NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: SB 1292 (Fourth Edition)

SHORT TITLE: Budget Revenue Act of 2002

SPONSOR(S):

FISCAL IMPACT

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

($million)

	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07
Revenues					
General Fund					
-Delay Child Tax Credit	19.8	34.9			
-Delay Standard Deduction	31.9	12.6			
-Drug Tax Receipt*	.9	.9	.9	.9	.9
-Conform Internal Rev. Code	(16.9)	(25.5)	(49.7)	(76.9)	(77.3)
-Estate Tax Credit	(5.5)	(7.3)	(17.7)	(5.9)	
- Conform Gift Tax Indexing	(0.2)	(0.2)	(0.2)	(0.4)	(0.4)
-Accelerated Depreciation**	38.2	68.8	22.8	0	(42.3)
-Conform Business Income	70.0	50.0	53.7	56.7	59.5
-Correct LLC Franchise Tax	20.0	21.2	22.5	23.8	25.2
-Corporate Throwout Rule	11.0	11.7	12.4	13.1	13.9
-Low Income Housing Credit	(2.2)	(2.2)	(2.2)	(2.2)	(2.2)
TOTAL GENERAL FUND	**167.0**	**164.9**	**42.5**	**9.1**	**(21.9)**
Utilities Special Fund	11.9				
Insurance Reg. Fund	25.0				
Local Governments					
-Drug Tax Deduction	(.9)	(.9)	(.9)	(.9)	(.9)

*Department of Revenue will deduct 70% of costs of Unauthorized Substance Tax Division from sales tax proceeds.

**The impact of the changes is essentially revenue neutral over the long-term since the conformity deals with an acceleration of depreciation, not the total amount of the deduction over the life of the asset. Thus, there will be substantial revenue losses starting in FY 2006-07.

PRINCIPAL DEPARTMENTS AFFECTED: Department of Revenue, Department of Insurance, Utilities Commission, NC Housing Finance Agency, Local Governments.

EFFECTIVE DATE: Section 2.1(a) (Married Standard Deduction $5,500) effective for taxable years beginning on or after January 1, 2003; Section 2.1(b) (Married Standard Deduction $6,000) effective for taxable years beginning on or after January 1, 2004; Section 2.2(a) (Child Care Credit $75) effective for taxable years beginning on or after January 1, 2003; Section 2.2(b) (Child Credit $100) effective for taxable years beginning on or after January 1, 2004; Sections 3.2 and 3.3 (Accelerated Depreciation) effective for taxable years beginning on or after January 1, 2002; Section 3.4 (Estate Tax) effective on or after January 1, 2002 and applies to estates of decedents dying on or after that date and is repealed for estates of decedents dying on or after January 1, 2004; Section 4.1 (Unauthorized Substance Tax) is effective June 30, 2002; Section 6 (Utility Regulatory Fee) is effective July 1, 2002; Section 9.1(a) and Sections 9.2(a) are effective for tax years beginning on or after January 1, 2002; Sections 9.3(a) and (b) are effective for taxes due on or after January 1, 2003. All other sections are effective when they become law.

BILL SUMMARY:

Parts I and VII of the bill are reserved.

Part II of the bill delays two tax breaks authorized in 2001. Section 2.1(a) delays the increase from $5000 to $5500 in the standard deduction for married filing jointly from tax year 2002 to 2003. Section 2.1(b) delays the increase from $5500 to $6000 in the same deduction from tax year 2003 to 2004. Section 2.2(a) delays the increase in the child tax credit from $60 to $75 from tax year 2002 to 2003. Section 2.2(b) delays the increase in the child tax credit from $75 to $100 from tax year 2003 to 2004.

Part III of the bill updates state statutory references to the Internal Revenue Code from January 1, 2001, to May 1, 2002, with exceptions for accelerated depreciation and the estate tax credit. This action would conform state tax laws to federal tax changes made in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Job Creation and Worker Assistance Act of 2002.

Under current law, North Carolina conforms to the federal estate tax in effect as of January 1, 2001. Thus, our pickup tax does not automatically tie into the 2001 federal changes. The estate tax language in this bill, coupled with the Internal Revenue Code conformity update provisions, would link North Carolina to the effect of the higher federal credits on the pickup tax but not to the phase-out of the death tax credit. The practical effect of the language in the bill is to ensure that with respect to the phased up federal credit for state death taxes, estates in North Carolina do not have to pay state tax if there is no federal tax due.

