NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: SB 1092 House PCS 6826

SHORT TITLE: Reduce North Carolina Taxes

SPONSOR(S): Representative Gray

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	($million)				
	FY 1998-99	**FY 1999-00**	**FY 2000-01**	**FY 2001-02**	**FY 2002-03**
REVENUES					
General Fund					
2% Food Tax Repeal	**(122.8)**	**(184.5)**	**(190.0)**	**(195.7)**	**(201.6)**
Repeal Inheritance Tax		**(52.5)**	**(79.4)**	**(85.7)**	**(92.6)**
Inc. Homestead Exemption		**(9.0)**	**(9.0)**	**(9.0)**	**(9.0)**
Corp. Charitable Deduction		**(4.0)**	**(4.0)**	**(4.0)**	**(4.0)**
Non-Itemizer Charity Credit		**(7.6)**	**(7.8)**	**(7.8)**	**(7.8)**
Repeal Gift Tax		**(18.5)**	**(21.1)**	**(23.9)**	**(27.2)**
Inc. Personal Exemption	**(56.1)**	**(133.0)**	**(175.3)**	**(219.2)**	**(264.2)**
Total - Gen. Fund	**(178.9)**	**(409.1)**	**(486.6)**	**(545.3)**	**(606.4)**

EXPENDITURES (See Technical Considerations)

PRINCIPAL DEPARTMENT(S) &
PROGRAM(S) AFFECTED: Department of Revenue; Counties and cities that levy a property tax

EFFECTIVE DATE: Sections 1 and 2 (sales tax on food) are effective October 1, 1998. Sections 3 and 4 (inheritance tax) become effective January 1, 1999. Sections 5 through 7 (property tax homestead exemption) are effective for taxable years beginning on or after July 1, 1999. Section 8 (personal exemption), sections 9 and 10 (corporate charitable deduction), and section 11 (non-itemizer credit) are effective for taxable years beginning on or after January 1, 1999. Section 11.1 becomes effective January 1, 1999 and applies to gifts made on or after that date.

BILL SUMMARY: The bill deals with six major tax issues: 1) eliminates the state sales tax on food, 2) eliminates the state's inheritance tax and retains a state estate tax equal to the federal State Death Tax Credit, 3) increases and indexes the individual income tax personal exemption to conform to the federal exemption, 4) increases the property tax homestead exemption amount and income eligibility amount and reimburses local governments for the resulting loss, 5) encourages charitable giving by expanding the corporate charitable deduction and by increasing the non-itemizer tax credit, and 6) repeals the gift tax.

ASSUMPTIONS AND METHODOLOGY:

REPEAL STATE SALES TAX ON FOOD

The 1996 General Assembly lowered the state sales tax on food items intended for home consumption (defined as those items eligible for purchase with Food Stamps) from 4% to 3%, effective January 1, 1997. The 1997 General Assembly lowered the sales tax on food from 3% to 2% effective July 1, 1998. Section 1 of this proposed committee substitute repeals the remaining 2 cents of the state sales tax on food on October 1, 1998.

The original source of data for the estimate was a 1961 field survey conducted by field auditors of the Department of Revenue assigned to tabulate the impact of eliminating the tax exemption on food. Over the years these numbers have been updated for growth with data from the monthly "type of business establishment" reports of the Department of Revenue. Data from a special tabulation of the Department of Revenue for February and March 1997 indicated that the estimates used in previous fiscal notes were on target. As a check on the data, estimates of food tax exemptions from other states have been reviewed. Furthermore, the estimates are consistent with nationwide food consumption data compiled by the U. S. Department of Commerce (and allocated to North Carolina by the Fiscal Research Division). Based on federal data, the estimated 3% annual growth in food tax purchases is also on target.

The October 1, 1998 reduction will be less than 9 months of revenue loss due to a lag between the retail sale and the remittance of the tax. The full year cost of the 2 cent reduction will be in FY 1999-00.

	STATE FISCAL YEAR ($million)				
	98-99	99-00	00-01	01-02	02-03
BACKGROUND INFORMATION (1)					
CURRENT TAX YIELD (2% effective 7/1/98)	$179.1	$184.5	$190.0	$195.7	$201.6
1 CENT	$89.6	$92.2	$95.0	$97.9	$100.8
REDUCE TO 0 % (10/1/98) (2)	($122.8)	($184.5)	($190.0)	($195.7)	($201.6)

NOTES:
(1) Assumes annual growth of 3%
(2) The effect is less than 75% in the first
year due to a lag between the retail sale and the remittance.

