

NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: SB 1292 (Second Edition)

SHORT TITLE: Budget Revenue Act of 2002

SPONSOR(S): Senate Finance Committee

FISCAL IMPACT					
	Yes (X)	No ()	No Estimate Available ()		
	(\$million)				
	<u>FY 2002-03</u>	<u>FY 2003-04</u>	<u>FY 2004-05</u>	<u>FY 2005-06</u>	<u>FY 2006-07</u>
General Fund					
-Local Reimbursements	333.4				
-Local Hold Harmless	(63.4)				
-Delay Sales Tax Holiday	8.4				
-Delay Child Tax Credit	19.8	34.9			
-Delay Standard Deduction	31.9	12.6			
-Conform Internal Rev. Code	(16.9)	(25.5)	(49.7)	(76.9)	(77.3)
-Drug Tax Receipt*	.9	.9	.9	.9	.9
-Estate Tax Credit	(5.5)	(1.8)			
-Accelerated Depreciation**	38.2	68.8	52.5	10.6	
-DOC Offender Supv. Fee	4.5	4.5	4.5	4.5	4.5
-Community Service Work Program Fee	1.9	2.5	2.6	2.6	2.7
-Seat Belt Court Costs	10.8	14.9	15.3	15.3	15.3
-Criminal Court Fee	7.6	10.3	10.4	10.5	10.6
-Dispute Settlement Center Fee	.4	.5	.5	.5	.5
-DOJ Expungement Fee	<u>.2</u>	<u>.3</u>	<u>.3</u>	<u>.3</u>	<u>.3</u>
TOTAL GENERAL FUND	372.2	122.9	37.3	(31.7)	(42.5)
Utilities Special Fund	11.9				
Insurance Reg. Fund	25.0				
Local Governments					
-1/2 Cent Sales Tax***	309				
-Local Reimbursements	(333.4)				
-Local Hold Harmless	63.4				
-Delay Sales Tax Holiday	4.7				
-DOR Admin. Expense****	(.3)				
-Drug Tax Deduction	(.9)	(.9)	(.9)	(.9)	(.9)
-Seat Belt Court Costs	<u>2.5</u>	<u>3.4</u>	<u>3.5</u>	<u>3.5</u>	<u>3.5</u>
TOTAL LOCAL GOVTS.	45.0	2.5	2.6	2.6	2.6

Law Enforcement Officers

Benefits Fund

-Seat Belt Court Costs 1.2 1.6 1.6 1.6 1.6

EXPENDITURES

General Fund

Department of Revenue***** .3

*Department of Revenue will deduct 70% of costs of Unauthorized Substance Tax Division from sales tax proceeds.

**The impact of the changes is revenue neutral over the long-term since the conformity deals with an acceleration of depreciation, not the total amount of the deduction over the life of the asset. Thus, there will be substantial revenue losses after FY 2006-07.

***Assumes 100 counties enact tax in August 2003

****Up to \$300,000 can be withheld from local sales tax collections for implementing half-cent local option.

POSITIONS:

PRINCIPAL DEPARTMENT(S) &

PROGRAM(S) AFFECTED: Department of Revenue, Department of Insurance, Department of Correction, Department of Justice, Utilities Commission, Local Governments.

EFFECTIVE DATE: Section 1.1 (Local Sales Tax) August 1, 2002, Section 1.3 (Distribution of New Revenues) July 1, 2002, Section 1.5 (Use Tax Distribution) taxable years beginning on or after January 1, 2002, Section 1.8 (Repeal Reimbursements) July 1, 2002, Section 2.1 (Sales Tax Holiday) January 1, 2003, Section 2.2(a) (Married Standard Deduction \$5500) effective for taxable years beginning on or after January 1, 2003, Section 2.2(b) (Married Standard Deduction \$6000) effective for taxable years beginning on or after January 1, 2004, Section 2.3(a) (Child Care Credit \$75) effective for taxable years beginning on or after January 1, 2003, Section 2.3(b) (Child Credit \$100) effective for taxable years beginning on or after January 1, 2004, Sections 3.2 and 3.3 (Accelerated Depreciation) effective for taxable years beginning on or after January 1, 2002, Section 3.4 (Estate Tax) effective on or after January 1, 2002 and applies to estates of decedents dying on or after that date, Section 4.1 (Unauthorized Substance Tax) July 1, 2002, Section 6 (Utility Regulatory Fee) July 1, 2002, and Part VII (Various Court Fees) October 1, 2002. All other sections are effective when they become law.

BILL SUMMARY:

Part I of the bill authorizes local county commissioners to levy an additional ½ cent local sales tax, effective August 1, 2002. This tax would not apply to food. It also repeals the payment of approximately \$333.4 million in reimbursements to North Carolina counties and municipalities. It holds local governments “harmless” in FY 2002-03. (Previous legislation holds local governments “harmless” from FY 2003-04 forward). It exempts the Department of Revenue from existing bid laws when making purchases to implement the new local option sales tax and authorizes the Department to deduct its excess costs from the proceeds of the new tax. Finally, it expedites the notice local governments must give the Department of Revenue before implementing the tax and makes technical corrections to the laws governing the distribution of use taxes to local governments.

Part II of the bill delays several tax breaks authorized in 2001. Section 2.1 delays the August sales tax holiday for clothing, school supplies and computers for one year, making the first sales tax holiday August 2003. Section 2.2(a) delays the increase from \$5000 to \$5500 in the standard deduction for married filing jointly from tax year 2002 to 2003. Section 2.2(b) delays the increase from \$5500 to \$6000 in the same deduction from tax year 2003 to 2004. Section 2.3(a) delays the increase in the child tax credit from \$60 to \$75 from tax year 2002 to 2003. Section 2.3(b) delays the increase in the child tax credit from \$75 to \$100 from tax year 2003 to 2004.

