GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2011

Legislative Fiscal Note

BILL NUMBER: Senate Bill 94 (First Edition)

SHORT TITLE: IRC Update.

SPONSOR(S): Senators Hartsell, Tillman, and Newton

FISCAL IMPACT					
	Yes (x)	**No ( )**	**No Estimate Available ( )**		
	FY 2010-11	**FY 2011-12**	**FY 2012-13**	**FY 2013-14**	**FY 2014-15**
REVENUES:					
($ millions)					
Decouple from Bonus depreciation	-.5	-1.1	-.2	1.1	.5
Decouple from Section 179 expensing for 2010 and 2011, keep 250k limit for 2011, conform to fed in 2012 and 2013	-.1	-4	-.3	.3	.4
Increase to capital gain exclusion for small business stock	0	0	0	0	-2
Increased start-up expense deduction	-2.5	-.8	.1	.2	.2
Deduction of health insurance for SE tax	2.8	1.2	.1	0	0
Allow 457 plan deferral to be treated as Roth	.1	.2	.2	.3	.4
Allow rollovers from elective deferral plans to Roth	1.6	4.3	4.7	3.9	4.4
Partial Annuitization of a nonqualified annuity contract	0	.2	.3	.5	.7
Source rules for income on guarantees	1.4	1.9	1.9	1.9	1.9
Tax Relief Act	0	0	0	5.4	3.1
Estate Tax	0	-59	-79	-20	0
Total	2.8	-57.1	-72.2	-6.4	9.6
PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Department of Revenue					
EFFECTIVE DATE: Effective when it becomes law					

BILL SUMMARY: This proposal would update the reference to the Internal Revenue code used in defining and determining certain State tax provisions from May 1, 2010, to January 1, 2011. By doing so, North Carolina would conform to many of the changes made by the federal Small Business Jobs Act of 2010 (2010 Jobs Act) and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act). The proposal would not conform to the following federal tax law provisions:

- Bonus depreciation. – Bonus depreciation allows a business to claim more of a deduction up front and spread the remainder out over the normal deprecation schedule. Over the life of the asset, the taxpayer receives the same benefit. The normal deprecation schedule is usually five to 15 years, depending upon the asset. In the past, Congress has provided 50% bonus depreciation for qualified property to spur economic investment. The bonus depreciation provision was scheduled to expire for property acquired and placed in service in 2010. The 2010 Jobs Act extended the 50% bonus depreciation provision to property placed in service in taxable years 2010 and 2011. The 2010 Tax Relief Act boosted the 50% bonus depreciation to 100% for property acquired and placed in service after September 8, 2010, and before January 1, 2012, and it provided 50% bonus depreciation for property placed in service after December 31, 2012, and before January 1, 2013. Although the proposal decouples from bonus depreciation, it provides that the property's basis is the same for federal and State purposes. The taxpayer must add-back 85% of the accelerated depreciation amount in the year that it is claimed for federal tax purposes, and then deduct 20% of this amount, plus the normal depreciation amount, over the next five years.

- Section 179 expensing. – Section 179 expensing allows the expensing of the purchase price of some business assets in the year of purchase rather than taking depreciation over the life of the asset. Section 179 has a deduction limit that begins to phase out on a dollar for dollar scale once an investment limit is reached. The deduction limit is $25,000 and the investment limit is $200,000. In the past, Congress has increased both the deduction limit and the investment limit to spur economic investment. For the 2010 taxable year, the deduction limit was $250,000 and the investment limit was $800,000. The expensing limits were scheduled to revert to their prior levels in 2011. The 2010 Jobs Act expanded the section 179 deduction limits from $250,000 to $500,000 for the 2010 taxable year and from $25,000 to $500,000 for the 2011 taxable year; it expanded the investment limits from $800,000 to $2,000,000 for the 2010 taxable year and from $200,000 to $2,000,000 for the 2011 taxable year; the expensing limits were scheduled to revert to their prior levels in 2012. It also broadened the definition of qualified property to include certain real property investments for the 2010 and 2011 taxable years. The 2010 Tax Relief Act expanded the section 179 deduction limits for the 2012 taxable year from $25,000/$200,000 to $125,000/$500,000; the expensing limits are scheduled to revert to their prior levels of $25,000/$200,000 in 2013. The proposal would maintain the 2010 deduction limits of $250,000 and $800,000 for taxable years 2010 and 2011. It would decouple from the enhanced limits of $500,000 and $2,000,000 for taxable years 2010 and 2011 but provide that the property's basis would be the same for federal and State purposes. The proposal provides that a taxpayer must add-back 85% of the additional expensing taken under federal law in 2010 and 2011 and may deduct 20% of this amount over the succeeding five years. The proposal would conform to the expensing limits of $125,000/$500,000 for the 2012 taxable year.

- Estate tax. – The federal estate tax expired for decedents dying in 2010. The estate tax had been scheduled to reemerge in 2011 at the 2001 exclusion amount of $1 million and the maximum estate tax rate of 55%. The 2010 Tax Relief Act revived the federal estate tax retroactively to January 1, 2010, with an exclusion amount of $5 million (the portability provision effectively provides an exclusion amount of $10 million for married couples) and a maximum estate tax rate of 35%. The estate of a decedent dying in 2010 may elect not to pay estate tax, and receive a modified carryover basis in the property passing through the estate. The estate tax provisions are scheduled to return to the 2001 rates and exclusion amounts for decedents dying on or after January 1, 2013. The proposal would conform to the higher exclusion amounts and give estates that chose to pay federal estate tax and receive the stepped-up basis in the property passing through the estate to elect to receive the stepped-up basis for NC purposes by paying the State estate tax for 2010.

