NORTH CAROLINA GENERAL ASSEMBLY

Session 2021

Fiscal Analysis Memorandum

CONFIDENTIAL

Requestor: Representatives Setzer, Szoka, and Bradford
Analyst(s): Rodney Bizzell, Denise Canada, Brent Lucas, Jonathan Tart, Emma Turner
RE: PCS to SB105

SUMMARY TABLE

The following table summarizes the PCS's impact on revenue. A more detailed fiscal chart is shown on page 5.

FISCAL IMPACT OF PCS for SB 105 ($ in millions)

	FY 2021-22	FY 2022-23	FY 2023-24	FY 2024-25	FY 2025-26
State Impact					
Tax Changes					
Personal Income Tax	(1,314.6)	(1,388.8)	(1,401.3)	(1,463.8)	(1,512.5)
Corporate Income Tax	(180.6)	(23.0)	(68.5)	(244.5)	(342.0)
Franchise Tax	-	(173.3)	(180.6)	(188.2)	(196.1)
Sales and Use Taxes	(7.9)	(6.5)	(6.7)	(6.8)	(7.0)
Insurance Taxes	0.5	(5.1)	(6.5)	(18.8)	(16.1)
Tobacco Tax	-	33.7	34.4	35.1	35.8
Fee Changes	See Fiscal Analysis Section.				
Less Expenditures	[Not addressed within this Fiscal Memo.]				
NET STATE IMPACT	**($1,502.6)**	**($1,563.0)**	**($1,629.2)**	**($1,887.0)**	**($2,037.9)**
Local Impact					
Sales and Use Taxes	(3.8)	(3.1)	(3.2)	(3.3)	(3.3)
Less Local Expenditures	-	-	-	-	-
NET LOCAL IMPACT	**($3.8)**	**($3.1)**	**($3.2)**	**($3.3)**	**($3.3)**

Fiscal Impact Summary

This Fiscal Memo addresses only those PCS sections that affect State or local revenue.

Fee Changes

- Sec. 7.62(a) may increase fee revenue because it allows boards of trustees to set fees for students at the State's two schools for the deaf.
- Sec. 10.2 may increase fee revenue because it allows the Board of Agriculture to create a fee for phytosanitary certificates.
- Sec. 12.10A(a) increases revenue by increasing the erosion and sedimentation fee.
- Sec. 16.12 may increase revenue by applying a current Court of Appeals printing fee to document management services to mirror current practice.
- Sec. 30.1.(a) reduces fee revenue by temporarily reducing the Insurance Regulatory charge from 6.5% to 5%.

Tax Changes

- Sec. 42.1 reduces revenue in two ways: first, by lowering the individual income tax rate from 5.25% to 4.99%; second, by increasing the standard deduction.
- Sec. 42.1A reduces revenue by exempting military retirement income from individual income tax.
- Sec. 42.1B reduces revenue by creating an individual income tax credit for living organ donors.
- Sec. 42.2 reduces revenue by reducing the corporate income tax rate from 2.5% to 2.25% in 2024 and to 1.99% in future years.
- Sec. 42.3 reduces revenue by eliminating the North Carolina property bases from the Franchise tax calculation.
- Sec. 42.4 reduces revenue by updating North Carolina's reference to the Internal Revenue Code (IRC) from May 1, 2020 to April 1, 2021. The fiscal impact results from: 1) conforming to a lower threshold amount for the medical expense deduction (7.5% of income instead of 10%) for 2021 and beyond; 2) conforming to the federal exclusion of unemployment benefits from income tax received in 2020; and 3) conforming to the federal tax treatment for expenses paid with PPP loans and other federal pandemic-related assistance. The PCS decouples from additional federal tax provisions that otherwise would reduce State revenue.
- Sec. 42.7 reduces revenue by re-enacting and making permanent the Mill Rehabilitation tax credit, including the credit for rehabilitated railroad stations.

