure, topping out with one of the highest rates in the country, to a lower, flat rate with a generous standard deduction. This reform also included an ambitious schedule of lowering the state's corporate income tax, then highest in the Southeast, and dozens of other smaller but still beneficial reforms.

Further rate reductions in subsequent years have dropped the corporate income tax rate to the lowest of any state currently imposing one, with a plan in place to zero it out after 2029. The personal income tax rate will also continue to fall — it is scheduled to drop below 4 percent by 2026, and it has the potential to drop to 2.49 percent in future years should certain revenue goals be met.

Groups across the country have taken notice of North Carolina's turnaround. In 2017, Forbes called North Carolina the "national model for tax reform."[1] In 2023, CNBC ranked North Carolina as the top state for business, a ranking it has enjoyed many times over the past several years.[2] In the Tax Foundation's annual Business Tax Climate Index, North Carolina ranked seventh worst in 2012,[3] but reforms have vaulted the Tar Heel State to ninth best in 2024.[4]

The results have been impressive. Job growth from 2013 to 2022 was 11th highest in the nation, well above the national average. Personal income growth during that time was 10th highest, also significantly outperforming the national trend.[5]

But now is not the time to stop. More improvements can be made.

One "weak point" of North Carolina's tax code, as the Tax Foundation called it, is the franchise tax.[6]

The franchise tax is destructive because, among other reasons, it punishes investment while imposing high compliance costs. Meanwhile it generates only a small fraction of state revenue. Eliminating this tax would align North Carolina with the majority of states and make us even more attractive to job creators.

WHAT IS THE FRANCHISE TAX?

The franchise tax is a tax on the net worth of a business. Essentially, a company totals its assets minus liabilities and accumulated depreciation, then adds affiliated indebtedness (more on this later) to calculate its net worth, which is what its franchise tax liability is based on.[7]

Complicating matters further is that this net worth needs to be apportioned to all the states in which the business makes sales. A company need not even be located in North Carolina to owe the North Carolina franchise tax. For instance, if a company sells 25 percent of its goods in North Carolina, then it must use 25 percent of its net worth to calculate its franchise tax liability.

Adding yet another layer of complexity is that of calculating affiliated indebtedness. This calculation can present difficulties, which makes it easy to seize upon by state auditors to impose penalties even against companies legitimately making every effort at compliance.

Affiliated indebtedness basically refers to when a business has a holding company that owns several different companies, and for accounting reasons the different companies owe each other money. The business would therefore need to back those debts out of its calculations for its net worth. It's a complication that theoretically makes sense but adds a big headache to accountants attempting to calculate their company's liability. It is a significant source for state auditors searching to punish companies for noncompliance.

Once a company's North Carolina net worth is calculated, the franchise tax is levied at a rate of $1.50 for every $1,000 of calculated North Carolina net worth. This rate applies to both C and S corporations. Thanks to the 2023 budget bill, however, both types of corporations have a cap on their liability for the first $1 million of net worth.[8]

"Because it's a tax on net worth, the franchise tax is owed even if a business loses money in any given year. And it's not a one-time tax; it's owed every year."

Beginning this tax year, S corporations will see their franchise tax liability on the first $1 million of net worth be $200, with a rate of $1.50 for every $1,000 of net worth in excess of the first million. Similarly, C corporations will pay $500 for their first $1 million of net worth, plus $1.50 for every additional $1,000 in net worth.

Because it's a tax on net worth, the franchise tax is owed even if a business loses money in any given year. And it's not a one-time tax; it's owed every year.

Moreover, the $200 minimum is especially harmful to small businesses and independent contractors. Even for an individual contractor who owns no business assets and has zero employees, if he organizes as an LLC to limit other tax liabilities, he would still be forced to pay the $200 franchise tax every year, regardless of whether he earned any income or not.

It's easy to see how the franchise tax creates a disincentive for businesses to invest in North Carolina and creates barriers to entry for small, independent businesses and contractors.

