Comprehensive Tax Reform
North Carolina’s Recent Experience

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Ed McLenaghan, NC Office of State Budget & Management
Tax Reform: It’s even more complicated than it looks.
North Carolina’s Tax System in 2013

Individual Income & Sales Taxes Comprise Vast Majority of Revenue

- Individual Income: 53%
- Sales & Use: 26%
- Corporate Income & Franchise: 9%
- Alcohol & Tobacco: 3%
- All Other Taxes: 4%
- Non-Tax: 6%

FY 2012-13 General Fund Revenues

Source: NC Department of Revenue data
Tax Reform Becomes Law July 2013

GOP has majority to update state’s tax structure

Cities could lose revenue under tax reform

House, Senate, governor reach tax deal

Realtors remain wary of NC tax reform

Senate GOP debuts far-reaching tax overhaul

Closing tax ‘loopholes’ could be painful for all

Is there hope for tax reform in NC? McCrory seems doubtful
Major Provisions of 2013 Tax Reform
Individual Income Taxes

**Tax Rates:**
Graduated to flat

**Deductions:**
Bigger standard, fewer itemized
Business income deduction repealed

**Exemptions:**
Personal exemption & others repealed

**Credits:**
Several sunset, others repealed, one expanded
Consumption Taxes

**Gross Receipts to Sales Tax:**
Electricity, natural gas, live entertainment, and movies

**Exemptions & Preferential Rates:**
Several repealed, several extended

**Base Expansions:**
Admission charges, service contracts
Corporate Income & Other Taxes

Corporate Income Tax Rates:
Two certain rate cuts, two performance-based

Repeals:
Estate tax, earmark for school construction

Incentives:
Extension of R&D credit
Sunset of major jobs & investment credits
Challenges Quantifying the Effects of Tax Reform
Quantifying Tax Reform: Challenges

- Uncertain Fiscal Impact
- Inconsistent analytical methods
- Undetermined timing of effects
- Integrating revenue estimates with revenue forecasts
- Little time to analyze proposals
- Incomplete, imperfect, and obsolete data
Quantifying Tax Reform: Challenges

**Fiscal Impact:**
- How Big?
- Potential Error?

**Revenue Forecast:**
- Timing of Impacts?

**Assessing Impacts:**
- Tracking Revenues
- Impact Error or Forecast Error?
Revenue Trends After Tax Reform

Initial Impacts

Withholding plummets in first months of 2014
Withholding Drops Sharply After Tax Reform

Adjusted Year-Over-Year Growth

Sep 2011 5.0%

Tax Reform Takes Effect

Dec 2013 3.9%

Mar 2014 -12.3%

Source: NC Department of Revenue data
Implementation of Tax Reform

Initial Impacts
Withholding plummets in first months of 2014
Negative April surprise
Downward revisions to forecasts
Withholding continues to disappoint through 2014
Big reversals in early 2015
Withholding Drops Sharply After Tax Reform

Source: NC Department of Revenue data
The Impacts of Tax Reform
Implementation of Tax Reform

Personal Income Tax:
New Withholding Certificates & Tables
Simplified Tax Return & Instructions

Sales & Use Tax:
Multiple Implementation Dates
Timing Issues
Many More Filers Claim Standard Deduction

Source: NC Department of Revenue data
Effective Tax Rates Fall at Top & Bottom

Source: NC Department of Revenue data
Share of Filers With Balance Due Doubled

All Resident

TY 2013

TY 2014

<table>
<thead>
<tr>
<th>AGI</th>
<th>TY 2013</th>
<th>TY 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; $10k</td>
<td>5%</td>
<td>9%</td>
</tr>
<tr>
<td>10-25k</td>
<td>16%</td>
<td>34%</td>
</tr>
<tr>
<td>25-50k</td>
<td>20%</td>
<td>45%</td>
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<tr>
<td>50-100k</td>
<td>22%</td>
<td>49%</td>
</tr>
<tr>
<td>100-200k</td>
<td>30%</td>
<td>58%</td>
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<tr>
<td>200-500k</td>
<td>30%</td>
<td>55%</td>
</tr>
<tr>
<td>500k-1m</td>
<td>35%</td>
<td>44%</td>
</tr>
<tr>
<td>1m+</td>
<td>35%</td>
<td>44%</td>
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</table>

Source: NC Department of Revenue data
Impact of Tax Reform: Looking Back

Personal Income Tax:
Many more filers claim standard deduction
Fiscal impact at high end of range
Biggest tax cuts at highest & lowest incomes