Part III of the bill updates state statutory references to the Internal Revenue Code from January 1, 2001 to May 1, 2002 with exceptions for accelerated depreciation and the estate tax credit. This action would conform state tax laws to federal tax changes made in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Job Creation and Worker Assistance Act of 2002.

Under current law, North Carolina conforms to the federal estate tax in effect as of January 1, 2001. Thus, our pickup tax does not automatically tie into the 2001 federal changes. The estate tax language in this bill, coupled with the Internal Revenue Code conformity update provisions, would link North Carolina to the effect of the higher federal credits on the pickup tax but not to the phase-out of the death tax credit. The practical effect of the language in the bill is to ensure that with respect to the phased up federal credit for state death taxes, estates in North Carolina do not have to pay state tax if there is no federal tax due.

In the bonus depreciation conformity section of the bill, an add-back equal to 100% of bonus depreciation is included in taxable income. The add-back is then offset by a subtraction from income starting with the 2005 tax year. This subtraction takes place in installments over a 5-year period.

Part IV allows the Department of Revenue to deduct 70% of the cost of the Unauthorized Substance Tax Division from the sales and use tax proceeds distributed to local governments.

Part V of the bill addresses the annual establishment of the insurance regulatory fee. Section 5(a) sets the insurance regulatory charge at 6.5%. The rate remains the same as in the previous year.

Part VI, Section 6(a) sets the regulatory fee rate for the Public Utilities Commission at 0.1%. This rate must be set annually and is the same as the previous year. Section 6(b) sets the regulatory fee for the electric membership corporations at a flat \$200,000. This fee has remained the same since it was first imposed in 1999.

Part VII increases the General Court of Justice Fees and two offender fees. It also extends court costs to seat belt/motorcycle helmet infractions, introduces a fee for cases resolved through community mediation, and begins charging a fee for expungement of criminal records.

ASSUMPTIONS AND METHODOLOGY:

PART I: ACCELERATE LOCAL OPTION SALES TAX

BACKGROUND

In 2001 the General Assembly approved a sales tax “swap”. Under this proposal the state levies an additional ½ cent sales tax, bringing the state rate to 4.5%, and the total rate to 6.5%. This additional ½ cent sunsets June 30, 2003. Starting July 1, 2003, county commissioners are authorized to levy an additional ½ cent at the county level, moving the local rate to 2.5% but holding the combined rate at 6.5%. Also effective July 1, 2003, the state will stop paying local governments approximately \$333.4 million in reimbursements for previous tax law changes in the areas of property taxes on inventory and intangibles, the homestead exemption, and sales taxes on food purchased with food stamps.

LOCAL OPTION SALES TAX

Part 1 collectively allows county governments to levy an additional ½ cent of local sales tax 11 months earlier than existing law. This means that in counties that choose to levy the tax, the combined state and local sales tax rate will be 7.0% (4.5% state, 2.5% local) until the state sunsets its recently enacted ½ cent in July 2003. The rate in Mecklenburg County will be 7.5% for the same time period, assuming Mecklenburg chooses to levy the tax.

Fiscal Research believes that in FY 2001-02, each penny of local sales tax will generate \$716.8 million in revenue. (This estimate does not include food). Using a growth rate of 1.2% suggests the following non-food, sales tax revenue stream for FY 2002-03:

<u>Fiscal Year</u>	<u>Revenue from 1 Cent</u>	<u>Revenue from 1/2 Cent</u>
2002-03	\$725.40	\$362.70

Once adjustments are made for the August effective date, the total estimated statewide potential revenue available to local governments from this additional ½ cent is approximately \$309 million. However, since the language is permissive and counties can decide to enact the tax at any time, no exact fiscal estimate is possible on this portion of the bill.

The Department of Revenue has indicated that it will be unable to process the August and September taxes collected under this provision in the traditional manner due to computer programming limitations. As a result, the amount of revenue each county and associated municipality receives from this tax in those two months will be distributed on the basis of their proportion of the previous fiscal year’s sales tax revenue (per capita and point of origin). In making this calculation, the Secretary of Revenue will only consider those communities that choose to levy the tax. Beginning October 1, 2002, distribution will be made as normal, with funds distributed ½ on a per capita basis and ½ on a point of origin basis.

Section 1.1(b) eliminated the public notice and hearing requirements for adopting the additional ½ cent tax when the tax is adopted without a vote of the people. No fiscal impact is expected as a result of this portion of the bill.

Section 1.7 allows local governments to begin levying the tax on the first day of any calendar month on or after August 1, 2002, and limits the amount of notice local governments must give the Department of Revenue for local sales tax changes effective between August 1, 2002, and December 31, 2002. No revenue side impact is expected as a result of this expedited process.

Sections 1.13, 1.14, 1.15(a) and 1.15(b) re-title and re-codify the existing local sales tax statutes. No fiscal impact is expected from these sections of the bill.

REPEAL OF LOCAL GOVERNMENT REIMBURSEMENTS AND MODIFICATION OF HOLD HARMLESS PAYMENTS

Sections 1.4 and 1.8, in combination, repeal the local government reimbursements and hold local governments “harmless” for at least a portion of the loss.

Since 1979, the General Assembly has made several changes to tax law that impact local governments. The state’s cities and counties have received reimbursements from the state for some of these losses, particularly as they relate to the sales and property tax bases. The state reimburses local governments for property tax losses related to the repeal of taxes on inventories and intangibles, as well as some of the losses associated with the homestead exemption. Locals also receive a reimbursement for sales taxes that are no longer paid on items purchased with food stamps.

According to the Department of Revenue’s Tax Research Division, annual reimbursements are as follows:

Reimbursement	Amount (Millions)
Food Stamps	\$6.4
Intangibles	\$128.7
Homestead	\$8.2
Retail & Wholesale Inventory	\$82.0
Manufacturers Inventory	\$108.1
TOTAL	\$333.4

Section 1.8 of the bill repeals all of these reimbursements. Because all reimbursement amounts are either fixed or frozen, no growth is included in the estimate.

