



# Finance Committee

## 2013-15 Fiscal Biennium Budget Highlights

Fiscal Brief

September 12, 2013

The North Carolina General Assembly House and Senate Finance Committees address changes to State tax law. This fiscal brief highlights the tax law changes enacted during the 2013 Session.

### Actual and Projected General Fund Tax and Non-Tax Revenue Sources Since FY 2010-11, (\$ In Millions)

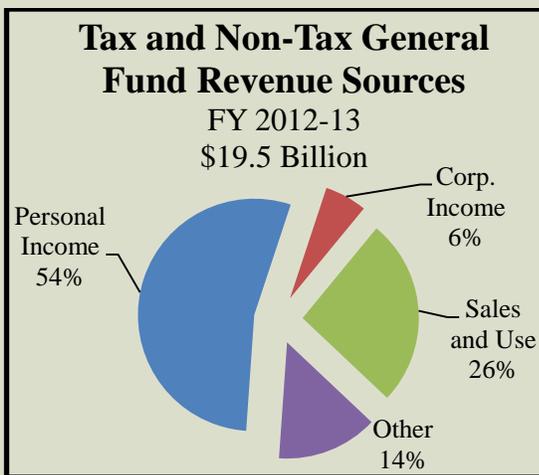
	<u>Actual</u> <u>FY 2010-11</u>	<u>Actual</u> <u>FY 2011-12</u>	<u>Actual</u> <u>FY 2012-13</u>	<u>Projected</u> <u>FY 2013-14</u>
<b>Personal Income</b>	9,735	10,272	10,953	11,105
<b>Sales and Use</b>	5,873	5,258	5,294	5,416
<b>Corporate Income</b>	1,014	1,133	1,192	1,215
<b>Other<sup>1</sup></b>	2,472	2,577	2,854	1,852
<b>Total</b>	\$19,094	\$19,239	\$20,293	\$19,587

<sup>1</sup>"Other" includes other taxes and non-tax revenue sources

#### Revenue Outlook and Finance Overview

The revised consensus revenue estimate continues to maintain a cautious approach to the State's fiscal outlook, while slightly increasing forecasted collections. The North Carolina economy appears to be returning to the pre-recession employment and population growth levels seen in 2007.

Final collections exceeded the original FY 2012-13 forecasts by five percent. The increase stemmed from modest growth in employment and personal income.



#### Overview

S.L. 2013-316, the Tax Simplification and Reduction Act (HB 998), resulted in a projected \$683.8 million reduction in total tax collections and a net \$524.4 million reduction in General Fund availability over the 2013-15 biennium. This \$524.4 million reduction in availability represents the repeal of the estate tax, a reduction in personal income and corporate income tax rates, a reduction in franchise taxes, the elimination of several tax earmarks, and an increase in the number of services included in the sales tax base. S.L. 2013-360, the Current Operations and Capital Improvements Appropriations Act of 2013, took corresponding reductions in availability of \$86.6 million in FY 2013-14 and \$437.8 million in FY 2014-15. S.L. 2013-316 also extended the sunset of several income and sales and use tax incentives.

During the 2013 Session, significant tax law changes occurred through the passage of three pieces of legislation: 1) S.L. 2013-10, the Internal Revenue Code Update (H.B. 82) 2) S.L. 2013-2, Unemployment Insurance Fund Solvency and Program Changes (H.B. 4), and 3) S.L. 2013-316, the Tax Simplification and Reduction Act (HB 998).



This Fiscal Brief provides a fiscal overview of these major legislative initiatives enacted by the 2013 House and Senate Finance Committees.

### **Internal Revenue Code Update**

The first of these significant pieces of legislation, S.L. 2013-10, the Internal Revenue Code Update (H.B. 82), updates the State's reference to the Internal Revenue Code, thereby conforming to current federal tax law, except for the provisions in which the legislation decouples. This decoupling establishes State tax laws that differ from the federal Code.

#### *Decoupling from Federal Tax Changes*

S.L. 2013-10 does not conform to several federal 2013 income tax changes, decoupling from the following items:

- Bonus depreciation;
- Enhanced Section 179 expensing (for 2012 and 2013);
- Qualified tuition and expenses deduction;
- Income exclusion for discharge of residence indebtedness;
- Income exclusion for IRA distributions to charity by a person who has attained age 70.5; and
- Mortgage insurance premium as interest deduction.

