Funding South Carolina's Future

A Comprehensive Review of State Revenue & Spending in the Palmetto State

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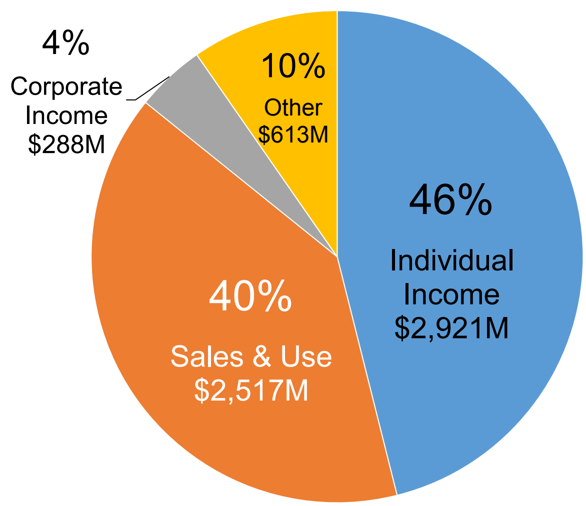
Overview

South Carolina Tax Analysis: Summary of Issues

This documents outlines key features of the tax system currently in place in South Carolina. Its purpose is to generate discussion and identify issues of particular importance with regards to the impact of comprehensive tax reform legislation. It is organized by key issues affecting the impact of the tax on economic agents and the economy.

General Fund Revenues are primarily composed of three major tax revenue sources—Individual Income, Sales and Use, and Corporate Income. For Fiscal Year (FY) 2013-2014, the amounts and percentage makeup of these sources are shown in Figure 1.

Figure 1: General Fund Tax Revenue by Source Fiscal Year 2013-2014



Source: South Carolina Revenue and Fiscal Affairs Office. *Historical Analysis* December 2014.
Note: Other Taxes include Aircraft, Bank, Coin-Operated Device, Controlled Substance, Deed Recording, Electric Power, Retail License, Savings & Loan, etc.

Table 1: General Fund Tax Revenue by Source All Southeastern States, Fiscal Year 2013-2014

State	Personal Income Tax		Sales Tax		Corporate Income Tax	
	$	%	$	%	$	%
Alabama	$3,212	57%	$2,070	37%	$359	6%
Florida	$0	0%	$19,708	91%	$2,043	9%
Georgia	$8,966	59%	$5,170	34%	$944	6%
Kentucky	$3,749	51%	$3,131	43%	$475	6%
Louisiana	$2,812	49%	$2,610	46%	$280	5%
Mississippi	$1,667	39%	$1,955	45%	$677	16%
North Carolina	$10,272	60%	$5,567	32%	$1,357	8%
South Carolina	**$2,921**	**51%**	**$2,517**	**44%**	**$288**	**5%**
Tennessee[1]	$239	3%	$7,274	78%	$1,855	20%
Texas[2]	$0	0%	$27,386	100%	$0	0%
Virginia	$11,253	75%	$3,067	20%	$758	5%
West Virginia	$1,770	55%	$1,222	38%	$204	6%
Average All States		**42%**		**51%**		**8%**
Average w/Inc Tax[3]		**55%**		**38%**		**7%**

Source: National Association of State Budget Officers, The Fiscal Survey of States, Fall 2014.
[1] Tennessee imposes personal income tax on dividend and interest income only.
[2] Texas imposes a Franchise Tax of 1% on entities with >$1.03 million in revenues, which is not included in results.
[3] Includes average of all states that impose full personal income tax (i.e.-does not include Florida, Tennessee, and Texas).

When compared to other Southeastern States, South Carolina's primary revenue sources are largely similar, as shown in Table 1. Versus the average, South Carolina collects a larger percentage of revenue from personal income tax rather than sales or corporate income tax. Removing states which do not levy personal income tax (i.e.-Florida, Tennessee, and Texas), South Carolina collects less on average from personal income tax and more from sales tax. In both cases, South Carolina collects less as a percentage in corporate income tax.

Individual Income Tax

The individual income tax is the largest source of revenue for the General Fund in South Carolina, accounting for 46.1% of revenues in FY 2013-2014. As shown in Table 2, South Carolina has the highest top marginal tax rate on personal income of all Southeastern States. Further, it has a particularly low level of taxable income on which that high rate is imposed. Finally, an examination of rates alone without the underlying structure of each state's income tax system will not yield sufficient meaningful comparisons.

