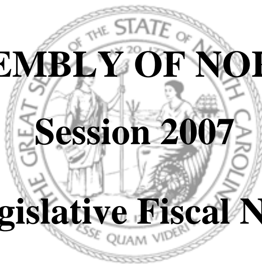

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2007

Legislative Fiscal Note

BILL NUMBER: Senate Bill 240 (First Edition)

SHORT TITLE: IRC Update.

SPONSOR(S): Senator Clodfelter

FISCAL IMPACT ($Mill.)

Yes (X) **No** ( ) **No Estimate Available** ( )

	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11
REVENUES					
State General Fund					
Small Business. Expensing	-----	-35.8	-27.9	-8.5	+11.4
Higher Education. Exp. Deduct	-----	-13.9	-14.4	-----	-----
Teacher Exp. Deduct	-----	-2.3	-1.3	-----	-----
Other Changes	-.8	-6.7	-5.5	-5.9	+18.3
Total Net Impact	-.8	-58.7	-49.1	-14.4	+29.7
Recurring	+1.2	-.7	-2.5	-4.4	+19.7
One-Time	-2.0	-58.0	-46.6	-10.0	+10.0

EXPENDITURES

POSITIONS (cumulative):

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: The income tax is administered by the Department of Revenue. The enactment of the bill is not expected to affect the Department's budget requirements.

EFFECTIVE DATE: When the act becomes law.

BILL SUMMARY: North Carolina's income tax law tracks many provisions of the Internal Revenue Code by reference to the Code as of a certain date. Under the North Carolina Constitution the State cannot automatically update the reference to the Code. Thus legislation is introduced each year to update the reference to the IRC.

The bill changes the Internal Revenue Code reference date to January 1, 2007. The language below describes the federal changes that will have a significant impact on State revenues

•**Passive income of minors**. Special rules apply to the unearned income of a child who is under age 14. The "kiddie tax," is applied if the child has not reached the age of 14 by the close of the taxable year; the child's unearned income was more than $1,700; and the child is required to file a return for the year. The tax applies regardless of whether the child may be claimed as a dependent on the parent's return. For children under age 14, unearned income is taxed at the parent's rate if the parent's rate is higher than the child's rate. The remainder of a child's taxable income is taxed at the child's rates, regardless of whether the tax applies to the child.

The federal change expands the rule to include all minors under the age 18 in the "kiddie tax." There is an exception for distributions from certain qualified disability trusts. The minor child tax does not apply to a child who is married and files a joint tax return.

This provision applies to tax years beginning after December 31, 2005.

•**Increased expensing for small businesses**. Prior to 2004 small businesses were eligible to expense up to $25,000 of the cost of qualifying property placed in service for the taxable year in lieu of depreciating the cost over a number of years. Qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $25,000 amount was reduced dollar-for-dollar by the amount by which the cost of the qualifying property exceeded $200,000.

The deduction was increased to $100,000, with costs exceeding $400,000 reducing the deduction in 2004 federal legislation. This change was to expire for tax years beginning after December 31, 2006.

This bill conforms State law to the federal sunset extension to December 31, 2009.

•**Increased income limit for conversion of traditional IRAs to Roth IRAs.** There are two general types of individual retirement arrangements (IRAs): traditional IRAs and Roth IRAs. The total amount an individual may contribute is limited to the lesser of a dollar amount ($4,000 for 2006), or the amount of the individual's taxable income for the year. Contributions to a traditional IRA are generally deductible. Distributions from a traditional IRA are included in gross income to the extent the distributions are not attributable to a return of nondeductible contributions. Contributions to a Roth IRA are not deductible. Distributions from a Roth IRA are excludable from gross income. A taxpayer with an adjusted gross income of $100,000 or less may convert all or a portion of a traditional IRA to a Roth IRA. Married taxpayers filing separate returns may not convert a traditional IRA into a Roth IRA.

SB 240 conforms State law to the federal change eliminating the income limits on conversions of traditional IRAs to Roth IRAs. The amount converted is treated as taxable income in the year it is converted; however. Taxpayers who convert in 2010 and do not take distributions from the converted plan until after 2012, have the option of either recognizing all of the income in 2011 or including the income ratably over the tax years 2011 and 2012.

This provision is effective for tax years beginning on or after January 1, 2010.

