GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2017

Legislative Fiscal Note

BILL NUMBER: Senate Bill 325 (First Edition)

SHORT TITLE: Billion Dollar Middle Class Tax Cut.

SPONSOR(S): Senators Tillman, Brock, and Tucker

FISCAL IMPACT
($ in millions)

☑ **Yes** ☐ **No** ☐ **No Estimate Available**

State Impact	FY 2017-18	FY 2018-19	FY 2019-20	FY 2020-21	FY 2021-22
General Fund Revenues:					
Part I: Personal Income Tax	($294.6)	($600.9)	($625.0)	($650.0)	($676.0)
Part II: Business Tax	($34.1)	($118.6)	($160.3)	($167.4)	($175.0)
Part III: Market-Based Sourcing	$5.0	$10.0	$10.5	$10.9	$11.4
General Fund Expenditures:					
NET STATE IMPACT	**($323.7)**	**($709.5)**	**($774.8)**	**($806.5)**	**($839.6)**

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

EFFECTIVE DATE: See bill summary

TECHNICAL CONSIDERATIONS:
None

BILL SUMMARY:

This summary was adapted from the summary prepared by the Legislative Analysis Division.

Part I: Personal Income Tax (all personal income tax changes are effective for taxable years beginning on or after January 1, 2018):

- *Reduce Personal Income Tax Rate*: In 2014, North Carolina moved to a flat tax rate system for personal income tax. The tax rate in 2014 was 5.8%. The rate has gradually decreased over time to 5.499%, where it stands today. Senate Bill 325 would further reduce this rate to 5.35%.
- *Increase Standard Deduction*: Currently the standard deduction is $17,500 for married filing jointly taxpayers and $8,750 for single filers. Senate Bill 325 would increase these standard deductions to $20,000 and $10,000, respectively. The bill would also change the standard deduction for head of household from 80% of the married filing jointly amount to 75%.
- *Increase Mortgage Interest/Property Tax Cap*: To deduct mortgage interest and property taxes, a taxpayer must itemize their deductions, rather than take the standard deduction. North Carolina capped the amount of mortgage interest and property taxes a taxpayer

could deduct in 2014. Currently, the mortgage interest/property tax deduction is capped at $20,000. Senate Bill 325 would increase the cap to $22,000 for married filing jointly taxpayers.

- *Tier the Cap based upon Filing Status*: Currently, the mortgage interest and property tax deduction is capped at $20,000 regardless of a taxpayer's filing status. Senate Bill 325 would vary the cap on this deduction based on the filing status of the taxpayer: for taxpayers married filing jointly, the cap would be $22,000; for taxpayers filing as single or married filing separately, the cap would be $11,000; for taxpayers filing as head of household, the cap would be $16,500.

- *Modify and Expand Child Tax Deduction*: North Carolina provides a child tax credit of up to $125 per child; a credit reduces a taxpayer's tax due on a dollar for dollar basis. However, the credit cannot be used to reduce a taxpayer's liability below zero; if a taxpayer does not have a tax liability, then the credit does not benefit that person. Senate Bill 325 would change this credit to a deduction of up to $2,500 per child; a tax deduction reduces a taxpayer's taxable income, to which the tax rate is applied.

  The child tax credit varies based upon the adjusted gross income and filing status of the taxpayer. For married filing jointly, the credit amount is $125 for AGI up to $40,000; $100 for AGI up to $100,000; and $0 for taxpayers whose AGI is over $100,000. The bill would provide a child tax deduction for each dependent child. The bill would expand the number of taxpayer who could benefit from the deduction by increasing the AGI limit from $100,000 to $120,000. It would also provide five deduction amounts, as opposed to the current two credit amounts. For married filing jointly, the deduction amounts and AGI brackets are as follows:

Adjusted Gross Income	**Deduction Amount**
Up to $40,000	$2,500
Over $40,000 – Up to $60,000	$2,000
Over $60,000 – Up to $80,000	$1,500
Over $80,000 – Up to $100,000	$1,000
Over $100,000 – Up to $120,000	$500
Over $120,000	$0

Part II: Business Tax (effective dates for corporate income tax changes are noted below):

- *Reduce Corporate Income Tax Rate*: North Carolina began gradually decreasing the corporate income tax rate in 2014. Prior to 2014, the corporate income tax rate was 6.9%. Currently the corporate income tax rate is 3%. Senate Bill 325 would reduce this rate further over the next two years to 2.75% for 2018 and 2.5% for 2019. The tax rate change to 2.75% would be effective for taxable years beginning on or after January 1, 2018. The tax rate change to 2.5% would be effective for taxable years beginning on or after January 1, 2019.

