Adopted by Full TRAC (as amended) 10/22/10

Draft Report of the Individual Income Tax Subcommittee of the South Carolina Taxation Realignment Commission (TRAC)

September 2, 2010

Much like the State's sales tax system, South Carolina's individual income tax structure is straining under the burden of a tax base which continues to narrow. As discussed in detail below, the ramifications of this reality are not short-lived, but have long-term implications for the ability of the current system to produce sufficient and stable revenues over time.

The individual income tax is the second largest source of revenue for the State's General Fund, only slightly trailing revenue generated by the State sales and use tax. Revenue from this important source is marking its third consecutive year of decline. Individual income tax collections totaled approximately $2.17 Billion in FY2009-10, a drop of more than $700 Million over the last three years.[1]

This near term and substantial decline in individual income tax revenue, the magnitude of which is attributable, in part, to the recent and protracted economic downturn, is also symptomatic of longer-term structural issues – issues that go deeper than often had cursory discussions about whether a particular rate is too high or too low, or if taxes should be cut or raised.

The subcommittee is aware that in recent years, policy discussions about the State's individual income tax structure have focused on the State's top marginal individual income tax rate of 7%. And while that rate is higher than some states top marginal rates, the subcommittee has focused not just on a comparison of top rates, but on "effective" tax rates as well. Ultimately, effective tax rates are what matter most to taxpayers. And in that category South Carolina outperforms almost every other state by comparison. South Carolina's effective individual income tax rate is 2.8%, a rate that is lower than 33 other states.[2]

South Carolina imposes one of the lowest individual income tax burdens on its residents than any state in the nation. Of the 41 states imposing an individual income tax, South Carolina's average state income tax liability per filer is lower than 35 other states.

Compare that to Georgia whose average tax liability is 46 percent higher than ours. And compare that to North Carolina as well, where the "average" South Carolina taxpayer living in York County, SC pays 70 percent less in income tax than he would as a tax filer living in Mecklenburg County, NC.[3] And that is before factoring into North Carolina's average tax liability that state's recent enactment of a 3% "surtax" at certain levels of income. A factor which would undoubtedly enhance South Carolina's distinct tax advantage compared to North Carolina.[4]

As further illustration, at no specific level of income, whether at $1 or $1,000,000, do single taxpayers, or married taxpayers, with two children, owe more tax to South Carolina than they would if they earned the same amount of income and lived in North Carolina.[5]

Ten states that have lower top marginal rates than South Carolina actually impose higher average effective rates on taxpayers than South Carolina.[6] Georgia is among those states, with a top marginal rate of 6%, but an effective tax rate of 3.5%.[7]

In addition, several states with so called "flat taxes" have rates that are lower than South Carolina's top marginal rate, but have effective rates that are higher than South Carolina's. A classic example is Massachusetts, who despite boasting a flat tax, imposes an effective tax rate of 5.3%, a rate almost 2 times higher than the effective rate imposed on the average South Carolinian.[8]

Fourteen states impose not only state level income tax, but local income tax as well.[9] Because South Carolina does not permit local income taxes to be levied, our advantage is further enhanced from a competitive national standpoint.

Based on its thorough and complete analysis, the subcommittee finds that South Carolina is not a high individual income tax state by any honest and in-depth measure or assessment.

However, our otherwise positive findings do not necessarily suggest certain structural concerns do not exist. These concerns involve the overall fairness of the current income tax system and structure. These concerns relate to the ability of the current system to produce adequate and stable revenues over time. The subcommittee has identified these concerns and believes that, if addressed, a fairer, more competitive and more stable tax structure for South Carolina will result.

Issue 1: Filers with zero income tax liability.

This subcommittee is concerned about the increasing number of South Carolina tax filers with zero ($0) individual income tax liability and the issues that surround the sheer magnitude of this reality.

Of the approximately 2.1 million state level individual income tax returns filed in South Carolina each year, more than 870,000, or 41 percent, have $0 income tax liability.[10]

When observed nationally (as based on the volume of federal returns reporting zero income tax liability), South Carolina stands out as well, ranking 6th highest in the country in terms of the number of taxpayers that pay no ($0) federal income tax.[11]

This phenomenon has nothing to do with, and is no fault of, taxpayers. Instead, it is a result of the tax system itself. South Carolina, primarily for simplicity, administrative, and taxpayer friendly reasons, adopts "federal taxable income" as its starting point for determining state taxable income.

