NORTH CAROLINA GENERAL ASSEMBLY
LEGISLATIVE FISCAL NOTE

BILL NUMBER: House Bill 59
SHORT TITLE: Update Internal Revenue Code
SPONSOR(S): Representatives Neely, Blue, Cansler, Capps, Church, Shubert, Mosley, and Hill

ESTIMATE
($ MILLIONS)
FISCAL IMPACT

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

	FY 1997-98	FY 1998-99	FY 1999-00	FY 2000-01	FY 2001-02
REVENUES					
General Fund *	**($8.48)**	**($16.75)**	**($11.52)**	**($12.97)**	**($17.03)**

* For revenue impact by policy see spreadsheet page 8.

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

EFFECTIVE DATE: See specific act under the bill summaries.

BILL SUMMARY: Section 1 rewrites the definitions of the Internal Revenue Code used in State tax structures to change the reference date form March 20, 1996 to January 1, 1997.

BACKGROUND: An update to the Internal Revenue Code is brought to the General Assembly annually as both a policy decision and a response to a legal restraint. The policy reason for specifying a particular date is that, in light of continuous changes made to the federal tax law, the State may not want to automatically adopt federal changes, particularly when they result in large revenue losses.

The legal restraint involves Article V, Section 2(1) of the North Carolina State Constitution which states in pertinent part that the "power of taxation shall never be surrendered, suspended, or contracted away". A 1977, memorandum from the State Attorney General's Office to the Tax Research Division of the Department of Revenue concluded that a "statute which adopts by reference future amendments to the Internal Revenue code would be

invalidated as an unconstitutional delegation of legislative powers".

Legislation enacted by Congress affecting the Internal Revenue Code is as follows:

Taxpayer Bill of Rights 2

Joint Return Contemporaneous Payment Requirement

The requirement that taxpayers who file separate returns pay the full tax liability when filing an amended joint return is repealed. In the past, taxpayers were required to pay the full amount of the joint tax liability at the time of filing an amended joint return or within three years of filing.

Effective for tax years beginning after July 30, 1996.

Small Business Job Protection Act of 1996

Increase in Small Business Expensing

The amount of tangible business property that may be expensed rather than depreciated over time is increased from $17,500 to $18,000 for tax year beginning in 1997, and increased every year there after until 2003 when the expense deduction will be $25,000.

Effective for tax years beginning after December 31, 1996.

Extension of Employer-Provided Education Assistance

The exclusion from an employer's gross income for employee educational assistance that expired for tax years beginning December 31, 1994, is retroactively extended. The maximum amount allowed under a qualified employer educational assistance program is $5,250 per employee. The exclusion is not available for expenses related to graduate courses beginning after June 30, 1996. The prohibited courses include any graduate level course leading to advanced academic or professional degrees.

The exclusion will expire effective for tax years beginning after May 31, 1997. Expenses paid for courses beginning before July 1, 1997, are excludable for tax year 1997.

Extension of Expired Provisions

- The 20% tax credit for research and experimentation that expired for amounts paid or incurred after June 30, 1995, is extended. Effective for amounts paid or incurred from July 1, 1996 through May 31, 1997.

- The orphan drug tax credit is extended for amounts paid between July 1, 1996, through May 31, 1997. Prior to January 1, 1995, a 50% tax credit was allowed for qualified clinical testing expenses incurred in testing certain drugs for rare disease conditions, generally referred to as "orphan drugs".

Qualified expenses are cost incurred after the FDA has approved a drug for human testing but before it has been approved for sale.

- The special treatment for contributions of appreciated stock to private foundations is extended for contributions made between July 1, 1996, through May 31, 1997. Qualified appreciated stock is publicly traded stock that is capital gain property.

- The targeted jobs credit is replaced by the work opportunity credit and is effective for individuals starting work for an employer after September 31, 1996. The credit will not apply to individuals beginning work for an employer after September 30, 1997. The work opportunity credit has fewer targeted jobs, an increased minimum period in which a targeted group member must work for an employer, and a credit percent of 35% rather than 40% of the first $6,000 of wages paid to each targeted group member during the first year of employment.

S Corporation Simplification Provisions

- The number of eligible S corporation shareholders is increased form 35 to 75.

- Allows certain trust to hold S corporation stock. The beneficiaries of an "electing small business trust" may participate so long as they are individuals or estates and their interest in the trust must have been acquired by gift or bequest.

- An S corporation is allowed to own S or C subsidiaries. An S corporation is allowed to own 80% or more of the stock of a C corporation and can own a qualified subchapter S subsidiary in tax years beginning after 1996.

