NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: House Bill 1429 (House Finance Committee Substitute, as amended)

SHORT TITLE: Financial Responsibility Act

SPONSOR(S): Representatives Baddour and Luebke

FISCAL IMPACT

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

($million)

	FY 2001-02	**FY 2002-03**	**FY 2003-04**	**FY 2004-05**	**FY 2005-06**
REVENUES					
General Fund					
Increase Standard Deduction	(41.0)	(44.3)	(45.0)	(45.8)	(46.5)
Increase Child Credit	(20.7)	(54.8)	(54.8)	(55.0)	(55.3)
Sales Tax/Hold Harmless	(130.0)	(35.0)	(29.1)	(24.4)	(20.1)
Repeal Reimbursements	333.4	333.4	333.4	333.4	333.4
8.75% Income Tax Rate	251.1	205.9	241.3	282.7	331.1
Tax HMOs/Blue Cross	31.3	28.3	30.6	33.2	35.9
Liquor Sales Tax	15.9	24.7	25.6	26.6	27.6
No Tax Break/Luxury Cars	1.7	2.4	2.6	2.7	2.9
Total General Fund	441.7	460.6	504.6	553.4	609.0
EXPENDITURES					
General Fund					
Income tax withholding tables	.14				
Sales Tax changes	1.7	.4	.4	.4	.4
POSITIONS					
Dept. of Revenue	6	6	6	6	6

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Department of Revenue; Alcoholic Beverage Control Commission; Division of Motor Vehicles

EFFECTIVE DATE: Parts 1a ($5,500 standard deduction), 2a ($75 child credit), 5 (8.75% tax rate), and 6 (insurance premium tax) are effective for taxable years beginning on or after January 1, 2001. Parts 4 (repeal reimbursements) and 8c (transfer luxury car tax to General Fund) are effective July 1, 2001. Parts 7 (sales tax on liquor) and 8 (repeal tax cap on luxury cars) are effective October

1, 2001. Part 3 (1/2 cent sales tax) is effective on November 1, 2001. Parts 1b and 2b are effective for taxable years beginning on or after January 1, 2002.

BILL SUMMARY:

House Bill 1429 PCS does the following:

1) Increases the standard deduction for married filing jointly filers from $5,000 to $6,000,
2) Increases the tax credit for children from $60 to $100,
3) Authorizes a local option half cent sales tax and guarantees local governments that their sales tax revenue will equal at least 105% of reimbursements repealed by the state,
4) Adds a new 8.75% individual income tax bracket,
5) Imposes a 1% gross premiums tax on HMOs and medical service companies,
6) Imposes a 6% state sales tax on liquor, and
7) Repeals the $1,500 highway use tax cap on motor vehicles and exempts fire and rescue vehicles from the highway use tax.

ASSUMPTIONS AND METHODOLOGY:

Eliminate the Marriage Tax Penalty for the Standard Deduction

The term "marriage penalty" refers to the income tax situation where married individuals filing jointly pay more in tax than if the two individuals were unmarried filing as single persons. For example, the North Carolina standard deduction for single filers is $3,000, but for married filing jointly the standard deduction is $5,000. The personal exemption favors single filers, because the exemption is $2,500 until you get to maximum of $60,000 Adjusted Gross Income (AGI) for single filers and $100,000 AGI for married filing jointly where it drops to $2,000. State tax brackets also favor single filers as shown below:

	6%	**7%**	**7.75%**
Single	0 to $12,750	$12,751 to $60,000	$60,000>
Married filing jointly	0 to $21,250	$21,251 o $100,000	$100,000>

Part 1 of House Bill 1429 reduces the marriage penalty by increasing the standard deduction for married filing jointly taxpayers from $5,000 to $6,000. The standard deduction is increased to $5,500 in tax year 2001 and then to $6,000 in tax year 2002. The FY 2001-02 reduction in General Fund revenue will be $41 million due to $21.6 million deducted from tax returns filed in the spring of 2002 and $19.4 million in estimated payments and withholding for tax year 2002. This change will benefit 751,705 couples in tax year 2001 and 774,413 couples in 2002.

FY 2001-02	$41.0 mil.
FY 2002-03	$44.3 mil.
FY 2003-04	$45.0 mil.
FY 2004-05	$45.8 mil.
FY 2005-06	$46.5 mil.

The revenue estimate for standard deductions was calculated using the North Carolina Individual Income Tax Model. This tax model was created by the Barents Group for the Department of Revenue and the General Assembly to use in estimating tax law changes. The model bases future year estimates on data from 1998 North Carolina individual income tax returns.

