To: Members of the Committee on Revenue

From: Mary Jane Egr Edson
Legal Counsel for the Committee

RE: LR 571 (Hadley) – An Examination of Individual and Corporate Income Taxes

Date: December 9, 2014

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41 states plus the District of Columbia impose an individual or personal income tax. [1] A survey of those states shows that at least eight states have changed their income tax rates at least once, or multiple times, since 2000.[2] Of the remaining 34 states, 32 did not change their rates or the number of brackets over this time period. [3]

This report focuses on recent significant changes in other states' individual income tax and recent changes to Nebraska's system. It provides a brief history of Nebraska's tax; a basic overview of both federal and Nebraska individual income tax systems; a review of the other states' approaches to modernizing or reforming their systems; and a brief look at legislative proposals that have been previously introduced but not enacted in Nebraska. The report concludes with a few common observations regarding reform of the individual income tax.[4]

Background.

The individual income tax is the largest of all Nebraska state taxes. Nebraska collected nearly $2.2 billion in individual income taxes during fiscal year 2012-13 and slightly less than $2.1 billion in fiscal 2013-2014. By comparison, the next largest tax is the sales tax, which totaled just over $1.5 billion in 2013-14.

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[1] Nine states do not impose a personal income tax. Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming.
[2] The states are Arizona, Idaho, Maine, New Mexico, North Carolina, Oregon, Rhode Island and Utah.
[3] See Attachment A of this report for a chart of all state rates and brackets from 2000 through 2014.
[4] This report is limited to state income tax changes implemented since 2000. For a more comprehensive review of tax reform initiatives see, Bourdeaux, Carolyn, *A Review of State Tax Reform Efforts,* Fiscal Research Center, Andrew Young School of Policy Studies, Georgia State University, FRC Report No. 216, Nov. 2010.

Nebraska was one of the last states to adopt an income tax. Originally, state individual income tax liability was a set percentage of federal income tax liability before credits. The percentage ranged from 10 – 20 percent of federal liability with a rate of 19 percent in the last effective year (1986) of this version of the income tax.

In 1986, Congress passed The Tax Reform Act (TRA) of 1986. Individual tax rates were reduced, $30 billion in annual "loopholes" were eliminated, capital gains were taxed at the same rate as earned or ordinary income and corporate taxes were increased. Overall the bill reduced federal revenues by $8.9 billion. Maintaining the old percentage of federal liability system would have meant dramatic revenue shortfalls for states like Nebraska. As a result, many states "decoupled" from the old system and implemented the systems we see today.[5]

Any discussion of changes to the individual income tax must begin with a discussion of the terms "base" and "rate." The base is the amount of income that is ultimately subject to tax once you have allowed certain deductions, exclusions or credits. One benefit of "decoupling" from the old percentage of federal tax liability method (in addition to avoiding a drastic revenue loss at the time) was that it gave states more control over their own tax base, because a state is only "coupled" to the point of federal AGI. By using federal AGI as a starting point, the state base only conforms to those deductions or exclusions allowed for federal purposes "above the line" – the line on which AGI is calculated. States are then free to either conform to deductions and credits allowed "below the line" or make their own modifications to AGI in determining state tax liability.[6] Many economists would argue that in a "perfect" tax system you would have a very broad base with few if any exemptions and a low rate. However, at both the federal and state levels, the base has been eroded to varying degrees by exclusions, exemptions and deductions. This is discussed in more detail below for both federal and Nebraska purposes.

Rate is simply the percentage applied to the base in order to determine the amount of tax. Rate becomes slightly more complicated when a progressive or graduated rate structure is used.

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[5] LB773 (1987) changed Nebraska's individual income tax from a percentage of federal liability to a separate state calculation starting with federal adjusted gross income.
[6] Of the 42 states with an income tax, 10 do not use federal AGI as a starting point, but rather federal gross income or taxable income.

Progressively higher tax rates apply to increasing portions of the base – i.e., increasing levels of income. These different levels of income are typically referred to as "brackets." States vary in the number of brackets used, anywhere from a single bracket (i.e. a flat tax system) up to 10 brackets in Missouri and 12 in Hawaii. Eight of the 42 states now use a single rate flat tax system. Nebraska uses a four-bracket income tax system. The tax applied on each bracket is known as the marginal rate of tax.

A progressive income tax system is used at the federal level and in the majority of states including Nebraska. The reason for this broad appeal of a progressive income tax is that it allows for a more equitable application of the tax, although it increases slightly the complexity of complying with the system. If, however, the differences in the brackets are too small and the brackets are too close together, the system will look and operate like a flat tax system. Several states have recently reduced the number of brackets, lowered rates, or modified their system to a flatter or flat tax.

Authors Kleine and Shannon observe in *Characteristics of a Balanced and Moderate State and Local Revenue System*[7] that marginal rates in a progressive income tax system may have lost some of their appeal as they may become a detriment to economic development if the rates are perceived as being too high. They note that a flatter income tax with lower marginal rates can still be made progressive through the use of standard deduction and other specific credits. They also caution that state individual income taxes are deductible at the federal level for taxpayers who itemize their deductions and any reduction in state income taxes will increase federal income taxes.

Federal and Nebraska Individual Income Tax.

The federal income tax base starts with "gross income" which is defined to specifically include the following types of income:

- Wages, salaries, tips, etc.
- Taxable Interest

[7] http://nebraskalegislature.gov/pdf/reports/committee/select_special/2-7_lr155_2013.pdf.

- Ordinary Dividends
- Taxable refunds, credits, or offsets of state and local income taxes
- Alimony received
- Business income (or loss)
- Capital gain (or loss)
- Other gains (or losses)
- Taxable IRA distributions
- Taxable pensions and annuities
- Rental real estate, royalties, partnerships, S corporations, trusts, etc.
- Farm income (or loss)
- Unemployment compensation
- Taxable social security income
- Other income

Federal gross income also specifically excludes certain items from ever being included in the base. Some of these exclusions are:

- Employer-sponsored health care
- Net pension contributions and earnings
- Capital gain assets transferred at death
- A percentage of Social Security and Railroad Retirement benefits.

Excluding these items from the definition of gross income is an example of narrowing the base.

Reductions or deductions from federal gross income (above the line deductions) include:

- Educator expenses
- Certain business expenses
- Health savings account deductions
- Moving expenses
- Deductible portion of self-employment tax
- Self-employed SEP, SIMPLE, and qualified plans
- Self-employed health insurance deduction
- Penalty on early withdrawal of savings
- Alimony paid
- IRA deduction
- Student loan interest deduction
- Tuition and fees
- Domestic production activities deduction

The resulting amount after these deductions is federal adjusted gross income (AGI). Most states with an income tax, including Nebraska, start with federal AGI when calculating the state tax.

As a result, the base for Nebraska and other states has already been significantly reduced even before beginning to calculate state income tax.

Adjustments are made by each state as deemed appropriate either by requiring taxpayers to add back an item deducted for federal purposes or allow additional deductions beyond what is allowed for federal purposes. Nebraska refers to these as "adjustments increasing" or "adjustments decreasing" federal AGI. Nebraska's adjustments are not significantly different from other states.

Nebraska begins with AGI from the federal return[8] and then allows a deduction for the greater of the Nebraska standard deduction (a statutory amount) OR itemized deductions taken on the federal return[9] along with a personal exemption deduction. The current standard deduction is $6,100 for single filers and $12,200 for those married filing jointly. Depending upon the number of dependents claimed, the standard deduction may go as high as $17,000 for those married filing jointly or $9,100 for single filers.