In the bonus depreciation conformity section of the bill, an add-back equal to 100% of bonus depreciation for the 2001-2003 tax year and 80% for 2004 is included in taxable income. The add-back is then offset by a subtraction from income starting with the 2005 tax year. This subtraction takes place in installments over a 5-year period.

This part of the bill also conforms the state gift tax exclusion to the indexing method used by the federal government.

Part IV allows the Department of Revenue to deduct 70% of the cost of the Unauthorized Substance Tax Division from the sales and use tax proceeds distributed to local governments.

Part V of the bill addresses the annual establishment of the insurance regulatory fee. Section 5(a) sets the insurance regulatory charge at 6.5%. The rate remains the same as in the previous year.

Part VI, Section 6(a) sets the regulatory fee rate for the Public Utilities Commission at 0.1%. This rate must be set annually and is the same as the previous year. Section 6(b) sets the regulatory fee for the electric membership corporations at a flat $200,000. This fee has remained the same since it was first imposed in 1999.

PART VIII attempts to limit the Governor's ability to withhold the local portion of revenues shared with cities and counties by declaring these funds local revenue. Specifically Section 8.1 addresses beer and wine taxes, while Section 8.2 discusses the franchise tax on electricity. Section 8.3 considers the tax on piped natural gas. Section 8.4 addresses the tax on telecommunications.

Section 8.5 considers the Highway Fund and Highway Trust Funds allocated as Powell Bill funds. Section 8.6 addresses the distribution to electric cities. Section 8.7 adds intent language to clarify that the funds committed or appropriated by the legislature for local governments shall not be reduced unless the governor has exhausted all other sources of revenue for the state. It also states that the Governor must be authorized by the legislature to withhold these funds.

Part IX makes the following corporate tax changes:

BUSINESS INCOME. Sec. 9.1 of the bill expands the definition of "business income" to include all of the income that may be apportioned under the U.S. Constitution. The practical effect of the provision is to include in the North Carolina income tax base more income from irregular events, such as the sale of a subsidiary.

THROWOUT RULE. For most multistate corporations, nationwide taxable income is apportioned among the states based on a three-factor formula that compares payroll in a state, property in the state, and sales within the state to the national totals for each of the respective factors. Thus, the sales factor would divide sales within North Carolina (numerator) by total national sales (denominator). Section 9.2 of the bill modifies the sales factor by taking out sales to the U.S. government from both the numerator and denominator and subtracting from the denominator "sales that are in a state in which the taxpayer is not taxable" during the tax year. In addition, the denominator would not include sales that are in a foreign country when that country does not subject the taxpayer to a tax on, or measured by, profits or income.

LLC FRANCHISE TAX. Legislation adopted by the 2001 General Assembly attempted to close a loophole that allowed corporations to avoid the state franchise tax by transferring potentially taxable assets to a controlled limited liability company (LLC). This occurs because LLCs do not pay franchise tax on their assets. The 2001 legislation tried to address this problem by requiring a corporation to pay tax on assets owned by the LLC if the corporation, including its affiliated corporations, indirectly owned[1] at least 70% of the LLC's assets. However, if the corporation interposed a partnership between it and the LLC holding its assets, then the 2001 change would not apply and the assets would continue to escape taxation.

Sec. 9.3 of the bill broadens the 2001 legislation to include "related members" (other entities and individuals) who may form a partnership with one or more corporate entities to own the LLC to which the corporate assets are transferred. "Related members" includes shareholders, partnerships, etc. If a corporation and its related members together indirectly own at least 70% of an LLC's assets, the bill provides that each corporation pays franchise tax on its relative share of the LLC's assets. The relative share is calculated after excluding those related members who are not corporations.

Part X backdates the effective date from 2001 to 2000 for enhanced low income housing tax credits for projects located in counties damaged by Hurricane Floyd.

[1] Indirect ownership of an LLC's assets is determined based on who is entitled to receive those assets upon dissolution of the LLC.