In contrast, most states use federal "adjusted gross income" as their starting point for determining what income will be taxable at the state level.[12] And while the seemingly subtle difference between the two starting points may not indicate a substantial difference between taxable vs. non-taxable income, the reality is quite the opposite.

By using a tax basis of federal taxable income, South Carolina automatically adopts the federal level of both standard deductions and personal exemptions. Further compounding this issue is the fact that these deductions and exemptions automatically adjust for inflation each year.

That means, for example, that a family of four, with 2 children over the ages of 6, has the first $26,000 of income exempt from income tax liability.[13] And that number continues to rise. Note: The subcommittee discusses its findings and recommendations regarding the impact of the substantial levels of deductions and exemptions below.

Progressivity. The subcommittee supports the concept of a progressive individual income tax structure, which, based on the State's number and level of tax brackets (3%, 4%, 5%, 6% and 7%) South Carolina appears to have.

However, we worry that while the state's income tax structure may appear appropriately progressive at first glance, the scale may have very well tipped towards "too progressive" based on the fact that more than 40 percent of all tax filers now pay zero individual income tax to the State of South Carolina.

As the "taxable base" (measured by the number of filers liable for at least some amount of tax) continues to erode, additional burden will be felt by the remaining filers who will have to shoulder more responsibility for generating revenue for the basic functions of state government.

By expanding, not narrowing, the tax base (as this subcommittee seeks to do), the overall fairness of the system will improve. As noted below, we recommend that any revenue generated by expanding the taxpaying base be applied to structural changes that will improve the overall fairness and stability of the current system.

And while there are various ways to address the narrowing taxpayer base, the subcommittee believes it has identified a fair, simple, and effective way to ensure that all tax filers can contribute a nominal amount to South Carolina via the individual income tax system.

Recommendation:

The subcommittee recommends the General Assembly consider the following:

1) All tax filers that are residents of South Carolina and have either a minimum level of South Carolina Adjusted Gross Income ("SC AGI" - discussed below) or are required to file a federal return would remit a nominal fee (to be known as "InvestSC" or some like name) depending on their level of SC AGI.
2) The subcommittee recommends that the fee structure be progressive in nature, with fees to be no more than:

| | |
|---|---|
| SC AGI $0 to $4,999= | $0 |
| SC AGI $5,000 to $49,999 = | $25 |
| SC AGI $50,000 - $99,999= | $50 |
| SC AGI $100,000+ | $75 |

This fee would be due by all filers regardless of tax liability and would have the effect of greatly broadening the tax base while ensuring that the fee amount would be minimal for residents with low SC AGI (e.g. no fee would be due on returns with AGI's of less than $5,000; a return with an AGI of $5,000 would owe just $25, a rate of just one half of one percent).

For this proposal, SC AGI would need to be clearly defined in law. If SC AGI was constructed to closely approximate Federal AGI, which would be a reasonable approach, based on the latest available data from the IRS, the subcommittee's initial (and unofficial) estimate is that the InvestSC fee structure could generate as much as $74 Million annually.[14]

As with all TRAC recommendations, proceeds from this nominal but broad based fee should be utilized for revenue neutral and long-term structural reform that further enhances the fairness and stability of the current structure (as described below).

Specifically, the subcommittee recommends that any revenue be used to provide both structural reform and tax relief by EXPANDING the current narrow width of the state's 6% tax bracket, which now applies to income between $10,960 and $13,700, to income between $10,960 and $21,249 (North Carolina's 7% tax bracket "kicks in" at $21,250 (married filing jointly).[15]

The practical effect of the narrow width of the current 6% bracket means that taxpayers are forced into the State's top 7% marginal bracket at a low level of income; a fact that actually works to undermine the progressive nature of the otherwise progressive bracket structure (as highlighted above).

This phenomenon, known as "bracket creep", is an issue of concern for the subcommittee. Under the current structure, almost all taxpayers "end up" in the top marginal 7% bracket.[16]

By expanding the 6% bracket to at least $21,249, all taxpayers with taxable income above just $13,700 will benefit from a tax savings, as thousands of dollars of their income will move <u>down</u> from the top marginal rate of 7% to the lower 6% bracket. This structural reform will offer tax relief, will lessen bracket creep, and will improve the overall progressive nature of the current system.

