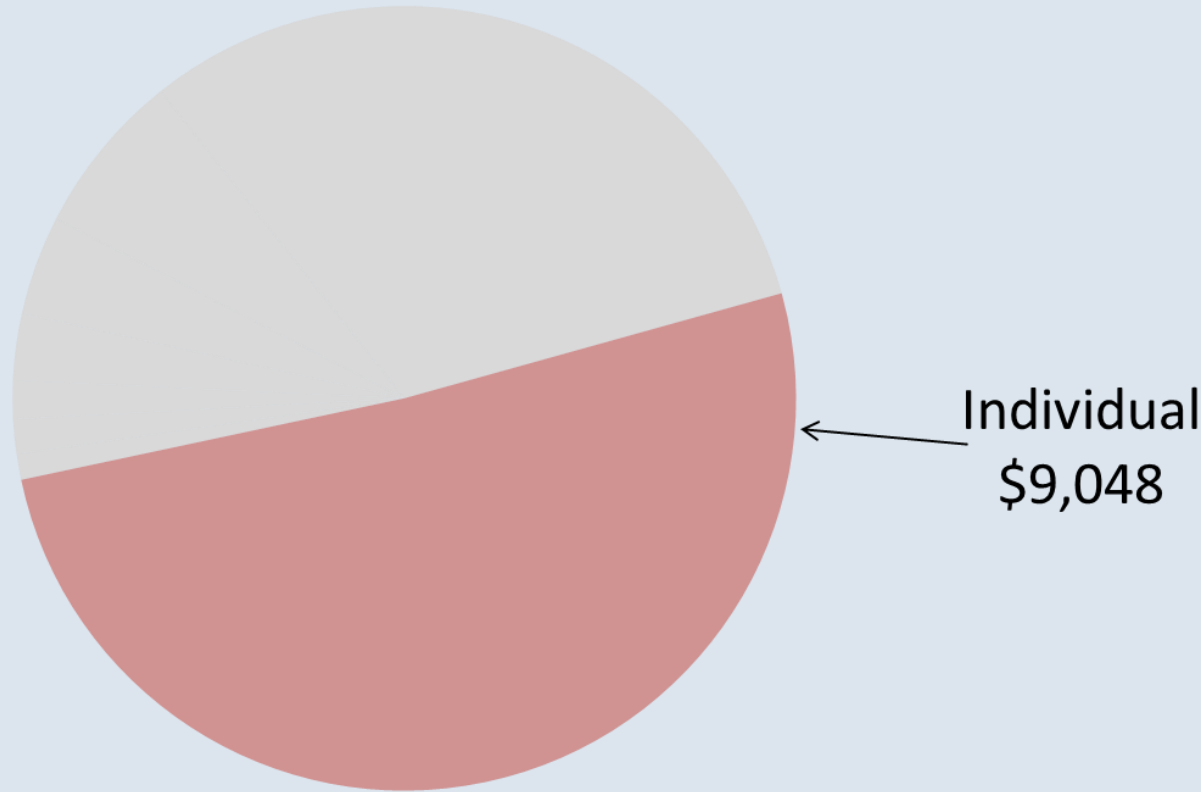


PERSONAL TAXES: INCOME AND ESTATE

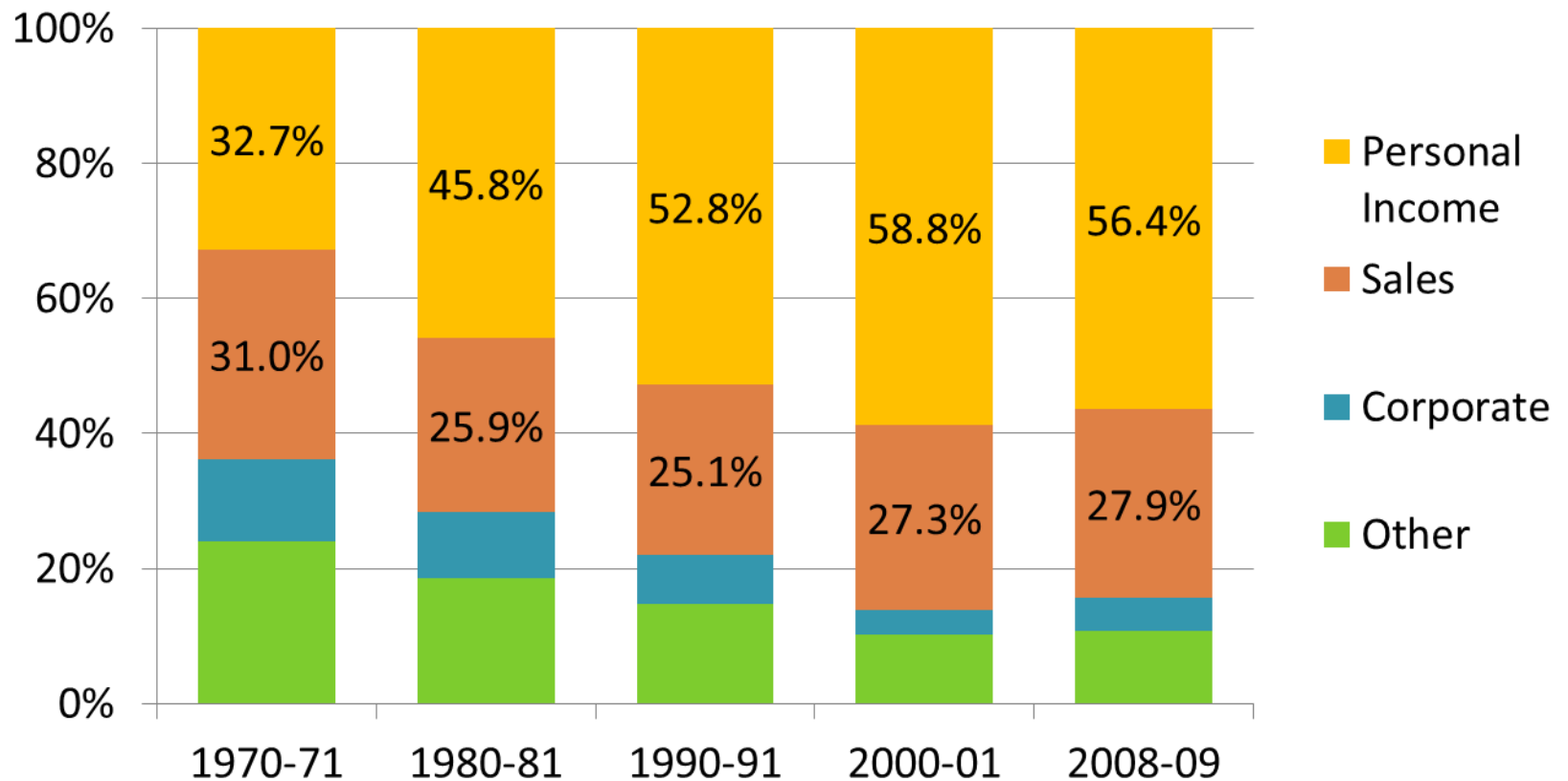
Joint House and Senate Finance, February 3, 2011
Cindy Avrette, Research Division



