



SENATE BILL 726: IRC Update.

2016-2017 General Assembly

Committee:	House Finance	Date:	May 3, 2016
Introduced by:	Sens. Rucho, Rabon, Tillman	Prepared by:	Trina Griffin
Analysis of:	Second Edition		Committee Counsel

SUMMARY: *Senate Bill 726 would update from January 1, 2015, to January 1, 2016, the reference to the Internal Revenue Code used in determining certain State tax provisions. The bill would not conform to the extensions listed below under the federal Protecting Americans from Tax Hikes Act of 2015 (PATH Act), but it would conform to the \$250 teacher expense deduction and to the income exclusion for amounts received by wrongfully incarcerated individuals.*

The bill does not conform to the following two provisions that were made permanent at the federal level:

- *Enhanced Section 179 expensing.*
- *Tax-free distribution from IRAs to public charities.*

The bill does not conform to the following three provisions that were extended at the federal level through the 2016 taxable year.

- *Deduction for higher education tuition expenses.*
- *Exclusion from income for forgiveness of debt on principal residence.*
- *Deduction for mortgage insurance premiums.*

CURRENT LAW: North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.¹ The General Assembly determines each year whether to update its reference to the Code.² 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 January 1, 2015.

¹North 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.

²The 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."

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BACKGROUND: On December 18, 2015, the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) was signed into law³ and extended several provisions and made others permanent.

BILL ANALYSIS:

UPDATE IRC REFERENCE DATE

Section 1 of the bill updates the reference to the Code from January 1, 2015, to January 1, 2016.

COUPLED PROVISIONS

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

Teachers' Classroom Expense Deduction

By updating the reference to the Code, this bill would conform to the teachers' classroom expense deduction.

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 EGTRRA⁴ in 2001, beginning with tax year 2002, and was scheduled to expire in 2006. It was subsequently extended through 2013. TIPA⁵ extended the deduction for one more year. The PATH Act made the deduction permanent.

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 or after January 1, 2014.

Income Exclusion for Amounts Received by Wrongfully Incarcerated Individuals

By updating the reference to the Code, this bill would allow a taxpayer to exclude from income amounts received as the result of being wrongfully incarcerated. However, to the extent a taxpayer took a State deduction prior to 2014 in the same taxable year for which the exclusion is being sought, the bill would prevent a double benefit by requiring a taxpayer to add back those amounts.

Federal Background. – Prior to this amendment to the tax code, there had effectively been no rulings and a limited number of cases specifically dealing with the federal income tax treatment of such awards. Until now, a strict reading of the law meant that victims of wrongful conviction had to argue that all or part of their award related to physical injuries sustained while in prison. The tax code has long exempted awards for personal physical injuries of all types, including car wrecks or sports accidents, from gross income; restitution payments fell under the same umbrella if they were tax exempt at all.

New Federal Provision Explained. – The PATH Act established Section 139F of the Code, which excludes from income amounts received by a wrongfully incarcerated individual relating to the incarceration for any criminal offense under federal or State law. The exclusion applies to civil

³ P.L. 114-113.

⁴ Economic Growth and Tax Relief Reconciliation Act of 2001.

⁵ Tax Increase Prevention Act of 2014.

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damages, restitution, or other compensatory or statutory damages imposed in a criminal matter. The provision applies to any taxable year. If a taxpayer applies for a refund for a tax year prior to the enactment of the Act that would otherwise be barred by the statute of limitations, the taxpayer has until December 18, 2016, one year from the passage of the Act, to apply for the refund.

North Carolina Background. – Prior to 2014, North Carolina had a deduction for any amounts paid to a taxpayer under G.S. 148-84 as compensation for pecuniary loss suffered by reason of erroneous conviction and imprisonment.

DECOUPLED PROVISIONS

Section 179 Expensing

The bill would not conform to the permanent extension of the enhanced section 179 expensing provision. Under the bill, the deduction and investment limits would be \$25,000 and \$200,000, for tax years beginning on and after 2015. These are the same limits that have been in place for the last two years. However, the State tax code would conform to the definition of qualifying Section 179 property.

