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North Carolina Considers Impressive Tax Reform Options

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Introduction

This week, the Finance and Appropriations Committees of the North Carolina House of Representatives approved legislation that would significantly reform the state's tax system. House Bill 998 would reduce individual and corporate income taxes while broadening their bases, in addition to lowering the combined state-local sales tax and expanding the tax to some services. These changes move North Carolina away from income taxation and towards consumption taxes in an effort to increase future economic growth and make the state more rate-competitive with its neighbors. They would also reduce distortions and waste associated with a complicated and non-neutral tax code.

The legislation will move to the House floor and, if passed, would be sent to the Senate where comparable legislation has been considered. Last month, Senate Republicans debuted their plan, which is now being considered by the Senate Finance Committee as Senate Bill 677. This proposal contains similar elements but is much more robust than the House plan because it more comprehensibly broadens the income and sales tax bases in addition to addressing the economic issues associated with taxing business inputs.

Both the House and Senate legislation would dramatically improve North Carolina's ranking on our *State Business Tax Climate Index*. The state ranked 44th in business tax friendliness in our 2013 *Index*. Had the House plan been in effect, the state would have ranked 19th. If the Senate plan were in place, the state would have ranked 13th.

House Lawmakers Consider "Tax Simplification and Reduction Act"

House Republicans are currently considering groundbreaking legislation with the explicit goal of phasing out North Carolina's reliance on income taxation.[1] In particular, the plan would:

- Collapse the state's three individual income tax brackets into one and lower the rate to 5.9 percent;
- Eliminate the personal exemption, cap local property tax and mortgage interest deductions, increase the standard deduction and child credit, limit the generous $50,000 deduction for net business income, and repeal charitable contribution credit for non-itemizers and severance wage deduction;
- Lower the corporate income tax to 5.4 percent; and
- Reduce the franchise tax to $1.35 from $1.50 per $1,000 of the tax base; and
- Lower the combined state-local sales tax from 6.75 percent to 6.65 percent[2] while broadening the tax base to include certain services.

A detailed list of changes can be found in Table 1, below. As a supplement to this legislation, House lawmakers have already passed a bill that would eliminate the state estate tax which now awaits action in the Senate.[3]

On the state level, the legislation in its entirety (including estate tax repeal) is expected to cost nearly $1 billion over the next five years and $212 million over fiscal years 2013 and 2014.[4] Local governments are projected to see annual funding increases due to the method by which the legislation would alter distribution of certain tax revenues to municipalities.[5]

Under this plan, sales tax base expansion is very moderate, because it is only expanded to include "businesses that already collect sales tax for goods."[6] This means that only those service providers that already sell goods, and thus already collect sales tax on those goods, would be required to do so on the services they offer. Further, it retains the state sales tax exemption for prescription drugs and

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[1] North Carolina General Assembly, H.B. 998, *Tax Simplification and Reduction*, Proposed Committee Substitute H998-CSRBx-23 [v.2], http://www.ncleg.net/sessions/2013/H998/H998-CSRBx-23.pdf.

[2] Laura Leslie, *N.C. House set to vote on tax reforms*, WRAL NEWS, June 6, 2013, http://www.wral.com/n-c-house-set-to-vote-on-tax-reforms-/12525069/.

[3] North Carolina General Assembly, H.B. 101, *Repeal Estate Tax*, http://www.ncleg.net/gascripts/billlookup/billlookup.pl?Session=2013&BillID=H101.

[4] This cost estimate relies on the most recent fiscal note (as of June 6, 2013) published by the General Assembly. *See* H.B. 998 *Fiscal Impact*, at 1, http://www.ncleg.net/sessions/2013/H998/H998-FiscalNote.pdf [hereinafter *H.B. 998 Fiscal Note*].

[5] *H.B. 998 Fiscal Note*, *supra* note 4.

[6] Laura Leslie & Mark Binker, *Dueling tax reform plans on tap Thursday*, WRAL NEWS, May 29, 2013, http://www.wral.com/dueling-tax-reform-plans-on-tap-thursday/12495811/.

food, two popular exemptions that are aimed at helping lower-income North Carolinians, but still significantly narrows the tax base.