Personal Income Tax

52% to 55% of General Fund Tax Revenues

State Tax Structure, 1970-2009



Principles of a Sound Tax System

Apply principles to the whole tax system

- ❑ **Promotes equity among taxpayers**
- ❑ **Relatively simple to administer**
- ❑ **Ease of compliance**
- ❑ **Minimizes economic distortions**
- ❑ **Delivers fairly reliable revenue stream during economic downturns**

History of PIT

□ 1849

- ▣ Enacted as a supplement to the property tax
- ▣ Did not fall on income derived from real property

□ 1920

- ▣ State-administered, broad-based income tax
- ▣ Rate limited to 6% of net income by Constitution
- ▣ Limitation increased to 10% in 1925 by amendment

□ 1989

- ▣ Tax Fairness Act of 1989 (Senate Bill 51)

NC PIT Prior to 1989

- ❑ NC did not employ a federal starting point for calculating State taxable income
- ❑ Numerous exemptions and deductions
- ❑ Five tax brackets
- ❑ Rates ranging from 3% to 7%

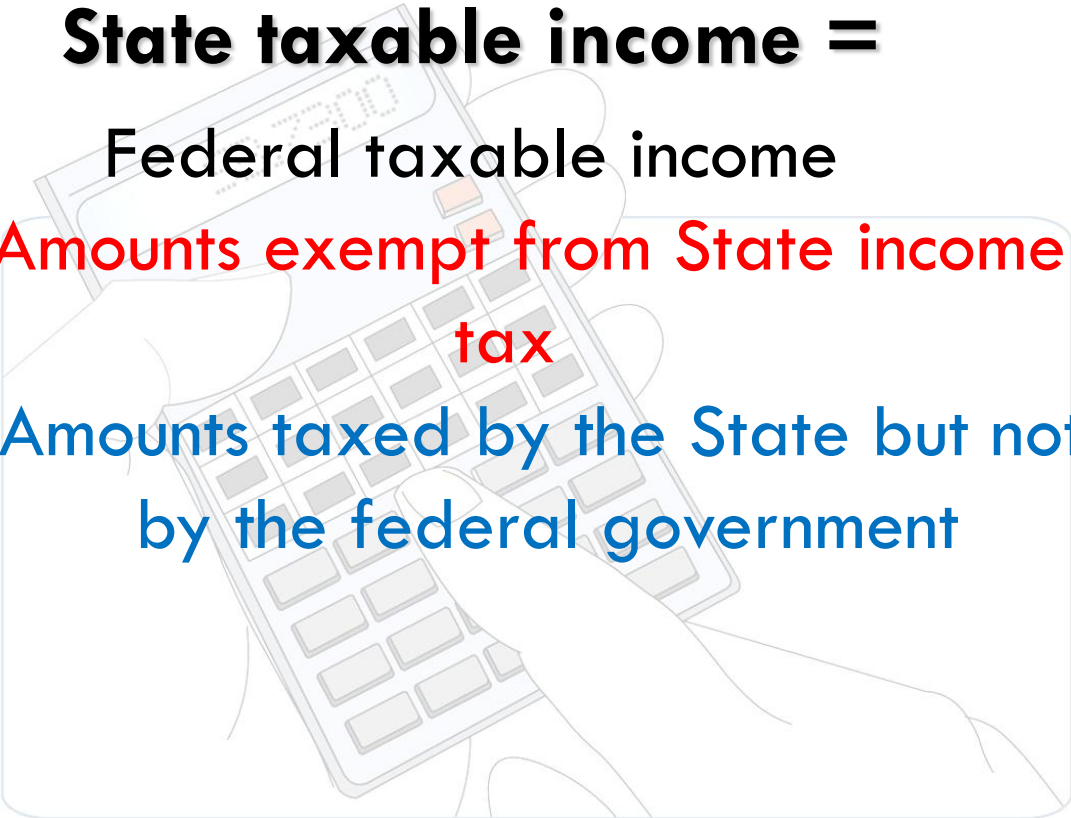


Tax Fairness Act of 1989 (SB 51)

- Simplification: Federal taxable income
 - ▣ Eliminated 30 exclusions
 - ▣ Reduced 47 deductions & exemptions to 7
- Reduced taxes for approximately 65% of the taxpayers