Itemized deductions that are allowed on both the federal and Nebraska returns include:

- Medical Expenses
- Real Estate Taxes
- Home Mortgage Interest
- Charitable Contributions
- Casualty or Theft Losses
- Certain Investment Interest

After deducting either the standard or itemized deductions, the result is Nebraska income before adjustments.

Nebraska adjustments <u>increasing</u> AGI include:

- Interest Income From All State And Local Obligations Otherwise Exempt From Federal Tax
- Financial Institution Tax Credit Claimed

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[8] If you were not required to file a federal return because you did not make enough income, you do not have to file a Nebraska return either, unless you have more than $5,000 or more of net Nebraska adjustments to federal AGI including non-Nebraska state and local bond interest exempt from federal tax.

[9] You may claim the greater of the two deductions - itemized deductions or the standard deduction.

- Long-term Care Savings Plan Recapture
- Nebraska College Savings Program Recapture

Nebraska adjustments decreasing AGI include:

- State Income Tax Refund Deduction
- Exempt U.S. Government Obligations
- Federally Taxable Tier I And Tier II Railroad Retirement Benefits
- Special Capital Gains Exclusion
- Nebraska College Savings Program Contributions
- Nebraska Long-term Care Savings Plan Contributions

This results in Nebraska taxable income before the application of non-refundable credits. Non-refundable credits include:

- Credit For Elderly and Disabled
- Credit For Child/dependent Care
- Credit For Tax Paid to Another State
- Community Development Credit
- Financial Institution Credit
- Nebraska Personal Exemption Credit
- Biodiesel Facility Investment Credit
- Nebraska Incentive Programs

The result is Nebraska taxable income before refundable credits. At this point taxpayers subtract Nebraska tax withheld and/or estimated payments made during the tax year. The final step is to apply any refundable credits that the taxpayer qualifies for, which include:

- Nebraska Advantage Rural Development Act Credits
- Nebraska Advantage Microenterprise Credits
- Nebraska Advantage Research and Development Act Credits
- Credit for Child/dependent Care
- Beginning Farmer Credit
- Earned Income Tax Credit (EITC)
- Angel Investment Credit

The result is the taxpayer's net Nebraska taxable income. Nebraska's current individual income tax brackets and rates (Tax Year Beginning January 1, 2014) are:

Bracket	Single Individuals	Married Filing Jointly	Married Filing Separate	Head of Household	Estates & Trusts	**Marginal Rate**
1	$0-2,999	$0-5,999	$0-5,599	$0-2,999	$0-499	**2.46%**
2	$3,000-17,999	$6,000-35,999	$5,600-28,799	$3,000-17,999	$500-4,699	**3.51%**
3	$18,000-28,999	$36,000-57,999	$28,800-42,999	$18,000-28,999	$4,700-15,149	**5.01%**
4	$29,000 and Over	$58,000 and Over	$43,000 and Over	$29,000 and Over	$15,150 and Over	**6.84%**

Effective Tax Rates.

The rates above which apply to the four income brackets are referred to as "marginal tax rates." Typical state rankings or other publications on tax rates frequently refer to the "highest marginal rate" which is 6.84% in Nebraska. However, these are not the actual rates that are paid by taxpayers. After accounting for the non-refundable credits, the actual tax rate paid is lower, resulting in what are commonly known as effective tax rates. The Department of Revenue most recently calculated these rates for Nebraska taxpayers in 2010.[10]

Tax Year	Nebraska	Effective	Tax	Rates	
	First 7 Deciles	8th Decile	9th Decile	10th Decile	Top 500 Returns
2010	1.62	2.98	3.61	4.58	3.26
2009	1.55	2.89	3.51	4.63	3.75
2008	1.67	2.92	3.52	4.63	3.62
2007	1.67	2.90	3.51	4.54	3.22
2006	1.75	3.05	3.64	4.57	3.51
2005	1.94	3.07	3.69	4.78	3.55

[10] The Department report defines effective tax rate as "Nebraska individual income tax net of non-refundable credits as a percent of federal AGI."

These lower effective rates notwithstanding, economists may argue that taxpayers make decisions "at the margins" in terms of investment decisions, savings and residency. Hence, a high marginal rate may be seen as detracting from economic development initiatives.

Recent State Income Tax Changes.

One approach used in some states is to lower their rates slightly over time. Some have also reduced the number of brackets. However, North Carolina, Rhode Island and Utah have made major changes to their systems beyond a slight lowering of the rates and have dramatically reduced the number of brackets – in the cases of North Carolina and Utah going to a single flat rate system. Two of Nebraska's neighboring states have very recently made major changes to their systems – Kansas and Missouri – and a regional neighbor, Oklahoma, has passed legislation similar to Missouri's.

These six states generally fall into one of three types of reform: 1) Collapsing the brackets to a single flat rate with adjustments to the income tax base replacing a portion of reduced revenues; 2) A combination of lower rates, fewer brackets, bigger exemptions and some income tax base broadening; and 3) Rate reductions based on revenue-triggers – if state tax receipts exceed a specified dollar amount at the end of a fiscal year, the rates for the next tax year are proportionately reduced.

North Carolina (2013), Rhode Island (2011) and Utah (2008) are the most recent states to implement a flat or flatter tax. Kansas stands out under the second category, with legislation in both 2012 and 2013 that made dramatic changes. Category three includes Missouri (2014) and Oklahoma (2014), although Kansas' legislation does include additional cuts under a revenue-trigger measure.

North Carolina.

North Carolina changed from a three bracket system to a single bracket single flat rate. The law[11] was enacted in 2013 and is in effect for the current tax year 2014.

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[11] H.B. 998, S.L. 2013-316.

1. Old bracket rates (6%, 7% and 7.75%) have been replaced by a flat rate of 5.8%. It is scheduled to drop to 5.75% for tax year 2015.
2. Itemized deductions are eliminated except for charitable contributions claimed on the federal return and a total of no more than $20,000 for a combination of mortgage interest and property taxes.
3. The following deductions are eliminated:
   - College Savings Plan (529 Plan) and other Parental Savings Plans;
   - $50,000 net business income
   - $4,000 deduction for government retirement income
   - IRC §179 deductions (deduction for business expenses by individuals) reduced from $250,000 to $25,000
4. The following credits are eliminated:
   - The Earned Income Tax Credit
   - Child care expenses (note that the child tax credit is increased to $125 if AGI is below $40,000, remains at $100 if AGI is below $100,000 and is not allowed if AGI is above $100,00)
   - Additional credit for the disabled
   - Charitable contributions by non-itemizers
   - Long-term care insurance
   - Adoption expenses
   - Education expenses
5. Personal exemptions are repealed

Revenue estimates for the individual income tax cuts only (corporate income tax rates were also lowered and some sales tax increases were implemented) were issued in July 2013 and revised in July 2014 as follows:

	TY 2014	TY 2015	TY 2016	TY 2017	TY 2018
Original 2013 Estimate	-475.0	-690.0	-850.0	-1,100.0	-1,300.0
July 2014 Estimate	**-680.0**	**-890.0**	**-1,000.0**	**-1,250.0**	**-1,475.0**
Difference	-205.0	-200.0	-150.0	-150.0	-175.0

The total cost over five years is now projected to be nearly $5.3 billion, approximately $900 million more than the original estimated revenue loss. [12] Income tax collections for the first quarter of FY2015 are $102.3 million behind forecast.

