

NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: House Bill 1417 (First Edition)

SHORT TITLE: Earned Income Tax Credit/Increase Upper Rates

SPONSOR(S): Representatives Insko and Luebke

FISCAL IMPACT					
	Yes (X)	No ()	No Estimate Available ()		
	(\$million)				
	<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>
REVENUES					
General Fund (GF)					
EITC		(\$93.8)	(\$109.0)	(\$119.2)	(\$124.0)
Rate Increase	<u>\$36.9</u>	<u>\$77.5</u>	<u>\$85.2</u>	<u>\$93.7</u>	<u>\$103.1</u>
GF – Net Revenue	\$36.9	(\$16.3)	(\$23.8)	(\$25.5)	(\$20.9)
EXPENDITURES					
General Fund (GF)					
Withholding Tables	\$.14				
EITC Processing		\$.91	\$.92	\$.92	\$.92
Total GF Impact	\$36.8	(\$17.2)	(\$24.7)	(\$26.4)	(\$21.8)
POSITIONS:	No estimate available				
PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Department of Revenue					
EFFECTIVE DATE: This act is effective for taxable years beginning on or after January 1, 2002.					

BILL SUMMARY: The bill creates a refundable earned income tax credit (EITC) for the state individual income tax equal to 10% of the federal EITC. The top tax rate for each filing status is increased from 7.75% to 8% to offset part of the credit cost.

BACKGROUND: The federal government has offered an earned income tax credit since 1975. A recipient must be a US citizen or resident alien for the entire year. The credit is for earned income such as wages, tips, and earnings from self-employment, but not unearned income such as pensions, Social Security benefits, workfare, or unemployment benefits. The taxpayer’s investment income must be \$2,400 or less.

For the 2000 tax year, a taxpayer must have a gross income of under \$27,413 with one qualifying child or a gross income under \$31,152 with two or more qualifying children. A qualifying child can be a son, daughter, adopted child, grandchild, stepchild or foster child under age 19 (under age 24 if full-time student) or any age if disabled. The qualifying child must live in the taxpayer's household more than six months. To receive the earned income credit without children, a taxpayer's income must be under \$10,380 and the taxpayer must be at least age 25 but under age 65.

The amount that a taxpayer can receive from the federal earned income tax credit is found in the Earned Income Tax Credit (EITC) Table in the 1040 Instructions booklet printed by the Internal Revenue Service (IRS). For the 2000 tax year, the following credits apply:

- A. **Childless Taxpayer** = The maximum credit earned is \$353 with an income between \$4,600 and \$5,800. For every \$50 increase in income after \$5,800, the credit is reduced \$3 to \$4. The credit is phased out entirely at \$10,350 in income.
- B. **Taxpayer with One Child** = The maximum credit is \$2,353 with an income between \$6,900 and \$12,700. For every \$50 increase in income after \$12,700, the credit is reduced \$8. The credit is phased out entirely at \$27,400 in income.
- C. **Taxpayer with Two or More Children** = The maximum credit is \$3,888 with an income between \$9,700 and \$12,700. For every \$50 increase in income after \$12,700, the credit is reduced \$10 to \$11. The credit is phased out entirely at \$31,152 in income.

A state earned income tax credit is offered in fourteen states. Twelve of the fourteen states piggyback on the federal earned income tax credit, expressing the state rate as a percentage of the federal credit. The following states offer state earned income tax credits:

<u>Refundable</u>	<u>% of Federal Credit</u>
Colorado	10%
Kansas	10%
Maryland	15%
Massachusetts	15%
Minnesota	33% (average, varies by earnings)
New Jersey	10% (income <\$20,000)
New York	22.5%
Vermont	32%
Wisconsin	4% - one child 14% - two children 43% - three children

<u>Non-refundable</u>	<u>% of Federal Credit</u>
Illinois	5%
Iowa	6.5%
Maine	5%
Oregon	5%
Rhode Island	26%

ASSUMPTIONS AND METHODOLOGY:

EITC

In 1998, the Internal Revenue Service reported that 642,853 North Carolinians with adjusted gross income of less than \$30,000 filed returns with earned income tax credits (EITC) worth \$1.036 billion. Of the North Carolina taxpayers that requested the EITC, 535,388 received refunds totaling \$896.6 million. North Carolinians received refunds for 86.6% of their earned income credit in 1998. Preliminary numbers for the 1999 tax year show 628,571 taxpayers received \$1.047 billion in earned income tax credits.

Among 1998 federal taxpayers with earned income tax credits, North Carolina residents made up 3.31% of the total US returns and received 3.36% of the US earned income tax credit amounts. The U.S. Treasury projects the EITC to grow from \$30.45 billion in FY 1998-99 to \$35.46 billion in FY 2004-05. Assuming North Carolinians continue to receive 3.36% of the U.S. earned income tax credits, the EITC benefits received by North Carolina residents will be as follows in the next five years.

