NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: Senate Bill 1145 (Third Edition)

SHORT TITLE: Revenue Laws Technical Changes.

SPONSOR(S): Senator Hartsell

FISCAL IMPACT ($MIL.)

Yes (x) **No ( )** **No Estimate Available ( )**

	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08	FY2008-09
REVENUES					
State General Fund	**-**	**$5.4**	**-**	**-**	**-**

PRINCIPAL DEPARTMENT AFFECTED: The tax is collected by the Department of Revenue. The enactment of the legislation is not expected to affect the budget requirements of the Department.

BILL SUMMARY: Estate Tax Changes. The federal Economic Growth and Tax Reconciliation Act of 2001 provided for the phase-out between 2002 and 2005 of the credit allowed under the federal estate tax for state death taxes. North Carolina, like most states, has repealed its regular inheritance/estate tax in lieu of an estate tax ("pickup tax") that is based on the amount of the federal credit. Without further changes by the General Assembly, the repeal of the federal credit would have automatically repealed the North Carolina estate tax.

As part of the 2002 budget package, amended during the 2003 session, the North Carolina estate tax was partially decoupled from the federal estate tax until July 1, 2005. Thus, the North Carolina estate tax continues to be levied without regard to the phase-out of the federal credit. However, under the "partial conformity" solution adopted by the General Assembly in 2002 and amended in 2003, the North Carolina tax is calculated using other provisions of federal estate tax law in effect on the date of the decedent's death. For example, the federal "unified credit" used to calculate the State estate tax that effectively sets the threshold for taxability of an estate, is the credit in effect as of the decedent's death. Under the federal Act, the amount effectively exempted under the unified credit was increased from $700,000 to $1 million in 2002, and then phased up over a period of years to $3.5 million in 2009. The partial conformity solution in current state law adjusts for the federal exemption increase so that estates do not have to file a North Carolina return if no federal return is required.

By remaining coupled to the federal estate tax base, the North Carolina estate tax will incorporate a provision of federal law effective beginning in 2005 that will allow a deduction for State death taxes paid in lieu of the previously allowed credit for State death taxes paid. Allowing the deduction of State death taxes for purposes of determining the State death tax base will result in a circular calculation because the tax being calculated results in a deduction from the tax base, which then alters the calculation of the tax owed. When the federal provision allowing a deduction for State death taxes takes effect, a series of calculations will be required to calculate the North Carolina estate tax.

SB 1145 creates an addition to the federal taxable estate for N.C. estate tax purposes that is equal to the amount of the federal deduction for State death taxes paid. The change is effective for deaths occurring on or after January 1, 2005.

Bill Lee Act Change. Under the incentives package adopted in 1996 and modified in subsequent sessions, there is a state income tax credit for new jobs created in the State. The law is not clear on how the determination of the number of new jobs is made. The third edition of SB 1145 specifies that the number of new positions is determined by subtracting the highest number of full-time employees the taxpayer had in North Carolina at any time during the immediately preceding tax year from the number at the end of the tax year. The change is effective for tax years beginning on or after January 1, 2004..

ASSUMPTIONS AND METHODOLOGY: **Estate Tax Changes**. The estates affected by the enactment of these provisions are those for deaths occurring between January 1, 2005 and June 30, 2005. The reason is that under current law, North Carolina will lose its estate tax base on July 1, 2005. Thus there would no impact of the proposal after that date. In addition, estates are not required to pay the tax until nine months after a death. This means that the reduction in General Fund revenue will take place during the period October 1, 2005 - March 31, 2006.

The estimated impact was based mostly on a refinement of some numbers from a similar proposal in Maryland. The Maryland estimates, which were based on an analysis of tax returns, had to be adjusted for the fact that Maryland still has a regular inheritance tax (though spouses and lineal ancestors are exempt) and the fact that North Carolina is a larger state.

The Maryland numbers indicate that the impact of the identical proposal will be 10.8% of baseline "death tax" collections in that state. We adjusted this ratio for the fact that the estate tax portion of their death tax is smaller due to the fact that a regular tax continues in place. The ratio selected for our analysis is 9.0%.

The North Carolina tax base is running around $120 million per year. Applying 9% to this estimate yields a 12-month cost of $10.8 million. The six-month impact under the bill is equal to 50% of this annual amount.

Bill Lee Act Change. Discussions with the Department of Revenue indicate that it is impossible to determine the impact of this change on General Fund tax revenue. For one thing, the January 1, 2004 effective date of the bill means that the first determination of the effect of the provision on a particular taxpayer would be based on comparing the December 31, 2004

employment level (for a calendar year taxpayer) with the highest employment level for the 2003 tax year. There is no way to know what the December 31, 2004 employment level will be for individual employers. In addition, a review would need to be made of quarterly unemployment insurance tax reports for 2003 for individual employers. The same issues come into play in estimating the impact on 2005, the last year of the Bill Lee Act. An estimate based on the experience of individual companies for prior years may not be relevant because many companies that have downsized in recent years are adding back employees as the economy improves. Finally, the large number of mergers, acquisitions, and other corporate reorganizations in recent years makes the calculation very tricky. The fact that the changes are effective for tax years beginning on or after January 1, 2004 means that any impact would primarily affect the 2005-06 and 2006-07 fiscal years since the jobs credit is taken in the tax year following the activity year. The Bill Lee Act sunsets on January 1, 2006 under current law. Thus, any impact for 2007-08 and future years would be minimal.

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