REPORT TO THE LEGISLATURE: LR155 – NEBRASKA'S TAX MODERNIZATION COMMITTEE (2013)

Balancing the Scales: A Comprehensive Review of Nebraska's State-Local Revenue System

TABLE OF CONTENTS

TAX MODERNIZATION COMMITTEE MEMBERS:

Sen. Galen Hadley, Kearney, District 37 – Chair
Chair, Revenue Committee
Sen. Paul Schumacher, Columbus, District 22 – Vice-Chair
Vice-Chair, Revenue Committee
Sen. Kate Sullivan, Cedar Rapids, District 41
Chair, Education Committee; Revenue Committee
Sen. Heath Mello, Omaha, District 5
Chair, Appropriations Committee
Sen. Kathy Campbell, Lincoln, District 25
Chair, Health and Human Services Committee
Sen. John Harms, Scottsbluff, District 48
Chair, Legislative Planning Committee
Sen. Ken Schilz, Ogallala, District 47
Chair, Agriculture Committee
Sen. Tom Hansen, North Platte, District 42
Revenue Committee
Sen. Beau McCoy, Omaha, District 39
Revenue Committee
Sen. Pete Pirsch, Omaha, District 4
Revenue Committee
Sen. Burke Harr, Omaha, District 8
Revenue Committee
Sen. Charlie Janssen, Fremont, District 15
Revenue Committee
Sen. Jeremy Nordquist, Omaha, District 7
Sen. Kate Bolz, Lincoln, District 29

ACKNOWLEDGEMENTS

The Committee thanks the following people and the organizations they represent for their assistance in conducting the public hearings across the state and for the invaluable assistance of Legislative Staff:

Legislative Staff
- Chuck Hubka
- Teresa Alexander
- Michael Evans
- Pam Huckins
- Kitty Kearns
- Peg Jones
- Janice Satra

Legislative Research Office
- Keisha Patent
- Nancy Cyr

Legislative Fiscal Analyst and Staff
- Michael Calvert
- Tom Bergquist
- Doug Gibbs

Revenue Committee Staff

Department of Revenue
- Former Tax Commissioner Doug Ewald
- Tax Commissioner Kim Conroy

Nebraska Educational Telecommunications (NET)

Harms Advanced Technology Center, Western Nebraska Community College, Scottsbluff, NE
- Patrick Leach, Senior Executive Secretary

Mid Plains Community College, South Campus, North Platte, NE
- Jennifer Morgan, Area Events Coordinator

Northeast Community College, Lifelong Learning Center, Norfolk, NE
- Lynda Kassmeier, Life Long Learning Center Coordinator

Metro Community College, South Omaha Campus, Omaha, NE
- Kay Friesen, Director, Event Services

The Committee gratefully acknowledges the contributions of our distinguished guests for their testimony on academic research, observations and recommendations:

Dr. John E. Anderson, *Baird Family Professor of Economics* – University of Nebraska-Lincoln
Dr. John L. Mikesell, *Chancellor's Professor* – Indiana University
Dr. David L. Sjoquist, *Professor*, Department of Economics – Andrew Young School, Georgia State University
Dr. Sally Wallace, *Chair*, Department of Economics – Andrew Young School of Policy Studies, Georgia State University

Finally, the Committee wishes to extend a special thank you to the remarkable number of citizens who took the time and made the effort to testify and/or attend the public hearings across the state. And also to the many citizens who submitted their own suggestions and ideas to the Tax Modernization Committee. Your involvement in this process was invaluable.

INTRODUCTION AND OVERVIEW

"The authors of this chapter originally planned to describe the characteristics of a "high-quality" tax system. It became apparent, however, that the term *high quality*, like goodness, is in the eye of the beholder. It was decided, therefore, to use a more objective title-"

> *Characteristics of a Balanced and Moderate State-Local Revenue System, Kleine and Shannon*, 1985.

Nebraska's Tax Modernization Committee was tasked under LR155 with reviewing and evaluating the state's tax laws and making any recommendations to update or "modernize" the revenue system. It quickly became apparent that the word "modern", in relation to a state and local revenue system, is also like goodness – it is in the eye of the beholder. As a result, the Committee turned to Characteristics of a Balanced and Moderate State-Local Revenue System by Robert J. Kleine and John Shannon as the criteria for judging the state's revenue system in terms of "modernization." These characteristics are almost uniformly cited in most tax studies and academic research as the appropriate standards by which to analyze a state revenue system.

Characteristics was written in 1985 as one chapter in the book *Reforming State Tax Systems*, Edited by Steven Gold for the National Conference of State Legislatures ("NCSL"). In 1991, the Foundation for State Legislatures joined NCSL in publishing the first edition of *Principles of a High-Quality State Revenue System*. The report has been updated four times, most recently in 2001. But across all these reports, the basic characteristics of a "balanced," "moderate" or even "high-quality" revenue system have remained materially unchanged.[1]

In general, the fundamental characteristics or principles of a state revenue system can be stated fairly succinctly:

- Diversified revenue sources – do not rely too much on one particular tax;
- Reliability and stability – make sure taxes produce sufficient revenue;

[1] "Characteristics" had seven general guidelines, while "Principles" outlined nine guidelines.

- Fairness – similar tax burdens should be imposed on people in similar circumstances, assessments should be uniform and taxes on low income households minimized;
- Equalization – state taxes should be complementary with local taxes;
- Accountability– taxpayers should know who is taxing them and why; and
- Competitiveness – be responsive to interstate and international economic competition.

LR155 echoes these same principles as guidance for the Committee, stating them as "Fairness, Competitiveness, Simplicity and (ease) of compliance, Stability, Adequacy and Complementariness with local taxes." It also directed the Committee to review and evaluate, in particular, the state's sales and use taxes, income taxes and property taxes. LR155 specifically required the Committee to examine previous Nebraska tax studies including two that are commonly known as the Syracuse Study (1987) and the Burling Commission (2007). The Committee's charge was not to identify ways to reduce or increase revenues (revenue neutrality) but to review the system as a whole and identify any issues that may require action to achieve a more balanced and "modern" tax system.

LR155 designated the members of the Committee as:

a) Members of the Revenue Committee;
b) Chairperson of the Appropriations Committee;
c) Chairperson of the Health and Human Services Committee;
d) Chairperson of the Education Committee;
e) Chairperson of the Agriculture Committee;
f) Chairperson of the Planning Committee; and
g) Two other members of the Legislature selected by the Executive Board of the Legislative Council.

The chairperson of the Revenue Committee was designated as Chair for this Committee. Three public meetings and five public hearings were held from July through October, 2013. The three meetings were open to the public but testimony was limited to experts in the field of economics and taxation, as well as Revenue Committee staff and Legislative Fiscal Office staff. These meetings were intended as informational sessions for the Committee. Copies of the various presentations are included in the appendix.

The public meetings were held in Lincoln but were webcast live via the Internet with the assistance of Nebraska Educational Telecommunications. The first meeting included presentations from Legislative staff regarding sources of Nebraska revenue and detailed reviews of each of the three main taxes. These reviews were then followed by a presentation and discussion with Dr. John Mikesell of the University of Indiana, a well-known expert in the field of retail sales and use tax systems. The following two public meetings included presentations and discussions with Dr. John Anderson from the University of Nebraska on the state's property tax system and Drs. Sally Wallace and David Sjoquist of Georgia State University's Andrew Young School of Public Policy addressing individual and corporate income taxes. Drs. Wallace and Sjoquist also discussed their participation in other state tax review studies and lessons learned from those experiences.

The Committee divided itself into three subcommittees to discuss the three major tax types and make recommendations to the full Committee regarding topics for the public hearings. This list of "Options" became the agenda for the hearings. The Options were divided into the three tax categories and time was allocated for each at the public hearings. Citizens were asked to testify specifically on the Options, but could also raise any other issues they desired. Please see the Appendix for the Options List.

Five public hearings were held across the state. The first two were held in Scottsbluff on September 23 and North Platte on September 24. The third hearing was held in Norfolk on September 26. The final two hearings were held in Omaha on October 17 and Lincoln on October 18. Nearly 1,000 people attended the public hearings and testimony was heard from approximately 250 citizens.

Following the public hearings, the Committee met three additional times in Executive Session to discuss the results of the hearings, what recommendations, if any, that the Committee members wanted to make and the outline of the final report. This report, while intended to be a holistic review of the revenue system, also addresses each of the three major tax topics independently.

EXECUTIVE SUMMARY

The Committee's findings are as follows:

1. The revenue system generally complies with the characteristics and principles outlined in LR155;
2. Nebraska's system is comparable in design to most states and does not require significant changes;
3. The state's reliance on property taxes as a share of state and local taxes is greater than the national average and greater than most of our border states;
4. The individual and corporation income tax programs are appropriately progressive but our "bracket system" has not kept pace with the rate of inflation in terms of personal income; and
5. The sales and use tax base has been both narrowed and expanded several times since its inception but is comparable to and broader than most border states, with the notable exceptions of taxing agricultural machinery and equipment repair and replacement parts and residential energy consumption.

II. Overview of Nebraska’s Tax System

a. Characteristics of a Balanced and Moderate State and Local Revenue System

CHARACTERISTICS OF A BALANCED AND MODERATE STATE AND LOCAL REVENUE SYSTEM.
A summary and description of an article by Robert Kleine and John Shannon: Characteristics of a Balanced and Moderate State and Local Revenue System. Originally published December 1986, as chapter III of *Reforming State Tax Systems*, National Conference of State Legislatures.

Authors Kleine and Shannon emphasis three values:

- Balance or Revenue Diversification;
- Tax Fairness (shielding low income households from the tax collectors reach); and
- Moderation

i. Balance. The authors advocate balanced use in a system of taxes which does not overly rely on one tax type. The logic here is that each type of tax has its own weaknesses, and strengths. They suggest that income taxes are faster growing in response to economic growth, but less reliable than property taxes or sales taxes.

Sales taxes are, in their view, slower growing, but more reliable than income taxes. Sales tax base erosion due to a change in consumer spending however, is raised as a weakness of the sales tax. The property tax is viewed as stable, reliable and responsive to economic growth.

Sales tax and property tax share limitations as to the fairness principles discussed by the authors, with sales tax described as regressive, (imposing a higher burden on low income households as a percent of income).

Property tax is viewed as less regressive, but stable in the facing of reduced annual incomes, which produces problems with the percentage of tax burden on annual income rising during an economic downturn.

ii. Revenue Diversification. Comparing Nebraska's mix of taxes to that used by other states can be done using United States Census Bureau figures for 2010, the most recently published.

Overview, Table 1 - National average percentage use of tax, by type of tax, compared to Nebraska percentage use of tax.

Tax	U.S. Average % Use	Nebraska % Use	Delta if NE% matches
Property	33.12%	36.85%	$291 million decrease
Individual Income	21.29%	22.07%	$61 million decrease
Corporate	3.63%	1.99%	$128 million increase
General Sales	22.52%	21.67%	$66 million increase
Selective Sales	11.91%	9.19%	$212 million increase
MV License	1.73%	2.20%	$36 million decrease
Other Taxes	5.80%	6.03%	$18 million decrease

This 2010 data suggests that Nebraska does not vary to a great degree in percentage use of taxes by type from the national average use of taxes. Property tax use is higher than average, personal income tax usage is at the national average, and general sales tax usage is only slightly less than average.

Revenue Stability and Moderation. Matching revenue growth with state economic growth will increase revenue stability, but the authors also advise creation of a state rainy day fund to achieve stability. Nebraska has a rainy day fund structure in place, and at present it contains healthy but not excessive balances. The association between revenue growth and spending growth over time is presented in the following charts on revenue growth and the history of the tax structure and were provided by Tom Bergquist, Legislative Fiscal Office.

The major state and local taxes in Nebraska included here are property taxes (net of homestead exemption and property tax credit), city and state sales tax (including motor vehicles), corporate and individual income taxes, state miscellaneous receipts (liquor, cigarette, etc...), and motor fuels taxes. Revenue sources for cities and counties such as inheritance tax, wheel tax, occupation taxes and franchise taxes are not included as data at the statewide level is not available.

Overview, Table 2

FY2009/10 % of Personal Income					FY2009/10 Per Capita			
	U.S. Avg.	Six State Avg.	Nebraska	Rank	U.S Avg.	Six State Avg.	Nebraska	Rank
Revenues								
Property Tax	3.7%	3.5%	3.9%	19	1,427.80	1,322.80	1,480.24	17
General sales taxes	2.4%	2.5%	2.3%	28	921.06	950.85	874.17	26
Individual income	2.2%	2.0%	2.2%	27	841.62	771.33	827.71	23
Corporate income	0.4%	0.2%	0.2%	34	138.56	65.62	84.33	34
Motor fuel taxes	0.3%	0.3%	0.4%	13	122.46	127.50	163.49	8
Alcohol and Tobacco	0.2%	0.1%	0.1%	48	75.31	52.85	43.43	44
Public utilities	0.2%	0.2%	0.2%	14	91.46	57.36	90.67	15
MV license	0.2%	0.2%	0.2%	16	72.73	84.60	89.95	14
All Other	1.1%	0.9%	1.0%	29	413.52	324.82	372.51	26
Subtotal:	10.7%	9.9%	10.6%	22	4,104.51	3,757.73	4,026.51	20
Misc. general revenue	5.1%	5.6%	5.5%	22	1,967.71	2,119.25	2,109.26	19
Fed Transfers	5.3%	5.2%	5.0%	36	2,016.40	1,948.69	1,902.48	34
Total General Revenue	21.1%	20.7%	21.1%	31	8,088.62	7,825.67	8,038.26	22
FY2009/10 % Personal Income					FY2009/10 Per Capita			
	U.S. Avg.	Six State Avg.	Nebraska	Rank	U.S Avg.	Six State Avg.	Nebraska	Rank
Utility revenues	1.2%	1.0%	5.2%	1	471.04	384.72	1,976.22	1
Liquor stores	0.1%	0.0%	0.0%	22	25.18	17.51	0.00	22
Insurance trust	4.4%	3.8%	2.1%	48	1,667.57	1,417.19	815.22	49
Total Revenue	26.8%	25.5%	28.4%	18	10,252.41	9,645.09	10,829.69	14
Population (millions)	309.330	18.334	1.80	38				
Personal Income	11,852,715	692,773	69,675	36				
Per Capita Personal Income	$38,317	$37,786	$38,071	22				

Overview, Table 3

	FY1990-2010 Total			FY1999-2010 Per Capita		
Expenditures:	U.S. Avg.	Six State Avg.	NE	U.S. Avg.	Six State Avg.	NE
Higher education	6.2%	5.8%	5.7%	5.0%	4.7%	4.9%
Elementary/Secondary education	5.4%	5.3%	5.4%	4.2%	4.2%	4.6%
Highways and Transportation	5.0%	5.0%	4.7%	3.9%	3.9%	3.9%
Health and Welfare	6.8%	7.4%	6.4%	5.6%	6.3%	5.7%
Public Safety (Police, Fire, Corrections)	6.1%	7.2%	6.8%	5.0%	6.1%	6.0%
Government Administration	5.3%	5.6%	5.4%	4.2%	4.4%	4.6%
Interest on general debt	3.8%	4.3%	2.3%	2.7%	3.2%	1.5%
Environment and housing:	5.3%	6.4%	6.2%	4.2%	5.3%	5.4%
All Other	5.4%	7.6%	6.7%	4.2%	6.5%	5.9%
Direct General Expenditure	5.7%	6.2%	5.7%	4.6%	5.1%	4.9%
Revenues						
Property Tax	5.4%	5.5%	4.1%	4.2%	4.4%	3.4%
General sales taxes	4.4%	4.8%	5.0%	3.2%	3.7%	4.3%
Individual income taxes	4.6%	4.9%	5.7%	3.5%	3.8%	5.0%
Corporate income taxes	3.0%	2.2%	3.9%	1.9%	1.1%	3.1%
Motor fuel taxes	3.2%	2.8%	1.8%	2.1%	1.7%	1.1%
Alcoholic and Tobacco taxes	4.8%	4.1%	1.9%	3.6%	3.0%	1.2%
Public utilities	4.6%	5.1%	11.1%	3.5%	4.0%	10.3%
Motor vehicle license	3.8%	3.8%	4.7%	2.7%	2.7%	4.0%
All Other	5.5%	6.0%	8.0%	4.3%	4.9%	7.2%
Subtotal: Taxes	4.8%	5.0%	4.8%	3.6%	3.9%	4.1%
Charges, Misc. General revenue	5.4%	6.0%	4.9%	4.3%	4.9%	4.1%
Intergovernmental (from Federal Government)	7.9%	8.3%	7.8%	6.7%	7.2%	7.0%
Total General Revenue	5.5%	5.9%	5.4%	4.4%	4.8%	4.6%

Examining the findings and recommendations of the Syracuse Tax Study in this context, we note that that study, using data for 1984, suggested that Nebraska was far above average as a user of property tax, motor fuel tax, and motor vehicle license tax. The percentages shown above suggest Nebraska is now closer to average use than was calculated in 1984 by the Syracuse Study, particularly in the property tax category. However, Nebraska remains far above average in motor fuels and motor vehicle license taxes, with percentages exceeding the national average by 36 percent and 25 percent, respectively.