COMPLEXITY MAKES THE FRANCHISE TAX A TARGET-RICH ENVIRONMENT FOR STATE AUDITORS

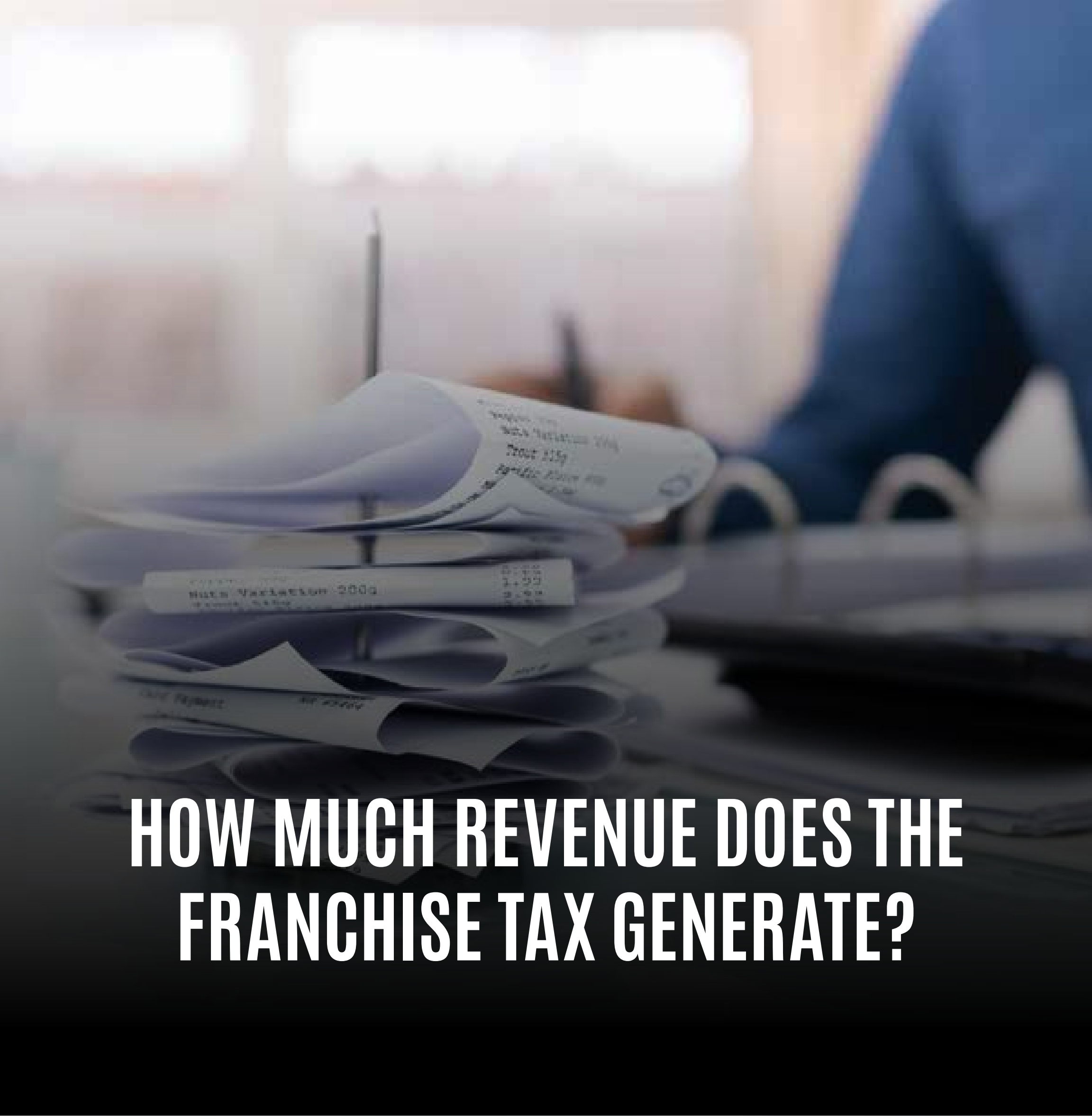
As if paying the franchise tax wasn't enough of a burden on businesses, the tax's complexities make it ripe for use by state auditors as a way to punish often unsuspecting companies with fines and interest.