Rhode Island.

Effective for tax year 2011:

1. Reduced brackets from 5 to 3;
2. Reduced all but lowest rate; Top rate reduced from 9.9% to 5.9%;
3. Totally eliminated itemized deductions;
4. Use of standard deduction only which is phased out at higher income levels;
    - Married filing jointly taxpayers receive a $15,000 standard deduction
    - If AGI exceeds $175,000, standard deduction is reduced
    - No standard deduction once AGI exceeds $195,000
5. Reduced personal exemptions, which are also phased out at higher income levels;
6. Eliminated credits such as investment tax credit, jobs training credit, R&D credit and employment tax credit.

Similar to what was seen in Utah (below), taxpayers with an AGI of $200,000 or more would pay tax on their federal AGI with no adjustments at the 5.9% rate.

It was originally estimated that the personal income tax changes would have no fiscal impact in FY2011. A revised estimate indicated a decrease of $6 million.[13] Rhode Islands' personal income tax receipts have increased in each year since the changes were enacted:

FY2010 (Year before change) - $909,674,060
FY2011 - $1,025,583,671
FY2012 - $1,068,405,400
FY2013 - $1,088,992,125
FY2014 - $1,109,637,064

For FY2015 year-to-date, income tax collections are running ahead of forecast by $8,229,333 or 3.0%.[14]

[12] North Caroline General Assembly, Legislative Services Office Memo, July 24, 2014.
[13] Department of Revenue, Rhode Island Revenue Changes, 2010 Session.
[14] Rhode Island Department of Revenue, September 2014 Report.

Utah

During 2006 and 2007, Utah revamped its individual income tax and transitioned to a flat single rate. As it was explained in a legislative briefing paper: [15]

> ...the system moves from a deduction-based system to a credit-based system. Rather than claiming deductions to arrive at taxable income and then applying various rates to different brackets of income, the bill allows certain tax credits which reduce tax liability on a dollar-for-dollar basis.

The Utah system is not quite as simple as it sounds. With few adjustments, federal AGI equals Utah taxable income, which is taxed at a flat five percent. The amount of tax due is then offset by six percent of the standard deduction or itemized deductions plus personal exemptions (the "taxpayer tax credit").

If the remaining amount exceeds what they call the "base phase out amount" (Single = $13,363, Married Filing Jointly = $26,726), the taxpayer credit is decreased proportionally. In effect, Married Filing Joint taxpayers with AGI above $300,000 receive no taxpayer tax credit, losing the benefit of both itemized deductions and personal exemptions, but pay tax at the flat rate of five percent.

Many traditional deductions have been converted to credits which may be applied to tax liability after using the taxpayer tax credit. However, most are nonrefundable so that tax liability cannot go below zero.

The tax cuts of 2006 and 2007 were designed to reduce individual income taxes by $110 million. This is an example of a flat tax system that remains progressive by phasing out and then eliminating most of the credits at a relatively moderate level of income ($300,000). Following the initial loss of roughly $110 million and the years of the great recession where personal

[15] *Tax Relief & Reform: What Does It Mean for Taxpayers*?, Utah Office of Legislative Research and General Counsel, Mar. 2007.

income taxes were repressed, Utah's income tax receipts have climbed at a significant and steady pace:

2006 (Year before Changes) $2,277,611,642

2007	$2,561,383,572	2008	$2,598,838,985	2009	$2,319,571,988
2010	$2,104,592,033	2011	$2,298,175,190	2012	$2,459,432,168
2013	$2,852,022,185				

As of September 16, 2014, Utah ended the 2014 fiscal year with a revenue surplus of $166 million for the year. Of that amount, $131 million goes to the Education Fund, which is comprised of individual income, corporate income and franchise taxes.

Missouri

This is an example of a "progressive" income tax that actually looks more like and functions more like a flat tax. There are 10 brackets between $1 and $9,000, which means the highest marginal rate starts at only $9,000 of taxable income (Nebraska's highest marginal rate starts at $29,000 and $58,000 for single or married filing joint taxpayers, respectively).

Effective for tax year 2017:

1. 10 bracket system (1.5% - 6% rates) on first $9,000 of taxable income
2. Top rate to be reduced 0.1% per year for five years beginning with tax year 2017
3. Brackets indexed for inflation
4. Personal exemption increases from $2,100 to $3,100 for those married filing jointly and $2,600 for most other filers
5. New exclusion from income of up to $25,000 in business income on individual return (Note that Kansas has recently excluded all such business income from the individual income tax and that North Carolina just eliminated their $50,000 business income exclusion)

It is important to note that all of these changes are predicated on a specific amount of growth in state tax revenues:

"....if the amount of net general revenue collected by the State of Missouri in the previous fiscal year exceeds the highest amount of net general revenue collected in any of the prior years by at least $150 million." [16]

Absent this annual growth in net revenue, it would appear the rate cuts would not be implemented.

The fiscal note prepared by the Committee on Legislative Research Oversight Division notes that the two bills would reduce net general funds by $620,987,000 in the fifth year, which is the first full year of implementation.[17]

Kansas

Kansas made significant changes over the past two years which have been covered extensively in the media. The initial changes passed in 2012 include:

1. Brackets. The middle of three brackets was eliminated. The two new brackets started at 3.5% and 6.45% respectively. They are set to be reduced by 2018 to 2.3% and 3.9%.
2. Eliminated the following notable deductions and credits:
   - IRC §179 deductions (deduction for business expenses by individuals) are eliminated; and
   - Kansas does not exempt food (groceries) from the sales tax but did provide a refundable low-income credit for sales tax paid on groceries;
   - Adoption expenses;
   - Child and dependent care expenses; and
   - Child day care expenses.
3. The most dramatic change is an exclusion from taxable income for "net business profits." This term covers three general types of income:
   - Payments received as an independent contractor, as a "statutory employee," or as the owner of a single-member limited liability company ("LLC");
   - Income from certain sources including rental real estate, royalties, net farm rental and net farm profit; and

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[16] SB Nos. 509 & 496.
[17] L.R. No. 4324-18, April 29, 2014.

- "Flow-through income" from partnerships, S corporations, estates and trusts (income from legal entities that do not pay an entity-level tax, such as the corporate income tax, but the income "flows through" to the individual partners or members and is otherwise subject to tax on the individual returns). An LLC is not included in this definition. Because LLC's are taxed like partnerships, the income from an LLC will flow through to the members and qualify for the exclusion.

4. The standard deduction was increased from $6,000 to $9,000 for married couples,

After making the 2012 legislative adjustments, the Kansas Legislative Research Department provided the fiscal analysis of the income tax changes as follows:

FY 2013	-249.2
FY 2014	-847.8
FY 2015	-884.3
FY 2016	-942.2
FY 2017	-967.9
FY 2018	-1,013.7
6 year total	-4,887.1

During the 2013 legislative session, certain changes were made to the original tax cuts:

1. Itemized deductions, except for charitable contributions, are reduced by 30% in tax year 2013 and by 5% each year until 2017 when only 50% will be deductible;
2. The food credit was partially restored but it is no longer refundable.
3. The standard deduction was decreased to $7,500 from the 2012 amount of $9,000.