Section 1.4 of the bill instructs the Secretary of Revenue to make a hold harmless payment in FY 2002-03 to those local governments whose gain from the sales tax is less than 100% of their loss from the repealed reimbursements. (Current law continues a 100% hold harmless payment in perpetuity, starting in 2003-04). The legislation offers a hold harmless payment to all communities, regardless if they levy the new tax, but only makes a payment for the gap between the estimated

sales tax revenue (as if they levied the tax) and the reimbursement. (This mirrors the existing law that does not come into effect until FY 2003-04).

Because there is no hold harmless payment in FY 2002-03 under existing law, all of the FY 2002-03 hold harmless payment is a loss to the state General Fund and a gain to local governments.

MODIFY USE TAX PAYMENTS

Section 1.5 modifies the distribution of the local portion of use taxes collected on the individual income tax form. North Carolina consumers have been liable for use tax payments on all purchases on which sales tax are not collected since 1939. The use tax is imposed at the same rate as the sales tax and is designed to capture the revenue lost through sales by retailers that do not collect North Carolina sales tax. Unlike the retail sales tax that is collected by the merchant, the consumer pays the use tax directly to the state. From a practical standpoint, the use tax generally applied to traditional out of state purchases for consumption in North Carolina, or those sales made through a catalog or mail order company. The 1999 General Assembly approved HB 1433 to simplify use tax collection by providing that the use tax will be paid on the taxpayer’s income tax return. That legislation also indicated that the state should forward one-third of the proceeds collected on this line to the state’s counties and cities in proportion to their total local sales tax payments. At that time, the combined state rate was 6%, with 2% or one-third of that amount being local sales taxes. Since that time, the combined state rate has increased to 6.5% and could go to 7.0% under the provisions of this bill. As a result, one-third is no longer the appropriate proportion to forward to local governments.

The Department of Revenue reports collecting approximately \$4.5 million in use taxes off of the individual income tax returns for calendar year 2001. The distribution formula in existing law, the standard sales tax growth rates, and an adjustment factor for a higher sales tax rate, are used to compute the following revenue stream:

	<u>FY 2001-02</u>	<u>FY 2002-03</u>	<u>FY 2003-04</u>	<u>FY 2004-05</u>	<u>FY 2005-06</u>	<u>FY 2006-07</u>
State	\$3,000,000	\$3,187,800	\$3,176,802	\$3,510,684	\$3,672,175	\$3,841,096
Local	\$1,500,000	\$1,593,900	\$1,588,401		\$1,836,088	\$1,920,548
TOTAL	\$4,500,000	\$4,781,700	\$4,765,203	\$5,266,026	\$5,508,263	\$5,761,643

The bill requires that the proportion of the tax paid to local units reflect what proportion of the general rate is actually local tax. Therefore, under the current rate structure, local units should receive 30.8% of the revenue (2.0% is 30.8% of a 6.5% tax). If the new rate in this bill is used, locals should receive 35.7% of the funds (2.5% is 35.7% of a 7.0% rate). When the state’s extra ½ cent is repealed in July 2003 the locals should begin receiving 38.5% of the revenue (2.5% is 38.5% of a 6.5% rate). Using these ratios suggests the following new revenue streams:

	<u>FY 2001-02</u>	<u>FY 2002-03</u>	<u>FY 2003-04</u>	<u>FY 2004-05</u>	<u>FY 2005-06</u>	<u>FY 2006-07</u>
State	\$3,000,000	\$3,191,785	\$2,997,313	\$3,238,606	\$3,387,582	\$3,543,411
Local	\$1,500,000	\$1,589,915	\$1,767,890	\$2,027,420	\$2,120,681	\$2,218,233
TOTAL	\$4,500,000	\$4,781,700	\$4,765,203	\$5,266,026	\$5,508,263	\$5,761,643

Note: Because individual income tax returns reflect purchases made during a calendar year, and all sales tax rate changes become effective in July, the average of the two fiscal year's proportions are used to determine the division of state and local revenue.

The projected potential revenue changes as a result of this bill are as follows:

	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07
State	\$3,985	(\$179,489)	(\$272,078)	(\$284,594)	(\$297,685)
Local	(\$3,985)	\$179,489	\$272,078	\$284,594	\$297,685

However, because the provision that allows this item to remain on the individual income tax return expires with tax year 2002, the only impact seen as the result of this bill is the first fiscal year.

CHANGE LOCAL BUDGET ORDINANCES

Section 1.6 allows local governments to amend their budget ordinances to reduce their property tax levy to reflect any additional and unanticipated revenues. Because this only applies to local units, no state General Fund impact is expected. Further, since the language is permissive and only gives local governments a new method to respond to the unclear status of revenues from the state or a local sales tax increase, no local estimate is possible on this portion of the bill.

PART II: DELAY 2001 TAX BREAKS

SALES TAX HOLIDAY

In 2001 the General Assembly created the state's first temporary, three-day sales tax exemption for clothing, clothing accessories, school supplies, computers, printers, and educational software. The exemption does not apply to clothing and footwear items that exceed \$100. The temporary exemption or "holiday" occurs each year over the first weekend in August. Section 2.1 of the bill delays the sales tax holiday from August 2002 to August 2003. The sales tax holiday would be an annual event from that year forward.

Using a model created by Arthur Andersen Consulting for use by the National Retail Federation, the Fiscal Research Division estimated that a three-day sales tax exemption that applies to clothing, accessories, and footwear with a \$100 per item cap, would result in a state revenue loss of \$6.53 million in FY 2002-03. Because the model does not include computers, Fiscal Research used data from Pennsylvania's computer sales tax holiday to develop a FY 2002-03 state cost estimate of \$1.87 million. This indicates a total FY 2002-03 state loss associated with the holiday of \$8.4 million. Since the bill effectively eliminates the August 2002 holiday, this portion of the bill creates an \$8.4 million General Fund gain for FY 2002-03.

