Finance Committee FY 2011-13 Highlights

Fiscal Brief

May 13, 2012

The North Carolina General Assembly House and Senate Finance Committees address changes to State tax law. This fiscal brief highlights the Committees' changes enacted during the 2011 Session.

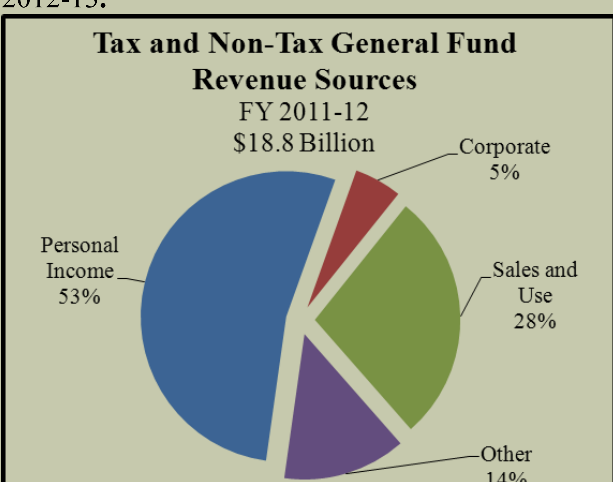
Actual and Projected General Fund Tax and Non-Tax Revenue Sources Since FY 2009-10, ($ in Millions)

	Actual FY 2009-10	Actual FY 2010-11	Projected FY 2011-12	Projected FY 2012-13
Personal Income	9,048	9,735	9,920	10,561
Sales and Use	5,565	5,873	5,270	5,510
Corporate Income	1,198	1,014	988	1,046
***Other**	2,700	2,472	2,583	2,716
Total	$18,510	$19,093	$18,761	$19,833

*Other includes other taxes and non-tax revenue sources

Revenue Outlook and Finance Overview

The 2011-12 consensus revenue forecast maintains a cautious approach to the State's revenue outlook. Baseline revenue is projected to grow 4.6 percent to $18.8 billion for FY 2011-12. Due to $1.3 billion in expiring taxes, the $18.8 billion represents a decline of $336.1 million from the previous year's collections. That decline, along with the uncertainty surrounding the pace of growth in the economy, further strengthens the position that a full economic expansion during the next biennium is improbable. The forecast includes a 5.6 percent growth in General Fund revenue for FY 2012-13.



S.L. 2011-145, the Appropriations Act of 2011 (H.B. 200), as amended by S.L. 2011-391, 2011 Budget Technical Corrections (H.B. 22), enacted several tax law changes to simplify the tax filing process, reduce taxes for small businesses and provide additional economic development incentives. For budgetary purposes, these changes reduced General Fund availability by $131.6 million during the 2011-12 fiscal year and will result in a $335.6 million reduction in General Fund availability during FY 2012-13. S.L. 2011-145, the Appropriations Act of 2011, enacts a $467.2 million reduction in budget availability for the biennium through tax law changes. The legislation also increased various fees, generating State and county revenues of $100.9 million in fiscal year 2011-12 and $101.4 million in fiscal year 2012-13.

When considering tax reductions in the Appropriations Act and separate legislation passed by the Finance Committees, the General Assembly reduced taxes by a total of $596.5 million during the 2011-13 biennium. The Finance committees considered various options for tax relief, focusing on three major themes: 1) tax relief for small businesses, 2) income tax law changes, and 3) economic development incentives. This Fiscal Brief provides a summary of legislation in those three areas as well as an overview of other 2011 House and Senate Finance Committee activities.

Tax Relief for Small Businesses

Initial Steps toward Tax Reform

Section 31A.1 of S.L. 2011-145, the Appropriations Act of 2011 (H.B. 22), changed the starting point for calculating North Carolina taxable income. The legislation amended G.S. 105-134.5 and G.S. 105-134.6 providing tax relief for small businesses and simplifying the calculation of personal income tax.

To calculate State income tax liability, filers will now start with Adjusted Gross Income (AGI) instead of federal taxable income. This change simplified the tax preparation process but did not expand the tax base and was revenue neutral. All deductions and credits when calculating federal taxable income were retained.