After making the 2013 legislative adjustments, the Kansas Legislative Research Department provided the fiscal analysis of the income tax changes as follows:

	Reduce Item. Deductions	Change Stand. Deduction	Rate Cuts	Total
FY 2014	114.6	56.3	-35.2	114.7
FY 2015	107.4	59.1	-145.1	-1.6
FY 2016	127.0	62.1	-238.3	-74.4
FY 2017	148.3	65.2	-317.4	-131.3
FY 2018	166.5	68.4	-459.5	-248.9
5 year total	663.8	311.1	-1,195.5	-341.4

(Note that the costs of the 2012 changes are not included here, except for the rate cuts.)

The consensus forecast was revised on November 17, 2014. It states that the fully annualized impact of the tax cuts was $730 million for tax year 2013 and that FY2014 individual tax receipts were 24.3% below the previous year. For fiscal years 2015, 2016 and 2017, individual receipts are estimated to be lower by an additional $153 million, $113 million and $101 million, respectively.[18]

Oklahoma

The cuts are dependent upon revenue triggers, meaning Oklahoma's general revenue collections must increase before the cuts take effect. The measure will reduce the personal income tax rate from 5.25 percent to 5 percent in 2016 if state revenue projections increase by enough to cover the cost.

A second reduction from 5 percent to 4.85 percent will occur no sooner than two years after the 5 percent rate is enacted, providing there's enough money to pay for the cost of the reduction. The Oklahoma Tax Commission estimates that if the cuts are fully implemented by 2018, income tax revenue will be cut by about $200 million a year.

The legislation applies to Oklahoma's top income tax bracket, which applies to individuals earning more than $8,700 a year or couples earning more than $15,000 a year. The Tax Commission estimates that more than 1.7 million taxpayers will be placed in the top income tax bracket in tax year 2016, resulting in a tax cut for 63 percent of all returns filed.

Nebraska's Recent Income Tax Changes

The Nebraska Legislature recently concluded a comprehensive study of the state tax system under the LR155 Tax Modernization Committee, which released its report in December 2013. Several of the Committee's recommendations have been enacted with regard to the income tax

[18] Kansas Legislative Research Department, November 17, 2014

during the 2014 session, in addition to several significant changes made during the 2012 and 2013 sessions. These include:

LB987 (Hadley) – 2014.

Indexes the brackets for inflation every year; increases the amount of Social Security income that is exempt from tax; and exempts certain military retirement income from tax. The following fiscal impact was estimated as a result of exempting Social Security benefits and indexing of the tax brackets:

FY2014-15: ($ 8,347,000)
FY2015-16: ($ 24,930,000)
FY2016-17: ($ 37,284,000)
FY2017-18: ($ 51,617,000)

Fiscal Impact Estimate for Indexing and Social Security Exemption: $122,178,000

The military retirement exemption was estimated to have the following fiscal impact:

FY2014-15: $ 0
FY2015-16: ($ 656,000)
FY2016-17: ($ 847,000)
FY2017-18: ($ 1,050,000)

Fiscal Impact Estimate Military Retirement Exemption: $ 2,553,000

Total Fiscal Impact Estimate LB987: $124,946,000

LB970 (Cornett) – 2012.

Expanded the brackets and reduced the first three rates but not the top rate;

FY2011-12: $ 0
FY2012-13: ($ 7,863,000)
FY2013-14: ($ 33,706,000)
FY2014-15: ($ 55,608,000)

Total Fiscal Impact Estimate LB970: $97,177,000

LB308 (Schumacher) – 2013.

Repealed Nebraska's alternative minimum tax and extended the net operating loss carryforward from five to 20 years.

FY2013-14: $ 0
FY2014-15: ($7,840,000)
FY2015-16: ($8,075,000)
FY2016-17: ($8,317,000)

Total Fiscal Impact Estimate LB308: $24,232,000

The combined fiscal impact of these bills from FY2012-13 through FY2017-18 is $246,355,000.

Previous Income Tax Reform Proposals

During the 2014 session, LB1097 was introduced by Senator Burke Harr. The bill makes changes to the individual income tax and corporation income tax brackets and rates. The individual brackets are reduced from four to three and adjusted in the first year. The brackets are indexed for inflation beginning on January 1, 2018.

It is important to note that the bill made no changes to base – i.e. no limits on or elimination of existing deductions, exclusions or credits. The rate changes are phased in over three years, as follows:

Tax years beginning or deemed to begin on January 1, 2015:

Bracket Number Jointly	Single Individuals	Married, Filing Joint	Head of Household	Married, Filing Separate	Estates and Trusts	Tax Rate
1	$0-17,999	$0-35,999	$0-24,999	$0-17,999	$0-999	2.30%
2	$18,000-35,999	$36,000-71,999	$25,000-39,999	$18,000-35,999	$1,000-19,999	4.90%
3	$36,000 and Over	$72,000 and Over	$40,000 and Over	$36,000 and Over	$20,000 and Over	6.50%

Tax years beginning or deemed to begin on January 1, 2016:

Bracket Number Jointly	Single Individuals	Married, Filing Joint	Head of Household	Married, Filing Separate	Estates and Trusts	Tax Rate
1	$0-17,999	$0-35,999	$0-24,999	$0-17,999	$0-999	2.30%
2	$18,000-35,999	$36,000-71,999	$25,000-39,999	$18,000-35,999	$1,000-19,999	4.80%
3	$36,000 and Over	$72,000 and Over	$40,000 and Over	$36,000 and Over	$20,000 and Over	6.00%

Tax years beginning or deemed to begin on January 1, 2017:

Bracket Number Jointly	Single Individuals	Married, Filing Joint	Head of Household	Married, Filing Separate	Estates and Trusts	Tax Rate
1	$0-17,999	$0-35,999	$0-24,999	$0-17,999	$0-999	2.30%
2	$18,000-35,999	$36,000-71,999	$25,000-39,999	$18,000-35,999	$1,000-19,999	4.75%
3	$36,000 and Over	$72,000 and Over	$40,000 and Over	$36,000 and Over	$20,000 and Over	5.90%

The fiscal note prepared on LB1097 estimated the revenue impact of the individual income tax rate reductions as follows:

2014-15	($134,888,000)	2015-16	($377,772,000)
2016-17	($474,443,000)	2017-18	($521,767,000)
2018-19	($564,664,000)		

5 Year Total: ($2,073,534,000)

Prior to the 2014 session, several other bills had been introduced that significantly altered the individual income tax.

In 2007 LB331 was introduced at the request of the Governor by Senator Ray Janssen. Among other things, this bill reduced the number of brackets from four to three, reduced the rates on the first two brackets to 3.07% and 5.12%, respectively, and lowered the top bracket rate over three years from 6.84% to 5.95%. There were no changes to exemptions, exclusions or credits, other than a slight increase in the personal exemption credit. The fiscal note estimated the revenue impact as follows:

2008-09	2009-10	2010-11	2011-12	Total
($226,147,000)	($205,704,000)	($245,354,000)	($279,380,000)	($956,585,000)

Also in 2007, LB436 was introduced by Senator Ron Raikes. This bill reduced the number of brackets from four to two with tax rates of 4.8% and a higher top marginal rate of 7.1% on taxable income above $90,000. It eliminated all itemized deductions, increased the standard deduction and eliminated the alternative minimum tax. The fiscal note estimated the revenue impact as follows:

2007-08	2008-09	2009-10	2010-11	Total
($196,136,000),	($159,261,000)	($170,203,000)	($181,186,000)	($706,786,000)

Over the course of his tenure in the Legislature (1997 – 2009), Senator Raikes served on the Revenue Committee for several years and proposed numerous bills, including a flat rate system, to simplify Nebraska's income tax system. One bill that he co-sponsored with Senator Pam Redfield was LB398 in 2003. This bill would have taxed all income at a flat rate of 5.1%, eliminated all itemized deductions and credits and increased the standard deduction and personal exemption credit. The fiscal estimate was as follows:

2003- 04	2004-05	2005-06	2006-07	Total
$4,239,000	$3,364,000	$3,590,000	$3,814,000	$15,007,000

Observations

1. There are numerous methods that may be utilized to reform an income tax system. The methods used include:
   - Reducing the number of brackets;

- Implementing a single bracket flat tax system;
- Reducing rates - either in addition to reducing brackets or as a stand-alone change; and
- Revenue triggered rate reductions in the future which may or may not come to fruition.