This proposal allows most individual income tax expenditures, such as the Earned Income Tax Credit, to sunset as scheduled.[7] However, more than twelve tax expenditures (currently with no sunset provisions) are left untouched.[8]

Overall, the plan is a moderate but promising reform of the state tax code. It should be applauded for its individual income tax bracket reduction and rate lowering, as well as its corporate income tax and franchise tax rate reductions, although more could be done to broaden tax bases.

Senate Pushes "Tax Fairness Act of 2013"

An alternative plan[9] currently under consideration in the Senate Finance Committee would cut taxes by a total of $1 billion by the time it is fully implemented in 2017.[10] Though similar to the House proposal, the Senate legislation goes much farther in many respects. The proposal would:

- Lower the individual income rate to a flat 4.5 percent;
- Completely remove the personal exemption, standard deduction, and itemized deductions, though the taxpayer would pay no income tax on the first $15,000 of earnings;
- Retain existing child credit, repeal the mortgage interest deduction and net business income deduction, remove other individual income tax carve-outs,[11] and apply income tax to certain retirement income;[12]
- Reduce the corporate income tax rate to 6 percent and repeal several corporate tax credits;
- Reduce combined sales tax rate to 6.5 percent and broaden base to include most services, food, and prescription drugs; and
- Repeal the estate tax.

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[7] For a full list of tax expenditures that would be allowed to sunset under the plan, *see Summary of H.B. 998: Tax Rate Reduction and Reform*, May 28, 2013, at 3, http://www.wral.com/asset/news/state/nccapitol/2013/05/30/12498348/House_Tax_Plan_Summary_Table.PDF [hereinafter *H.B. 998 Summary*].

[8] For a full list of tax expenditures that would remain in place, *see H.B. 998 Summary*, *supra* note 7, at 3.

[9] North Carolina General Assembly, S.B. 677, *NC Fair Tax Act*, Proposed Committee Substitute S677-CSRBx-22 [v.3], http://www.ncleg.net/documentsites/committees/senatefinance2013/Meeting%20Documents/5-30-2013/S677-NC%20Fair%20Tax%20Act%20PCS.pdf [hereinafter *Senate Bill 677*]. The original Senate plan also reduced the franchise tax to $1.35 per $1,000 of tax base and expanded to the base. The most recent proposed committee substitute does not include this provision, however.

[10] *North Carolina Tax Fairness Act 2013*, http://nctaxcut.com/.

[11] Repeals credits for child care and employment-related expenses, the disabled, taxes paid on certain federal retirement benefits, property taxes paid on farm machinery, charitable contributions, and education expenses.

[12] Social security beneficiaries who derive income from an additional source would be subject to the income tax. *See* John Frank, *Senate GOP debuts far-reaching tax overhaul*, NEWS OBSERVER, May 7, 2013, http://www.newsobserver.com/2013/05/07/2876647/senate-gop-to-debut-major-tax.html.

The Senate plan creatively ties the business input sales exemption to payment of the franchise tax. Business inputs should be exempted from the sales tax because this practice leads to sales tax pyramiding.[13] The language of the Senate Republican plan states that "sales of capital equipment purchased by a business subject to the franchise tax . . . or to a farmer for use by the farmer in the planting, cultivating, harvesting, or curing of farm crops or in the production of dairy products, eggs, or animals" and any "service [now taxable] . . . that is provided to a business subject to the franchise tax . . . for use in that business" will be exempt from the sales and use tax. Any sales tax reform enacted in North Carolina should include a provision such as this to ensure no sales tax pyramiding occurs.

This proposal is the most robust in terms of income tax base broadening. It closes multiple tax expenditures in the individual and corporate income tax code that distort behavior, adds unnecessary complexity, and requires higher rates to compensate for a small tax base. Further, the Senate plan expand the sales tax to cover more than 130 services,[14] which would make North Carolina's sales tax base the broadest in the country and enable significant reductions in complexity and distortions. By comprehensively expanding to all services at one time, this removes the political incentive for certain service providers to lobby for special tax exemptions.[15]

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[13] For more information on sales tax pyramiding, *see* Andrew Chamberlain & Patrick Fleenor, *Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes*, TAX FOUNDATION SPECIAL REPORT NO. 147 (Dec. 2006), at 6, http://taxfoundation.org/article/tax-pyramiding-economic-consequences-gross-receipts-taxes.