 - ▣ Increased personal exemption and standard deduction, did not index
 - ▣ Two tax brackets with rates of 6% and 7%, did not index

Calculating NC Taxable Income

Federal
taxable
income


$$\begin{aligned} &\text{State taxable income} = \\ &\quad \text{Federal taxable income} \\ &\quad - \text{Amounts exempt from State income tax} \\ &\quad + \text{Amounts taxed by the State but not by the federal government} \end{aligned}$$

Taxable Income v. AGI

Taxable Income

- 6 states use as a starting point
- Represents income after all federally allowed deductions
 - ▣ Personal exemptions
 - ▣ Itemized deductions or standard deduction

Adjusted Gross Income

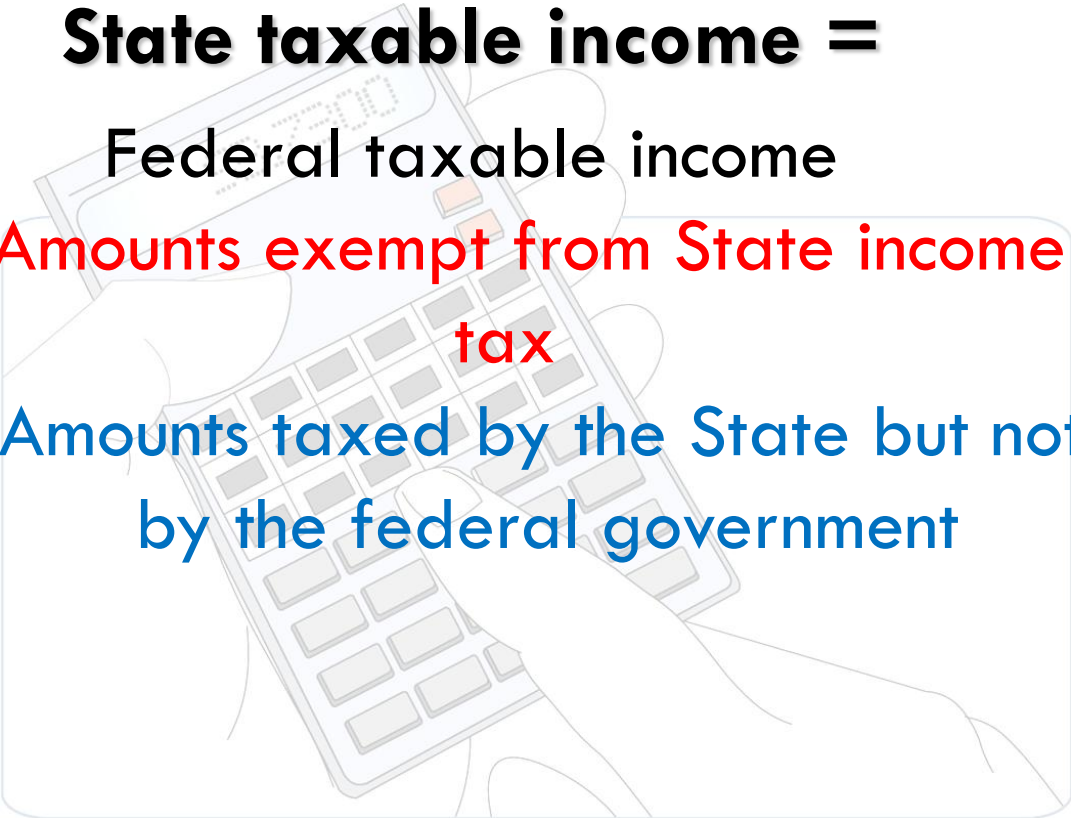
- 29 states use as a starting point
- Represents income after 'above the line' deductions
 - ▣ Business related expenses
 - ▣ Few non-business related expenses

Federal Taxable Income

- Constitutional limitation on delegation of taxing authority
 - ▣ IRC Update legislation each year
- Subjects NC tax revenues to greater number of federal tax policies
- Large number of adjustments (40)
 - ▣ NC does not index personal exemptions or standard deduction
 - ▣ Confusing to taxpayers