Authors Kleine and Shannon address additional values:

iv. Tax Fairness. Shielding the income of low income households is a goal articulated in this report. Lowering the tax burdens of low income households can be accomplished by exempting some initial amount of income from taxation, which the Nebraska system does. Exempting food, prescription drugs, utilities, and even some small dollar clothing purchases from sales tax have been tried in other states. Nebraska exempts food purchased for home consumption, but taxes prepared food at the statutory rate.

In recent years, three of Nebraska's largest cities have imposed another 2 percent tax rate on the purchase of prepared food through a restaurant business occupation tax. Since low income households do spend some portion of their budget on prepared food meals, this has increased the regressivity of the Nebraska state and local tax system. Nebraska does <u>not</u> provide an exemption for utilities or clothing items of low dollar value, as some states do. Strategies other than exemptions do exist, including refundable income tax credits.

Measuring household tax burdens, and comparing them, can be done using tax burden models. Models of household tax burdens can be categorized as legal incidence models, and one example of this is the District of Columbia Tax Rates and Tax Burden Study ("D.C. Study"). This model has been published since 1995 and compares household tax burdens for the largest city in each of the fifty states. Taxes reported are income, property, sales and motor vehicle, including motor fuels.

An economic incidence model has also been developed by the Institute on Taxation and Economic Policy ("ITEP"). This type of model calculates three major taxes, income, property and sales by income groups on a statewide basis. It accounts for "tax shifting" between first payers of a tax and other taxpayers in the economy. Some states, Minnesota being one, have developed their own economic incidence tax burden models. The Minnesota model accounts for more forms of tax than that accounted for in the ITEP model.

We reviewed two models of household tax burdens, the D.C. Study and the ITEP economic tax burden model, for their results in Nebraska. Our conclusion was that refundable income tax credits of $250 to $500 dollars for family households below $25,000 dollars in income could accomplish the goal of making the burden of Nebraska's system proportional, at the $250 dollar level, or progressive, at the level of $500 dollars, if legislators desire to achieve that goal.

v. State Fiscal Equalization. The authors believe that states should avoid property tax over load by assuming a high level of financing of health care and hospitals and education services with spillover benefits. The State of Nebraska's takeover of the county share of Medicaid meets this goal. It is estimated that in 2012 this shifts $350 million of expense from counties to the state.

Fiscal equalization aid is recommended for policymakers preferring decentralized local government operations. Nebraska has fiscal equalization aid policies for schools, and cities. A county fiscal equalization policy was repealed in 2012, along with other non-equalized aid programs for counties, cities and natural resources districts.

vi. Political Accountability. The authors believe that tax increases due to economic growth or change should be explicit and transparent. For this reason, they recommend a property tax "truth in taxation provision," and income tax indexing.

In the case of truth in property taxation, a recommended provision is one in which valuation growth is recognized and rate setting to adjust for this growth in tax base are subject to an explicit vote of local budget decision makers. Nebraska has such a provision in Section 77-1601.02 of state law:

§77-1601.02. Property tax request; procedure.

> (1) The property tax request for the prior year shall be the property tax request for the current year for purposes of the levy set by the county board of equalization in section 77-1601 unless the governing body of the county, municipality, school district, learning community, sanitary and improvement district, natural resources district, educational service unit, or community college passes by a majority vote a resolution or ordinance setting the tax request at a different amount. Such resolution or ordinance shall only be passed after a special public hearing called for such purpose is held and after notice is published in a newspaper of general circulation in the area of the political subdivision at least five days prior to the hearing. The hearing notice shall contain the following information: The dollar amount of the prior year's tax request and the property tax rate that was necessary to fund that tax request; the property tax rate that would be necessary to fund last year's tax request if applied to the current year's valuation; and the proposed dollar amount of the tax request for the current year and the property tax rate that will be necessary to fund that tax request. Any resolution setting a tax request under this section shall be certified and forwarded to the county clerk on or before October 13 of the year for which the tax request is to apply.
>
> (2) Any levy which is not in compliance with this section and section 77-1601 shall be construed as an unauthorized levy under section 77-1606.

In the case of income tax indexing, the authors also recommend indexing income tax brackets so that inflationary growth in income will not result in hidden tax increases, as more income is taxed in a higher rate bracket. Nebraska does not index its rate bracket dollar amounts. Nebraska indexes its standard deduction and personal exemption credit, something which is also recommended by the authors in a state with flat income tax rate structure.

vii. Property Tax Equity. The authors recommend high standards be set for assessment uniformity and statistical accuracy of measurement. Statewide statistical standards for an acceptable range of value are set by law in Section 77-5023 below. Measurement of compliance with these and other standards for uniformity are analyzed annually in hearings held before the Tax Equalization and Review Commission. State officials review county data for compliance with these standards. This provides taxpayers with an independent review of the statistics submitted by county assessors.

§77-5023. Commission; power to change value; acceptable range.

> (1) Pursuant to section 77-5022, the commission shall have the power to increase or decrease the value of a class or subclass of real property in any county or taxing authority or of real property valued by the state so that all classes or subclasses of real property in all counties fall within an acceptable range.
>
> (2) An acceptable range is the percentage of variation from a standard for valuation as measured by an established indicator of central tendency of assessment. Acceptable ranges are: (a) For agricultural land and horticultural land as defined in section 77-1359, sixty-nine to seventy-five percent of actual value; (b) for lands receiving special valuation, sixty-nine to seventy-five percent of special valuation as defined in section 77-1343; and (c) for all other real property, ninety-two to one hundred percent of actual value.
>
> (3) Any increase or decrease shall cause the level of value determined by the commission to be at the midpoint of the applicable acceptable range.
>
> (4) Any decrease or increase to a subclass of property shall also cause the level of value determined by the commission for the class from which the subclass is drawn to be within the applicable acceptable range.
>
> (5) Whether or not the level of value determined by the commission falls within an acceptable range or at the midpoint of an acceptable range may be determined to a reasonable degree of certainty relying upon generally accepted mass appraisal techniques.

viii. Tax Competitiveness. Seven characteristics of an *uncompetitive* interstate tax climate are identified by the authors:

1) A relatively heavy tax burden - Nebraska is mid ranked among the states on tax burden on the economy;
2) A highly progressive tax policy - Nebraska has a progressive income tax;
3) No property tax inventory for business - Nebraska exempts inventory;
4) No sales tax exemption for industrial machinery - Nebraska exempted as of 2005 - Agricultural machinery is also exempt except for repair parts;

5) A classified property tax - Unlike many states, Nebraska residential property is *not* classified and as result taxed at a lower value relative to business property;
6) Agricultural land is classified and taxed at a lower level of market value – Nebraska has classified Agricultural land and values it at 75 percent of market value - This is a higher ratio of taxable value to market value than Nebraska border states; and
7) Above average rates for unemployment insurance and workers compensation - Nebraska's rates are competitive.

III. OBSERVATIONS AND FINDINGS

a. Property Tax

i. History

The Property Tax in Nebraska. In the sections of the report which follow we will describe the Nebraska property tax system and policies, compare it to other states property tax systems and policies, and show how the Nebraska property tax compares to widely accepted tax policy principles. We will also report the results of past tax studies in Nebraska, including the Syracuse Tax Study. We will address the observations of tax experts consulted by the Tax Modernization Committee. Finally, we report the suggestions of citizens who appeared at hearings held by the Committee.

Description of the Property Tax. The structure of the Nebraska property tax is governed by state laws and a specific constitutional provision known as the uniformity clause. This clause is shown below. The constitutional language shown here has been modified many times since the state constitution was adopted:

> Article VIII-1. Revenue; raised by taxation; legislative powers. The necessary revenue of the state and its governmental subdivisions shall be raised by taxation in such manner as the Legislature may direct. Notwithstanding Article I, section 16, Article III, section 18, or Article VIII, section 4, of this Constitution or any other provision of this Constitution to the contrary: (1) Taxes shall be levied by valuation uniformly and proportionately upon all real property and franchises as defined by the Legislature except as otherwise provided in or permitted by this Constitution; (2) tangible personal property, as defined by the Legislature, not exempted by this Constitution or by legislation, shall all be taxed at depreciated cost using the same depreciation method with reasonable class lives, as determined by the Legislature, or shall all be taxed by valuation uniformly and proportionately; (3) the Legislature may provide for a different method of taxing motor vehicles and may also establish a separate class of motor vehicles consisting of those owned and held for resale by motor vehicle dealers which shall be taxed in the manner and to the extent provided by the Legislature and may also establish a separate class for trucks, trailers, semitrailers, truck-tractors, or combinations thereof, consisting of those owned by residents and nonresidents of this state, and operating in interstate

commerce, and may provide reciprocal and proportionate taxation of such vehicles. The tax proceeds from motor vehicles taxed in each county shall be allocated to the county and the cities, villages, and school districts of such county; (4) the Legislature may provide that agricultural land and horticultural land, as defined by the Legislature, shall constitute a separate and distinct class of property for purposes of taxation and may provide for a different method of taxing agricultural land and horticultural land which results in values that are not uniform and proportionate with all other real property and franchises but which results in values that are uniform and proportionate upon all property within the class of agricultural land and horticultural land; (5) the Legislature may enact laws to provide that the value of land actively devoted to agricultural or horticultural use shall for property tax purposes be that value which such land has for agricultural or horticultural use without regard to any value which such land might have for other purposes or uses; (6) the Legislature may prescribe standards and methods for the determination of the value of real property at uniform and proportionate values; (7) in furtherance of the purposes for which such a law of the United States has been adopted, whenever there exists a law of the United States which is intended to protect a specifically designated type, use, user, or owner of property or franchise from discriminatory state or local taxation, such property or franchise shall constitute a separate class of property or franchise under the laws of the State of Nebraska, and such property or franchise may not be taken into consideration in determining whether taxes are levied by valuation uniformly or proportionately upon any property or franchise, and the Legislature may enact laws which statutorily recognize such class and which tax or exempt from taxation such class of property or franchise in such manner as it determines; and (8) the Legislature may provide that livestock shall constitute a separate and distinct class of property for purposes of taxation and may further provide for reciprocal and proportionate taxation of livestock located in this state for only part of a year. Each actual property tax rate levied for a governmental subdivision shall be the same for all classes of taxed property and franchises. Taxes uniform as to class of property or the ownership or use thereof may be levied by valuation or otherwise upon classes of intangible property as the Legislature may determine, and such intangible property held in trust or otherwise for the purpose of funding pension, profit-sharing, or other employee benefit plans as defined by the Legislature may be declared exempt from taxation. Taxes other than property taxes may be authorized by law. Existing revenue laws shall continue in effect until changed by the Legislature.

a. Property Tax

ii. Building the Base

The Nebraska property tax as structured is primarily a tax on real property, which can be described as real estate and improvements to real estate. Nebraska property tax laws also require owners of certain types of what is termed personal property to pay taxes on this value. This is business equipment and agricultural machinery. Nebraska generally exempts governmentally owned property, religious, charitable and private educational institution property are treated as exempt under most circumstances. An excellent description of the property tax in Nebraska and its history can be found on the public website of the Nebraska Department of Revenue's Property Assessment Division.

In the last 45 years, the laws of Nebraska have been modified to allow some property that was taxed to be exempt. These include household goods like furniture, business and agricultural inventories, and intangible assets like stocks, bonds and bank accounts. In 1970 voters approved a constitutional amendment which allowed personal property value to be exempted and treated in a non-uniform manner. Some items of business personal property were removed from the tax system in the late 1970's, but were added back to the property tax system in 1992.

In 1972 voters approved a constitutional amendment which allowed agricultural land to be valued in a non-uniform manner relative to other property. Agricultural land can be valued at its market value in agricultural use under this provision. The voters passed a subsequent amendment of this same language in 1990, after a 1987 Nebraska Supreme Court decision invalidated agricultural land valuation practices in use at that time. This amendment authorized the current practice of valuation of agricultural land at a reduced percentage of its agricultural use market value. Today, Nebraska state law authorizes valuation of such property at 75% of market value in agricultural use.

Motor vehicle valuation and tax were separated from the ad valorem property tax base after a constitutional amendment passed in 1998. Taxes are still paid on motor vehicles as a form of personal property tax. The tax is based on a tax schedule which declines with the age of the vehicle, and is found in state law. The tax amount paid in first year of existence is based on manufacturer's suggested retail price. As a result, the tax paid on a motor vehicle is an amount which is now uniform across the state, regardless of local property tax rates. State law provides that this property tax is no longer part of the system of locally imposed rates on locally determined value. The tax is collected by the county treasurer in each county. Tax amounts go only to schools, counties and cities pursuant to distribution percentages found in state law.

Passage in 1998 of another constitutional amendment provided that governmentally owned property would continue to be exempt if it was determined to be in a public use. After its passage, governmental land held primarily as investment property, including the land owned by the State Board of Educational Lands and Funds, was valued for tax purposes and made subject to property tax. Much other public land remains exempt based on a successful court challenge to this law. The Nebraska Supreme Court took the broad view that public ownership constitutes public use.

Over time, then, the base of the property tax as defined by constitutional and statutory law changes has been narrowed, increased and redefined. The base reduction or narrowing may have reduced the base by 15 to 20% from the base found in Nebraska law prior to 1970.