[14] Dan Kane & John Frank, *Far-reaching Senate tax plan closes loopholes, adds sales taxes*, NEWS OBSERVER, May 30, 2013, http://www.charlotteobserver.com/2013/05/30/4076680/far-reaching-senate-tax-plan-closes.html.

[15] *See* Joseph Henchman, *Maryland Covertly Singles Out Computer Services For New Tax*, TAX FOUNDATION TAX POLICY BLOG, Dec. 17, 2007, http://taxfoundation.org/blog/maryland-covertly-singles-out-computer-services-new-tax; Joseph Henchman, *MD Computer Services Tax Repealed; GA Tax Plans Die*, TAX FOUNDATION TAX POLICY BLOG, Apr. 8, 2008, http://taxfoundation.org/blog/md-computer-services-tax-repealed-ga-tax-plans-die.

Table 1: Comparison of House Bill 998 and Senate Bill 677			
	Current Law	**H.B. 998**	**S.B. 677**
Individual Income Tax			
Rate	6 percent > $0 7 percent > $12,750 7.75 percent > $60,000[16]	Flat 5.9 percent (2014)	Flat 5.5 percent in 2014, 5 percent in 2015, and 4.5 percent in 2016
Personal Exemption	$2,500 for AGI < $60k; $2,000 for AGI > $60k[17]	Eliminate	Eliminate (see below)
Standard and Itemized Deductions	$3,000[18] standard deduction; itemized deductions allowed	Increase standard deduction to $6,000; allows itemized deductions (charitable contribution and mortgage interest) if exceeds standard deduction (subject to cap on local property tax and mortgage interest deductions)[19]	Eliminate, but replace with new zero bracket of $10k in 2014, $12.5k in 2015, and $15k in 2016
Base broadening		Eliminate charitable contribution credit for non-itemizers and severance wage deduction in; reduce $50k net business income deduction by half in 2013 and fully repeal in 2014[20]	Repeal mortgage interest deduction;[21] include temporary Working Families exemption for incomes between $30k and $80k (2015 and 2016 only; exemption ranges from $8,500 to $2,500 depending on income);[22] repeal multiple individual income tax credits;[23] repeal $50k net business income deduction (2014)
Child Credit	$100 per child for AGI < $60k[24]	Increase to $250 for AGI < $50k ($125 for AGI > $50k)	No change
Corporate Income Tax			
Rate	6.9 percent	6.5 percent in 2014, 6.35 percent in 2015, 6.2 percent in 2016, 5.6 percent in 2017, and 5.4 percent thereafter	6.5 percent in 2014, 6.25 percent in 2015, and 6 percent in 2016
Apportionment	Double-weighted sales factor apportionment[25]	Move to singe sales factor apportionment over four years (2014-2017)	Move to single sales factor apportionment over three years (2014-2016)
Other Measures			Repeal certain smaller credits[26]

[16] North Carolina Department of Revenue, *Tax Rate Schedule for Tax years 2011 and 2012*, http://www.dor.state.nc.us/taxes/individual/rates.html.

[17] North Carolina Department of Revenue, *North Carolina Personal Exemption Allowance*, http://www.dor.state.nc.us/taxes/individual/exemption.html.

[18] North Carolina Department of Revenue, *North Carolina Standard Deduction for Individuals Claiming the Standard Deduction on their Federal Return*, http://www.dor.state.nc.us/taxes/individual/400standard.html.

[19] *H.B. 998 Fiscal Note*, *supra* note 4.

[20] North Carolina General Statutes § 105-134.6(b)(22), *available at* http://www.ncleg.net/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-134.6.html.

[21] Kane & Frank, *supra* note 14.

[22] For a detailed explanation of Working Families exemption, *see Senate Bill 677*, *supra* note 9, at pt. 1, § 1.3(a).

[23] Repeals credits for child care and employment-related expenses, the disabled, taxes paid on certain federal retirement benefits, property taxes paid on farm machinery, charitable contributions, and education expenses.

[24] North Carolina Department of Revenue, *Credit for Children*, http://www.dor.state.nc.us/taxes/individual/kids.html.

[25] Connecticut Office of Legislative Research, Judith Lohman, *Corporation Tax Income Apportionment Formulas* (Sept. 26, 2012), http://www.cga.ct.gov/2012/rpt/2012-R-0414.htm.

[26] *See Senate Bill 677, supra* note 9, at pt. IV, § 4.4(b).

