GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

Legislative Fiscal Note

BILL NUMBER: House Bill 1892 (First Edition)

SHORT TITLE: IRC Update.

SPONSOR(S): Representatives Wainwright, Luebke, Carney, and Wilkins

FISCAL IMPACT (millions)

	Yes (x)	No ( )	No Estimate Available ( )		
	FY 2005-06	**FY 2006-07**	**FY 2007-08**	**FY 2008-09**	**FY 2009-10**
REVENUES:	**(5.1)**	**(5.1)**	**(5.0)**	**(5.0)**	**(5.0)**
EXPENDITURES:					
POSITIONS (cumulative):					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: Sections 1, 2, and 10 are effective when law. Sections 3, 4, 5, and 6 become effective July 1, 2006 and apply to federal determinations made on or after that date. Sections 7, 8, and 9 are effective for taxable years beginning on or after January 1, 2006.

BILL SUMMARY: Generally North Carolina tracks federal law as it relates to income tax provisions. However, because of constitutional limitations, the General Assembly must proactively decide each year to update its reference to the Internal Revenue Code (IRC). Updating the reference date for the code allows the state to track recent changes in federal tax law. The legislation changes the reference date in North Carolina statutes from January 1, 2005 to January 1, 2006, effectively including several recent federal tax law changes.

The bill also makes several other changes to the State's tax law. First, it shortens the amount of time a taxpayer has to file an amended State return to reflect changes or corrections in their federal return. Currently taxpayers have two years after the change to file an amended return. The legislation shortens this period to six months. This provision applies to all state taxes which are based on federal returns including estate, income, and gift taxes. The legislation also conforms state nonresident alien return due dates to similar federal dates. Finally, the legislation conforms the state amounts associated with the child care credit and certain employment related expense credits to those allowed under federal law.

ASSUMPTIONS AND METHODOLOGY: The legislation makes numerous changes to the state's tax laws which have some revenue impact.

IRC Update: Section 1 of the bill updates the reference to the federal code from January 1, 2005 to January 1, 2006. This has the effect of including the changes associated with four pieces of federal legislation: the Energy Tax Incentive Act of 2005 (Energy Act), the Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005 (SAFE Act), the Katrina Emergency Tax Relief Act of 2005 (Katrina Act), and the Gulf Opportunity Zone Act of 2005 (GO Act). While these bills included a significant number of tax changes, only some flow through to the state return. The items with a likely fiscal impact are addressed below.

Energy Act: The Energy Act created a variety of incentives to purchase energy efficient vehicles, facilities, and home improvement items. Because many of these incentives are in the form of credits, they do not impact North Carolina taxable income. As such, they produce no revenue gain or loss. However, there are four items in the bill that do create a potential loss for the state.

- <u>Alternative Fuel Vehicles:</u> The Energy Act eliminated the existing deduction for clean-fuel vehicles and certain refueling property, and replaced it with a tax credit. Because federal tax credits do not affect North Carolina taxable income, the credit has no impact on state revenues, while eliminating the deduction would actually create a revenue gain. The Joint Committee on Taxation estimates a national loss in 2006 of $8.0 million from this change. Data from the Bureau of Economic Analysis and Economy.com suggest that North Carolina will be approximately 2.85% of US auto sales. Using this percent as a proxy for alternative fuel vehicle sales suggests a state revenue gain of $225,000 in 2006. In future years the change will be less than $100,000.
- <u>Electric Transmission Assets:</u> Under previous federal law, a taxpayer could recognize a qualified gain from a qualifying electric transmission transition if that transaction was completed before January 1, 2007. The Energy Act extends that date to January 1, 2008. Conforming to the Code will also extend this date to 2008. The Joint Committee on Taxation estimates a national 2006 loss of $105 million, and a 2007 loss of $237 million. However, because of the limited information available concerning the distribution of these assets and transitions, no North Carolina estimate is possible on this portion of the bill.
- <u>Energy Efficient Commercial Buildings Property Deduction:</u> The Act allows taxpayers to claim a deduction (as opposed to depreciation or amortization) for costs associated with energy efficient commercial building property placed into service between January 1, 2006 and January 1, 2008. The estimated state revenue change as a result of the proposal is outlined below. It assumes an average federal tax rate of 34% and uses North Carolina's portion of federal corporate tax payments as a proxy for North Carolina's portion of the loss. In addition, because this can be used by both individuals and corporations, the average loss is used as a proxy for the actual loss.

