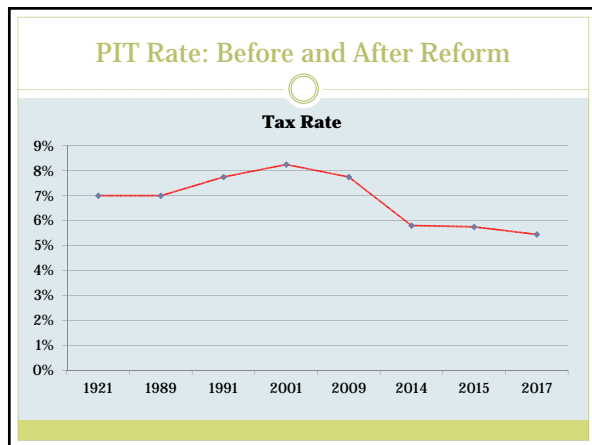
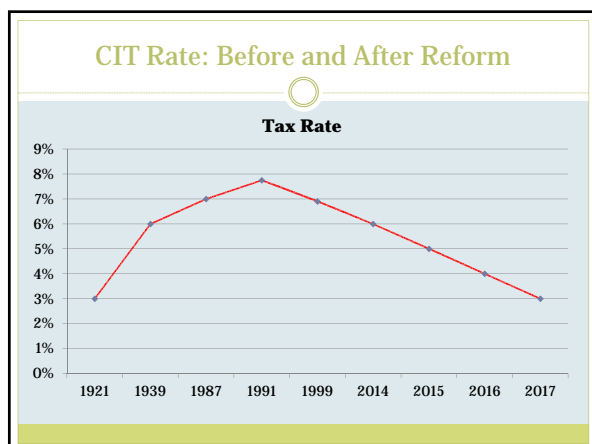


Tax Reform: Putting Recent Legislative Proposals and Changes in Context

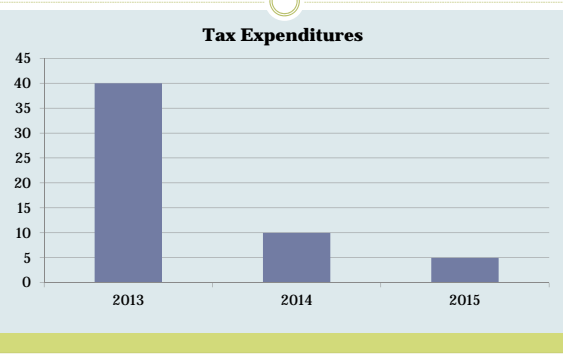
WHITNEY AFONSO
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~
CINDY AVRETTE
RESEARCH DIVISION, NCGA
~
JONATHAN TART
FISCAL RESEARCH DIVISION, NCGA

*PUBLIC LAW FOR THE PUBLIC'S LAWYER
NOVEMBER 13, 2015*





Tax Expenditures: Before and After Reform



Sales Tax Base Expansion



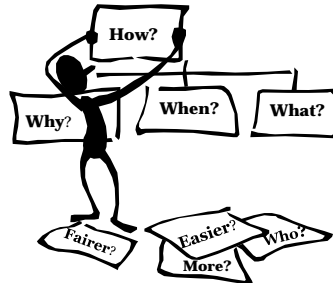
Estimated Fiscal Impact of Tax Changes

\$Millions					
	FY 2015-16	FY 2016-17	FY 2017-18	FY 2018-19	FY 2019-20
Personal Income Tax	-117.3	-437.1	-719.8	-755.8	-793.6
Corporate Income Tax	-1.9	-23.3	-42.8	-69.9	-73.3
Franchise Tax	0	0	0	0	0
Sales Tax	44.5	159.5	166.7	174.2	182
Historic Tax Credit	0	-8	-8	-8	-8
Total	-74.7	-308.9	-603.9	-659.5	-692.9