Using the same methodology noted above, Fiscal Research estimated that the 2002 sales tax holiday would cost local governments \$3.74 million. However, that estimate assumed the local tax rate would be 2%. Because other parts of this bill authorize local governments to increase their rate to 2.5% before the sales tax holiday, the local revenue loss could have been 25% more or \$4.68 million. As a result of the delay, this amount is now shown as a gain for local units.

STANDARD DEDUCTION – MARRIAGE TAX PENALTY

The term “marriage penalty” refers to the income tax situation where married individuals filing jointly pay more in tax than if the two individuals were unmarried filing as single persons. For example, the North Carolina standard deduction for single filers is \$3,000, but for married filing jointly the standard deduction is \$5,000. The personal exemption also favors single filers. For single filers, the personal exemption is \$2,500 until you get to a maximum Adjusted Gross Income (AGI) of \$60,000 where it drops to \$2,000. For married filing jointly, the personal exemption is \$2,500 up to \$100,000 AGI, then drops to \$2,000. State tax brackets also favor single filers as shown below:

Single	0 to \$12,750	\$12,751 to \$60,000	\$60,000>
Married filing jointly	0 to \$21,250	\$21,251 to \$100,000	\$100,000>

The 2001 General Assembly reduced the marriage penalty by increasing the standard deduction for married filing jointly taxpayers from \$5,000 to \$6,000. The standard deduction was increased to \$5,500 in tax year 2002 and then to \$6,000 in tax year 2003. The FY 2001-02 reduction in General Fund revenue was projected to be \$9.7 million due to estimated payments and withholding by 762,340 couples in the first half of tax year 2002. The estimated loss for the following fiscal years is shown below.

FY 2001-02	-\$9.7 mil.
FY 2002-03	-\$32.0 mil.
FY 2003-04	-\$45.0 mil.
FY 2004-05	-\$45.8 mil.
FY 2005-06	-\$46.5 mil.

Section 2.2(a) delays the first \$500 increase in the standard deduction to tax year 2003 and Section 2.2(b) delays the additional \$500 standard deduction increase to 2004. Since the original fiscal estimate assumed income tax withholding in tax year 2002 (second half of FY 01-02 and first half of FY 02-03), a delay in the standard deduction increase will result in a General Fund revenue gain from increased tax liability on 2002 tax returns. However, not all of the \$41.7 million shown in the first two years of the chart will be regained by the General Fund next fiscal year. The 2003 effective date for the standard deduction increase means married filing jointly taxpayers can change their income tax withholding in the first half of 2003 and reduce their tax payments by \$9.8 million. The net gain from this delay from 2002 to 2003 is \$31.9 million (\$41.7 million minus \$9.8 million). For the \$6000 standard deduction delayed until 2004, the estimated revenue loss is \$32.4 million in FY 2003-04. Since the original estimate for FY 2003-04 was \$45 million, the General Fund will gain \$12.6 million that year.

Note: All revenue estimates for the standard deductions were calculated using the North Carolina Individual Income Tax Model. This tax model was created by the Barents Group for the Department of Revenue and the General Assembly for use in estimating tax law changes. The model bases future year estimates on data from 1998 North Carolina individual income tax returns.

INCREASE TAX CREDIT FOR CHILDREN

The current \$60 child tax credit was approved by the 1995 General Assembly. The 2001 General Assembly increased the child credit from \$60 to \$75 per child in tax year 2002 and from \$75 to \$100 in tax year 2003. The first increase will reduce General Fund revenue \$19.8 million in FY 2002-03 for taxpayers filing returns in the spring of 2003. The second year increase will boost the revenue loss to \$54.8 million in FY 2003-04. This tax change will benefit 18,354 single tax filers, 496,286 married couples, and 411,648 heads of households in tax year 2002. This revenue estimate was calculated using the North Carolina Individual Income Tax Model.

Section 2.3(a) delays the first \$15 increase in the tax credit from 2002 to 2003 and Section 2.3(b) delays the second \$25 increase from 2003 to 2004. The delay will eliminate the \$19.8 million General Fund loss for FY 2002-03 and result in a General Fund revenue gain of an equal amount. There is a revenue gain of \$34.9 million in FY 2003-04 because the \$75 credit in 2003 has a \$19.9 million revenue loss versus the \$54.8 million loss for the now scheduled \$100 credit.

PART III: UPDATE IRC REFERENCE

CONFORMITY

Section 3.1 changes the state tax law reference to the Internal Revenue Code from January 1, 2001 to May 1, 2002. Since North Carolina individual and corporate income tax law tracks the federal income tax law, it is necessary each year to update state statutory references to the Internal Revenue Code (IRC). Congress enacted two major bills in calendar years 2001 and 2002 that have a negative revenue impact on the state General Fund.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) included numerous provisions that impact North Carolina individual and corporate income tax. This bill conforms the state to the education provisions in the bill that affect education IRAs, Qualified Tuition Plans, deduction for higher education expenses, interest from student loans, and employer provided assistance. The bill conforms to the pension provisions in the act that affect IRA contribution limits, deferred comp plan deferral limits, and plan portability. The bill accepts changes in the phase out of itemized deductions and personal exemptions beginning in 2006. However, the bill does not conform to the estate tax changes in the act (see page 12 of note).

The state will conform to the Job Creation and Worker Assistance Act of 2002 except for the accelerated depreciation rules. Included in the bill were changes to net operating losses, the extension of expiring tax provisions, and a new above the line \$250 deduction for teachers' classroom expenses.