- Sec. 42.7A reduces revenue by expanding and making permanent the historic rehabilitation tax credit.
- Sec. 42.8 reduces revenue by limiting the Gross Premium tax base for premiums paid to a surety bondsman to the amount paid by the surety bondsman to the insurer of the bail bonds.
- Sec. 42.9 increases revenue to the General Fund by expanding the State's existing 12.8% excise tax on Other Tobacco Products (OTP) to include all cigars shipped to North Carolina residents from out of State sellers. It also reduces the share of the 12.8% OTP tax that goes to the University Cancer Research Fund, to hold that Fund's revenue stable despite the expansion of the tax's scope.
- Sec. 42.10A reduces State and local sales tax revenue by expanding the existing sales tax exemption for some alcohol manufacturers to all alcohol manufacturers.
- Sec. 42.10B reduces State and local sales tax revenue by creating a sales tax exemption for all items, except alcohol, sold by Continuing Care Retirement Communities to residents of independent living communities.
- Sec. 42.11 replaces the 10% penalty for failure to pay tax due with a graduated penalty of 2% for each month that the payment is late, not to exceed a total penalty of 10%.
- Sec. 42.12 reduces local property tax revenue by exempting vaccines held by private medical practices from property tax.

FISCAL ANALYSIS

Fee Changes

Fees for Students at State-Operated Schools for the Deaf (Section 7.62(a))
Under current law, fees for students at the two schools for the deaf are set by the State Board of Education. The PCS takes the two schools for the deaf outside of the State Board's direct jurisdiction and creates a new board of trustees for each of the two schools. This provision transfers fee-setting authority for the schools to these newly created boards of trustees.

Fee Authority for State Phytosanitary Certificate (Section 10.2)
Because the PCS authorizes a new fee but does not enact it, no estimate is available. (Note: the term "phytosanitary" relates to measures for the control of plant diseases, especially in agricultural crops.)

Erosion and Sedimentation Fee (Section 12.10A(a))
The PCS increases the erosion and sedimentation fee from $65 per acre to $150 per acre of land planned to be, or actually, disturbed under an erosion and sedimentation control plan. The fee was last increased in 2007, and the increase in the PCS is estimated to generate $2.7M in new revenue to be used to support additional positions for the program. The section also increases the maximum fee from $130 to $200 for erosion and sedimentation plans submitted to a unit of local

government participating in a limited program. No local governments currently participate in the limited program, so no revenue is expected to be generated by this increase.

Court of Appeals Fee Change (Section 16.12)
The provision clarifies that fees for document management and the reproduction of appellate records and briefs also apply to document management services. Fees are currently being assessed for document management services, and the provision brings statutory language up to current practice. As such, no net fiscal impact is expected.

Insurance Regulatory Charge (Section 30.1.(a))
The PCS lowers the insurance regulatory charge from the Statutory rate of 6.5% to 5% for calendar year 2022 to spend down an accrued cash balance. The change is expected to lower revenue by $6.2 million in each fiscal year of the biennium, based on estimates provided by the North Carolina Department of Insurance.

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Tax Changes

The following table summarizes the five-year State revenue impact of the PCS's tax changes.