ASSUMPTIONS AND METHODOLOGY:

PART II: DELAY 2001 TAX BREAKS

STANDARD DEDUCTION – MARRIAGE TAX PENALTY

The term "marriage penalty" refers to the income tax situation where married individuals filing jointly pay more in tax than if the two individuals were unmarried filing as single persons. For example, the North Carolina standard deduction for single filers is $3,000, but for married filing jointly the standard deduction is $5,000. The personal exemption also favors single filers. For single filers, the personal exemption is $2,500 until you get to a maximum Adjusted Gross Income (AGI) of $60,000 where it drops to $2,000. For married filing jointly, the personal exemption is $2,500 up to $100,000 AGI, then drops to $2,000. State tax brackets also favor single filers as shown below:

Single	0 to $12,750	$12,751 to $60,000	$60,000>
Married filing jointly	0 to $21,250	$21,251 to $100,000	$100,000>

The 2001 General Assembly reduced the marriage penalty by increasing the standard deduction for married filing jointly taxpayers from $5,000 to $6,000. The standard deduction was increased to $5,500 in tax year 2002 and then to $6,000 in tax year 2003. The FY 2001-02 reduction in General Fund revenue was projected to be $9.7 million due to estimated payments and withholding by 762,340 couples in the first half of tax year 2002. The estimated loss for the following fiscal years is shown below.

FY 2001-02	-$9.7 mil.
FY 2002-03	-$32.0 mil.
FY 2003-04	-$45.0 mil.
FY 2004-05	-$45.8 mil.
FY 2005-06	-$46.5 mil.

Section 2.1(a) delays the first $500 increase in the standard deduction to tax year 2003 and Section 2.1(b) delays the additional $500 standard deduction increase to 2004. Since the original fiscal estimate assumed income tax withholding in tax year 2002 (second half of FY 01-02 and first half of FY 02-03), a delay in the standard deduction increase will result in a General Fund revenue gain from increased tax liability on 2002 tax returns. However, not all of the $41.7 million shown in the first two years of the chart will be regained by the General Fund next fiscal year. The 2003 effective date for the standard deduction increase means married filing jointly taxpayers can change their income tax withholding in the first half of 2003 and reduce their tax payments by $9.8 million. The net gain from this delay from 2002 to 2003 is $31.9 million ($41.7 million minus $9.8 million). For the $6000 standard deduction delayed until 2004, the estimated revenue loss is $32.4 million in FY 2003-04. Since the original estimate for FY 2003-04 was $45 million, the General Fund will gain $12.6 million that year.

Note: All revenue estimates for the standard deductions were calculated using the North Carolina Individual Income Tax Model. This tax model was created by the Barents Group for the Department of Revenue and the General Assembly for use in estimating tax law changes. The model bases future year estimates on data from 1998 North Carolina individual income tax returns.

INCREASE TAX CREDIT FOR CHILDREN

The current $60 child tax credit was approved by the 1995 General Assembly. The 2001 General Assembly increased the child credit from $60 to $75 per child in tax year 2002 and from $75 to $100 in tax year 2003. The first increase will reduce General Fund revenue $19.8 million in FY 2002-03 for taxpayers filing returns in the spring of 2003. The second year increase will boost the revenue loss to $54.8 million in FY 2003-04. This tax change will benefit 18,354 single tax filers, 496,286 married couples, and 411,648 heads of households in tax year 2002. This revenue estimate was calculated using the North Carolina Individual Income Tax Model.

Section 2.2(a) delays the first $15 increase in the tax credit from 2002 to 2003 and Section 2.2(b) delays the second $25 increase from 2003 to 2004. The delay will eliminate the $19.8 million General Fund loss for FY 2002-03 and result in a General Fund revenue gain of an equal amount. There is a revenue gain of $34.9 million in FY 2003-04 because the $75 credit in 2003 has a $19.9 million revenue loss versus the $54.8 million loss for the now scheduled $100 credit.