According to one former North Carolina Department of Revenue (NCDOR) auditor:

> *When auditing a corporation, I was trained to look at the franchise tax calculation first, particularly affiliated indebtedness. North Carolina's franchise tax is uniquely complex because of the affiliated indebtedness add-back, which made the franchise tax particularly profitable for the state because it was mistakenly omitted fairly often, especially among out-of-state companies with tax returns in most or all of the fifty states. So it was generally the easiest component of a return on which to charge penalties and interest.*[9]

Because North Carolina's franchise tax is somewhat obscure — most states don't impose one — and complex, it's fairly easy for national companies to overlook or otherwise miscalculate it. Sadly, NCDOR seems all too eager to play a game of "gotcha" with these companies.

Such eagerness, added the former auditor, "seemed to be a bad faith approach because it was tacking penalties and interest on to a tax that was unnecessarily complex and unknown to most tax preparers, so a simple ignorance of the law ended up costing companies doing business in the state."[10]



HOW MUCH REVENUE DOES THE FRANCHISE TAX GENERATE?

Revenue from North Carolina's franchise tax comprises a very small part of total General Fund revenues, a share that will dwindle even more starting this year due to the cap put in place. Budget writers projected that the franchise tax would generate $742.3 million in Fiscal Year (FY) 2023–24. With total General Fund revenues predicted to be $33.7 billion, the revenue from the franchise tax would make up just 2.2 percent of projected 2023 revenue.[11]

As you can see from the chart below, the share of total revenue consisting of the franchise tax has been trending downward over the past several years.

Chart 1: Trending Downward: Total State Revenue from the Franchise Tax, 2013–22

Year	Franchise Tax Revenue	Total Revenue	Percentage of Total Revenue
2022	$879,789	$39,699,744	2.22%
2021	$882,332	$36,706,297	2.40%
2020	$640,865	$28,841,668	2.22%
2019	$754,936	$28,767,114	2.62%
2018	$676,309	$27,342,149	2.47%
2017	$749,408	$22,528,928	3.33%
2016	$521,628	$22,153,936	2.36%
2015	$556,786	$21,318,989	2.61%
2014	$556,786	$19,981,025	2.79%
2013	$845,130	$20,152,253	4.19%

SOURCE: NORTH CAROLINA COMPREHENSIVE ANNUAL FINANCIAL REPORT, VARIOUS YEARS.[12]

According to the 2023 budget bill's Legislative Fiscal Note, total tax savings from the newly imposed franchise tax cap mentioned above was estimated to be $49 million in its first year (FY 2024–25), then grow to be $223 million by FY 2027–28.[13] As such, the franchise tax will generate an even smaller share of total General Fund revenues moving forward.

HOW MANY STATES STILL HAVE A FRANCHISE TAX?

Levying a net worth tax on businesses puts North Carolina in the minority of states. According to the Tax Foundation, North Carolina is one of only 15 states imposing what they call a “capital stock tax.”[14]