Increase Tax Credit for Children

The current $60 child credit was approved by the 1995 General Assembly. Part 2 of the bill increases the child credit from $60 to $75 per child in tax year 2001, and then increases the credit from $75 to $100 in tax year 2002. The first increase will reduce General Fund revenue $20.7 million in FY 2001-02 for taxpayers filing returns in the spring of 2002. The second year increase will boost the revenue loss to $54.8 million in FY 2002-03. This tax change will benefit 18,130 single tax filers, 522,540 married couples, and 400,696 heads of households in tax year 2001. This revenue estimate for was calculated using the North Carolina Individual Income Tax Model.

Local Option Sales Tax /Hold Harmless

Part 3 of the bill authorizes counties to levy an additional ½ cent sales tax. The board of commissioners can direct the county board of elections to conduct a special election on the issue, although it is not required.

The General Assembly's Fiscal Research Division and the Office of State Budget, Planning and Management have agreed to the following sales tax revenue projections for FY 2001-02 and FY 2002-03:

(millions)

Fiscal Year	Revenue from 1 Cent	Revenue from 1/2 Cent
2001-02	$765.2	$382.6
2002-03	$797.3	$398.7

These estimates assume a full year of tax and do not include tax on food.

In addition, Fiscal Research and the State Budget Office have agreed to sales tax growth rate estimates for the next several fiscal years. The growth rates, as well as the corresponding 1 cent and ½ cent revenue estimates (in millions), are listed below.

Fiscal Year	Growth from Previous Year	Revenue from 1 Cent	Revenue from 1/2 Cent
2003-04	5.3%	$839.6	$419.8

2004-05	5.1%	$882.4	$441.2
2005-06	4.9%	$925.6	$462.8

Assuming a November 1, 2001 effective date, local governments could generate the following revenue stream from a ½ cent sales tax:

(millions)

Fiscal Year	Potential Revenue
2001-02	$230.3
2002-03	$398.7
2003-04	$419.8
2004-05	$441.2
2005-06	$462.8

These estimates also assume no tax on food.

Part 4 of the bill (discussed below) repeals the existing reimbursements to local governments for previous law changes. These reimbursements total $333.4 million annually. However, Part 3 instructs the Secretary of Revenue to make an annual hold harmless payment to those local governments whose estimated gain from the sales tax is less than 105% of their loss from the repealed reimbursements. The sales tax distribution formula mirrors the existing formula, with ½ of the revenues distributed on an adjusted per capita basis and ½ distributed on a point of sale basis.

In order to calculate a statewide hold harmless cost, FY 1999-00 annual sales tax reports were used to determine what proportion of all annual sales tax distributions were forwarded to each community. These percentages of the total were then applied to the estimated revenue streams noted above to create local sales tax revenue estimates. The individual revenue estimates were compared with the annual reimbursement data for each county and municipality. If a particular community's sales tax revenue did not compare favorably with 105% of the reimbursement amount, a hold harmless estimate was generated for that community. These individual hold harmless amounts were then totaled to determine the combined state liability for the 105% hold harmless provision. This calculation was made for each of the next five fiscal years.

(millions)

Fiscal Year	Hold Harmless Cost
2001-02	$130.0
2002-03	$35.0

2003-04	$29.1
2004-05	$24.4
2005-06	$20.1

Under this legislation, local governments that do not choose to levy the tax may receive a reimbursement equal to the gap between their estimated sales tax revenue and 105% of their current reimbursements. This analysis assumes that all communities that qualify for a state payment will receive the payment regardless of their decision on levying the tax.

Local Government Reimbursements

Since 1979 the General Assembly has made several changes to tax law that impact local governments. The state's cities and counties have received reimbursements from the state for some of these losses, particularly as they relate to the sales and property tax bases. The state reimburses local governments for property tax losses related to the repeal of taxes on inventories and intangibles, as well as some of the losses associated with the homestead exemption. Locals also receive a reimbursement for sales taxes that are no longer paid on items purchased with food stamps.

The legislature began exempting certain categories of intangible property in 1979. At that time, deposit accounts of less than $1,000 were exempted. In 1985 that exemption was expanded to include money on deposit, money on hand, and certain accounts receivable. In 1995 most of the remaining forms of intangible property were exempted. Through legislation in 1980, 1985, and 1987 the property tax on inventories was also removed. In 1985 the General Assembly exempted food stamps from local sales taxes. Most major changes in the homestead exemption have also included reimbursement, at least in part, by state government. Many of these reimbursement amounts are based on actual tax losses related to the first year of the repeal. These reimbursement amounts are fixed. The remainder was frozen in 1991.

