Bill Draft 2015-SVxz-2D: IRC Update.

2015-2016 General Assembly

Committee:	Revenue Laws Study Committee	**Date:**	January 13, 2015
Introduced by:		**Prepared by:**	Trina Griffin Committee Counsel
Analysis of:	2015-SVxz-2D		

SUMMARY: Updates from December 31, 2013, to January 1, 2015, the reference to the Internal Revenue Code used in determining certain State tax provisions. The bill decouples from the following extensions under the federal Tax Increase Prevention Act of 2014 for the 2014 tax year, but it would conform to the $250 teacher expense deduction:

- ***Bonus depreciation***
- ***Enhanced Section 179 expensing***
- ***Exclusion from income for forgiveness of debt on principal residence***
- ***Deduction for mortgage insurance premiums***
- ***Deduction for higher education tuition expenses***
- ***Tax-free distribution from IRAs to public charities***

CURRENT LAW: North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.[1] The General Assembly determines each year whether to update its reference to the Code.[2] Updating the reference makes recent amendments to the Code applicable to the State to the extent that State law previously tracked federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. Maintaining conformity with federal tax law simplifies tax reporting because a taxpayer will not need to account for differing federal and State treatment of the same asset. The current reference to the Code is December 31, 2013.

BACKGROUND: On December 19, 2014, the Tax Increase Prevention Act of 2014 (TIPA) was signed into law[3] and extended several provisions that were enacted last year in the American Taxpayer Relief Act (ATRA). ATRA was intended to avert the anticipated "fiscal cliff" due to the sunset provisions scheduled to take effect in 2013 that would have ended the Bush-era tax cuts contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), which were temporarily extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act).

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[1]North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

[2]The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation … shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would … be invalidated as an unconstitutional delegation of legislative power."

[3] P.L. 113-295.

ANALYSIS:

UPDATE IRC REFERENCE DATE

Section 1 of the bill would update the reference to the Code from December 31, 2013, to January 1, 2015.

COUPLED PROVISION

By updating the reference to the Code, North Carolina would conform to various provisions, including the following:

Teachers' Classroom Expense Deduction

This bill would result in conformity with the extension of the federal teachers' classroom expense deduction for tax year 2014.

Explained. – This deduction allows primary and secondary education professionals to take an above-the-line deduction for qualified expenses up to $250 paid out-of-pocket during the year.

Federal Background. – This deduction was established under EGTRRA in 2001 (beginning with tax year 2002) and was scheduled to expire in 2006. It was subsequently extended through 2013. TIPA extended the deduction for one more year.

North Carolina Background. – Prior to 2012, teachers in North Carolina were allowed the deduction at the State level because North Carolina began its calculation of taxable income with federal AGI. In 2012, North Carolina enacted a stand-alone individual income tax deduction for this purpose. The stand-alone provision was enacted because, at the time, the federal deduction was set to expire and Congress had not yet acted to extend it. However, this deduction was repealed as part of the Tax Simplification and Reduction Act of 2013 (HB 998), effective for tax years beginning on or after January 1, 2014. Because Congress has extended the deduction for tax year 2014, the update of the IRC reference in this bill would mean that teachers will continue to be able to take advantage of this deduction.

DECOUPLED PROVISIONS

Bonus Depreciation[4]

Explained. – Businesses may depreciate the cost of a new asset[5] over a period of time, usually five to 15 years. Bonus depreciation allows a business to claim more of a deduction up front and spread the remainder out over the normal depreciation schedule.

Federal Background. – Since 2002, businesses have been authorized to take an additional depreciation deduction on depreciable property ranging from 30% to 100%, known as bonus depreciation. The 2010 Tax Relief Act provided 50% bonus depreciation for qualified property placed in service after December 31, 2012, and before January 1, 2013. The American Taxpayer Relief Act of 2013 extended the 50% bonus depreciation provision for one year, and TIPA extended it for an additional year.