PART III: UPDATE IRC REFERENCE

CONFORMITY

Section 3.1 changes the state tax law reference to the Internal Revenue Code from January 1, 2001, to May 1, 2002. Since North Carolina individual and corporate income tax law tracks the federal income tax law, it is necessary each year to update state statutory references to the Internal Revenue Code (IRC). Congress enacted two major bills in calendar years 2001 and 2002 that have a negative revenue impact on the state General Fund.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) included numerous provisions that impact North Carolina individual and corporate income tax. This bill conforms the state to the education provisions in the bill that affect education IRAs, Qualified Tuition Plans, deduction for higher education expenses, interest from student loans, and employer provided assistance. The bill conforms to the pension provisions in the act that affect IRA contribution limits, deferred comp plan deferral limits, and plan portability. The bill accepts changes in the phase out of itemized deductions and personal exemptions beginning in 2006. However, the bill does not conform to the estate tax changes in the act.

The state will conform to the Job Creation and Worker Assistance Act of 2002 except for the accelerated depreciation rules. Included in the bill were changes to net operating losses, the extension of expiring tax provisions, and a new above the line $250 deduction for teachers' classroom expenses.

The estimate of the state's revenue gain or loss from the federal changes is based on the fiscal analysis of the Congressional Joint Committee on Taxation. The federal analysis includes the effects of certain behavioral responses to tax proposals, including shifts between nontaxable and taxable sources of income, changes in amounts of charitable giving, and changes in the timing of realization of some sources of income. To derive an estimate for North Carolina for individual income tax changes, the federal income tax receipts for the U.S. were compared to the North Carolina General Fund income tax receipts for the July 2000 to July 1 2001 period (with adjustments for earmarks and refunds). The resulting percentage was .735%. For corporate income tax, a .59% rate was derived using the 1997 US Economic Census on Manufacturing.

The state revenue impact from conforming to the two federal bills is as follows:

Conformity		**($million)**			
Category	**02-03**	**03-04**	**04-05**	**05-06**	**06-07**
Economic Growth and Tax Relief Reconciliation Act of 2001					
Education	-14.6	-20.5	-25.3	-27.8	-15.8
Pensions, IRA's	-6.1	-14.3	-18.5	-24.7	-29.4
Other					-12.8
Job Creation and Worker Assistance Act of 2002					
Net operating losses	-4.7	-3.9	2.5	1.7	1.1
Other	8.5	13.2	-8.4	-26.1	-20.3
	-16.9	**-25.5**	**-49.7**	**-76.9**	**-77.3**

The bill also conforms the North Carolina gift tax exclusion to the federal inflation-adjusted gift tax exclusion used by the federal government. This indexing process was introduced as a part of the 1997 federal tax revision. Under current North Carolina law the annual gift tax exclusion is $10,000. Tax rates of 1% to 17% are applied to the portion of a gift beyond that amount, depending upon the amount of the gift and the relationship between the donee and donor (Rates of 1% to 8% apply to the smaller gift amounts). These tax rates will not change as a result of the bill. However, the amount excluded from taxation will change as the amount of the federal exclusion changes. This year the federal inflation adjusted exclusion amount was increased to $11,000. The next exclusion amount change is not expected for at least three years, as that exclusion is only adjusted by increments of $1,000 whenever a threshold is crossed. As such, Fiscal Research assumes that the bill effectively increases the exclusion to $11,000 for three fiscal years, and then moves the exclusion to $12,000 in the following two fiscal years.

In FY 2001-02 the Department of Revenue, Personal Taxes Division received 6,500 gift tax returns. However, the report that the year was rather extraordinary, as they generally receive approximately 6,000 returns a year. Recently the Tax Research Division pulled a sample of 114 returns from the 2001-02 fiscal year. These returns indicate the following revenues from the $1,000 gap between $10,000 and $11,000 in gifts:

Relationship to Donor	**Tax Rate**	**Revenue**
Lineal Ancestor	1%	53,596
Other Family	4%	4,664
Other	8%	127,712
Total		185,972

Given the volatility in gift tax returns, Tax Research believes an estimate of approximately $180,000 to $200,000 for the $1,000 threshold change is reasonable. This suggests that conforming to the indexing of the gift tax will cost the state approximately $180,000 to $200,000 in the first three years and $360,000 to $400,000 in the next two fiscal years. The larger of these amounts are used as the estimate.

ACCELERATED DEPRECIATION

The first step in the analysis of Sections 3.2 and 3.3 was a simulation of the impact of the 30% bonus depreciation and the add-back on individual projects. A project size of $10 million was selected, although the analysis is the same regardless of the magnitude of the investment. Bonus depreciation is eligible for projects with a class life of up to 20 years. Thus, the following classes of asset lives would be impacted.