The method utilized depends in large part on the goals of the reform – to simply lower the amount of taxes paid, to incent economic development and bring more workers to the state , to simply lower the marginal rates to compete with neighboring states, to simplify the system, to make the system more balanced and fair. For example, the stated goals of reform in the states reviewed include:

a. Kansas – "to reduce the tax burden on Kansas families and businesses, particularly job creating small business. For too many years the Kansas economy was static with a significant number of people leaving …"[19]
b. Missouri - "This will bring more growth, more opportunity and more prosperity for more Missourians."[20]
c. North Carolina – "the new tax law will help the state attract new businesses and create jobs by lowering income tax rates that have been the highest amount Southeastern states."[21]
d. Utah – "What problems did the Legislature Want to Solve? Federal taxable income as a starting (rather than AGI), revenue volatility and tax rates higher than neighboring states."[22] One impetus was the state's surging revenue, resulting in a $1.6 billion surplus in a $10 billion budget.[23]
e. Oklahoma – "This is a responsible, measured tax cut that will make Oklahoma more economically competitive while providing much needed tax relief to working families."[24]

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[19] Press Release, Oct. 7, 2014, Office of the Kansas Secretary of Revenue.
[20] House Speaker Tim Jones, Kansas City Star, May 6, 2014. "The tax cuts meet a need for Missouri to keep pace with its neighbors and grow its economy." Ibid.
[21] Gary D. Robertson, Printed from the Charlotte Observer in *Politics*, De. 28, 2013.
[22] What Happened to Taxpayers Under Utah's New Individual Income Tax, Utah Office of Legislative Research and General Council, Jan.26, 2010.
[23] Heartlander.org, The Heartland Institute, quoting Senator Wayne Niederhasuer, sponsor, S.B. 223. 2008.
[24] Governor May Fallin, April 29, 2014, Washington Examiner.

f. Rhode Island – "The 2010 reform…was designed to be revenue-neutral. The principal objective of the 2010 reform was to reduce the state's top income tax rate from 9.9% to a level that was more competitive with neighboring states and national averages. State policy makers succeeded in lowering the marginal income-tax rate to 5.9% without reducing overall state revenue by eliminating itemized deductions and most tax credits."[25]

2. Those states that have sought to reduce the fiscal impact of reform like Utah or to make it revenue neutral like Rhode Island have broadened their bases as a way to reduce the lost revenue from the tax rate reductions. Typical base broadening measures include:
   - Capping itemized deductions or phasing them out at higher income levels;
   - Eliminating all itemized deductions in favor of a standard deduction; and
   - Eliminating some or all credits and deductions, including personal exemption credits.

(Please refer to pages 4-7 of this report for a list of itemized deductions, exemptions and credits allowed under the Nebraska income tax.)

3. Prior to enacting significant tax reforms, some of the states attempted to analyze how the tax changes would affect taxpayers under the proposals. Rhode Island's Department of Revenue conducting reform simulation runs to compare the average tax change and the median change.[26] Utah went to great lengths using data from actual returns to analyze the changes in tax liability, effective tax rates and distribution of the tax. (Please see the appendices to this report). Other states were simply looking to solve for a specific dollar amount of reductions and therefore made trade-offs between credits for low-income households and reductions in top rates. Still others appear to have done little or no analysis of their changes.

4. At least one state utilized increase in other types of taxes to help offset the lost income tax revenue:

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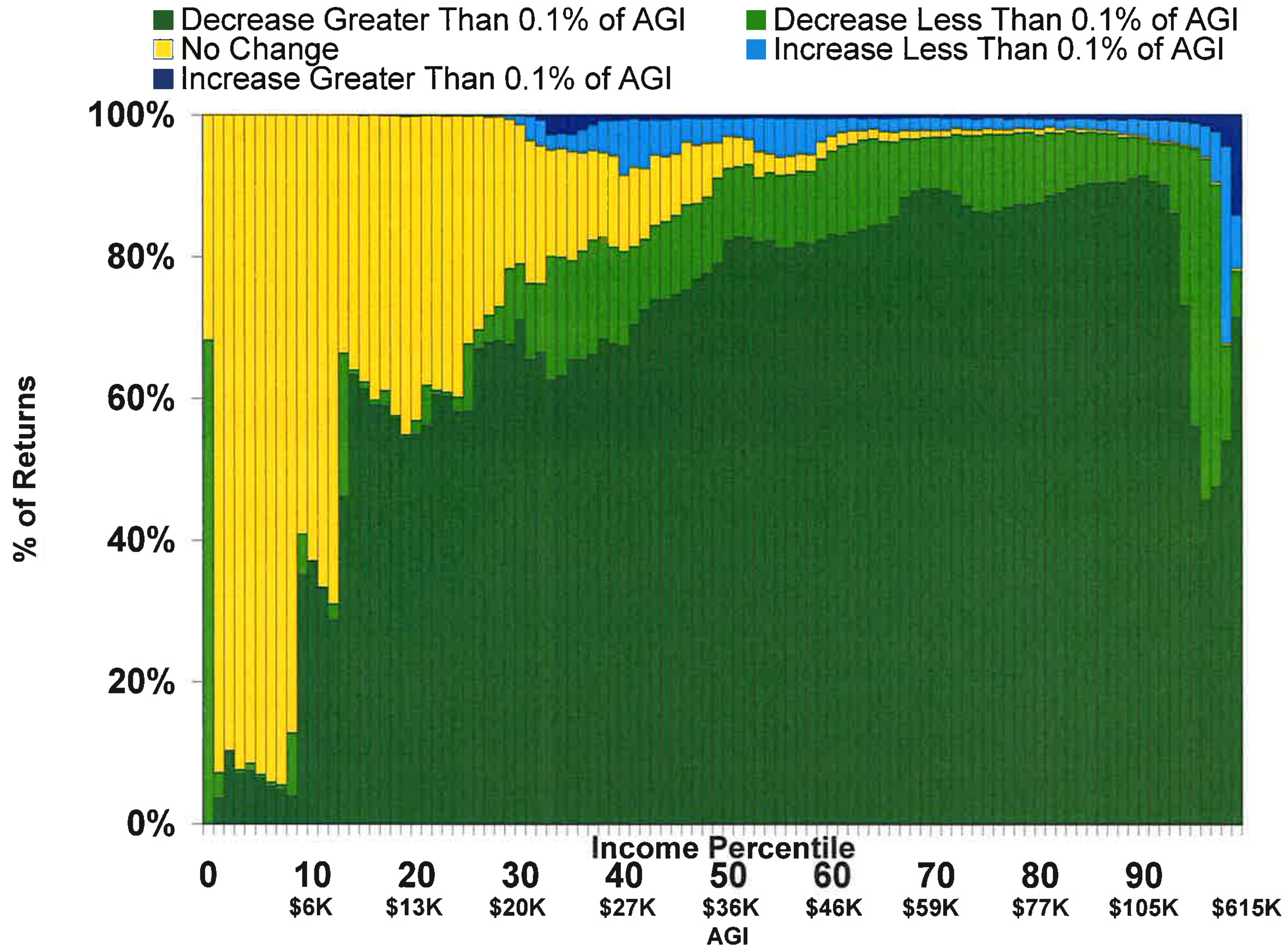
[25] R. Kelly Sheridan, Wait before judging R.I. tax reform, The Providence Journal, Many 17, 2012.
[26] Understanding the Personal Income Tax Reform Simulation Runs, Rhode Island Department of Revenue, Jan. 18, 2011.

