OVERVIEW: Part 38 of the proposed committee substitute for Senate Bill 257 contains the tax law changes passed by the Senate on April 5, 2017, in Senate Bill 325. This part does the following:

- Reduces the personal income tax rate from 5.499% to 5.35%.
- Increases the standard deduction for all personal income tax filers.
- Increases the maximum amount certain taxpayers may deduct for mortgage interest and property taxes and varies the cap based on filing status.
- Changes the child tax credit to a child tax deduction and expands the number of taxpayers who qualify for the deduction.
- Reduces the corporate income tax rate from 3% to 2.75% in 2018 and 2.5% in 2019.
- Reduces the franchise tax on S Corporations.
- Codifies market based sourcing as set forth in S.L. 2016-94.

CURRENT LAW, BILL ANALYSIS AND EFFECTIVE DATE: Part 38 of Senate Bill 257 would do the following:

Personal Income Tax Changes (all personal income tax changes are effective for taxable years beginning on or after January 1, 2018)

- **Lower Personal Income Tax Rate:** In 2014, North Carolina moved to a flat tax rate system for personal income tax.\(^1\) The tax rate in 2014 was 5.8%. The rate has gradually decreased over time to 5.499%, where it stands today. Section 38.1 would further reduce this rate to 5.35%.

- **Increase Standard Deduction:** In 2014, North Carolina began increasing the standard deduction substantially.\(^2\) Currently the standard deduction is $17,500 for married filing jointly taxpayers and $8,750 for single filers. Section 38.2 would increase these standard deduction amounts to $20,000 and $10,000, respectively. The bill would also change the standard deduction for head of household from 80% of the married filing jointly amount to 75%.\(^3\)

- **Modify Mortgage Interest:** To deduct mortgage interest and property taxes, a taxpayer must itemize their deductions, rather than take the standard deduction. North Carolina capped the amount of mortgage interest and property taxes a taxpayer could deduct in 2014 at $20,000,\(^1\)

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\(^1\) Personal income taxes contributed $11.618 billion to the State's General Fund for Fiscal Year 2016-17; that represents approximately 55% of General Fund revenues.

\(^2\) In 2014, the personal exemptions were repealed and replaced by a substantially higher standard deduction amount: the standard deduction amount increased from $6,000 to $15,000 for married filing jointly taxpayers and $3,000 to $7,500 for single filers.

\(^3\) Currently, federal head of household is roughly 72% of the federal married filing jointly amount.
regardless of a taxpayer's filing status. Section 38.3 would make two modifications to the mortgage interest deduction:

- It would increase the deduction cap to $22,000 for married filing jointly taxpayers.
- It would vary the deduction cap based on the filing status of the taxpayer. For taxpayers married filing jointly, the cap would be $22,000; for taxpayers filing as single or married filing separately, the cap would be $11,000; for taxpayers filing as head of household, the cap would be $16,500.

- **Convert Child Tax Credit to a Deduction**: North Carolina provides a child tax credit of up to $125 per child for a taxpayer who is allowed a federal child tax credit under section 24 of the Code. The amount of the State child tax credit varies based upon the adjusted gross income and filing status of the taxpayer. For married filing jointly, the credit amount is $125 for AGI up to $40,000; $100 for AGI up to $100,000; and $0 for taxpayers whose AGI is over $100,000. Section 38.4 would make several changes related to the child tax credit. Whether a taxpayer would see a benefit or not from the changes will vary depending upon each taxpayer's specific circumstances.
  - It would convert the credit to a deduction. A credit reduces a taxpayer's tax due on a dollar for dollar basis; however, the credit cannot be used to reduce a taxpayer's liability below zero. Section 38.4 would change the credit to a deduction of up to $2,500 per child; a tax deduction reduces a taxpayer's taxable income, to which the tax rate is applied.
  - It would expand the number of taxpayer who could benefit from the deduction by increasing the AGI limit from $100,000 to $120,000. It would also provide five deduction amounts, as opposed to the current two credit amounts. For married filing jointly, the deduction amounts and AGI brackets are as follows:

