Part I of Revenue Laws Recommendations: IRC Update.

2019-2020 General Assembly

Committee:	Revenue Laws Study Committee	**Date:**	May 11, 2020
Introduced by:		**Prepared by:**	Cindy Avrette Staff Attorney
Analysis of:	Part I		

***OVERVIEW:** The Revenue Laws Study Committee voted to update the State's reference to the Internal Revenue Code from January 1, 2019, to January 1, 2020, at its March meeting.*

Since the March meeting, Congress enacted the CARES Act. Part I of the Revenue Laws Recommendations bill draft would update the State's Code reference to May 1, 2020 and decouple from the tax changes in the CARES Act that would negatively impact State tax revenues.

CURRENT LAW: North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code. Article V, Section 2(1) of the North Carolina Constitution does not allow the General Assembly to delegate its taxing power. Therefore, the General Assembly must determine each year whether to update its reference to the Code.

BILL ANALYSIS: Part I of the *Revenue Laws Recommendations* bill draft would update North Carolina's Code reference from January 1, 2019, to May 1, 2020. Congress enacted two bills since January 1, 2019 that change the federal tax laws: Public Law 116-94, enacted on December 20, 2019, and Public Law 116-136, enacted on March 27, 2020.

Public Law 116-94 incorporated the *Taxpayer Certainty and Disaster Tax Relief Act of 2019*. The Act extended certain individual and business-related tax provisions. One of the "extenders" is a reduction of the threshold amount by which unreimbursed medical expenses for the year must exceed adjusted gross income to qualify for the itemized medical expense deduction. The law reduced the percentage from 10% to 7.5% for the 2019 and 2020 taxable years.[1] The bill would conform to this change. It would decouple from the following "extenders", from which the State has historically decoupled:

- Income exclusion for forgiveness of debt on primary residence.
- Mortgage insurance deductible as mortgage interest.
- Deduction for tuition and expenses.

Public Law 116-136, the Coronavirus Aid, Relief, and Economic Security Act, also known as the CARES Act, provided tax relief to individuals and businesses. The *Background* section describes the tax relief in more detail. The bill draft would decouple from the following provisions:

- Modifications for net operating losses, that includes the suspension of the 80% taxable income limitation and the five-year carryback period.

[1] The percentage was 7.5% for 2017 and 2018. It was scheduled to increase to 10% for 2019. The federal legislation "extended" the 7.5% for an additional two years.

- Increase of the percentage of a taxpayer's adjusted taxable income that factors into the calculation of the limitation on deduction of business interest from 30% to 50% for taxable years 2019 and 2020.
- Loan forgiveness of a covered loan, which is a loan forgiven under the Paycheck Protection Program.
- Temporary suspension of the limitations on individual itemized charitable contributions during 2020, and the $300 above-the-line deduction for charitable contributions available to non-itemizers.
- Exclusion from wages and gross income of employer-provided payments on student loans for the 2020 tax year.

EFFECTIVE DATE: This act is effective when it becomes law.

BACKGROUND: Public Law 116-94 also incorporated the *Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act).* The SECURE Act makes several changes related to tax-advantaged retirement accounts and 529 accounts. North Carolina will conform to these changes. One of the IRA changes pushes back the age at which a retirement plan participant must take required minimum distributions from 70 ½ to 72, and another requires most non-spouses inheriting IRAs to take distributions that end up emptying the account in 10 years. The 529 account plan changes expand the allowable uses for 529 funds to pay for certain student loan expenses up to $10,000 lifetime maximum as well as certain apprenticeship program expenses.

Public Law 116-136, the CARES Act, provided the following tax modifications:

- A refundable income tax credit for 2020 that taxpayers may receive in advance of filing a 2020 income tax return. The amount of the credit is equal to $1,200 ($2,400 in the case of a joint return), and $500 for each qualifying child. The credit amount is phased out at a rate of 5% of AGI above $150,000 for joint returns, $112,500 for heads of household, and $75,000 for all other filers. There are no State tax consequences of this federal tax credit.
- The Paycheck Protection Program provided loans to qualifying businesses. The loan amount may be forgiven if certain conditions are met. Generally, the amount of debt forgiven is includable in gross income of the recipients for tax purposes. The CARES act provided that this amount would be excluded from gross income for federal tax purposes. The bill draft would decouple from this provision, meaning the amount of debt forgiven would be included in gross income for State purposes.[3] This treatment is the same the State has historically taken with income exclusion for forgiveness of debt on primary residences.
- Several temporary changes with respect to net operating losses (NOL) arising in taxable years 2018, 2019, and 2020. NC's individual income tax laws follow the federal NOL rules.[4] A NOL generally means the amount by which a taxpayer's business deductions exceed its gross income.

