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North Carolina Proposal Builds on Landmark 2013 Reform

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Executive Summary

In 2013, North Carolina policymakers accomplished fundamental tax reform, implementing overhauls in multiple areas of the tax code. The multi-bracket individual income tax that topped out at 7.75 percent was replaced with a flat 5.75 percent tax with a generous standard deduction. The corporate tax rate was cut from 6.9 percent to 6 percent in year one, with trigger reductions scheduled to bring the rate to 3 percent by 2017. The sales tax base was broadened to offset some of the revenue reductions.

Initial indicators on the effect of the tax changes are positive. The state improved its ranking in the *State Business Tax Climate Index* from 44th to 16th,[1] tax revenue exceeded projections by $400 million this year.[2] Additionally, the tax reform was paired with unemployment reform, and unemployment rates dropped from 8.3 percent to 6.9 percent in the second half of 2013.[3]

In recent months, the North Carolina House has responded to calls from Governor Pat McCrory to renew tax incentive programs with a bill that allocates $45 million to Job Development Investment Grants (JDIG).[4] On June 10th, the Senate responded with a bill that makes changes to the existing tax incentive scheme, but also includes numerous broad-based reforms as well.

1 Scott Drenkard & Joseph Henchman, Tax Foundation, *2015 State Business Tax Climate Index*, Oct. 28, 2014, http://taxfoundation.org/article/2015-state-business-tax-climate-index.
2 Colin Campbell, Projections show $400 million NC surplus, The News & Observer, May 6, 2015, http://www.newsobserver.com/news/politics-government/state-politics/article20331933.html.
3 John Hood, Wall Street Journal, *North Carolina Got It Right on Unemployment Benefits*, Jul. 4, 2014, http://www.wsj.com/articles/john-hood-north-carolina-got-it-right-on-unemployment-benefits-1404509638.
4 Richard Craver, Winston-Salem Journal, *NC Senate Proposes New Tax Cuts, Lowers Funding for Economic Development*, Jun. 11, 2015, http://www.journalnow.com/news/state_region/nc-senate-proposes-new-tax-cuts-lowers-funding-for-economic/article_6f79e6ca-0fe2-11e5-bf37-239061fec235.html.

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The broad-based reforms in the Senate package include:

- a reduction in the individual income tax rate from 5.75 percent to 5.5 percent by 2016,
- the reinstatement of federal deductions,
- an increase in the standard deduction from $7,500 to $9,250 by 2020,
- a decrease in the franchise tax rate from 0.15 percent to 0.1 percent,
- a reduction in the corporate rate to 3 percent by 2017, and
- moving the state to a single sales factor corporate tax apportionment method.

Revenue offsets in the Senate package include: an expansion of the sales tax base to manufactured and modular homes, aircrafts and boats, and purchases for nonprofit organizations that currently enjoy an exemption.

Other notable elements of the Senate proposal include a redistribution of sales tax dollars based on population instead of point of sale and a new authority given to counties to levy an additional 0.5 percent local option sales tax for education purposes via referendum. Each of these elements are discussed in detail below.

In whole, the approach the Senate has adopted is a noteworthy continuation of the positive tax reforms in the North Carolina tax code over the past few years. While the plan incorporates costly economic development incentives and also includes geographical redistribution in the local sales tax code, those gripes take a back seat to robust reforms in the individual, corporate, and franchise tax systems.

Once fully phased in, the Senate plan is projected to improve North Carolina's ranking in the *State Business Tax Climate Index* from 16th to 14th overall, with sizeable improvements in the component tax scores, most notably improving the corporate component score from 25th to 11th (Table 1).

Table 1: State Business Tax Climate Index Ranking under Senate Proposal

	Current Law	Under Senate Proposal
Overall	16	14
Corporate	25	11
Individual	15	14
Sales	33	35
Unemployment Insurance	11	11
Property	29	28

Individual Income Tax Reductions Improve on 2013 Reform

One of the key components of the Senate proposal is a reduction in the individual income tax rate from its current rate of 5.75 percent to 5.5 percent beginning in 2016. This is an across-the-board tax cut to the single tax rate, but it is also paired with an increase in the standard deduction, which provides additional tax relief for lower-income tax payers as well.

The standard deduction increases are phased in over time (Table 2), such that by 2020, the first $18,500 in taxable income for a married filing jointly couple would be free from income tax.

Table 2: Proposal Increases Standard Deduction Over Time

Tax Year	Single	Head of Household	Married Filing Jointly
2015	$7,500	$12,000	$15,000
2016	$8,750	$14,000	$17,500
2017	$8,875	$14,200	$17,750
2018	$9,000	$14,400	$18,000
2019	$9,125	$14,600	$18,250
2020	$9,250	$14,800	$18,500

The Senate plan would also reinstate all deductions allowed on the federal income tax, up to $20,000. Many of these were removed as a component of the 2013 reform in an effort to broaden the tax base, but the change has been met with pushback from taxpayers.5

Corporate Tax Reform Would Give North Carolina Lowest Rate East of the Mississippi

North Carolina's 2013 tax reform package brought the corporate tax rate from 6.9 percent in 2013 to 5 percent by 2015. It also included a trigger mechanism to bring the rate to 3 percent by 2017 if certain revenue conditions were met.