Projected Revenue

GF Revenue	FY16	FY17	FY18	FY19	FY20
Projected Revenue*	21,965.1	22,576.1	23,253.4	23,997.5	24,777.4
Finance Changes in H97 CCS	(74.7)	(308.9)	(603.9)	(659.5)	(692.9)
Other Enacted Tax and Non-tax changes	(162.5)	(255.4)	(246.1)	(246.1)	(246.1)
Net Projected Revenue	21,727.9	22,011.8	22,403.4	23,091.9	23,838.4
% growth net revenue		1.3%	1.8%	3.1%	3.2%

Lot of Changes
in NC's Tax
Structure



Tax Code Used to Achieve ...




Principles of a Sound Tax Structure

Basics	Advanced
<ul style="list-style-type: none"> • Revenue Sufficiency • Revenue Stability • Simplicity <ul style="list-style-type: none"> ◦ Ease of Compliance ◦ Ease of Administration • Economic Neutrality 	<ul style="list-style-type: none"> • Economic Competitiveness • Equity <ul style="list-style-type: none"> ◦ Vertical ◦ Horizontal • Distribution of Tax Revenue between State and Local Governments

Tax Reform Begins ...

Revenue Insufficiency

- FY 1990-1991
 - 8.1% shortfall
- FY 2001-02, 2005-06
 - 10.8% shortfall
- FY 2008-09
 - 15.2% shortfall



Change is gonna come ...

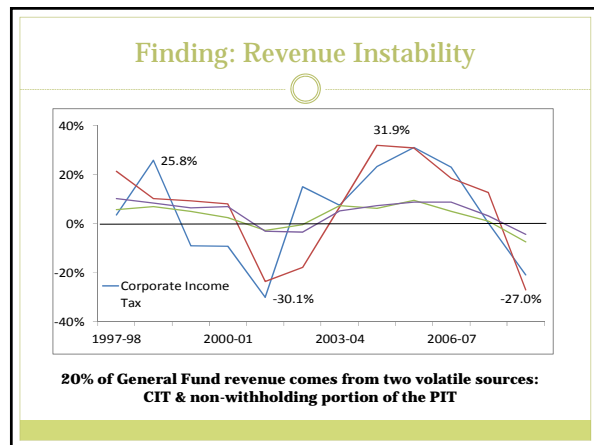
Ad hoc Tax Changes

- 1991: Tax increases
 - Sales tax rate
 - CIT & PIT rates
- 1996-1999: Tax decreases
 - CIT rate reduction
 - Phase-out of sales tax on food
 - Dozens of tax expenditures
- 2001: Temporary tax increases
 - 4th PIT bracket
 - Sales tax rate

- 2003: Extension of tax increases
- 2005: Extension of tax increases
- 2006 -2007: Tax decreases
 - CIT & PIT expenditures
 - Early sunset of tax rate increases
- 2009: Temporary tax increases
- 2011: Tax decreases
 - Tax increases sunset
 - \$50,000 Business deduction

Reform, aka "Change"

- 1991 Economic Future Study Committee
- 1999 Tax Policy Study Committee
- 2001 Governor's Commission on Tax Loopholes
- 2002 Governor's Commission to Modernize State Finance
- 2008-09 IEI: Financing the Future
- 2008 State and Local Fiscal Modernization
- 2009 Joint Select Committee on Economic Development Incentives
- 2009-10 Joint House and Senate Finance Committee on Tax Reform



Broaden the Base Lower the Rate

Broader the Base, greater the indifference between choice of goods or services

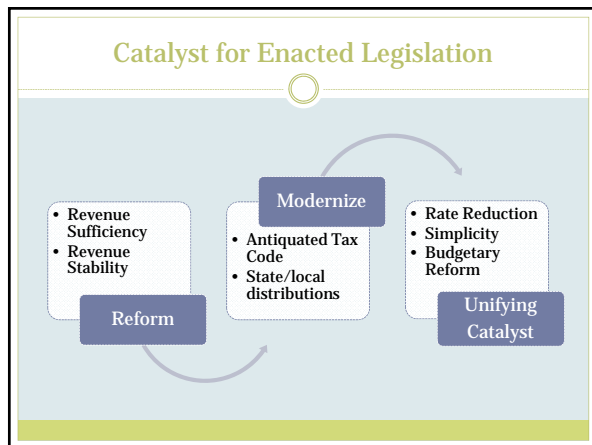
Lower the Rate, greater the indifference between doing something taxed v. doing something not taxed