In prior years, individuals calculated federal taxable income and then made the necessary adjustments to compute their North Carolina taxable income. Differences in the federal and State standard deductions and personal exemptions made this process confusing.

Reducing the Tax Liability of Small Businesses

Section 31A.1 also provided an income tax deduction of up to $50,000 for business income received during the tax year. The deduction is not available to C-corporations. This section applied to tax years beginning January 1, 2012.

Section 31A.2 of the budget exempted from the franchise tax base reserves for amortization of intangible assets from surplus and undivided profits. Examples of intangible assets include goodwill, patents, copyrights, franchises, trademarks and trade names. This change became effective retroactively for tax years beginning on or after January 1, 2007.

Other Income Tax Law Changes

Conforming to the Federal Income Tax Code

North Carolina tax law was modified to conform with most of the federal tax law changes made during 2010, including changes to the estate tax. S.L. 2011-5 (H.B. 124), the Internal Revenue Code Update, as amended by S.L. 2011-330 (S.B. 267), modified G.S. 105-228.90 to update North Carolina's reference to the federal Internal Revenue Code. The act incorporated many, but not all, of the tax provisions contained in the federal Small Business Jobs Act of 2010 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. North Carolina did not conform to bonus depreciation and the enhanced business property expensing. With the exception of the estate tax, the Act's impact on General Fund availability was minimal.

North Carolina's conformity to the higher estate tax exclusion amount of $5 million, and effectively $10 million for married couples, reduced General Fund availability by $59 million in FY 2011-12 and by $79 million in FY 2012-13. Starting in calendar year (CY) 2011, the exclusion amount for estates was scheduled to be $1 million and the maximum estate tax rate was scheduled to be 55 percent. By conforming to the federal changes, the exclusion amount for 2011 and 2012 is $5 million ($10 million for married couples) and the maximum tax rate is 35 percent.

Combined Returns for Multistate Corporations

S.L. 2011-390 (H.B. 619) changed the Secretary of Revenue's authority to adjust the income of a multistate corporation by requiring it to file a combined return. The legislation repealed G.S. 105-130.6 replacing it with G.S. 105-130.5A to establish criteria concerning the Secretary of Revenue's authority. Under current law, a corporation must file a combined return if the Secretary determines that the corporation conducts its business in a way that failed to accurately reflect its income attributable to North Carolina. The Secretary, in these instances, may re-determine the net income of a corporation.

Effective for taxable years beginning on or after January 1, 2012, the Secretary may only make this redetermination if the corporation fails to accurately report its State net income through the use of transactions that are not at fair market value or transactions that lack economic substance.* The appendix provides more detail on economic substance.

Economic Development Incentives

S.L. 2011-302 (H.B. 751) modified three different areas of North Carolina's tax law: Article 5F (sales tax for manufacturing machinery), Article 3J (tax credits for growing businesses), and Article 3A (tax incentives for new and expanding businesses).*

*Article 5F (Excise Tax for Manufacturing Machinery)**

S.L. 2011-302 (H.B. 751) added two types of machines to those exempt from the sales and use tax but subject to the mill machinery excise tax, Article 5F. Under Article 5F, a one percent tax applies to purchase price of manufacturing machinery. The maximum tax liability per piece of machinery is $80 (G.S. 105-187.51B). For this reason, the excise tax for mill machinery, Article 5F, is also referred to as the one-percent or $80 tax (1%/$80).

S.L. 2011-302 (H.B. 751) expanded the types of machinery eligible for taxation under Article 5F to include: 1) specialized equipment purchased by a business used at a port facility to unload or process bulk cargo making it suitable for delivery and use by manufacturing facilities, and 2) distribution machinery, and parts or accessories for mill machinery purchased by a large manufacturing and distribution facility for storage, use, or consumption in the State.

The expansion of the 1%/$80 excise tax to include distribution and assembly equipment becomes effective July 1, 2013 and did not impact revenues this biennium.

*Article 3J (Tax Credits for Growing Businesses)**

S.L. 2011-302 (H.B. 751) amended Part 2 of Article 10 of Chapter 143B authorizing the Secretary of Commerce to designate certain areas as Port Enhancement Zones. This change made certain businesses located within the port enhancement zones eligible for preferential tax treatment under the Article 3J incentives. The tax incentives for port enhancement zones become effective for tax years beginning on or after January 1, 2013. These changes did not impact revenues in this biennium.