According to the Department of Revenue's Tax Research Division, annual reimbursements are as follows:

(millions)

Reimbursement	**Amount**
Food Stamps	$6.4
Intangibles	$128.7
Homestead	$8.2
Retail & Wholesale Inventory	$82.0
Manufacturers Inventory	$108.1
TOTAL	$333.4

The legislation repeals all of these reimbursements. Because all reimbursement amounts are either fixed or frozen, no growth is included in the estimate.

New Tax Bracket for Taxable Income Over $200,000

Individual income tax rates are now 6%, 7%, and 7.75% as shown below.

Filing status		Taxable income is more than	But not over
	6%	$0	$12,750
Single	7%	$12,750	$60,000
	7.75%	$60,000	
	6%	$0	$17,000
Head of Household	7%	$17,000	$80,000
	7.75%	$80,000	
	6%	$0	$21,250
Married Filing Jointly	7%	$21,250	$100,000
or Qualifying Widow(er)	7.75%	$100,000	
	6%	$0	$10,625
Married Filing	7%	$10,625	$50,000
Separately	7.75%	$50,000	

Part 5 of the bill adds a new tax bracket for taxable incomes that are twice the current top rate as shown in the chart below.

8.75% for taxable incomes over:

$200,000	Married filing jointly
$160,000	Head of household
$120,000	Single
$100,000	Married filing separately

In tax year 2001, this tax increase will impact 9,848 single filers, 52,471 married couples, and 1,148 heads of households. The revenue estimates below were calculated using the North Carolina Individual Income Tax Model.

FY 2001-02*	$251.1 mil.
FY 2002-03	$205.9 mil.
FY 2003-04	$241.3 mil.
FY 2004-05	$282.6 mil.
FY 2005-06	$331.1 mil.

*First year revenues equal all of Tax Year 2001 for returns filed in spring 2002 and 45% of Tax Year 2002 because of withholding and two quarterly estimated payments. High-income taxpayers avoid a penalty if estimated payments during the tax year equal at least 90% of actual liability. In the following fiscal years, the taxpayers will pay the remaining 55% of the tax due in one tax year and again pay 45% in estimated payments for the next tax year.

Equalize Taxation of HMOs & Medical Service Companies

I. HMOs

Under current law, HMO's are not subject to a gross premiums tax but do pay corporate income and franchise taxes and the insurance regulatory fee. Regular insurance carriers pay a 1.9% premiums tax and no corporate income or franchise tax.

According to Department of Revenue reports from HMO's, the historical premium volume that would be subject to the tax is:

Tax Year	Taxable Premiums ($ Billions)
1998	$1.568
1999	1.825
2000	2.180

This data indicates annual growth of 17.9%. For this estimate, an annual growth estimate of 10.0% was used. This yields $2.40 billion of taxable premiums for 2001 and $2.64 billion for 2002. The application of a 1.0% tax rate in Part 6 of the bill produces $24.0 million for the 2001 tax year (2001-02 fiscal year) and $26.4 million for (2002-03 fiscal year).

The provisions of the bill exempt HMO's from the corporate income and franchise taxes. According to the Tax Research Division of the Department of Revenue, these payments amounted to $3.63 million for the 1999 tax year. This amount was grown by 19% for 2000 and by 10% for 2001 and 2002. The resulting corporate liability forecast is $4.21 million for 2001 (2001-02 fiscal year) and $4.63 million for 2002 (2002-03 fiscal year). In this analysis, it is assumed that the companies take their offset through lower final tax payments or higher refunds, not lower estimated tax payments. Thus, the calendar year change converts to fiscal year.

Finally, the fact that HMO's will make installment payments in April and June 2002 in addition to 2001 tax year payments in March 2002 means that in theory the 2001-02 fiscal years could contain a one-time windfall of $16.0 million. However, the statutes do allow an exemption from the required installment payments under certain circumstances. For this reason, the estimate includes only 25% of the potential windfall.

The finalized estimate for the proposal to tax HMO's at 1%, effective beginning with the 2001 tax year, is shown below:

	($ Millions) 2001-02	($ Millions) 2002-03
Premium Tax-Recurring	$24.0	$26.4
Premium Tax-Nonrecurring	4.0	
Less: Repeal of Corporate Taxes	-4.2	-4.6
Net Impact	$23.8	$21.8

II. Medical Service Companies

Blue Cross/Blue Shield and Delta Dental now pay a .5% premiums tax and no corporate income or franchise tax. Regular insurance carriers pay a 1.9% premiums tax and no corporate income or franchise tax.