Calculating NC Taxable Income

Adjustments to
federal
taxable
income:
Exemptions

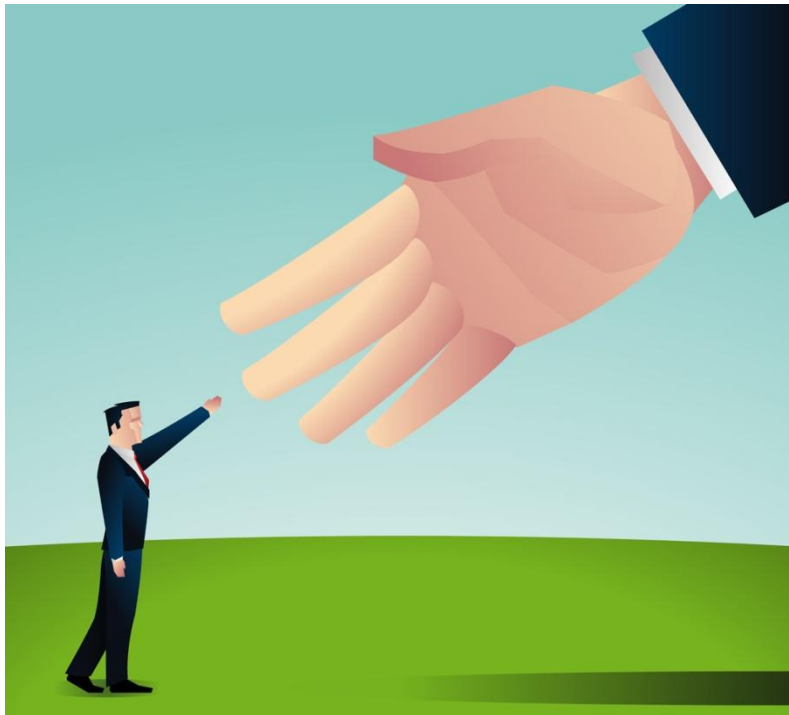

$$\begin{aligned} \text{State taxable income} = & \\ & \text{Federal taxable income} \\ & - \text{Amounts exempt from State income tax} \\ & + \text{Amounts taxed by the State but not} \\ & \quad \text{by the federal government} \end{aligned}$$

State Tax Exemptions: Federal Law

- ❑ Interest on US obligations
- ❑ Income from an Indian tribe
- ❑ Amounts paid under the Railroad Retirement Act of 1937



State Tax Exemptions: Contractual



- Gain from obligations issued before 1995 to the extent allowed by State law
- Bailey retirement income (\$401.7 m)

State Tax Exemptions: Practice

- ❑ Interest on NC and local government obligations and obligations of a nonprofit educational institution chartered in NC
- ❑ The deductible amount for interest on US, NC, and nonprofit educational institutions = \$20.9 m
 - ▣ Deductible amount for NC obligations > \$ 1 m



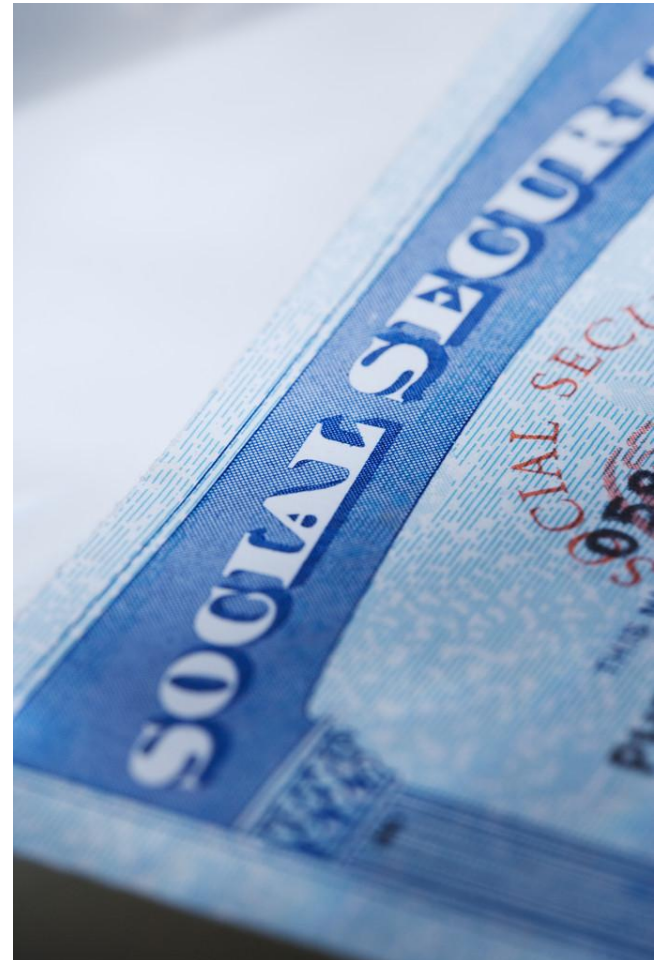
State Tax Exemptions: Accounting



- Refunds of state, local, and foreign taxes
- Amount by which basis of property under State law differs from the basis of the property under federal law

State Tax Exemptions: Social Security

- Full exemption
 - ▣ SSI benefits in excess of federal limit = \$375.4 m
- Other states
 - ▣ 15 states tax SSI to some extent
 - 5 follow federal practice
 - ▣ 26 states fully exempt
 - ▣ 9 states do not impose a PIT