Note: As examples, North Carolina's 7% bracket for married filing jointly begins at $21,250 (as noted above); Arkansas's 7% bracket kicks in at $31,700.[17]

<u>Issue 2: Standard Deduction and Personal Exemption Amounts</u>

As mentioned above, South Carolina, by adopting as its tax base federal taxable income, has some the most generous levels of standard deductions and personal exemptions in the entire country.

And because these amounts are annually adjusted for inflation, they continue to grow each year. The unintended consequence of such high levels of deductions/exemptions is a continual narrowing of the tax base.

Only 9 states have deduction and exemption levels that are as generous as South Carolina's (and that are adjusted for inflation annually). Seven states annually adjust their deduction and exemption amounts, but their base amounts are less than South Carolina's and are less advantageous compared to South Carolina.[18]

We find that the majority of states (24) have deduction and exemption amounts that are: (a) substantially lower than South Carolina's and (b) "fixed" so that they are not annually adjusted for inflation.

The best illustration of the significant disparity between our level of deductions and exemptions and much of the country is seen in the following comparison of deduction and exemption amounts between South Carolina, Georgia and North Carolina:

| | SC | GA | NC |
|---|---|---|---|
| <u>Deductions</u> | | | |
| Single | $5,700 | $2,300 | $3,000 |
| Married/Single | $5,700 | $1,500 | $3,000 |
| Married/Joint | $11,400 | $3,000 | $6,000 |
| Head of House | $8,350 | $2,300 | $4,400 |
| 65 yrs.+/Single | $9,750 | $2,800 | $3,750 |
| 65 yrs. +/Joint | $13,600 | $5,600 | $7,200 |
| <u>Exemptions</u> | | | |
| Per filer/single | $3,650 | $2,700 | $2,500/$2,000* |
| Dependent | $3,650 | $3,000 | $100 credit |
| Under 6 yrs. old | $7,300 | $3,000 | $100 credit |

*NC personal exemption <u>reduced</u> to $2,000/filer at AGI <$60K/<$100 (single/married)

Recommendation:

South Carolina's deduction and personal exemption amounts are between 2 and 3 times higher than its neighbors Georgia and North Carolina (and is substantially larger than many other states).

Given the significant and continued erosion of the State's tax base as described under "Issue 1" above, the subcommittee believes South Carolina can no longer afford to adopt the annual inflation adjustments to federal standard deduction and personal exemption amounts.

The subcommittee recommends that the standard deduction and personal exemption amounts be permanently capped at their Tax Year 2009 levels.*

This recommendation ensures South Carolina retains its competitive advantage over its two neighbors (and most states across the nation). South Carolina's amounts, though capped, would remain between 2 and 3 times higher than both Georgia and North Carolina because their amounts are capped as well.

The subcommittee recommends that any revenue generated by this change should be used for additional tax relief including either lowering the top marginal rate from 7% (see below for related recommendation) or further expansion of the 6% bracket, or a combination of both, depending on available revenue (yet to be estimated).

*Note: Because the subcommittee recommends the General Assembly consider adopting recommended changes presented in this report in a comprehensive (e.g., as a "package"), it is sufficient that the subcommittee's recommendation simply caps, but does not reduce, the exemption and deduction levels. However, as clearly demonstrated above, South Carolina's levels of standard deductions and/or personal exemptions are among the most generous both regionally and nationally. As such, there is certainly "room" for the General Assembly to significantly reduce these deductions and/or amounts while still remaining competitive from a regional and national standpoint. The more adjustment made in this area of the tax code (e.g. adjusting the deduction/exemption amounts to more reasonable, but still fair, levels), the greater the ability the General Assembly has to broaden the tax base, and use the resulting revenue from that broadening for structural reform to include addressing issues of bracket creep (described above) and/or to lower the top marginal rate (as discussed in greater detail below) by an amount commensurate to the revenue raised from these changes.