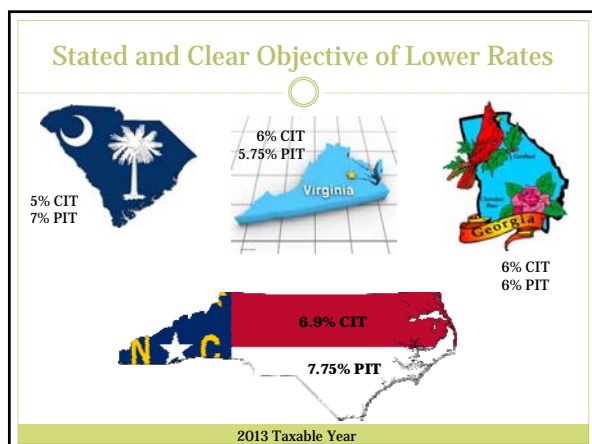
- Modernize the tax code
- Simplify the tax code by eliminating many of the exemptions, deductions, credits, and refunds
- Eliminate corporate tax incentives
- Reduce tax rates to be competitive
- Expand sales tax base to services
 - Equalize tax rates on entertainment
 - Include repair and installation services

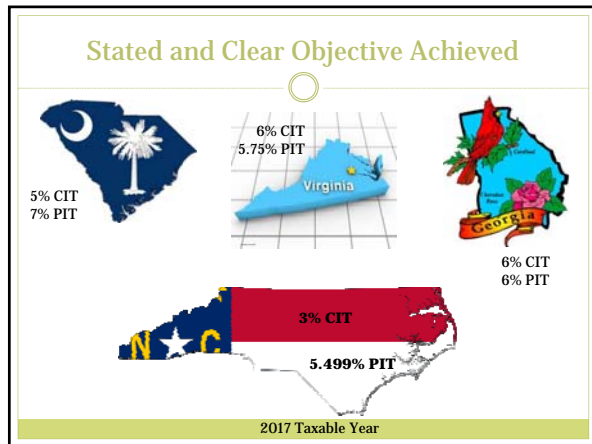
Guidelines for Successful Tax Reform

Dr. Ben Russo
UNC-Charlotte
State Tax Notes
Feb. 13, 2006

- Start with principles
- Apply principles to the whole, not the parts
- Push for broader bases, lower rates
- Strive for revenue neutrality
- Acknowledge reforms involve losers
- Educate
- Listen







INCOME TAX CHANGES

CORPORATE INCOME & FRANCHISE TAX

INDIVIDUAL INCOME

CIT Rate Changes

- 2013 – 6.9%
- 2014 – 6%
- 2015 – 5%
- 2016 – 4%
 - Trigger for rate reduction for taxable year 2016 met
 - Net GF tax collections for FY14-15 exceeded \$20,200,000,000
- 2017 – 3%
 - Rate will fall to 3% when the next trigger is met
 - Trigger = net GF tax collections exceed \$20,975,000,000
 - Revenue projection for FY15-16 assumes trigger will be met

