ISSUE

Business Taxes

RECOMMENDATION:

Review and strategically reform business taxes to better meet the state's needs.

OVERVIEW

Since 1987, Nebraska has made several changes to its tax code in an effort to be more business-friendly. As a result of these efforts, the state now offers many tax breaks to businesses. In FY 17, the state reported that businesses received $360 million in tax abatements from 11 state incentive programs.[1] But there are questions about whether these measures attract new jobs and economic activity to our state.[2] There also is concern about the growing cost of these tax incentives, particularly at a time when state revenues are failing to keep up with demands for services like education, health care and public safety. These concerns are deepened by a U.S. Government Accountability Office report that found states may be entering a run of budget shortfalls that may last more than 40 years and by federal tax and budget changes that could further affect the state's ability to maintain services that are vital to our state and its economy.[3]

RESEARCH SHOWS NEBRASKA BUSINESS INCENTIVES ARE GENEROUS, NOT TARGETED

In recent years, the effectiveness of state tax incentives have drawn growing interest and attention from legislators, policy researchers and journalists. An example of this includes research by Dr. Timothy Bartik of the W.E. Upjohn Institute for Employment Research. Dr. Bartik found business tax breaks have little correlation with employment or future economic growth, can be excessively costly and may not have the promised effects.[4] Overly investing in ineffective tax breaks causes a state to forgo significant amounts of revenue that could be used to bolster services like education and job training, which Dr. Bartik said can be more cost-effective than tax breaks in encouraging local job growth.[5] In a national report on incentive use, Dr. Bartik found Nebraska ranked very high in terms of the incentives it offers, ranking as high as fifth nationally in one measure of tax incentive volume.[6] Dr. Bartik also found Nebraska's business incentives are greater than the U.S. average by 79 percent and that they aren't broadly provided to firms that pay high wages or invest in research and development.[7]

NE Advantage sunsets in 2020 but obligations will linger

The Nebraska Advantage Act – the state's largest business tax incentive program – is scheduled to sunset in 2020, which means lawmakers will have to decide if the program should continue or be changed moving forward. However, the state's obligations to provide incentives to businesses currently using Nebraska Advantage will carry on for more than a decade regardless of the program's continuation.

NEBRASKA ADVANTAGE SUCCESS HARD TO GAUGE, COSTS MORE THAN PROJECTED

The state's largest business tax incentive program – The Nebraska Advantage Act – was created in 2005. Businesses can earn income tax credits and exemptions against sales and personal property taxes by increasing investment and/or employment in Nebraska. Whether or not this program has been effective has been hard to determine. In 2016, the Legislature's Performance Audit Committee found it cost the state between $24,000 and $320,000 to create a single job under The Nebraska Advantage Act.[8] When Nebraska Advantage was proposed, it was initially projected to cost between $24 million and $60 million annually[9] but the program depleted the state of $160 million in revenue in FY 2017.[10] The Department of Revenue projects that even when economic job growth caused by the program is factored in, Nebraska Advantage will result in a cumulative net revenue loss of $996.5 million by 2027.[11]

EFFORTS TO BE MORE BUSINESS FRIENDLY CONTINUE TO HAVE MAJOR REVENUE IMPACT

Prior to the creation of The Nebraska Advantage Act, state lawmakers enacted a package of tax changes in response to ConAgra's threat to leave the state in 1987, including the enactment of Nebraska's first business incentive program under LB 775 and a shift to a single-sales factor state.[12] As a single-sales factor state, Nebraska taxes the state's multi-state corporations based only on the percentage of their total sales that takes place in our borders and not on such factors as the value of their facilities or what they pay in salaries, which are considered in some other states. Nebraska was one of the first single-sales factor states[13] but that policy has since been adopted by about half of the country.[14] Companies and high-income individuals received major tax savings under those changes – many of which are still in effect and will continue to reduce state revenue for years to come. LB 775 incentives, for example, reduced state revenue by $122 million in 2016 and will continue to be in effect and reduce state revenue until 2025. The amount of revenue forgone by Nebraska for being a single-sales factor state is difficult to calculate, but Good Jobs First reported that the change created windfalls for ConAgra[15] – which left Nebraska in 2015 – and other multi-state companies that have large property and employment investments in Nebraska.