FY 2001-02	\$1,071 million
FY 2002-03	\$1,104 million
FY 2003-04	\$1,147 million
FY 2004-05	\$1,192 million
FY 2005-06	\$1,240 million

Assuming 100% participation in the state EITC program, a 10% state credit would yield the following tax benefit:

FY 2002-03	\$110.4 million
FY 2003-04	\$114.7 million
FY 2004-05	\$119.2 million
FY 2005-06	\$124.0 million

It is unlikely that 100% participation will be achieved in the first year or two of an EITC program due to the lack of taxpayer awareness about the credit and the need to file a state tax return for those persons not filing state returns now. States with refundable credits have experienced 80% to 85% participation in the first year after enactment. In a 1999 telephone interview with the Wisconsin Department of Revenue, tax officials estimated that only 85% of the taxpayers eligible for the Wisconsin EITC applied for the credit in the program's first year. In Minnesota, the state Revenue Commissioner reported in 1997 that 10,000 Minnesota residents who qualified for the federal EITC failed to file state returns to collect the Minnesota EITC. These 10,000 citizens represented 15% of the eligible population. The

New York Department of Taxation and Revenue found that only 83% of the taxpayers eligible for the state EITC applied in the program's first year. The number of applicants rose to 90% of eligible taxpayers in the second year of the EITC.

This fiscal note assumes that North Carolina taxpayers will follow the pattern of other state taxpayers in applying for a state EITC. In Tax Year 2002, it is assumed that 85% of the eligible taxpayers will apply for the credit. In Tax Year 2003, taxpayer awareness of the credit should increase and so will the percentage applying for the credit increase to 95%. By 2004, applications are assumed to reach 100%. Applying these percentages to the numbers shown above, the revenue impact will be as follows:

FY 2002-03	\$93.8 million
FY 2003-04	\$109.0 million
FY 2004-05	\$119.2 million
FY 2005-06	\$124.0 million

The first fiscal year impact will be in FY 2002-03 when taxpayers file their 2002 tax returns in the spring of 2003 to receive the refundable credit. Changes in employee income tax withholding are not anticipated.

8% Tax Rate

HB 1417 increases the top tax rate for each filing status from 7.75% to 8%. The 1999 individual income tax detail report supplied by the Tax Research Division of the Department of Revenue is used to estimate the revenue gained from this rate increase. The 1999 tax returns report 161,958 taxpayers with taxable income subject to the maximum tax rate of 7.75%. After subtracting out the income taxed at 6% and 7%, the chart shows the remaining income taxable at the 7.75% rate. The column of taxable income is multiplied by .0025 in the last column of the chart to obtain the revenue gained by going to an 8% rate.

Filing Status	Size of income taxable in NC	Number of returns	Taxable Income Subject to Top Tax Rate	Revenue Gain From .0025 Increase
Married - Jointly	over \$100,000	116,802	\$18,338,339,922	\$45,845,850
Head of Household	over \$80,000	3,827	\$398,895,432	\$997,239
Single	over \$60,000	35,475	\$2,861,114,310	\$7,152,786
Married - Sep	over \$50,000	5,854	\$573,992,671	\$1,434,982
Total		161,958	\$22,172,342,335	\$55,430,856

The 8% tax rate is effective in 2002 and collections from the new rate will begin immediately in 2002 due to employer withholding and quarterly estimated payments by high income individuals. To project future year revenue from the 8% tax rate, the \$55.4 million in Tax Year 1999 is increased by 10% each year in the chart below. The 10% rate reflects historical experience in individual income tax revenue growth in recent years. As shown in the chart below, the 8% top tax rate will yield \$73.8 million in new revenue in 2002. Because of withholding and estimated payments, this fiscal note assumes half of this new income will be collected in the first half of 2002 which is FY 2001-02 and the remaining half will be collected in the second half of 2002 which is FY 2002-03. This pattern

continues in future years with the fiscal year estimate equaling the second half of one calendar year and the first half of the next calendar year.

<u>Tax Year</u>	<u>Tax Year Revenue</u>	<u>Fiscal Year</u>	<u>Fiscal Year Revenue</u>
1999	\$55,430,857		
2000	\$60,973,943		
2001	\$67,071,337		
2002	\$73,778,471	FY 2001-02	\$36,889,235.33
2003	\$81,156,318	FY 2002-03	\$77,467,394.20
2004	\$89,271,950	FY 2003-04	\$85,214,133.62
2005	\$98,199,144	FY 2004-05	\$93,735,546.98
2006	\$108,019,059	FY 2005-06	\$103,109,101.68
2007	\$118,820,965	FY 2006-07	\$113,420,011.85

Expenditures

To increase the top tax rate from 7.75% to 8%, the Department of Revenue estimates that it will need a one-time appropriation of \$143,228 in FY 2001-02. These funds will be used to print and mail revised withholding tables to employers.

As mentioned above, there were 535,388 federal taxpayers that received a refund of their earned income tax credit. It is the Department’s belief that these federal taxpayers are not filing a state tax return because the standard deduction and personal exemptions reduce their state tax liability to zero. However, this fiscal note assumes these taxpayers will return to the tax rolls to collect the state EITC. The Department estimates that the first year cost of printing and mailing forms to these new taxpayers will be \$913,143 in FY 2002-03. The Department estimates the recurring cost of administering the EITC is \$919,610 each year. The Department has not yet provided the line item detail to support these expenditure estimates.

TECHNICAL CONSIDERATIONS:

FISCAL RESEARCH DIVISION 733-4910

PREPARED BY: Richard Bostic

APPROVED BY: James D. Johnson

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