<table>
<thead>
<tr>
<th>AGI</th>
<th>Deduction Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $40,000</td>
<td>$2,500</td>
</tr>
<tr>
<td>Over $40,000 – Up to $60,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Over $60,000 – Up to $80,000</td>
<td>$1,500</td>
</tr>
<tr>
<td>Over $80,000 – Up to $100,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Over $100,000 – Up to $120,000</td>
<td>$500</td>
</tr>
<tr>
<td>Over $120,000</td>
<td>0</td>
</tr>
</tbody>
</table>

4 To qualify for the federal credit, a child must be under the age of 17 and meet certain other tests, such as dependency and residency requirements.
5 A tax credit amount of $125 is roughly equivalent to a tax deduction amount of $2,300. A $100 tax credit amount is roughly equivalent to a tax deduction amount of $1,800.
Business Tax Changes (effective dates for business tax changes are noted below)

- **Lower Corporate Income Tax Rate:** In S.L. 2013-316, the General Assembly began reducing the corporate income tax rate. The legislation reduced the rate from 6.9% to 6% for 2014 and to 5% for 2015. It also enacted a rate reduction trigger based upon net General Fund tax collections. General Fund revenues exceeded the trigger amounts for 2015 and 2016, and accordingly the corporate income tax rate fell to 4% for 2016 and 3% for 2017. Section 38.5 would continue this rate reduction over the next two years by reducing the rate to 2.75% for 2018 and to 2.5% for 2019. This section also codifies the existing corporate income tax rate of 3% by repealing the trigger, since it has been met, and changing the statutory tax rate to 3% for 2017.

- **Lower Franchise Tax for S Corporations:** S Corporations currently pay franchise tax at a rate of $1.50 per $1,000 of net worth. Section 38.6 would reduce this amount to a flat rate of $200 on the first $1,000,000 of net worth and $1.50 for every $1,000 of net worth over $1,000,000. This change is effective for taxable years beginning on or after January 1, 2019, and would be applicable to the calculation of franchise tax reported on the 2018 and later corporate tax returns.

- **Market Based Sourcing:** Market-based sourcing, coupled with single sales factor, would apportion the income of a multistate corporation based on the amount of the corporation's products and services consumed in North Carolina. The General Assembly directed the Department of Revenue to adopt rules on market-based sourcing last session based upon uncodified language in Section 38.4 of S.L. 2016-94. These rules have been adopted and approved by the Rules Review Commission. Section 38.7 codifies the language that was in S.L. 2016-94, and makes market-based sourcing effective for taxable years beginning on or after January 1, 2018, the taxable year that single-sales factor apportionment will be fully phased-in.

A corporation that does business in more than one state must pay income tax to each of the states in which it has nexus. A state may tax the income of multistate corporations as long as the income is fairly sourced to the state. In 2015, North Carolina began phasing in single sales factor apportionment over a three year period. Single sales factor apportionment is based on the percentage of in-state sales a corporation makes, which arguably incentivizes multistate companies that provide products to expand its property and payroll because those factors are ignored in determining state tax on profits. This does not incentivize multistate companies who provide services because the tax is not based off of the consumption of the company's services in a state, but rather the percentage of business activities conducted in the state, which is generally measured by the amount of labor costs and capital investment in a state to provide the services. Therefore, states that adopt a single sales factor apportionment usually adopt a market-based calculation of the sales factor for all multistate corporations, including those that provide services.

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6 Corporate income tax revenue contributed $912 million to the State's General Fund for Fiscal Year 2016-17; that represents approximately 5% of General Revenue.

7 Franchise tax revenue contributed $552 million to the State's General Fund for Fiscal Year 2016-17.

8 Roughly 95% of S-corporations in NC have a net worth of less than $1,000,000.