



SENATE BILL 20: Internal Revenue Code Update/Motor Fuel Tax Changes

2015-2016 General Assembly

Committee:

Introduced by:

Analysis of: S.L. 2015-2

Date:

Prepared by: Trina Griffin
Staff Attorney

SUMMARY: *S.L. 2015-2 consists of two Parts. The first Part, which was a recommendation of the Revenue Laws Study Committee, updates from December 31, 2013, to January 1, 2015, the reference to the Internal Revenue Code used in determining certain State tax provisions. The act decouples from the extensions listed below under the federal Tax Increase Prevention Act of 2014 for the 2014 tax year, but it conforms to the \$250 teacher expense deduction¹. Enhanced Section 179 expensing*

- *Exclusion from income for forgiveness of debt on principal residence.*
- *Deduction for mortgage insurance premiums.*
- *Deduction for higher education tuition expenses.*
- *Tax-free distribution from IRAs to public charities.*

This Part became effective March 31, 2015.

The second Part of the act makes the following changes to the motor fuels tax:

- *Reduces the motor fuels tax rate from 37.5 cents to 36 cents beginning April 1, 2015, through December 31, 2015. It sets the rate at 35 cents per gallon (cpg) from January 1, 2016, through June 30, 2016, and at 34 cpg from July 1, 2016, through December 31, 2016.*
- *Changes the variable component of the formula for determining the rate. Beginning January 1, 2017, the rate will be 34 cpg multiplied by a percentage reflecting population change and the annual change in the Energy component of the Consumer Price Index for all Urban Consumers as produced by the U.S. Bureau of Labor Statistics.*
- *Replaces the two 6-month base periods used in determining the gas tax rate with a single 12-month base period.*
- *Makes \$3.35 million and \$10.1 million reductions in the Highway Trust Fund and Highway Fund budgets for the 2014-2015 fiscal year.²*

The motor fuels tax rate changes are effective as described above. The remainder of this Part became effective March 31, 2015.

PART I: IRC UPDATE

CURRENT LAW: North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.³ The General Assembly determines each year whether to update its

¹ The IRC Update portion of the act is identical to the version passed by the Senate, which was the 2nd Edition of the bill. The IRC Update version passed by the House also conformed to the exclusion from income for forgiveness of debt on principal residence, the deduction for higher education tuition expenses, and the income exclusion for distribution from IRAs to public charities.

² The Senate version had a total cut of approximately \$33 million.



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reference to the Code.⁴ Updating the reference makes recent amendments to the Code applicable to the State to the extent that State law previously tracked federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. Maintaining conformity with federal tax law simplifies tax reporting because a taxpayer will not need to account for differing federal and State treatment of the same asset. The current reference to the Code is December 31, 2013.

BACKGROUND: On December 19, 2014, the Tax Increase Prevention Act of 2014 (TIPA) was signed into law⁵ and extended several provisions that were enacted last year in the American Taxpayer Relief Act (ATRA). ATRA was intended to avert the anticipated "fiscal cliff" due to the sunset provisions scheduled to take effect in 2013 that would have ended the Bush-era tax cuts contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), which were temporarily extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act).

ANALYSIS:

UPDATE IRC REFERENCE DATE

Section 1.1 of the act updates the reference to the Code from December 31, 2013, to January 1, 2015.

COUPLED PROVISION

By updating the reference to the Code, North Carolina conforms to various provisions, including the following:

Teachers' Classroom Expense Deduction

This act results in conformity with the extension of the federal teachers' classroom expense deduction for tax year 2014.

Explained. – This deduction allows primary and secondary education professionals to take an above-the-line deduction for qualified expenses up to \$250 paid out-of-pocket during the year.

Federal Background. – This deduction was established under EGTRRA in 2001 (beginning with tax year 2002) and was scheduled to expire in 2006. It was subsequently extended through 2013. TIPA extended the deduction for one more year.

North Carolina Background. – Prior to 2012, teachers in North Carolina were allowed the deduction at the State level because North Carolina began its calculation of taxable income with federal AGI. In 2012, North Carolina enacted a stand-alone individual income tax deduction for this purpose. The stand-alone provision was enacted because, at the time, the federal deduction was set to expire and Congress had not yet acted to extend it. However, this deduction was repealed as part of the Tax Simplification and Reduction Act of 2013 (HB 998), effective for tax years beginning on

³North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

⁴The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation ... shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would ... be invalidated as an unconstitutional delegation of legislative power."

⁵ P.L. 113-295.