We suggest in the next section that the property tax base for valuation in Nebraska remains broader than that found in most states. A broad base for taxation is generally viewed by economists examining a tax system as a sound tax policy principle.

Nebraska funds two direct relief programs for taxpayers. These are the homestead exemption program, which funds an offset to property taxes owed by low income elderly and some disabled persons. Current funding is set at 72.5 million dollars. The funding has grown over the past decade, as shown in the chart below. In 2012 approximately 47,000 persons had their applications for relief approved.

Property Tax, Chart 1

Homestead Exemption Program Funding

Fiscal years		
2002	2003	$40,918,956
2003	2004	$43,566,167
2004	2005	$50,455,089
2005	2006	$53,721,132
2006	2007	$56,749,803
2007	2008	$62,355,697
2008	2009	$60,633,379
2009	2010	$65,569,800
2010	2011	$68,607,607
2011	2012	$67,574,378
2012	2013	$72,500,000[2]
		Annual rate of actual growth
		5.73%

The state also funds a property tax credit levy rate offset program, funded at 115 million dollars. This program reduces each parcel of properties tax rate by a fixed levy amount. This is determined by dividing the funding amount by the statewide real property value. The result is a credit of a fixed number of cents per one hundred dollars of value. The tax credit levy offset has decreased in effectiveness as valuation levels increase and funding is frozen, as shown in the chart below.

[2] 2012 budgeted, not actual.

Property Tax, Chart 2
Nebraska Tax Credit Program

Levy offset	Funding ($ millions)
0.08300	105
0.08600	115
0.08222	115
0.07891	115
0.07531	115
0.07150	115
0.06597	115

a. Property Tax
iii. Review and Comparison

All states in the United States use a property tax in their state and local tax systems. For the most part, the property tax is used by local governments like cities, counties, and independent school districts. Some state governments continue to use a statewide property tax. Article VIII-5 of the Nebraska Constitution prohibits Nebraska state government from using a property tax for state funding purposes.

The property tax represents the largest percentage share of total state and local taxes collected in Nebraska, as the Table PT 1 below illustrates. These results are based on reports from the United States Census Bureau, the major source of information for state to state comparisons of taxation. The property tax share of total state and local taxes is higher in Nebraska than in other states in the nation, and higher than the six state region which borders Nebraska. (Source: United States Census Bureau, State and Local Finances: 2010.)

Property Tax, Chart 3

		U.S Average % Use	Nebraska % Use	Regional % Use
Property Tax		33.12%	36.85%	34.20%

Were the Nebraska property tax share of total taxes to be reduced to the same share of total taxes as the national average, it would require a shift equal to 3.7% of the total state and local taxes reported in 2010. While this does not seem like a large change in state and local tax revenues, it does amount to a 200 to 300 million dollar change in the use of the 7.8 billion dollars of taxes reported by the Census Bureau. This amount could represent a 10% reduction in the use of the property tax in Nebraska. (The amount of tax shift varies based on whether average regional or national shares are a policy goal.)

The choice of how, or whether, to decrease or increase this share is an important one. Greater use of other taxes, or reductions in local property tax funding, have several consequences. These consequences effect who pays, but also impact the equity of the tax system, and the quality of public services. This choice could result in an increase in federal income taxes, as property taxes are an itemized deduction for Nebraskans, while sales taxes generally are not.

<u>Comparing Tax Rates.</u> In order to compare rates levied on property in different states, an effective rate must be calculated. This is done by dividing the market value of a property by the amount of tax paid. In Nebraska, residential and commercial properties are assessed tax valuation purposes at 100% of market value, or somewhere between 92% and 100% of market value for purposes of meeting statistical standards set by state law. Agricultural property is assessed at 75% of market value, or somewhere between 69% and 75% of market value in order to meet state standards of statistical accuracy. In many other states, it is often not the case that residential property is valued at 100% of its market value. The valuation of residential property for tax purposes is often subject to what is referred to as classification. This term commonly refers to treating one <u>class</u> of property differently for value purposes when implementing the property tax. (In some instances, classified rates are also set as well.)

One published source reports that residential property is valued at a reduced percentage of market value in 27 states. (Tax Rates and Tax Burdens Nationwide: 2011, Chief Financial Officer of the District of Columbia.) The average percentage level of market value is reported as approximately 60% in that same study. In almost all cases, the level of value found in law is lower than that assigned to commercial property. Typically, commercial property would include small and large businesses, commercial apartment complexes, utilities, pipelines, railroads, and telecommunications companies. This policy effectively shifts the property tax burden to those properties, if all properties are taxed at a locally determined and uniform rate of property tax.

Because classification of residential property is often done, the effective rate on residential property is reduced by the value preference or reduction authorized by state law. Two reliable public sources on effective tax rate on properties suggest that Nebraska has a high effective rate of tax on residential property. These are, "Tax Rates and Tax Burdens 2011 Nationwide, published by the Chief Financial Officer of the District of Columbia", and 50 State Property Tax Comparisons" published by the Minnesota Center for Fiscal Excellence.

In the District of Columbia study, the report ranks the largest city in each of the 50 states, which is Omaha in Nebraska. In the Minnesota Center for Fiscal Excellence report, the ranking is based on the largest 50 cities in the United States, with 3 cities added to the list of rankings. Again, Omaha is in this group of ranked places. In both cases, the residential effective rate in Omaha is shown as slightly over 2 dollars per one hundred dollars of market value.   Omaha ranks 12th in both reports.

The residential preferential valuation classification used in other states is the major source of Omaha's high relative rank. This policy of other states also reduces the share of the local tax base represented by the preferred class.   In some cases, in particular the case of Colorado, the reduced market value is created by a policy of limiting valuation growth for the entire residential sector statewide. Colorado's residential property is reported in 2010 for both these studies as assessed at 8% of its market value. Residential property is valued at just over 50% of its market value in Des Moines, Iowa, but taxed at a nominal rate of well over 4 dollars per one hundred dollars of taxable value. This results in a slightly higher effective rate of tax than that experienced in Nebraska, despite the lower level of market value taxed.

One other important consequence of this policy is the reduction in the total dollar value of the tax base which is available to tax. Reducing value requires a higher rate to yield the same total tax revenue. In many states school aid systems local capacity is measured by examining taxable value. When classified and reduced property value is used in those states school aid formulas, the result can be higher levels of state funding to meet school needs. Theses state's fund a higher percentage of local schools as a result.

Comparing Base and Tax Growth of the Property Tax. As the chart below shows, Residential property represents the largest share of taxable value and taxes paid in the Nebraska system. Chart PT 2 shows the share of value for four major groups of value, and the change in share from 2002 to 2012. As can be observed, the residential share of value and tax has declined over this period, after rising from 2002 to 2007. This reflects the housing boom and new construction value over that period, the subsequent decline in housing value and new construction. It also reflects the rising share of agricultural land and improvements value and taxes as a share of statewide amounts over the period 2007 to 2012.

Rates are also shown, and rising rates are evident on residential and business properties. The 2002 to 2007 rate increases reflect in part the increase in school levy limits which were part of the budget reductions following the 2002 recession. At that time the school tax rate or levy limit was raised by five cents. Lower value growth and actual decreases in large urban areas, combined with sales tax revenue declines for cities, also shows up here in higher combined rates on residential property.

The difference in the rates shown for agricultural land, versus the 2.000 or more rates on residential and business property, is explained by the fact that very little agricultural land is located inside the incorporated limits of cities levying a property tax. The city property tax adds 40 or more cents to the combined levies faced on residential or commercial property. The vast majority of both types is located inside incorporated city limits. Personal property value is a combination of business equipment, agricultural machinery, and the personal property value of railroads, pipelines, and telecommunications companies. Because much of this personal property value, including railroad value, is located outside the limits of an incorporated city and their added rates, the average rates on this type of property are lower than the rates on urban residences and commercial businesses.

Comparison of effective rates on business investment property, not including agricultural land, shows that Nebraska effective rates are the same as residential property effective rates in the nation. This results in a lower relative ranking for commercial properties. This results from the policy of shifting the burden to the business class of property which was described above. This class of property usually includes apartment complexes, where renters face a higher burden of property taxes as a share of rent as a result. The Minnesota Center for Fiscal Excellence in their study of property taxes develops a ratio showing the amount of cross subsidization which results from this practice. The report shows that Omaha Nebraska is one of 20 of the 53 ranked places where little or no cross subsidization of residential property taxes by renters takes place. A similar ratio computation on urban industrial or commercial properties shows the same result of little or no cross subsidization of residential property owners due to preferences in valuation.

Nebraska's effective rates on agricultural land and its policy of reducing agricultural land value to a lower level of agricultural use market value cannot be so easily compared. In 1999, the Nebraska Legislature sponsored a study done by Dr. Bruce Johnson of the University of Nebraska which showed that agricultural land in Nebraska in Nebraska was taxed at the highest effective rate in the nation, despite this level of value reduction.

The results of this 1999 study are not easily replicated, and no national organization regularly examines this issue in detail. A study of agricultural use value is in progress at the Lincoln Land Institute. Dr. John Anderson of the University of Nebraska-Lincoln, School of Business, is a coauthor and lead researcher on this study, which has yet to be published.

Comparing Property Tax Burdens on Household Income. The comparison of household tax amounts paid by Nebraskans to that paid by other households in other states can be done using one often cited national study published by the District of Columbia Chief Financial Officer. The results are shown below.

Property Tax, Chart 4

Income Family of 3	Nebraska	U.S. average	Nebraska	National	Difference	
$25,000	$1,618	$1,891	6.47%	7.56%	16.9%	National average higher
			as percent of income			
$50,000	$2,579	$2,686	5.16%	5.37%	4.1%	national average higher
			as percent of income			
$75,000	$2,962	$3,092	3.95%	4.12%	4.4%	national average higher
			as percent of income			
$100,000	$3,416	$3,045	3.42%	3.05%	-10.9%	national average LOWER
			as percent of income			
$150,000	$4,252	$4,067	2.83%	2.71%	-4.4%	national average LOWER
			as percent of income			

These results suggest that low and moderate income households living in Omaha pay a lower amount of taxes as a percent of income than the average household in the nation's largest cities. The rate paid in Omaha is 2.1800, a rate higher than that paid on average in cities across the state. The important variable taken into account in this study is the relationship between house value and income in these places. Midwestern cities like Omaha have lower ratios of house value to income. Where a household faces a rate of $2.00 per one hundred dollars of value, and a house value which is twice the family income, the 4% burden level is a result. Persons with higher house value to income ratios will face higher tax as a percentage of income. A 2.0800 rate is common in incorporated places in Nebraska. House value to income ratios are often lower in communities smaller than Omaha. Rates are higher in suburban areas of Douglas and Sarpy County where sanitary improvement districts tax a rate which is typically 30 to 40 cents higher than combined rates in adjoining cities.

Distribution of Property Tax by Types of Value. The valuation and tax shares of the Nebraska property tax system for different types of property value are shown in Property Tax Chart 3. Types shown here are residential, agricultural, other business, and business and agricultural personal property value.

Property Tax, Chart 5

Nebraska Property Tax Base and Tax Shares: 2002 to 2012.

Residential Real Property Value and Tax Share, and statewide rate

	share of value	share of tax	rate of tax
2002	49.3%	52.3%	2.0158
2007	52.5%	55.1%	2.0532
2012	44.4%	48.8%	2.0887

Agricultural Real Property Value and Tax Share, and statewide rate

	share of value	share of tax	rate of tax
2002	23.7%	19.9%	1.5995
2007	22.7%	19.5%	1.6840
2012	30.4%	25.0%	1.5600

Business (non Ag) Real Property Value and Tax Share, and statewide rate

	share of value	share of tax	rate of tax
2002	19.1%	20.1%	2.0001
2007	19.1%	19.8%	2.0267
2012	18.3%	19.8%	2.0552

Personal property value and tax share

	share of value	share of tax	rate of tax
2002	7.8%	7.7%	1.8749
2007	5.8%	5.6%	1.9052
2012	6.8%	6.4%	1.7937

The last category, business equipment personal property value, is a category of value not taxed in several states, including some border states of Nebraska. These states have eliminated the taxation of business equipment and agricultural machinery. These states generally have also eliminated the valuation and taxation of household goods and business inventories, as

Nebraska has also done. Nebraska does provide targeted exemptions for personal property as part of the Nebraska Advantage Act and the Employment and Investment Growth Act. These exemptions, in tax year 2012, accounted for approximately 6 tenths of one percent of the total property value base and taxes.

The 1987 Syracuse tax study estimated that the base narrowing described earlier in this report, removing household goods, and business and agricultural inventory, reduced the base and yield by a factor of 18%. As noted earlier, the agricultural machinery value which was partially and then fully exempted in the later part of the 1970's was restored to the base in 1992 to resolve lawsuits brought by other businesses which had continued to pay property taxes on this type of value. Today, all personal property value and business equipment constitutes a 6 to 7% share of value and tax, as shown above.

Comparing Growth rates in the Use of the Property Tax. Census Bureau Data shows that nationally, from 2002 to 2010, property taxes reported have grown faster than income and sales tax receipts. The combination of two recessions, impacting income and sales tax receipts growth, and a housing boom, enabling growth in property tax receipts from newly constructed property, have produced a growth rate in nationwide property tax revenues which exceeds the rate of other taxes, and the rate of economic growth. The national annual rate of growth in property tax collections reported by Census Bureau is 5.85% for the period 2002 to 2010. This exceeds the growth in sales and income tax receipts nationally, and results in a property tax being a higher percentage share of state and local tax revenues. Nebraska's rate of growth in property tax, calculated at 5.65% using Census Data, lagged slightly behind the national rate of growth. Nebraska growth in total taxes of all types also lagged behind national growth rates during this period, with national growth calculated at 4.33% and Nebraska at 4.04%.

Review of Recommendations from Past Tax Studies. LR 155 asks for an examination of past tax studies, including a comprehensive study now referred to as the Syracuse Tax Study, published in 1987. That study identified the following issues regarding the property tax in Nebraska, and made recommendations to address these issues.

First, regarding the system or structure of the property tax, the Syracuse study reviewed exemptions and the base and found it structurally comparable and sound, relative to the recommended base for taxation. The authors did recommend putting agricultural machinery back on the property tax list and restoring this value to the base. They also recommended exempting such machinery from sales tax. By doing so, they felt Nebraska would be achieving balance and consistency in tax treatment of property and sales tax. This policy recommendation was implemented in 1992 in regard to agricultural machinery property tax and sales tax. A related recommendation that manufacturing equipment be exempted was not implemented until 2005. The sales tax exemption for agricultural machinery repair parts is not yet implemented.

The main focus of the Syracuse study was Nebraska's higher than average use of property tax in its tax system. Syracuse authors recommended reducing the role of property taxes in financing government services. The main policy option they identified was an increase in state aid to local governments. They reported that all Nebraska local governments experienced lower levels of state revenue sharing than local governments in other states. They advised retaining existing aid programs for all governments, and supplementing these aid programs with aid based on equalizing concepts. The equalizing concept they advocated involved uniformly measuring public services needs and economic capacity to meet needs.

In regard to schools, the largest user of property tax revenues, the recommendation for increased aid was made with a caveat. The view of the Syracuse authors was that a consolidation of Nebraska' over 900 school districts ought to precede any increase in aid. They believed fiscally stronger and more efficient school systems would result.