ELIMINATE NORTH CAROLINA INHERITANCE TAX

North Carolina has both an inheritance tax and an estate tax. These taxes are borne by the beneficiary. When calculating taxes owed, a determination is made of the net value of the estate and the beneficiary's proportion of that estate. Then inheritance taxes are applied based on the beneficiary's classification. Once a state inheritance tax is determined, that number must be compared to the State Death Tax Credit (This credit amount is drawn from the federal estate tax form). If the inheritance tax is larger than the State Death Tax Credit, the beneficiary forwards the total inheritance tax to the state. If the credit is larger, a North Carolina Estate Tax is charged to bring the total tax up to the State Death Tax Credit level. As of January 1997 only 17 states, including North Carolina, still retain an inheritance tax. Sections 3 and 4 of this bill repeal the inheritance tax, with the net effect of expanding the state estate or "pick-up" tax.

The Tax Research Division of the Department of Revenue provided data based on inheritance tax returns filed and closed out in 1993. The loss associated with the 1993 data equals $42.3 million, or 45.1% of total potential inheritance tax collections, in General Fund revenue. This percentage loss was applied to current 1999-00 inheritance tax collections estimates. Future years were forcasted based on the expected growth rate in inheritance tax collections as defined in the North Carolina model (7.986%). A one time 5% adjustment was included to capture the impact of the increase in the federal unified credit and its influence on the State Death Tax Credit. No FY 1998-99 fiscal impact is shown for this item because there is a nine month lag in the payment of inheritance taxes. For example, if a benefactor dies on January 1, 1999 the inheritance tax paid by their beneficiaries would not be due until September 1, 1999, which is the next fiscal year. The estimate for FY 1999-00 has also been reduced to allow for this lag factor.

It should be noted that the federal government requires that beneficiaries pay at least the amount of the death tax credit to the state, or the federal government will retain the balance. As such, reducing a North Carolina beneficiary's total tax liability to below the State Death Tax Credit level (i.e. eliminating both the inheritance and estate taxes) will only result in additional funds to the federal government. The beneficiary's total tax liability will not change.

PROPERTY TAX HOMESTEAD EXEMPTION

The Homestead Exemption is a partial exemption from property taxes for the residence of a person who is either aged 65 or older, or totally disabled, and who has an income of less than $15,000. The exemption amount was last increased in 1996, when it was increased from $15,000 to $20,000 effective July 1, 1997. Before then the exemption was last increased in 1993 from $12,000 to $15,000. The income eligibility amount was last increased in 1996, when it was increased from $11,000 to $15,000. Before then the income threshold had last been increased in 1987, when it was increased from $10,000 to $11,000.

Sections 5 and 6 of the proposed bill increase the Homestead Property Tax Exemption amount for the elderly and disabled from $20,000 to $25,000 and increase the income eligibility threshold from $15,000 to $25,000. Section 7 of the proposal holds counties and cities harmless for the loss attributable to the increase proposed by the bill. As such, the full financial cost of the expansion of the Homestead Exemption will be borne by the state.

The current annual cost of the Homestead Exemption program is approximately $27 million. That cost is divided between the state and the counties. History indicates that approximately 80% of the total cost is related to the property exemption and 20% is related to the income requirement. The proposed act increases the value of exempt property 25% and increases the income threshold 66.7%. If 80% of the cost or $21.6 million is devoted to exempt property, then a 25% increase in the exemption equals $(5.4) million. If 20% of the cost of the program is devoted to the income threshold or $5.4 million, then a 66.7% increase in the threshold equals ($3.6) million. The $9 million increase in the cost of the Homestead Exemption will be borne by the state.

INCREASE AND INDEX PERSONAL EXEMPTIONS

By repealing the add-back to income in GS 105-134.6(c)(4a) in Section 8 of the bill, the state personal exemption rate will equal the federal personal exemption amount each year beginning in tax year 1999. The General Assembly last increased the state personal exemption amount to the federal rate in 1995, but did not index it for inflation. The current state personal exemption is $2500, while the federal personal exemption rate for tax year 1999 is projected to be $2750. The rate is set each year by increasing the prior year amounts by the CPI, then round down to the nearest $50. The projected rates for tax years 1999 to 2003 are follows:

	State	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Personal Exemption	$2,500	$2,700	$2,750	$2,850	$2,950	$3,050	$3,150
CPI		1.032	1.031	1.03	1.034	1.033	1.035

This section will also end the personal exemption of $2,000 placed on the following income groups:

Married filing jointly	$100,000
Head of Household	$80,000
Single	$60,000
Married filing separately	$50,000

The state will still conform to the federal phase-out of the personal exemption at the highest income levels. ($181,800 married filing jointly; $151,500 head of household; $121,200 single; $90,900 married filing separately)

The cost for indexing the personal exemption was derived using the Individual Income Tax computer model operated by the Department of Revenue, the Fiscal Research Division, and the Office of State Budget and Management. The microsimulation model uses actual state and federal tax return data from tax year 1994 to estimate the impact of tax changes on the General Fund. The results from the model were checked against the 1994 Individual Income Tax Detail Report issued by the Department of Revenue. Manual calculations were consistent with the model projections.