Tax Changes in PCS to SB105	FY 2021-22	FY 2022-23	FY 2023-24	FY 2024-25	FY 2025-26
PERSONAL INCOME TAX					
• Reduce Tax Rate to 4.99% (Effective 2022 Tax Year)					
• Increase the Standard Deduction effective 2022 (not indexed). MFJ, $25,500; HoH, $19,125; S/MFS, $12,750 (Eff 2022)					
• Conform to 2022 federal medical expense deduction					
• Eliminate tax on military pension income (Effective 2021)					
Subtotal: Personal Income Tax	**(638.0)**	**(1349.1)**	**(1395.1)**	**(1445.3)**	**(1496.8)**
CORPORATE INCOME TAX					
• Reduce Tax Rate to 2.25% in 2024, 1.99% in 2025 and thereafter	**0.0**	**0.0**	**(57.6)**	**(209.0)**	**(312.0)**
FRANCHISE TAX					
• Eliminate Franchise Tax Alternate Property Bases (Effective for Franchise Tax Calculated on 2022 Tax Returns)	**0.0**	**(173.3)**	**(180.6)**	**(188.2)**	**(196.1)**
IRC UPDATE					
• Conform to 2022 federal medical expense deduction	Included in Personal Income Tax estimates above.				
• SALT cap workaround and State NOL calculation	0.0	0.0	0.0	0.0	0.0
OTHER TAX PROVISIONS					
• Extend time to complete previously-eligible mill rehab projects; reenact mill rehab credit; make permanent mill rehab and railroad tax credits.	5.8	(15.0)	(20.8)	(56.0)	(45.0)
• Expand and make permanent the historic rehab credit.	(1.0)	(1.0)	(1.0)	(15.0)	(15.0)
• Living Donor Protection Act (HB 71)	(0.8)	(0.8)	(0.8)	(0.8)	(0.8)
• Limit Gross Premiums Tax on surety of bail bonds to the amounts received by an insurer from a surety bondsman (Effective 1/1/22)	(0.7)	(1.0)	(1.0)	(1.0)	(1.0)
• Expand cigar excise tax to all retailers (Effective 7/1/22)	0.0	33.7	34.4	35.1	35.8
• Create a sales tax exemption for items, except alcoholic beverages, sold by Continuing Care Retirement Communities (Effective 10/1/21)	(7.9)	(6.5)	(6.7)	(6.8)	(7.0)
• Alcohol Bev. Manufacture Sales Tax Exemption			No estimate		
• Create local property tax exemption for vaccines held by private medical practices. (Effective 7/1/21)	0.0	0.0	0.0	0.0	0.0
Subtotal: Other Tax Provisions	**(4.6)**	**9.4**	**4.1**	**(44.5)**	**(33.0)**
Subtotal: General Fund Impact	**(642.6)**	**(1513.0)**	**(1629.2)**	**(1887.0)**	**(2037.9)**
PANDEMIC-RELATED PROVISIONS					
• Allow deduction for PPP loans	(550.0)	(50.0)	0.0	0.0	0.0
• Allow deduction for EIDL, Shuttered Venue, and similar smaller programs.	(60.0)	0.0	0.0	0.0	0.0
• Unemployment income exclusion	(250.0)	0.0	0.0	0.0	0.0
Subtotal: Pandemic-Related Provisions	**(860.0)**	**(50.0)**	**0.0**	**0.0**	**0.0**
Grand Total: General Fund Impact	**(1502.6)**	**(1563.0)**	**(1629.2)**	**(1887.0)**	**(2037.9)**

Personal Income Tax Rate and Standard Deduction Changes (Sections 42.1)

Fiscal Research estimated the impact of the individual income tax changes using the Fiscal Research Division's Individual Income Tax Microsimulation model. Because the rate and standard deduction changes are effective for taxable years beginning January 1, 2022, the FY 2021-22 estimate includes the withholding and estimated payments for the first half of 2022, which represents approximately 45% of the annual impact.

Military Pension Income Tax Deduction (Section 42.1A)

Certain military retirement income is already exempt from State personal income tax under the "Bailey Settlement." The PCS makes additional military retirement income exempt.

To determine the amount of military retirement income that would become exempt under the PCS, Fiscal Research obtained 2020 data on the total amount of military retirement benefits paid to residents who first earned service after 1984. This analysis assumes that all military retirement benefits based on service earned after 1984 are subject to taxation under current law. Projections of benefit payments were based on the growth predicted in the Department of Defense's (DOD) FY 2018 Valuation of the Military Retirement System

The share of pension income that is subject to State income tax will increase each year because new retirees are less likely to meet the criteria required for exemption under the "Bailey Settlement." To determine this share, Fiscal Research used data provided by DOD about retirees' average years of service and year of retirement to approximate a year of first employment for current retirees. This was used to approximate the share of benefit payments that would be eligible for the Bailey exemption each year, assuming no breaks in service during the first five years of employment. The share of benefits that would not be eligible for the Bailey exemption was multiplied by the total amount of benefits to determine the amount of income that is taxable under current law. The fiscal impact was calculated by multiplying this amount by the estimated average effective tax rate applicable to filers who received income from the military retirement system. The estimates effective tax rates used reflect the tax rate and standard deduction changes included in this legislation for tax years 2022 onwards. Because the military retirement system does not automatically withhold state income tax, the impact for each fiscal year is assumed to equal the impact of the tax year ending in December.