a. North Carolina – Expanded their sales tax base to include service contracts; increased the sales tax rate on manufactured and modular homes; repealed exemptions for nutritional supplements sold by chiropractors, certain newspaper sales and food prepared for university dining halls; generally increased the rate for live sporting and entertainment events and movie tickets to the combined state and local rate; and increased the one percent rate on electricity.

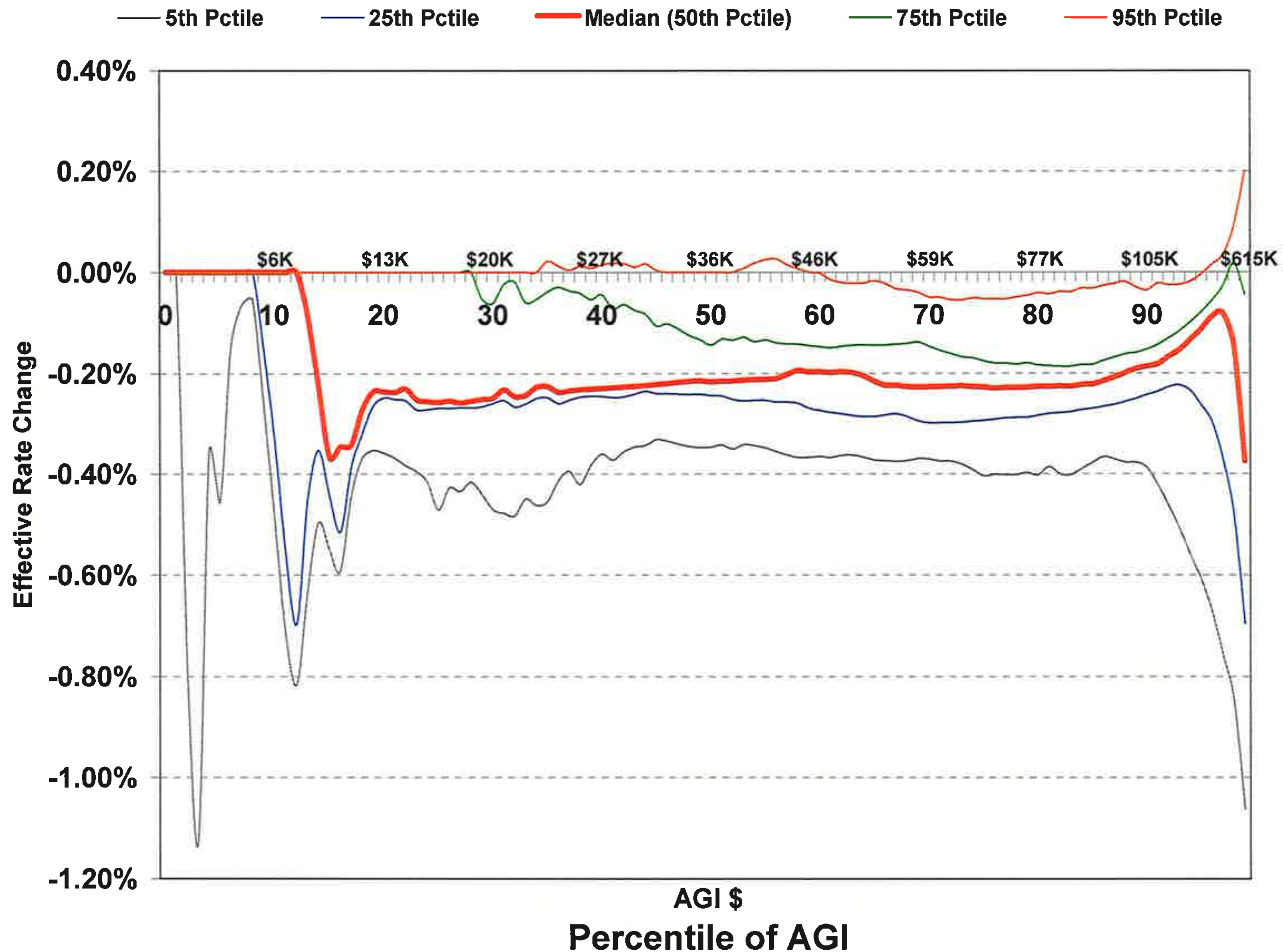
5. Some states have found it difficult to accurately estimate or forecast the reductions in income taxes. As noted previously, both North Carolina and Kansas have made significant adjustments to their projected losses and still remain behind projections for the individual income tax. Some of this may be attributable to timing issues such as for withholding and estimated payments. But in general, it seems to be difficult in some states to accurately predict revenue impacts.

