NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: Senate Bill 1411 (Third Edition)

SHORT TITLE: Corporate Income Tax Exemption.

SPONSOR: Senator Smith

FISCAL IMPACT ($ Mil.)

	Yes ( )	No ( )	No Estimate Available ( )		
	FY 2004-05	**FY 2005-06**	**FY 2006-07**	**FY 2007-08**	**FY 2008-09**
REVENUES:					
STATE GENERAL FUND	**-11.7**	**-24.1**	**-24.5**	**-25.1**	**-25.6**

PRINCIPAL DEPARTMENT AFFECTED: The corporate 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: Tax year beginning on or after January 1, 2005.

BILL SUMMARY: Allows a corporation to exempt a specified amount of taxable income (income after deductions) from the corporate income tax as follows:

Taxable Income	Exemption Amount
$100,000 or Less	$25,000
100,000 – 200,000	12,500
Over 200,000	0

In addition, the formula earmarking 7.25% of net corporate income tax revenue for school facilities is raised to 7.40% in order to hold-harmless the school facilities earmarking.

ASSUMPTIONS AND METHODOLOGY: The starting point for the analysis is a tabulation of 2001 tax year corporate income tax returns by the Department of Revenue. The tabulation was based on a grouping of tax returns by taxable income amount. For each statistical reporting bracket, data on the number of returns, taxable income, and tax liability was shown. This data allowed for the determination of "average taxable income" and "average tax liability" for each bracket.

The next step was to grow the 2001 data to 2005. This process is complicated because during a period of economic recovery the growth rates for the number of returns and the average taxable income per return differ by statistical reporting bracket. For example, the typical experience is for the number of smaller returns to decline slightly while the largest reporting bracket ($1 million and over) rises exponentially. The average taxable income per bracket is relatively stable over time for smaller and medium-sized taxpayers but the amount for the highest brackets will increase at a very high rate.

The forecast of number of returns and average return size was accomplished by a review of the experience of three other states (Wisconsin, Utah, Virginia) for the mid-1990's period in addition to the 1990-94 North Carolina data. The other states were selected because of the availability of distribution data and the absence of major tax changes. The mid-1990's data was used because of the feeling that overall economic conditions during 2001-05 would be similar to the earlier period.

In addition, a projection of overall corporate income tax liability for 2005 was developed using the national forecasts of pre-tax corporate profits by Global Insight (used by Office of State Budget and Management) and Economy.com (used by Fiscal Research Division). The national outlook firms indicated that corporate profits should expand by 78-96% from 2001 to 2005. However, historical data indicates that federal and state tax bases have not kept up with the improvement in profitability over time due to a multitude of factors including the shift of business organizations to S corporation tax status and other types of corporate organizations, as well as efforts to minimize tax liability.

For this reason this analysis assumes that the state tax base will increase by 45% during this period. The original projection of the number of returns and average liabilities was then fine tuned to reconcile the total tax base using the distribution analysis to the amount using the tax base growth estimate. This adjustment took place largely in the upper statistical reporting brackets because of the sensitivity of these taxpayers to economic conditions. The adjustment had little practical impact on the estimate of the impact of this bill because, under the bill, the relief applies exclusively to corporations with the smallest taxable incomes.

The result of the analysis is that the projected 2005 statistical reporting bracket data can be used as a tax calculator to determine the impact of a policy change. The first step of this methodology is to determine the impact of the change on the average tax return in each bracket is calculated. This calculation is repeated for each statistical reporting bracket. The results for each bracket are then weighted by the number of returns in each bracket to come up with the total impact.

The projected 2005 data by size of income indicates that the exemption will completely eliminate the tax on 15,470 corporate returns, or 53% of the total of 28,952 returns. Another 9,273 returns (32%) will receive partial relief.

The calculation of the impact on the State General Fund includes the additional cost of 2.1% of the gross amount of the relief in order to hold harmless the dollar amount of the school facilities finance fund.

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