Issue 3: Capital Gains

South Carolina is one of only 13 states that provide preferential tax treatment for income from capital gains (held for one year or longer) as compared to the tax treatment of ordinary income (e.g. "wages" from a job).[19]

In contrast, 28 states tax capital gains as ordinary income thereby making gains fully taxable under those states standard tax rates and/or structures.[20]

Of the 13 states providing preferential tax treatment for capital gain income, South Carolina (and 6 others) provides preferential treatment without imposing various restrictions, limitations or caveats. For example, Hawaii provides a lower rate of taxation on capital gains, but only for those incomes greater than $24,000 (single), $36,000 (head of household) and $48,000 (married/joint). Iowa provides preferential treatment, but only for certain gains that are held 10

years or more (Iowa does not exempt stock sales). Mississippi taxes ordinary capital gains at full rates, but provides an exemption only if the gains are associated with certain "in-state" investment.[21]

South Carolina excludes 44 percent of capital gains income from state income tax liability, which equates to an actual tax rate on capital gains of 3.92%, below the state's top marginal rate of 7% (the rate at which capital gains would most likely otherwise be taxed at in South Carolina absent this exclusion).

Of the 41 states imposing an individual income tax, only 6 states impose a lower income tax liability on capital gains than South Carolina.[22]

And compared to its neighbors, South Carolina's tax levy on capital gains is 50 percent less than North Carolina and 35 percent less than Georgia. Both states, unlike South Carolina, fully tax capital gains income.[23]

Recommendations:

The subcommittee finds that it is sound tax policy to incentive investment, particularly in South Carolina based businesses. The subcommittee further finds it imperative for South Carolina to retain its tax advantage with regards to tax treatment of capital gains, particularly compared to its neighbors North Carolina and Georgia.

South Carolina should continue excluding a portion of capital gains held for more than one year from taxation, but should reduce the exclusion from 44% to 20%. At 20%, South Carolina retains its tax advantage both nationally and regionally (most importantly over North Carolina and Georgia particularly) with respect to capital gains tax treatment.

And while the subcommittee recommends a modest reduction in the capital gains tax exclusion (but only to a point where the State still retains competitive advantage), it recommends that the General Assembly give constitutional consideration to increasing the capital gain exclusion for South Carolina based investment gain (not yet defined) from 44% to some higher amount (say to 55% as an example).

While it is imperative to maintain a competitive advantage regarding capital gains tax treatment regardless of the location of the investment (and the subcommittee's proposal does that), it seems only proper that policy makers give consideration to offering greater incentive for investment in South Carolina based start-ups and/or other in-state businesses, as opposed to, for example, investment in Dell (Texas) or Hewlett-Packard (California). Note: The subcommittee recommends that the General Assembly study states such as Nebraska, Utah, and Mississippi that have some version of this approach to capital gains treatment.

*Perception vs. Reality – Top 7% bracket (We Address the Perception).*

Any net revenue generated by reducing the exclusion for capital gains (potentially offset by some amount if the General Assembly was able to increase the exclusion for South Carolina based gains) should be used for a dollar for dollar reduction in the top marginal rate from 7% to a commensurately lower amount.

While the subcommittee's research demonstrates the misleading picture that can be painted by those who limit their critique of a state's income tax structure to a superficial comparison of only

top marginal rates, we believe that adoption of this recommendation offers the opportunity to lower the state's top rate below 7%. This would help eliminate this misperception and enhance our competitive advantage among states that have top marginal rates below 7%.

But more important than perception is the tax savings that will be generated for the majority of South Carolinians under this proposal.

Issue 4: Tax Preferences for the Elderly.

The subcommittee finds that the "tax preference" or "bonus" for South Carolina taxpayers age 65 and older is substantial. Consider the following example:

| | Senior Couple* | Non-Senior, 2-children** |
|---|---|---|
| Standard Deduction | $13,600 | $11,400 |
| Personal Exemption | $7,300 | $14,600 |
| Age 65+ Exclusion | $30,000 | $0 |
| Social Security Exc. | $25,709 | $0 |
| Total Income Tax Free | **$76,609** | **$26,000** |

*Example assumes a married couple filing jointly, each 65 or older, both receiving an average monthly Social Security benefit of $1,071 per month (national average benefit as of July 2010).[24] Note: Social Security benefits in South Carolina, as in many states, are tax free for state income tax purposes.[25]

**Example assumes a married couple filing jointly, both under age 65, with 2 children ages 10 and 12. The example does not factor a maximum tax credit available to working families, the maximum credit which cannot exceed $210.[26]

In this example, the "tax preference" offered by the State of South Carolina is more than 3 times higher for the elderly couple with no dependents compared to the working family supporting two children.