- Base adjustments for distributions made by an S corporation during the tax year are taken into account before applying the loss limitation for the year. As a result, distributions reduce the adjusted basis for determining the allowable loss for the year, but that loss does not reduce the adjusted basis for purposes of determining the tax status of the distribution. This provision provides the same tax treatment of distributions by S corporation during a (loss) year as allowed for partnerships.

  All provisions effective for tax years beginning after December 31, 1996.

Lump-sum Distributions
The five year averaging option for lump-sum distributions from a qualified pension plan is repealed for individuals born after 1935; for tax years beginning after December 31, 1999. Individuals born before 1936 can elect a 10 year averaging option based on 1986 tax rates for a single person or a five year averaging method based on the single person tax rate in effect for the year in which the lump-sum distribution was taken. Individuals born after 1935 can elect a five year averaging if the distribution was made after they reached the age of 59 ½. (Under current law, the ten year averaging option is disallowed for this group.) After the effective date, the rules affecting those born before 1935 will not change. Those born after 1935 will not be allowed to average.

Effective for tax years beginning after December 31, 1999.

Special Employer-Provided Death Benefit Exclusion
The exclusion allowed the beneficiary or estate of a deceased employee to exclude up to $5,000 in benefits paid by or on behalf of an employer by reasons of the employee’s death is repealed.

Effective for decedents dying after August 20, 1996.

Simplified Method of Determining Annuity Recovery Basis
The number of anticipated payments by age group used in calculating the nontaxable portion of each annuity payment from a qualified retirement plan, qualified annuity, or tax-sheltered annuity are increased. The nontaxable portion of an annuity payment, generally, is equal to the employee’s total investment in the contract as of the annuity starting date, divided by the number of anticipated monthly payments, which are determined by reference to the age of the participant. The “new law” increases the number of monthly payments to be used in figuring the tax-free portion of each annuity payment. The age categories remain the same.

Effective with annuities commencing after November 17, 1996.

New Required Beginning Date for Distribution of Retirement Plans
Participants in qualified retirement plans, other than five-percent owners and IRA holders, are no longer required to begin receiving distributions from the fund after attaining the age of 70 ½ if they are still employed.
Distributions must begin by April 1, of the calendar year following the later of : (1) the calendar year in which the participant reaches age 70 ½, or (2) the calendar year in which the employee retires.

Effective January 1, 1997

Deductible Contributions to Spousal IRAs

The maximum amount a married individual may contribute to a spousal IRA for a non-working spouse is increased from $250 to $2,000 a year. Prior to this change the maximum amount a couple filing jointly could contribute to an IRA was $2,250. Under the new law, a couple filing jointly can contribute $2,000 each for a total of $4,000.

Effective for tax years beginning after December 31, 1996

Adoption Assistance Credit and Expansion

Employees are allowed to exclude "qualified adoption expenses" from income if such amounts are paid or incurred by their employer. Qualified adoption expenses include adoption fees, court costs, attorney fees, and other expenses related to the legal adoption of an eligible child.

Effective for tax years beginning after December 31, 1996

Personal Injury or Sickness Damages Received; Limited Exclusion

The exclusion from income for damages received on account of personal injury or sickness is restricted to non-punitive damages. The exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. Punitive damages awarded in wrongful death actions may be excluded from gross income where applicable State law only allows punitive damages to be awarded.

Effective with respect to amounts received after August 20, 1996, unless the amounts were received under a written binding agreement, court decree, or mediation award in effect on September 30, 1995.

Depreciation of Water Utility Property.

Under prior law, property used in the gathering, treating, and distribution of commercial water and municipal sewers systems was depreciated over 20 years using the 150% declining balance method. This method ensures a rate of depreciation that depreciated the asset exactly to salvage value over the period. The change allows for such property to be depreciated over a 25 year period using the straight-line method. The straight-line method is customarily used on assets where creeping obsolescence is the primary reason for a limited service life.

The act is effective for property placed in service June 12, 1996, other than property placed in service pursuant to a binding contract in effect before June 10, 1996.

Health Insurance Portability and Accountability Act of 1996

Medical Savings Accounts

Medical Savings Accounts are created for the purpose of defraying the un-reimbursed health care expenses on a tax-favored basis. A MSA is a trust or custodial account created exclusively for the benefit of the account holder and subject to rules similar to individual retirement accounts. Earnings on an MSA are not subject to tax, however, distributions for expenses other than medical are to be included as income and subject to penalty unless made after the participant reaches age 65, dies, or is disabled. Upon death, if the beneficiary is the individual's spouse, the spouse may continue the MSA as their own. Otherwise, the beneficiary must include the MSA balance in income in the year of death. If there is no beneficiary, the MSA balance is to be included on the final return of the decedent. In any case, no federal estate tax applies. Distributions from an MSA for medical expenses can be excluded from income.