The estimate of the state's revenue gain or loss from the federal changes is based on the fiscal analysis of the Congressional Joint Committee on Taxation. The federal analysis includes the effects of certain behavioral responses to tax proposals, including shifts between nontaxable and taxable sources of income, changes in amounts of charitable giving, and changes in the timing of realization of some sources of income. To derive an estimate for North Carolina for individual income tax changes, the federal income tax receipts for the U.S. were compared to the North Carolina General Fund income tax receipts for the July 2000 to July 1 2001 period (with adjustments for earmarks and refunds). The resulting percentage was .735%. For corporate income tax, a .59% rate was derived using the 1997 US Economic Census on Manufacturing.

The state revenue impact from conforming to the two federal bills is as follows:

Conformity Category	(\$million)				
	<u>02-03</u>	<u>03-04</u>	<u>04-05</u>	<u>05-06</u>	<u>06-07</u>
Economic Growth and Tax Relief Reconciliation Act of 2001					
Education	-14.6	-20.5	-25.3	-27.8	-15.8
Pensions, IRA's	-6.1	-14.3	-18.5	-24.7	-29.4
Other					-12.8
Job Creation and Worker Assistance Act of 2002					
Net operating losses	-4.7	-3.9	2.5	1.7	1.1
Other	8.5	13.2	-8.4	-26.1	-20.3
	-16.9	-25.5	-49.7	-76.9	-77.3

ACCELERATED DEPRECIATION

The first step in the analysis of sections 3.2 and 3.3 was a simulation of the impact of the 30% bonus depreciation and the add-back on individual projects. A project size of \$10 million was selected, although the analysis is the same regardless of the magnitude of the investment. Bonus depreciation is eligible for projects with a class life of up to 20 years. Thus, the following classes of asset lives would be impacted.

<u>Class (Years)</u>	<u>Class Life Range (Years)</u>
3	Less than 4
5	4-9
7	10-15
10	16-19
15	20-24
20	25 or more

The analysis assumed the use of the modified accelerated cost recovery system (MACRS). This system includes depreciation schedules based on double-declining balance depreciation rates for 3, 5, and 7-year property. For other classes, straight-line depreciation must be used. In addition, the analysis used the "mid-year convention" for the assumed investments.

The simulation looked at investments for all class lives. Each calculation compared the current law depreciation with that under the 30% bonus. Under the 30% bonus schedule, the "regular depreciation" declines since it is calculated against the depreciation base after the application of bonus depreciation. Thus, the decline in normal depreciation offsets the first-year increase in total depreciation due to the bonus amount so that over the life of the asset there is no net change in the depreciation taken.

In addition, the impact of the 100% add-back, and the add-back subtraction beginning in 2005 is calculated. The first-year net impact of bonus depreciation varies by asset class, with the largest short-term tax savings going to the assets with the longest lives. **The net impact of both the bonus depreciation and add-back are zeroed out over the long term.**

To determine the impact on state revenues, a mathematical relationship was established between the net impact of "bonus depreciation with add-back" and "bonus depreciation only". This ratio was then compared to the "bonus depreciation only" fiscal impact of numerous states as reported in the National Conference of State Legislatures (NCSL) survey. These estimates were then adjusted to North Carolina based on corporate tax receipts in each state. In addition, the recent report of the Center for Budget and Policy Priorities (CBPP) contained estimates for particular states. The estimate used in this analysis relies heavily on the CBPP report.

In addition to the steps listed above, Fiscal Research also reviewed the fiscal impact statements in the three states that have adopted add-backs. The states are Nebraska (85% add back), Ohio (83.33%), and Minnesota (80%). This review, coupled with phone conversations with tax analysts in all three states, indicated that the add-backs used make the bonus depreciation approximately revenue-neutral for FY 2002-03. For future years, the net impact depends on the "add-back subtraction" schedule adopted.

The discussions with other states confirmed the difficulty of developing a precise fiscal estimate. The biggest problem is that after simulating the case-by-case impact of the proposal on investments on different class lives, there is no way to know how to weigh the different simulations. The reason is that capital investment data compiled by the U.S. Department of Commerce does not provide a breakdown by asset life.

A particular problem encountered was the 2001 tax year. The federal change was effective for investments after September 10 of the year. Under current Department of Revenue instructions, calendar year taxpayers were able to use bonus depreciation for the 2001 tax year if they were able to modify their return in the few days between the federal enactment and the March 15 filing date. Other affected taxpayers will be eligible for a refund, but only after action by the General Assembly. These different possibilities make it difficult to determine how much of the 2001 tax year impact will occur in FY 2001-02 versus FY 2002-03.

In this analysis, Fiscal Research focused primarily on the 7-year asset class simulation and the estimates of other states, especially the Nebraska analysis. These calculations indicate that the 85% add-back essentially offsets the impact of bonus depreciation for FY 2002-03.

For future years, there could be a short-term revenue gain of \$32 million to \$36 million for FY 2003-04 and FY 2004-05. Starting in FY 2005-06, there would be a revenue loss that would offset the FY 2003-04 and FY 2004-05 gains. As stated earlier, the bonus depreciation add-back provisions are essentially revenue-neutral over the long term. Thus, any short-term gains or losses in some years will be fully offset in other years.

The cash-flow estimates are conservative in terms of the weighting of asset classes in the calculations.

ESTATE PICK UP TAX

The regular inheritance tax was repealed in North Carolina by the 1998 General Assembly, effective for deaths occurring on or after January 1, 1999. Following the tradition of the other 36 states that have repealed their primary death tax, a “pickup” tax continues to be levied in North Carolina to use up the credit allowed on the federal estate tax return for state death taxes. In the absence of such a levy, the federal tax liability of the estate would be increased and potential state dollars would flow to the U.S. treasury.