Living Organ Donor Tax Credit (Section 42.1B)

Providing a non-refundable tax credit to living organ donors is estimated to cost a maximum of $800,000 annually in the form of lost personal income tax revenue. Based on data from the US Department of Health and Human Services, North Carolina has less than 200 living donors annually; estimates range from 120 to 190 living donors per year. The tax credit is intended to offset unreimbursed expenses incurred by these donors.

Under the National Organ Transplant Act, it is illegal to buy or sell organs. Thus, any tax incentives must be structured as an expense reimbursement that cannot result in a monetary benefit for donors. Most living donors are related to the recipient or are part of a paired donor exchange; only a handful of people choose to donate to an anonymous recipient. Generally, if the donor is a family member or friend, the recipient's Medicare or private health insurance will pay the donor's medical expenses. In cases of anonymous donations, insurance may not cover the donor's medical

expenses. Other donor expenses, such as lost wages and travel expenses, are not typically covered by insurance; it is these types of uncovered expenses to which the tax credit would apply.

Corporate Income Tax Changes (Section 42.2)
The estimated fiscal impact of phasing out the corporate income tax is based on the most recent Consensus Revenue Forecast for the biennium and is adjusted for growth in subsequent years. Timing adjustments were made to account for differences between the State's fiscal year and the typical tax year.

Franchise Tax Change (Section 42.3)
Fiscal Research estimated the impact of the franchise tax change based on the Consensus Revenue Forecast and on franchise tax statistics provided by the Department of Revenue.

IRC Update (Section 42.4)

Medical Expense Deduction
Reducing the threshold for the medical expense deduction to 7.5% is expected to reduce revenue collections by approximately $22.5 million initially, and this estimate is adjusted for growth in subsequent years. The estimate was developed using the Fiscal Research Microsimulation Tax Model using Federal and North Carolina tax return data.

Unemployment Insurance Income Tax Exclusion
This section allows a taxpayer to deduct unemployment compensation that is excluded from federal income tax in tax year 2020. The Internal Revenue Service (IRS) instructs taxpayers to use "the amount reported in box 1 of your Form 1099-G" to determine the amount of unemployment compensation that may be excluded, up to a maximum exclusion of $10,200 per person. Taxpayers with federal adjusted gross income of at least $150,000 are not eligible for the exclusion. According to the NC Division of Employment Security, approximately 950,000 claimants received 1099-G's for tax year 2020 with an average benefit of $9,600.

To determine the fiscal impact of this deduction, Fiscal Research used data from the NC Division of Employment Security showing the count of claimants aggregated into buckets by total unemployment compensation received in 2020. Based on historical data and the Fiscal Research Division Individual Income Tax Microsimulation model, we assumed a 3.6% effective tax rate and that approximately 50,000 claimants (5%) would not be eligible for the deduction because their federal adjusted gross income in 2020 was at least $150,000. This analysis assumes that the fiscal impact will be recognized in FY 2021-22. However, the timing could fluctuate, particularly based on the timing of the bill becoming law.

Payroll Protection Program (PPP) Loan Conformity
The estimated fiscal impact of conforming to the federal tax treatment for expenses paid with PPP loans and other federal pandemic-related assistance is based on data provided by the U.S. Small Business Administration. Fiscal Research reviewed the data for NC recipients to distinguish between non-profit organizations, C corporations, and all other business entity types. The total tax value of the deductions is equal to the sum of the deductions available by business type multiplied by the applicable tax rate for the specific business entity classification. The actual fiscal

impact and the timing of the fiscal impact may vary due to unknown variables, as some aspects of the federal programs have not been closed. Additionally, businesses that operate in North Carolina and in other states are subject to North Carolina tax even if they are domiciled in another state; allowing businesses to take the deduction would reduce revenue collections from these businesses. However, sufficient data is not available to determine the extent of the fiscal impact.