Class (Years)	**Class Life Range (Years)**
3	Less than 4
5	4-9
7	10-15
10	16-19
15	20-24
20	25 or more

The analysis assumed the use of the modified accelerated cost recovery system (MACRS). This system includes depreciation schedules based on double-declining balance depreciation rates for 3, 5, and 7-year property. For other classes, straight-line depreciation must be used. In addition, the analysis used the "mid-year convention" for the assumed investments.

The simulation looked at investments for all class lives eligible for bonus depreciation. Each calculation compared the current law depreciation with that under the 30% bonus. Under the 30% bonus schedule, the "regular depreciation" declines since it is calculated against the depreciation base after the application of bonus depreciation. Thus, the decline in normal depreciation offsets the first-year increase in total depreciation due to the bonus amount so that over the life of the asset there is no net change in the depreciation taken.

In addition, the impact of the 100% and 80% addbacks, and the “giveback” of the addback beginning in 2005, is calculated. The first-year net impact of bonus depreciation varies by asset class, with the largest short-term tax savings going to the assets with the longest lives. **The net impact of both the bonus depreciation and add-back are essentially zeroed out over the long term**.

To determine the impact on state revenues, a mathematical relationship was established between the net impact of "bonus depreciation with add-back" and "bonus depreciation only". This ratio was then compared to the "bonus depreciation only" fiscal impact of numerous states as reported in the National Conference of State Legislatures (NCSL) survey. These estimates were then adjusted to North Carolina based on corporate tax receipts in each state. In addition, the recent report of the Center for Budget and Policy Priorities (CBPP) contained estimates for particular states. The estimate used in this analysis relies heavily on the CBPP report.

In addition to the steps listed above, Fiscal Research also reviewed the fiscal impact statements in the three states that have adopted add-backs. The states are Nebraska (85% add back), Ohio (83.33%), and Minnesota (80%). This review, coupled with phone conversations with tax analysts in all three states, indicated that the add-backs used make the bonus depreciation approximately revenue-neutral for FY 2002-03. For future years, the net impact depends on the "add-back subtraction" schedule adopted.

The discussions with other states confirmed the difficulty of developing a precise fiscal estimate. The biggest problem is that after simulating the case-by-case impact of the proposal on investments with different class lives, there is no way to know how to weight the different simulations. The reason is that capital investment data compiled by the U.S. Department of Commerce does not provide a breakdown by asset life.

A particular problem encountered was the 2001 tax year. The federal change was effective for investments after September 10 of the year. Under current Department of Revenue instructions, calendar year taxpayers were able to use bonus depreciation for the 2001 tax year if they were able to modify their return in the few days between the federal enactment and the March 15 filing date. Other affected taxpayers will be eligible for a refund, but only after action by the General Assembly. These different possibilities make it difficult to determine how much of the 2001 tax year impact occurred in FY 2001-02 versus FY 2002-03.

The cash-flow estimates are conservative in terms of the weighting of asset classes in the calculations.

ESTATE PICK UP TAX

The regular inheritance tax was repealed in North Carolina by the 1998 General Assembly, effective for deaths occurring on or after January 1, 1999. Following the tradition of the other 36 states that have repealed their primary death tax, a “pickup” tax continues to be levied in North Carolina to use up the credit allowed on the federal estate tax return for state death taxes. In the absence of such a levy, the federal tax liability of the estate would be increased and potential state dollars would flow to the U.S. treasury.

In 2001 the congressional tax package made two changes that will have an effect on a small number of large estates as well as pickup tax collections in many states. First, the federal tax was phased out over a number of years until it is completely eliminated in 2010. This was accomplished primarily through higher federal credits. In the first few years, the higher credits reflect an acceleration of the credit phase-up under the 1997 federal tax relief bill. In addition, the 2001 bill phases out the state death tax credit over four years, beginning with deaths occurring on or after January 1, 2002.