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[4] Because North Carolina has already permanently decoupled from bonus depreciation, this bill has no impact in that regard. It is mentioned in the summary because it is the first tax year that the permanent provision is in effect (See. G.S. 105-153.6(a)).

[5] One important difference between bonus depreciation and section 179 expensing is that bonus depreciation applies only to new equipment, while section 179 expensing may apply to new and used equipment.

North Carolina Background. – Since 2002, North Carolina has decoupled from the federal bonus depreciation provisions. Under the Tax Simplification and Reduction Act[6], North Carolina permanently decoupled from this provision, which means that the General Assembly does not have to take any action to decouple from this provision to the extent Congress continues to extend it. For taxable years beginning on or after January 1, 2014, a taxpayer is required to add back 85% of the accelerated depreciation amount in the year it is claimed for federal purposes with a corresponding 20% deduction over the next five years. The taxpayer will be deducting the same amount of an asset's basis under State law as under federal law, it is just that the timing of the deduction differs.

Section 179 Expensing

Section 2 of the act does not conform to the one-year extension of the enhanced section 179 expensing provision. For tax year 2014, the deduction and investment limits are $25,000 and $200,000, which are what the limits would have been at the federal level if TIPA had not been enacted.

The act further provides that the property's basis will be the same for federal and State purposes and treats the difference in the same manner as State tax law has historically treated the bonus depreciation: A taxpayer must add back 85% of the additional expensing taken under federal law in 2014 and then deduct 20% of this amount over the succeeding five years. Full conformity to the section 179 expense deduction would have been $52 million.

Explained. – Section 179 of the Code allows taxpayers to immediately deduct, rather than gradually depreciate, the cost of qualified assets, subject to certain limitations.[7] Use of the allowance has two components: a dollar limitation and an investment limitation. The dollar limitation is the maximum amount of the deduction that the taxpayer may elect to take. The investment limitation is the maximum amount that can be spent on equipment before the deduction begins to be reduced. The deduction is reduced, dollar for dollar, by the amount that exceeds the investment limitation. Prior to 2010, section 179 was commonly thought to apply to small businesses because of its maximum deduction and investment limits.[8] However, the enhancements made by the Small Business Jobs Act of 2010 (2010 Jobs Act) were the most expansive ever enacted and those limits were extended under ATRA and TIPA.

Federal Background. – Since 2010, the deduction limitation has been $500,000 and the investment limitation has been $2 million. Without the recent extensions, the limits would have reverted to the prior levels of $25,000 and $200,000.

North Carolina Background. – Prior to 2010, North Carolina typically conformed to the enhanced section 179 expense deduction provisions. However, given the expansive nature of the enhancements made by the 2010 Jobs Act, which have been extended over the last several years, North Carolina has decoupled and adopted lower limits since 2010.[9]

Income Exclusion for Discharge of Qualified Principal Residence Indebtedness

Section 3 of the act does not conform to the extension of the income exclusion for the discharge of qualified principal residence indebtedness. It requires a taxpayer to add back the amount excluded at the

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[6] HB 998; S.L. 2013-316.
[7] Generally, taxpayers take the Section 179 expensing deduction first and claim bonus depreciation on any remaining basis.
[8] Prior to the Emergency Economic Stabilization Act of 2008 (EESA), deduction limit was $125,000 with a phase-out beginning at $500,000.
[9] North Carolina's dollar and investment limitations were $250,000 and $800,000, respectively, for taxable years 2010 through 2012. The dollar and investment limitations for 2013 were $25,000 and $200,000, respectively.

federal level for purposes of determining North Carolina taxable income. The cost to conform to this provision would be approximately $14 million.

Explained. – Taxpayers are generally required to recognize income from the discharge of indebtedness. An exception from this rule is for the discharge of qualified principal residence indebtedness, which has been excludible from gross income on a temporary basis since 2007.[10] The exclusion is limited to $2 million, and applies to indebtedness incurred in the acquisition, construction, or substantial improvement of a principal residence and secured by the residence.