Business Tax Base: Before and After Reform	
Tax Base Before	Tax Base After
Local privilege license taxes Privilege tax on banks	
Credits & Deductions Available Tax credits for ports charges, recycling oyster shells, renewable fuels, work opportunity, interactive digital media, Article 3J, qualified business venture, film, renewable energy, historic and mill rehabilitation, low income housing, research & development, construction of dwelling units for handicapped, real property donations, conservation tillage equipment, gleaned crops, and construction of poultry composting facility. Deductions for amortization in excess of depreciation allowed under the Code on the cost of sewage or waste treatment plant, air cleaning devices, recycling facilities, emergency facilities acquired before 1955, reforestation and cultivation of commercially grown trees, eligible income of an international banking facility, tobacco marketing assessments, settlement agreements, hurricane assistance, interest earned on deposits by a savings and loan association	Credits & Deductions Available Historic rehabilitation, miscellaneous others that are administrative in nature

Corporate Income and Franchise Tax Apportionment

- Apportionment - method of allocating profits and net worth among the states where a company is taxable
- A company is taxable in a state in most cases because it has property or employees there
- NC calculates apportionment % using double weighted sales factor through 2015

Double-Weighted Sales Factor

Under double weighted sales factor, NC apportionment is equal to average of:

$\frac{\text{NC Property}}{\text{Total Property}}$	+	$\frac{\text{NC Payroll}}{\text{Total Payroll}}$	+	$\frac{\text{NC Sales}}{\text{Total Sales}}$	+	$\frac{\text{NC Sales}}{\text{Total Sales}}$
--	---	--	---	--	---	--

Single Sales Factor Apportionment

- **Phased in over three years**
 - 2016: Sales factor counted three times
 - 2017: Sales factor counted four times
 - 2018: Property and Payroll no longer part of calculation of apportionment formula
- **Property and Payroll gradually diluted in the apportionment formula until elimination in 2018**
- **Majority of states with a CIT have SSF (21 states)**
 - GA and SC
 - VA for retail and manufacturing

PIT Starting Point

- **2011 personal income tax calculation starts with federal **taxable income****
- **2012 and after the calculation starts with federal **adjusted gross income****
- **Change in the starting point set the stage for significant changes in the calculation of North Carolina taxable income**

PIT Itemized Deduction Changes

- **2013**
 - Substantially the same as federal itemized deductions
- **2014**
 - Eliminated all itemized deductions but three
 - Three remaining itemized deductions:
 - Charitable contributions
 - Home mortgage interest + Property taxes paid on real estate, capped at \$20,000
- **2015**
 - Additional itemized deduction for Medical and Dental Expenses
 - Unlimited; no cap

PIT Standard Deduction Changes

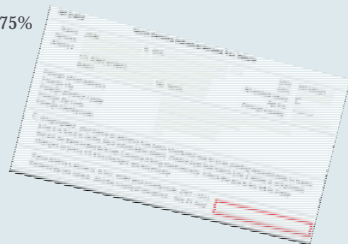
- **2013**
 - Personal Exemptions and Standard Deductions
- **2014**
 - No personal exemptions
 - Larger standard deductions
 - Married filing jointly \$15,000
 - Head of Household \$12,000
 - Single \$ 7,500
 - Married filing separately \$ 7,500
- **2016**
 - 3% increase in standard deduction amounts
 - Married filing jointly moves from \$15,000 to \$15,500
 - Others move accordingly

PIT Base: Before and After Reform

Tax Base Before			Tax Base After		
Standard Deduction	Personal Exemption	Child Tax Credit	Standard Deduction	Personal Exemption	Child Tax Credit
\$6,000	\$2,000	\$100	\$15,500	None	\$125
For Married Filers	per Person	For All Taxpayers	For Married Filers		Enhanced Credit Amount For MEJ If AGI is less than \$40,000
More if taxpayer is 65 years or Older or blind	\$2,500 if income is less than \$100,000				
Credits & Deductions Available			Credits & Deductions Available		
Tax credits for earned income tax, child care, adoption expenses, non-itemized charitable expenses, disability, property taxes on farm machinery			Tax credit for children		
Deductions for retirement income, social security income, severance income, certain bond obligation interest, long-term care insurance, \$50,000 business deduction, parental savings trust fund, firefighter & rescue squad, erroneous conviction, qualified sale of a manufactured home community			Deduction for social security income, Bailey retirement income, limited itemized deductions, certain bond obligation interest		
Estate tax					

