GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

Legislative Fiscal Note

BILL NUMBER: Senate Bill 172 (First Edition)

SHORT TITLE: Corporate Income Tax Exemption.

SPONSOR(S): Senator Smith

FISCAL IMPACT ($Mil.)

Yes (x) **No ( )** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:					
State General Fund	**-33.4**	**-23.1**	**-23.2**	**-23.3**	**-23.4**
EXPENDITURES:					
POSITIONS (cumulative):					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: The corporate income tax is administered by the Department of Revenue. The enactment of the bill is not expected to affect the department's budget requirements.

EFFECTIVE DATE: Tax years beginning on or after January 1, 2005.

BILL SUMMARY: Allows a corporation to exempt a specified amount of taxable income (income after deductions) from the corporate income tax as follows:

Taxable Income	Exemption Amount
$100,000 or Less	$25,000
$100,000 – $200,000	$12,500
Over $200,000	$0

In addition, the formula earmarking 7.25% of net corporate income tax revenue for school facilities is raised to 7.41% to hold-harmless the dollar amount of school facilities earmarking.

ASSUMPTIONS AND METHODOLOGY: The starting point for the analysis is a tabulation of 2001 tax year corporate income tax returns by the Department of Revenue. The tabulation was based on a grouping of tax returns by taxable income amount. For each statistical reporting bracket, data on the number of returns, taxable income, and tax liability was shown. This data allowed for the determination of "average taxable income" and "average tax liability" for each bracket.

The next step was to grow the 2001 data to 2005. This process is complicated because during a period of economic recovery, the growth rates for the number of returns and the average taxable income per return differ by statistical reporting bracket. For example, the typical experience is for the number of smaller returns to decline slightly while the largest reporting bracket ($1 million and over) rises exponentially. The average taxable income per bracket is relatively stable over time for smaller and medium-sized taxpayers but the amount for the highest brackets will increase at a very high rate.

The forecast of number of returns and average return size was accomplished by a review of the experience of three other states (California, Utah, Virginia) for the mid-1990's period in addition to the 1990-94 North Carolina data. The other states were selected because of the availability of distribution data and the absence of major tax changes. The mid-1990's data was used because of the feeling that overall economic conditions during 2001-05 would be similar to the earlier period.

In addition, a projection of overall corporate income tax liability for 2005 was developed using the national forecasts of pre-tax corporate profits by Economy.com. The national outlook firms indicated that corporate profits should expand by 47% from 2001 to 2005.

The original projection of the number of returns and average liabilities was then fine tuned to reconcile to the total target tax base using the distribution analysis from the other states and the 1990-94 North Carolina data on the growth by size of return. This adjustment took place largely in the upper statistical reporting brackets because of the sensitivity of these taxpayers to economic conditions. The adjustment had little impact on the estimate of the impact of this bill because, under the bill, the relief applies exclusively to corporations with the smallest taxable incomes.

The result of the analysis is that the projected 2005 statistical reporting bracket data can be used as a tax calculator to determine the impact of a policy change. In effect, the average situation in each statistical bracket is treated as one taxpayer and the results of any tax calculation are then weighted by the number of taxpayers in the reporting bracket.

The projected 2005 data by size of income indicates that the exemption will completely eliminate the tax on 15,025 returns, or 53.3% of the total of 28,165 taxable returns. Another 9,328 returns (33.1%) will receive partial relief.

The calculation of the impact on the State General Fund includes the additional cost of 2.1% of the gross amount of the relief in order to hold harmless the dollar amount of the school facilities finance fund.

The estimated annual 2005 tax year impact was grown to future year amounts based on the mid-1990's growth pattern determined by looking at the tax collection data for other states for tax returns with less than $200,000 of net taxable income. This growth rate is fairly small because the number of returns for this size class does not change much from year to year and the average net taxable income for each statistical reporting bracket is fairly constant from year to year at an amount near the middle of the range. The reason for stability in the number of returns has to do with the fact that as many smaller taxpayers move to a large bracket over time up in size over time they are replace by start-up companies.

Finally, the tax year costs were then split into fiscal years using the assumption that 45% of the cost of a credit would occur during the January-June period and the remainder during the second half of the tax year. These assumptions reflect the fact that taxpayers can avoid an underpayment penalty for estimated taxes by sending in at least 90% of the annual liability during the tax year. Thus, one half of the 90% would come in with the April and June estimated payments.

For the 2005-06 fiscal year, the cost is substantially higher than the annualized cost due to the January 1, 2005 effective date of the bill. This date means that during the 2005-06 state fiscal year, taxpayers will receive 100% of the 2005 tax year credits plus 45% of the 2006 tax year credits.

SOURCES OF DATA:

TECHNICAL CONSIDERATIONS: None

FISCAL RESEARCH DIVISION: (919) 733-4910

PREPARED BY: David Crotts

APPROVED BY: James D. Johnson, Director
Fiscal Research Division

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