Federal Background. – This exclusion was scheduled to expire for debt discharged after December 31, 2013, but was extended for one year under TIPA.

North Carolina Background. – North Carolina conformed to this provision from 2007 through 2012, but decoupled for the first time for tax year 2013.

Deduction for Mortgage Insurance Premiums as Interest

Section 3 of the act does not conform to the extension of the deduction for mortgage insurance premiums as interest for tax year 2014. Therefore, taxpayers are required to add back the amount they took as a deduction at the federal level for purposes of determining North Carolina taxable income. The cost to conform to this provision would be approximately $4 million.

Explained. – Generally, taxpayers may not deduct any interest paid or accrued during the tax year that is considered personal interest. This restriction does not apply to certain types of interest, including qualified residence interest. Qualified residence interest includes interest on home acquisition indebtedness of up to $1 million and interest on home equity indebtedness of up to $100,000. In the case of a home acquisition loan, an individual who cannot pay the entire down payment amount may be required to purchase mortgage insurance.

Federal Background. –Since 2006, premiums paid for qualified mortgage insurance in connection with acquisition indebtedness for a qualified residence are treated as qualified residence interest and are deductible.[11] The treatment of qualified mortgage insurance as qualified residence interest was set to expire for amounts paid or accrued after December 31, 2013. TIPA extends the availability of the deduction for one year.

North Carolina Background. – North Carolina conformed to this provision from 2006 through 2012, but decoupled for the first time for tax year 2013.

Higher Education Deduction

Section 3 of the act does not conform with the extension of the federal qualified tuition and expenses deduction for tax year 2014. The cost to conform to this provision would be approximately $1 million.

Explained. – Subject to income limitations, a taxpayer may take an above-the-line deduction for qualified education expenses paid during the year for the taxpayer or the taxpayer's spouse or dependents. Generally, any accredited public, nonprofit, or proprietary post-secondary institution is an eligible educational institution. The maximum deduction is $4,000 for an individual whose adjusted gross income for the tax year does not exceed $65,000 ($130,000 for MFJ filers), or $2,000

[10] This exclusion was originally authorized in the Mortgage Debt Relief Act of 2007.
[11] The deduction is subject to a phaseout. For every $1,000, or fraction thereof, by which the taxpayer's AGI exceeds $100,000, the amount of mortgage insurance premiums treated as interest is reduced by 10%.

for other individuals whose adjusted gross income does not exceed $80,000 ($160,000 for MFJ filers).

Federal Background. – This deduction was established under EGTRRA and was scheduled to expire in 2006. It was subsequently extended through 2013. TIPA extended the deduction for one more year.

North Carolina Background. – North Carolina had conformed to this provision until last year when it decoupled for the 2013 taxable year.

Income Exclusion for Distributions from IRAs to Charity

This bill would not conform with the extension of the income exclusion for a qualified charitable distribution from an individual retirement plan by a person who has attained the age of 70½ for tax year 2014. The treatment is capped at a maximum of $100,000 per taxpayer.

Explained. – Generally, a taxpayer must include in gross income distributions made from a traditional or Roth IRA account except to the extent they represent a return of nondeductible contributions or are rolled over into another qualified retirement plan.

Federal Background. – Since 2006,[12] taxpayers age 70½ or older may contribute up to $100,000 from their IRA account to a charity tax-free. This income exclusion was set to expire for distributions made in tax years beginning after December 31, 2013. TIPA extends the availability of this exclusion for one year.

North Carolina Background. – North Carolina conformed to this provision for 2006 through 2012, but decoupled for 2013.

[12] This exclusion was originally authorized by the Pension Protection Act of 2006. The law was extended through 2009 by the Emergency Economic Stabilization Act of 2008, and through 2011, by the 2010 Tax Relief Act.