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or after January 1, 2014. Because Congress has extended the deduction for tax year 2014, the update of the IRC reference in this act means that teachers will continue to be able to take advantage of this deduction.

DECOUPLED PROVISIONS⁶

Section 179 Expensing

Section 1.2 of the act does not conform to the one-year extension of the enhanced section 179 expensing provision. For tax year 2014, the deduction and investment limits are \$25,000 and \$200,000, which are what the limits would have been at the federal level if TIPA had not been enacted. However, it does conform to the definition of qualifying Section 179 property.

The act further provides that the property's basis will be the same for federal and State purposes and treats the difference in the same manner as State tax law has historically treated the bonus depreciation: A taxpayer must add back 85% of the additional expensing taken under federal law in 2014 and then deduct 20% of this amount over the succeeding five years. Full conformity to the section 179 expense deduction would have been \$52 million.

Explained. – Section 179 of the Code allows taxpayers to immediately deduct, rather than gradually depreciate, the cost of qualified assets, subject to certain limitations.⁷ Use of the allowance has two components: a dollar limitation and an investment limitation. The dollar limitation is the maximum amount of the deduction that the taxpayer may elect to take. The investment limitation is the maximum amount that can be spent on equipment before the deduction begins to be reduced. The deduction is reduced, dollar for dollar, by the amount that exceeds the investment limitation. Prior to 2010, section 179 was commonly thought to apply to small businesses because of its maximum deduction and investment limits.⁸ However, the enhancements made by the Small Business Jobs Act of 2010 (2010 Jobs Act) were the most expansive ever enacted and those limits were extended under ATRA and TIPA.

Federal Background. – Since 2010, the deduction limitation has been \$500,000 and the investment limitation has been \$2 million. Without the recent extensions, the limits would have reverted to the prior levels of \$25,000 and \$200,000.

North Carolina Background. – Prior to 2010, North Carolina typically conformed to the enhanced section 179 expense deduction provisions. However, given the expansive nature of the enhancements made by the 2010 Jobs Act, which have been extended over the last several years, North Carolina has decoupled and adopted lower limits since 2010.⁹

Income Exclusion for Distributions from IRAs to Charity

⁶ Since 2002, North Carolina has decoupled from the federal bonus depreciation provisions. Under the Tax Simplification and Reduction Act⁶, North Carolina permanently decoupled from this provision, which means that the General Assembly does not have to take any action to decouple from this provision to the extent Congress continues to extend it. Therefore, although Congress extended the 50% bonus depreciation provision for one more year under TIPA, North Carolina does not conform to this extension. For taxable years beginning on or after January 1, 2014, a taxpayer is required to add back 85% of the accelerated depreciation amount in the year it is claimed for federal purposes with a corresponding 20% deduction over the next five years. The taxpayer will be deducting the same amount of an asset's basis under State law as under federal law, it is just that the timing of the deduction differs.

⁷ Generally, taxpayers take the Section 179 expensing deduction first and claim bonus depreciation on any remaining basis.

⁸ Prior to the Emergency Economic Stabilization Act of 2008 (EESA), deduction limit was \$125,000 with a phase-out beginning at \$500,000.

⁹ North Carolina's dollar and investment limitations were \$250,000 and \$800,000, respectively, for taxable years 2010 through 2012. The dollar and investment limitations for 2013 were \$25,000 and \$200,000, respectively.

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This act does not conform to the extension of the income exclusion for a qualified charitable distribution from an individual retirement plan by a person who has attained the age of 70½ for tax year 2014. The treatment is capped at a maximum of \$100,000 per taxpayer. However, a taxpayer who itemizes and who elected to take the income exclusion would be able to deduct the amount that would have been allowed as a charitable deduction under the Code had the taxpayer not elected to take the income exclusion.

Explained. – Generally, a taxpayer must include in gross income distributions made from a traditional or Roth IRA account except to the extent they represent a return of nondeductible contributions or are rolled over into another qualified retirement plan.

Federal Background. – Since 2006,¹⁰ taxpayers age 70½ or older may contribute up to \$100,000 from their IRA account to a charity tax-free. This income exclusion was set to expire for distributions made in tax years beginning after December 31, 2013. TIPA extends the availability of this exclusion for one year.

North Carolina Background. – North Carolina conformed to this provision for 2006 through 2012, but decoupled for 2013.