Three years following the Syracuse report publication, in 1990, the Legislature did implement a new school aid system which is based on equalizing needs and capacity, as measured by fiscal capacity of the property tax base. In that same year the Legislature passed legislation to require school district common levies, forcing affiliations of elementary and high school districts to financially support high schools. This began a long, and to some degree tortured, process of school consolidation. The system Syracuse criticized, involving over 900 districts with independent taxing authority and separate systems of elementary and secondary education has been reduced in size to 249 independent districts offering a comprehensive kindergarten to high school education supervised by the same elected board.

In regard to other governments, specifically cities and counties, Syracuse recommended that an increase in aid and state sales or income tax revenue sharing be implemented. The view they reflected was that these taxes could be used to substitute for property tax use. They also recommended that the aid be based on equalization concepts. The suggested approach to making this transition was to make the change in a manner which forced a one year freeze on local property tax resources so the transition could be effective in the view of the taxpayer. (In the case of school aid increases mentioned above, and made in 1990, this policy recommendation was followed.) The Legislature was slower to increase its funding commitment to city and county aid. A property tax reform package developed in 1995 and put in place in 1998 did involve new forms of equalization aid, and other state aid, for cities and counties. Older aid programs put in place to mitigate property value capacity losses due to past exemptions were left in place.

This expanded commitment to aid to replace property taxes was decreased in 2010. Older capacity loss aid programs for cities and counties, and more recently created county aid programs, were repealed to meet state budget cutting goals. School aid growth was reduced. (Federal school aid replaced state aid in a significant manner during this period.)

Syracuse authors suggested other reforms, including a focus on what they viewed as a low quality of assessment practice. They found highly variable sales assessment ratios and other statistical measures such as the coefficient of dispersion.   The Legislature in the mid 1990’s established a separate state administered property tax agency with a director appointed to a six year tenure. Laws regarding statistical standards to be achieved by each county, and an annual review of compliance with those standards were passed. The State

Board of Equalization, consisting of elected state officials with other full time duties, was replaced by an appointed tax equalization and review commission. Members of that commission have a full time duty of hearing taxpayer appeals and reviewing county efforts to meet statewide equalization standards. For a brief period, state agency administration of property valuation in counties was implemented. This effort, involving nine counties for a period of several years, has since been repealed.

The Tax Modernization Committee requested a review of the statistics cited by Syracuse, and the current practices of counties. (This will be the subject of a separate report.) In general, we can report that these measures have improved, with more counties achieving the statistical results recommended by the Syracuse authors.

Syracuse authors recommended against adopting certain property tax reforms or policies. These included classification or preferential assessment practices, which they believed violated principles of tax fairness and distorted the economics of taxpayer decision making. They suggested full market value assessment remain a standard, including for agricultural land. They suggested annual review of assessment practices compliance be instituted, which has been done.

The authors recommended repeal of tax rate limits, including the constitutional limit imposed on county governments. They also recommended repeal of city government tax rate limits, or simplification of these limits with an aid program to mitigate impacts on low capacity governments.

Syracuse authors noted that schools faced no levy limits in 1987, although they were the largest user of the property tax. Schools, like all other governments in Nebraska, had levy or rate limits from the time they were originally authorized by legislation. School levy limits for all schools were removed in the early 1950's. This was done as an alternative to providing greater state aid or revenue sharing for schools. A state aid to local schools program funded by a statewide property tax began in 1907, and was based on an equalizing of capacity and needs concept. This program was defunded in 1952. Levy limits were removed at that time as an alternative to a greater state role in providing funding. A prohibition against a state government property tax, if a state sales or income tax was to be imposed, was also added to the Constitution in 1954. School consolidation committees and studies were also mandated at that time. Between that period of time, and the 1987 Syracuse recommendation for a school consolidation effort, the number of independent school districts dropped from over 7000 to the 900 examined by Syracuse authors.

In 1998, the Legislature renewed tax rate limits for schools, and dramatically reduced city tax rate limits. The county government constitutional fifty cent limit, which was established by a 1919 constitutional convention, was left intact. Counties were required to allocate levy authority to other county subdivisions like fire districts and townships under a modification of statutory county levy limits. Lower city levy limits imposed were accompanied by a larger commitment to city aid. School levy limits were imposed with an increased commitment to school aid. All three levy limit changes were implemented with revisions to aid programs which addressed high local rates due to low property tax fiscal capacity.

Finally, the Syracuse authors recommended the development of more detailed information on the finances of local governments. They suggested the state invest more heavily in this effort. In 1998, efforts to improve reporting were instituted in the State Auditor’s office. A similar effect was made for the school annual financial reporting system maintained by the Department of Education. An on line data report on city and county finances was the result, for both budgeted and audited data. This was done as a feature of implementing local budget, tax rate and revenues limits. Syracuse authors did not recommend budget or receipt growth limits, except in the year of transition to greater state revenue support to substitute for property tax use.

<u>Characteristics.</u> In examining Nebraska’s state and local tax system the Tax Modernization Committee examined several reports on tax policy principles, and the policy recommendations made by analysts that have examined tax systems in the context of these principles.

One report reviewed early in the Committees working session is titled *“Characteristics of a Balanced and Moderate State-Local Revenue System*, by Robert J. Kleine and John Shannon. This work, written in 1986, describes some general policy principles, and characteristics, which policymakers should consider.

A major emphasis of these authors was the need for balance in use of taxes of different types. This observation is based on the idea that each method or means of taxation contains weaknesses or flaws. Overuse, or higher than average use, of a particular tax type may emphasize its flaws. The authors suggested a broad guideline for percentage shares of total state and local tax used, with major taxes representing approximately equal shares of the total of state and local taxes. In their view, property taxes should represent no more than 30% of the total taxes used in a state and local tax systems. Income and sales taxes, in their view, should each represent between 20 and 30 % if the total taxes.

Other tax types, such as special excise taxes, like motor fuel and tobacco products would make up the remainder of the system. In some states, energy severance taxes would represent a significant share of these other taxes. At the point the authors wrote this article, Census Bureau data suggested that average state use of the property tax was just over 30%. At that same point in time, Nebraska’s use of the property tax was over 40%, a fact which was suggested as a problem in the Syracuse Tax Study commissioned by the Nebraska Legislature.

The authors of both these reports suggested that in regard to the property tax, states would be best advised to focus on reduced use of the tax accomplished using relief mechanisms that relied on providing statewide collected resources like sales or income taxes distributed to local property taxing governments. In Kleine and Shannon’s view, the state, with sales and income tax resources, should be the larger contributor to the funding of services like education and health care. They stated the policy framework in these terms. “If the state prefers a more decentralized fiscal approach, it can share, unconditionally, a substantial part of its revenues with its localities on an equalizing basis. It should also be noted that local revenue diversification stands out as the preferred way to keep property tax at reasonable levels if local political accountability is favored over inter-local fiscal equalization.

Achieving balanced shares tax use can be established as a tax policy goal. Nebraska currently makes use of a lower level of property taxes as a share of total taxes than it did 30 years ago when these two reports were written. The share reported here, 37%, is higher than the national or regional average, although the gap has narrowed over this same period. This is a result of increased state to local revenue sharing in Nebraska, and recent trends in other states of increasing shares of property tax use. Property taxes have increased faster during the past ten years as an outgrowth of the housing boom, and the income and sales tax shares have become smaller as the economy has slowed dramatically in the wake of a national and international recession driven in large part by the housing sector financial meltdown.

Over the past 40 years state policymakers throughout the nation have responded in a variety of ways to concerns about rising property taxes. Much of this response was generated by the implementation of Proposition 13 in California and a similar limitation passed in Massachusetts in this period. The ways of responding have included increased use of classification, or value preferences for the residential class of property. Limitations on local spending, tax rates, and tax revenue growth have become widespread. Defacto classifications or value preferences have emerged or been the result of class or parcel specific valuation growth limits.

In the case of agricultural land, methodologies that avoid use of real estate market values in favor of commodity prices and derived capitalization rates have been developed to set value. The consequences of the latter approach have become evident in those states, like Iowa, where commodity price increases have driven value increases at a rate that match or even exceed the real estate market derived value growth.

Strategies or policies for structuring a tax system that experts view as effective are those that create a minimum of distortions in a market economy. Policies that lead taxpayers and policymakers down a path which requires constant adjustment or readjustment to changing political circumstances are generally not recommended. Stability in tax policy is highly valued.

Nebraska's property tax policy provides a stable and broad base which responds to economic growth. The impact of this tax on the economy of a place, and its public services, can be controlled and guided by local officials. State policies which take into account and compensate for relatively lower capacity to deliver public services can assure access to adequate services throughout the state, while avoiding excessive tax rate burdens on any one area.

<u>Recommendations from Citizens Participating in Public Hearings.</u> Over 1000 persons attended hearings of the Tax Modernization Committee. Testimony was taken from over 250 persons. Property tax issues were the main focus of a majority the testifiers.

The testimony on property taxes focused on these policy issues:

- Rates of growth in property tax that exceeded growth in annual household income.
- Valuation practices that were viewed as inaccurate.
- High rates of growth in taxable values for agricultural land.
- State government mandates that shift costs to local property tax governments.
- Reductions in state aid that shift local government to rely on other revenue sources including sales tax, occupation taxes, inheritance taxes and user fees.

a. Property Tax
iv. Findings

1. Nebraska makes greater use of the property tax to fund public services than other states in the nation or region. Achieving the same average balance of sources in the region or nation would require a 200 to 300 million dollar shift and reduction in use of property tax;

2. Nebraska property tax effective rates on residential and agricultural property are higher than averages for the nation or the region. This is largely due to valuation preferences for these property types found in other states, including the majority of states in our border region;

3. Property tax effective rates for agricultural land owners are 150% to 300% higher than the level of effective rates in 3 other border states. Property tax effective rates for residential property owners exceed the national average by 44%. Property tax effective rates on urban commercial properties exceed the national average by six percent;

4. Nebraska property tax burdens on household income are <u>below</u> national average levels for low and moderate income households. These amounts are 5 to 10% <u>higher</u> than average for higher income households;

5. Nebraska policies to shield low income elderly and disabled households from high property tax rated and burdens on income are effective and useful. House value levels are indexed to county averages. House value levels for inclusion in the program have been revised in recent years. Income guidelines established 10 years ago have been indexed to inflation;

6. Nebraska's property tax credit against valuation for all property owners is losing its effectiveness to reduce property taxes. This occurs as the level of state funding is frozen, while value continues to rise. Defunding the credit system would raise effective property tax rates and tax burdens on property owners. As presently structured the credit reduces property tax rates and burdens by 3% in for most urban property owners, and 4% for most rural property owners;

7. Nebraska's property tax revenue growth has exceeded the rate of other tax receipts growth in a recent time period when income and sales tax growth has slowed due to two successive recessions. Property tax growth in Nebraska is lower than that found nationally. It exceeds growth in the economy, as measured by personal income;

8. The quality of property tax valuation practice has improved since the Syracuse tax study was published in 1987; and

9. The primary policy option for reducing property tax use recommended by the Syracuse Tax Study was increased aid to local governments, emphasizing equalization aid for local governments. This was to supplement the then existing aid programs, which had been implemented to offset loss of property tax capacity from prior exemptions granted. The recommendation was implemented in part. The preexisting aid programs which Syracuse recommended retaining have been repealed.

III. OBSERVATIONS AND FINDINGS

b. Income Taxes

i. Nebraska's Individual Income Tax: Building the Base

Nebraska collected more than $2.0 billion in individual and corporate income taxes during fiscal year 2011-12. It is the largest of all state or local taxes. By comparison, the next largest tax is the sales tax, which totaled just under $1.9 billion. Individual income taxes accounted for $1.8 billion and corporate income taxes totaled just over $234 million.

The Nebraska income tax began in 1968 as we were 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 annually in "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.[3]

Most states now use federal adjusted gross income ("AGI") as the starting point for calculating state income taxes. The federal return starts with gross income which includes:

- Wages, salaries, tips, etc.
- Taxable Interest
- Ordinary Dividends
- Taxable refunds, credits, or offsets of state and local income taxes
- Alimony received

[3] 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.

- 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

The Characteristics authors note that state income tax systems should have a broad base in order to keep rates low, a generally accepted economic theory for all taxes, not just income taxes. Accordingly, the items of income that go into the base are important, just as are the items of income that are excluded or deducted from the base.

Exclusions are those items of income that are not included in the definition of "gross income." Deductions are those items that are allowed to reduce gross income. Many of those exclusions and deductions occur at the federal level and are frequently referred to as "above the line" because they are excluded before arriving at federal AGI, the starting point for most state income tax systems.

It is important to note at this juncture that one of the major reasons for decoupling from the old federal system (in addition to the drastic revenue losses) was that it gave states more control over their own tax base. Above the line deductions, however, are still outside the control of states, and so to a certain extent, most states still do not completely control their own tax base.

Some items that are excluded from federal gross income include:[4]

• Employer-sponsored health insurance	$248B[5]
• Net pension contributions and earnings	$137B
• Capital gains on assets transferred at death	$43B
• % of Social Security and RR Retirement	$33B

Deductions are allowed for items such as:

• Educator expenses	
• Certain business expenses	
• Health savings account deductions	$1.88B
• Moving expenses	
• Deductible portion of self-employment tax	
• Self-employed SEP, SIMPLE, and qualified plans	$15.03B
• Self-employed health insurance deduction	
• Penalty on early withdrawal of savings	
• Alimony paid	
• IRA deduction	$12.84B
• Student loan interest deduction	$1.4B
• Tuition and fees	
• Domestic production activities deduction	

As a result, states that use federal AGI as their starting point then make numerous other adjustments to either add back exclusions and deductions taken for federal purposes or to allow more deductions and credits at the state level. Most states have common adjustments for items such as Social Security income, itemized deductions, own-state municipal bond interest and others. Nebraska's deductions include:

[4] Congressional Budget Office 2013 estimates
[5] Single largest tax expenditure in the federal individual income tax code = 1.5% of federal GDP

- 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

Most states then allow refundable or non-refundable (or both) credits against state income tax liability. The most common credits are:[6]

Credit for taxes paid to other states .... 42 states
Child/dependent care .... 24 states
Earned income tax credit* .... 22 states
Elderly/disabled .... 18 states
Property tax/rent/homestead** .... 18 states
Low-income... 17 states

*Does not include working family credits in Minnesota and New Mexico, or the earned income tax credit in Washington State, which does not have a state income tax.
**In some cases, states counted in this category provide such credits only for elderly or disabled individuals.

Nebraska's credits are:

- 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
- Nebraska Incentive Programs
- Credit For Child/dependent Care

[6] From *Individual Income Tax Provisions in the States*, Prepared by Rick Olin and Sandy Swain, Wisconsin Legislative Fiscal Bureau 2013.