*Article 3A (Tax Incentives for New and Expanding Businesses)**

S.L. 2011-302 (H.B. 751) also modified G.S. 105-129.12A, Article 3A, creating an exception for which a taxpayer may continue to take the remaining installments of the Bill Lee tax credit. The Bill Lee tax credit for substantial investment in other real property can be claimed, but at a reduced amount, when the number of employees the taxpayer employs at the property falls below 200 workers.

Lastly, the law amended G.S. 142-83 clarifying a provision passed in S.L. 2007-323 (H.B. 1473) and modified in S.L. 2009-451(S.B. 202) related to the use of special indebtedness funds received by Appalachian State University.

The retention of the remaining installments of an Article 3A tax credit became effective retroactively for taxable years beginning on or after January 1, 2009, and reduced revenue by approximately $400,000 annually for five years, beginning in FY 2010-11.

Other Legislation

Tax Credits for Children with Disabilities

S.L. 2011-395 (H.B. 344) created a tax credit for parents of children with special needs who choose to educate those children in a non-public school or in a public school at which tuition is charged. The credit amount is up to $3,000 per semester, for up to two semesters a year. The credit is non-refundable, but any unused portion of the credit may be carried forward for the succeeding three years. Effective for tax years beginning on or after January 1, 2011, the legislation applies to semesters beginning on or after July 1, 2011 and reduced General Fund availability by an estimated $1.4 million in FY 2011-12. The legislation increases General Fund availability in future years by producing an annual net savings of approximately $9.0 million once fully implemented.

Prepaid Wireless/Point of Sale Collection

S.L. 2011-122 (H.B. 571) amended Chapter 62A of the General Statues imposing a fee on prepaid wireless telecommunication services. The revenue generated from the $0.60 per transaction prepaid wireless fee will be used to finance the technological improvements and administrative costs of enhancing emergency telephone services as determined by the 911 Board. The fees, effective July 1, 2013, are expected to generate $7.3 million per year in e-911 funds when fully implemented.

*Definitions provided in the appendix.

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APPENDIX

2011 House and Senate Finance Committee Highlights, ($ in Millions)

	FY 2011-12	FY 2012-13	FY 2013-14	FY 2014-15
Tax Relief for Small Businesses				
Initial Steps Toward Tax Reform	0	0	0	0
Reducing the Tax Liability of Small Businesses	(131.6)	(335.6)	(359.1)	(381.5)
Other Income Tax Changes				
Conforming to the Federal Income Tax Code	(57.1)	(72.2)	(6.4)	9.6
Combined Returns for Multistate Corporations		Undetermined		
Economic Development Incentives				
Article 5F: Sales Tax for Manufacturing Machinery			(0.1)	(0.1)
Article 3J: Tax Credits for Growing Businesses		Undetermined		
Article 3A: Tax Incentives for New and Expanding Businesses	(0.4)	(0.4)	(0.4)	(0.4)
Other Legislation				
Tax Credits for Children with Disabilities	(1.4)	2.3	9.2	9.0
Prepaid Wireless/Point of Sale Collection			4.9	7.3
Total	($190.5)	($405.9)	($351.9)	($356.1)

Definitions for Frequently Used Terms

Term	Definition
Article 5F	Article 5F refers to the excise tax applied to Manufacturing Fuel and Certain Machinery and Equipment. Under Article 5F, a one percent excise (sales) tax applies to purchase price of manufacturing machinery. The maximum tax liability per piece of machinery is $80.
Article 3J	S.L. 2006-252, created Article 3J, Tax Credits for Growing Businesses. This article provides income tax incentives for certain companies that meet location, employment, and wage standards among other criterion.
Article 3A	The General Assembly enacted Article 3A, Tax Incentives for New and Expanding Businesses, during the second extra session of 1996. Article 3A includes income tax incentives for certain types of companies that meet investment, wage, and employment standards among other criterion.
Economic Substance	The economic substance test is a legal definition used to identify whether a business transaction was conducted for business purposes or for tax purposes. Transactions with economic substance are those that have purpose and change in a meaningful way the taxpayer's economic position apart from income tax effects.