NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: HB 1670 (4th Edition)

SHORT TITLE: Subsidiary Dividend Changes

FISCAL IMPACT

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

	FY 2002-03	FY 2003-04	FY 2004-05	FY 2005-06	FY 2006-07
REVENUES	"See Assumptions and Methodology"				

PRINCIPAL DEPARTMENTS AFFECTED: The corporate income tax is collected by the Department of Revenue. The enactment of the bill will not affect the department's budget requirements.

EFFECTIVE DATE: Tax years beginning on or after January 1, 2001.

BILL SUMMARY: The 2001 General Assembly enacted legislation conforming state law to the federal rules for the deduction of dividends received. This would apply, for example, to dividends received by a holding company from its subsidiaries. The change eliminated the adjustments that had previously been required to reflect differences between the federal and State dividends deduction.

North Carolina has a general law that disallows the deduction of expenses incurred in earning income that is not taxable. However, there is an **exception to the rule** in cases where the federal and state laws differ regarding the taxability of an income item. Thus, prior to the 2001 changes, companies were able to use the exception to deduct expenses associated with income earned from subsidiaries. However, the adoption of federal conformity for the rules governing the deductibility of dividends effectively eliminated the deduction of expenses associated with subsidiary dividends. This meant that related expenses would have to be netted against the dividends that are deducted.

After the 2001 act was adopted, the Department of Revenue developed rules that companies could use to determine which expenses were associated with the deductible income. Since that time there has been much discussion about whether the Department's rules accurately attribute expenses incurred.

The Proposed Committee Substitute creates new statutory language that clarifies the expense attribution rules and limits the impact of the 2001 change on expense deductibility. Under the bill, the new rules will be in effect for the 2001 and 2002 tax years. For future years, the bill states the intent for the Revenue Laws Study Committee to review the issue and recommend modifications to the system. In addition, the language states that intent for the 2003 General Assembly to address the issues raised by this year's bill.

The new expense attribution rules are as follows:

1. The amount of related expenses that must be netted from deductible dividends is capped as follows:
   - Most companies 15% of dividends
   - Bank holding companies 20% of dividends
   - Electric power holding companies 15% of total interest expenses

2. The additional tax that a bank holding company and its related companies must pay as a result of the expense netting is subject to a maximum of $11 million per corporate family.

3. Bank holding company corporate families receive a tax credit beginning in 2003. For bank corporate families that reach the $11 million cap, the credit is $2 million. For other bank corporate families, the credit is equal to the amount of tax reduction that would result if bank holding companies were subject to a 15% cap rather than a 20% cap. These credits may be taken against income tax or franchise tax and are spread out over four tax years beginning in 2003.

Electric power holding companies receive a credit equal to one-half of the additional tax that each must pay as a result of the expense netting. The credit is taken in the following year. The credit may be taken against income tax or franchise tax. As an alternative, an electric power holding company may elect to allocate the credit among the members of its affiliated group. If this election is made, the credit is spread over four tax years, beginning in 2003.

ASSUMPTIONS AND METHODOLOGY: The Department of Revenue has examined tax year 2000 tax returns from a group of selected large corporations and a sample of several hundred smaller corporations in order to analyze the impact of subsidiary dividends and associated expenses. In addition, Department personnel have had conversations with affected parties. Finally, Fiscal Research has been involved in numerous meetings on the issue with the Department of Revenue and the affected parties.

The 2003 General Assembly just enacted legislation modifying the 2002-03 budget. This package included $50 million in additional budget availability from a re-estimate of the 2001 bill. The adjustment came as a result of numerous discussions with the Department of Revenue and affected parties about the expense attribution rules. During the discussions, it was apparent that the 2001 session estimate of $32.3 million of impact understated the effect of the indirect change in the expense attribution rules. The reason for the under-estimate is that the Department of Revenue's analysis of the bill, which used confidential tax returns for the 1994 tax year and an update of the 1994 data, did not include financial institutions. The Department feels that if the affected bank holding companies fully comply with the 2001 law and administrative rules, the additional $50 million will be collected during the 2002-03 fiscal years.

Shown below is a comparison of the General Fund revenue anticipated under the original 2001 bill, the 2002 re-estimate, and the current proposal:

Additional General Fund Revenue ($Mil.)				
	01-02	02-03	03-04	04-05
2001 Legislation	30.8	32.3	33.6	34.5
2002 Re-estimate*	30.8	82.3	83.6	84.5
HB 1670**	30.8	82.3	59.9	62.9

* The actual impact per calendar year could be $120 million or more but is heavily dependent of the compliance of taxpayers affected by the 2001 change. The amount shown is the figure used in modifying the 2002-03 budget.

**The analysis indicates that a major portion of the unanticipated 2001 tax year impact will be paid in 2002-03. The same pattern is likely to occur under the annual impact discussed in the first footnote.

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