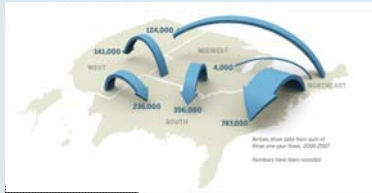
PIT Rate Changes

- **2013**
 - Graduated rates
 - Range from 6% to 7.75%
- **2014**
 - Flat rate
 - 5.8%
- **2015 & 2016**
 - 5.75%
- **2017**
 - 5.499%



Expectations & Concerns

- **Neo-Classical Economic Theory**
 - Predicts major consequences



Literature

- **What we “know”**
 - High income workers
 - Migration decisions are costly



Literature

- **Everything else...**
 - Very mixed evidence
- **Relationship between PIT &**
 - Migration
 - Same-sign problem
 - Wages
 - Economic growth



"Good" Tax Policy

- We want taxes that are:
 - Efficient
 - Equitable
 - Adequate
 - Feasible
- What does that look like for PITs?
 - Flat?
 - Deductions?

North Carolina's Reforms

- How do the reforms since 2013 stack up?
 - Efficiency
 - Equity
 - Adequacy



Sales Tax Changes



Sales Tax on Services

- Sales tax is a tax on consumer spending
- American sales tax is and historically has been essentially a tax on the sale of tangible personal property at retail
- More the product of historical accident than logic
- Acquisition of services constitutes consumer spending
- No difference between tangible personal property and services to warrant a different tax treatment

Walter Hellerstein, "Sales Taxation of Services: An Overview of Critical Issues"

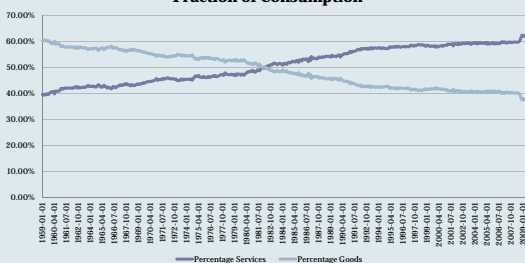
PERSONAL CONSUMPTION EXPENDITURES 1979 and 2007

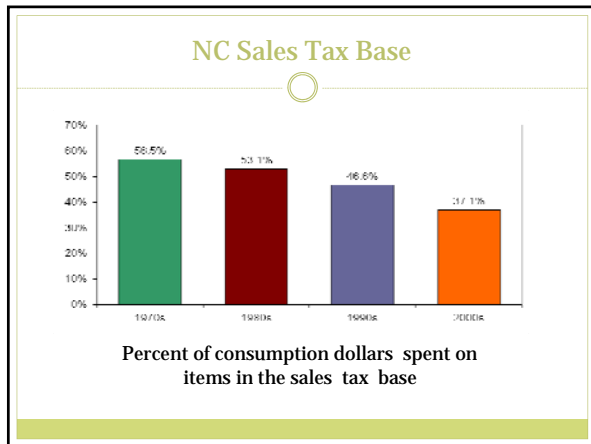
	1979 Percent	2007 Percent
Total Expenditure	100.0	100.0
Durable Goods	13.4	11.2
Autos	5.9	4.5
Furn & Household	5.2	4.3
Other Durables	2.4	2.3
Nondurable Goods	39.1	29.2
Food and Beverage	20.3	13.7
Other Nondurables	18.8	15.2
Services	47.4	59.7

