# NORTH CAROLINA GENERAL ASSEMBLY

## LEGISLATIVE FISCAL NOTE

**BILL NUMBER**: SB 1366 (Proposed Amendment)

**SHORT TITLE**: Appropriations Act of 1998

**SPONSOR(S)**: Senator McDaniel

### FISCAL IMPACT

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

**($million)**

| | FY 1998-99 | FY 1999-00 | FY 2000-01 | FY 2001-02 | FY 2002-03 |
|---|---|---|---|---|---|
| **REVENUES** | | | | | |
| **General Fund** | | | | | |
| **2% Food Tax Repeal *** | (68.9) | (6.0) | | | |
| **Repeal Inheritance Tax** | | (52.5) | (79.4) | (85.7) | (92.6) |
| **Inc. Standard Deduction** | (112.9) | (241.1) | (274.0) | (311.5) | (350.7) |
| **Inc. Personal Exemption** | (56.1) | (133.0) | (175.3) | (219.2) | (264.2) |
| **Total - Gen. Fund** | (237.9) | (432.6) | (528.7) | (616.4) | (707.5) |

*** SB 1366 does not include the food tax repeal, but makes reference to such a repeal in Section 6 of the bill. See Assumptions and Methodology for details.**

**EXPENDITURES (See Technical Considerations)**

**PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED**: Department of Revenue

**EFFECTIVE DATE**: The sales tax on food is effective October 1, 1998. The inheritance tax repeal is effective January 1, 1999. The change in personal exemption and standard deduction are effective for taxable years beginning on or after January 1, 1999.

**BILL SUMMARY**: This amendment 1) eliminates the state sales tax on food sooner than SB 1092, 2) eliminates the state's inheritance tax and retains a state estate tax equal to the federal State Death Tax Credit, and 3) increases and indexes the individual income tax personal exemption and the standard deduction to conform to the federal exemption and standard deduction rates.

**ASSUMPTIONS AND METHODOLOGY**:

## REPEAL STATE SALES TAX ON FOOD

The Senate budget bill availability statement makes allowance for the passage of the original Senate version of SB 1092 (Eliminate Food Tax). This bill would repeal one cent on the state food tax on November 1, 1998 and repeal the remaining one cent state food tax on July 1, 1998. This amendment would repeal the two cent state food tax on October 1, 1998. As shown below, the difference to the General Fund is an additional revenue loss of $68.9 million in FY 1998-99 and $6 million in FY 1999-00. The fiscal impact is the same for fiscal years 2000-01 through 2002-03.

| | STATE FISCAL YEAR | ($million) | | | |
|---|---|---|---|---|---|
| | 98-99 | 99-00 | 00-01 | 01-02 | 02-03 |
| **BACKGROUND INFORMATION (1)** | | | | | |
| CURRENT TAX YIELD (2% effective 7/1/98) | $179.1 | $184.5 | $190.0 | $195.7 | $201.6 |
| 1 CENT | $89.6 | $92.2 | $95.0 | $97.9 | $100.8 |
| **SB 1092** | | | | | |
| **Reduce to 1% (11/1/98)** | ($53.9) | ($92.2) | ($95.0) | ($97.9) | ($100.8) |
| **Reduce to 0% (7/1/98)** | ____ | ($86.3) | ($95.0) | ($97.9) | ($100.8) |
| **Total SB 1092** | ($53.9) | ($178.5) | ($190.0) | ($195.7) | ($201.6) |
| **Proposed Amendment** | | | | | |
| **Reduce to 0 % (10/1/98)** | ($122.8) | ($184.5) | ($190.0) | ($195.7) | ($201.6) |
| **Difference** | **($68.9)** | **($6.0)** | | | |

NOTES:
(1) Assumes annual growth of 3%
(2) The effect is less than 75% in the first
year due to a lag between the retail sale and the remittance.

The October 1, 1998 reduction will be less than 9 months of revenue loss due to a lag between the retail sale and the remittance of the tax. The full year cost of the 2 cent reduction will be in FY 1999-00.

## ELIMINATE NORTH CAROLINA INHERITANCE TAX

The proposed amendment will eliminate the North Carolina inheritance tax as of January 1, 1999. North Carolina has both an inheritance tax and an estate tax. These taxes are borne by the beneficiary. When calculating taxes owed, a determination is made of the net value of the estate and the beneficiary's proportion of that estate. Then inheritance taxes are applied based on the beneficiary's classification. Once a state inheritance tax is determined, that number must be compared to the State Death Tax Credit (This credit amount is drawn from the federal estate tax form). If the inheritance tax is larger than the State Death Tax Credit, the beneficiary forwards the total inheritance tax to the state. If the credit is larger, a North Carolina Estate Tax is charged to bring the total tax up to the State Death Tax Credit level. As of January 1997 only 17 states, including North Carolina, still retain an inheritance tax. This amendment repeals the inheritance tax, with the net effect of expanding the state estate or "pick-up" tax.

The Tax Research Division of the Department of Revenue provided data based on inheritance tax returns filed and closed out in 1993. The loss associated with the 1993 data equals $42.3 million, or 45.1% of total potential inheritance tax collections, in General Fund revenue. This percentage loss was applied to current 1999-00 inheritance tax collections estimates. Future years were forecast based on the expected growth rate in inheritance tax collections as defined in the North Carolina model (7.986%). A one time 5% adjustment was included to capture the impact of the increase in the federal unified credit and its influence on the State Death Tax Credit. No FY 1998-99 fiscal impact is shown for this item because there is a nine month lag in the payment of inheritance taxes. For example, if a benefactor dies on January 1, 1999 the inheritance tax paid by their beneficiaries would not be due until September 1, 1999, which is the next fiscal year. The estimate for FY 1999-00 has also been reduced to allow for this lag factor.