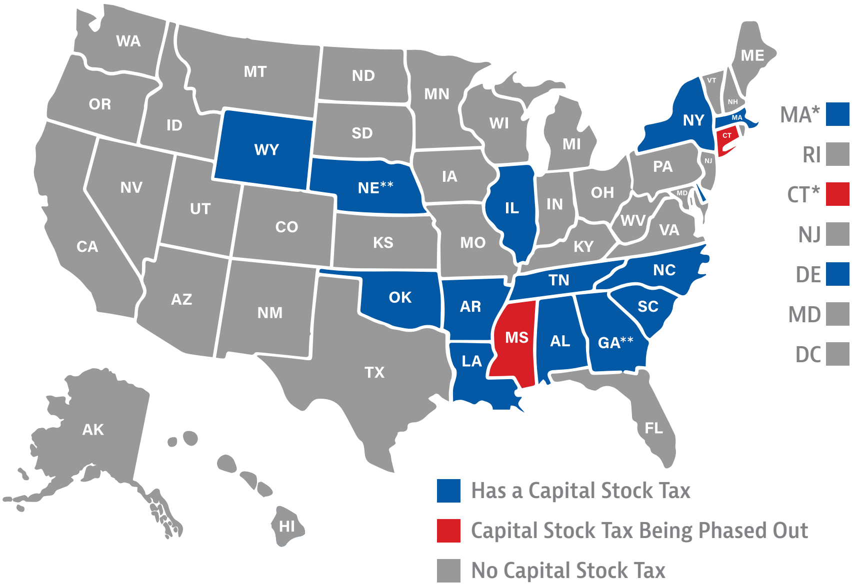
That number of states keeping franchise taxes has been shrinking and will continue to do so in the coming years.

“As legislators have increasingly recognized the damaging effects of capital stock taxes, many states have reduced them or repealed them altogether. Kansas completely phased out its capital stock tax prior to tax year 2011, followed by West Virginia and Rhode Island in 2015 and Pennsylvania in 2016,” the Tax Foundation reported in 2023.[15]

Moreover, Oklahoma just repealed its capital stock tax in 2023. Connecticut and Mississippi are phasing theirs out by 2028. Without any further action, in a handful of years North Carolina could be one of just 13 states taxing the net worth of businesses simply because they sell some goods in the state. The other dozen states are Alabama, Arkansas, Delaware, Georgia, Illinois, Massachusetts, Nebraska, New York, South Carolina, Tennessee, and Wyoming.

Calculating franchise tax liability varies by state, as does the rate of taxation. Rates range from 0.02 percent in Wyoming up to 0.3 percent in Arkansas. North Carolina’s rate is in the middle of the pack at 0.15 percent (see chart below).[16]

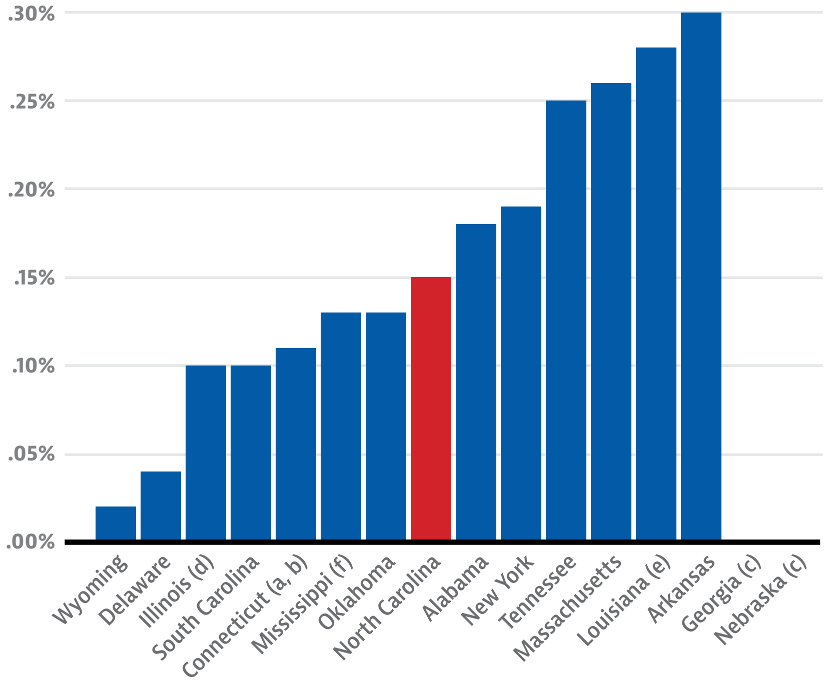
Figure 1: States That Still Have a Franchise Tax (as of January 1, 2023)