Table 2: State Personal Income Tax Rates All Southeastern States, 2014

State	Top Rate	Taxable Income
Alabama	5.0%	$3,000
Florida	0%	$0
Georgia	6.0%	$7,000
Kentucky	6.0%	$75,000
Louisiana	6.0%	$50,000
Mississippi	5.0%	$10,000
North Carolina	5.8%	$0
South Carolina	**7.0%**	**$14,400**
Tennessee[1]	6.0%	$0
Texas	0%	$0
Virginia	5.75%	$17,000
West Virginia	6.5%	$60,000
Average All States	**4.92%**	**$19,700**
Average w/Inc Tax[2]	**5.89%**	**$26,267**

Source: Tax Foundation, State Personal Income Tax Rates and Brackets 2014 Update, Fiscal Fact No. 422, March 2014.

[1] Tennessee imposes personal income tax on dividend and interest income only.
[2] Includes average of all states that impose full personal income tax (i.e.-does not include Florida, Tennessee, and Texas).

Large Number of Filers with Zero Tax Liability

• In 2012, 42.9% of individual filers paid no state income tax (up from 27.0% in 2000 and 31.8% in 2007).
• Higher standard deductions and exemptions than most southeastern states keep the average effective rate low for most (including the zero filers).
• Elimination of the 2.5% tax bracket in 2007 further facilitated expansion of filers with zero liability.

Key SC Components & Issues

South Carolina's tax structure is evolving, in effect, into a 2-tier system with rates of 0% and 7%. As this trend continues, a greater percentage of those filing returns will pay no income taxes, while the entire burden will fall on fewer and fewer individuals.

High Marginal Tax Rate on Low Levels of Taxable Income

• In 2008, individuals in the 7% tax bracket made up 42% of returns filed and bore 96% of the tax liability.
• SC has the highest marginal tax rate (7%) on the lowest level of taxable income ($14,400 in 2014). This situation is largely due to lack of full indexation of brackets to inflation. Had brackets been indexed to CPI since 1959, the top bracket would affect only those making in excess of $101,895.
• Over time, tax bracket changes have not kept pace with inflation, moving taxpayers into higher tax brackets (see Table 3).
• Higher tax on labor income discourages human capital investment and entrepreneurial activities.

Table 3: South Carolina Tax Brackets, 1959 - 2014

Tax Rate	Starting Income (1959)	Starting Income (2014)	Starting Income (CPI-Adjusted from 1959)
2.5%	$0	-	$0
3%	$2,000	$2,880	$20,379
4%	$4,000	$5,760	$40,758
5%	$6,000	$8,640	$61,137
6%	$8,000	$11,520	$81,516
7%	$10,000	$14,400	$101,895

Expansive Network of Credits and Deductions

• In 2012, South Carolina offered approximately 60 individual income tax credits totaling $261,428,130 (83% of those credits were for non-resident filer credits).

• The burden for administering these 60 credits as well as providing oversight, ensuring compliance, and detecting fraud is extensive.

• There exists a disparity of taxation of income from W-2 wages versus Schedule C income. Although not formally termed a deduction, Schedule C income (reported on Form 1099) is taxed at a flat rate of 3% rather than the standard income brackets that peak at 7%.

• The elderly are allowed extensive reprieves from tax payments, including the following:

1. Social Security income is exempt in South Carolina.

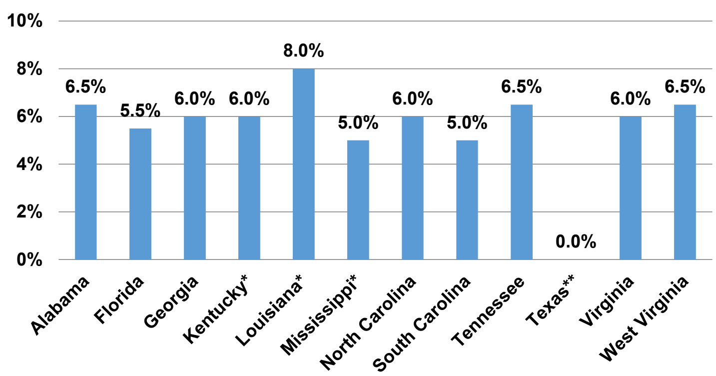
2. A $3,000 deduction on qualified retirement income for individuals under the age of 65 and a $10,000 deduction for individuals 65 and over are also allowed per individual.