Federal Taxation of SSI Benefits

Federal law began taxing a portion of social security benefits in 1987

- Provisional income
 - ▣ < \$32K, no taxation
 - ▣ \$32K - \$44K, up to 50% taxable
 - ▣ > \$44K, up to 85% taxable
- Only 25% of SSI beneficiaries pay any tax liability on their benefits
- Over 80% of taxable SSI are reported by taxpayers with over \$50,000 of AGI

State Tax Exemption: Retirement

- Retirement income
 - ▣ \$4,000 for governmental retirement income
 - ▣ \$2,000 for private retirement income
- \$80.9 million

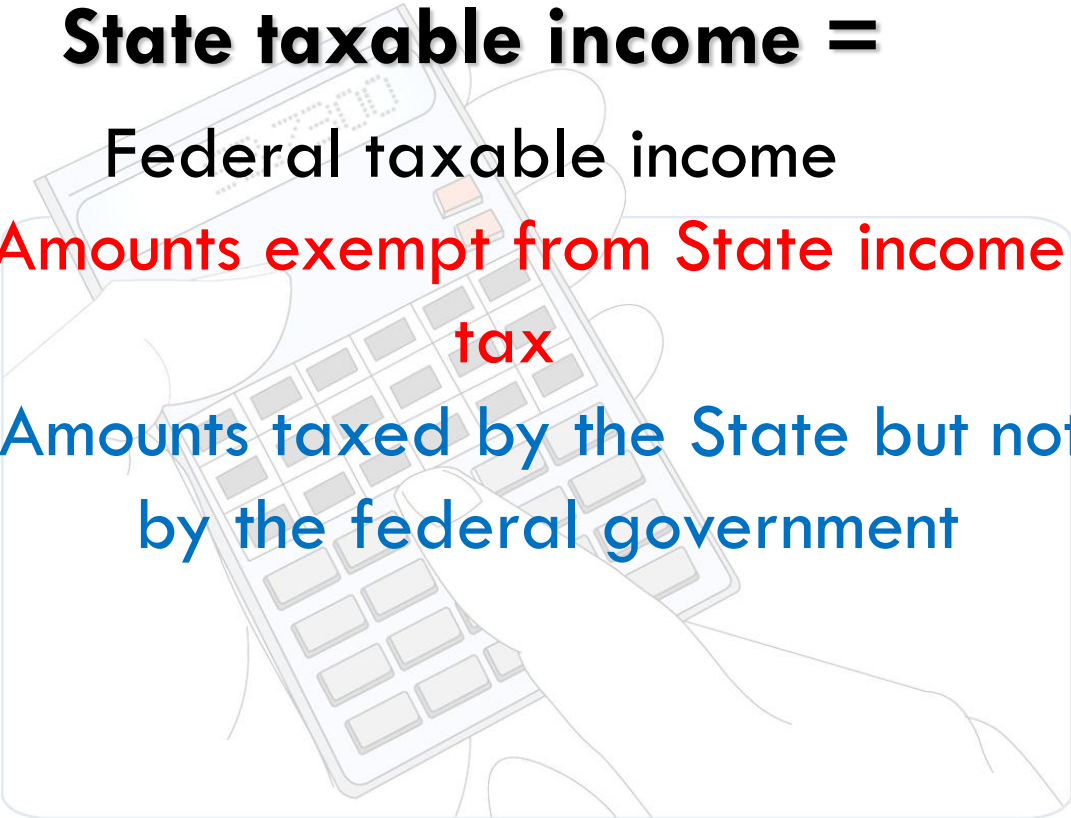


Misc. State Tax Exemptions

- Severance Wages
 - ▣ Not to exceed \$35,000
 - ▣ \$15.5 million
- Erroneous Conviction
- Disaster Relief Reserve Fund
- NC 529 Plan
 - ▣ AGI limits in 2012
 - ▣ \$5 million
- Volunteer Fire and Rescue
 - ▣ \$1 million
- Sale of Mfg'd Home Community to Mfg'd Home Owners