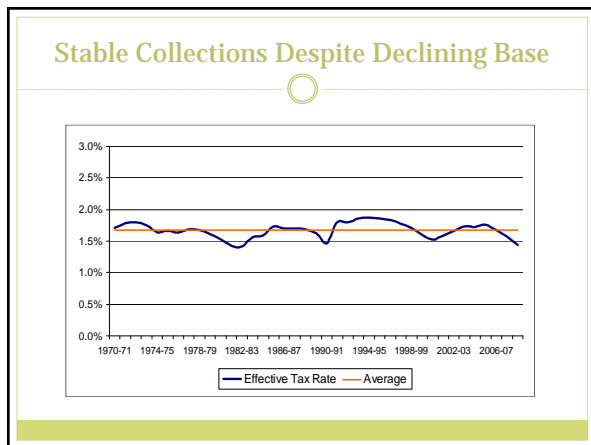
11/2/2009

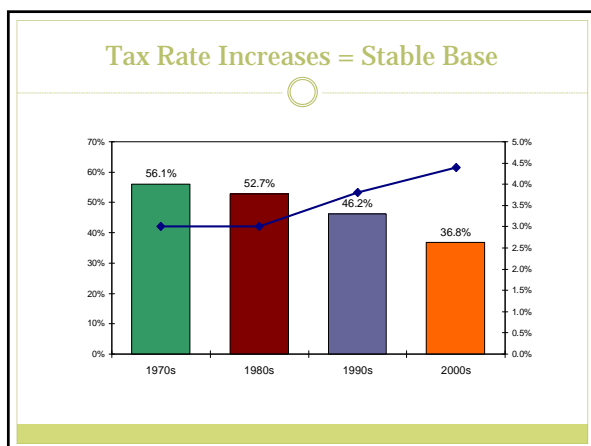
Sales of Goods and Services

Fraction of Consumption

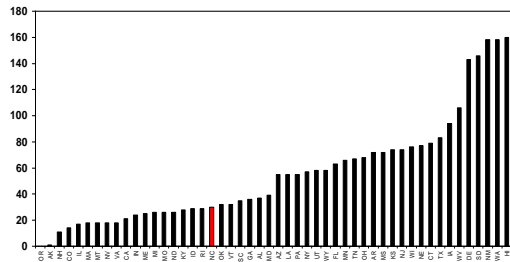








Taxation of Services by State, 2007



Federation of Tax Administrators

Categories of Taxable Services

- **Primarily household services**
- **Services purchased by households and businesses**
- **Primarily business services**
- **Entertainment**
- **Personal & pet care**
- **Utilities**
- **Service contracts, installation, repair, and maintenance**
 - Exemption for items exempt from sales tax
- **Professional**
 - B2B
 - Sourcing
 - Cascading
 - Vertical integration

Sales Tax Base Expansion, 2014-2016

- **Tax rate increases:**
 - Manufactured and modular homes from 2% and 2.5% to 4.75%
 - Aircraft from 3%, \$1,500 cap to 4.75%, \$2,500 cap
- **Tax base expanded to include gross receipts derived from:**
 - Entertainment charges
 - Service contracts
 - Repair, maintenance, and installation services
- **Tax base expanded by eliminating sales tax exemptions for:**
 - Nutritional supplements sold by a chiropractor
 - Meals sold in higher educational facilities
 - Newspapers
 - Bakery thrift stores
 - Sales tax holidays for school supplies and energy star products
 - Installation charges
- **Sales tax exemption for farmers requires income threshold**
- **Sales tax refund for nonprofits capped**

Considerations with Sales Taxes

- **Benefits:**
 - Diversification
 - Large base
 - Unavoidable
 - Residents and non-residents
- **Classic concerns:**
 - Volatility
 - Equity
 - Tax competition
 - Evasion?



Taxing Services

- **Why services?**
- **Services have become more important**
 - 57% of personal income
 - Up by 35% since 1970
 - Shift from tangible items to services
 - Narrower tax base
- **Regressive?**

Services & Burden

- **Index**
 - ~0 much more burdensome for low income
 - ~1 equal burden on low and high income
- **Services:**
 - Maintenance and repairs (0.33), Auto maintenance (0.26), Vehicle insurance (0.16)
 - Health insurance (0.19) & Medical services (0.25)
 - Personal services (0.78) & Fees and admissions (0.83)

Services & Burden

What has North Carolina done?