Sales & Use Tax:
Likely underestimate of some fiscal impacts

Corporate Income Tax:
Change in overpayments applied to estimated tax
Additional Rounds of Tax Reform

**Personal Income Tax:**
- Medical expenses
- Increases in standard deduction
- Higher withholding rate
- Further rate reduction

**Corporate Taxes:**
- Additional rate cuts
- Phase in sales-only apportionment
- Sunset of major credits
Additional Rounds of Tax Reform

Sales and Use Tax:
Two rounds of base expansions for repair, maintenance, and installation services
Adjust local distribution

Other Taxes:
Eliminate local privilege license taxes
Lessons for Other States

Ensure detailed, reliable data
Develop consensus on analytical methods
Coordinate across agencies and branches
Plan ahead for real-time evaluation
Appendices
<table>
<thead>
<tr>
<th>Personal Income Taxes</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Rates</td>
<td>6.0% to 7.75%</td>
<td>5.8%</td>
</tr>
<tr>
<td>Standard Deduction</td>
<td>$6,000 (MFJ); Additional blind/elderly deduction</td>
<td>$15,000 (MFJ)</td>
</tr>
<tr>
<td>Itemized Deductions</td>
<td>Federal excluding state income and sales taxes</td>
<td>Charitable contributions; Real estate taxes and mortgage interest (capped at $20,000)</td>
</tr>
<tr>
<td>Personal Exemptions</td>
<td>$2,500 below $100,000 AGI; $2,000 otherwise (MFJ)</td>
<td>Repealed</td>
</tr>
<tr>
<td>Other Notable Deductions</td>
<td>$50,000 business income deduction; $2,000/$4,000 retirement income deduction</td>
<td>Repealed</td>
</tr>
<tr>
<td>Credits</td>
<td>$100 per child credit below $100,000 AGI; Dependent care credit; Non-itemizer charitable credit; Many smaller credits</td>
<td>Sunset of EITC; Additional $25 child credit for AGI below $40,000 (MFJ); Eliminate dependent care credit, non-itemizer charitable credit, real-property donation credit, and others</td>
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</table>
### Major Provisions of 2013 Tax Reforms

#### Consumption Taxes

<table>
<thead>
<tr>
<th>Good/service</th>
<th>2013</th>
<th>2014</th>
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</thead>
<tbody>
<tr>
<td>Electricity</td>
<td>3.0% sales tax; 3.22% gross</td>
<td>7.0% state sales tax w/ local</td>
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<tr>
<td></td>
<td>receipts tax</td>
<td>distribution</td>
</tr>
<tr>
<td>Natural gas</td>
<td>Tax dependent upon amount</td>
<td>7.0% state sales tax w/ local</td>
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<tr>
<td></td>
<td>purchased</td>
<td>distribution</td>
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<tr>
<td>Admission charges for live entertainment</td>
<td>3.0% gross receipts tax</td>
<td>Subject to state and local</td>
</tr>
<tr>
<td></td>
<td></td>
<td>sales tax rates</td>
</tr>
<tr>
<td>Movies</td>
<td>1.0% gross receipts tax</td>
<td>Subject to state and local</td>
</tr>
<tr>
<td></td>
<td></td>
<td>sales tax rates</td>
</tr>
</tbody>
</table>

#### Other Changes

- Repealed exemptions: service contracts, food sold in college/university dining halls, sales tax holidays, and several others
- Caps/thresholds: minimum receipts threshold for farming exemptions, $45 million cap on sales tax refunds for nonprofits
# Major Provisions of 2013 Tax Reforms

## Corporate Income & Other Taxes

<table>
<thead>
<tr>
<th>Provision</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
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<tbody>
<tr>
<td><strong>Corporate Income Tax Rate</strong></td>
<td>6.9%</td>
<td>6.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td><strong>Major Credits</strong></td>
<td>Film, jobs, investment, low-income housing, renewables, historic rehabilitation, R&amp;D</td>
<td>Film, low-income housing, renewables, historic rehabilitation, R&amp;D</td>
<td>R&amp;D, renewables</td>
</tr>
</tbody>
</table>

### Other Changes

- Estate tax repealed retroactively to January 1, 2013
- Adopted automatic tax-revenue triggers to reduce CIT rate to 4% in 2016 and 3% in 2017 if total General Fund tax revenues exceeded a specified threshold
- Credit for renewable energy property sunset after 2015; Redesigned historic rehabilitation credit adopted for 2016
- Film credit replaced with a grant program in 2015
- Corporate income tax earmark for school construction repealed
- Extended sunset of business incentives for R&D, motorsports teams, and airlines
- Required studying additional changes, many of which later became law