The first step in estimating the impact of the rate increase on Blue Cross/Blue Shield and Delta Dental was to review the recent history of taxable premiums for these carriers. This data was provided by the Department of Revenue, the agency that collects the existing .5% tax. The data for recent years is shown below:

Tax Year	($ Billions) Taxable Premiums
1997	$1.082
1998	1.185
1999	1.175
2000	1.256

This data indicates that the average annual growth rate during this period was 3.8%. To be conservative, this fiscal analysis uses a 2.0% rate, yielding an estimate of $1.281 billion for the 2001 tax year and $1.307 billion for 2002. The application of the .5% rate increase in the bill would mean an additional $6.41 million for 2001 (converts to 2001-02 fiscal year) and $6.53 million for the 2002 tax year (2002-03 fiscal year).

In addition, there would be a one-time windfall for the 2001-02 fiscal year due to the fact that in April, June, and October of each calendar year insurance companies must pay installments on their tax liability for the that year. Unlike the corporate income tax, the installment payments are not based on a percentage of estimated liability for the year, but are tied to the annual liability for the prior year. The required percentage for each installment payment is 33 1/3% of the prior year's liability. Thus, for the 2001-02 fiscal year the General Fund will receive not only 100% of the 2001 calendar year liability (for which no installment payments have been made) but also two installment payments against the 2002 tax year. These installments would be equivalent to 66 2/3% of the prior year's annual liability, or $4.27 million. However, the statutes do allow an exemption from the required installment payments under certain circumstances. For this reason, the estimate includes only 25% of the potential windfall, or $1.1 million

Spirituous Liquor Sales Tax

Part 7 of the bill imposes a 6% state sales tax on spirituous liquor effective October 1, 2001. The North Carolina Alcoholic Beverage Control Commission reports annually on its retail sales and the volume of bottles sold in its 392 stores. Retail sales have grown from $308.6 million in FY 1994-95 to $367.7 million in FY 1999-00. The average annual growth rate in this five-year period is 3.82%. The five-year projection for the 6% sales tax on retail liquor sales is based on FY 1999-00 actual sales inflated each year by 3.82%. This growth rate appears reasonable based on sales in the first nine months of FY 2000-01 that exceed the annual average. Since there is no readily available data to predict how North Carolinians will react to an increase in liquor prices, no adjustment is made in retail sales based on consumption. Sales tax collections in FY 2001-02 will be for only eight months given the October 1 effective date and a month lag in collections. Instead of a full year's collections of $23.8 million as shown in the chart below, the state will collect only $15.85 million.

	Liquor Sales **Retail Sales**	**6% State Sales Tax**
FY 2000-2001	$381,703,699	
FY 2001-2002	$396,284,781	$23,777,087
FY 2002-2003	$411,422,859	$24,685,372
FY 2003-2004	$427,139,213	$25,628,353
FY 2004-2005	$443,455,931	$26,607,356
FY 2005-2006	$460,395,947	$27,623,757

No Tax Break for Luxury Cars/No Fire & Rescue Vehicle Tax

Part 8 of the bill proposes to delete the $1,500 cap on the 3% Highway Use Tax for non-commercial vehicles and exempt fire trucks and rescue vehicles owned by qualifying volunteer fire departments and volunteer rescue squads from the Highway Use Tax. The additional revenue generated from this section of the bill will go to the General Fund, not the Highway Trust Fund.

According to the Division of Motor Vehicles, approximately 4,800 vehicles were taxed at the maximum rate of $1,500 (corresponding to a vehicle price of $50,000) in FY1999-2000. The tax on these vehicles totaled $7.2 million. The actual average price of these vehicles is not available, but it is reasonable to assume that there is a gradual decline in the number of vehicles in each price bracket as the price moves higher. The number of vehicles in the price bracket from $48,000 to $49,000 was 390. It is assumed that there were 300 vehicles in the price bracket from $49,000 to $50,000 and that there is a constant percentage decline in the number of vehicles as the price bracket changes. Because the number of vehicles in each tax bracket decreases as the tax brackets increase, the average tax paid by vehicles in each bracket is something less than the midpoint of the bracket. That is, in each bracket most of the vehicles are clustered toward the lower end. It is assumed that in each $30 tax bracket the average vehicle will have a tax due of $10 greater than the minimum for that bracket. Using this methodology, the average value of the 4,800 vehicles that paid the maximum tax in FY1999-2000 was $66,350 and the additional tax that would have been paid for the average vehicle was $491 (equal to 3% of the average value in excess of $50,000). In FY1999-00 the fiscal impact would have been the number of vehicles (4,800) multiplied by the additional tax per vehicle ($491), or $2,358,296. This figure is used as the base and the fiscal impact is assumed to grow for the fiscal note forecast period by the same percentage as the Highway Use Tax collections as projected by the Office of State Budget, Planning and Management (see table below).