- Beginning Farmer Credit
- Earned Income Tax Credit ("EITC")
- Angel Investment Credit

Some of Nebraska's largest tax expenditures include:[7]

• Nebraska Itemized Deductions	$252,000,000
• Nebraska Standard Deduction	$187,700,000
• Nebraska Personal Exemption Credit	$171,000,000
• Interest and dividends on U.S. Obligations	$45,300,000
• Non-Nebraska S Corp Income/Loss	$45,000,000
• Foreign Income Taxed Above Max Fed Rate	$39,100,000
• Credit for Tax Paid to another State	$39,000,000
• Earned Income Credit	$29,000,000
• Net Operating Losses	$27,100,000
• Special Capital Gains and Dividend Exclusion	$26,000,000
Total	$861,200,000

Tax Brackets and Rates. Once the base is established, Nebraska net taxable income is calculated and taxed according to the bracket and rate system established by law. The brackets segregate income from the first dollar of taxable income into four groups or bands of income. Each bracket has a progressively higher rate at which the band of income is taxed. Once income exceeds the threshold for the fourth bracket, all income above that amount is taxed at the highest marginal rate.

[7] Nebraska Department of Revenue 2012 Tax Expenditure Report

State law sets the brackets and rates as follows for the years indicated:

Income Tax, Chart 1

	2012 Brackets			
Bracket Number	MFJ	HOH	Single	Marginal Rate
1	$0-4,800	$0-4,500	$0-2,400	2.56%
2	4,800-35,000	4,500-28,00	2,400-17,500	3.57%
3	35,000-54,000	28,000-40,000	17,500-27,000	5.12%
4	Over 54,000	Over 40,000	Over 27,000	6.84%

	2013 Brackets			
Bracket Number	MFJ	HOH	Single	Marginal Rate
1	$0-4,800	$0-4,500	$0-2,400	2.46%
2	4,800-35,000	4,500-28,00	2,400-17,500	3.51%
3	35,000-54,000	28,000-40,000	17,500-27,000	5.01%
4	Over 54,000	Over 40,000	Over 27,000	6.84%

	2014 Brackets			
Bracket Number	MFJ	HOH	Single	Marginal Rate
1	$0-5,999	$0-5,599	$0-2,999	2.46%
2	6,000-35,999	5,600-28,799	3,000--17,999	3.51%
3	36,000-57,999	28,800-42,999	18,000-28,999	5.01%
4	Over 58,000	Over 43,000	Over 29,000	6.84%

Basic Liability. Most Nebraskans earn enough income to require the filing of a state income tax return. Most single filers will begin paying Nebraska income tax when their income is in the $15,000 - $20,000 range. For married filing joint taxpayers, the threshold is $30,000 - $35,000. The exact threshold depends on the amount of deductions and exemptions that may apply.

In general, a federal and Nebraska return are due if:

- You are a Single Filer under age 65 and earned $9,750
- You are a Single Filer age 65 or over and earned $11,200
- You are a Married Filing Joint Filer under age 65 and earned $19,500; or
- You are a Married Filing Joint Filer age 65 or over and earned $21,800.

If taxpayer AGI is more than $713,650 for married filing joint, $173,650 single or $86,825 if married filing separately, Nebraska "recaptures" the benefit of the lower tax rates and brackets. This is known as the Nebraska Additional Tax.

b. Income Taxes

ii. The Syracuse Study.

Nebraska was in the process of decoupling from the percentage of federal liability system when the Syracuse Study was conducted. Therefore, there were no specific recommendations. Rather, the researchers compared the old "coupled" system with the transition to the "reformed" system used today. They assessed the impact of the new system by comparing the distribution of effective state personal income tax rates – also referred to as tax burdens – by income decile for the coupled and new systems.[8]

The study did reach two major conclusions from the analysis. The first conclusion was that tax burdens under the new system were less progressive than under the coupled system. In other words, the burden of the income tax shifted to lower income taxpayers under the new system for both 1987 and 1991 (when the reform was fully implemented).

[8] See Appendix.

The second conclusion was the new system promoted greater "horizontal equity," which means similarly situated taxpayers were treated more equally under the new system. The tax liabilities became more uniform *within* income deciles than they were under the coupled system. However, there was less horizontal equity in low-income classes than in high-income classes under both systems, due primarily to wide variations in taxable and non-taxable income sources, capital losses, and in the number of dependents in the lower income groups. Overall, the study concluded, the progressivity of the state personal income tax had decreased while also increasing its horizontal equity.

One model used in the study increased the standard deductions and personal exemptions to federal levels and increased tax rates proportionally to hold the revenue generated from the tax at a constant amount. That model concluded that this lead to lower effective tax rates (tax burden) for taxpayers in the first eight income deciles and to slight increases in the effective tax rates in the two upper income deciles. This approach would offset the regressive nature of decoupling from the old system and make Nebraska's new system more progressive.

The study concluded that due to both the federal and state changes, the highest marginal rate has been lowered and the number of rates had decreased. Different types of income were now more equally treated than before and the new system decreased some of the economic distortions created by any tax system. "In effect, the system is benefitted by increased efficiency." The cost of that efficiency gain was that the system had become more regressive. Potential methods to address this were modeled which included:

- Increased deductions for the elderly and the blind;
- Increases in the standard deduction to benefit lower income households; and
- Creating an additional top tax bracket that could be adjusted as necessary.

b. Income Taxes
iii. Review and Comparison

The Syracuse Study. In the intervening decades since the Syracuse Study, Nebraska has made many changes to its income tax, although it retains the general characteristics of the reformed system. In comparison to the observations and conclusions of the Syracuse Study, several observations may be made. The first is with regard to tax burden.

The Nebraska Department of Revenue conducts a Tax Burden Study every two years by law. The most recent study, released in November 2013, calculates the "Nebraska Effective Tax Rate" or the "Tax Burden Index":

Income Tax, Chart 2

	Effective Tax Rate					Nebraska Tax Burden Index				
Tax Year	First 7 Deciles	8th Decile	9th Decile	10th Decile	Top 500 Returns	First 7 Deciles	8th Decile	9th Decile	10th Decile	Top 500 Returns
2010	1.62	2.98	3.61	4.58	3.26	0.49	0.90	1.09	1.38	0.98
2009	1.55	2.89	3.51	4.63	3.75	0.48	0.89	1.08	1.42	1.15
2008	1.67	2.92	3.52	4.63	3.62	0.50	0.88	1.06	1.39	1.09
2007	1.67	2.90	3.51	4.54	3.22	0.50	0.87	1.05	1.36	0.96
2006	1.75	3.05	3.64	4.57	3.51	0.51	0.89	1.07	1.34	1.03
2005	1.94	3.07	3.69	4.78	3.55	0.55	0.87	1.04	1.35	1.00
2004	1.92	3.02	3.64	4.79	3.70	0.55	0.86	1.04	1.37	1.06
2003	1.91	2.94	3.54	4.72	3.52	0.56	0.86	1.04	1.38	1.03
2002	1.86	2.79	3.36	4.48	3.30	0.57	0.86	1.03	1.37	1.01
2001	1.93	2.83	3.40	4.53	3.45	0.58	0.85	1.02	1.36	1.04
2000	1.94	2.87	3.44	4.46	2.84	0.58	0.85	1.02	1.33	0.85
1999	1.86	2.82	3.37	4.55	3.30	0.56	0.84	1.01	1.36	0.98
1998	1.81	2.72	3.27	4.33	2.67	0.56	0.85	1.02	1.35	0.83
1997	1.70	2.52	2.99	4.04	3.12	0.57	0.85	1.01	1.37	1.05
1996	1.97	2.77	3.27	4.68	3.89	0.58	0.82	0.97	1.39	1.15
1995	1.91	2.70	3.18	4.42	2.84	0.59	0.84	0.99	1.37	0.88
1991[9]	0.99	2.12	2.30	3.01	3.84[10]					

[9] This line does not appear in the Department's report. It was added by the authors and represents the Tax Burden calculated in the Syracuse Study for tax year 1991.

[10] Syracuse did not calculate the effective rate for the top 500 returns but it did determine the effective rate for the top one percent of taxpayers with comprehensive income exceeding $97,226.

One of the observations drawn from the report states:

Reading down the columns of the Nebraska burden index, we can see that the index has generally decreased for the bottom seven deciles since 1995. A possible explanation for the decrease in the burden index is because AGI for the higher income group grew more rapidly compared to the lower AGI group. Note that the index for the top 500 returns is lower than the index for the top decile as a whole. The same is true for the effective tax rate on the left side of Table 13. A possible explanation for this apparent exception to the general progressivity of Nebraska's income tax code was mentioned above. The top 500 resident returns are much more likely to report pass-through income from business investment. Therefore, taxpayers are also much more likely to report large amounts of capital gains from the sale of businesses or business assets. In addition, these taxpayers are also more likely to have benefited from Nebraska's economic development programs – including the Employment and Investment Growth Act (LB 775) and the Nebraska Advantage Act (LB 312) – reducing tax liability for individuals.[11]

The three stated conclusions from the Syracuse Study again were to:

- Increase deductions for the elderly and the blind;
- Increase the standard deduction to benefit lower income households; and
- Create an additional top tax bracket that could be adjusted as necessary.

As the Syracuse Study indicated in their modeling, increasing the standard deductions and personal exemptions to federal levels would lead to lower effective tax rates (tax burden) for taxpayers in the first eight income deciles and to slight increases in the effective tax rates in the two upper income deciles. This approach was suggested as a method to offset the regressive nature of decoupling from the old system and make Nebraska's new system more progressive.

Nebraska has in fact increased the standard deduction and deductions for the elderly and the blind. Nebraska's system allows for the following:

[11] Burden Report at page 23.

1) A personal exemption credit set at $88 in 1998, which is indexed for inflation each year, multiplied by the number of exemptions claimed on the federal return; the credit for 2012 was $123;

2) A standard deduction is allowed for non-itemizers but is the lower of, not the higher of, the federal deduction or the Nebraska amount (i.e., it is not as generous as the federal deduction);

3) A choice between federal itemized deductions (minus the federal deduction for state or local income taxes) or the Nebraska amount, whichever is greater (as generous as the federal deduction); and

4) Additional federal standard deduction amounts because of age or blindness.

As of January 1, 2007, the standard deduction amounts, including the additional standard deduction amounts, are indexed for inflation.

Review and analysis of this data in comparison to the Syracuse Study would indicate that Nebraska's income tax system has remained fairly constant in its distribution of the tax burden across income sectors. The system maintains its balance between progressive and regressive outcomes by indexing exemptions and deductions for inflation and by refraining from large adjustments to the rates or brackets.

One area where Nebraska does not index for inflation, however, is in the income bands of the brackets. While modest adjustments have been made a few times (most recently under LB970, 2012, which adjusts the income bands beginning on January 1, 2014), the income bands have not kept pace with inflation. This is one area of concern that is addressed further below.

<u>The D.C. Burden Study</u>. Another measure of comparison regarding tax burden is the D.C. Study which as mentioned previously has been published since 1995 and compares household tax burdens for the largest city in each of the fifty

states. For income tax purposes, the burden is expressed as a dollar amount and also as an effective tax rate on income. The burden is calculated for a hypothetical family of three in each of five income brackets and as a combined total for all brackets.

For our comparison, we selected each of Nebraska's neighboring states. Notably, neither South Dakota nor Wyoming have an income tax.

Income Tax, Chart 3: Income tax burden as liability per largest city, Nebraska and neighboring states.

CITY/STATE	**$25,000 AGI**	**$50,000 AGI**	**$75,000 AGI**	**$100,000 AGI**	**$150,000 AGI**	**COMBINED**
DENVER, CO	$39	$989	$2,058	$3,143	$5,358	$11,587
WICHITA, KS	$-	$1,007	$2,443	$3,916	$6,996	$14,362
DES MOINES,IA	$203	$1,011	$2,226	$3,530	$6,034	$13,004
K.C.MO	$248	$1,427	$2,698	$3,538	$7,142	$15,569
OMAHA,NE	**$-**	**$806**	**$2,003**	**$3,584**	**$6,825**	**$13,218**
SIOUX FALLS,SD	$-	$-	$-	$-	$-	
CHEYENNE,WY	$-	$-	$-	$-	$-	

Income Tax, Chart 4: Income tax burden as percent of income per largest city, Nebraska and neighboring states.

CITY/STATE	**$25,000 AGI**	**$50,000 AGI**	**$75,000 AGI**	**$100,000 AGI**	**$150,000 AGI**
DENVER, CO	0.2%	2.0%	2.7%	3.1%	3.6%
WICHITA, KS	0.0%	2.0%	3.3%	3.9%	4.7%
DES MOINES,IA	0.8%	2.0%	3.0%	3.5%	4.0%
K.C.MO	1.0%	2.9%	3.6%	4.1%	4.8%
OMAHA,NE	**0.0%**	**1.6%**	**2.7%**	**3.6%**	**4.6%**
SIOUX FALLS,SD	0	0	0	0	0
CHEYENNE,WY	0	0	0	0	0

As can be seen from the data, Nebraska has neither the highest nor the lowest income tax burden as compared to its neighboring states. Denver and Des

Moines are slightly lower and Wichita and Kansas City are slightly higher. The observation may be made that Nebraska compares favorably with its neighboring states that impose an income tax in terms of tax burden or effective tax rate.

<u>Characteristics</u>. Authors Kleine and Shannon emphasize six values relative to the income tax for analysis and comparison purposes:

1) A personal income tax should provide 20-30 percent of all state-local revenue;

   Nebraska's individual income tax, while being the largest single source of general fund revenue, comprised 20.6 percent of total state and local taxes based on 2010 Census data. The national average use of individual income tax was 20.5 percent.

2) The rates of an income tax should not be markedly higher than rates in surrounding areas;

   As noted previously, Nebraska's effective tax rate or tax burden compares favorably with its neighbors. The marginal rates, however, continue to be an issue of contention amongst policy makers in the state. Nebraska's highest marginal rate is 6.84%. The following chart shows the lowest and highest marginal rate for Nebraska and its neighboring states:

Income Tax, Chart 5

State	Lowest marginal rate	Highest marginal rate	Number of Brackets
Colorado	4.63% Flat Rate	4.63% Flat Rate	
Iowa	0.36%	8.98%	9
Kansas	3.00%	4.90%	3
Missouri	1.50%	6.00%	10
Nebraska	2.56%	6.84%	4
South Dakota	No Tax		
Wyoming	No Tax		

Nebraska's marginal rates are the second highest in the region of the states that impose an income tax. Nationally, Nebraska has the 19th highest top marginal rate as can be seen in Table 5 of the Wisconsin Study.

Kleine and Shannon note in particular that "There has been rethinking of the advantages of graduated income taxes in recent years…High marginal tax rates generally are viewed as detrimental to economic growth because they discourage saving and reduce the incentive to work. The high elasticity of the graduated income tax no longer is considered a clear advantage, because it can permit excessive increases in government spending. The new view is that revenue growth should not outpace economic growth."

Two observations may be made with regard to Nebraska's rates. One is that the highest marginal rate is very high in comparison to our neighboring states and relatively high in comparison to all states. The second observation is that while the top marginal rate is high, the effective rate or tax burden is comparable to other states, both regionally and nationally. Accordingly, this is a policy matter for further analysis and discussion.

It is also worth noting the authors' statement regarding elasticity of the income tax (how well it expands or contracts in comparison to economic conditions). Because the income tax is highly responsive to both upticks and downturns in the economy, it does generate more revenue during economic boon times. This in turn can lead to what the authors' term "excessive increase in government spending." In Nebraska's case, those additional revenues that exceed the official forecast are directed to the Cash Reserve or "Rainy Day" Fund.