Mill Rehabilitation Tax Credit Changes (Section 42.7)

The impact of reenacting the mill rehabilitation tax credit is based on historical data on the average annual cost of the credit and the timing of enactment, adjusted for the fiscal impact associated with eliminating the deadline for completing eligible mill rehabilitation projects under the tax credit that expired in 2015 (grandfathered mill rehab projects) and for known railroad rehabilitation projects. The fiscal impact of eliminating the completion deadline for grandfathered mill rehab projects was estimated based on a review of projects with prior certifications that are still eligible for a credit. The actual number of projects that will be completed is unknown. Consequently, the fiscal impact could vary and may fluctuate significantly from year to year.

Historic Rehabilitation Tax Credit Changes (Section 42.7A)

The fiscal impact of expanding and making permanent the historic rehabilitation tax credit is based on historical data on the average annual cost of the credit. The actual number of potential projects that will be completed and the timing of completion is volatile. Consequently, the fiscal impact could vary significantly and fluctuate from year to year.

Gross Premiums Tax on Surety Bonds (Section 42.8)

Fiscal Research estimated the impact using industry data comparing tax liability under current law vs. tax liability under the proposed tax base change.

Excise Tax on Cigars (Section 42.9)

Fiscal Research's estimate for the total new revenue generated is based on confidential, proprietary data from one or multiple tobacco companies. The estimates used to adjust the split between the General Fund and the University Cancer Research Fund are based on the Consensus Revenue Forecast.

Sales Tax Exemption for Alcohol Beverage Manufacturing (Section 41.10A)

Expanding the scope of the current sales tax exemption will reduce tax collections for both the State and local governments. However, Fiscal Research cannot estimate the potential revenue loss under this PCS. There is no reliable data available to help forecast how much equipment is purchased annually that would qualify under this expanded exemption. The cost is expected to be minimal relative to the State's $7.8 billion sales tax base.

Sales Tax Exemption & Forgiveness for Continuing Care Retirement Communities (CCRCs) (Section 42.10B)

Three aspects of the provision have a potential fiscal impact on the State and on local governments. First, the provision provides a sales tax exemption, beginning in October 2021, for items sold by CCRCs to their independent living residents. Second, it forgives existing sales tax assessments issued on or after February 1, 2015. Finally, it allows for a refund of sales taxes paid from 2015-2021.

The estimate is based on proprietary data provided by one or more North Carolina CCRCs about the number of residents and cost of some items included in the exemption; on market information; and on data and information from the Department of Revenue.

Graduated Late Payment Penalty (Section 42.11)
Changing the automatic full 10% penalty for failure to pay tax due to a graduated penalty of 2% for each month the payment is late, not to exceed 10%, will reduce collections in the Fines and Forfeitures Fund by an unknown amount. About $75 million per year is credited to the Fund currently.

Property Tax Reductions (Section 42.12)
Most vaccines are provided by governmental or nonprofit health organizations; these vaccines are already exempt from business personal property taxes. The additional revenue loss from exempting vaccines held by private health facilities is unknown but minimal.

TECHNICAL CONSIDERATIONS

N/A.

DATA SOURCES

Fiscal Research Microsimulation Tax Model; Moody's Analytics; Internal Revenue Service; North Carolina Departments of Revenue, Health and Human Services, Transportation, Commerce, and Insurance; NC Association of Assessing Officers; Cigar Association of America; confidential information from one or more tobacco companies; confidential information about Continuing Care Retirement Communities; U.S. Census Bureau; U.S. Department of Defense; U. S. Small Business Administration.

FISCAL ANALYSIS MEMORANDUM – PURPOSE AND LIMITATIONS

This document is a fiscal analysis of a bill, draft bill, amendment, committee substitute, or conference committee report that is confidential under Chapter 120 of the General Statutes. The estimates in this analysis are based on the data, assumptions, and methodology described in the Fiscal Analysis section of this document. This document only addresses sections of the bill that have projected direct fiscal impacts on State or local governments and does not address sections that have no projected fiscal impacts. This document is not an official fiscal note. If a formal fiscal note is requested, please email your request to the Fiscal Research Division at FiscalNoteRequests@ncleg.net or call (919) 733-4910.