SOUTH CAROLINA
REVENUE AND FISCAL AFFAIRS OFFICE

FRANK A. RAINWATER
Executive Director

September 27, 2019

Mr. W. Hartley Powell
Director
South Carolina Department of Revenue
P.O. Box 125
Columbia, SC 29214

Dear Mr. Powell:

This letter is to provide you with our estimates for the 2019 Individual Income tax credit for preventative maintenance on a motor vehicle pursuant to S.C. Code of Laws §12-6-3780. We will provide annual updates for this credit through tax year 2022, after which the total credit is eliminated. Because of the interest in this issue, I am using this opportunity to share more details about our analysis and the risks and other factors affecting our estimate. If you or your staff have any questions, please do not hesitate to contact us.

This code section allows a resident taxpayer to claim a refundable income tax credit for preventive vehicle maintenance on private passenger motor vehicles as defined in Section 56-3-630, including motorcycles, registered in this state. The credit may not exceed the lesser of the resident's actual motor fuel user fee increase incurred as a result of the increases imposed in Section 12-28-310(D) or the amount the resident pays for vehicle maintenance. Vehicle maintenance includes, but is not limited to, costs incurred for new tires, oil changes, and regular vehicle maintenance. A taxpayer may claim the credit for up to two qualifying vehicles. Total credits are limited to a maximum by tax year, which is $65,000,000 for 2019.

The Revenue and Fiscal Affairs Office (RFA) is required to estimate the number of taxpayers expected to claim the credit for each tax year and the total amount expected to be claimed annually on or before September 30th. In the event that RFA estimates that the total credits claimed will exceed the maximum amount of the aggregate credit allowed, RFA shall certify to the Department of Revenue (DOR) the pro rata adjustment to the credit.

We have reviewed DOR's guidance for the credit and the experience of the first year of the credit for the 2018 income tax returns and considered these factors in our analysis. Our estimates largely depend on the same factors as last year, which include identifying the number of vehicles that will qualify for the credit, estimating the average gallons to be claimed and the total amount of credits, and then determining the pro rata adjustment necessary to ensure that the total amount of credits does not exceed the limit. We did not place significant weight on the results for 2018. This analysis also incorporates a discussion regarding the risks associated with missing the estimate and the impact on both the state and taxpayer and how that factors into our estimates.

Number of Taxpayers and Qualifying Vehicles

While the statute references the number of taxpayers, our analysis relies on an estimate of the expected number of qualifying vehicles. We anticipate that information will allow us to more accurately estimate the potential total dollar amount of credits claimed and any pro rata adjustment. Private passenger motor vehicle as defined in Section 56-3-630 includes every motor vehicle designed, used, and maintained for the transportation of ten or fewer persons and trucks with an empty weight of nine thousand pounds or less and a gross weight of eleven thousand pounds or less. This credit also specifically includes motorcycles and mopeds. Based upon August 2019 data from the Department of Motor Vehicles (DMV) on registered vehicles, we have estimated the number of vehicles expected to qualify to be 4,253,375, before adjustments for number of vehicles by taxpayer. We have excluded vehicles owned by governments that would not pay taxes and not be eligible for the credit, trucks that are over the weight limitations, buses, and trailers.

Further, each taxpayer may claim the credit for up to two vehicles. Based upon guidance from DOR, a joint return includes two taxpayers who may each claim the credit for two vehicles, for a total of four vehicles. Single and separate filers will be limited to a credit for two vehicles each. To account for households with more vehicles than can be claimed, we used the U.S. Census Bureau's 2017 American Community Survey data on the number of household vehicles by household size to estimate the percentage of vehicles that will be ineligible for the credit. Based upon this data, approximately 2.6 percent of vehicles will be ineligible, thereby reducing the number of motor vehicles expected to qualify to 4,142,787.

One risk with this aspect of the estimate is that the DMV registration data do not indicate if owners meet the residency requirements necessary to claim the credit. Additionally, we use household vehicle ownership to estimate the number of vehicles that will be ineligible based upon the two vehicle limit, and this approach may over or under state ownership of excess vehicles, particularly for businesses. However, without any better information to adjust this variable, we anticipate that the estimated 4,142,787 qualifying vehicles is the best forecast given the available data.

Total Amount of Credits Claimed

The credit may not exceed the actual motor fuel user fee increase incurred by a taxpayer as a result of the increase in Section 12-28-310(D) or actual maintenance expenses. Section 12-28-310(D) increases the current $0.16 per gallon motor fuel user fee by $0.02 per gallon per year for six years for a total increase of $0.12 per gallon of fuel. The first increase occurred July 1, 2017, and will continue each July 1 thereafter until July 1, 2023. However, the credit must be claimed for increases incurred on a tax year basis. Therefore, we have estimated the motor fuel increase based upon one-half of the increase for each fiscal year. The increase was $0.04 for January through June of 2019 and then $0.06 for July through December, resulting in an average increase of $0.05 in 2019.

Revenue collections for the motor fuel user fee show growth in total gallons of motor fuel. To estimate motor fuel purchases by an average vehicle, however, we use the U.S. Department of Transportation, Federal Highway Administration, Highway Statistics reports from 2012 to 2017. The average annual gallons used has declined from 529 to 516, an annual decrease of 0.5 percent per year on average over the period. When factored into our projections, this change decreases the estimated average gallons to 511 for 2019. While usage has moved up and down, we anticipate a downward trend. Based upon federal regulations requiring improvements in fuel economy under Corporate Average Fuel Economy (CAFE) standards, we expect the trend toward improvements in fuel efficiency will continue to reduce average usage long-term and have used this growth rate to project future average gasoline gallons used. This assumption, however, also poses another risk to the estimate as other factors may affect driver behavior in any one year and cause deviations from this trend.

