NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: House Bill 1430 (First Edition)

SHORT TITLE: IRC Update

SPONSOR(S): Representatives Miner, Luebke, G. Allen, et al.

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	($million)				
	FY 2004-05	**FY 2005-06**	**FY 2006-07**	**FY 2007-08**	**FY 2008-09**
REVENUES					
General Fund	(2.6)	(5.0)	(5.5)	(6.1)	(6.6)
EXPENDITURES					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Department of Revenue

EFFECTIVE DATE: This act is effective when it becomes law.

BILL SUMMARY: This bill updates the statutory reference to the Internal Revenue Code used in defining and determining certain state income tax provisions. The referenced date is changed from June 1, 2003 to January 1, 2004.

ASSUMPTIONS AND METHODOLOGY: This bill conforms the North Carolina tax code to changes made in the Internal Revenue Code in 2003 by Congressional approval of P.L. 108-121, The Military Family Relief Act of 2003, and by P.L. 108-173, The Medicare Prescription Drug, Improvement, and Modernization Act of 2003.

I. The Military Family Relief Act

Of the ten major provisions in the Military Family Relief Act of 2003 (H.R. 3365), only two have a fiscal impact on North Carolina. The first major change is in the exclusion of gain from the sale of a principal residence. Current tax law allows an individual to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale of a principal residence. The taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the date of sale. The Military Family Relief Act of 2003 allows a member of the Armed

Forces, Public Health Service, National Oceanic and Atmospheric Administration, or the Foreign Service to suspend for a maximum of ten years the five-year principal residence test. To qualify, these federal employees must be stationed more than 50 miles from their principal residence for duty in excess of 90 days. The provision is effective for sales made after May 6, 1997 and these employees have one year (November 11, 2003 to November 11, 2004) to apply for a refund.

The staff of the Congressional Joint Committee on Taxation (JCT) estimates that this exclusion will cost the federal treasury $68 million in the first year due to the refund provision. The federal loss in the following years is $14 million to $17 million a year. Both the Tax Research Division of the Department of Revenue and the Fiscal Research Division of the General Assembly base the North Carolina tax impact on the JCT estimate. The chart below shows the JCT estimate of federal tax loss divided by the capital gains tax rate of 25% to determine the loss in federal taxable income. Since the Department of Defense reports that 2.44% of active military personnel in the US claim North Carolina as their residence, then this percentage multiplied by the federal taxable income yields the loss of state taxable income. Multiplying the average personal income tax paid in 2001 (6.8%) times the North Carolina taxable income results in the estimated tax loss for this provision.

			($Million)		
Exclusion on Gain of Principal Residence	FY 04-05	FY 05-06	FY 06-07	FY 07-08	FY 08-09
JTC Estimate of Federal Tax Loss ($Millions)	($68.0)	($14.0)	($14.0)	($15.0)	($15.0)
Divide By Capital Gains Tax Rate on Sec 1250 gains	25%	25%	25%	25%	25%
Estimated Loss of Federal Taxable Income	($272.0)	($56.0)	($56.0)	($60.0)	($60.0)
Multiply By NC Residents as Percent of Total Military	2.44%	2.44%	2.44%	2.44%	2.44%
Estimated Loss of NC Taxable Income	($6.6)	($1.4)	($1.4)	($1.5)	($1.5)
Multiply By NC Average Tax Rate	6.8%	6.8%	6.8%	6.8%	6.8%
Estimated NC Tax Loss	($0.5)	($0.1)	($0.1)	($0.1)	($0.1)

The second provision of the Military Family Relief Act of 2003 that has a fiscal impact on North Carolina is an above the line deduction for the travel expenses of the National Guard and Reserves. Currently, National Guard and Reserve personnel may claim as itemized deductions their non-reimbursable expenses for transportation, meals, and lodging when they stay overnight for National Guard and Reserve meetings. However, these expenses must exceed 2% of a taxpayer's adjusted gross income (AGI) to be claimed. The provision in the Military Family Relief Act allows an above the line deduction on the transportation, meals, and lodging expenses of National Guard and Reserves who travel more than 100 miles and stay overnight at National Guard and Reserve meetings.

Again, the Joint Committee on Taxation estimate of the national revenue loss for this deduction is used. To obtain federal taxable income, the federal tax loss is divided by the average federal tax rate of 21.9%. To get state taxable income, the federal taxable income is multiplied by North Carolina's percentage of the U.S. Selected Reserve personnel (2.57%). Selected Reserve includes Air and Army National Guard; Army, Navy, Air Force, and Marine Corps Reserves, and when detached from the Department of Homeland Security to the Department of the Navy, the Coast Guard Reserve. The North Carolina taxable income is multiplied by the average income tax rate of 6.8% to obtain the North Carolina tax loss from conforming to this provision.