The starting point for the analysis of Section 3.4 was the pickup tax revenue estimates included in the official revenue forecast used in amending the FY 2002-03 General Fund budget. The FY 2002-03 forecast of $117.3 million of pickup taxes was grown by 4% per year to determine receipts for future years (until the tax is effectively eliminated due to the repeal of the federal credit for state death taxes). Fiscal Research then reviewed the projected cost for each year of full conformity to the 2001 federal changes contained in the Center For Budget and Policy Priorities (CBPP) report. In addition, we looked at state by state estimates contained in the NSCL survey and adjusted these numbers to North Carolina by using state-specific federal estate tax return data for 1993-99 (reported gross estate numbers). The estimates finally adopted for purposes of this fiscal note were slightly higher than the CBPP numbers and near the top of the range of the estimates of other states.

This "full conformity" estimate was then modified to determine the "higher federal credits" conformity ("partial conformity") cost by comparing the CBPP estimates for full conformity and partial conformity for the 2002-03 fiscal year (18%). This led to an annualized FY 2002-03 projection of $7.3 million. For future years, the partial conformity estimate was based on the relationship of the CBPP projection of partial conformity for North Carolina to full conformity.

PART IV: UNAUTHORIZED SUBSTANCE TAX EXPENSES

Part IV will reduce the General Fund share of the administrative costs of the Unauthorized Substance Tax Division of the Department of Revenue, which administers the excise tax on unauthorized substances. Seventy-five percent (75%) of the tax proceeds are distributed to the law enforcement agencies that conducted the investigations that led to the assessments, and twenty-five percent (25%) of the tax proceeds are credited to the General Fund. In some years, the amount credited to the General Fund has not covered the costs of the Unauthorized Substance Tax Division.

Local law enforcement agencies receive most of the proceeds from the 75% that is distributed to law enforcement agencies. Therefore, the proposal is that local entities bear their proportionate share of the costs of the Unauthorized Substance Tax Division. To accomplish this, seventy percent (70%) of the costs would be taken from local sales and use tax revenue, as this percentage of the Division's cost is considered to be for the benefit of the local entities. This change in cost assignment requires an amendment to G.S. 105-501. This proposal does not change the amounts that are distributed to local law enforcement agencies. It simply recognizes that the Unauthorized Substance Tax Division primarily benefits local entities and that local entities should therefore bear their share of the expense.

The amount of the costs to be taken from the local sales and use tax is 70% of the costs of the Division rather than 75% because a small part of the amount that is distributed to law enforcement agencies is distributed to State law enforcement agencies. By the Department's records, the amount distributed to State law enforcement agencies is less than 5%. Using 70% instead of 75% therefore ensures that the costs borne by local entities are proportionate to the benefits they receive.

The General Fund will be reimbursed from local Sales and Use Tax funds transferred to a non-tax GF revenue account for 70% or $886,893 of the division's operating budget. Essentially, relieves the GF of a portion of the division's operating expense.

PART V: INSURANCE REGULATORY CHARGE

Part V of the bill sets the insurance regulatory charge at 6.5%. This is the same amount set in the previous year. This fee is assessed against the 1.9% premiums tax paid by insurers or against the presumed premiums tax that would be paid by HMOs and Article 65 companies (Blue Cross/Blue Shield) if taxed at 1.9%. The revenue is used to reimburse the General Fund for appropriations to the Department to pay expenses incurred in regulating the industry and other industries and to other departments as specified in G.S. 58-6-25(d).

The premiums tax collections for FY 2002-2003 are estimated to be $315.79 million. The HMOs and the Article 65 companies must pay a regulatory charge based on their presumed premiums tax at 1.9% (they pay .833% in 2002 and 1% in 2003). The presumed premium tax for the HMOs and Article 65 companies is estimated to be $68.83 million.

With the premiums tax collections of $315.79 million and the presumed premiums tax of $68.83 million from the HMOs and Article 65 companies, the total base against which the insurance regulatory charge will be assessed is estimated to be $384.62 million. Applying the 6.5% regulatory fee to the $384.62 million base would generate $25 million in regulatory fee revenue.

The certified budget for the Department, based on actions taken during the 2001 Session, is $23.5 million. In addition to reimbursing the General Fund for appropriations to the Department, the Insurance Regulatory Fund will also reimburse the General Fund for the $486,000 appropriated to support the Managed Care Patient Assistance Program (MCPAP), established by S.L. 2001-446. The total reimbursement to the General Fund is estimated to be $24 million. The Department estimates that the reserve will have a balance of $11.98 million at the beginning of FY 2002-2003. The total available from the reserve fund of $11.98 million and the estimated collections of $25 million will be $36.98 million. The total available less the estimated General Fund reimbursement of $24 million will leave a year-end reserve balance of $12.98 million. This reserve is above one-third of the estimated General Fund reimbursement.