- Index
 - ...
 - ... high income
- Services:
 - Maintenance and repairs (0.33), Auto maintenance (0.26), Vehicle insurance (0.16)
 - Health insurance (0.19) & Medical services (0.25)
 - Personal services (0.78) & Fees and admissions (0.83)

Overall

- If we were to add in services?
 - Approximate without services (0.25)
 - Household services and base (0.26)
 - All services and base (0.25)
- Revenue?
 - Addition of personal services (+22.99%)
 - Addition of financial services (+16.6%)
 - Addition of health and education (+47.86%)
- Volatility?
 - Slight increase

Tax Reform and Local Governments

~

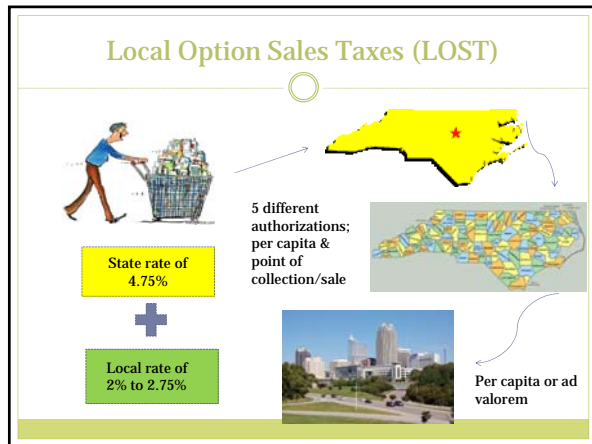
LOCAL SALES TAX BASE

~

LOCAL SALES TAX DISTRIBUTION

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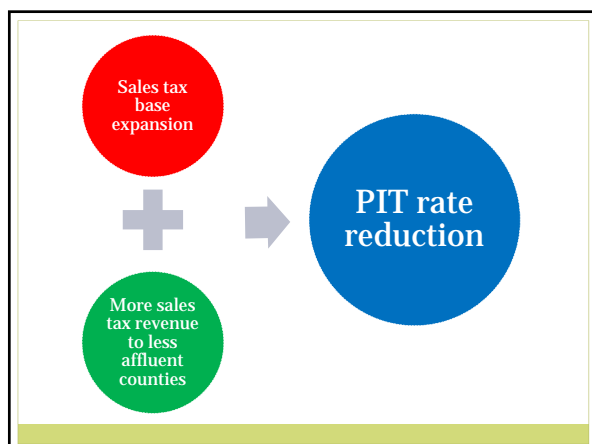
IS THERE A UNIFYING OBJECTIVE?