	Current Law	H.B. 998	S.B. 677
Franchise Tax			
Rate	$1.50 per $1,000[27]	$1.35 per $1,000 (2015)	No change[28]
Base and Other Changes	Highest of three possible tax bases[29]	No change	No change
Sales Tax			
State Rate	4.75 percent	No change	5 percent
Local Rate	2 percent in most counties	1.9 percent	1.5 percent
Combined Rate (in most counties)	6.75 percent in most counties[30]	6.65 percent in most counties	6.5 percent in most counties
Special Franchise Taxes		Repeal amusements tax and subject admissions to sales tax; repeal franchise tax on electric power, water, and sewage companies; repeal tax on piped natural gas; and make piped natural gas and electricity subject to sales tax (2014)	
Base Broadening	Most services exempt[31]	Expand to maintenance of tangible personal property, and service contracts related to tangible personal property (2014); repeal Energy Star sales tax holiday	Expand base to cover over 130 services, all of which are taxed in at least one state; repeals sales tax holidays
Taxation of Food for Home Consumption and Prescription Drugs	Exempt from state sales tax	No change	Food subject to state sales tax; prescription drugs purchased by insurance still exempt[32]
Estate Tax		Repeal	Repeal

Source: Tax Foundation review of legislation.
Note: All exemptions and deductions are for single filers. For information on head of household, married filing separately, or married filing jointly, see actual legislation.

[27] North Carolina Department of Revenue, *General Business Corporations*, at Section 8, http://www.dor.state.nc.us/practitioner/corporate/bulletins/2007-2008/I-E.pdf#I.E.8.
[28] The original Senate plan also reduced the franchise tax to $1.35 per $1,000 of tax base and expanded to the base. The most recent proposed committee substitute does not include this provision, however.
[29] For more information on current base calculation, *see* Sabra Faires, *Overview of North Carolina's Franchise Tax*, Study of North Carolina's Tax Structure, prepared for the Interim Joint House and Senate Finance Committees (Apr. 7, 2010), at 7, http://www.ncleg.net/documentsites/committees/jhsfctr/Meeting%20Documents/4-7-2010%20Meeting/Franchise%20Tax%20Overview.pdf [hereinafter Faires, *Overview*].
[30] North Carolina Department of Revenue, *Sales and Use Tax Rates Effective April 1, 2013*, http://www.dornc.com/taxes/sales/salesrates_4-13.html.
[31] North Carolina Department of Revenue, *Sales and Use Frequently Asked Questions*, *Are any services taxable?*, http://www.dor.state.nc.us/faq/sales.html.
[32] Kane & Franke, *supra* note 14.

Crafting Optimal Tax Reform Legislation

Income Tax Reform Reduces Distortions and Improves Neutrality

Income taxation, by definition, taxes wealth creation. It disincentivizes the activities that add productive value to the economy—work and investment. The best way to mitigate the deadweight loss associated with income taxation is to levy a tax that is as flat and as broad-based as possible so that the rate can be kept low. This minimizes economic distortions and keeps the structure simple and neutral.

Both tax reform plans flatten and lower the individual income tax rate in addition to reducing the corporate income tax rate. The Senate plan offers the most significant individual income tax rate reduction, while the house proposal lowers the corporate income tax rate the most.

Each tax reform plan closes income tax expenditures and other tax preferences to varying degrees. Each would eliminate the $50,000 business income deduction, a tax expenditure that costs over $131 million annually.[33] The House plan does little individual income tax base broadening, while the Senate proposal would eliminate many of carve-outs.

Neither of the plans do a complete job of closing corporate income tax carve-outs, though S.B. 677 goes the farthest. It closes twelve corporate income tax expenditures, totaling approximately $22.7 million annually.[34] Unfortunately, neither bill touches one of the largest and most inefficient tax expenditure programs—the film production tax credit, which forces the state to forego $35.8 million annually. Closing such programs not only eliminates inefficient programs but also brings in more revenue for the state to use as it sees fit.

Applying the Sales Tax to Service Transactions Modernizes Antiquated System

Most states exempt service transactions from the sales tax base due to the fact that sales taxes were implemented in the 1930s, a time when the goods industry dominated the economy. Now, services make up the majority of the U.S. economy. In North Carolina, services make up more than 70 percent of the economy. [35] By exempting these transactions from the sales tax, the state is effectively subsidizing those industries and foregoing a significant amount of revenue.