Deduction for Mortgage Insurance Premiums as Interest

Section 1.3 of the act does not conform to the extension of the deduction for mortgage insurance premiums as interest for tax year 2014. Therefore, taxpayers may not include any amount for mortgage insurance premiums in their deduction for qualified residence interest. The cost to conform to this provision would be approximately \$4 million.

Explained. – Generally, taxpayers may not deduct any interest paid or accrued during the tax year that is considered personal interest. This restriction does not apply to certain types of interest, including qualified residence interest. Qualified residence interest includes interest on home acquisition indebtedness of up to \$1 million and interest on home equity indebtedness of up to \$100,000. In the case of a home acquisition loan, an individual who cannot pay the entire down payment amount may be required to purchase mortgage insurance.

Federal Background. – Since 2006, premiums paid for qualified mortgage insurance in connection with acquisition indebtedness for a qualified residence are treated as qualified residence interest and are deductible.¹¹ The treatment of qualified mortgage insurance as qualified residence interest was set to expire for amounts paid or accrued after December 31, 2013. TIPA extends the availability of the deduction for one year.

North Carolina Background. – North Carolina conformed to this provision from 2006 through 2012, but decoupled for the first time for tax year 2013.

Income Exclusion for Discharge of Qualified Principal Residence Indebtedness

Section 1.3 of the act does not conform to the extension of the income exclusion for the discharge of qualified principal residence indebtedness. It requires a taxpayer to add back the amount excluded at the federal level for purposes of determining North Carolina taxable income. The cost to conform to this provision would be approximately \$14 million.

¹⁰ This exclusion was originally authorized by the Pension Protection Act of 2006. The law was extended through 2009 by the Emergency Economic Stabilization Act of 2008, and through 2011, by the 2010 Tax Relief Act.

¹¹ The deduction is subject to a phaseout. For every \$1,000, or fraction thereof, by which the taxpayer's AGI exceeds \$100,000, the amount of mortgage insurance premiums treated as interest is reduced by 10%.

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Explained. – Taxpayers are generally required to recognize income from the discharge of indebtedness. An exception from this rule is for the discharge of qualified principal residence indebtedness, which has been excludible from gross income on a temporary basis since 2007.¹² The exclusion is limited to \$2 million, and applies to indebtedness incurred in the acquisition, construction, or substantial improvement of a principal residence and secured by the residence.

Federal Background. – This exclusion was scheduled to expire for debt discharged after December 31, 2013, but was extended for one year under TIPA.

North Carolina Background. – North Carolina conformed to this provision from 2007 through 2012, but decoupled for the first time for tax year 2013.

Higher Education Deduction

Section 1.3 of the act does not conform to the extension of the federal qualified tuition and expenses deduction for tax year 2014. The cost to conform to this provision would be approximately \$1 million.

Explained. – Subject to income limitations, a taxpayer may take an above-the-line deduction for qualified education expenses paid during the year for the taxpayer or the taxpayer's spouse or dependents. Generally, any accredited public, nonprofit, or proprietary post-secondary institution is an eligible educational institution. The maximum deduction is \$4,000 for an individual whose adjusted gross income for the tax year does not exceed \$65,000 (\$130,000 for MFJ filers), or \$2,000 for other individuals whose adjusted gross income does not exceed \$80,000 (\$160,000 for MFJ filers).

Federal Background. – This deduction was established under EGTRRA and was scheduled to expire in 2006. It was subsequently extended through 2013. TIPA extended the deduction for one more year.

North Carolina Background. – North Carolina had conformed to this provision until last year when it decoupled for the 2013 taxable year.

PART II: MOTOR FUEL TAX CHANGES

The second part of the act reduces the motor fuels tax rate, it changes the formula for determining the motor fuels tax rate beginning January 1, 2017, it replaces the two 6-month base periods used in determining the gas tax rate with a single 12-month base period beginning January 1, 2016, and it makes corresponding \$3.35 million and \$10.05 million reductions in the Highway Trust Fund and Highway Fund budgets for the 2014-2015 fiscal year.

CURRENT LAW:

Rate. – A motor fuel¹³ excise tax is imposed on all motor fuels sold, distributed, or used in the State. The rate of tax consists of a flat rate of 17.5¢ per gallon plus a variable wholesale component equal to the greater of 7% of the average wholesale price of motor fuel during a base six-month base period or 3.5¢ per gallon.

At the time of this act's passage, the motor fuel tax rate was 37.5¢ per gallon. Section 8 of S.L. 2013-316 capped the tax at this rate for the period October 1, 2013, through June 30, 2015. The current rates in surrounding states are: South Carolina -16¢ per gallon; Virginia - 19.88¢ per gallon, and Tennessee - 20¢ per gallon.