Because of the $400 million surplus this year, those triggers have been met. Accordingly, the Senate plan removes the trigger language and writes the rate cuts firmly into statute. Once fully phased in in 2017, the state's 3 percent corporate income tax rate would be the lowest rate east of the Mississippi River (Table 3 and Figure 1).[6]

5 *Id.*
6 Jared Walczak, *State Corporate Income Tax Rates and Brackets for 2015*, Tax Foundation Fiscal Fact No. 463, Apr. 21, 2015, http://taxfoundation.org/article/state-corporate-income-tax-rates-and-brackets-2015

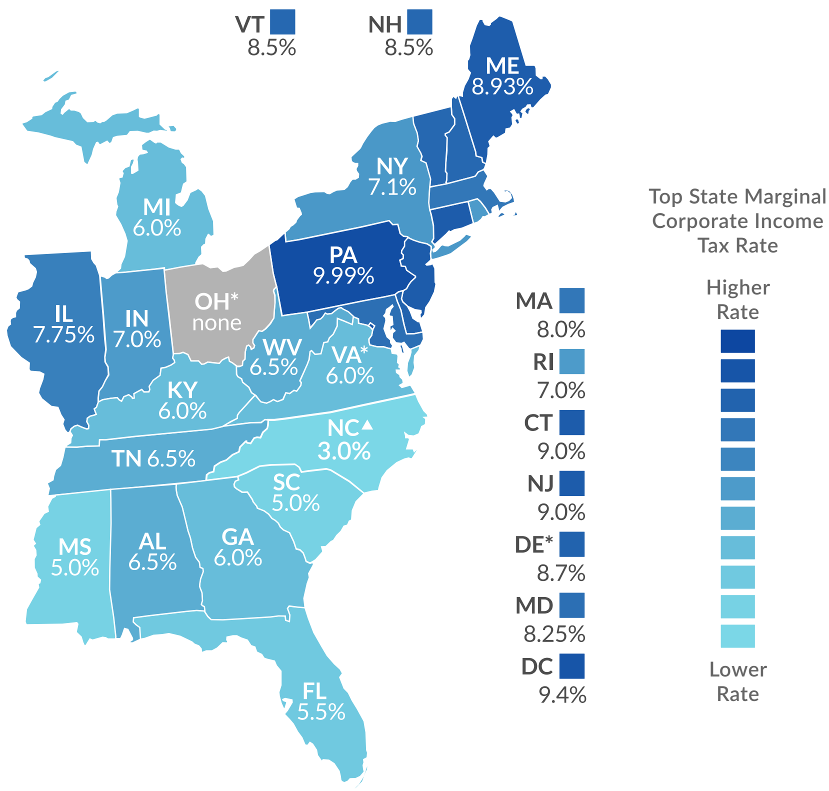
Table 3: Corporate Tax Rate Phases Down Over Time

Tax Year	Corporate Tax Rate
2013	6.9%
2014	6%
2015	5%
2016	4%
2017	3%

CHART 1.

Proposed Corporate Tax Reform Would Make North Carolina Lowest Rate East of Mississippi

Top State Marginal Corporate Income Tax Rates (as of Apr. 15, 2015)



▲ Proposed rate
(*) State has gross receipts taxes with rates not strictly comparable to corporate income tax rates.
Notes: Connecticut's rate includes a 20% surtax. Illinois' rate includes two separate corporate income taxes.
Sources: State tax statutes, forms, and instructions; Commerce Clearinghouse.

Academic studies find the corporate income tax to be one of the most harmful taxes to economic growth,[7] but it tends to also be one of the smaller portions of the state and local revenue toolkit. For example, in North Carolina in fiscal year 2012, the corporate income tax only generated 3.5 percent of state and local tax collections.[8] For these reasons, cutting the

7 William McBride, *What Is the Evidence on Taxes and Growth?*, Tax Foundation Special Report No. 207, Dec. 18, 2012, http://taxfoundation.org/article/what-evidence-taxes-and-growth

8 Tax Foundation, *Facts & Figures 2015, How Does Your State Compare?*, Mar. 10, 2015, http://taxfoundation.org/article/facts-figures-2015-how-does-your-state-compare, at Table 8.

corporate rate can be one of the better bang-for-your-buck tax reform options in that it aids economic growth without hitting state coffers too heavily.

Franchise Tax Cuts Address Weak Point in North Carolina Business Tax Code

Another key element of the Senate proposal is a reduction in the rate of the state's franchise tax from 0.15 percent to 0.1 percent. The franchise tax has been an unpopular part of the state's tax code for years.