Calculating NC Taxable Income

Adjustments to
federal
taxable
income:
Additions

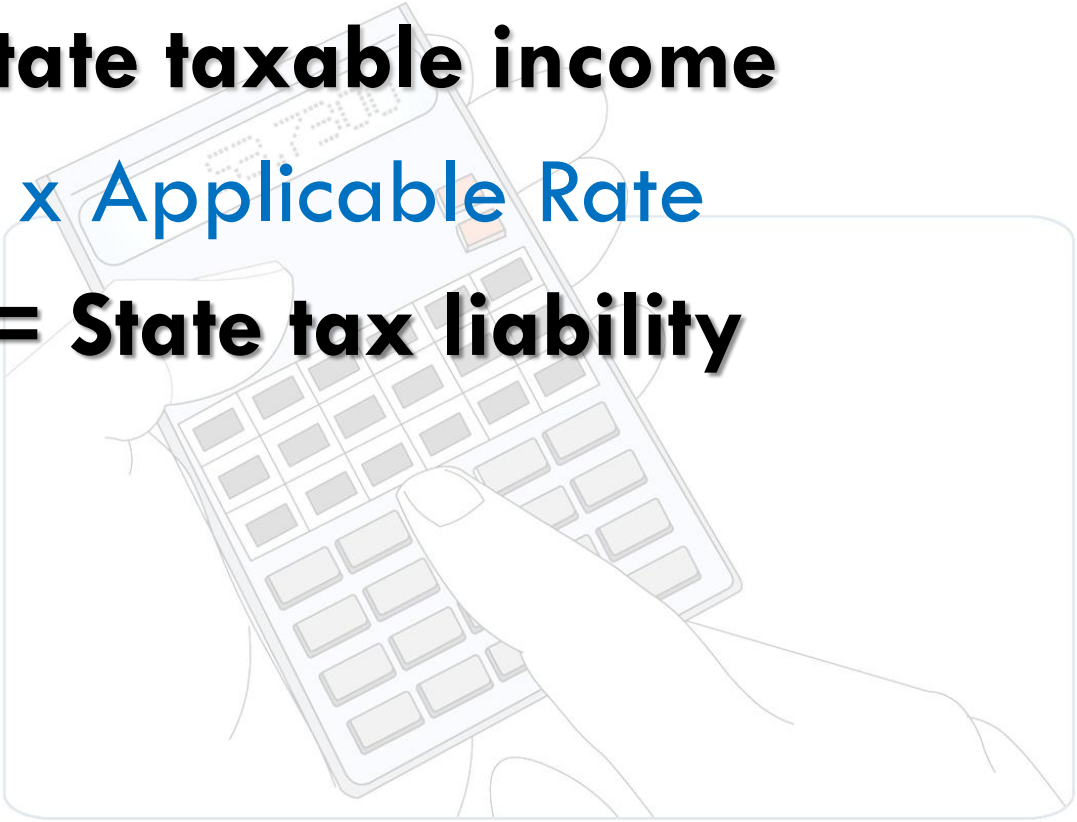

$$\begin{aligned} \text{State taxable income} = & \\ & \text{Federal taxable income} \\ & - \text{Amounts exempt from State income tax} \\ & + \text{Amounts taxed by the State but not by the federal government} \end{aligned}$$

Add Backs: IRC Decoupling

- Standard deduction
 - ▣ Federal = \$5,700 (single; MFS) \$8,350 (H/H)
 - ▣ State = \$3,000 (single; MFS); \$\$4,400 (H/H)
 - ▣ **Add back \$2,700**
- Personal exemption
 - ▣ Federal = \$3,650
 - ▣ State = \$2,500 if AGI < \$100,000 (MFJ)
 - ▣ State = \$2,000 if AGI = or > \$100,000 (MFJ)
 - ▣ **Add back at least \$1,150 for each PE claimed**

Calculating NC State Tax Liability

Applicable
tax rates

$$\begin{aligned} &\text{State taxable income} \\ &\times \text{Applicable Rate} \\ &= \text{State tax liability} \end{aligned}$$
A faint, light blue illustration of a hand holding a calculator, positioned behind the equation. The calculator is tilted, and the hand is shown from the side, with fingers pressing the buttons. The entire illustration is enclosed in a light blue rounded rectangular border.

Tax Brackets and Rates

- Prior to 1989
 - ▣ 6 brackets
 - ▣ Rates ranging from 3% to 7%
- 1989
 - ▣ Two brackets
 - ▣ Rates of 6% and 7%
- 1991
 - ▣ Three brackets
 - ▣ 6%, 7%, and 7.75%
- 2001-2006
 - ▣ Temporary 4th bracket of 8.25%
 - ▣ Extended twice
- 2007
 - ▣ Temporary rate phased down to 8%
- 2008
 - ▣ 3 brackets
 - ▣ 6%, 7%, and 7.75%
- 2009 and 2010
 - ▣ Temporary surtax
 - ▣ 2% surtax, taxable income exceeds \$100K (MFJ)
 - ▣ 3% surtax, taxable income exceeds \$250K (MFJ)