OTHER 1987 TAX CHANGES ALSO AFFECTING REVENUE SIGNIFICANTLY

Other business tax changes from this era that are reducing revenue significantly

Improving the ability to evaluate tax incentives

In 2013, a Legislative Performance Audit Committee report on Nebraska Advantage found "the program goals expressed by the Legislature in the statutes and during legislative debate are too general to permit a meaningful evaluation of whether the programs are, in fact, accomplishing what the Legislature hoped they would accomplish."[16] In the time since, lawmakers have taken several steps to improve their ability to assess tax incentives including a 2018 law that will improve the information available to audit Nebraska Advantage. Such efforts are important in ensuring tax incentives are a good use of taxpayer dollars.

include the special capital gains election and the S-corp and LLC non-Nebraska income exclusion. The special capital gains election is a one-time tax exclusion that allows Nebraskans to sell stock in their employers' companies without paying state income taxes on the capital gains. The election was expanded in 2007 to include income from special stock dividends and again in 2013 to allow participants in employee stock ownership programs to sell their company stock tax free. No other state appears to have a similar exclusion.[17] According to the Department of Revenue's Tax Expenditure Report, the exemption reduced revenue by $20.8 million in 2016[18] and was claimed on only 810 Nebraska tax returns.[19] About 83 percent of the election went to taxpayers with annual federal adjusted gross income (AGI) of $1 million or more.[20] In contrast, Nebraska's earned income tax credit (EITC) in 2016 reduced revenue by about $30 million and was claimed on about 125,000 Nebraska tax returns. About 96 percent of the EITC benefit went to Nebraskans with $40,000 or less in AGI.[21]

The s-corp and LLC non-Nebraska income exclusion allows Nebraskans to avoid paying income tax on earnings from S-Corporations and Limited Liability Companies that are generated from goods or services sold outside Nebraska, even when the income isn't being taxed in another state. Few – if any – states have exclusions similar to the s-corp and LLC non-Nebraska income exclusion.[22] According to the Tax Expenditure Report, this exclusion reduced revenue by $84 million in 2016.[23] About 80 percent of the exclusion was claimed on 600 tax returns that were filed by taxpayers with at least $1 million in AGI.[24] Furthermore, 55 percent of the exclusion was claimed on about 90 returns from taxpayers who had AGI of at least $5 million.[25]

BUSINESSES ALSO HAVE BENEFITTED FROM BRACKET AND RATE CHANGES

Nebraska lawmakers have made multiple adjustments to rates and brackets for individual income taxes, which is what the vast majority of Nebraska businesses pay, as well as corporate income taxes. Several changes have been made since 2006 that are reducing state revenue by hundreds of millions of dollars annually.[26] These changes include a 2006 measure that expanded individual income tax brackets, a 2008 measure that changed the income threshold of the top corporate income tax bracket and reduced the amount of corporate income subject to the highest tax rate and a 2012 law that expanded income tax brackets and reduced rates in the bottom three brackets. In more recent years, there have been multiple proposals to reduce Nebraska's income tax rates. These include a 2013 push to eliminate state income taxes completely, a 2017 effort to use revenue triggers – which call for tax cuts when state revenues or revenue projections meet certain thresholds –

A one-time, big-time tax break

$20.8 million – that's how much revenue was forgone by Nebraska in 2016 because of the special capital gains election. This one-time tax break was claimed on only 810 Nebraska tax returns, the vast majority of which were filed by Nebraskans with $1 million or more in federal adjusted gross income. No other state appears to have a similar tax break.

to reduce the top corporate and individual income tax rates and a 2018 effort to cut the top corporate and individual income tax rates and use revenue triggers to increase a new credit to offset property taxes.

CONCLUSION

The sunsetting of the Nebraska Advantage Act in 2020 presents an opportunity to discuss making Nebraska's business tax policy more strategic while at the same time protecting funding for schools, roads and other services that are essential to a strong economy. One possible step could be to examine tax incentives – such as Nebraska Advantage – and exclusions – such as the special capital gains election and the s-corp and LLC non-Nebraska income exclusion – to see if they still serve the state's needs or should be reformed. With Nebraska entering what could be a long period of budget gaps that would make funding key services more difficult, it's important to ensure that every aspect of our tax code, including our business taxes, are designed to help our state and its economy move forward optimally.

S-corp/LLC exclusion also likely one-of-a-kind

Like the special capital gains election, the s-corp and LLC non-Nebraska income exclusion also appears to be unique to Nebraska. The exclusion allows Nebraskans to avoid paying income tax on earnings from S-Corporations and Limited Liability Companies that are generated from goods or services sold outside Nebraska, even when the income isn't being taxed in another state. The exclusion, which goes largely to high-income Nebraskans, reduced state revenue by about $84 million in 2016.

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[17] After surveying various experts on state taxes, it appears no other state has a tax break like the special capital gains election.
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[19] Department of Revenue, "Nebraska Statistics of Income 2016," accessed at http://revenue.nebraska.gov/research/statistics_of_income/stat_2016/stat_2016_excel.html, on July 11, 2018.
[20] Ibid 19
[21] Ibid 19
[22]Various state tax experts we surveyed were not aware of any other state with the same provision as the s-corp and LLC non-Nebraska income exclusion.
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[24] Ibid 19
[25] Ibid 19
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