In 2012, Tax Foundation analysts and economists conducted dozens of interviews with North Carolina business owners, taxpayers, legislators, accountants and other policy stake holders as a component of our research for a large publication laying out comprehensive reform recommendations for the state.[9]

The one tax that was mentioned as problematic in nearly every meeting was the franchise tax. Our findings in that report still hold true today:

> North Carolina is one of 20 states retaining the once-universal franchise, or capital stock, tax on the net worth of businesses. Described as a "tax on breathing," the North Carolina franchise tax is a 0.15 percent annual tax paid on the wealth of a C or S corporation. Because the tax is paid in good times and bad, businesses often find themselves using precious cash flow to pay it. The tax raises approximately $700 million per year.
>
> In broad economic terms, franchise taxes (or capital stock taxes, as they are sometimes called) are destructive because they disincentivize the accumulation of additional wealth, which distorts the size of firms. Several states have recognized this harmful effect and are moving away from franchise taxes as a source of revenue. West Virginia and Pennsylvania will fully phase out their tax by 2015 and 2014, respectively, and Kansas recently completely repealed its tax in 2011.
>
> Only three of North Carolina's neighbors retain the tax: Georgia has only a de minimis tax capped at $5,000, Tennessee has a higher tax, and South Carolina has a lower tax. At present rates, a large business (one with $100 million or more in assets) in North Carolina would face the 9th highest franchise tax liability in the country (tied with New York).[10]

9 Joseph Henchman & Scott Drenkard, Tax Foundation, *North Carolina Tax Reform Options: A Guide to Fair, Simple, Pro-Growth Reform*, Jan. 23, 2013, http://taxfoundation.org/article/north-carolina-tax-reform-options-guide-fair-simple-pro-growth-reform.
10 *Id.*, at 23.

The reduction in this tax would improve North Carolina's ranking on the property tax component of the *State Business Tax Climate Index*, and would reduce the cost of accumulating and maintaining capital.

Sales Tax Base Expansion Offsets Tax Reductions

Revenue raisers in the Senate tax plan include an increase in the sales tax on mills, boats, and aircraft to match the general sales tax rate; a cap on the sales tax exemptions nonprofits can claim in a year; and an expansion of the sales tax base to include veterinary services, pet care services, and the installation, repair, and maintenance of tangible personal property.

An ideal sales tax base would apply broadly to all consumption, taxing each good or service once and only once at its point of final sale. States vary widely from this ideal, however, with most states leaving a variety of final service transactions untaxed or problematically overtaxing business inputs like raw materials.[11]

The Senate proposal does a relatively good job of improving on this. For example, expanding the sales tax to include pet care services is a step in the right direction. Pets are universally adored, but veterinary and animal services should be subject to the same sales tax that consumers pay on other consumer transactions.

One provision of the plan where this gets more complex is in the cap on nonprofit sales tax exemptions. Nonprofit organizations in North Carolina are currently exempt from paying sales taxes on purchases they make up to $666,666,667. The Senate plan would make that exemption less generous over the next five years, reducing it to $15 million by fiscal year 2021.

In the broad sense, this exemption should be available in an uncapped fashion to the entire business community, as all business purchases of products and services should be exempt. On the other hand, lowering this cap to $15 million would still give most nonprofits an ample exemption. It is also a rather clever way to collect some sales tax from the very largest nonprofits, hospitals, whose final consumer services currently go untaxed even though they ought to be included in the sales tax base.

Sales Tax Redistribution Would Benefit Rural Areas, Hurt Cities

One element of the proposed plan that deserves scrutiny is the provision to reformulate how local sales tax revenues are distributed back to localities after they are collected. The current system allocates locally collected taxes back to the counties in proportion to the taxable sales of each county.[12] Each dollar collected returns to the county it was collected in.

11 Scott Drenkard & Jared Walczak, *State and Local Sales Tax Rates in 2015*, Tax Foundation Fiscal Fact No. 461, Apr. 8, 2015, http://taxfoundation.org/article/state-and-local-sales-tax-rates-2015.

12 North Carolina General Statutes §105-472(a).

The new system, however, would detach localities from their tax dollars by phasing in a formula that allocates the sales tax revenue back to counties based not on sales, but primarily on the number of residents (see Table 4).

Table 4: Proposed Local Sales Tax Distribution Formulas

	Per Capita	At Point of Collection
Current law	0%	100%
FY 2017	40%	60%
FY 2018	55%	45%
FY 2019	70%	30%
FY 2020	80%	20%

This process would move local option sales taxes away from being a truly local tax, with the state redistributing collections from more commercial parts of the state to less commercial areas.

Conclusion

The North Carolina Senate's proposed tax reform package improves further on the fundamental tax reform the state made in 2013. Though the package has been sold as an economic incentive plan, it is much more than that—it provides broad-based tax relief across the income spectrum while broadening tax bases to offset some of the rate cuts.