Comparison to Other States

Rates

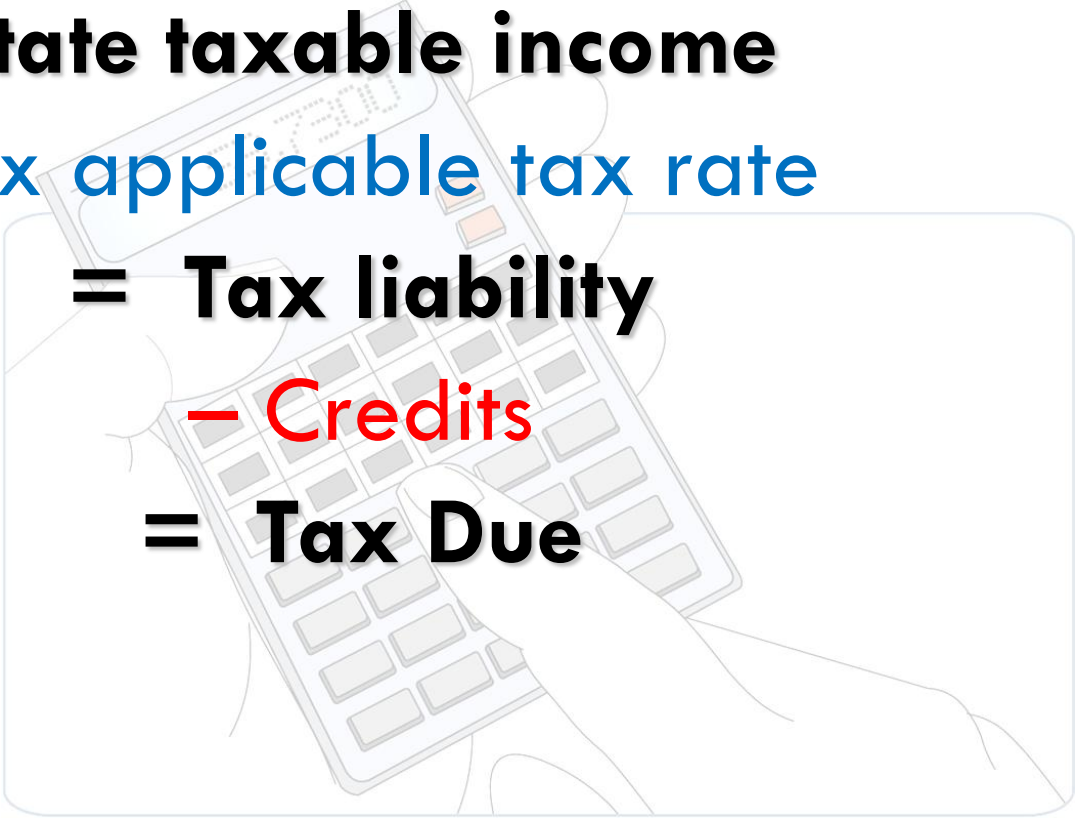
- ❑ 30 states have a lower rate than North Carolina
- ❑ 1 state has the same highest tax rate
- ❑ 11 states have a higher tax rate
- ❑ 7 states do not have an income tax

The rest of the story ...

- ❑ What is the tax base?
- ❑ What are the applicable deductions and exemptions?
- ❑ What are the tax brackets?
- ❑ What are the applicable credits?

Calculating NC State Tax Due

Credits


$$\begin{aligned} &\text{State taxable income} \\ &\times \text{applicable tax rate} \\ &= \text{Tax liability} \\ &- \text{Credits} \\ &= \text{Tax Due} \end{aligned}$$

Tax Credits: Children

- Children < 17
 - ▣ AGI limitation
 - ▣ \$147.3 million
- Childcare
 - ▣ \$53.6 million
- Adoption
 - ▣ \$5.9 million
 - ▣ Sunsets 2013



Tax Credit: Earned Income



- Refundable tax credit
- 5% of the federal credit amount
- \$100 million
- Sunsets 2013

Tax Credits: Non-itemizers



- Charitable contributions by non-itemizers
 - ▣ \$26.5 million

Tax Credits: Health

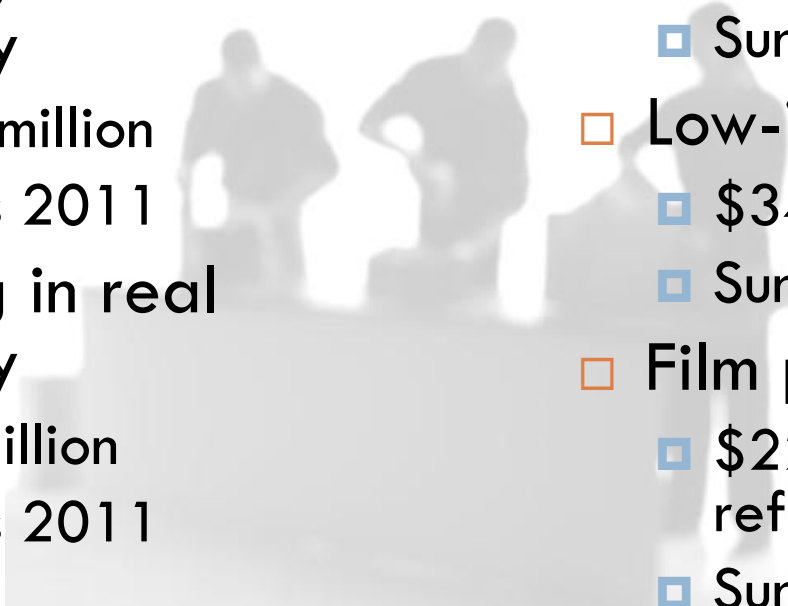
- Long-term care premiums
 - ▣ AGI limitation
 - ▣ \$4.7 million
 - ▣ Sunsets 2013
- Disabled persons
 - ▣ \$1.5 million
- Construction of dwellings for handicapped persons



Tax Credits: Energy

- Investing in renewable energy property
 - ▣ \$4 million
 - ▣ Sunsets 2016
- Donations to acquire renewable energy property
- Refund motor fuel excise tax for biodiesel
 - ▣ \$1.2 million
 - ▣ Sunsets 2010
- Tax Credits for renewable fuels
 - ▣ Fuel dispensing facilities
 - ▣ Constructing fuel processing facilities
 - ▣ Sunset 2011
- Recycling facility
 - ▣ \$7.0 million