¹² This exclusion was originally authorized in the Mortgage Debt Relief Act of 2007.

¹³ Motor fuel is defined as gasoline, diesel fuel, and blended fuel (G.S. 105-449.60(31)).

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Base Period. – The two base periods are six-month periods. For the base period ending on September 30, the tax rate applies to the six-month period that begins the following January 1. For the base period ending on March 31, the tax rate applies to the six-month period that begins the following July 1.

Distribution of Revenue. – The revenue generated by the motor fuel tax is distributed as follows¹⁴: One-half cent of the excise tax on each gallon of gas is distributed to funds for underground tank storage cleanup water and air quality. The remaining excise tax revenue is allocated as follows:

- 75% to the Highway Fund and used for maintenance, transit, rail, State Highway Patrol, DMV, some secondary road improvement, Powell Bill distribution to local governments, and some other administrative needs. G.S. 105-449.126 credits 1/6 of 1% of this amount annually to the Wildlife Resources Fund to be used for the boating and water safety activities described in G.S. 75A-3(c).
- 25% to the Highway Trust Fund and used for construction of the intrastate system, some secondary road improvement, and Powell Bill distribution to local governments.

BILL ANALYSIS:

Sections 2.1 and 2.2 of the act sets the motor fuels tax rate as follows:

April 1, 2015 – December 31, 2015	36 cpg ¹⁵
January 1, 2016 – June 30, 2016	35 cpg
July 1, 2016 – December 31, 2016	34 cpg

Beginning January 1, 2017, the motor fuels tax rate will be 34 cents per gallon multiplied by a percentage. The percentage would be 100% plus or minus the sum of the following:

- The percentage change in population multiplied by 75%.
- The percentage change in the Consumer Price Index for all Urban Consumers multiplied by 25%. The "Consumer Price Index for All Urban Consumers" means the United States city average for energy index released by the Bureau of Labor Statistics.

Under current law, the gas tax rate will be reset on July 1, 2015, and is projected to drop approximately 6 to 8 cents. Under the version of this bill passed by the Senate, the rate would have dropped from 37.5 to 35 cents beginning March 1, 2015, through the end of the year with a new formula beginning January 1, 2016. The new formula would have had a variable component of 9.9% of the average wholesale price of gas. Under the version passed by the House, the rate would have dropped to 36 cents beginning April 1, 2015, and did not make any changes to the formula.

Section 2.2 of the act also changes the period upon which the motor fuels tax rate is determined. Under current law, the rate is set twice a year. A rate goes into effect on January 1 based on the prior six-month period from April to September, and also on July 1 based on the prior six-month period from October to March. Under this act, the rate would be determined once a year, using a 12-month base period that runs from October 1 to September 30, with a new rate going into effect on the following January 1.

¹⁴ G.S. 105-449.125.

¹⁵ Absent this act, the rate would be 37.5 cpg from April 1, 2015 through July 1, 2015.

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Section 2.3 is a conforming change regarding the shift from two six-month base periods to one 12-month base period.

Section 2.4 of the act reflects reductions in the Highway Trust Fund and Highway Fund budgets for FY 14-15 to balance the reduction in revenues derived from the tax. The reductions would include the following:

- ***Reductions to the Highway Trust Fund:***
 - A general cut of \$3.35 million to the strategic funding plan.
- ***Reductions to the Highway Fund:***
 - A 1 2/5% across-the-board cut from within the Highway Fund, but excluding maintenance funds, transfers, and certain other accounts, which amounts to \$5.9 million.
 - A 1/2% cut to three maintenance funds from within the Highway Fund amounting to \$2.38 million: primary maintenance, secondary maintenance, and to pavement preservation funds.
 - A reduction of \$1,045,200 in Powell Bill funds.
 - A reduction of \$16,750 credited to the Wildlife Resources Fund.
 - A reduction of \$16,750 credited to the Shallow Draft Navigation Channel and Lake Dredging Fund.
 - The elimination of at least 40 vacant positions within the Department of Transportation.¹⁶

¹⁶ The version passed by the Senate would have also required a reduction-in-force of 500 filled, full-time positions within the Department of Transportation by March 1, 2015. The PCS presented to the House Finance Committee moved the date of this RIF to September 1, 2015, and required that the average salary and benefits of the positions eliminated be no less than \$50,000. This provision was deleted by an amendment adopted in committee on March 3, 2015.