While this is a hypothetical example, a 2007 analysis by Georgia State University found that among ten Southeastern states, South Carolina had the highest elderly tax advantage for senior vs. non-senior taxpayers, especially when comparing high income households.[27] Other studies have highlighted South Carolina's substantial tax preference for senior tax payers to be among the highest nationwide.[28]

Recommendation – (Further study and analysis):

The subcommittee, for reasons of fairness and equity, encourages the General Assembly to study this issue further to determine whether or not the seeming disparity between the current tax treatment of elderly vs. non-elderly taxpayers is appropriate or if the gap should be narrowed.

The subcommittee specifically suggests that the General Assembly carefully examine the $15,000 ($30,000 married filing jointly) income exclusion for seniors 65 and over allowed under current law. South Carolina offers this level of income exclusion regardless of the source of the income (e.g., the benefit applies whether or not the income is from a pension or is wage income from a job).

This substantial exclusion appears unique compared to other states, where such benefits are often limited specifically to pension or retirement income. The General Assembly should consider, for reasons of equity and fairness among all taxpayers, closely examining the cost and benefits of both the level and structure of this component of the elderly tax preference.

However, the subcommittee affirms the General Assembly's decision to fully exempt social security benefits from State income tax liability. Regardless of other factors and concerns that the subcommittee may have regarding the elderly tax preference, we believe that this component of the tax preference should be maintained.

Issue 5: Wage and Income Compensation for Personal Injury or Sickness:

As noted above, South Carolina's income tax laws, with little exception, "piggyback" the federal income tax code. According to S.C. Code Section 12-6-40(B), "All elections made for federal income tax purposes in connection with Internal Revenue Code sections adopted by this State automatically apply for South Carolina income tax purposes unless otherwise provided."

As such, where states (like South Carolina) conform to the Internal Revenue Code (IRC), the state tax base begins with federal taxable income as the starting point.

The practical effect of this piggybacking is that, unless South Carolina actively "decouples" from federal provisions, South Carolina's law mirrors federal law when it comes to definitions of what is and is not considered "taxable" income to the State of South Carolina.

For reasons already mentioned (simplicity, administrative ease, and taxpayer friendliness, etc.), South Carolina conforms to the majority of federal definitions of what is considered to be (or not to be) taxable income.

While this subcommittee does not recommend repealing our conformity to federal tax code as a starting point for taxable income and the definitions contained therein, it does recommend that the General Assembly consider "decoupling" from additional IRC provisions.

One such provision the subcommittee suggests that the General Assembly give serious consideration to decoupling from involves the federal tax treatment of personal injury and/or sickness lawsuit settlements.

Specifically, federal law 26 USCS Section 104(a)(2), which South Carolina follows, provides an exemption from taxation, "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness . . ."

The issue of concern expressed here by the subcommittee is one of equity and fairness. Of specific concern is the fact that personal injury settlements or judgments almost always have as a percentage of the recovery "lost wages".

However, as noted below, federal law prohibits federal income taxation (and therefore state income taxation because we "piggyback" the feds) of compensatory damages which include provision of past and future wage income that would otherwise be taxable as ordinary income absent the injury.

"An award of damages for personal injuries is not subject to state income taxation. Compensatory damage awards are tax-exempt, and the exemption applies even though such damages often include compensation

for the loss of past and estimated future earnings which would have been taxable had the plaintiff not been injured."[29]

Recommendation:

The subcommittee recommends that South Carolina consider "decoupling" from the federal law which prohibits the taxation of personal injury and sickness benefits. Doing so would make the wages and income components of legal settlements, specifically related to physical injuries, taxable as ordinary income, and would promote equitable and fair treatment of income that would otherwise be taxed absent the injury or sickness.

Note: As a parallel (and potentially counterintuitive 'tax policy'), unemployment benefits and "sick pay" benefits are taxable under current law, but personal injury and sickness settlements are not.

