COUNTY OF DURHAM

BUDGET & MANAGEMENT SERVICES DEPARTMENT

Memo: Analysis of Sales Tax Distribution Method Related to Durham City and County Sales Tax Interlocal Agreement

To: Director Keith Lane - Budget and Management Department
Claudia Hager – General Manager Accountable, Efficient & Visionary Government
County Manager Wendell Davis Durham Board of County Commissioners

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North Carolina state law provides two county distribution options for proceeds collected from Local Option Sales Taxes. The County Commissioners of all 100 counties may annually select which method will be used by April of each year. This analysis compares the two different distribution methods (after the state collects the taxes and prepares to disburse them): Ad Valorem and Per Capita. Currently Durham County is using the per capita method with a subsequent, mutually approved, five-year interlocal agreement to maximize the distribution benefits to both governments. The recommendation herein is to continue the interlocal agreement between Durham County and the City of Durham for an additional five years, which modifies the final local sales tax distribution between the City and County to a fixed 58% and 42% respectively.

The four taxes that are included in this analysis are:

- Article 39 – 1% tax on items sold in Durham County
- Article 40 – ½% tax on items sold across the state with revenue dispersed on a Per Capita basis to all 100 counties in North Carolina
- Article 42 – ½% tax on items sold in Durham County
- Article 44 – A repealed tax, that is still receiving very small amounts of revenues and refunds from late collections

As noted, the two available distribution options are Ad Valorem and Per Capita. The Ad Valorem distribution method uses formulas based off property valuations of the County, City and other tax districts within the municipalities, while the Per Capita method provides for distribution of sales tax by populations of the County and its municipalities. The most impactful difference between the two methodologies is that under Ad Valorem there is a requirement to distribute revenues to each special taxing district as well as the County and City, such as fire districts and the Business Improvement District. Another important factor is that due to fewer variables influencing distribution formulas, the Per Capita distribution method provides a more stable basis of revenue projection. That stability of annual growth estimates is highly valued as part of the annual budget process. The Per Capita method relies on the relatively stable population statistics and wider economic trends while the Ad Valorem method adds variables based off property valuations and tax rates of all entities, which in turn makes it susceptible not only to economic fluctuations, but also annual political choices and local property growth fluctuations.

For the past ten years the County and City have been operating under an interlocal agreement that modifies the Per Capita distribution method for the Local Option Sales Taxes (two successive five-year terms). Rather than utilizing the state calculated Per Capita distribution percentage, which is updated every year based on the most recent population estimates, the County and City have agreed to allocate their joint distributions by 58% and 42% respectively. *As a reference the state provided straight Per Capita distribution is approximately 45.5% to the City and 53.7% to the County, and is adjusted slightly each year based on City and County population changes.* The benefit of this modified 58% (County)- 42% (City) split is that it provides a cooperative agreement between the County and City where both parties mutually benefit from the Sales Tax distribution, as opposed to a less equitable result if the actual Per Capita or Ad Valorem distributions were used.

For the Ad Valorem distribution method, sales tax proceeds are allocated to all taxing districts within the municipalities including the City and County. While the County would receive a higher in actual allocation from the state, the requirement to further distribute these funds to other special taxing districts results in a reduction of County only revenue (as compared to the interlocal agreement). These other special taxing districts are currently being supported by property tax as their main revenue source; if the Ad Valorem method were adopted then sales tax proceeds would be distributed to these districts, which would mean a commensurate reduction in their property tax needed.

A thorough County Budget department analysis of the next five years comparison of the current 58% (County) - 42% (City) split versus moving to an Ad Valorem collection method leads to the conclusion that the current 58% - 42% five-year interlocal split is still the best path forward. This provides both the County and City with more stable annual revenue growth predictability and equal or greater revenue than if the County advocated going with the Ad Valorem method. The County is not recommended to go to a straight Per Capita collection agreement (no interlocal with the City) as that would significantly hurt County sales tax collection (a drop from the current interlocal split of 58% to 53.7%).

FY2018-19 projected Local Option Sales Tax Distribution using three distribution methodologies:

FY 2018-19 Projection	**Ad Valorem**	**Per Capita**	**Interlocal (58-42)**
Durham County	$64,187,030	$63,273,626	$67,797,345
City of Durham	$49,015,531	$53,618,349	$49,094,629

Notable in the table above is that the interlocal agreement amount provides the largest total distribution to Durham as a whole; while maintaining an amount for the City that provides for very a similar net amount as would Ad Valorem distribution. The driver of this difference is the requirement of the Ad Valorem method to further disburse sales tax proceeds to the other taxing special tax districts for each municipality.

Included in estimated future years sales tax variables, when the Ad Valorem method is used, are trends increasing the rate of valuation growth in the City (i.e. total valuation growth for the City is calculated at 13% over the five years, and only 10% for the County). This city growth is further captured when the Business Improvement District is calculated to grow at a 5% increase each year, as opposed to the other taxing districts at a 2% rate. On the other hand, the County is expected to have a faster rising property tax rate over future years due to having less available dedicated fees to charge residents. As valuation for the City may out pace overall County valuation, future tax rate growth in the County may offset some of that growth. This situation is an excellent example of the compounding effect seen when the Ad Valorem distribution method is used, which results in less stability and predictability in future year sales tax revenue projections. *As a note of caution, it must be acknowledged that all future projected growth in valuations, sales tax proceeds, and property tax rates are quite nebulous numbers to predict with accuracy. The model cannot project unforeseen recessionary activities (related to property valuation, nor sales tax revenue), economic growth outside of a normal projection, or potential City or County property tax increases. For that reason, realistic and conservative variables were used.*

In summary, it is the recommendation of the Durham County Budget & Management Services department to enter into another five-year interlocal Agreement with the City of Durham, continuing to allocate Local Option Sales Tax proceeds using the state Per Capita method, with the further local amendment providing for a 58% (County) and 42% (City) distribution split respectively.

Attached below is a copy of the current sales tax distribution interlocal agreement between the City and County.

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Please see these articles for more detailed information about these distribution methods:
https://canons.sog.unc.edu/local-sales-and-use-tax-distributions-where-does-the-money-go/
http://www.ncacc.org/DocumentCenter/View/1175