Each of the tax proposals expand the sales tax to some degree, though S.B. 677 again does so most comprehensively. It would expand the sales tax to cover over 130 additional services, all of which are taxed in at least one other state. Further, the plan takes care to ensure business inputs are exempt from the sales tax to avoid tax pyramiding, arguably the most important aspect of sales tax reform.

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[33] North Carolina Department of Revenue, *North Carolina Biennial Tax Expenditure Report 2011*, at 65, http://www.dor.state.nc.us/publications/nc_tax_expenditure_report_11.pdf [hereinafter *Biennial Tax Expenditure Report*].

[34] Totals were calculated based on the tax expenditures listed as being repealed in § 4.4(b) of S.B. 677, using amounts found in the *Biennial Tax Expenditure Report 2011*, *supra* note 32.

[35] Joseph Henchman & Scott Drenkard, *North Carolina Tax Reform Options: A Guide to Fair, Simple, Pro-Growth Reform* (Jan. 2013), at 18, http://taxfoundation.org/sites/taxfoundation.org/files/docs/Tax_Foundation_Carolina_Business_Coalition_North_Carolina_Recommendations.pdf.

H.B. 998 expands the base to cover services that are tied to the sale of goods. That is, taxes are levied on service providers that already sell goods and that they argue are already reasonably equipped to act as sales tax collectors. Unfortunately, the House plan does not expressly exempt business-to-business transactions.

Franchise Simplification Reduces Distortions and Waste

North Carolina currently levies a complicated franchise tax on certain businesses within the state. It requires firms to first calculate three separate tax bases and then pay the tax on the highest of the three. The tax is levied on C corporations, S corporations, electric membership corporations, and LLCs that elect to be taxed as corporations under the federal tax code.[36] The House plan would lower the rate of taxation, but not expand the base.

The complicated nature of the franchise tax wastes time and monetary resources. Broadening the base to include LLCs would allow the rate to be lowered for all firms subject to the tax. This is desirable since it is essentially a tax on capital stock, and taxing this will disincentive capital accumulation, a driver of economic growth.

Tax Reform Proposals Would Improve North Carolina's Business Climate

Both the House and Senate tax reform plans would significantly improve North Carolina's score on our *State Business Tax Climate Index*.[37] In 2013, North Carolina's overall score was 44th—meaning that only six states scored worse than North Carolina. Table 2 outlines how the House and Senate plans would each have changed North Carolina's 2013 *Index* rankings.

Table 2: North Carolina's 2013 *State Business Tax Climate Index* Alternative Scenarios

	Current Law	House Plan	Senate Plan
Overall	44	19	13
Corporate	29	20	25
Individual	43	17	13
Sales	47	48	16
UI	5	5	5
Property	36	27	27

Both pieces of legislation would have drastically improved North Carolina's 2013 *Index* ranking, moving the state's overall rank up at least 25 spots. The House plan would move North Carolina to second best among its neighbors, while the Senate legislation would make it the most business-friendly in the region. S.B. 677's robust expansion of the sales tax base and its provisions to exclude business inputs make it stand apart from

[36] *See* Faires, *Overview, supra note 28.*
[37] Scott Drenkard & Joseph Henchman, *2013 State Business Tax Climate Index*, BACKGROUND PAPER NO. 64 (Oct. 9, 2013), http://taxfoundation.org/article/2013-state-business-tax-climate-index.

H.B. 998 in the *Index*'s sales tax category. However, the House plan outperforms the Senate plan in terms of the corporate income tax due to the lower rate.

Conclusion

North Carolina's tax system is in need of reform. The system includes high, graduated-rate individual income taxes, a corporate income tax that exceeds its neighbors', and a sales tax base that excludes a large portion of transactions. By flattening and lowering individual income taxes, the system becomes fairer, simpler, and more neutral. Lowering corporate income taxes brings the rate more in line with those of neighboring states and encourages business investment. Expanding the sales tax base to services would bring in additional revenue and level the playing field between producers of goods and services.

Ideally, the final piece of legislation will flatten and lower the individual income tax, lower the corporate income tax and franchise tax rates, significantly broaden income tax bases by closing costly tax expenditure programs, broaden the franchise tax base to include all companies with limited liability, and expand the sales tax to include services without causing tax pyramiding.

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