***Additional "Options for Consideration" for the General Assembly regarding the Individual Income Tax:***

*Note: Any and all "savings" generated by the options below could be used to lower the State's top marginal rate from 7% to a commensurately lower amount, thereby providing broad based, rather than targeted, tax relief.*

Internal Revenue Code Section 179 "Business Expensing"

- Consider amending Code Section 12-6-50 to limit IRC Section 179 to $25,000 (or some amount). IRC Section 179 allows certain taxpayers to immediately expense, rather than depreciate over time, business equipment purchases. Initially the amount that could be expensed was $25,000. Prior to 2010, the deduction had risen to $250,000. The deduction was reduced by the amount that the cost of the equipment exceeded $800,000 (phase-out level). Under the Small Business Act of 2010 signed into law on September 27, 2010, for tax years beginning in 2010 and 2011, the maximum amount a taxpayer can expense is increased to $500,000 and the phase-out level is increased to $2 million. Also, some depreciable real property now qualifies for the Section 179 deduction. If the State did not adopt (decouples from) the new federal law or lowers the amount of the Section 179 expense, the taxpayer would still be able to depreciate the property over time rather than receiving the larger deduction in the year of the purchase.

South Carolina Research Credit

- Consider amending the South Carolina research credit to make it more in line with the federal research credit. Both the South Carolina a federal research credits are for research and development costs in the experimental or laboratory sense, including costs incident to the development or improvement of a product. The federal research credit, Section 41 of the Internal Revenue Code, is 20% of **the increase** in qualified research expenses incurred by the company for the tax year over a base year amount calculated pursuant to the statute. South Carolina's research credit (SC Code Section 12-6-3415) is equal to 5% of the taxpayer's **total** qualified research expenses. To claim the South Carolina research credit, a taxpayer must claim the federal increased research expenditures credit, so the taxpayer must have some increase in eligible research expenses to claim the South Carolina research credit, but because South Carolina's credit is not limited to increases in research costs, the South Carolina credit may be much larger than the credit allowed under federal law, which is an unusual, and probably unintended, outcome.

Modifications to federal gross or taxable income

- Consider bringing back the requirement that for exchanges of real property IRC §1031, like-kind exchanges, be limited to an exchange for real property located in South Carolina. (Former SC Code §12-6-1120(3)). Gains or losses from exchanges of property are generally recognized for tax purposes. However, under Internal Revenue Code Section 1031, the exchange of qualifying real property does not result in recognized gain (or deductible loss). For example, assume a taxpayer exchanges his South Carolina beach condominium for a North Carolina mountain house. The gain from the exchange is not recognized for federal or South Carolina purposes. When the North Carolina house is later sold, the taxpayer will recognize gain for federal income tax purposes, but not for South Carolina income tax purposes since the house is located in North Carolina. Prior to 2000, property in South Carolina could only receive like-kind exchange treatment if it was exchanged for other property in South Carolina. (Former SC Code § 12-6-1120(3)).

- Consider repealing the portion of SC Code §12-6-1120(7) pertaining to the exclusion of retirement income from the US Reserves or National Guard inactive and training duty, since after age 65 the $15,000/$30,000 deduction will apply to this income.

- Consider modifying SC Code §12-6-1160, dependent deduction for residents. Specifically, current law allows taxpayers with children under 6 yrs. of age to essentially "double" the personal exemption deduction they could otherwise claim if their dependents were over the age of 6. Consider limiting the exemption to the new capped personal exemption amount(s) recommended in the body of the report ("Issue 2" above) or consider "phasing out" this special exemption in the same manner that the current benefit was "phased in" (in 1994, the dependent deduction was an additional 25% of the federal personal exemption amount; 50% in 1995; 75% in 1996; and 100% in 1997 and thereafter).

- Consider amending Article 11 of Chapter 6, Catastrophe Savings Account (CSA), to eliminate the deduction for up to $250,000 for those who self insure. Under the law, an individual can self-insure losses up to the value of the taxpayer's legal residence or $250,000, whichever is less, and place the self-insured amount in a CSA. In general, contributions to the account are deducted for South Carolina income tax purposes; interest on the account is not included in South Carolina income; and distributions for qualified catastrophe expenses are not included in South Carolina income. This can be a very large South Carolina deduction. The account is also not subject to collection by legal creditors. Additionally, if a taxpayer had a catastrophic loss, he could receive money from this account without paying taxes and receive a casualty loss deduction on his income tax return. As such, the General Assembly may want to consider eliminating this self-insurance provision.

Credits

- Generally speaking, sound tax policy suggests broad based taxes with low rates are preferable to higher rates that are offset for (some) taxpayers through either special exemptions or targeted tax credits. As such, TRAC recommends the General Assembly give serious consideration to a thorough review of each of the State's almost 40 specific targeted income tax credits provided in statute today; credits that totaled almost $250 Million in TY 2006 alone. TRAC finds that the sheer number of credits likely makes our income tax system more complex than it otherwise needs to be.