Tax Change by Income



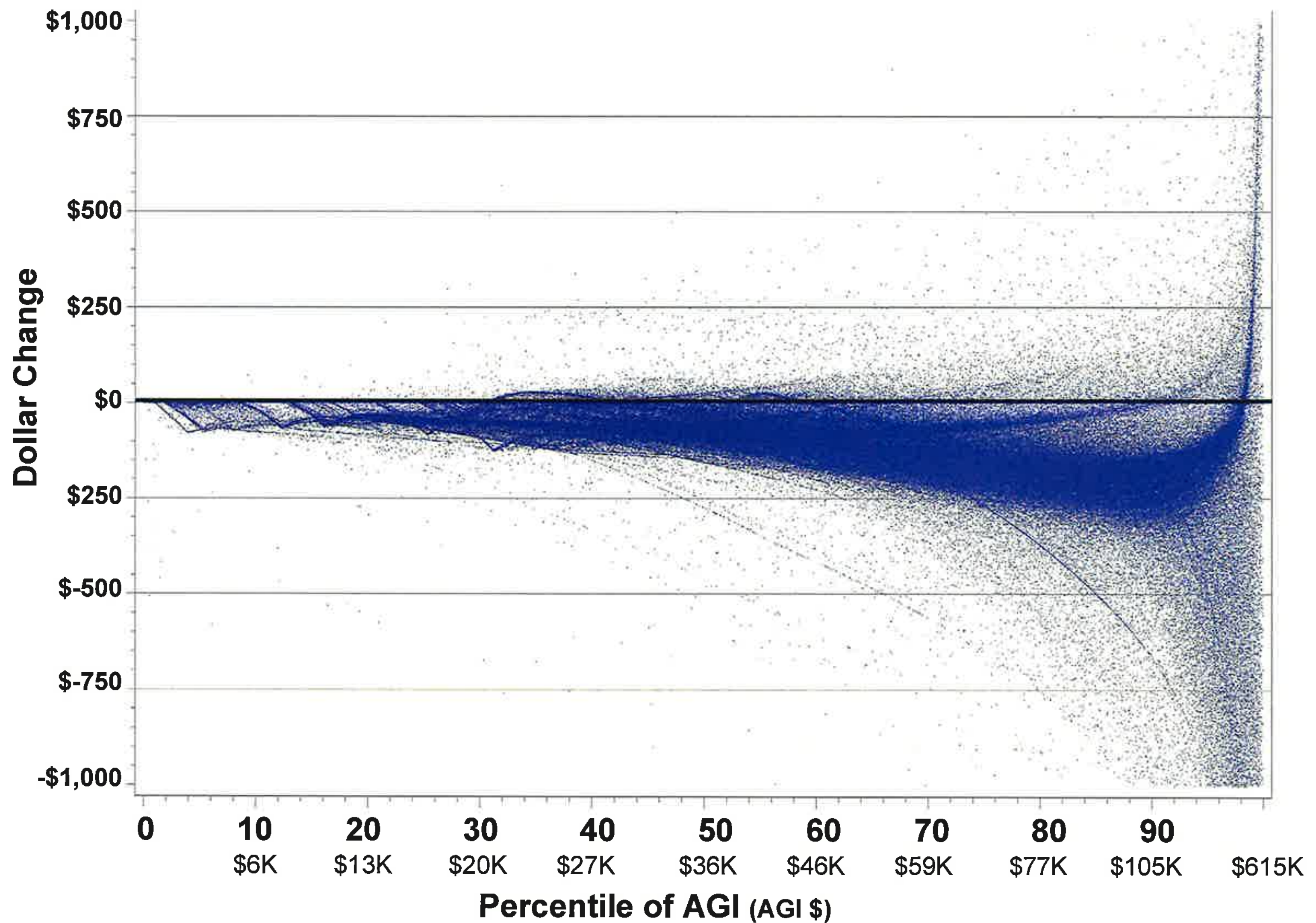
OLRGC

Effective Tax Rate Change
By Income



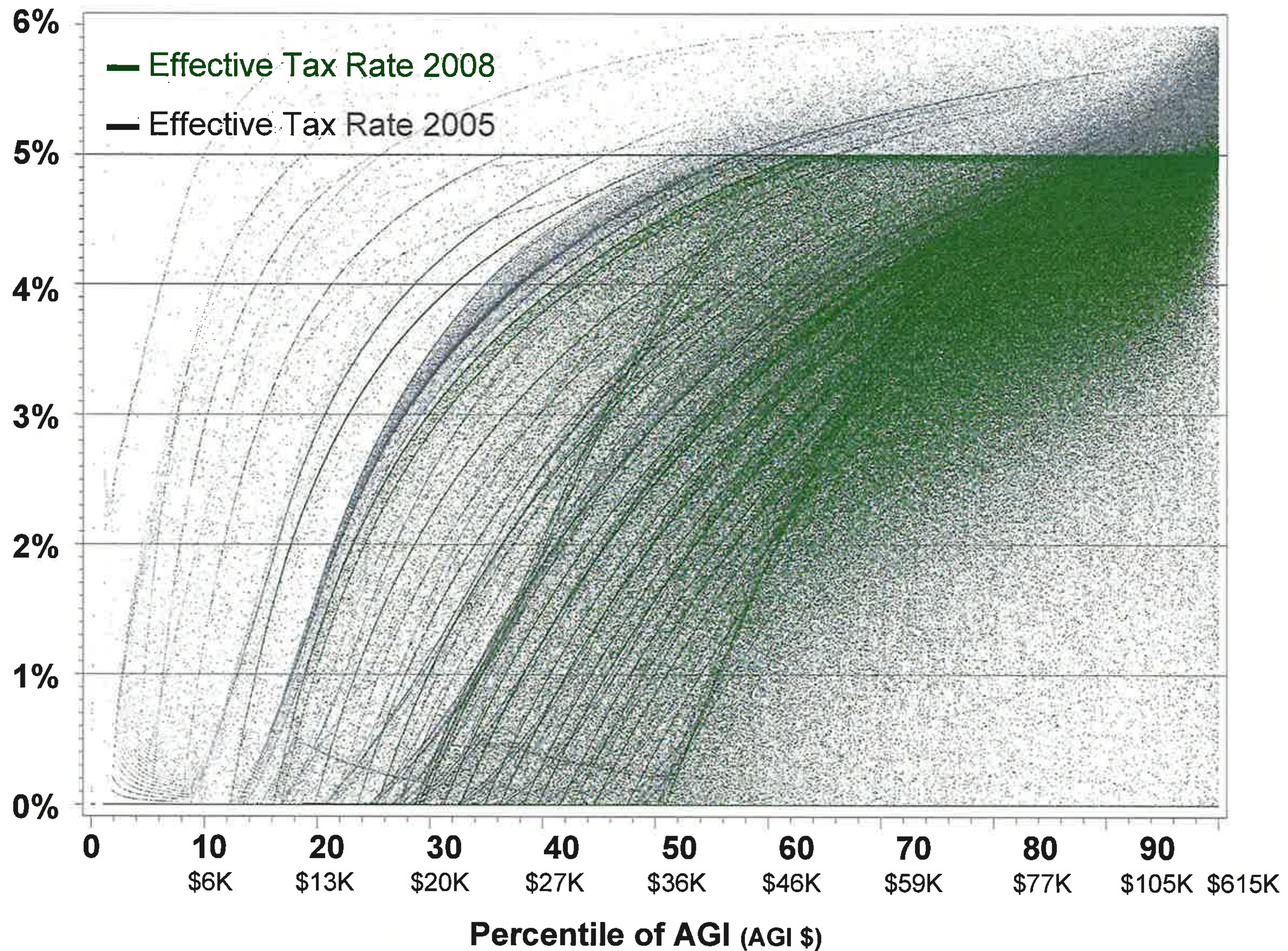
OLRGC

Dollar Amount of Change By Taxpayer & Income



OLRGC

Effective Tax Rate By Taxpayer & Income



OLRGC

All States Personal Income Tax Brackets and Rates - 2000 - 2014 Tax Years

	2000			2001			2002			2003			2004			2005			2006			2007		
State	Low	High	# of Brackets	Low	High	# of Brackets	Low	High	# of Brackets	Low	High	# of Brackets	Low	High	# of Brackets	Low	High	# of Brackets	Low	High	# of Brackets	Low	High	# of Brackets
Alabama	2.00%	5.00%	3			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Alaska																								
Arizona	2.80%	5.04%	5			N/C	2.87%	5.04%	5			N/C			N/C			N/C			N/C	2.59	4.57	5
Arkansas	1.00%	7.00%	6			N/C			N/C	1	6.5	6	1	7	6			N/C			N/C			N/C
California	1.00%	9.30%	6			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Colorado	4.80%		Flat Rate			N/C			N/C			N/C	4.63					N/C			N/C			N/C
Connecticut	3.00%	4.50%	2			N/C			N/C			N/C	3	5	2			N/C			N/C			N/C
Delaware	2.20%	5.95%	7			N/C			N/C			N/C			6			N/C			N/C			N/C
Florida																								
Georgia	1.00%	6.00%	6			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Hawaii	1.60%	8.75%	8	1.50%	8.50%	8	1.40%	8.30%	8	1.4	8.25	8			9			N/C			N/C			N/C
Idaho	2.00%	8.20%	8			N/C	1.6	7.8	8			N/C			N/C			N/C			N/C			N/C
Illinois	3.00%		Flat Rate			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Indiana	3.40%		Flat Rate			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Iowa	0.36%	8.98%	9			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Kansas	3.50%	6.45%	3			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Kentucky	2.00%	6.00%	5			N/C			N/C			N/C			N/C			N/C			6			N/C
Louisiana	2.00%	6.00%	3			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Maine	2.00%	8.50%	4			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Maryland	2.00%	4.80%	4			N/C	2	4.75	4			N/C			N/C			N/C			N/C			N/C
Massachusetts	5.95%		Flat Rate	5.60%			5					N/C			N/C	5.3					N/C			N/C
Michigan	4.30%		Flat Rate	4.20%					N/C	4					N/C	3.9					N/C			N/C
Minnesota	5.50%	8.00%	3	5.35%	7.85%	3	5.4	7.85	3	5.35	7.85	3			N/C			N/C			N/C			N/C
Mississippi	3.00%	5.00%	3			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Missouri	1.50%	6.00%	10			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Montana	2.00%	11.00%	10			N/C			N/C			N/C			N/C	2	6.9	7			N/C	1	6.9	7
Nebraska	2.51%	6.68%	4			N/C			N/C	2.56	6.84	4			N/C			N/C			N/C			N/C
Nevada																								
New Hampshire																								
New Jersey	1.40%	6.37%	6			N/C			N/C			N/C			N/C			N/C	1.4	8.97	6			N/C
New Mexico	1.70%	8.20%	7			N/C			N/C			N/C	1.7	6.8	5	1.7	6	4	1.7	5.3	4			N/C
New York	4.00%	6.85%	5			N/C			N/C			N/C	4	7.7	7			N/C			N/C	4	6.85	5
North Carolina	6.00%	7.75%	3			N/C	6	8.25	4			N/C			N/C			N/C			N/C	6	8	4
North Dakota	2.67%	12.00%	8			N/C	2.1	5.54	5			N/C			N/C			N/C			N/C			N/C
Ohio	0.716%	7.228%	9	0.690%	6.980%	9	0.734	7.5	9	0.743	7.5	9			N/C			N/C	0.712	7.185	9			N/C
Oklahoma	0.50%	6.75%	8			N/C			N/C	0.5	7	8	0.5	6.65	8			N/C	0.5	6.25	8	0.5	5.65	7
Oregon	5.00%	9.00%	3			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Pennsylvania	2.80%		Flat Rate			N/C			N/C			N/C			N/C	3.07					N/C			N/C
Rhode Island	26.00%		% of Fed	25.50%		% of Fed	24		% of Fed			N/C	25		% of Fed			N/C			N/C			N/C
South Carolina	2.50%	7.00%	6			N/C			N/C			N/C			N/C			N/C			N/C			N/C
South Dakota																								
Tennessee																								
Texas																								
Utah	2.30%	7.00%	6			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Vermont	24.00%		% of Fed			N/C	25		% of Fed	3.6	9.5	5			N/C			N/C			N/C			N/C
