SENATE BILL 325:
Billion Dollar Middle Class Tax Cut.

2017-2018 General Assembly

Committee:	Senate Rules and Operations of the Senate	**Date:**	March 30, 2017
Introduced by:	Sens. Tillman, Brock, Tucker	**Prepared by:**	Cindy Avrette and Nicholas Giddings Committee Co-Counsel
Analysis of:	First Edition		

OVERVIEW: Senate Bill 325 would make the following tax law changes:

- ***Reduce the personal income tax rate from 5.499% to 5.35%.***
- ***Increase the standard deduction for all personal income tax filers.***
- ***Increase the maximum amount certain taxpayers may deduct for mortgage interest and property taxes and vary the cap based on filing status.***
- ***Change the child tax credit to a child tax deduction and expand the number of taxpayers who qualify.***
- ***Reduce the corporate income tax rate from 3% to 2.75% in 2018 and 2.5% in 2019.***
- ***Reduce the franchise tax on S Corporations.***
- ***Codify Market Based Sourcing.***

CURRENT LAW, BILL ANALYSIS AND EFFECTIVE DATE: Senate Bill 325 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):

- *Reduce 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. Senate Bill 325 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. Senate Bill 325 would increase these standard deductions 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]

- *Increase Mortgage Interest/Property Tax Cap*: 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

[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[2] In 2014, the personal exemptions were repealed and replaced by a substantially higher standard deduction amount: the standard deduction amount increased from $6,000 to $15,000 for married filing jointly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.

2014. Currently, the mortgage interest/property tax deduction is capped at $20,000. Senate Bill 325 would increase the cap to $22,000 for married filing jointly taxpayers.

- *Tier the Cap based upon Filing Status*: Currently, the mortgage interest and property tax deduction is capped at $20,000 regardless of a taxpayer's filing status. Senate Bill 325 would vary the cap on this deduction 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.

- *Modify and Expand Child Tax Deduction*: North Carolina provides a child tax credit of up to $125 per child; 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; if a taxpayer does not have a tax liability, then the credit does not benefit that person. Senate Bill 325 would change this credit to a deduction of up to $2,500[4] per child; a tax deduction reduces a taxpayer's taxable income, to which the tax rate is applied.

  The 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. The bill would provide a child tax deduction for each dependent child. The bill 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:

AGI	**Deduction Amount**
Up to $40,000	$2,500
Over $40,000 – Up to $60,000	$2,000
Over $60,000 – Up to $80,000	$1,500
Over $80,000 – Up to $100,000	$1,000
Over $100,000 – Up to $120,000	$500
Over $120,000	0

Corporate Income Tax Changes (effective dates for corporate income tax changes are noted below):

- *Reduce Corporate Income Tax Rate*: North Carolina began gradually decreasing the corporate income tax rate in 2014. Prior to 2014, the corporate income tax rate was 6.9%. Currently the corporate income tax rate is 3%.[5] Senate Bill 325 would reduce this rate further over the next two years to 2.75% for 2018 and 2.5% for 2019. The tax rate change to 2.75% would be effective for taxable years beginning on or after January 1, 2018. The tax rate change to 2.5% would be effective for taxable years beginning on or after January 1, 2019.

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[4] 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.

[5] 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.

- *Reduce Franchise Tax for S Corporations*: S Corporations currently pay franchise tax[6] at a rate of $1.50 per $1,000 of net worth. Senate Bill 325 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.[7]
- *Codify Market Based Sourcing*:
  - 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.
  - 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. North Carolina Department of Revenue was directed during the 2016 Legislative Session to adopt rules on market-based sourcing. These rules have been adopted and approved by the Rules Review Commission.
  - This section is effective for taxable years beginning on or after January 1, 2018.

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[6] Franchise tax revenue contributed $552 million to the State's General Fund for Fiscal Year 2016-17.
[7] Roughly 95% of S-corporations in NC have a net worth of less than $1,000,000.