The estimated average credit is calculated by multiplying the tax year average motor fuel fee increase of $0.05 times the estimated average annual gallons purchased of 511 to yield an average credit of amount of $25.54. We anticipate that all taxpayers will incur maintenance expenses of at least $25.54 annually and that the credit amount would be limited by the motor fuel increase incurred. Multiplying the average credit amount of $25.54 by the estimated 4,142,787 vehicles yields total potential credits for eligible vehicles of $105,825,000.

Estimate, Risks, and Potential Impacts

This analysis and methodology follow the same approach as last year, and we believe these to reasonable. There has been no change to the underlying data or statistics. The major issue and risk factor is determining how many taxpayers will actually claim the credit. While we have the experience from one year, 2018, which had a very low claim rate, we believe that experience is not representative of the future and over-reliance would add undesired risk. In developing the estimate, therefore, we considered the implications of how a missed estimate would impact the taxpayer, the State's General Fund, and the Infrastructure Maintenance Fund.

In Section 12-6-3780, the Department of Transportation (DOT) is required to transfer sufficient funds to DOR by January 31st to offset the estimated total credit, as the credit is not intended to impact the State's General Fund. If the amount transferred from the Safety Maintenance Fund to DOR is not sufficient to fund the total estimated credits, DOT is required to transfer sufficient funds to offset the credit fully. If the total credit amount claimed by all taxpayers in a tax year is less than the amount transferred by DOT, then the excess reverts back to DOT as soon as practicable within the same year that the transfer occurred.

Conversely, if the estimate and required transfer are less than the actual amount of the credits claimed, the credit would still be credited or refunded as part of DOR's normal income tax processing system, but the difference would have to be absorbed by the State's General Fund as the statute does not provide for an alternate source.

Although the statute allows for a pro rata adjustment of the credit to guard against issuing credits in excess of the annual maximum, an incorrect pro rata adjustment could impact the taxpayer or the General Fund, and our analysis considered the risk to both parties. If a pro rata adjustment is made but fewer taxpayers take the credit than estimated, then the amount of credit is too low and taxpayers who took the credit could have received a higher amount. This event occurred with the tax credit for 2018. However, if the pro rata adjustment is not low enough, more taxpayers take the credit, and total credits exceed the transfer, then the additional credits are paid by the General Fund.

The major issue in this analysis, therefore, is estimating how many taxpayers actually will claim the credit. For tax year 2018, the first of the credit, DOR tax records show 81,079 tax returns have claimed the credit totaling $1,973,450 to date before October extensions are filed. If the current claims rate continues, extensions may increase the final claims to approximately 85,749 returns and $2,087,000 based upon the expected 5 percent of returns with extensions. We believe this low compliance level for 2018 was due to several factors:

- Tax year 2018 was the first year of the credit, and most taxpayers likely were not aware of the recordkeeping requirements for claiming the credit.
- Taxpayers may not have claimed the credit if they failed to keep their receipts or if they deemed the potential credit amount too small, given the effort required to calculate the credit.

- Taxpayers may have experienced difficulty claiming the credit as electronic tax preparation software presented difficulties filing for the tax credit or did not allow for electronic filing of the required form.

Without the pro rata adjustments, total credits could have been $3,112,697. At this time, however, we continue to be concerned about over or underestimating compliance and do not rely on 2018 as a guide.

Conclusion
In making our estimate for tax year 2019, we considered the economic and financial data as well as the risks and settled on the following.

First, we believe the data and process for estimating the full potential amount of credits is reasonable and totals $105,825,000.

The next step would then be deciding on how many taxpayers will take the credit and whether a proration is necessary so the total credits do not exceed the maximum. This presents us with three choices: (1) assume all eligible taxpayers will take the credit and thereby prorate the credit by 61.4 percent to stay under $65,000,000, (2) assume less than 61.4 percent of eligible taxpayers will take the credit and allow those to take the maximum, or (3) have some option in between the first two.

The risk in overestimating the credits results in the unused credits being returned to DOT, and the risk in underestimating the credits means the State's General Fund is reduced by the difference. The risk in over or under estimating the claims also affects the taxpayer.

Since the potential use exceeds the transfer limit, our estimate will assume the maximum of $65,000,000 in credits.

We believe the number of returns taking the credit for 2018 was low, and we expect a higher compliance rate for 2019 returns. The key factors for expecting a higher compliance level are a higher value of the credit this year, the experience and increased taxpayer awareness of the credit, and better ease and improved use of tax software.

Therefore, our decision is to have an estimate that balances all of these issues. Our estimate for the credits for 2019 is based on taxpayers claiming a credit for 80 percent of the eligible vehicles. At the average overall estimated credit amount per vehicle of $25.54, this estimate requires a pro rata adjustment for all taxpayers of 76.8 percent in tax year 2019 to reduce credits claimed to $65,000,000.

We hope this explanation provides meaningful insight and understanding on our estimate. But again, if we may be of any further assistance, please advise.

Sincerely,

Frank A. Rainwater

FAR/lhj

cc: Ms. Christy Hall, Secretary of Transportation
Mr. Meredith Cleland, Department of Revenue