3. A $15,000 income deduction exists for individuals 65 and older if married and filing jointly.

Corporate Income Tax

South Carolina imposes corporate income tax at a rate of 5% (one of the lowest in the nation). This tax created $351.1 million in tax revenue in FY 2012-2013 and accounted for 5.8% of General Fund revenues. In FY 2013-2014, this amount was $288.1 million and 4.5% of General Fund revenues. The state also levies a corporate license fee, generating $74.2 million, or 1.2% of General Fund revenues, in FY 2012-2013.

Figure 2: Corporate Income Tax Rates, All Southeastern States, 2014



Source: Tax Foundation, State Corporate Income Tax Rates, 2000-2014.
* Kentucky, Louisiana, and Mississippi have graduated tax rates. The top tax rate (on taxable incomes of $100,000, $200,000, and $10,000, respectively) is shown.
** Texas imposes a Franchise Tax of 1% on entities with >$1.03 million in revenues, which is not included in results.

Compared to other Southeastern States, South Carolina currently has one of the lowest corporate income tax rates, as shown in Figure 2. This listing of rates does not, however, account for the rules under which the tax is implemented, the types of businesses that are affected, or the exemptions granted for certain circumstances. Thus, a comparison of the rates alone will not yield sufficient meaningful results.

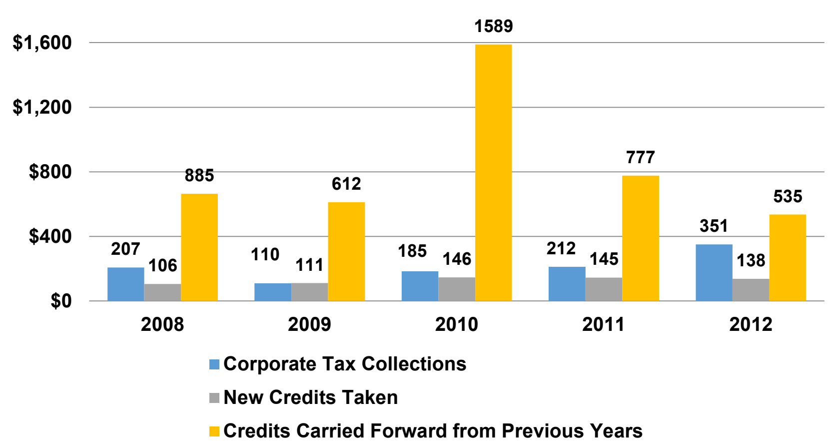
Key SC Components & Issues

Though the revenues generated are exceptionally small relative to other taxes, the issues surrounding collection are exceptionally complex. As a result, some of the solutions are administratively burdensome.

Extensive Corporate Credits Favoring Few Firms

• While investment tax credits stimulate new investment, they lower the value of existing capital.
• South Carolina allows credits to be carried forward up to 15 years. The increasing use of tax credits and carry-forwards over time reduces state corporate revenues and increases year-over-year variability.
• SC had over 20 credits against corporate income tax in FY 2012-2013. 237 claims (some claims by the same filer) were made for $673.6 million in credits. $535.3 million credits were carried forward from the previous year. Figure 3 displays the comparative size of annual corporate tax collections to annual corporate tax credits taken and carried over.
• The majority of credits accrue to larger, newer companies rather than smaller and/or older in-state companies.
• Corporate tax collections make up very little of the state revenues and have been highly variable year-over-year, oscillating between a low of $109.6 million In FY 2009-2010 (2.2% of state general revenues) to $351.1 million in FY 2011-2012 (5.6% of general revenues).

Figure 3: South Carolina Corporate Tax Collections Versus Credits, 2008 - 2012



Source: South Carolina Department of Revenue. *Annual Reports*, FY2007-2008 through FY2012-2013.

Other Issues

• South Carolina transitioned to a Single Sales Factor (SSF) method of calculating Corporate Income Tax liability in 2011. The use of the SSF favors companies with large in-state property and employee bases but having a large percentage of out-of-state sales. This policy creates a disincentive for companies with large in-state sales but no physical presence to locate and/or invest in the state.

• Lower state corporate income taxes positively influence foreign direct investment (FDI).

• C corporations are taxed as an entity on profits. Earnings distributions are then taxed as dividend income, resulting in double-taxation of profits.