#### *Adjusting Federal Tax Credits for Revenue Neutrality*

Congress enhanced several tax credits, allowing qualified taxpayers to reduce their taxable income. Conforming to the enhanced credits at the Federal level would also in turn reduce the taxpayers North Carolina taxable income. S.L. 2013-10 addresses this issue by conforming to the enhanced credits, but adjusting the State tax treatment of the credits so that no additional cost is incurred. S.L. 2013-10 adjusts the following three tax credits that were enhanced under federal law to achieve revenue neutrality:

- Work Opportunity credit: a tax credit to employers hiring individuals that face barriers to employment. The employers receive a credit based on the amount of wages paid to qualified workers.
- Earned Income credit: an individual income tax credit for working people who have low to moderate income.

- Adoption credit: a tax credit for qualified adoption expenses paid to adopt an eligible child.

### **Unemployment Insurance Changes**

The second significant piece of legislation passed during the 2013 Session, S.L. 2013-2, UI Fund Solvency and Program Changes (H.B. 4), which was later amended by S.L. 2013-224, UI Laws Administrative Changes (H.B. 743), and S.L. 2013-391, UI Laws Administrative Changes (S.B. 420), reflects recommendations made by the Revenue Laws Study Committee. During the 2012 Interim, the Revenue Laws Study Committee developed legislation to address the cost of the state's Unemployment Insurance system and repay the \$2.6 billion debt owed to the federal government for payment of benefits during the recent recession.

The Unemployment Insurance Program is a federal-State partnership that provides unemployment benefits to eligible workers who become unemployed through no fault of their own and meet other eligibility requirements of State law. Benefits are paid from the North Carolina Unemployment Insurance Trust Fund. When funds are not available from the Trust Fund, the State must borrow from the federal government to pay benefits.

S.L. 2013-2 makes several tax rate and programmatic changes to the unemployment insurance system to accelerate the payment of the \$2.6 billion debt owed to the federal government. The Fiscal Research Division estimates that the legislative changes will result in repayment of the debt in 2015, three years sooner than repayment would have occurred without the changes.

The legislation enacts the following major programmatic changes:

- Reduces the maximum duration of benefits from 26 weeks to 20 weeks;
- Ties the duration of benefits to a sliding scale based on the unemployment rate in North Carolina. The maximum duration of benefits is 20 weeks when the unemployment rate is greater than 9% and is reduced by one week for each half-percentage drop in the unemployment rate to a maximum of 12 weeks when the rate is 5.5% or less;
- Reduces the maximum weekly benefit from \$535 to \$350; and



- Changes the calculation of weekly benefits from a formula based on the highest quarter of wages in the past five quarters to the average wages received in the two most recent quarters.

S.L. 2013-2 also increases the maximum and minimum state unemployment tax rates by 0.06% of taxable wages and changes the computation of tax rates from a table system to a formula. Tax tables identified the tax rates assigned to employers based on the individual employer accounts. Employer accounts are either positive or negative depending on amount of taxes paid into the system compared to benefits paid out for employee benefits. The tax formula uses the same criteria to calculate tax rates, but because the formula calculates rate changes to a greater degree of precision, it is more responsive to changes in employers' account balances. Governmental and nonprofit employers that elect to reimburse for benefits paid rather than pay regular UI taxes are required to maintain a 1% reserve for payment of benefits.

**Tax Simplification and Reduction Act**

House Bill 998 represents the most significant piece of tax-related legislation passed by the 2013 General Assembly. HB 998 creates a flat personal income tax, reduces personal and corporate income tax rates, and increases sales tax revenues through an expanded base. The paragraphs below provide a bulleted summary of the bill in eight tax law areas: 1) individual income taxes, 2) corporate income taxes, 3) sales and use taxes, 4) franchise taxes, 5) privilege license taxes, 6) service contracts, 7) estate taxes, and 8) motor fuel taxes.

*Part I: Individual Income Tax Changes*

- Creates a broad base, flat rate of 5.8% in 2014 and 5.75% thereafter. In 2013, and years prior North Carolina implemented a graduated income tax with rates of 6%, 7%, and 7.75%;
- Allows all deductions, exemptions, and credits to sunset, except the following:
  - Income not allowed to include in tax base by federal law or court action,
  - Social security income;
  - Interest on certain bond obligations;
- Provides an option for individuals to utilize the standard deduction amount or a NC itemized deduction amount;

- Increases the standard deduction amount from \$3,000 for individuals and \$6,000 for those married and filing jointly to \$7,000 for individuals and \$15,000 for those married and filing jointly;
- Limits itemized deductions, maintaining only two deductions;
  - Charitable contributions deducted for federal purposes (no State cap);
  - Mortgage interest and property taxes paid on real estate (capped at \$20,000); and
- Enhances the per child tax credit for adjusted gross income under \$40,000 (married filing jointly ) from \$100 per child to \$125 per child

*Part II: Corporate Income Tax Changes*

- Broadens the corporate income tax base by eliminating all credits except the one for investing in major recycling facilities;
- Reduces the corporate tax rate from 6.9% to 6% in 2014, and to 5% in 2015;
- Provides a trigger for possible rate reduction in 2016 to 4% and in 2017 to 3%; and
- Extends the tax credit for research and development, originally set to expire in January 1, 2014, for two years to January 1, 2016.