The above calculation is based on the certified budget for FY 2002-2003 and does not include any adjustments to the FY 2002-2003 Budget that are or will be under consideration during the 2002 Session. Based on the above, the regulatory surcharge rate of 6.5% is sufficient to defray the estimated cost of the operations of the Department and provide for a reserve fund. The Department recommends that the rate remain the same and would not recommend a decrease in the rate because of the unknowns in the economy.

PART VI: REGULATORY FEE FOR UTILITIES COMMISSION

<u>Part VI</u> of the bill sets the fees for regulation by the North Carolina Utilities Commission ("Commission"). <u>Section 6(a)</u> of the bill sets the rate at 0.1%, the same as the current rate. Revenue from this fee, which is assessed against regulated public utilities, is used to support the operations of both the Commission and the Public Staff. Based on estimated FY 2002-03 jurisdictional revenues of $10,854,768,332, the regulatory fee will produce $11,700,238. For the same period, the Commission estimates that the combined operations of the Commission and Public Staff will require total expenditures of not less than $11,695,970. The net change in the Commission's Accumulated Fee Margin Reserve Account is therefore approximately $4,268. The estimated balance in this account as of June 30, 2003, is $4,941,393. This represents approximately five months of operating reserve.

<u>Section 6(b)</u> of the bill sets the public utility regulatory fee to be paid by the North Carolina Electric Membership Corporation for the 2002-03 fiscal year at $200,000. In 1999 the initial fee of $200,000 was developed as a result of discussions between the industry and the Utilities Commission, based on what the Utilities Commission believed to be the cost associated with regulating the electric membership cooperatives. In 2001 the Utilities Commission provided information to Fiscal Research illustrating that these fees will support approximately 4000 hours of accounting, engineering, and legal time. This fee amount must be set by the General Assembly each year.

PART VIII: SECURE LOCAL REVENUES

In the spring of 2001, as a result of substantial budget shortfall, the governor escrowed $95.0 million of reimbursement payments to local governments. This payment is made as a reimbursement for revenues lost by the state's repeal of the property tax on various inventories. The funds were placed in an escrow account in case they were needed to balance the state budget on June 30, 2001. These funds were later released to the local units. In 2002, again facing a difficult fiscal situation, Governor Easley escrowed the spring inventory tax reimbursement to local governments. This $95.0 million was again placed in a special account to hold in case it was needed to balance the state budget in 2002. At the same time the governor announced he was holding an additional $114.0 million in reimbursements and shared revenues to secure his ability to balance the state budget. The $114 million included the following estimated amounts:

Fund Type	***Amount Withheld***
Franchise Utility Tax	
March Distribution	35.6
June Distribution	25.0
Piped Natural Gas	
March Distribution	6.9
June Distribution	11.8
Beer and Wine Tax	26.8
Homestead Exemption	7.9
TOTAL	**114.0**

Sections 8.1 – 8.7 are an attempt to secure these revenues from future gubernatorial action. This legislation has no direct impact on the budgets passed by the General Assembly, as these shared revenues have not been used in the legislative process for state expenditures. However, the legislation could limit the options available to the Governor. Because of the lack of clarity about what actions will be required of the Governor in future years, and the impact this particular legislation will have on the individual's decisions, no fiscal estimate is possible on the impact of the legislation.

Part IX: CLOSE CORPORATE TAX LOOPHOLES

BUSINESS INCOME

The Tax Research Division of the Department of Revenue analyzed 1999 corporate income tax returns and found that the maximum amount of additional tax revenue from the proposal would be $293.4 million. For 2000, the maximum would be $442.5 million. The higher number for 2000 is due to an increase in the amount of nonbusiness income from all sources shown on 2000 returns and a higher weighted average apportionment factor.

The extent to which total reported nonbusiness income can be brought into the tax base depends on how much of this income is not reported to other states and whether there are certain types of nonbusiness income that could not be taxed under the federal standards in the bill. The Department of Revenue does not have a good feel for the magnitude of these factors. In addition, the impact of the 2001 recession has reduced the corporate tax base in North Carolina by 33% and economists are still cautious about the outlook for 2002 national corporate profits.