• The Corporate Income Tax deters savings for future period investment across calendar years.

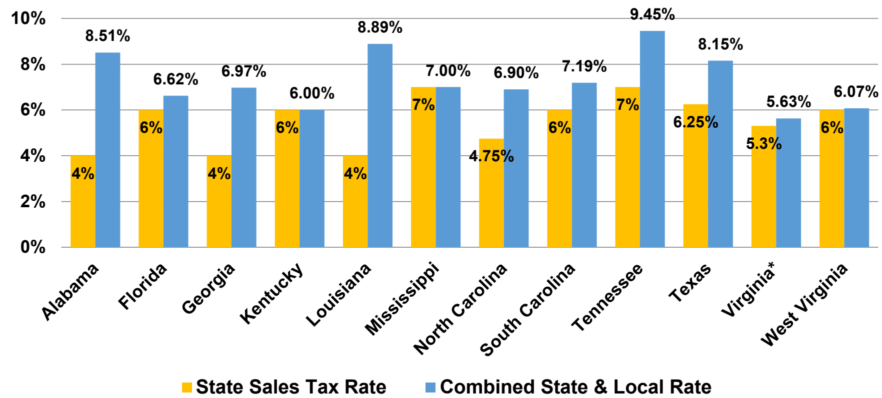
• Combined reporting, in which all income of a company—regardless of the state in which it was earned—is reported on a single form, prevents the use of transfer pricing, holding companies, passive investment companies, etc. to shift profits from higher tax states to lower tax states. Currently, 21 states require combined reporting (AK, AZ, CA, CO, HI, ID, IL, KS, ME, MI, MN, MO, NE, NH, NY, ND, OR, TX, UT, VT, and WV).

• Economic Development activities largely rely upon providing financial incentives (often as credits against corporate income tax) to companies for expansion, start-up and relocation. Although South Carolina has an already low corporate income tax to spur capital investment and make it attractive versus other states, Economic Development organizations alternatively look for additional methods of providing incentives. For example, the 2013 South Carolina Innovation Plan notes how the low corporate tax rate and the Single Sales Factor render many companies with very small or no tax liabilities. As a result, it recommends "corporations that do not pay state corporate income tax should be allowed to claim qualified R&D expenses in the state as a credit against monthly withholding payments."

Sales Tax

South Carolina collected $2.52B in sales tax for FY2013-2014, making up 39.7% of General Fund Revenues. Figure 4 displays a comparison of state and local sales tax rates for Southeastern states. South Carolina's statewide rate is above the average, while it's combined state and local rate is slightly below. A simple comparison of rates alone does not address the underlying components of the tax structure and, thus, will provide limited analysis capability.

Figure 4: State and Local Sales Tax Rates, All Southeastern States, 2014



Source: Tax Foundation. *State and Local Sales Tax Rates in 2014, Fiscal Fact No. 420*. March, 2014.
*State rate includes a mandatory, statewide local sales tax levied in Virginia.

Key SC Components & Issues

The sales tax is considered a regressive tax, in that poorer people pay a greater share of their income in sales tax than in other forms of taxation.

Excessive Exemptions, Caps, Discounts

• SC has "80 plus sales and use tax exemptions, exclusions, "max" taxes, and/or discounts."

• The SC Revenue and Fiscal Affairs Office estimated $3.05 billion in tax revenues were not collected on items exempt sales tax in FY 2012-2013.

• Caps, dependent upon the level and category, can further increase the regressive nature of the sales tax.

• Excessive exemptions, exclusions, "max" taxes, and/or discounts require individual tax form and computer system changes at the SC Department of Revenue. They also require excessive oversight to ensure compliance and detect fraud. Further, it complicates the tax code for taxpayers, and it places a hardship on retailers and businesses, particularly small businesses, who have to record and report every type of sales exemption, reduction, etc.

High Tax on Narrow Range of Goods and Services

• Because South Carolina taxes relatively little of its retail sales, it requires a higher tax to raise sufficient revenue. At 6%, the statewide sales tax is one of the higher in the nation.

• Only 34.3% of $164.5B gross retail sales were taxed in 2012. This percentage has been declining since 2002, when 47.8% of gross retail sales were taxed.

• Consumption patterns have shifted from goods to services in the US. In 1965, 54% of consumption was goods while 46% was services. In 2008, consumption was comprised of 26% goods and 74% services.