Contributions made by an "eligible" employee or self-employed individual are deductible. Contributions made by an employer on behalf of an employee are excludable from the employee's income and wage for social security tax purposes. An "eligible" employee is one covered under an employer sponsored high deductible plan of a small employer and self-employed individuals. A high deductible health plan is one having an annual deductible of at least $1,500 and no more than $2,250 for individual coverage and at least $3,000 and no more than $4,500 for family coverage. An employer is a small employer if it employed, on average, no more than 50 employees during either the preceding or the second preceding years.

Effective for taxable years beginning on or after December 31, 1996.

Health Insurance Deduction Allowed to Self-employed Individuals

Self-employed individuals are allowed annual increases in health insurance premiums paid on behalf of self-employed individual, a spouse, and dependents. In 1993, the maximum deduction allowed was 25% of the qualified premiums and increased to 30% for tax years beginning after December 31, 1994.

The deduction is increased by the following amounts by tax year:

Tax Year	% Allowed Deduction
1997	40%
1998-2002	45
2003	50
2004	60
2005	70
2006	80

Medical Expenses Deduction for Long-term Care

Un-reimbursed amounts paid for qualified long-term care services are treated as medical care for purposes of the medical expense

deduction. Eligible long-term care insurance premiums that do not exceed certain limits are deductible from gross income.

Effective for tax years beginning after December 31, 1996

Insurance Proceeds Received by the Chronically or Terminally Ill

The following are excluded from gross income:

- Proceeds received by the chronically ill from long-term care insurance.
- Proceeds received by the terminally ill from life insurance.

Effective for tax years beginning after December 13, 1996.

SOURCES OF DATA:

Federal Tax Guide Reports

Taxpayer Bill of Rights 2

Small Business Job Protection Bill of 1996

Health Insurance Portability and Accountability Bill

Personal Responsibility and Work Opportunity Reconciliation Bill; 1996

1996 Tax Legislation: Law and Explanation

ASSUMPTIONS AND METHODOLOGY:

Estimates prepared using federal and neighboring state computed impacts. The basic assumption used assumes that the State's cost will be .65% of the federal predicted cost. The State's personal income is approximately 2.5% of the U.S. total and the State's average tax rate is 25% of the federal.

FISCAL RESEARCH DIVISION
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DATE: February 21, 1997

House Bill 59; First Edition
Internal Revenue Code Up-Date
February 21, 1997

Signed Copy Located in the NCGA Principal Clerk's Offices

Estimates ($ IN MILLIONS)

Federal Legislation Affecting NC.	**Tax Year 1997**	**Tax Year 1998**	**Tax Year 1999**	**Tax Year 2000**	**Tax Year 2001**

1. Small Business Expensing	($0.43)	($1.17)	($1.69)	($2.15)	($4.96)
2. Employer Educational Assistance	($6.00)	($6.70)			
3. S Corporation Simplification	($0.11)	($0.33)	($0.33)	($0.44)	($0.44)
4. Lump-Sum Distributions	$0.33	$0.66	$0.77	$0.66	$0.55
5. Employer Provided Death Benefits	$0.15	$0.45	$0.45	$0.56	$0.74
6. Simplify Annuity Recovery	($0.11)	($0.22)	($0.22)	($0.22)	($0.22)
7. Simplify Retirement Plans	($0.32)	($0.49)	($0.51)	($0.52)	($0.55)
8. Spousal IRAs	($0.37)	($1.10)	($1.20)	($1.26)	($1.34)
9. Personal Injury, Limit Exclusion	$0.33	$0.36	$0.40	$0.40	$0.42
10. Medical Savings Accounts	($0.77)	($1.62)	($1.72)	($1.85)	($2.00)
11. Increase Insurance Deduction; Self-Employed	($0.42)	($1.55)	($2.20)	($2.45)	($2.70)
12. Long Term Medical Care Expense Deduction	($0.70)	($4.34)	($4.20)	($4.30)	($4.83)
13. Accelerated Death Benefits	($0.06)	($0.70)	($1.07)	($1.40)	($1.70)
Total	($8.48)	($16.75)	($11.52)	($12.97)	($17.03)