Virginia	2.00%	5.75%	4			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Washington																								
West Virginia	3.00%	6.50%	5			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Wisconsin	4.73%	6.75%	4	4.60%	6.75%	4			N/C			N/C			N/C			N/C			N/C			N/C
Wyoming																								
DC	5.00%	9.50%	3			N/C	4.5	8.5	3	4.5	8.7	3			N/C	4.5	9	3			N/C	4.5	8.7	3

*N/C denotes no change from previous year

As of June 1, 2014

All States Personal Income Tax Brackets and Rates - 2000 - 2014 Tax Years

	2008			2009			2010			2011			2012			2013			2014		
State	Low	High	# of Brackets	Low	High	# of Brackets	Low	High	# of Brackets	Low	High	# of Brackets	Low	High	# of Brackets	Low	High	# of Brackets	Low	High	# of Brackets
Alabama			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Alaska																					
Arizona	2.59	4.54	5	2.59	4.54	5			N/C			N/C			N/C			N/C			N/C
Arkansas			N/C			N/C			N/C			N/C			N/C			N/C			N/C
California			N/C	1	10.3	7	1.25	9.55	6	1	9.3	6			N/C	1	12.3	9			N/C
Colorado			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Connecticut			N/C			N/C	3	6.5	3			N/C	3	6.7	6			N/C			N/C
Delaware			N/C			N/C	2.2	6.95	6			N/C	2.2	6.75	6			N/C	2.2	6.6	6
Florida																					
Georgia			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Hawaii			N/C			N/C	1.4	11	12			N/C			N/C			N/C			N/C
Idaho			N/C			N/C			N/C			N/C			N/C	1.6	7.4	7			N/C
Illinois			N/C			N/C			N/C	5					N/C			N/C			N/C
Indiana			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Iowa			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Kansas			N/C			N/C			N/C			N/C			N/C	3	4.9	2	2.7	4.8	2
Kentucky			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Louisiana			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Maine			N/C			N/C			N/C			N/C			N/C	0	8	3	0	7.95	3
Maryland	2	5.5	7	2	6.25	8			N/C	2	5.5	7			N/C	2	5.8	8	2	5.75	8
Massachusetts			N/C			N/C			N/C			N/C			N/C			N/C	5.2		
Michigan	4.35					N/C			N/C			N/C			N/C	4.25					N/C
Minnesota			N/C			N/C			N/C			N/C			N/C	5.35	7.85	3	5.35	9.85	4
Mississippi			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Missouri			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Montana			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Nebraska			N/C			N/C			N/C			N/C			N/C	2.46	6.84	4			N/C
Nevada																					
New Hampshire																					
New Jersey			N/C			N/C	1.4	10.75	8	1.4	8.97	6			N/C			N/C			N/C
New Mexico			N/C	1.7	4.9	4			N/C			N/C			N/C			N/C			N/C
New York			N/C			N/C	4	8.97	7			N/C	4	8.82	8			N/C			N/C
North Carolina	6	7.75	3			N/C			N/C			N/C			N/C			N/C	5.8		Flat Rate
North Dakota			N/C			N/C	1.84	4.86	5			N/C	1.51	3.99	5			N/C	1.22	3.22	5
Ohio	0.618	6.24	9	0.587	5.925	9	0.618	6.24	9	0.587	5.925	9			N/C			N/C	0.534	5.392	9
Oklahoma	0.5	5.5	7			N/C			N/C			N/C	0.5	5.25	7			N/C			N/C
Oregon			N/C			N/C	5	11	5			N/C	5	9.9	4			N/C			N/C
Pennsylvania			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Rhode Island			N/C	3.75	9.9	5	3.8	9.9	5	3.75	5.9	3	3.75	6	3	3.75	5.99	3			N/C
South Carolina			N/C	0	7	6			N/C			N/C			N/C			N/C			N/C
South Dakota																					
Tennessee																					
Texas																					
Utah	5		Flat Rate			N/C			N/C			N/C			N/C			N/C			N/C
Vermont			N/C			N/C	3.55	8.95	5			N/C			N/C			N/C			N/C
Virginia			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Washington																					
West Virginia			N/C			N/C			N/C			N/C			N/C			N/C			N/C
Wisconsin			N/C			N/C	4.6	7.75	5			N/C			N/C			N/C	4.4	7.65	4
Wyoming																					
DC	4	8.5	3			N/C			N/C			N/C	4	9	4	4	8.95	4			N/C

*N/C denotes no change from previous year

As of June 1, 2014