• Of the 168 services that the Federation of Tax Administrators has identified as taxable, South Carolina taxes 35, or just 20 percent of all services that are potentially taxable. The national average was 57 in 2010.

eCommerce

• The increasing shift to consumer purchases via the internet, which is typically untaxed unless the vendor has a nexus in the state, reduces sales tax revenue and creates inequity between brick and mortar and online companies. (Except in the case of Amazon, which has been exempted from this provision, although that exemption is set to expire January 1, 2016.)

Property Tax

The property tax is the primary source of revenue for local government entities in the state of South Carolina. In 2012, the property tax represented 50% of all tax collections in South Carolina at the local government level, totalling $4.97 million. Property tax rates vary significantly across other Southeastern states. As shown in Table 4, South Carolina's average rate as a percentage of home value was 0.56% for the period covering 2007 – 2011, coresponding to a mean annual tax liability of $801. Average rates and tax liabilities do not fully capture the underlying tax structure of each state's property tax implementation and should, thus, be evaluated in conjunction with other aspects of the tax system for a more complete analysis.

Table 4: Average Property Tax Rates
All Southeastern States, 2007-2011

State	Property Taxes Paid	Property Tax Rate (as % of Home Value)
Alabama	$526	0.42%
Florida	$1,997	1.01%
Georgia	$1,493	0.90%
Kentucky	$963	0.78%
Louisiana	$643	0.43%
Mississippi	$724	0.70%
North Carolina	$1,278	0.82%
South Carolina	**$801**	**0.56%**
Tennessee	$1,102	0.79%
Texas	$2,531	1.93%
Virginia	$2,303	0.79%
West Virginia	$573	0.55%
Average All States	**$1,245**	**0.81%**

Source: Moore, B. and Harris, B. (2013) Residential Property Rates in the United States, Urban-Brookings Tax Policy Center. (Authors calculated utilizing American Community Survey data weighted for number of housing units per county.)

Key SC Components & Issues

Local spending drives property tax increases, despite several mechanisms put in place to reduce property tax burden for residential homeowners. Further, varying assessment rates plus targeted exemptions create an uneven and non-competitive distribution of tax burden.

Unequal Assessment Rates

• SC has the most categories for assessment rates of any southeastern state. Varying assessment rates distort economic incentives for individuals, as they tax properties for similar usage differently (homeowners vs. renters) and add complexity to the tax system.

• Industrial real property is assessed at 2.625 times the rate of primary residential, more than all other southeastern states.

• Fee-in-lieu of tax (FILOT) arrangements help mitigate the effect of unequal assessment rates, but accrue only to large, new investment, in effect placing smaller and/or established investment in a higher relative tax schedule. Some FILOTs are 4% (larger companies) while others are 6%, and they typically have fixed millage rates too.

• Commercial and rental property taxes are significantly higher than primary residence taxes (the highest difference in the US) due to a 6% vs. 4% assessment rate as well as tax exemptions for primary residence.

Exemptions

• There are 47 total exemptions for property taxes in SC, although exemption status varies across counties and assessors' offices.

• Exemptions foster inequity across municipalities, are potentially subjective, shrink the tax base, shift the tax burden, and complicate the overall property tax structure.

• Homestead Exemption exempts $50,000 of primary residence's value for those 65+. This credit increased from $45.9 million to $172.4 million between 2000 and 2013. The number of claimants is anticipated to increase rapidly with the retirement of the baby boomers.

Local Government Spending

• Property taxes have grown from 2.2% to 2.7% of GSP from 1999 to 2013.

• Local government expenditures have grown from 6.4% to 8.1% of GSP from 1999 to 2013.

Endnotes

1. Source: National Association of State Budget Officers, The Fiscal Survey of States, Fall 2014. (online: https://www.nasbo.org/sites/default/files/NASBO%20Fall%202014%20Fiscal%20Survey%20of%20States.pdf)

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3. Tax Foundation, State Personal Income Tax Rates and Brackets 2014 Update, Fiscal Fact No. 422, March 2014. (online: http://taxfoundation.org/sites/taxfoundation.org/files/docs/FF422%20%20State%20Income%20Tax%20Rates%20and%20Brackets.pdf)

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16. Moore, B. and Harris, B. (2013) Residential Property Rates in the United States, Urban-Brookings Tax Policy Center. Online (http://www.brookings.edu/research/interactives/2013/county-property-taxes-map)

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