We have not found any situations in which states have recently adopted this legislation and thus had fiscal notes available. Many states have had such laws on the books for many years and a 1992 U.S. Supreme Court decision opened the door for states to pursue enforcement. New Jersey adopted the proposal this year but the quality of the fiscal information was lacking, partly due to the difficulty of making the estimate.

Based on discussions with the Department of Revenue and concern about the uncertainty surrounding the estimates, we have taken a very cautious approach to this estimate.

THROWOUT RULE

There is very little data from other states on this issue. The New Jersey corporation business tax reform package included the item but there was no statement of the methodology behind the fiscal estimate. We are concerned with the lack of quality data on the issue and feel that a conservative estimate equal to roughly 50% of the earlier proposed throwback rule would be workable. In our analysis, we consulted with the corporate staff of the Department of Revenue.

LLC FRANCHISE TAX

There is little available information on this matter. The fiscal estimate used for the 2001 proposal to address the issue was $10.8 million. Discussions with the Department of Revenue about the impact on some taxpayers indicated that the proposal would not only close some of the loophole not addressed last year but would also pick up some of the erosion in the corporate income tax due to the tax planning strategies that have taken place since the 2001 change or might occur in the future. Thus, the proposed change is broader than last year's action.

Part X: HOUSING TAX CREDIT EFFECTIVE DATE CHANGE

The North Carolina Housing Finance Agency identified 8 projects authorized for a 25% state tax credit in 2000 that would qualify for the 75% state tax credit for those in counties damaged by Hurricane Floyd. These projects have been completed or are nearing completion thus the investors in the projects can begin taking the tax credit in FY 2002-03. Assuming the project investors use 100% of the available tax credit, the additional tax credits granted by this part is $10,727,800. Since the state tax credit is taken over five years, the General Fund revenue loss is spread over five fiscal years. The annual General Fund loss due to Part X of the bill is $2.15 million for Fiscal Years 2002-03 to 2006-07.

Projects	County	Federal Tax Credit	State Tax Credit @ 25%	State Tax Credit @ 75%	Additional Credit	2000 Tiers
#1	Craven	$2,648,010	$662,003	$1,986,008	$1,324,005	4
#2	Lenoir	$3,257,450	$814,363	$2,443,088	$1,628,725	3
#3	Lenoir	$2,530,000	$632,500	$1,897,500	$1,265,000	3
#4	Nash	$2,602,800	$650,700	$1,952,100	$1,301,400	4
#5	Pitt	$2,520,980	$630,245	$1,890,735	$1,260,490	4
#6	Pitt	$2,647,460	$661,865	$1,985,595	$1,323,730	4
#7	Wayne	$2,584,270	$646,068	$1,938,203	$1,292,135	3
#8	Wilson	$2,664,630	$666,158	$1,998,473	$1,332,315	3
			$5,363,900	$16,091,700	$10,727,800	

SOURCES OF DATA: Part II: Individual Income Tax Model. Part III: (1) The May, 2002 state-by-state survey of the National Conference of State Legislatures (**Recent Federal Tax Legislation and the States**); (2) A January, 2002 analysis of the Center On Budget and Policy Priorities on state options to conform to the 2001 federal estate tax changes; (3) Bonus depreciation fiscal estimate material from Ohio, Minnesota, and Nebraska; (4) Congressional Joint Committee on Taxation. Part VIII: Office of State Budget and Management. Part X: NC Housing Finance Agency

TECHNICAL CONSIDERATIONS: The January 1, 2002, effective date of the federal changes in Part III means that only three quarters of the 2002-03 fiscal year will be affected by the change since estates have up to nine months after death to file a return. In addition, the January 1, 2005, repeal of the state death tax credit on federal estate tax returns means that one quarter of FY 2005-06 revenues will be affected.

In Part IX of the bill, the 2002-03 estimate for the nonbusiness income change assumes that during the fiscal year the State would receive 100% of the 2002 tax year impact and about 40% of the 2003 tax year. For the other corporate changes, we did not assume that April and June, 2003 estimated tax payments would be adjusted up because the magnitude of the calendar year change is relatively small.

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