NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: House Bill 1413 (Second Edition)

SHORT TITLE: Tax Credit for Long-Term Care Insurance.

SPONSOR(S): Representatives Earle, Howard, Nye, and England

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		(6.0)	(6.0)	(6.0)	
EXPENDITURES					

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

EFFECTIVE DATE: This act is effective for taxable years beginning on or after January 1, 2005.

BILL SUMMARY:
The bill reinstates the long-term care insurance tax credit beginning January 1, 2005, but sunsets the credit for taxable years beginning on or after January 1, 2008. The bill also mandates the Revenue Laws Study Committee study the effectiveness of the credit.

BACKGROUND:
The long-term care insurance tax credit was one of 13 tax provisions included in the budget act for Fiscal Year 1998-99 by the 1998 General Assembly (1998 S.L. chapter 212, SB 1366). The state individual income tax credit equals 15% of the premium paid each year on long-term care insurance, but the credit may not exceed $350 for each policy for which the credit is claimed. The credit may not exceed the amount of tax owed by the taxpayer (nonrefundable), and there is no provision to allow unused portions of the credit to be carried forward. The credit became effective for the taxable year beginning on or after January 1, 1999, and expires for taxable years beginning on or after January 1, 2004.

A taxpayer may claim a credit for policies that provide coverage for either the taxpayer, the taxpayer's spouse, or a family member for whom the taxpayer provides over half of the support and whose income is below an exemption amount. A long-term care insurance policy is one that provides only coverage of long-term care services and meets the following requirements:

1. Is guaranteed renewable.
2. Does not provide for a cash surrender value.
3. Provides that refunds and dividends may be used only to reduce future premiums or to increase future benefit.
4. Does not pay or reimburse expenses that are reimbursable under Medicare.
5. Satisfies consumer protection laws.

Under federal law, premiums paid on long-term care insurance contracts are treated as deductible medical expenses. Under the medical expense itemized deduction, unreimbursed medical expenses may be deducted to the extent that the expenses exceed 7.5% of adjusted gross income. To the extent a taxpayer will receive a deduction for long-term care insurance premiums under the Code, the taxpayer will receive a deduction for State income tax purposes as well since North Carolina uses federal taxable income as the starting point for calculating State taxable income. To prevent a double tax benefit in those cases, the credit is limited to those expenses for which a deduction has not been claimed.

ASSUMPTIONS AND METHODOLOGY:
Tax year 1999 is the first year that taxpayers could claim the long-term care tax credit. In the inaugural year, 21,029 tax returns claimed approximately $4.2 million in credits for an average long-term care insurance credit of $199. The total amount of credits claimed each year has been consistent except for 2001, which may be explained by a high error rate (see discussion below).

Tax Year	Number of Returns	Total Long-Term Care Credits	Average Credit Per Return
1999	21,029	$4,181,454	$198.84
2000	29,206	$5,974,615	$204.57
2001	51,959	$10,367,883	$199.54
2002	27,516	$5,652,648	$205.43

The Department of Revenue has encountered serious taxpayer problems with the long-term care insurance tax credit. Audits of selected tax returns in 2001 showed a 91% error rate for the long-term care credit. The most common taxpayer errors were 1) claiming the credit for regular insurance premiums, 2) claiming the total amount of premiums paid as a credit instead of the $350 limit, and 3) claiming the credit in addition to deducting the long-term care premium as a medical expense. One factor that may have increased errors in 2001 was the repeal of the tax credit for child health insurance. Taxpayers may have tried to continue taking the credit on the long-term care insurance line. By rewording the tax return instructions, contacting error making tax preparers, and revising verbiage in tax preparation software, the Department of Revenue reduced the error rate in audited returns to 27% in 2002. According to preliminary estimates for the 2003 tax year, the error rate among audited returns climbed to 40%.

High error rates make it difficult to accurately project the future cost of this tax credit. Many taxpayers have thus far ignored the Department's efforts to clarify the eligibility of this credit. Accurate projections are also hampered by the lack of demographic information on North Carolina long-term care insurance policy holders. A study by the Health Insurance Association of America reports the average purchaser of long-term care insurance is 67 years old. Elderly policy holders with little taxable income would explain why only 51.2% of 86,272 long-term care insurance purchasers in this state claimed a credit in 2002 (counted married filing jointly returns as two policies). Many elderly have little taxable income because North Carolina does not tax Social Security benefits, nor does it tax the pensions of local, state and federal employees vested before August 12, 1989. Furthermore, government pensions not excluded are granted a $4000 income exemption and private pensions are given a $2000 exemption.

The Department of Revenue provided the following information about the taxable income of those claiming the long-term care credit in the 2002 tax year.

NC Taxable Income	Number of Returns	Total Long-Term Care Credits
0 - $15,000	9,139	$2,061,818
$15,001 - $30,000	5,349	$1,080,491
$30,001 - $50,000	4,685	$874,385
$50,001 - $75,000	3,564	$651,047
$75,001 - $100,000	1,953	$364,294
$100,001 or more	2,826	$620,613
Total	27,516	$5,652,648

This fiscal note assumes that the near term General Fund revenue loss from the long-term care insurance tax credit will be in the $5.5 million to $6 million range of recent years. While the number of policy holders may increase in the next five years, this estimate assumes no growth in credits claimed due to the likelihood that the new purchases will be made by an elderly population with low state tax liability. The increase in credit claims due to growth in policies may also be countered by a reduction in credits fraudulently claimed.

Since the credit was scheduled to sunset in 2004, an increase in General Fund availability was anticipated for FY 2004-05 and beyond. Passage of this bill will again create a General Fund revenue loss of approximately $6 million a year. Taxpayers will take the 2005 tax credit on their returns filed in 2006, thus the first year impact of this bill is FY 2005-06.

SOURCES OF DATA: Department of Revenue, Department of Insurance

TECHNICAL CONSIDERATIONS: None

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