The Hidden Tax Expenditures

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In my last post, I wrote about the largest State tax expenditures identified by the Department of Revenue in a report issued in December 2011 and how those expenditures fared under tax reform efforts in 2013 and 2014. Those tax expenditures were all relatively straightforward. However, there are other large tax expenditures that affect State General Fund revenues that remain relatively hidden from view. In each case, these tax expenditures are the result of federal tax expenditures that impact the State individual income tax.

Since 1989, North Carolina has relied on federal tax law to define the starting point used in computing State taxable income. North Carolina currently uses federal adjusted gross income as this starting point. Thus, items that are not included in federal adjusted gross income generally are also not included in State taxable income. (However, in some cases, income that is excluded from federal adjusted gross income are specifically added back at the State level.)

These 'federal tax flow-through expenditures' can be quite significant. In a report issued by the Department of Revenue in 2013, the four largest of these federal tax flow-through expenditures would have each been included in the top 10 on the combined list of State tax expenditures and federal tax flow-through expenditures. The following is a brief description of each of the four largest federal tax flow-through expenditures.

4. Exclusion of Medicare benefits. Medicare is a government health care program for the aged and disabled. Medicare is paid for through a combination of special payroll taxes paid by workers and employers, premiums paid by beneficiaries, and general appropriations. Unlike private health insurance, total premiums paid (whether in the form of premiums paid by beneficiaries or special payroll taxes paid by workers or employers) are not designed to cover the full cost of benefits paid. Amounts paid by the federal government (or in some cases state governments) to cover the costs of benefits in excess of premiums paid are excluded from income. If these amounts were included in taxable income, the Department of Revenue estimates that State General Fund receipts would be $466M higher in FY 14-15, making this the ninth largest expenditure on the combined list of State tax expenditures and federal tax flow-through expenditures.

3. Exclusion of capital gains at death. Generally a taxpayer will pay a capital gains tax on the increase in value of a capital asset when the taxpayer transfers that asset. The amount of the capital gain is equal to the difference between the amount the taxpayer receives as a result of the transfer of the asset and the amount of the taxpayer's basis in the asset. (The basis is equal to the amount paid for the asset, subject to some adjustments such as decreases for amounts claimed as depreciation deductions or increases for amounts spent on certain improvements to the asset.) Assets transferred at the death of their owners receive a step-up in basis to their current value, thus the appreciation that occurred prior to death is not taxed. The Department of Revenue estimates that this exclusion will result in a reduction in State General Fund receipts of $541M in

FY 14-15, placing it fifth on the combined list of State tax expenditures and federal tax flow-through expenditures.

2. Exclusion of contributions and earnings to pension plans. Contributions to many types of pension plans are excluded from income tax at the time of the contribution. In addition, the earnings of these plans are generally excluded from tax until amounts are distributed from the plan in the form of benefits. The combined effect of these provisions is to push tax liability into the future and, if you assume a constant tax rate, to effectively provide an exemption on the return. The Department of Revenue estimates the net cost of these provisions (the exclusion from taxable income of contributions and earnings made today less the tax imposed on benefits paid today) at $787M in FY 14-15, placing this expenditure third on the combined list of State tax expenditures and federal tax flow-through expenditures.

1. Exclusion of employer contributions for health care, health care insurance premiums, and long-term care insurance premiums. Generally speaking, the gross income of an employee does not include employer contributions for coverage under an accident or health plan. Receiving compensation in the form of non-taxable fringe benefits is a great perk. The Department of Revenue estimates that if employees were subject to tax on the amount spent by their employers to provide these benefits, State General Fund tax receipts would be $1.483 billion higher in FY 14-15, placing this expenditure second on the combined list of State tax expenditures and federal tax flow-through expenditures (behind only the tax expenditure for the standard deduction).

Keep in mind, as I pointed out in my last post, noting that an item can be described as a tax expenditure is not a judgment of its worthiness. There may be numerous tax policy or public policy bases that support the decision to tax one type of income, but not another. The point of this post is merely to demonstrate that those decisions have significant fiscal consequences. The fiscal impact to the State General Fund of these four federal tax flow-through expenditures is estimated at over $3.27B in FY 14-15. Again, to put these numbers in context, total State General Fund receipts for FY 14-15 are estimated to be roughly $19.97B.

Note: As with my last post, estimated General Fund tax revenues for FY 14-15 are taken from the Appropriations Act of 2014, (S 744, S.L. 2014) enacted August 7, 2014, whereas the tax expenditure estimates come from the Biennial Tax Expenditure Report 2013 released in December 2013 – so the numbers were not derived by the same entity at a single point in time. Thus, these numbers should only be used to give a general impression of the relative size of the largest federal tax flow-through expenditures.