3) Personal exemptions or credit should be at least as generous as the federal exemptions;

As noted previously, Nebraska's exemptions and credits are in some cases (e.g. itemized deductions, additional deductions for the elderly and the blind, etc.) at least as generous as the federal, but not in all cases, such as the standard deduction.

4) The number of deductions should be minimized to avoid narrowing of the base;

   As discussed above, Nebraska's base has been narrowed to some degree due to the number of deductions and credits that are allowed. In comparison to other states, Nebraska does not have an excessive number of deductions and credits but they are clearly being utilized, as borne out by the effective tax rates. One observation that may be made is that Nebraska's base has become too narrow and could be expanded by eliminating some deductions and credits which could then be used to reduce the marginal rates proportionately.

5) Income taxes should be indexed to avoid unlegislated tax increases;

   Nebraska has never indexed the individual income tax brackets for inflation. As a result, there is a hidden tax increase each year due to "bracket creep." Adjusting the brackets for inflation helps to maintain the progressive aspect of the relationship between the rates and personal income. In the example below, 1993 brackets are shown, followed by actual 2012 brackets and then by 2012 brackets that have been inflation adjusted back to 1993. The fiscal analysis was provided by the Nebraska Department of Revenue.

   As measured by comparison to inflation, the brackets lag personal income growth by nearly 40 percent. The estimated fiscal impact to adjust the brackets from 1993 to 2012 is $215 million.

Income Tax, Chart 6

	1993 Brackets			
Bracket Number	MFJ	HOH	Single	Marginal Rate
1	$0-4,000	$0-3,800	$0-2,400	2.62%
2	4,000-30,000	3,800-24,000	2,400-17,000	3.65%
3	30,000-46,750	24,000-35,000	17,000-26,5000	5.24%
4	Over 46,750	Over 35,000	Over 26,5000	6.99%

	2012 Actual Brackets			
Bracket Number	MFJ	HOH	Single	Marginal Rate
1	$0-4,800	$0-4,500	$0-2,400	2.56%
2	4,800-35,000	4,500-28,00	2,400-17,500	3.57%
3	35,000-54,000	28,000-40,000	17,500-27,000	5.12%
4	Over 54,000	Over 40,000	Over 27,000	6.84%

	2012 Indexed Brackets			
Bracket Number	MFJ	HOH	Single	Marginal Rate
1	$0-7,700	$0-6,050	$0-3,850	2.56%
2	7,700-54,400	6,050-38,400	3,850-27,200	3.57%
3	54,400-84,800	38,400-56,000	27,200-42,000	5.12%
4	Over 84,800	Over 56,000	Over 42,000	6.84%

With the passage of LB970 (2012), the brackets will be adjusted for tax years beginning on or after January 1, 2014, as shown below. However, the brackets are still not fully adjusted. Over time, the rates tend to look more like (and act more like) a flat rate system, because the highest marginal rate applies to income thresholds that do not accurately reflect personal income growth. As Kleine and Shannon observed, when the top marginal rate begins at a relatively low level of income, the benefits of a graduated rate system are significantly reduced and the system functions more like a flat rate tax with a high rate. Adjusting the brackets helps preserve the benefits of a graduated rate, that is, tax fairness and adequacy.

Income Tax, Chart 7

	2013 Actual Brackets			
Bracket Number	MFJ	HOH	Single	Marginal Rate
1	$0-4,800	$0-4,500	$0-2,400	2.46%
2	4,800-35,000	4,500-28,00	2,400-17,500	3.51%
3	35,000-54,000	28,000-40,000	17,500-27,000	5.01%
4	Over 54,000	Over 40,000	Over 27,000	6.84%

	2014 Actual Brackets			
Bracket Number	MFJ	HOH	Single	Marginal Rate
1	$0-5,999	$0-5,599	$0-2,999	2.46%
2	6,000-35,999	5,600-28,799	3,000--17,999	3.51%
3	36,000-57,999	28,800-42,999	18,000-28,999	5.01%
4	Over 58,000	Over 43,000	Over 29,000	6.84%

Adjusting the brackets for inflation is recommended, beginning in tax year 2014 and going forward. The estimated fiscal impact from the Department of Revenue is actually neutral, given the combination of LB970 and inflation indexing, for the first two fiscal years. The estimate is that FY2013-2014 would see a reduction of $11 million while FY2014-15 would generate an increase in revenue of the same amount. The estimated fiscal cost for FY2015-16 is $141,000. It can be assumed that the cost of indexing will rise each year.

6) Income tax proceeds should be shared with local units of government or they should be imposed at the local level.

Nebraska has never authorized the imposition of a local income. In those states that do impose one (e.g. Maryland and Ohio) the local income tax liability is a percentage of state liability. This is not option that is currently being considered. For a more detailed analysis of the revenue sharing aspect of this value, please see the Property Tax section of this report.

b. Income Taxes

iv. Social Security Income and Other Retirement Income

Social Security and the Internal Revenue Code. Under federal tax law, a two-tiered taxation scheme was established for social security benefits. Taxpayers receiving benefits must first calculate what is known as "provisional income" to determine whether any of their benefits are taxable, and if so, to what extent. Provisional income is one-half of social security plus federal AGI, tax-exempt interest income, and amounts earned in a foreign country, U.S. possession, or Puerto Rico that are excluded from gross income.

If a taxpayer's provisional income does not exceed a base amount, no social security benefits are subject to tax. The base amounts are $25,000 for single taxpayers, $32,000 for married couples filing a joint return, and zero for married couples filing separate returns.

If provisional income exceeds the base amounts, the taxable portion of social security is the lesser of: (a) 50% of net social security benefits; or (b) 50% of the amount by which provisional income exceeds the base amount.

A second tier was established under the federal Revenue Reconciliation Act of 1993, effective with tax year 1994, for taxpayers with provisional income in excess of a second set of base amounts: $34,000 for single taxpayers and $44,000 for married taxpayers filing jointly. For taxpayers with provisional income above these higher thresholds, the taxable portion of social security payments is the lesser of: (a) 85% of net social security benefits; or (b) the amount included under the old law (not to exceed $4,500 for single taxpayers or $6,000 for married-joint taxpayers) plus 85% of the excess of provisional income over the higher income thresholds. Married taxpayers who file separate returns are taxed on the lesser of 85% of social security or 85% of provisional income.[12]

---

[12] From *Individual Income Tax Provisions in the States*, Prepared by Rick Olin and Sandy Swain, Wisconsin Legislative Fiscal Bureau 2013.

The IRS has simplified the calculation of provisional income to a worksheet which is included in the Appendix.

<u>State Treatment.</u> 30 states exempted social security income from taxation in 2011. Iowa recently completed a phased approach to exempt social security income. A total of fourteen states taxed social security benefits to some extent: eight states followed current federal practice and taxed up to 85% of benefits; and six states provided their own taxation scheme. Nebraska is one of the eight states that follows federal treatment.

Nebraska taxation and exclusion of social security benefits are quantified in the table below reproduced from the Department of Revenue report, Nebraska Statistics of Income 2013, using 2011 data:

Income Tax, Chart 8

Federal AGI Amount	# Of Returns with Soc.Sec. Income	**Amount of Total Benefits**	# Of Returns with Taxable Soc.Sec. Income	**Amount of Taxable Benefits**
<0-0	5,020	85,405,000	20	116,000
>0-5	10,470	155,160,000	50	143,000
>5-10	13,120	210,070,000	150	669,000
>10-15	15,040	253,522,000	410	981,000
>15-20	12,720	219,253,000	3,640	3,794,000
>20-25	10,190	182,862,000	7,630	13,338,000
>25-30	8,740	160,052,000	8,210	24,960,000
>30-40	13,970	258,673,000	13,940	74,552,000
>40-50	11,440	209,097,000	11,440	104,276,000
>50-75	23,710	447,029,000	23,700	329,299,000
>75-100	14,920	323,434,000	14,910	272,680,000
>100-200	14,070	339,712,000	14,070	288,576,000
>200-500	3,100	83,604,000	3,100	71,059,000
>500	710	20,860,000	710	17,730,000
Total	157,210	**2,948,734,000**	101,980	**1,202,143,000**

Other Retirement and Pension Income. In 2011, many states provided state tax exclusions for other forms of retirement and pension income. Table 2 of the Wisconsin Study[13] summarizes the basic exclusion amounts for the various types of retirement income in each state. The amounts shown in the table are the maximum exclusions per person, and, in some cases, may be reduced by social security and railroad retirement benefits or may be phased out at higher income levels. When two figures are indicated, the exclusion provided is based on a factor such as age or disability level. "State calculation" indicates that the exclusion is limited by additional factors. For example, some states limit the exclusion based on the source of the income, the date of retirement, the age of the taxpayer, or the taxpayer's total income. Federal law prohibits states from taxing railroad retirement benefits.[14]

Numerous testifiers encouraged the Committee to exempt all or some portion of not only Social Security income, but all forms of retirement income. Military retirement income was of particular interest to many. Several bills have been introduced in the Legislature to move in this direction. Testimony focused on comparisons with surrounding states that exempt some or all forms of retirement income and, of course, South Dakota and Wyoming, which have no personal income tax. Comparison to neighboring states that do impose an income tax include:

Colorado – Provides a subtraction from taxable income for "Pensions and Annuities" for taxpayers to the extent they were included in federal taxable income for:

- Age 55 but under age 65, the smaller of $20,000 or the amount of federally taxable pensions or annuities; or
- Age 65 and older, the smaller of $24,000 or the amount of federally taxable pensions or annuities.

[13] See Appendix.
[14] Individual Income Tax Provisions in the States, Informational Paper 4, Wisconsin Legislative Fiscal Bureau, January 2013.

Spouses both receiving Social Security that file married-joint must prorate their portion of federally taxable Social Security benefits for purposes of claiming the subtraction.

“Pensions and Annuities” essentially includes all forms of retirement benefits, such as employer based, military, 401(k) type accounts, certain lump-sum distributions from profit or pension sharing plans, self-employed or IRA accounts, non-employer annuities and Social Security benefits.

Kansas – Provides an exclusion for Social Security benefits to the extent they were included in federal AGI, if federal AGI is less than $75,000.

Income from numerous types of retirement plans or annuities are also excluded to the extent included in federal AGI. These include payments from federal civil service or military retirement, several Kansas pension plans, including the Kansas Public Employees' Retirement System (KPERS), Police and Fireman, Teachers, Highway Patrol, Judges, Board of Public Utilities, annuities purchased by the State Board of Regents or Washburn University retirement and pension benefits, and certain pensions from first class cities not covered by KPERS.

Iowa – As noted previously, Iowa now fully exempts social security income from tax. In addition, an exclusion from tax is provided for up to the first $6,000 of retirement income for single filers and up to $12,000 for married filing joint.

Missouri - Provides an exclusion for Social Security benefits to the extent they were included in federal AGI, if federal AGI is less than $85,000 single or $100,000 married-joint and the taxpayer is age 62 or older. Taxpayer's that are over the thresholds may still qualify for a partial exclusion if income does not exceed the thresholds by more than 80% of taxable social security benefits. Spouses both receiving Social Security that file married-joint must prorate their portion of federally taxable Social Security benefits for purposes of claiming the subtraction.

Public pension (federal, state or local government) income is excluded, to the extent included in federal AGI, using the same thresholds, with a cap of $6,000 or 100% of the taxable pension, not to exceed the maximum Social Security benefit of $35,234. Private pensions and military pensions are also excluded but at lower thresholds for private pensions and at 45% of benefits for military pensions.

One important observation was made by Drs. Wallace and Sjoquist before the Committee. That is that many states that have exempted retirement income have been and will continue to pull back from this exemption due to demographic changes in their populations. Demographic analysis indicates that the growing population of retired taxpayers and their exempt retirement income will put increasingly difficult pressure on state budgets to maintain such exemptions.

Nebraska too could find itself in a similar fiscal situation if it begins to exempt all or a portion of retirement income as large numbers of residents retire over the next decade. It is also important to note that most retirement income is diverted to these accounts on a pre-tax basis. In other words, the taxpayer did not pay state or federal income tax on the income contributed to the retirement account. If Nebraska exempts the income when it is withdrawn from the account, the income will never have been subject to state income tax at all.

The final observation in this area is that while Nebraska currently follows federal treatment of Social Security Income, as described above, raising the provisional income thresholds for Nebraska purposes would serve to exclude more Social Security Income for low income taxpayers. Further study of any additional exemption of retirement income is recommended before proceeding any further.

b. Income Taxes

vi. Findings

1) Nebraska's top marginal individual rate is high in comparison to our neighboring states and relatively high in comparison to all states. While the top

marginal rate is high, the effective rate or tax burden is comparable to other states, both regionally and nationally, as Nebraska taxpayers benefit from the use of credits and deductions;

2) Nebraska does not index the individual income tax brackets for inflation. As a result, there is a hidden tax increase each year due to "bracket creep;"

3) Nebraska is one of eight states that generally do not exempt any portion of retirement or pension income. Demographic analysis indicates that the growing population of retired taxpayers and their exempt retirement income will put increasingly difficult pressure on state budgets to implement and maintain such exemptions.

4) Nebraska is one of eight states that follows Federal rules regarding taxation of Social Security Income. Federal provisional income thresholds have not kept pace with personal income. Since Nebraska follows Federal practice, it taxes some Social Security Income at these low-income levels.

b. Income Taxes

v. Nebraska's Corporate Income Tax: Building the Base

Like most states again, Nebraska looks to the federal return for its starting point to calculate the corporate income tax. Federal Taxable Income is that starting point. Only "C corporations" are required to file a corporate return. S corporations and other types of pass-through or flow-through entities file informational returns and a Schedule K-1: Income/Loss, which calculates the flow-through of income and losses to shareholders, partners or members proportionately and are then reported on the individual's income tax return. While banks or financial institutions are legally subject to the corporate tax and must file a return, they receive a credit against the corporate income tax for the financial institution tax or deposits tax paid.

42 of the 44 states with a corporate income tax start with federal taxable income (Arkansas and DC are the exceptions). State specific adjustments vary widely, but common adjustments are:

- Interest on government bonds
- Net operating loss
- Federal bonus depreciation allowances
  34 of 48 states decouple[15]

The federal calculation of gross income includes gross receipts or sales, minus returns, allowances and cost of goods sold. It also includes:

- Dividends;
- Interest;
- Gross Rents and Royalties;
- Capital gain/loss; and
- Other Income

The amount of exclusions or deductions from gross income are significant and include:[16]

- Officer Compensation $1.389B
- Salaries and Wages $13.834B
- Repairs and Maintenance $1.536B
- Bad Debts $0.619B
- Rents
- Taxes and Licenses $2.706B
- Interest $4.365B
- Charitable Contributions $0.114B
- Depreciation $3.599B
- Depletion $0.217B
- Advertising

[15] Source: 2013 State Tax Handbook, CCH; bonus depreciation from Ernst & Young, 2011
[16] Figures are from the Department of Revenue Tax Expenditure Report, 2005.