It should be noted that the federal government requires that beneficiaries pay at least the amount of the death tax credit to the state, or the federal government will retain the balance. As such, reducing a North Carolina beneficiary's total tax liability to below the State Death Tax Credit level (i.e. eliminating both the inheritance and estate taxes) will only result in additional funds to the federal government. The beneficiary's total tax liability will not change.

## INCREASE AND INDEX PERSONAL EXEMPTIONS

By repealing the add-back to income in GS 105-134.6(c)(4a) in this amendment, the state personal exemption rate will equal the federal personal exemption amount each year beginning in tax year 1999. The General Assembly last increased the state personal exemption amount to the federal rate in 1995, but did not index it for inflation. The current state personal exemption is $2500, while the federal personal exemption rate for tax year 1999 is projected to be $2750. The rate is set each year by increasing the prior year amounts by the CPI, then round down to the nearest $50. The projected rates for tax years 1999 to 2003 are follows:

| | State | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|
| **Personal Exemption** | $2,500 | $2,700 | $2,750 | $2,850 | $2,950 | $3,050 | $3,150 |
| **CPI** | | 1.032 | 1.031 | 1.03 | 1.034 | 1.033 | 1.035 |

This amendment will also end the personal exemption of $2,000 placed on the following income groups:

| | |
|---|---|
| Married filing jointly | $100,000 |

| | |
|---|---|
| Head of Household | $80,000 |
| Single | $60,000 |
| Married filing separately | $50,000 |

The state will still conform to the federal phase-out of the personal exemption at the highest income levels. ($181,800 married filing jointly; $151,500 head of household; $121,200 single; $90,900 married filing separately)

The cost for indexing the personal exemption was derived using the Individual Income Tax computer model operated by the Department of Revenue, the Fiscal Research Division, and the Office of State Budget and Management. The microsimulation model uses actual state and federal tax return data from tax year 1994 to estimate the impact of tax changes on the General Fund. The results from the model were checked against the 1994 Individual Income Tax Detail Report issued by the Department of Revenue. Manual calculations were consistent with the model projections.

The first year impact in FY 98-99 equals half the loss for tax year 1999 ($56.1 million) due to taxpayers adjusting their withholding tables and their estimated payments in January through June of 1999. The impact for each following year is half of one tax year plus half of the next tax year. For example, the FY 99-00 estimate of $133 million is half of tax year 1999 ($56.1 million) plus half of tax year 2000 ($76.9 million).

## INCREASE AND INDEX STANDARD DEDUCTION

This amendment will increase the standard deduction for the state individual income tax to the federal rate, then conform the standard deduction to the federal rate from tax year 1999 onward. The 1998 federal rates published by the Internal Revenue Service are shown below. The rates are set each year by increasing the prior year amounts by the CPI, then round down to the nearest $50. The projected rates for tax years 1999 to 2003 are as follows:

| | State | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|
| **Standard Deduction** | | | | | | | |
| Single | $3,000 | $4,250 | $4,350 | $4,500 | $4,650 | $4,800 | $4,950 |
| Married | 5,000 | 7,100 | 7,300 | 7,500 | 7,750 | 8,050 | 8,300 |
| Head of Household (HoH) | 4,400 | 6,250 | 6,400 | 6,600 | 6,850 | 7,050 | 7,300 |
| Aged Single (HoH) | 750 | 1,050 | 1,050 | 1,100 | 1,150 | 1,150 | 1,200 |
| Aged Married | 600 | 850 | 850 | 900 | 900 | 950 | 950 |
| Dependent | 500 | 700 | 700 | 700 | 750 | 750 | 800 |

The cost for indexing the standard deduction was derived using the same Individual Income Tax computer model as mentioned above. The first year impact in FY 98-99 equals half the loss for tax year 1999 ($112.9 million) due to taxpayers adjusting their withholding tables and their estimated payments in January through June of 1999. The impact for each following year is half of one tax year plus half of the next tax year. For example, the FY 99-00 estimate of $241.1 million is half of tax year 1999 ($225.8 million) plus half of tax year 2000 ($256.3 million).

**TECHNICAL CONSIDERATIONS**:

Inheritance Tax - Although the inheritance tax is repealed, the State would maintain compliance with the Federal Estate Tax (pick-up tax). With the Federal pick-up tax still in place, a portion of the returns that are currently filed would continue to be required. For example in FY 1996-97 there were 7,931 Inheritance Tax returns. Of that number, the Department estimated that 35% or 2,776 required filing under the Federal pick-up.

The Department could abolish two of the six employees in Office Examinations who work with Inheritance Tax and with Gift Tax. Two positions are needed for the Gift Tax portion. At least two will be needed for the changed State estate tax and to work with the existing Inheritance Tax files until they are all resolved. **The Department could abolish the remaining two positions and save $52,453, but would like to reallocate these positions to the Correspondence Unit that was created in 1997 .** This unit resolves correspondence not attached to payments before that correspondence is referred to audit in Office Examinations, to administrative officers in Office Services, or to Tax Administration. If the bill is enacted, the Appropriations Committee in the 1999 Session should determine the number of personnel needed in this section.

**FISCAL RESEARCH DIVISION**
**733-4910**
**PREPARED BY**: Linda Struyk Millsaps & Richard Bostic
**APPROVED BY**: Tom Covington
**DATE**: June 30, 1998