NOTE: (*) TAXPAYER PAYS THE GREATER OF CORPORATE INCOME TAX OR CAPITAL STOCK TAX LIABILITY. (**) BASED ON A FIXED DOLLAR PAYMENT SCHEDULE. EFFECTIVE TAX RATES DECREASE AS TAXABLE CAPITAL INCREASES. CAPITAL STOCK TAXES ARE LEVIED ON NET ASSETS OF A COMPANY OR ITS MARKET CAPITALIZATION.

SOURCE: TAX FOUNDATION

Figure 2: Range in State Franchise Rates



NOTES:

(A) TAXPAYER PAYS THE GREATER OF CORPORATE INCOME TAX OR CAPITAL STOCK TAX LIABILITY.

(B) TAX WILL BE FULLY PHASED OUT BY JANUARY 1, 2024.

(C) BASED ON A FIXED DOLLAR PAYMENT SCHEDULE. EFFECTIVE TAX RATES DECREASE AS TAXABLE CAPITAL INCREASES.

(D) THE TAX RATE IS 0.15% FOR THE FIRST YEAR AND 0.1% FOR ALL FOLLOWING YEARS.

(E) THE FIRST $300,000 OF TAXABLE CAPITAL IS EXEMPT FROM TAX.

(F) TAX WILL BE FULLY PHASED OUT BY JAN. 1, 2028.

(G) NEBRASKA'S CORPORATION OCCUPATION TAX IS DUE EVERY OTHER YEAR. THE MAXIMUM TAX IS $23,990 FOR DOMESTIC (NEBRASKA) CORPORATIONS AND $30,000 FOR FOREIGN (OUT-OF-STATE) CORPORATIONS.

SOURCE: TAX FOUNDATION

WHY NORTH CAROLINA SHOULD ELIMINATE ITS FRANCHISE TAX

There are numerous reasons why North Carolina should eliminate its franchise tax. High compliance costs due to its complexity along with the barriers to small businesses and contractors are just the tip of the iceberg.

Because it's a direct tax on wealth and the accumulation of capital, the franchise tax discourages investment in the state. Businesses can largely avoid paying this tax by setting up shop in other states, depriving North Carolina of job-creating investments.

Moreover, due to the apportionment formula, companies located elsewhere nevertheless get dinged with North Carolina's franchise tax merely for selling goods here. With the threat of paying the tax — or paying a fine if not perfectly adhering to the complex reporting requirements — some businesses on the margin will forgo selling goods in North Carolina altogether. Consumers are deprived of more choices, and the limitations on supply help to drive up prices.

Most objectionable, however, is the unjustness of the tax. Dr. Roy Cordato, John Locke Foundation senior economist emeritus, wrote in a 2019 brief that the franchise tax "is, at best, morally suspect." Cordato said that "if we start with the idea of tax fairness within the construct of a free society based on equal treatment under the law, North Carolina's franchise tax unjustly punishes companies for using their profits to grow their businesses."[17]

That's not the end of it. "If a company builds a new plant or purchases equipment and therefore enhances its value, it is penalized," Cordato added. "And from a justice perspective, the state doesn't just penalize the company once when its capital stock is initially enhanced, but year after year, as those original purchases continue to be part of the company's base of wealth. In other words, the same stock of wealth is hit over and over again. In a free society, it is difficult to see how such a punitive approach to taxation can be justified morally."[18]

"Beyond the moral objections, the franchise tax is economically destructive to critical investment that spurs economic growth and job creation."

Beyond the moral objections, the franchise tax is economically destructive to critical investment that spurs economic growth and job creation.