•**Inflation indexing of IRA limits.** The maximum annual deductible and nondeductible contributions to IRA's varies, depending on the particular circumstances, including the individual's income. Indexed amounts are rounded to the nearest $1,000 multiple.

The federal change indexes the limits for inflation, effective for tax years beginning on or after January 1, 2007.

•**Health insurance premiums for retired public safety officers**. Distributions from a qualified retirement plan are generally included in taxable income the year of the distribution except to the extent attributable to after-tax contributions.

Under the new federal rules, retired public safety officers may exclude from taxable income up to $3,000 of otherwise taxable distributions from a government pension if used to pay for health insurance premiums. To be eligible, the individual is required to have separated from service either due to disability or by reaching normal retirement age.

This provision is effective for tax years beginning on or after January 1, 2007.

•**Tax-free IRA distributions to charities**. Generally, to make a charitable donation from an IRA, a distribution must be taken and the applicable rules regarding taxable income apply. The distribution is included in taxable income to the extent the distributions are not attributable to a return of nondeductible contributions. The standard charitable deduction rules then apply to the donation.

The bill conforms State tax law to the federal change providing that individuals 70 ½ or older can now distribute up to $100,000 per taxable year from their IRAs to charitable institutions without recognizing the income. The distribution must be made directly to the charitable organization from the trustee. This distribution counts towards the required minimum distribution.

The provision is effective for distributions made after December 31, 2005 and before January 1, 2008.

•**Charitable contributions of clothing and household items**. The charitable deduction of noncash property is generally the property's fair market value. For contributed items used in a manner unrelated to the donee's exempt purpose, the deduction is generally the donor's basis in the item. For donations of clothing and household items with a value of less than the original basis, most taxpayers deduct the fair market value of the item.

The federal change provides that contributions of clothing or household goods are limited to items that are in "good" used conditions or better unless the deduction for a single item exceeds $500 and the taxpayer includes a qualified appraisal.

This provision applies to contributions made after August 17, 2006.

•**Charitable deduction for contribution of food inventories**. A taxpayer's deduction for charitable contributions of inventory is generally limited to the lesser of the taxpayer's basis in the inventory (usually cost) or the fair market value of the inventory. For certain contributions of inventory, a C corporation may claim an enhanced deduction equal to the lesser of: (1) basis plus one-half on the item's appreciation; or (2) two times basis. To be eligible for the enhanced deduction, the contributed property must generally be inventory of the corporation, contributed to a charitable organization described in section 501(c)(3) of the Code, and the donee must: (1) use the property consistent with the donee's exempt purpose only for the care of the ill, the needy, or infants; (2) not transfer the property in exchange for money, other property, or services; and (3) provide the taxpayer with a written statement attesting to the proper use of the property.

The new federal rules allow the enhanced deduction to any taxpayer engaged in a trade or business that makes a donation of food inventory. For taxpayers other than C corporations, the total deduction for contributions of food inventory may not exceed 10% of the taxpayer's income from all business entities from which a contribution of food inventory is made. The enhanced deduction is available only for food that qualifies as "apparently wholesome food," – food intended for human consumption that meets all quality and labeling standards imposed by federal, state, and local laws even though the food may not be readily marketable for any number of reasons.

This provision is effective for contributions made beginning January 1, 2006 and ending December 31, 2007.

•**Deduction for higher education expenses**. Under prior law, individuals were allowed a deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year. The maximum deduction is $4,000 for an individual whose adjusted gross income for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), or $42,000 for other individuals whose adjusted gross income does not exceed $80,000 ($160,000 in the case of a joint return). This deduction had a December 31, 2005 sunset for most taxpayers.

Under the bill this deduction is extended to tax years beginning on or after January 1, 2006 and ending December 31, 2007.

•**Qualified expenses of elementary and secondary schoolteachers.** Under prior law, an eligible educator was allowed a deduction of up to $250 for amounts paid by the teacher for books or supplies used in the class room. An eligible educator is a k-12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during the school year. This deduction had a December 31, 2005 sunset for most taxpayers.

The bill extends the deduction to expenses incurred for tax years beginning on or after January 1, 2006.