*Part III: Sales and Use Tax Changes*

The legislation expands the tax base by removing several sales and use tax exemptions and preferential sales and use tax rates. Major changes include:

- Increases the tax rate on modular homes and manufactured homes to the State general rate of 4.75% with no cap, effective January 1, 2014 (currently 2.5% and 2% with a \$300 cap per home, respectively);
- Repeals the sales and use tax exemption for nutritional supplements sold by a chiropractor, meals served in higher educational institution facilities, and newspapers, effective January 1, 2014;
- Requires farmers to meet an annual income threshold of \$10,000 from farming activities to qualify for farm-related sales and use tax exemptions, effective July 1, 2014;
- Repeals sales tax exemption for certain bakery items sold in a bakery thrift store effective July 1, 2014;



- Eliminates two sales tax holidays for school items and energy star products, effective July 1, 2014;
- Caps the sales tax refund allowed to nonprofit entities at \$45 million per entity (State and local), effective July 1, 2014; and
- Extends the sales tax refund for air passenger carriers and motorsports two years, from January 1, 2014, to January 1, 2016.

*Part IV: Franchise Tax Changes*

- Repeals the gross receipts franchise tax on electricity and the excise tax on piped natural gas, effective July 1, 2014;
- Requires the Utilities Commission to change rates charged by these utilities accordingly;
- Includes electricity and piped natural gas utilities in the State sales and use tax base and taxes them at the combined general rate of 7%, effective July 1, 2014; and
- Replaces the current tax-sharing of revenues with cities with a distribution of part of the sales and use tax collected on these items.

*Part V: Privilege License Taxes: Entertainment and Amusements*

- Repeals the gross receipts franchise tax on live entertainment and movies, effective January 1, 2014;
- Includes admission charges to a live event, a movie, or an attraction to the State and local sales tax, effective January 1, 2014; and
- Exempts admission charges to elementary or secondary school events, agricultural fairs, limited nonprofit events, youth athletic contests, and State attractions from sales tax.

*Part VI: Service Contracts*

- Defines a service contract as an agreement by which the provider agrees to maintain or repair tangible personal property
- Includes service contracts in the State and local sales tax base, effective January 1, 2014
- Exempts from the sales tax an item used to fulfill a service contract; and
- Exempts from sales tax a service contract for an item exempt from sales tax.

*Part VII: Estate Taxes*

- Repeals the estate tax applicable to the estates of decedents, effective January 1, 2013.

*Part VIII: Motor Fuel Tax Caps*

- Caps the excise tax on motor fuel at 37.5 cents/gallon, effective October 1, 2013, until June 30, 2015.

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**APPENDIX**

**Table 1. Five-Year General Fund Fiscal Impact of Tax Law Changes Occurring During the 2013 Session  
(\$ In Millions)**

		<u>FY 2013-14</u>	<u>FY 2014-15</u>	<u>FY 2015-16</u>	<u>FY 2016-17</u>	<u>FY 2017-18</u>
H82/S64	IRC Update	(24.0)	(18.0)	(19.0)	(19.0)	(22.0)
H248	Taxpayer Debt Information Act	Fiscal Impact Unknown				
H743	UI Laws Administrative Changes	No Fiscal Impact				
S490/H453	Exclude Custom Software from Property Tax	Fiscal Impact Unknown, Local Impact				
H998	Tax Simplification and Reduction Act	(86.6)	(437.8)	(644.6)	(623.5)	(649.8)
S337	NC Charter School Advisory Board	No Estimate Available				
H269	Children w/ Disabilities Scholarship Grants	(3.7)	(2.8)	(2.5)	(2.3)	2.1
S76	Domestic Energy Jobs Act	No Fiscal Impact				
H14/S5	Rev Laws Technical, Clarifying and Admin. Chg.	Fiscal Impact Unknown				
<b>TOTAL</b>		<b>(\$114.3)</b>	<b>(\$458.6)</b>	<b>(\$666.1)</b>	<b>(\$644.8)</b>	<b>(\$669.7)</b>