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ALERTS

The Eye of the Beholder

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09.12.2013

"A tax loophole is something that benefits the other guy. If it benefits you, it is tax reform." – former U.S. Senator Russell B. Long (D – Louisiana).

"The precise point at which a tax deduction becomes a 'loophole' or a tax incentive becomes a 'subsidy for special interests' is one of the great mysteries of politics." – former U.S. Senator John Sununu (R – New Hampshire)

During any debate about tax reform, one is almost certain to hear discussion of 'closing loopholes'. But what is a 'loophole'? The quotes above illustrate the thorny political issue one runs into when talking about 'loopholes'. Like beauty, it seems that a loophole is in the eye of the beholder. Perhaps this is one reason that many tax analysts use the less politically charged term 'tax expenditure'.

A tax expenditure is broadly defined as an exemption, exclusion, deduction, allowance, credit, refund, preferential tax rate or other device that reduces the amount of tax revenue that otherwise would be collected. In other words, if you were to assume that taxation of an item or activity is the norm, a tax expenditure is some preferential deviation from that norm. In many cases, there are sound tax policy or popular public policy reasons for tax expenditures. Noting that an item constitutes a tax expenditure is NOT a judgment about its worthiness.

During the most recent round of tax reform in North Carolina, the subject of tax expenditures was often debated. It's clear that recent reform efforts eliminated many, though not all, tax expenditures. It may surprise you, however, to learn that only one of the five largest tax expenditures identified by the Department of Revenue in a December 2011 report was eliminated by tax reform efforts in 2013 and 2014. The following is a look at the impact of tax reform legislation during 2013 and 2014 on the five largest State tax expenditures identified by the Department of Revenue in 2011.

5. Income Tax Deduction for Certain Government Retirement Income. The government retirement benefits of retirees subject to the *Bailey*, *Emory*, and *Patton* decisions are not subject to State income taxes. Due to the rulings in those decisions, the General Assembly is powerless to tax this income – so this is an expenditure that could not have been eliminated regardless of whether the General Assembly desired to do so. The Department of Revenue estimated the size of this tax expenditure at $366.8M in FY 14-15.

4. Sales Tax Exemption on Prescription Drugs and Insulin. Sales of drugs sold on prescription and insulin are exempt from the sales and use tax. No changes to this exemption were made during 2013 or 2014. The Department of Revenue estimated the size of this tax expenditure at $523.1M in FY 14-15.

3. Sales Tax Exemption on Food. Generally speaking, most sales of food are not subject to sales and use tax at the State level, but are subject to local sales and use taxes at the rate of 2%. Certain types of food (such as dietary supplements, prepared food, food sold through vending machines, candy, and soft drinks) are generally subject to both State and local sales and use taxes. During 2013 and 2014, relatively few changes were made with respect to the sales tax on food. (The General Assembly did, however, eliminate or reduce some tax expenditures with respect to sales of food, most notably a sales tax exemption for food sold by educational institutions to students in dining halls). The Department of Revenue estimated that the State sales tax exemption for most sales of food will result in a tax expenditure of $720.5M in FY 14-15.

2. Individual Income Tax Personal Exemptions. Personal exemptions are specific amounts that may be deducted for each person whom the taxpayer may claim as a dependent. For example, a single taxpayer with no other dependents would be allowed a single personal exemption whereas a married couple filing a joint return with three dependent children would be allowed five personal exemptions. The General Assembly eliminated the deduction for personal exemptions beginning with the 2014 taxable year.

1. Individual Income Tax Standard or Itemized Deductions. In computing taxable income, individuals are allowed to claim either a standard deduction or itemized deductions. The standard deduction is a set amount based on the filing status of the taxpayer. In this context, 'itemized deductions' refers to deductions taken at the federal level (such as deductions for mortgage interest expense, charitable contributions, business expenses, medical expenses above a certain threshold, etc.). In 2013, the General Assembly did two main things with respect to standard and itemized deductions for State purposes. First, the General Assembly more than doubled the amount of the standard deduction for each filing type for the 2014 taxable year. Second, the General Assembly limited the federal itemized deductions that could be taken at the State level. Prior to the 2014 taxable year, a taxpayer could claim on his or her State tax return a deduction for the amount of the federal itemized deduction (this was subject to some adjustments with respect to specific items included in federal itemized deductions). Beginning in 2014, the State deduction related to federal itemized deductions was limited to a) the amount claimed as a federal deduction for charitable contributions, and b) an amount not to exceed $20,000 claimed as a federal deduction for mortgage interest expense and real property taxes.

The exact size of this final tax expenditure cannot be easily gleaned from the Department of Revenue report. For the report, the Department estimated the fiscal impact of the standard deduction in excess of a 'base' amount. The Department of Revenue estimated that amount at $1.233B in FY 14-15. The Department of Revenue estimated the amount of the tax expenditure for itemized deductions in excess of the standard deduction at $486.6M in FY 14-15. Based on conversations with the Department of Revenue, I've learned that the amount estimated for the 'base' standard deduction is $1.854B in FY 14-15. Combining these three numbers gives you a total amount in excess of $3.57B for FY 14-15.

To put these numbers in context, remember that State General Fund tax revenues for FY 14-15 are expected to total roughly $19.97B*. Combining the totals for the five largest tax expenditures identified in 2011 (before tax reform) still yields total tax expenditures for just these items of over $5.18B in FY 14-15*. As the above discussion illustrates, significant tax expenditures remain in North Carolina's tax code despite recent tax reform efforts. As the above discussion also illustrates, the largest State tax expenditures are not ones that most people would call 'loopholes'.

*Note: 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 remaining tax expenditures.