Forecast Growth Rate in Highway Use Tax

ear	**Growth Rate**
FY2000-01	1.6%
FY2001-02	3.0%
FY2002-03	7.8%
FY2003-04	5.8%
FY2004-05	5.7%
FY2005-06	5.2%

Section 8(d) of the bill exempts vehicles purchased by volunteer fire departments. According to the Department of Insurance, approximately 1,000 volunteer fire departments would qualify for this tax exemption. Each of those departments will have approximately three qualifying vehicles that are replaced on a twenty-year cycle. The result is that approximately 150 vehicles are purchased each year. Based on their high cost and weight (generally over 26,000 pounds), the loss in Highway Use Tax would be 150 vehicles at $1,000 each or about $150,000 per year.

Section 8(d) also exempts vehicles purchased by volunteer rescue squads. According to the North Carolina Association of Rescue and EMS, there are approximately 400 rescue squads that would qualify under the legislation. On average, these rescue squads would have approximately 1.5 emergency service vehicles each and the State total would be about 600 vehicles. Since these vehicles are replaced about every eight years on average, there will be approximately 75 emergency service vehicles purchased each year. These vehicles generally cost over $50,000 but they generally weigh less than 26,000 pounds and would therefore be taxed at $1,500 per vehicle. The loss in Highway Use Taxes would therefore be 75 vehicles at $1,500 each or about $112,500 per year.

The net impact of the Highway Use Tax changes is shown below. The first year revenue is reduced by one fourth ($1.7 million) due to an October 1, 2001 effective date.

	FY 01-02	**FY 02-03**	**FY 03-04**	**FY 04-05**
Highway Use Tax (delete $1500 cap)	**$2,467,910**	**$2,660,407**	**$2,814,710**	**$2,975,149**
Highway Use Tax (exempt vehicles)	**($262,500)**	**($262,500)**	**($262,500)**	**($262,500)**
Net impact	**$2,205,410**	**$2,397,907**	**$2,552,210**	**$2,712,649**

Expenditures

I. Sales Tax Changes

The Department of Revenue has projected that the implementation cost of a half-cent sales tax with a 105% hold harmless clause will be $1,512,745 in nonrecurring expenses and $193,180 in recurring expenses in FY 2001-02. Future recurring costs are estimated to be $386,357 per fiscal year. The Department requests the following nonrecurring expenses:

Planning, Development & Technology	FY 2001-02
Contractual Services	$750,000
Computers	$23,000
Maintenance Agreements - Equipment/Software	$1,800
Taxpayer Assistance	
Temporary Wages	$60,000
Social Security Contribution	$4,590
Examination and Collection	
Temporary Wages	$60,000
Social Security Contribution	$4,590
Administrative Services	
Temporary Wages	$10,000
Social Security Contribution	$765
Postage/Forms	$350,000
Telephone service/General office supplies	$5,100

Furniture/Office Equipment	$27,600
<u>Documents/Payment Processing</u>	
Temporary Wages	$200,000
Social Security Contribution	$15,300
Total Nonrecurring Expenses	$1,512,745

The recurring expenses proposed by the Department are for 5 new positions in the Examination and Collections Division and 1 position in Taxpayer Assistance. The first year salaries and benefits in the chart below are for 6 months.

	FY 2001-02	FY 2002-03
<u>Taxpayer Assistance</u>		
Salaries (1 position)	$25,865	$51,729
Fringe Benefits	$5,179	$10,356
<u>Examination and Collection</u>		
Salaries (5 positions)	$118,015	$236,030
Fringe Benefits	$24,121	$48,242
Travel - In state	$20,000	$40,000
Total Recurring Expenses	$193,180	$386,357

NOTE: Current law allows the Department of Revenue to reduce local sales tax distributions to absorb the cost of collection. While the bill does not explicitly give the Department this authority for the new tax, the data used to calculate revenues includes that administrative expense. Recent reports from the Department indicate that the cost of collection is $0.484 per $100.00 of collections. Applying this ratio to the estimated statewide revenues suggests that $1.11 million has been allocated from the FY 2001-02 revenues for administration. In FY 2002-03 that amount increases to $1.9 million. Out year projections include $2.0 million in FY 2003-04, $2.1 million in FY 2004-05, and $2.2 million in FY 2005-06.

II. Income Tax Withholding Tables
To implement the new 8.75% tax rate and increased standard deduction, the Department of Revenue estimates that it will need a one-time appropriation of $143,228 in FY 2001-02. These funds will be used to print and mail revised withholding tables to employers.

TECHNICAL CONSIDERATIONS:

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