As Cordato wrote, "From an economics perspective, the tax discourages growth by penalizing capital accumulation. Taxing a company's wealth is the equivalent of taxing its capacity to grow as a business. It restrains its ability to satisfy its customers and to provide employment opportunities."[19]

Accumulated capital is what generates future income and wage growth. Because it is, Cordato said, "[i]f you tax wealth, either at the individual level or the business level, you simultaneously tax and therefore reduce the incomes that flow from that wealth. And because all income flows from an economy's existing stock of wealth, all wealth taxes, whether on individuals … or on businesses … reduce[s] the incomes of workers and employers alike."[20]

The franchise tax is such a discouragement to investment that the NC Chamber as recently as 2021 made its elimination a higher priority than reducing the corporate income tax rate.[21]

“Making the franchise tax particularly burdensome is that it is levied annually, in perpetuity, even if a business has no or negative revenue in a particular year.”

According to Chamber President and CEO Gary Salamido, when speaking with business leaders from around the nation, “the two issues we hear are about talent and about the franchise tax. … For us, it’s a competitiveness issue.”[22]

Labeling the franchise tax an “onerous, duplicative tax” and “a major impediment to new investments,” the Chamber urges its immediate elimination. Doing so, according to the Chamber, would “result in direct bottom-line savings for the vast majority of job creators throughout the state” that will “support our long-term competitiveness.”[23]

Making the franchise tax particularly burdensome is that it is levied annually, in perpetuity, even if a business has no or negative revenue in a particular year. There’s no good reason to tax a business with zero positive revenue. This practice is especially punishing during economic downturns when many businesses are struggling to survive some losing years and avoid going bankrupt. It also creates particular hardships on start-up businesses, which often take several years to turn a profit.

Furthermore, the franchise tax especially harms a state’s competitiveness because it taxes capital, which can be much more mobile than real property, which is subject to property taxation. As tax analyst David Brunori wrote in Forbes, “[T]he difference between a property tax on business capital and a property tax on real property is plain: Business capital can be moved and real property cannot. Again, taxing mobility in a world in which governments are competing for business does not work.”[24] North Carolina’s taxation of business assets via the franchise tax incentivizes businesses to move those mobile assets elsewhere, a choice made easier considering that most states do not impose this tax.

Some argue that the franchise tax is a double — or even triple — tax on businesses. The franchise tax is levied in addition to the corporate income tax and the property tax. Salamido agrees with this notion, saying the franchise tax amounts to "double taxation" because many of these companies are already paying hefty property tax bills. "Capital-intensive manufacturers are hit disproportionately," he said.[25]

"Some argue that the franchise tax is a double – or even triple – tax on businesses."

To be sure, the franchise tax adds yet another layer of taxation on businesses already taxed in several forms. For instance, if a company runs a profit, it must pay a tax on its income. Then whether it uses some of that after-tax income to buy assets or merely retains it in cash, it will have to pay a franchise tax on those assets — every year. And let's not forget the sales tax it likely pays when acquiring an asset. If the business uses that after-tax income to acquire land, it will be forced to pay property tax on it — every year.

So, it is entirely possible that a business could earn income, pay tax on that income, buy an asset with that after-tax income, pay sales tax when buying the asset, then pay both property tax and franchise tax on the asset every year that the business owns it.

Research from other states provides still more evidence of the franchise tax's destructive nature.

Louisiana

In 2023, Louisiana's Pelican Institute for Public Policy teamed up with the Economic Research Center to model the results if that state were to eliminate its franchise tax.[26] Louisiana's legislature passed a bill in 2023 to phase out the tax, but it was vetoed by Gov. John Bel Edwards.[27]

The Pelican Institute reported:

> *Removing this tax on capital would support more investment and economic output over time with the largest effect in the first year.*
>
> *Their [the Economic Research Center's] results show that eliminating the costly corporate franchise tax would result in gross domestic product (GDP) increasing by $330 million, with employment increasing by at least 1,000 jobs, consumer spending increasing by $30 million, and investment jumping by $170 million in 2024.*[28]

Moreover, the loss of the franchise tax revenue would be partially offset by increased tax revenue generated by the increased economic activity, the report found.