- Pension, Profit-Sharing and other Plans $0.777B
- Employee Benefit Plans $1.953B
- Domestic Production Deduction
- Other Deductions $31.527B
- Net Operating Loss $0.635B
- Special Deductions $0.496B

Nebraska Total $63.068B

After deductions and exclusions, you are left with federal taxable income, the starting point for the Nebraska corporate income tax calculation.

Federal net operating losses, federal capital carryover losses, state and local government interest, dividend income and other adjustments are added back to the base. Adjustments that are deducted from the base include:

- Qualified federal interest deduction
- Foreign dividends, gross-up or special foreign tax credit
- Income not subject to apportionment
  Expenses, including interest, related to above must be deducted
- Nebraska College Savings Plan
- Other Adjustments

After these adjustments you have calculated adjusted federal taxable income. Nebraska then allows a deduction for Nebraska net operating losses and capital loss carryovers. This results in net Nebraska taxable income which is then taxed in two brackets with two rates. The first $100,000 of taxable income is taxed at the rate of 5.58%. The excess above that amount is taxed at a rate of 7.81%. The resulting amount is Nebraska tax before credits. Allowable credits include:

- Insurance Premiums Tax Credit
- CDAA Credit (Community Development Assistance Act)

- Non-refundable Nebraska Incentive Credits
- Refundable Nebraska Incentive Credits
- Beginning Farmer Credit

After all credits have been applied, the final result is net Nebraska tax due.

<u>Multistate Apportionment</u>. Corporations are required to file a return in every state in which they are doing business. The definition of that standard, "doing business", varies from state to state and is a separate topic of debate and litigation. However, assuming that a corporation is doing business in more than one state, it must file returns in those states and adhere to each state's laws as to how the income is apportioned or "rationed" among the various taxing states. Under Nebraska law, corporations that are subject to tax both within and without Nebraska are required to apportion their income using what is known as the single-factor sales formula unless the Tax Commissioner has previously approved an alternative method. Corporations that are subject to tax solely in Nebraska may not apportion their income.

Historically, most states started with a three-factor general apportionment formula which included property, payroll and sales as the factors. Over the past decades, many states have changed to the single-factor sales method, like Nebraska, as a better measure of income earned in the state. Today, states lack any real consistency in how their apportionment formulas are structured. 10 states continue to use a three-factor formula. 17 states have moved to double or triple-weighting of the sales factor under the three-factor formula, again to give greater emphasis to income actually earned in the state. 20 states, including Nebraska, now use the single-factor sales approach. Nevada, South Dakota, Washington and Wyoming do not impose any type of corporate income tax.

An additional complication in corporate income tax is the combined reporting versus separate entity reporting methods. Unitary or "combined" reporting generally means that all corporations included in the federal consolidated return must combine their income and/or losses on one return. Separate reporting, conversely, means each corporation files its own return with its own income and losses. Generally the separate reporting method has proven to be more susceptible to manipulation and creation of what is known as “nowhere income” which is income that can be isolated in one corporation in a state without a corporate tax.

26 states including Nebraska now use some form of combined or “consolidated” reporting. 19 states still utilize separate reporting. 12 states proposed legislation in 2010-2012 to adopt combined/consolidated reporting, including Arkansas, Indiana, Iowa, Missouri, Michigan, and Oklahoma.

The Syracuse Study. Again there were very few recommendations or observations regarding the corporate income tax as, like the individual income tax, Nebraska was in the process of reforming the tax when the study was conducted. The only recommendation noted in the summary report was to not move to single-factor sales apportionment but rather to continue with the traditional three-factor formula, giving double weight to the sales factor.

The basis for this recommendation was that very few states had move to the single-factor approach and that “The move to such a formula introduces an unwarranted redistribution of corporate income tax burdens to out-of-state firms that sell primarily in the state of Nebraska and which have little or no property and payroll in the State of Nebraska.” Subsequently, many more states did move in this direction for the very reason cited, which is that it allows a state to tax out-of-state business more and reduces the burden on in-state businesses. In effect, you have exported a portion of your tax burden.

c. Income Taxes

vi. Corporate Income Tax Comparison and Review

43 states plus the District of Columbia have a corporate income tax. Four states tax business utilizing something other than a traditional corporate income tax:

- Michigan: Business Income Tax & Gross Receipts Tax
- Ohio: Commercial Activity Tax (a gross receipts tax)
- Texas: Margin Tax
- Washington: Business and Occupation Tax.

Corporate Income Tax, Chart 1

State	CIT per Capita	CIT per $1000 of Income	CIT as a percent of taxes
Colorado	$94.89	$2.10	4.80%
Iowa	$138.50	$3.29	5.44%
Kansas	$110.04	$2.63	4.28%
Missouri	$50.10	$1.28	2.79%
Nebraska	$126.27	$2.97	5.38%
South Dak	No tax		
Wyoming	No tax		

Corporate income taxes represent only 1.99 percent of total state and local revenues in Nebraska, making it one of the smallest contributors to the general fund. By comparison, the U.S. average for corporate income taxes is 3.63 percent as a total of state and local taxes. However, on a regional basis, the share is 1.78 percent.

Nebraska has the 21st highest top marginal rate on corporations at 7.81 percent. As compared to our neighboring states, only Iowa has a higher top marginal rate at 12.00 percent, but a 50 percent deduction of federal liability is allowed to offset the high rate. Nebraska too has offset a significant amount of corporate income tax liability through the various tax incentive programs.

As with the individual income tax, there has been much discussion about lowering the top marginal rate or making other adjustments to the corporate income tax. Most of the observations made above with regard to the individual income tax might also apply here. While the rate is not out of line in a national comparison, it is high in comparison to our neighboring states. If competitiveness is a primary characteristic for purposes of evaluating this tax, then several observations may be made.

First, the base has narrowed over time due to deductions and credits. Eliminating some or a significant number of these would allow the rate to be reduced proportionately. Secondly, as with indexing the brackets for the individual income tax, the first bracket could be indexed from $100,000 to $250,000 of taxable income at the rate of 5.58 percent. The top bracket rate of 7.81 percent would apply to the excess over $250,000. Another observation is that, unlike the individual income tax, Nebraska does not recoup the benefit of the graduated rates for high income corporations. Therefore, a threshold of $5 million net Nebraska taxable income might be an appropriate point at which to recapture the benefit of the lower rate on the first $250,000 of taxable income.

c. Income Taxes

vii. Corporate Income Tax Findings

1) As a percentage share of use, Nebraska is significantly below the national average use of corporate income taxes and slightly above the regional average of use;
2) The concerns raised in the Syracuse Study regarding the change to single-factor sales apportionment have been mitigated by the large number of other states that have subsequently adopted the same formula;
3) Nebraska's top marginal rate is comparable to other states on the national level but second highest in the region. The high rate is offset by the number of deductions and credits available for use; and
4) Nebraska does not index the corporate income tax brackets for inflation, nor have the brackets been adjusted legislatively since 2008.

d. Sales and Use Taxes

i. Building the Base

Overview. Nebraska's sales tax was originally established by passage of three separate bills in the 1967 Legislature. The tax focused on the final sale, at retail, of any item of tangible personal property or goods. Sales of certain services were specifically made subject to the tax by law. Services sold to the final consumer are not taxed unless specifically state in the sales tax law. This structure is similar to that used in most of the other 45 state that have a retail sales and use tax. Nebraska was one of the last state to implement a sales tax, and it original structure appears to be the result of implementing what was well established policy in other states. Nebraska's sales tax contains the same exemptions and structure as most other states.

The 2006 Department of Revenue Annual Report contains one of the best overall descriptions of the sales and use tax:

> Nebraska sales tax is imposed upon the gross receipts from all sales, leases, or rentals of tangible personal property made at retail in this state and upon the gross receipts of selected services; gross receipts of every person engaged as a public utility or as a community antenna television service operator; the gross receipts from the sale of admissions in the state; the gross receipts of persons selling, leasing, or otherwise providing intellectual or entertainment property; and the gross receipts from the sale of warranties, guarantees, service agreements, or maintenance agreements when the items covered are subject to tax. Property is defined as all tangible and intangible property that is subject to tax in the above paragraph.
>
> All gross receipts from the sale of the items listed above are subject to the tax unless an exemption is specified by law. Sales tax exemptions are generally based upon the nature of the seller, the nature of the property sold, the nature of the purchase, or the purchaser's intended use of the product.

> The use tax is a complement to the sales tax and is paid directly to the state by the consumer. The consumer may be a business or an individual. The tax is imposed on the storage, use or consumption in this state of tangible personal property and certain taxable services when the appropriate sales tax has not been paid. Examples of purchase that may be subject to consumer's use tax include items purchases from out-of-state vendor, and inventory items purchased for resale that are withdrawn from inventory for personal or business use.
>
> The retailer's use tax is a component of the state sales and use tax. Out-of-state retailers who do not have sufficient business contact with Nebraska may voluntarily become licensed to collect the appropriate sales tax for their Nebraska customers. The tax applies to items delivered to a customer's home or business in Nebraska for storage, use, or consumption."

Exemptions. In 1962 a study of Nebraska taxes was commissioned and published by the Committee on Taxation of the Nebraska Legislative Council. The study was done by Harold F. McClelland of Claremont College. McClelland made suggestions and recommendations for structuring the sales tax in Nebraska. Many of these recommendations appear to have been followed in writing the 1967 act.

McClelland's report recommended the use of what are called the "sale for resale" and "component parts exemptions." He also recommended other business to business sales or business inputs as an exemption. This was to be done in order to avoid the imposition of a tax on several transactions before taxing the final consumption and purchase. This practice was followed in other states which had implemented a retail sales tax. The following quote taken from the McClelland report explains why this is recommended.

> "But the general rule is to levy equally on all goods and services purchased by consumers. Commodities sold other than for final consumption – that is, goods sold in the production and marketing process which will be sold again later – should be exempt. For example, a tax levied on textiles when they are sold to the manufacturer, levied again when the finished suit of clothes is

sold to the retailer, and levied still again when the retailer sells it to the consumer, involves multiple taxation on the consumption of that suit of clothes. To avoid taxing some consumer commodities more than others, every attempt must be made to levy only on final sales to consumers."[17]

Like all states with a sales tax, Nebraska exempts a significant number of transactions, items, or purchasers for a wide variety of policy reasons. Sales for resale and ingredient and component parts are exempt in every state. Since the tax is, by definition, imposed on the final sale at retail, a purchase for resale is clearly not a final retail sale. Ingredient and component parts are those items that become part of the final product that is sold at retail. Without the exemption, these items would be taxed twice, a concept known as "pyramiding of the tax."

Most economists have observed that taxing these business inputs, or pyramiding, is an ineffective and harmful way to administer a sales tax. The taxes on inputs are hidden from the final consumer, they result in higher prices for consumers, and business expenses are increased, putting them at an economic disadvantage compared to businesses in other states that exempt these inputs. They have become such a core, structural aspect of a modern sales tax system that many states no longer consider them exemptions and do not quantify them in a tax expenditure report. Nebraska does continue to list them for transparency purposes.

Machinery and equipment used in manufacturing and agriculture are exempt in most states, mainly to avoid the pyramiding of the tax. Most agricultural inputs and purchases are exempt for the same reason. These exemptions were found in the 1967 sales tax law and remain in place today.

When analyzed as part of the Syracuse Study, this category, described as intermediate purchases, constituted over 82 percent of the tax amount exempted at that time. By 2008, it was approximately 75 percent of the total amount

[17] State and Local Finance, A report of the Nebraska Legislative Council Committee on Taxation, November, 1962.

exempted. Based on the 2012 Tax Expenditure Report, these exemptions now amount to approximately 83 percent of the amount exempted.

The bulk of the remainder of the exemptions can be connected to other policy choices that have been made by most states. For example, most states avoid taxing what are thought of as "necessities" – food, housing, health care including prescription drugs and durable medical equipment. Purchases by churches, schools chartered under Nebraska law, nonprofit colleges, and medical facilities are typical exemptions as are purchases by the federal, state and local governments.

The current exemptions follow in rank order:

SALES AND USE TAX EXEMPTIONS	**ESTIMATE**[18]
Structural Exemptions:	
Sale for Resale	$1,837,738,303
Ingredient and Component Part	$1,265,250,000
Subtotal	$3,102,983,303
Animal Life	$630,489,000
Purchases by Political Subdivisions	$315,477,000
Water and Veterinary Medicines	$299,782,000
Grains for Feed	$167,043,000
Purchases by Churches, Nonprofit Colleges, And Medical Facilities	$163,793,000
Food or Food Ingredients	$127,812,000
Energy Used in Industry	$124,235,000
Medical Equipment and Medicine	$114,346,000
Energy Used in Farming	$82,805,000
Agricultural Chemicals	$77,617,000
Manufacturing machinery and Equipment ("MM&E")	$69,837,000
Room Rentals by Certain Institutions	$63,966,000

[18] 2012 Tax Expenditure Report, Nebraska Department of Revenue

Agricultural Machinery and Equipment (“M&E”)	$60,090,000
Motor Vehicle/Motorboat Trade-Ins	$55,527,000
Seeds	$37,724,000
Contractor as Purchasing Agent for Public Agencies	$34,763,000
Railroad Rolling Stock, Repair Parts and Services	$18,337,000
Containers	$17,386,000
Nebraska Lottery Tickets	$15,539,000
SNAP Program $14,106,000	
Minerals, Oil and Gas Severed from Real Property	$10,654,000
Common/Contract Carriers	$8,863,000
Nonprofit Corporations Formed by Exempt Government Entities	$5,125,000
Molds and Dies	$3,980,000
School Lunches	$3,541,000
Nonprofit Nebraska-licensed Health Clinics	$2,290,000
Newspapers	$2,274,000
Access Charges	$2,004,000
Data Center Purchases	$1,674,000
Meals Sold by Institutions at a Flat Rate	$1,172,000
Conference Bridging Services	$1,080,000
Meals Sold by Hospitals	$819,000
Prepaid Calling Arrangements	$838,000
Water for Irrigation	$739,000
Sales on Native American Indian Reservations	$616,000
Commercial Artificial Insemination	$522,000
Biochips	$362,000
Laundromats-Coin-op machines	$444,000
Fine Art Purchases by a Museum	$442,000
Nonprofit Nebraska-licensed Mental Health Centers	$426,000
Admissions to School Events	$338,000
School-supporting Fundraisers	$285,000
Tele-floral Deliveries	$230,000
Mineral Oil as Dust Suppressant	$206,000
Film Rentals	$149,000
Purchases by State Fair Board	$67,000

Animal Grooming	$52,000
Admission Charged by Organization Dedicated to Youth Development and Healthy Living	$50,000
Syndicated Programming	$40,000
Food for Elderly, Handicapped and SSI Recipients	$40,000
Sales by Religious Organizations	$27,000
Admission to Statewide Sports Events	$20,000
Motor Vehicle Discounts for the Disabled	$10,000
Accessories for RRRS	Not Available
Safety Equipment required by federal or State regulatory agency	Not Available
Oxygen for Use in Aquaculture	Not Available
Nonvoice Data Services	Not Available

Fuels Exempt from Sales Tax But Subject to Separate Excise Tax

Motor Fuels	$248,042,000
Aviation Fuels AV Gas and Jet A Fuel	$8,216,000
Subtotal	$256,258,000
Grand Total	**$5,899,299,303**

For a more detailed description of these exemptions, please see the Appendix.