- In undertaking this important review, TRAC recommends that the General Assembly consider:

- Review of both "individual" income tax credits and "business" tax credits as many business credits affect individual income tax returns because the businesses are sole proprietorships, S corporations, or partnerships, or limited liability companies taxed as sole proprietorships, S corporations, or partnerships.

- Repeal of credits that are rarely used. Rare use may indicate that they are not influencing behavior, but may instead only serve to provide windfalls for those that happen to come within the credit's terms.

- Repeal of credits that cost the state more than the value of the activities they are otherwise intended to encourage.

- Simplification of credits that are unnecessarily complex (e.g. the small business jobs tax credit).

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Notes:

1 Individual income tax collections peaked at $2.88 Billion in FY2006-07. "Historical Analyses", South Carolina Budget and Control Board, data through October 31, 2009. www.budget.sc.gov

2 "Effective tax rate" typically refers to the percent of one's income actually paid in taxes and can differ substantially from "marginal" or "top marginal" rates. According to The Tax Foundation (as summarized by "Google.com"), "Effective rates are typically lower than marginal rates because most tax systems have some forms of deductions, exclusions, credits, other adjustments, or a progressive marginal tax structure." Based on the Board of Economic Advisors (BEA) comprehensive 50 state analysis of individual income tax systems (entitled "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009"), South Carolina's effective tax rate is 2.8% (when comparing state individual income tax collections vs. federal adjusted gross income). See page 3 of the above referenced BEA study.

3 "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 10 of full report on TRAC's website. Note: South Carolina's average state individual income tax liability is $1,209 per return.

4 "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 10 of full report on TRAC's website. Note: Georgia's average state individual income tax liability is $1,763 and North Carolina's is $2,057 per return, respectively.

5 See www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/TRACquestionsbearesponse.pdf for a complete description of the North Carolina surtax referenced in this report.

6 "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 15 of full report on TRAC's website. As an example, a married couple, filing jointly with two children, and with adjusted gross income of $1 Million would owe $75,453 to North Carolina and $67,504 to South Carolina, a "tax savings" of almost $8,000 to the South Carolina couple. A South Carolina couple married filing jointly with two children pays less tax than a similarly situated couple from Georgia up until approximately $150,000 of adjusted gross income. At $150,000, the South Carolina couple owes just $128 more in tax than their Georgia counterparts.

7 "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 3 of full report on TRAC's website.

8 "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 3 of full report on TRAC's website.

9 "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 4 of full report on TRAC's website.

10See www.scstatehouse.gov/citizensinterestpage/TRAC/021910Meeting/TRACquestionsbearesponse.pdf. Note: The growth in the number of South Carolina tax filers with $0 individual income tax liability has been dramatic in recent years. Since Tax Year (TY) 1999, the number of tax returns has grown at a rate of just 1.87% per year (a rate roughly mirroring the rate of the State's population growth) between TY 1999 and TY 2007. That is equivalent to 17% growth during that period. However, growth over that same period of returns filed owing $0 tax increased by 80%; a rate of growth of approximately 9% per year. That is a ratio between the growth of $0 filers to total filers of almost 5 to 1. Note: Effective TY 2007, the bottom income tax bracket was eliminated, increasing the number of filers with $0 individual income tax liability. However, prior to this elimination, there was still a substantial disparity between the growth in the number of returns vs. the growth in $0 filers. Specifically, between TY 1999 and TY 2006, the ratio between the growth of $0 filers to total filers was almost 3 to 1. (Source: South Carolina Department of Revenue Annual Reports (www.sctax.org)).

11 "States Vary Widely in Number of Tax Filers with No Income Tax Liability", Scott A. Hodge, The Tax Foundation, May 24, 2010.

12 "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 2 of full report on TRAC's website.

13 "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 10 of full report on TRAC's website. Note: The standard deduction amount for TY 2009 for a married couple filing jointly was $11,400. In addition, "personal exemption amounts" for each filer and/dependents over the ages of 6 was $3,650 per person. Dependents under the age of 6 receive double the exemption, or $7,300 each.

14 Unofficial staff draft estimate based on an analysis of the distribution of federal individual income tax returns (TY 2008) at various intervals of adjusted gross income. Source: "Statistics of Income Tax Stats", Internal Revenue Service.