The first year impact in FY 98-99 equals half the loss for tax year 1999 ($56.1 million) due to taxpayers adjusting their withholding tables and their estimated payments in January through June of 1999. The impact for each following year is half of one tax year plus half of the next tax year. For example, the FY 99-00 estimate of $133 million is half of tax year 1999 ($56.1 million) plus half of tax year 2000 ($76.9 million).

INCREASE CHARITABLE GIVING

Section 9 of the bill increases the allowable annual deduction from the corporate income tax for charitable contributions from 5% to 10% and provides for a five-year carry forward for deductions in excess of 10%. Using 1994 corporate income tax return data, the Tax Research Division of the Department of Revenue estimates **this change will produce a revenue loss in the General Fund between $3 million and $4 million per year.** Approximately 69% of returns with contributions deducted less than 5% of net income. The remaining 31% of returns with contributions had deductions equal to or greater than 5%. However, this group probably included contributions to NC government and educational institutions which can be unlimited.

Section 11 of the bill increases the income tax credit for charitable contributions by non-itemizers from 2.75% to 7%. The credit is allowed for those contributions that exceed 2% of the taxpayer's adjusted gross income. The non-itemizer charitable contribution tax credit of 2.75% went into effect on January 1, 1997. The estimated cost of the 2.75% credit is approximately $5 million a year. If this credit were increased to 7%, the annual cost would be approximately $12.7 million each year. The net fiscal impact of the 7% proposal is shown below. A 1% growth factor is assumed for this tax credit and is based on the actual growth in the number of individual income tax returns filed from 1989 to 1993. The increased credit would not affect the budget until FY 99-00, because taxpayers will not file returns for Tax Year 1999 until the spring of 2000.

	($ Millions)			
	1999-00	2000-01	2001-02	2002-03
2.75% credit	(5.1)	(5.1)	(5.2)	(5.3)
7% credit (1-1-99)	(12.7)	(12.9)	(13.0)	(13.1)
Additional General Fund Loss	**(7.6)**	**(7.8)**	**(7.8)**	**(7.8)**

These estimates are based on charitable giving rates for non-itemizers provided by the Independent Sector, a non-profit coalition of over 800 corporate, foundation and voluntary organization members. The number of non-itemizers in North Carolina is based on estimates from the Department of Revenue's personal income tax model.

It should be noted that the above estimates are based on current giving behavior. If the credit is successful in increasing charitable giving, then the credit will produce additional losses for the General Fund. For every 5% increase in charitable giving, an additional $2 million in State revenues will be lost.

REPEAL GIFT TAX

Under current law a tax is levied on the donor against all property transferred as gifts in excess of $10,000, real or personal, during a calendar year. Special arrangements are made for non-residents. Gifts to a spouse are exempt from taxation. This amendment would repeal, in total, the North Carolina Gift Tax.

The Department of Revenue reports 1996-7 gift tax receipts of $12.56 million. Forecasts of future revenues assume a gift tax elasticity of 2.17, creating growth rates of 14.5% (1997-8), 13.5% (1998-9), and 13.7% (1999 and beyond). Gift tax revenues are highly violable and subject to significant income spikes. Because 1997-8 collects appear to be one of those spiked years, it was determined that those figures should not be used as a baseline for the model.

TECHNICAL CONSIDERATIONS:

I. Food Tax - The Department of Revenue estimates that each change in the sales tax rate cost the department $100,000 to hire temporary employees to review error returns and process assessments generated by errors. The Department also estimates that another $19,000 is spent on accounting and computer system changes. **However , it should be noted that when the food tax reduction from 4% to 3% was implemented in 1997, the administrative cost was absorbed in the Department's budget. There was also no appropriation made for the food tax reduction scheduled for July 1, 1998.**

II. Inheritance Tax - Although the inheritance tax is repealed, the State would maintain compliance with the Federal Estate Tax (pick-up tax). With the Federal pick-up tax still in place, a portion of the returns that are currently filed would continue to be required. For example in FY 1996-97 there were 7,931 Inheritance Tax returns. Of that number, the Department estimated that 35% or 2,776 required filing under the Federal pick-up

The Department could abolish two of the six employees in Office Examinations who work with Inheritance Tax and with Gift Tax. Two positions are needed for the Gift Tax portion. At least two will be needed for the changed State estate tax and to work with the existing Inheritance Tax files until they are all resolved. **The Department could abolish the remaining two positions and save $52,453, but would like to reallocate these positions to the Correspondence Unit that was created in 1997 .** This unit resolves correspondence not attached to payments before that correspondence is referred to audit in Office Examinations, to administrative officers in Office Services, or to Tax Administration. If the bill is enacted, the Appropriations Committee in the 1999 Session should determine the number of personnel needed in this section.

FISCAL RESEARCH DIVISION
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PREPARED BY: Linda Struyk Millsaps & Richard Bostic
APPROVED BY:
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