•**Depreciation rules for qualified leasehold improvements and qualified restaurant property**. Prior law provided for 15-year straight-line depreciation for qualified leasehold improvements to nonresidential real property placed into service beginning October 22, 2004 and ending December 31, 2005. A qualified leasehold improvement is an improvement made to the interior of a building by either the lessor or lessee and placed in service more than three years after the building is

placed in service. Under prior law, a qualified leasehold improvement was depreciated using straight-line depreciation over a 39-year period, the same period as for nonresidential property in general.

A similar depreciation schedule was put into place for qualified restaurant property placed into service beginning October 22, 2004 and ending December 31, 2005. In order to qualify as "qualified restaurant property", the property must be a building improvement placed in service more than three years after the building is placed in service and the restaurant must use more than half of the square footage of the building.

This provision extends the new tax treatment for qualified leasehold improvements and qualified restaurant property placed in service between January 1, 2006 and December 31, 2007.

•**Enhanced deduction for the charitable donation of computer technology and equipment**. Prior federal law allowed an enhanced deduction for contributions of computer technology or equipment to schools or public libraries that would use the computer equipment for educational purposes. This deduction had a December 31, 2005 sunset.

This provision is extended to contributions made between January 1, 2006 and December 31, 2007.

•**Deduction for energy efficient commercial buildings**. Prior law allowed a deduction for energy efficient commercial buildings. Energy efficient expenditures are certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, and ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building. The deduction is limited to $1.80 per square foot of property for which such expenditures are made. A partial allowance of the deduction is allowed for buildings that do not meet the requirement of a 50% energy savings but are certified by a qualified profession as meeting or exceeding the applicable system specific savings targets established by the Secretary of the Treasury. This deduction had a December 31, 2007 sunset.

This provision extends the deduction to property placed in service beginning January 1, 2008 and ending December 31, 2008.

•**Contribution limits for Health Savings Accounts**. Under current law individuals with a high deductible health plan may establish health savings accounts ("HSA") for the payment of current and future medical costs. Contributions to HSAs made by or on behalf of an individual are deductible by the individual. The contributions are limited to the lesser of: (1) the annual deductible of the health plan; or (2) $2,850 for individual coverage and $5,650 for family coverage.

Under the new federal rules contributions are limited to $2,850 for individual coverage and $5,650 for family coverage. Thus, the limit tied to the annual deductible of the health plan is eliminated.

This provision is effective for taxable years beginning on or after January 1, 2007.

ASSUMPTIONS AND METHODOLOGY:

•**Increased expensing for small businesses.** The estimates for this change involved an update of the data for the 2003 legislation that conformed the State tax code to original Section 179 changes. The earlier numbers involved a modification of state-by-state estimates provided by the Center for Budget and Policy Priorities in Washington, DC. In addition, we reviewed the nationwide estimates of the Joint Committee on Taxation of the U.S. Congress. The JCT estimates related to the nationwide federal impact and were expressed in federal fiscal year effects. These impact estimates were "shared down" to states based on various allocation methods including state personal income, or state corporate tax revenues relative to federal collections.

The original 2003 estimates were revised to the current period based on the growth of capital investment as shown by Moody's Economy.com., a forecasting service used by Fiscal Research Division.

It should be noted also that over a 10-year period the proposal has a net impact approaching zero due to the fact that 100% of the acquisition cost of eligible property will be deducted under both the current law and the proposed schedule.

•**Other Changes.** The methodology used begins with the Joint Tax Committee estimates of the nationwide federal impact by federal fiscal year. Fiscal Research adjusted these numbers back to an approximate calendar year tax impact. The next step was to prorate the national numbers to the state impact. This adjustment involved two steps: accounting for relative size of the state and then adjusting for the difference in federal and state marginal tax rates. The result of this analysis suggests that the North Carolina share, based on the combination of size and lower tax rates, is around .85% of the federal total for the personal income tax and .25% for the corporate income tax.

After calculating the estimated State tax year impacts, the numbers were converted to state fiscal year by assuming that the traditional FRD method of putting 45% of a calendar year tax liability in the January-June period that finishes up one fiscal year and the allocating the remainder to the following fiscal year.

SOURCES OF DATA: See "Assumptions and Methodology".

TECHNICAL CONSIDERATIONS: None

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Signed Copy Located in the NCGA Principal Clerk's Offices