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[3] The intent of the General Assembly is to maintain the current law taxability of amounts included in gross income by reason of forgiveness and the deductibility of business expenses. To do so, the bill decouples from the federal policy decision to exclude from gross income any amount that would otherwise be included in gross income by reason of forgiveness of a loan under the Paycheck Protection Program. Indications from Congress are that it intended to allow a double tax benefit: the exclusion from income of the amount forgiven and the deductibility of the expenses. The deductibility of business expenses, for State tax purposes, may need to be amended later depending upon what actions are taken at the federal level.

[4] NC has its own corporate net loss rules.

The NOL deduction generally[5] is limited to 80% of taxable income determined without regard to the NOL deduction and excess losses may be carried forward indefinitely, but not back. Under the CARES Act, the 80% taxable income limitation is suspended for tax years 2018, 2019, and 2020 and the NOL may be carried-back five years.[6] The bill draft decouples from these temporary changes. A taxpayer will be able to deduct the entire NOL, but over a longer period. The bill draft requires the taxpayer to addback the excess amount allowed to be deducted by the CARES Act, and to deduct this excess amount evenly over five years, tax years 2021-2025.

- Permits taxpayers to increase the percentage of the taxpayer's adjusted gross income that factors into the calculation of the limitation on deduction of business interest. The interest expense limitation caps the amount of interest expense a taxpayer can deduct at 30% of its adjusted taxable income. The limitation only applies to taxpayers whose three-year average gross receipts is greater than $25 million. Any amount that exceeds the cap may be carried forward indefinitely. The CARES act increased the percentage to 50%. The bill draft would decouple from this change, leaving the percentage limitation at 30%; a taxpayer must addback the excess amount in determining State taxable income.
- Allows non-itemizers an above the line tax deduction of up to $300 for charitable contributions, for the 2020 tax year. The bill draft would decouple from this provision; a taxpayer that takes the federal deduction will need to addback the amount deducted in determining State taxable income.
- Liberalizes the charitable contribution limitations for contributions made by individuals and corporations. Charitable contributions of cash are deductible in the amount contributed. For individuals, the amount deductible as a charitable contribution is limited to a percentage of the taxpayer's contribution base[7], and for corporations it is limited to 10% of the corporation's taxable income computed with certain modifications. Excess contributions may be carried forward for five years. Qualifying contributions of food inventory are typically subject to 15% limitations. The CARES act increased the 15% limitation to 25% for charitable contributions of food inventory, the general corporate limitation to 25%, and the general individual limitation to 100%. The increased limits apply to cash contributions only and are limited to gifts to public charities and certain foundations. NC has its own corporate statute regarding charitable contributions, so the federal changes will not impact State corporate income tax. The bill draft decouples from the individual income tax limitation modifications; a taxpayer will have to addback the excess amount deducted at the federal level and carry it forward to succeeding tax years.
- Excludes from wages and gross income certain employer payments of student loans. An employee may exclude from gross income for income tax purposes and from wages for employment tax purposes up to $5,250 annually of educational assistance provided by the employee's employer. Generally, this exclusion does not apply to payments of principal or interest on an education loan incurred by an employee. The CARES Act expanded the definition of "educational assistance" to include student loans. The expansion is only applicable to the 2020 tax year, and the exclusion is still subject to the $5,250 cap. The bill draft decouples from this provision; an employee would be

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[5] Special rules apply with respect to NOLs arising in certain circumstances. For example, there is a special rule providing a two-year carryback in the case of certain farming losses.
[6] For example, a loss incurred in 2018 may be carried back to offset any income in tax years 2013-2017, a loss in 2019 may be carried back to tax years 2014-2018, and a loss in 2020 may be carried back to tax years 2015-2019. Taxpayers will be able to file amended returns for the preceding tax years.
[7] Contribution base is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage varies depending on the type of recipient organization and type of property contributed, but it is generally 60% for cash contributions.

required to addback the amount of payment excluded from federal gross income in determining State taxable income.