Mississippi

In 2016, Mississippi Gov. Phil Bryant signed a law to phase out the franchise tax over a 10-year period, from 2018 to 2028. Council on State Taxation President Douglas Lindholm wrote, "By eliminating its franchise tax, Mississippi will enhance its attractiveness for new and expanded business investment in the state." Lindholm said the tax was "widely viewed by economists as a disincentive to economic growth" and that, by ending it, Mississippi "will encourage business investment and job creation by significantly reducing the direct costs imposed on businesses seeking to expand or relocate in the state."[29]

Indeed, according to Lindholm, calculations run by accounting firm Ernst & Young in response to Mississippi's franchise tax elimination showed that "the incremental elimination of the franchise tax … will improve the state's ranking on numerous levels and will particularly boost the state's attractiveness to headquarters facilities."[30]

Oklahoma

When Oklahoma approved the repeal of its franchise tax in 2023, the Tax Foundation applauded. Calling it a "nuisance tax" because of the "significant amounts of time and effort" required by businesses to track and report the franchise tax liability, the Tax Foundation noted that the tax "disincentivizes investment in the state and its repeal is a competitive and pro-growth development."[31]

Moreover, the Tax Foundation and Oklahoma Chamber of Commerce published a 2021 report that included the recommendation that the state repeal its franchise tax. The report called the franchise tax "damaging" and said that because franchise taxes "are levied regardless of whether a business makes a profit," the taxes "are especially onerous for businesses during periods of economic downturn and are a burden to new businesses that have yet to turn a profit."[32]

According to their report:

> *Taxing a company based on its net worth essentially penalizes the firm for making additional capital investments. This disincentive results in firms that underproduce and operate below their full potentials. Purchasing additional equipment, or replacing old equipment, becomes more costly—both in terms of tax liability and tax compliance costs. Without additional capital investment, fewer workers are hired, and those that are employed are less productive. Since productivity directly influences wages, underproducing workers are also unable to realize their full earning potential. In short, the unintended consequences of capital stock taxation can have a limiting effect on the state's economy.*[33]

All of the arguments used in favor of repealing the franchise tax in Oklahoma, Louisiana, and Mississippi apply in North Carolina as well.

Conclusions and Recommendations

The franchise tax is a burdensome, complex tax that harms economic growth and imposes high compliance costs both on businesses and the state yet generates only a small fraction of state revenue. Only 14 other states impose this destructive tax, with two of those planning on its elimination. There are plenty of reasons why so many states have abandoned this onerous and duplicative tax.

North Carolina should join the majority of states and eliminate its franchise tax.

The reduction in revenue would be very minor and would be partially offset by increased tax revenue from increased economic activity. More North Carolinians would have job opportunities, the state would attract more investment that helps drive up worker wages, and consumers would benefit from more choices.

North Carolina has come a long way in making significant improvements to its tax climate. Eliminating the franchise tax is the next logical step in making North Carolina the most competitive state in the nation.

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THE JOHN LOCKE FOUNDATION

Our History

The John Locke Foundation was created in 1990 as an independent, nonprofit think tank that would work "for truth, for freedom, for the future of North Carolina." The Foundation is named for John Locke (1632-1704), an English philosopher whose writings inspired Thomas Jefferson and the other Founders. The John Locke Foundation is a 501(c)(3) research institute and is funded by thousands of individuals, foundations and corporations. The Foundation does not accept government funds or contributions to influence its work or the outcomes of its research.

Our Vision

Locke envisions a North Carolina in which liberty and limited, constitutional government are the cornerstones of society so that individuals, families, and institutions can freely shape their own destinies.

Our Mission

Locke's mission is to be North Carolina's most influential force driving public policy so North Carolinians flourish in a free and prosperous society.

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