	($Million)				
Above the Line Deduction for Reserve and Guard	**FY 04-05**	**FY 05-06**	**FY 06-07**	**FY 07-08**	**FY 08-09**
JTC Estimate of Federal Tax Loss ($Millions)	($90.0)	($77.0)	($78.0)	($80.0)	($82.0)
Divide By Average Federal Tax Rate	21.9%	21.9%	21.9%	21.9%	21.9%
Estimated Loss of Federal Taxable Income	($411.5)	($352.1)	($356.7)	($365.8)	($374.9)
Multiply NC Selected Reserve as Percent of Total	2.6%	2.6%	2.6%	2.6%	2.6%
Estimated Loss of NC Taxable Income	($10.6)	($9.0)	($9.1)	($9.4)	($9.6)
Multiply By NC Average Tax Rate	6.8%	6.8%	6.8%	6.8%	6.8%
Estimated NC Tax Loss	**($0.7)**	**($0.6)**	**($0.6)**	**($0.6)**	**($0.7)**

II. Medicare Prescription Drug, Improvement, and Modernization Act

There is one provision in the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (HR1) that will impact North Carolina revenues. This bill creates Health Savings Accounts (HSAs) that provide tax-favored treatment of savings for medical expenses under a high deductible health plan. A person is eligible for a HSA if he or she has a health plan with a deductible that is at least $1,000 for self only coverage or $2,000 for family coverage and the plan has an out-of-pocket expense limit that is no more than $5,000 for an individual or $10,000 for a family. Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) spent for covered benefits under the plan.

Individual contributions to a HSA are deductible from adjusted gross income and employer contributions to a HSA are excludable from gross income and wages for employment tax purposes. Distributions from a HSA for qualified medical expenses are excluded from gross income. HSA distributions not spent on qualified medical expenses are included in gross income and subject to an additional 10% tax.

The Department of Insurance reported to the Fiscal Research Division in May 2004 that the following companies have high deductible health plans that are HSA eligible:

John Alden
Fortis
United Wisconsin Life
Medical Security
American Republic has a product pending approval.

As in the examples above, the Joint Committee on Taxation is used to determine the North Carolina revenue loss. The federal tax loss is divided by the average federal tax rate of 21.9% to determine the federal taxable income. State taxable income is 2.9% of the federal taxable income based on 2003 US Census data on population. Multiplying the state taxable income times the 6.8% average state income tax rate yields the state tax loss from this provision.

		($Million)			
Health Savings Account	FY 04-05	FY 05-06	FY 06-07	FY 07-08	FY 08-09
JTC Estimate of Federal Tax Loss ($Millions)	-$160.0	-$474.0	-$533.0	-$597.0	-$650.0
Divide By Average Federal Tax Rate	21.9%	21.9%	21.9%	21.9%	21.9%
Estimated Loss of Federal Taxable Income	-$731.6	-$2,167.4	-$2,437.1	-$2,729.8	-$2,972.1
Multiply By NC Populations as a Percent of US	2.9%	2.9%	2.9%	2.9%	2.9%
Estimated Loss of NC Taxable Income	-$21.2	-$62.7	-$70.5	-$78.9	-$85.9
Multiply By NC Average Tax Rate	6.8%	6.8%	6.8%	6.8%	6.8%
Estimated NC Tax Loss	**-$1.4**	**-$4.3**	**-$4.8**	**-$5.4**	**-$5.8**

SOURCES OF DATA: Congressional Joint Committee on Taxation; Department of Revenue-Tax Research Division; Department of Defense "2002 Selected Manpower Statistics"; IRS "Statistics of Income Bulletin Fall 2003"; US Census Bureau "2003 US Statistics in Brief"; Department of Insurance

TECHNICAL CONSIDERATIONS: This act does not conform the state tax code to P.L. 108-218, The Pension Funding Equity Act of 2004 (H.R. 3108), which became law on April 10, 2004. Many of the provisions of this act affect corporate income tax payers.

FISCAL RESEARCH DIVISION: (919) 733-4910
PREPARED BY: Richard Bostic

APPROVED BY: James D. Johnson, Director
Fiscal Research Division

Official
Fiscal Research Division
Publication

DATE: May 18, 2004

Signed Copy Located in the NCGA Principal Clerk's Offices