15 "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 10 of full report on TRAC's website.

16 Unofficial staff estimate based on TY 2007 individual income tax return data from the South Carolina Department of Revenue which showed that of the approximately 2.07 Million returns filed, just 1.22 Million had at least some tax liability, and of those, approximately 870,000 (or 71%) had "state taxable income" of at least $13,001 or more, putting those returns in the 7% top marginal rate category ($13,150 was the level of income subject to the 7% top marginal rate in TY 2007).

Note: According to the Board of Economic Advisors' report "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", South Carolina is one of only 11 states that annually adjusts its tax brackets for inflation (beginning in 1995, South Carolina annually adjusts its tax brackets for one-half of inflation (CPI)). In contrast, 30 states do not adjust their tax brackets for inflation. As information, full indexation of tax brackets would have only a marginal impact on the "bracket creep" as described in the report. Specifically, based on unofficial staff estimates, if fully adjusted for inflation, the top bracket would begin at roughly $15,100 in TY 2007, not $13,150, slightly reducing the number of taxpayers in the top bracket from 71% to approximately 67%.

17 "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 10 of full report on TRAC's website.

18 "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. See Page 4 of full report on TRAC's website.

19 Staff analysis of data compiled by the Board of Economic Advisors regarding capital gains tax treatment and presented in "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009.

20 Staff analysis of data compiled by the Board of Economic Advisors regarding capital gains tax treatment and presented in "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. Note: According to a January 2010 research report by the Minnesota House of Representative's Research Department titled "Capital Gains Taxation, Federal and State", the number of states not providing preferential treatment to capital gains income is 24.

21 Staff analysis of data compiled by the Board of Economic Advisors regarding capital gains tax treatment and presented in "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009.

22 Staff analysis of data compiled by the Board of Economic Advisors regarding capital gains tax treatment and presented in "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009.

23 Staff analysis of data compiled by the Board of Economic Advisors regarding capital gains tax treatment and presented in "State Individual Income Tax Comparisons for Tax Year 2007 and Computed Tax Liabilities for Tax Year 2009", Board of Economic Advisors, August 24, 2009. Note: At 3.92%, South Carolina is 50% more favorable in terms of capital gains tax treatment compared to North Carolina, where capital gains are fully taxable at 7.75%. Likewise, South Carolina is 35 percent less than Georgia, where capital gains are fully taxable at 6%.

24 "Monthly Statistical Snapshot, July 2010 - Table 2", Average monthly benefit, "all beneficiaries", U.S. Social Security Administration, Office of Retirement and Disability Policy.

25 Pursuant to SC Code Section 12-6-1120(4), Social Security benefits are not considered "taxable income" to the State of South Carolina ("...South Carolina gross income is determined without application of Internal Revenue Code Sections 78 (Gross-up of Dividends received from Certain Foreign Corporations), 86 (Social Security and Tier 1 Railroad Retirement Benefits), and 87 (Alcohol Fuel Credit")).

Note: South Carolina offers a specific deduction for retirement income (such as income from a 401k) of up to $10,000 per filer age 65 and over and up to $3,000 per filer up to age 64. For filers age 65 and over, the $15,000 deduction they are eligible for regardless of the source of income is not in addition to, but in essence, in lieu of, this $10,000 deduction specific to retirement income. For example, a filer age 65 has $10,000 of income from a 401k and $15,000 from wage income. His deduction would not be $25,000, but would be $15,000 ($10,000 retirement deduction and $5,000 for wage).

Also note that senior tax filers also often benefit from the State's favorable tax treatment of capital gains income (as discussed in the report), further advancing the favorable tax treatment of many seniors compared to the average non-senior taxpayer.

26 Pursuant to SC Code Section 12-6-3330, married couples filing jointly (when both spouses have earned income) are eligible for a maximum individual income tax credit of $210.

27 "Comparing State Income Tax Preferences for the Elderly in the Southeast", A Policy Brief by the Fiscal Research Center of the Andrew Young School of Policy Studies, Georgia State University, February 2007.

28 "Ensuring a Competitive Revenue System for South Carolina - Findings and Conclusions from an Evaluation of the South Carolina Revenue System", Holley H. Ulbrich, November 18, 2005.

29 71 Am Jur 2d. State and Local Taxation § 426.