In 2001 the congressional tax package made two changes that will have an effect on a small number of large estates as well as pickup tax collections in many states. First, the federal tax was phased out over a number of years until it is completely eliminated in 2010. This was accomplished primarily through higher federal credits. In the first few years the higher credits reflect an acceleration of the credit phase-up under the 1997 federal tax relief bill. In addition, the 2001 bill phases out the state death tax credit over 4 years, beginning with deaths occurring on or after January 1, 2002.

The starting point for the analysis of Section 3.4 was the pickup tax revenue estimates included in the official revenue forecast used in amending the FY 2002-03 General Fund budget. The FY 2002-03 forecast of \$117.3 million of pickup taxes was grown by 4% per year to determine receipts for future years (until the tax is effectively eliminated due to the repeal of the federal credit for state death taxes). Fiscal Research then reviewed the projected cost for each year of full conformity to the 2001 federal changes contained in the Center For Budget and Policy Priorities (CBPP) report. In addition, Fiscal Research looked at state by state estimates contained in the NSCL survey and adjusted these numbers to North Carolina by using state-specific federal estate tax return data for 1995-99 (reported gross estate numbers). The estimates finally adopted for purposes of this fiscal note were slightly higher than the CBPP numbers and near the top of the range of the estimates of other states.

This “full conformity” estimate was then modified to determine the “higher federal credits” conformity (“partial conformity”) cost by comparing the CBPP estimates for full conformity and partial conformity for the 2002-03 fiscal year (18%). This led to an annualized FY 2002-03 projection of \$7.27 million.

PART IV: UNAUTHORIZED SUBSTANCE TAX EXPENSES

Part IV will reduce the General Fund share of the administrative costs of the Unauthorized Substance Tax Division of the Department of Revenue, which administers the excise tax on unauthorized substances. Seventy-five percent (75%) of the tax proceeds are distributed to the law enforcement agencies that conducted the investigations that led to the assessments, and twenty-five

percent (25%) of the tax proceeds are credited to the General Fund. In some years, the amount credited to the General Fund has not covered the costs of the Unauthorized Substance Tax Division.

Local law enforcement agencies receive most of the proceeds from the 75% that is distributed to law enforcement agencies. Therefore, the Department proposes that local entities bear their proportionate share of the costs of the Unauthorized Substance Tax Division. To accomplish this, the Division would become partially receipt-supported. Seventy percent (70%) of the costs would be taken from local sales and use tax revenue, as this percentage of the Department's cost is considered to be for the benefit of the local entities. This change in cost assignment requires an amendment to G.S. 105-501. This proposal does not change the amounts that are distributed to local law enforcement agencies. It simply recognizes that the Unauthorized Substance Tax Division primarily benefits local entities and that local entities should therefore bear their share of the expense.

The amount of the costs to be taken from the local sales and use tax is 70% of the costs of the Division rather than 75% because a small part of the amount that is distributed to law enforcement agencies is distributed to State law enforcement agencies. By the Department's records, the amount distributed to State law enforcement agencies is less than 5%. Using 70% instead of 75% therefore ensures that the costs borne by local entities are proportionate to the benefits they receive.

With the Division becoming 70% receipt-supported, there is a reduction in General Fund expenditures of \$886,683, which will be allocated to personnel and operating expenses (\$781,683) and IT services (\$105,000), and 14 of the 20 positions in the Division transferred to receipt-support. The remaining 30% of the Division's expenditures will continue to be funded as a General Fund appropriation.

PART V: INSURANCE REGULATORY CHARGE

Part V of the bill sets the insurance regulatory charge at 6.5%. This is the same amount set in the previous year. This fee is assessed against the 1.9% premiums tax paid by insurers or against the presumed premiums tax that would be paid by HMOs and Article 65 companies (Blue Cross/Blue Shield) if taxed at 1.9%. The revenue is used to reimburse the General Fund for appropriations to the Department to pay expenses incurred in regulating the industry and other industries and to other departments as specified in G.S. 58-6-25(d).

The premiums tax collections for fiscal year FY 2002-2003 are estimated to be \$315.79 million. The HMOs and the Article 65 companies must pay a regulatory charge based on their presumed premiums tax at 1.9% (they pay .833% in 2002 and 1% in 2003). The presumed premium tax for the HMOs and Article 65 companies is estimated to be \$68.83 million.

With the premiums tax collections of \$315.79 million and the presumed premiums tax of \$68.83 million from the HMOs and Article 65 companies, the total base against which the insurance regulatory charge will be assessed is estimated to be \$384.62 million. Applying the 6.5% regulatory fee to the \$384.62 million base would generate \$25 million in regulatory fee revenue.

The certified budget for the Department, based on actions taken during the 2001 Session, is \$23.5 million. In addition to reimbursing the General Fund for appropriations to the Department, the Insurance Regulatory Fund will also reimburse the General Fund for the \$486,000 appropriated to support the Managed Care Patient Assistance Program (MCPAP), established by S.L. 2001-446. The total reimbursement to the General Fund is estimated to be \$24 million. The Department estimates that the reserve will have a balance of \$11.98 million at the beginning of FY 2002-2003. The total available from the reserve fund of \$11.98 million and the estimated collections of \$25 million will be \$36.98 million. The total available less the estimated General Fund reimbursement of \$24 million will leave a year-end reserve balance of \$12.98 million. This reserve is above one-third of the estimated General Fund reimbursement.

The above calculation is based on the certified budget for FY 2002-2003 and does not include any adjustments to the FY 2002-2003 Budget that are or will be under consideration during the 2002 Session. Based on the above, the regulatory surcharge rate of 6.5% is sufficient to defray the estimated cost of the operations of the Department and provide for a reserve fund. The Department recommends that the rate remain the same and would not recommend a decrease in the rate because of the unknowns in the economy.