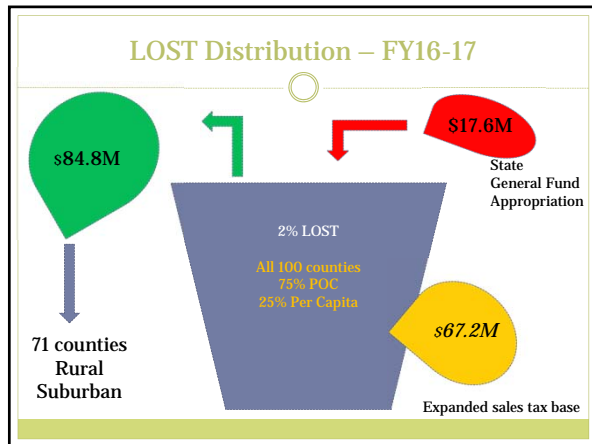


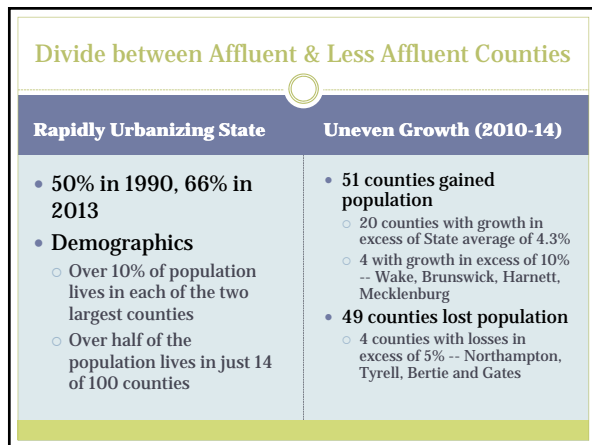
Current Local Sales Taxes

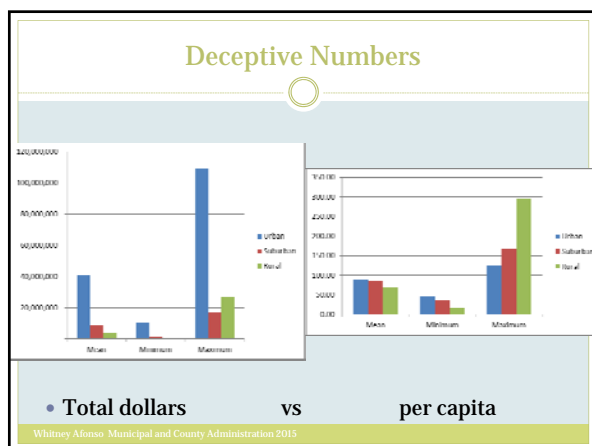
1 st 1 cent Art. 39		Any lawful purpose	Point of collection
1 st ½ cent Art. 40		Counties - 30% school capital	Per capita
2 nd ½ cent Art. 41		Counties - 60% school capital	Per-capita Point of collection
Third ½ cent Art. 42		Any lawful purpose	½ Point of collection
Repealed			
¼ cent Art. 46		Any lawful purpose	Point of collection – distributed to County only.

Art. 43: Sales Tax for Public Transit
½ cent (6 counties) or ¼ cent (94 counties)









Equity of LST Revenue

Per Capita Local Sales Tax Revenue (Article 39)



• <http://sogpubs.unc.edu/electronicversions/pdfs/lfb49.pdf>

What Explains this Pattern?

• Factors driving sales tax revenue:

- Income of residents
- Retail agglomerations
 - Tax leakage
- Residents vs Non-Residents
 - Commuters
 - Tourists
 - College students



• Which is more volatile?

- Tourists.

Whitney Afonso Municipal and County Administration 2015

Revenue Raising Capacity

Average Property Tax and LOST Revenue				
		LOST		Property tax revenue
				Total Property Value
In total dollars (000s)	Urban	14,700	291,709	44,000,000
	Suburban	5,463	41,237	8,225,920
	Rural	3,020	19,948	3,308,751
	Tourism rich	8,953	60,061	12,300,000
In per capita dollars	Urban	89.75	610	93,316
	Suburban	89.53	633	143,451
	Rural	64.54	465	79,799
	Tourism rich	100.71	554	132,354

The suburban and rural counties that have been re-coded as tourism are not included in the suburban and rural averages. The totals are presented in thousands of dollars, the per capita terms are not.

Whitney Afonso Municipal and County Administration 2015

Further Considerations

- Sales taxes are often seen as extremely inequitable
 - One caveat:
 - Tourism rich and urban areas have a lot of non-resident traffic
 - This means they are able to export a portion of the burden
 - However they also have large populations coming and using resources and services that do not pay traditional taxes
- Statistically...
 - There is no difference between the overall revenue raising capacity of these different classifications

Whitney Afonso Municipal and County Administration 2015

Is there more to come?

CIT rate set to drop to 3%

SSF apportionment set to occur


PIT rate set to drop below 5.5%

Standard deduction set to increase to \$15,500

Sales tax base expansion divide between personal care and professional services

County sales tax distribution

Sen. Rucho announced he is not seeking re-election



The End

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