- *Reduce Franchise Tax for S Corporations*: S Corporations currently pay franchise tax at a rate of $1.50 per $1,000 of net worth. Senate Bill 325 would reduce this amount to a flat rate of $200 on the first $1,000,000 of net worth and $1.50 for every $1,000 of net worth over $1,000,000. This change is effective for taxable years beginning on or after January 1, 2019, and would be applicable to the calculation of franchise tax reported on the 2018 and later corporate tax returns.

Part III: Market Based Sourcing (This section is effective for taxable years beginning on or after January 1, 2018):

A corporation that does business in more than one state must pay income tax to each of the states in which it has nexus. A state may tax the income of multistate corporations as long as the income is fairly sourced to the state. In 2015, North Carolina began phasing in single sales factor apportionment over a three year period. Single sales factor apportionment is based on the percentage of in-state sales a corporation makes, which arguably incentivizes multistate companies that provide products to expand its property and payroll because those factors are ignored in determining state tax on profits. This does not incentivize multistate companies who provide services because the tax is not based off of the consumption of the company's services in a state, but rather the percentage of business activities conducted in the state, which is generally measured by the amount of labor costs and capital investment in a state to provide the services. Therefore, states that adopt a single sales factor apportionment usually adopt a market-based calculation of the sales factor for all multistate corporations, including those that provide services.

Market-based sourcing, coupled with single sales factor, would apportion the income of a multistate corporation based on the amount of the corporation's products and services consumed in North Carolina. North Carolina Department of Revenue was directed during the 2016 Legislative Session to adopt rules on market-based sourcing. These rules have been adopted and approved by the Rules Review Commission.

ASSUMPTIONS AND METHODOLOGY:

Part I: Personal Income Tax

Fiscal Research estimated the impact of the individual income tax changes using the FRD Tax Model and 2014 taxpayer data from the North Carolina Department of Revenue. Because the income tax changes are effective for taxable years beginning January 1, 2018, the FY 2017-18 estimate includes the withholding and estimated payments for the first half of 2018, which represents approximately 50% of the annual impact.

Part II: Business Tax

Sections 2.1 and 2.2 – Corporate Tax Rate

Fiscal Research estimated the impact of the corporate income tax rate reductions based on the Consensus Revenue Forecast. Timing adjustments were made to account for estimated tax payments and differences between the State's fiscal year and the typical calendar tax year.

Section 2.3 – Franchise Tax

Fiscal Research estimated the impact of the franchise tax rate reduction based on the Consensus Revenue Forecast, and based on franchise tax statistics provided by the Department of Revenue.

Part III: Market-Based Sourcing

The estimated fiscal impact is derived from Market Based Sourcing Informational Reports submitted by multistate corporations comparing the apportionment calculation as filed on 2014 tax returns to what the apportionment calculation would have been if a market based apportionment calculation was used. Fiscal Research made further adjustments to account for legislative changes that have gone into effect after the 2014 tax year, including reductions in the corporate income tax rates. Multi-state corporations using North Carolina more as their primary place of employment and capital investment have less income subject to tax with market based sourcing. Multi-state corporations using North Carolina more as a consumer marketplace rather than as a place of employment and capital investment have more income subject to tax under market based sourcing. This offsetting effect results in an estimated $10 million increase in annual tax collections. This amount is comprised of both income and franchise tax collections because the percentage used to determine the share of a multi-state corporation's income to tax is also used to determine the percentage of a corporation's net worth that is subject to the franchise tax. Because of the difference between the State's fiscal year and the calendar year, a partial fiscal impact for the 2018 tax year is recognized in FY 2017-18.

SOURCES OF DATA: North Carolina Department of Revenue; Internal Revenue Service; Moody's Analytics

TECHNICAL CONSIDERATIONS: None

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