PART VI: UTILITIES COMMISSION

Part VI of the bill sets the fees for regulation by the North Carolina Utilities Commission (“Commission”). Section 6(a) of the bill sets the rate at 0.1%, the same as the current rate. Revenue from this fee, which is assessed against regulated public utilities, is used to support the operations of both the Commission and the Public Staff. Based on estimated FY 2002-03 jurisdictional revenues of \$10,854,768,332, the regulatory fee will produce \$11,700,238. For the same period, the Commission estimates that the combined operations of the Commission and Public Staff will require total expenditures of not less than \$11,695,970. The net change in the Commission’s Accumulated Fee Margin Reserve Account is therefore approximately \$4,268. The estimated balance in this account as of June 30, 2003, is \$4,941,393. This represents approximately five months of operating reserve.

Section 6(b) of the bill sets the public utility regulatory fee to be paid by The North Carolina Electric Membership Corporation for the 2002-03 fiscal year at \$200,000. In 1999 the initial fee of \$200,000 was developed as a result of discussions between the industry and the Utilities Commission, based on what the Utilities Commission believed to be the cost associated with regulating the electric membership cooperatives. In 2001 the Utilities Commission provided information to Fiscal Research illustrating that these fees will support approximately 4000 hours of accounting, engineering, and legal time. This fee amount must be set by the General Assembly each year.

PART VII: OTHER FEES

COMMUNITY SERVICE WORK PROGRAM FEES

The community service work program fee is increased from \$100 to \$150 in Section 7.1. Offenders sentenced to community service, either as part of supervised probation, parole, unsupervised probation, a DWI offense, or first offender/deferred prosecution, pay a one-time \$100 fee. The fee is paid within two weeks of judgment, generally prior to beginning community service. Fees are

collected by Clerks of Court and remitted to the State Treasurer/General Fund. This fee was last increased in 1986. Current collections and admissions are detailed below.

Year	1999-2000	2000-2001	2001-02 ytd	2001-02 proj
Fees collected	\$5,103,549	\$5,147,750	\$3,964,885	\$5,286,500
Admissions	69,300	73,010	56,050	74,733
Collection rate	73.6%	70.5%	70.7%	70.7%

Ytd is through March 31

These statistics show a growth rate of almost 4% per year in admissions and of 1.8%/year in fees. Future year projections assume continued growth in fees due of 1.8% but a decrease in collection rate from 71% to 69% due to the higher fee. The chart below shows new revenue realized at \$150 fee, effective October 1, 2002.

Year	2002-03	2003-04	2004-05	2005-06	2006-07
Total	\$7.88 Mil.	\$8.02 Mil.	\$8.16 Mil.	\$8.31 Mil.	\$8.46 Mil.
Increase Rev	\$ 1.87 Mil.	\$2.54 Mil.	\$2.59 Mil.	\$2.63 Mil.	\$2.68 Mil.

OFFENDER SUPERVISION FEES

The new offender supervision fee in Section 7.2 of this bill is \$30. Offenders on probation, parole and post release supervision currently pay \$20/month during their term of supervision. At least half the states collect similar fees, ranging from \$15/month to \$103/month. In a recent survey by the American Probation and Parole Association, of the 19 states that reported specific fee amounts, 11 were \$30 or more.

The current population on probation/parole is 116,856 and is projected to remain stable. Currently, 58% of probationers are ordered to pay the fee and 62% of those pay it for an overall collection rate of 37%. About 75% of those who pay are on community punishment rather than intermediate punishment. Fees are paid to the Clerk of Court then remitted to the General Fund.

The Department of Correction (DOC) is reviewing policies and is in discussion with the Judicial Branch to encourage higher collection rates. Collection rates were projected to increase to 45% in FY 2003-04 if the fee remained at \$20. With the \$30 fee, collection rates are assumed to plateau at 40% in FY 2002-03. That reduces the net gain from the fee increase in the years FY 2003-04 and later.

Current Collections

Year	1999-2000	2000-2001	2001-02 ytd	2001-02 proj
Fees collected	\$10,603,000	\$10,499,000	\$8,103,504	\$10,804,672

Projected Collections, assume Oct 1 effective date and 40% collection rate

Year	2002-03	2003-04	2004-05	2005-06	2006-07
Total	\$12 Mil.	\$17.99 Mil.	\$17.99 Mil.	\$17.99 Mil.	\$17.99 Mil.
New Revenue	\$4.5 Mil.	\$4.5 Mil.	\$4.5 Mil.	\$4.5 Mil.	\$4.5 Mil.

DISPUTE SETTLEMENT CENTER FEE

Section 7.3 of the bill imposes \$75 in General Court of Justice fees to parties who successfully resolve criminal issues through dispute settlement centers. In these cases, charges have initially been filed in criminal court but with the cooperation of the prosecutor are resolved by community mediation/dispute settlement centers. Once an agreement or memorandum of understanding is reached, the prosecutor dismisses the original charges. In these cases, no court costs are levied although court resources have been used. This bill would require a fee equal to the General Court of Justice Fee, to be collected by the Clerk of Courts but remitted to the General Fund.

The Mediation Network of North Carolina reports receiving 12,969 referrals from court officials for criminal matters in FY 2000-01. They also report a 71% success rate in resolving these referrals. That suggests 9,260 cases subject to this new fee. At a \$75 fee, the annual receipts would be \$694,500. However, we assume collection will be less than 100%. Assuming 75% collection, the fee will raise \$520,867 per year. With an October 1 effective date, first year proceeds are \$390,650. No growth is assumed in these proceeds.

COLLECTING COURT COSTS ON SEAT BELT/MOTORCYCLE INFRACTIONS

Section 7.4 will end the exemption from court costs for violators of the mandatory seat belt (driver and passenger) and motorcycle/moped helmet laws. Violators of these infractions do not currently pay court costs, but they do pay a \$25 fine that is redistributed to the county school fund. In calendar year 2001, there were 184,525 convictions/admissions of responsibility with payment of fines for the seat belt violations. (The number of motorcycle violations is small and not included in revenue projections.)