Millions

Commercial Building Property	FY 06-07	FY 07-08	FY 08-09	FY 09-10	FY 10-11
JCT Estimate of Federal change	(81,000,000)	(141,000,000)	(48,000,000)	6,000,000	5,000,000
Federal Tax Base Change (34%)	(238,235,000)	(414,706,000)	(141,176,000)	17,647,060	14,705,880
NC Portion of Federal Collections	0.53%	0.53%	0.53%	0.53%	0.53%
NC Base Change	(1,262,650)	(2,197,940)	(748,240)	93,529	77,941
Corporate Estimate	(87,120)	437	437	437	437
Individual Estimate	(104,170)	(1,098,750)	(373,900)	46,983	39,189
Average	(95,650)	(549,160)	(186,730)	23,710	19,813

- Depreciation, Amortization, and Other Changes: The federal legislation creates more favorable depreciation and amortization schedules for a number of large purchases including air pollution control facilities for coal-fired plants, certain electric power purchases. The JCT has developed a series of estimates related to these changes. However, because these investments are highly concentrated, based on the individual business decisions of a limited number of companies, and are not linked to any particular state or national ratio, no exact fiscal estimate is possible on these portions of the legislation.

SAFE Act: Although the Act makes a substantial number of changes at the federal level, the changes do not impact North Carolina taxable income. As such, there is no state impact associated with this legislation.

Katrina Act: The federal legislation defines both a "Hurricane Katrina Disaster Area" and a "core disaster area" and provides additional tax advantages for individual who live in those areas, own property in those areas, or make certain charitable contributions to relief efforts in those areas.

While many of these changes could have a revenue impact, the largest potential fiscal impact will likely come from the changes related to charitable contributions. Under federal law. the size of deduction allowed for charitable contributions is limited for certain types of taxpayers, certain types of property donated, and the type of organization receiving the donation. Generally cash contributions are deductible in the amount contributed, "capital gain property" is deductible at fair market value, other appreciated property donations are deductible at the donor's base in property, and depreciated property is deductible at fair market value. In addition, the tax value of the donation can not exceed a certain proportion of their adjusted gross income. The Katrina Act provides several exceptions to these limitations on charitable contribution deductions. The Joint Committee on Taxation estimates a 2006 cost associate with this change of $819.0 nationwide. Using North Carolina's proportion of charitable contributions at the federal level as a proxy suggests conforming on this change will result in a one time loss to the General Fund of $5.89 million. In addition, there were numerous changes related to the cost of assisting with the relief effort including a change in the standard deductible mileage rate, mileage reimbursements to volunteers, enhanced deductions for contributions of food and book inventories, and an increased personal exemption for housing victims of the hurricanes. Based on data from the Joint Committee on Taxation, North Carolina's portion of federal taxes, and the average North Carolina tax rate, Fiscal Research estimates a 2006-07 loss associated with this change of $142,000. In 2007-08 that number drops to $53,000.

Most of the remaining changes related specifically to residents, former residents, and property owners in the Gulf Region. Clearly most of the victims of Hurricanes Katrina and Rita were relocated to areas closer to the gulf than North Carolina. However, the North Carolina Department of Public Instruction indicates that approximately 1,462 students entered the North Carolina school system as a result of the hurricanes. Thus, at least some former residents relocated to the state. To the extent they take advantage of the new special tax changes the State will see a loss. However, given the limited number of families involved, the potential loss is expected to be relatively insignificant.

GO Act: While this Act makes numerous tax law changes, most are related specifically to the Gulf area. Based on data provided by the Joint Committee on Taxation, it appears that the only change that will have a measurable fiscal impact on North Carolina is the temporary suspension of limitation on qualified corporate charitable contributions for Hurricanes Rita and Wilma relief efforts. The Joint Committee estimates that in 2006 this change will result in a $85 million loss for the federal government. Using the state's portion of Gross Domestic Product as a proxy for North Carolina's portion of the revenue loss, and adjusting for base differences, suggests a potential revenue loss for the state of $34,000. This is a one time loss, as it relates only to contributions made between August 28, 2005 and December 31, 2005. Any other revenue affects related to this legislation are expected to be negligible.

While the above outlines the IRC update conformity issues, the legislation also addresses several other tax issues.

Credit for Child Care: Under current law taxpayers can receive both a federal and state credit for work related child care expenses. For many years, the amount of expenses that could be considered when calculating the credit was the same at both the state and federal level. In 2003 the federal government increased the cap on those qualifying expenses from $2,400 to $3,000 ($4,800 to $6,000 if there is more than one qualifying individual in the household). At that time the state did not conform to this change. The legislation would bring state caps in line with the federal caps. According to the Policy Analysis and Statistics Division of the North Carolina Department of Revenue (formerly Tax Research), the annual cost of such a change is approximately $5.0 million.

Other: The legislation also addresses several other tax issues. First, the bill reduces the period of time in which a taxpayer must report a federal change from two years to six months. This change is expected to ease processing at the North Carolina Department of Revenue, but will have no revenue side implications. Second, the bill alters the tax filing date for nonresident aliens. Specifically, it conforms the State filing deadlines to the federal filing deadlines for nonresident aliens and would ease compliance for those taxpayers. No revenue impact is expected as a result of this change.

SOURCES OF DATA: Joint Committee on Taxation, Internal Revenue Service, North Carolina Department of Revenue, and the North Carolina Department of Public Instruction.

TECHNICAL CONSIDERATIONS: None

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DATE: May 22, 2006

Official Fiscal Research Division Publication

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