Tax Credits: Business

- 
- Creating jobs
 - ▣ \$8 million
 - ▣ Sunsets 2011
 - Investing in business property
 - ▣ \$16.5 million
 - ▣ Sunsets 2011
 - Investing in real property
 - ▣ \$0.4 million
 - ▣ Sunsets 2011
 - Research & development
 - ▣ Business (\$19 million)
 - ▣ UNC (\$2.5 million)
 - ▣ Sunsets 2014
 - Low-income housing
 - ▣ \$34 million, refundable
 - ▣ Sunsets 2015
 - Film production
 - ▣ \$22.5 million, refundable
 - ▣ Sunsets 2014

Miscellaneous Tax Credits

- Real property donations
 - ▣ \$25.7 million
- Conservation tillage equipment
- Gleaned crops
- Poultry composting facility
- Property taxes paid on farm machinery
 - ▣ \$1.6 million
- Recycling oyster shells
 - ▣ Sunsets 2011
- Work opportunity
 - ▣ \$0.4 million
 - ▣ Sunsets 2012

Tax Credits: Historic Rehabilitation

- Income producing historic structure
 - ▣ \$3.0 million
- Non-income producing historic structure
 - ▣ \$5 million
- Income producing mill property
 - ▣ \$1 million
 - ▣ Sunsets 2011
- Non-income producing mill property
 - ▣ \$5 million
 - ▣ Sunsets 2011



PIT Points to Remember

Issues

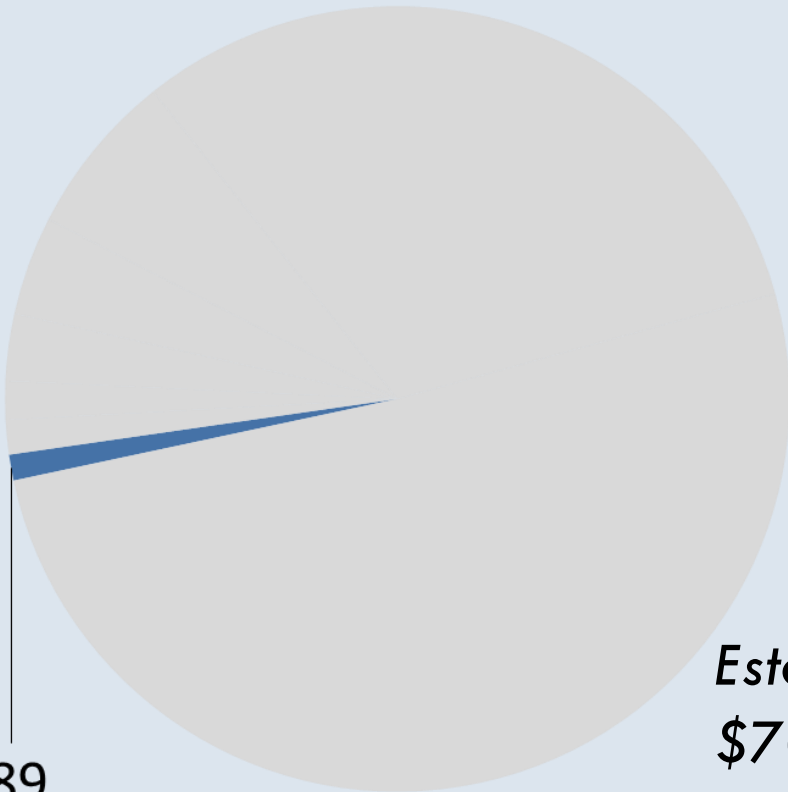
- ❑ Largest single source of GF revenues
- ❑ Non-withholding portion of the tax is highly volatile
- ❑ Reliance on federal tax code changes
- ❑ Many adjustments



Tax Reform Recommendations

Personal Income Tax

- Broaden the base, lower the rates
 - ▣ Use AGI as the starting point
 - ▣ Eliminate exemptions, deductions, and credits
- Lessen the State's exposure to the volatility of the current PIT structure
- Ensure tax equity in tax structure as a whole



■ Other \$189

*Estate tax =
\$70+ million*

Estate Tax

Less than 1% of General Fund Tax Revenues

NC's Estate Tax

History

- Repealed inheritance tax in 1998
- Replaced with estate tax = “pickup tax”
 - ▣ State estate tax credit on federal return
 - ▣ Federal credit phased out in 2005
- Repealed gift tax in 2008, effective 2009

NC's Estate Tax

Decedents dying in 2010

- No State estate tax
- State estate tax imposed when a federal estate tax is imposed
- Modified carry-over basis in property

Decedents dying in 2011

- State estate tax imposed
- Tax = State estate tax credit amount, 2001
- Exclusion amount
 - ▣ 2001 = \$1 million
 - ▣ 2010 = \$5 - \$10 million (w/ portability)

Questions?

Contacts

- Department of Revenue
 - ▣ Tom Dixon, Assistant Secretary of Tax Administration
 - 733-4433
 - Tom.dixon@dornc.com
- Legislative Staff
 - ▣ Research, 733-2578
 - ▣ Fiscal Research, 733-4910
 - ▣ Bill Drafting, 733-6660
 - ▣ First name.last name@ncleg.net