The bill 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 and then deduct 20% of this amount over the succeeding five years. Full conformity to the section 179 expense deduction would have a fiscal impact of \$90 million in FY 15-16 and \$65 million in FY 16-17.

Explained. – Section 179 of the Code allows taxpayers to immediately deduct, rather than gradually depreciate, the cost of qualified assets, subject to certain limitations.⁶ 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.⁷ 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 and then made permanent by the PATH Act.

Federal Background. – Since 2010, the deduction limitation has been \$500,000 and the investment limitation has been \$2 million.

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 2010.⁸

Income Exclusion for Distributions from IRAs to Charity

This bill would not conform to the permanent 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. The treatment is capped at a maximum of \$100,000 per taxpayer. However, a taxpayer who itemizes

⁶ Generally, taxpayers take the Section 179 expensing deduction first and claim bonus depreciation on any remaining basis.

⁷ Prior to the Emergency Economic Stabilization Act of 2008 (EESA), deduction limit was \$125,000 with a phase-out beginning at \$500,000.

⁸ 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 and 2014 were \$25,000 and \$200,000, respectively.

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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. The cost to conform to this provision is approximately \$3 million.

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 2006,⁹ taxpayers age 70½ or older may contribute up to \$100,000 from their IRA account to a charity tax-free. The PATH Act made this exclusion permanent.

North Carolina Background. – North Carolina conformed to this provision for 2006 through 2012, but decoupled for 2013 and 2014.

Tuition & Higher Education Expense Deduction

The bill would not conform to the extension of the federal qualified tuition and expenses deduction for tax years 2015 and 2016. The cost to conform to this provision would be approximately \$5 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 in 2001 was scheduled to expire in 2006. It was subsequently extended through 2014. The PATH Act extended the deduction for two more years.

North Carolina Background. – North Carolina had conformed to this provision through 2012 but decoupled for the 2013 and 2014 taxable years.

Income Exclusion for Discharge of Qualified Principal Residence Indebtedness

The bill would 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 \$8 million.

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 2007.¹⁰ 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, 2014, but was extended for two years under the PATH Act.

North Carolina Background. – North Carolina conformed to this provision from 2007 through 2012, but decoupled for tax years 2013 and 2014.

⁹ 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.

¹⁰ This exclusion was originally authorized in the Mortgage Debt Relief Act of 2007.

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Deduction for Mortgage Insurance Premiums as Interest

The bill would not conform to the extension of the deduction for mortgage insurance premiums as interest for tax years 2015 and 2016. 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 \$8 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, 2014. The PATH Act extended the provision for tax years 2015 and 2016.

North Carolina Background. – North Carolina conformed to this provision from 2006 through 2012, but decoupled for tax years 2013 and 2014.

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%.

Federal Provision	Cost to Conform (\$millions) (items with a 5-year impact made permanent; Other items extended 2 years)					Whether NC Conformed or Decoupled in Prior Years	Action by Feds under PATH Act
	FY 15-16	FY 16-17	FY 17-18	FY 18-19	FY 19-20		
BUSINESS-RELATED PROVISIONS							
Enhanced Section 179 Expensing up to \$500,000		-155.2	-51.0	-41.2	-33.9	Decoupled from increased federal limit, allowed deduction over 5 years	Made permanent
INDIVIDUAL-RELATED PROVISIONS							
\$250 Deduction for Teacher Classroom Expenses	-1.5	-1.5	-1.6	-1.6	-1.7	Conformed	Made Permanent
Tax-free distribution from IRAs to charity/age 70.5 or older		-6.1	-3.2	-3.3	-3.4	Decoupled for 2013 and 2014	Made Permanent
Tuition & Expense Deduction		-10.2				Decoupled for 2013 and 2014	Extended for 2015 and 2016
Mortgage Insurance premium as interest		-16.2				Decoupled for 2013 and 2014	Extended for 2015 and 2016
Income exclusion for discharge of residence indebtedness		-16.2				Decoupled for 2013 and 2014	Extended for 2015 and 2016
TOTAL	-91.5	-205.4	-55.8	-46.1	-39.0		

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