Offenders would pay the \$25 fine plus the following:

- \$75 Court of Justice Fee (assuming \$10 increase in this bill)
- \$12 Facilities Fee
- \$8 LEOB (Law Enforcement Officer Benefits Fund)
- \$5 Service Fee

The service fee and facilities fees are remitted to the counties and municipalities.

Collections for seat belt violations have increased an average of 6% over the past four years. These projections assume a more conservative growth rate of 3% for the first two years and no growth in future years. This no growth assumption is based on the expectation of some deterrent effect and because of the difficulties of projecting in the future.

Projected impacts are as follows, assuming effective October 1, 2002:

Year	2002-03	2003-04	2004-05	2005-06	2006-07
General Fund	\$10,851,281	\$14,902,426	\$15,349,499	\$15,349,499	\$15,349,499
County-facilities & service	\$2,459,624	\$3,377,883	\$3,479,220	\$3,479,220	\$3,479,220
LEOB	\$1,157,470	\$1,589,592	\$1,637,280	\$1,637,280	\$1,637,280

GENERAL COURT OF JUSTICE FEES

Section 7.5 increases the General Court of Justice Fees by \$10 for District and Superior Court Criminal only. General Court of Justice fees were last raised in 2000, by \$4. General Court of Justice Fees are currently as follows:

District Court Criminal	\$65
District Court Civil	\$44
Superior Court Criminal	\$72
Superior Court Civil	\$59
Magistrate-Civil	\$33
Special Proceedings	\$30
Estates	\$30

Parties also pay facilities and service fees that are remitted to the county, varying from \$17 to \$35 depending on the specific level of court. An LEOB charge of \$8 applies to criminal cases only.

Each \$1 of General Court of Justice Fees raises approximately \$1,547,085, based on FY 2000-01 collections. Limiting the increase to criminal cases raises \$1,016,984, almost entirely from District Court. Court fees have grown modestly in recent years and these projections assume a 1% growth rate each year.

The projected impact is as follows, assuming an October 1, 2002 effective date.

2002-03	2003-04	2004-05	2005-06	2006-07
\$7,627,380	\$10,271,538	\$10,374,254	\$10,477,996	\$10,582,776

EXPUNGEMENT FEE

Section 7.6 authorizes the Department of Justice (DOJ) to charge \$65 to process an expungement request beginning October 1, 2002. NCGS 15A-145 and 15A-146 state that “the cost of expunging such records shall be taxed against the petitioner”, but to date, no petitioners have ever been charged for this service. This new fee will cover the Department’s cost of researching, documenting, and eliminating criminal records targeted for expungement. According to DOJ data, in calendar year 2001, the State Bureau of Investigation received 5,897 applications for expungement. Of that total, 4,734 qualified for an expungement and were processed. About 15 percent of expungement applications are not generated by the petitioner or required by the court as a result of NCGS 15A-145 and 15A-146 and may result from judgment or court orders involving the indigent or the wrongfully accused. For these requests, no charges would be assessed for the cost of processing their expungement.

	FY02-03	FY03-04	FY04-05	FY05-06	FY06-07
# Applications Submitted	5,900	5,900	5,900	5,900	5,900
# Applications Exempt from Fee	900	900	900	900	900
Collection Rate	80%	80%	80%	80%	80%
Estimated Total Receipts	\$195,000	\$261,000	\$261,000	\$261,000	\$261,000

EXPENDITURES:

ACCELERATED LOCAL OPTION SALES TAX

Section 1.10 allows the Department of Revenue to take the cost of implementing the new local option sales tax from the proceeds of that tax. This effectively charges local governments with the cost of collecting the tax. This provision applies only to FY 2002-03. In future years the cost of administering the tax will also be drawn from the proceeds, but will be governed by a different statute. In addition, during FY 2002-03, the Department may only charge the local units if the cost exceeds the funds available in its FY 2002-03 budget. Section 1.11 allows the Department of Revenue to contract for supplies, materials, equipment and services related to the provision of notice and development of computer software needed to implement the new tax without being subject to traditional state bid requirements.

The Department of Revenue estimates that implementing the new sales tax will cost approximately \$200,000 for programming and \$75,000 for each notice to retailers. They indicate that a notice would have to be generated each month that additional counties enact the tax. Because the number of months is not known, Fiscal Research cannot appropriately estimate the cost of implementing the tax.

SOURCES OF DATA: Part I: Department of Revenue Tax Research Division. Part II: (1) National Retail Federation (2) Individual Income Tax Model. Part III: (1) The May, 2002 state-by-state survey of the National Conference of State Legislatures (**Recent Federal Tax Legislation and the States**); (2) A January, 2002 analysis of the Center On Budget and Policy Priorities on state options to conform to the 2001 federal estate tax changes; (3) Bonus depreciation fiscal estimate material from Ohio, Minnesota, and Nebraska; (4) Congressional Joint Committee on Taxation

TECHNICAL CONSIDERATIONS: The January 1, 2002, effective date of the federal changes in Part III means that only three quarters of the 2002-03 fiscal year will be affected by the change since estates have up to nine months after death to file a return. In addition, the January 1, 2003, repeal of the changes means that one quarter of FY 2003-04 revenues will be affected. In effect, this means that 75% of the annualized FY 2002-03 cost occurs in FY 2002-03 and the remaining 25% in FY 2003-04.

FISCAL RESEARCH DIVISION: (919) 733-4910

PREPARED BY: Richard Bostic, Marilyn Chism, David Crofts, Adam Levinson, Linda Millsaps, Michele Nelson, Denise Thomas, and Elisa Wolper

APPROVED BY: James D. Johnson

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