The proposal would conform to all other provisions in the 2010 Jobs Act and the 2010 Tax Relief Act. The other provisions in the 2010 Jobs Act include the following:

- An increased exclusion amount of the gain realized on qualified small business stock. The exclusion amount is increased from 50% to 75% for stock acquired after February 17, 2009, and before January 1, 2011, and held for more than five years.
- An increased deduction limit for start-up expenses. The deduction is reduced by the amount of start-up costs that exceed a certain amount. The deduction limit is increased from $5,000 to $10,000 and the phase-out threshold is increased from $50,000 to $60,000.
- Various other small provisions that are intended to generate revenue. – Deduction for health insurance costs, 457 plans, 401(k) rollovers to Roth accounts, annuitization of a nonqualified annuity contract, sources rules for income on guarantees.

The 2010 Tax Relief Act extended many of the tax incentives enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 for two years. North Carolina conformed to these incentives in 2002; however, under existing North Carolina law, several of these incentives expired for the 2010 taxable year and many others are scheduled to expire for the 2011 taxable year. The proposal would conform to the federal effective date extensions.

The 2010 Tax Relief Act extended the following business tax incentives that were set to expire for the 2010 taxable year for the 2010 and 2011 taxable years:

- 15-year recovery period for qualified leasehold improvements, restaurant building and improvements, and retail improvements
- Seven-year recovery period for motor sports entertainment costs recovery
- Expensing election for certain film and television production costs
- Brownfields remediation expensing

The 2010 Tax Relief Act extended the Work Opportunity Tax Credit (WOTC) to include individuals who begin employment after August 31, 2011, and before January 1, 2012. North Carolina's WOTC is equal to 6% of the federal WOTC for wages paid for positions located in this State. The federal WOTC was scheduled to expire September 1, 2011.

The 2010 Tax Relief Act extended the following charitable incentives for taxable years 2010 and 2011:

- Deduction for contributions of food inventory
- Deduction for contributions by C corporations of books to public schools
- Deduction for corporate contributions of computer equipment for educational purposes
- Basis adjustment to stock of S corporations making charitable contributions of property

The 2010 Tax Relief Act extended the following individual income tax incentives retroactively for the 2010 taxable year and the 2011 taxable year:

- Tax deduction for higher education tuition expenses
- Up to $250 deduction for teacher's classroom expenses
- Charitable contribution of IRA proceeds

The following individual income tax incentives were scheduled to expire in 2011, but 2010 Tax Relief Act extends the incentives for the 2011 and 2012 taxable years:

- No limitation on itemized deductions.
- Enhancements to the earned income tax credit (EITC). North Carolina's EITC is equal to 5% of the federal credit amount.
- Enhancements to the adoption tax credit. North Carolina's adoption tax credit is equal to 50% of the federal credit amount.
- Deductibility of mortgage insurance premiums.
- Educational assistance exclusion.
- Student loan interest deduction.
- Increased amount that may be contributed to Coverdale education savings accounts and expansion of qualified expenses to include elementary and secondary school expenses.
- Exclusion of scholarships received from the national Health Services Corps Scholarship Program and the Armed Forces Scholarship Program from income.

***Source*:** Committee Counsel Bill Summary

ASSUMPTIONS AND METHODOLOGY:
Except as outlined below, the fiscal impact to the General Fund from partial conformity with the IRC update is based on the US Joint Committee on Taxation (JCT) estimates on changes to federal taxes from the update. The methodology used begins with these JCT estimates, which are calculated by federal fiscal year. Fiscal Research adjusts these numbers back to an approximate calendar year tax impact. Then the next step was to prorate the national numbers to the state impact. This adjustment involved two steps: accounting for the relative size of the state based on federal tax collections and then adjusting for the difference in federal and state marginal tax rates. Once North Carolina’s share of the JCT estimates were determined, state tax liability changes were estimated and allocated to the appropriate fiscal year.

The estimate of the bonus depreciation provision is based on data obtained from the Department of Revenue from the 2004 and 2008 tax returns. The estimate is derived from the tax that would not have been paid had North Carolina not required an add-back for bonus depreciation in computing State taxable income for both of those years. In order to assess the impact of the 85% add-back of the bonus depreciation and the Section 179 deduction, a depreciation schedule was developed. The depreciation simulation was used to determine the impact of the bonus depreciation and the Section 179 deduction with the adoption of an 85% add-back rule and a 5 year deduction for each fiscal year.

The estimate to conform to the estate tax provision of the Tax Relief Act was prepared based on tax return data obtained from the Department of Revenue for the 2007, 2008, and 2009 tax years. The impact is estimated from the tax that would not have been received as a result of the increase in the federal exclusion amount.

The Tax Relief Act of 2010 included multiple extensions of tax credits and deductions which were first enacted under the Economic Growth and Tax Relief Reconciliation Act of 2001. Because the changes were extensive and the Act was in place for ten years, the revenue base was adjusted to include the impacts from the Act. If the Tax Relief Act had not been enacted, then the result would have been an increase in General Fund revenue as result of the various federal tax law changes expiring for the 2011 tax year. Because they were extended for two years, there is no impact for FY 2011-12 and FY 2012-13. In the out years, after the latest extensions expire there will be a net gain to General Fund revenues. As with other calculations related to federal tax changes, analysis from the JCT was used to determine state tax liability. General Fund revenue changes would occur in FY 2013-14 and FY 2014-15.

SOURCES OF DATA: US Joint Committee on Taxation, US Bureau of Economic Analysis, NC Department of Revenue

TECHNICAL CONSIDERATIONS: None

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