Services.[19] As mentioned above, only those services which are specified in statute are subject to the sales tax. Historically, most states have not implemented a broad-based tax on services, with a few notable exemptions. South Dakota and Hawaii both have very broad service taxes. South Dakota taxes approximately 146 services, Hawaii 160, Connecticut 143, and Wisconsin 105. New Mexico, which uses a gross receipts tax on the retailer rather than a true retail sales tax on the purchaser, taxes 158 services. Washington State, which uses a Business and Occupation Tax, taxes 158 services.

Nebraska does tax a number of consumer and personal services, including labor charges for installation and repair when the item of property being installed,

[19] All data used in this section is from the Federation of Tax Administrators, Survey of Services Taxation, Update, July 2008.

repaired, or replaced is taxable and is not annexed to real property. Nebraska has added a number of consumer and personal services to the tax base since 1967. Most have been done in an ad hoc manner with the exception of LB 1085 (2002) and LB 759 (2003) which added:

LB 1085

- Building cleaning and maintenance;
- Pest control;
- Security services;
- Motor vehicle washing, waxing, towing, and painting;
- Computer software training;
- Installation and application labor on tangible personal property if the sale of the property is subject to tax.

LB 759

- Recreational vehicle park services;
- Detective services;
- Repair and maintenance labor on tangible personal property, excluding motor vehicles;
- Animal specialty services; and
- Contractor labor.

The tax on contractor labor was modified in 2004 (LB 1017). Labor on residential or new construction was repealed in 2006 (LB 968) and commercial labor was repealed in 2007 (LB 367).

From a national perspective, Nebraska has done an adequate job in expanding its base to include consumer services. The Federation of Tax Administrators (FTA) published its first survey of sales tax on services in 1990. The report has been updated several times (1991, 1994, 1996, 2004, and 2007). Nebraska taxed only 49 services in 1996. By 2004 and 2007 the number had risen to 76 and 77, respectfully. This puts Nebraska relatively on par with Kansas, Minnesota, Wisconsin and Wyoming, far ahead of Colorado, Missouri, North

Dakota and Oklahoma, somewhat behind Iowa and far behind South Dakota, of course.

Sales Tax, Chart 1

1996

	Utilities	Personal Services	Business Services	Computer Services	Admissions/ Amusements	Professional Services	Fabrication, Repair & Installation	Other Services	Total
Nebraska	14	6	6	3	11	0	5	4	49
So. Dakota	12	19	28	6	12	4	18	42	141

2004

	Utilities	Personal Services	Business Services	Computer Services	Admissions/ Amusements	Professional Services	Fabrication Repair & Installation	Other Services	Total
Colorado	4	0	2	1	2	0	3	2	14
Iowa	13	15	18	1	13	0	14	20	94
Kansas	7	10	9	1	13	0	16	15	71
Minnesota	15	7	12	2	14	0	6	11	67
Missouri	8	1	2	2	11	0	0	4	28
Nebraska	14	8	15	3	12	0	13	11	76
North Dakota	6	1	4	2	11	0	1	2	27
Oklahoma	8	3	4	2	10	0	0	5	32
South Dakota	14	19	28	8	13	5	18	41	146
Wisconsin	11	11	7	3	14	0	14	14	74
Wyoming	10	6	7	3	7	0	16	13	62

2007

State	Utilities	Personal Services	Business Services	Computer Services	Admission/ Amuse	Professional Services	Fabrication, Repair & Installation	Other Services	Total
Colorado	4	0	2	1	2	0	3	2	14
Iowa	13	15	18	1	14	0	13	20	94
Kansas	10	11	9	1	13	0	15	15	74
Minnesota	15	7	12	2	13	0	6	11	66
Missouri	8	1	2	2	10	0	0	3	26
Nebraska	14	9	14	3	12	0	13	12	77
North Dakota	6	1	4	2	11	0	0	2	26
Oklahoma	9	3	4	1	10	0	0	5	32
South Dakota	14	19	28	8	13	5	18	41	146
Wisconsin	11	11	8	3	14	0	14	15	76
Wyoming	10	6	6	2	6	0	16	12	58

Local Option Sales and Use Tax. Nebraska, like many states, has authorized cities and counties to impose a local sales and use tax on the same goods and services that are subject to the state sales tax. The rates are specifically set forth by law, no local rate may exceed the cap, and the local tax may only be implemented, adjusted or repealed by a vote of the people. The majority of cities have voted for the imposition of a local sales tax. Counties are also authorized to impose a local sales tax outside of the borders of any city within the county that has a local sales tax. Only Dakota County has ever adopted a local sales tax and it was repealed effective January 1, 2014.

The local rates may be imposed at 0.5, 1.0, 1.5 or 2.0 percent. The local tax is collected at the same time as the state tax and remitted to the Department of Revenue. After deducting a percentage of the local tax for administrative costs, the Department redistributes the balance of the local sales and use tax to the appropriate city. For a complete listing of Nebraska cities and their local option sales tax rates, please see the Nebraska Tax Rate Chronology in the Appendix.

c. Sales and Use Taxes

i. Review and Comparison

The Syracuse and Burling Studies. The Syracuse authors made the following observation regarding Nebraska's sales tax system in 1987:

> For the most part, the sales tax in Nebraska is well designed. An ideal sales tax would apply comprehensively to all consumer goods and services, and exclude from the tax base products and services in the production of other goods and services.

The Syracuse study did make a series of specific recommendations for changes to the Nebraska tax system:

1) Exempt business and farm purchases of materials, machinery and equipment. This recommendation has been adopted in part since the study. Farm machinery and equipment has been exempt since 1992, although repair and replacement parts remain subject to tax. LB 96 (2013) would exempt agricultural machinery and equipment repair and replacement parts, excluding labor.

   LB 312 (2005) created an exemption for manufacturing machinery and equipment, but non-manufacturing businesses remain subject to tax on their purchases of materials, machinery and equipment, unless they are exempt under another specific category or qualified to obtain a refund via the Nebraska Advantage Act.

2) Tax "gourmet food" items not typically bought by lower-income households.

   This recommendation was not adopted. Nebraska continues to tax food for immediate consumption but exempts most food purchased at a grocery store. Nebraska's membership in the Streamlined Sales Tax Project has led to the passage of uniform definitions in this area. See §77-2704.24.

3) Repair, maintenance and cleaning of tangible personal property including housing, personal services by commercial establishments and recreation should be subject to sales tax.

   This recommendation has been implemented in large part. See discussion on services above.

   The Nebraska Tax Policy Commission Report, November, 2007, commonly referred to as the "Burling Commission," also suggested an expansion of the sales tax base by $750 million. The recommendation has not been implemented. The expansion recommended would have involved repeal of the food sales tax, accompanied by some refund of food sales tax to low income households and continued exemption of federal food assistance programs ("SNAP").

   Also contained in this recommendation was an expansion to tax all services except medical. The Burling Study made no specific recommendations for exemption repeals beyond the food sales tax exemption. The study did recommend a review of all exemptions be done.

4) Eliminate trade in allowance for motor vehicles.

   Nebraska has not eliminated the reduction in taxable value of a motor vehicle created by the offset of the value of a trade-in vehicle. Legislation has been introduced at least once, but has never advanced out of committee.

   It should be noted that sales and use taxes derived from registration of motor vehicles, trailers, and semi-trailers are deposited in the Highway Trust Fund. As a result, eliminating the trade in allowance would not result in additional general fund revenue for the state but would generate additional revenue for the Highway Trust Fund.

5) Impose personal property tax on agricultural machinery and equipment.

This recommendation was made in concert with the recommendation that agricultural machinery and equipment should be exempt from sales tax but subject to the personal property tax. Nebraska adopted this recommendation, in part, in 1992. However, repair and replacement parts for agricultural machinery and equipment remain subject to sales tax but not personal property tax.

Burden. The Tax Foundation ranks states by state rate, average local rates, and average combined rates. The following table is adapted from Tax Foundation Fiscal Fact No. 392, August, 2012.

Sales Tax, Chart 2

Rates as of January 1, 2013

State	State Rate	Local Rates	Average Combined Rate
Colorado	2.9%	0-7.5%	7.39%
Iowa	6.0%	0-1.0%	6.78%
Kansas[20]	6.15%	0-3.5%	8.13%
Missouri	4.225%	0.5-4.75%	7.51%
Nebraska	5.5%	0-2.0%	6.79%
South Dakota	4.0%	0-2.0%	5.83%
Wyoming	4.0%	0-2.0%	5.50%

The D.C. Burden Study again gives more insight into the effective tax rate or burden of the sales tax for the largest city in each state. The following charts compare Nebraska to its neighbors in terms of general sales tax rate and burden:

[20] Kansas state rate was 6.3% as of January 1, 2013 and was to be reduced to 5.7% on July 1, 2013. However, the rate was not reduced and remains at 6.15%

Sales Tax, Chart 3

CITY	State	Total Rate	State	City	County	School	Transit
DENVER	CO	7.720	2.9000	3.620			1.200
WICHITA	KS	7.300	6.300		1.000		
DES MOINES	IA	6.000	6.000				
Kansas City	MO	7.725	4.225	2.375	1.125		
OMAHA	**NE**	**7.000**	**5.500**	**1.500**			
SIOUX FALLS	SD	6.000	4.000	2.000			
CHEYENNE	WY	6.000	4.000	2.000			

CITY/STATE	**$25,000 AGI**	**$50,000 AGI**	**$75,000 AGI**	**$100,000 AGI**	**$150,000 AGI**	**COMBINED**
DENVER, CO	$724	$968	$1,303	$1,439	$2,250	$6,684
WICHITA, KS	$890	$1,192	$1,548	$1,739	$2,541	$7,910
DES MOINES,IA	$591	$933	$1,261	$1,396	$2,155	$6,337
K.C.MO	$918	$1,220	$1,604	$1781	$2,710	$8,234
OMAHA,NE	**$707**	**$930**	**$1,246**	**$1,361**	**$2,111**	**$6,354**
SIOUX FALLS,SD	$851	$1,128	$1,467	$1,643	$2,436	$7,525
CHEYENNE,WY	$672	$892	$1,198	$1,319	$2,035	$6,115

Once again the observation may be made that Nebraska is exactly in the middle of the range of sales tax rates and burden with its neighboring states.

Klein and Shannon. The authors start with these observations about the sales tax:

The sales tax deserves heavy weight in a state-local tax system because it is: (1) productive; (2) relatively stable; (3) exportable to nonresidents, particularly in tourist states; and (4) according to most public opinion survey, the least unpopular tax largely because it is viewed as voluntary by the taxpayer and is collected in small amounts.

The authors emphasize again their six values relative to the sales tax for analysis and comparison purposes:

1) It should provide 20-30 percent of all state-local tax revenue.

   Nebraska's general sales tax comprised 21.67 percent of total state and local taxes based on 2010 Census data. The national average use of general sales tax was 22.52 percent.

2) The sales tax rate should not be out of line with rates in surrounding states.

   As noted above, Nebraska's state rate, as well at the local option rates, are higher than South Dakota and Wyoming but lower than the other surrounding states. This can lead to some amount of "border bleed" for those cities that are close in proximity to cities in South Dakota and Wyoming that have lower rates.

3) It should exempt food, drugs, and utilities or provide a tax credit for purchase of these items.

   Nebraska exempts food and food ingredients but taxes food for immediate consumption. Prescriptions drugs are also exempt. However, Nebraska taxes residential utilities (gas and electric) and provides a limited exemption for commercial utilities used in manufacturing and agriculture.

All of Nebraska's surrounding states have a general sales tax but all exempt residential utilities. Nebraska is the only state in the area that taxes them. No credit is provided to residential users.

As the authors point out, exempting these items is expensive, as the exemption applies to everyone. As an alternative, they suggest taxing the items and providing a credit against the income tax for the sales tax paid by low-income households. This alternative requires the taxpayer to file an income tax return even if they have no income tax liability in order to receive the credit. Therefore it creates its own set of challenges. However, the observation must be made that Nebraska is the only state in the region that does not exempt residential utilities. A refundable credit through the income tax system for low-income households is recommended.

4) It should tax most services, as well as goods.

The taxation of services in Nebraska has already been discussed in great detail. The authors note that this may make the tax less regressive, but that the most "progressive services," such as foreign travel and most personal household services are difficult to tax. The services likely to be taxed, dry cleaning, barber and hair salons, may not lessen the overall regressivity. The authors also note that as the service sector continues to grow faster than other sectors of the economy, taxing more services will improve the growth potential of the tax. Finally, they state that compliance and administration will be easier as those businesses that currently must separate taxable goods and exempt services will simply collect tax on the total amount.

There has had significant discussions around expanding Nebraska's sales tax base to include more services. The policy reasons for doing so have varied from using the additional revenue to lower property taxes to reducing or eliminating state income taxes. Another policy option would be to expand the sales tax base to more services and then lower the state sales tax rate to offset the inherent regressivity in the tax.

In terms of principles and characteristics, there are several considerations to be taken into account. First, adequacy of the sales tax is a consideration. Consumer expenditure and demographic data indicate that consumers continue to purchase an increasing number of services than in the past. If a general sales tax is intended to be reflective of the economy, then the observation may be made that expanding the base to more services would increase stability and adequacy of the sales tax in Nebraska.

However, many of those services being purchased are not likely to be added to the base. In addition to foreign travel, which is not a service provided or consumed in the state and therefore incapable of being taxed at the state level, consumers continue to expend more income on health related services. If health care is viewed as a necessity, akin to food and housing, it is unlikely to be added to the general sales tax. Accordingly, the list of potential consumer services that could be added begins to dwindle, along with the potential for significant increases in revenue, stability or adequacy.

The second consideration is tax fairness. If, as Klein and Shannon observe, the services most likely to be taxed are those that are typically consumed by low-income households, adding these services does little if anything to offset the regressive impact of taxing those services. However, taxing goods purchased by low-income households like clothing and utilities while not taxing purchases of common consumer services, leads to inequities and a lack of balance in the sales tax base. Again, the mantra of “broad base and low rates” would imply that exempting consumer services continues to narrow the base and prohibits a state from lowering its rate.

Consumer expenditure data again shows that even during economic downturns, consumers do not restrain spending on services as much as they do on durable goods. As a result, the stability of the sales tax to generate adequate revenue is lessened. If adequacy, equity, fairness and stability are indicative of a “modern” system, then the observation may be made that the sales tax base be broadened to include more common consumer services.

Based on the generally accepted concept of avoiding pyramiding of the tax, principles and characteristics would argue against adding services that are exclusively or primarily purchased by businesses. Unlike tangible personal property, it is much more difficult to determine whether a service is being purchased solely as a business input or whether it is simply being consumed by the business as part of its costs. Further, there are certain services, such as motor vehicle repair, that would be very difficult to precisely delineate between a business purchase and a consumer service. The classic example is the pickup truck used for both business and personal purposes. The observation to be made then is that it is desirable to avoid adding services to the sales tax base that are exclusively business to business purchases.

5) The proceeds of the sales tax should be shared with local governments, or localities should be allowed to levy sales taxes subject to state-imposed safeguards.

Nebraska's local option sales tax has been discussed previously above. In addition to the general structure which allows cities and counties to impose their own tax subject to base and rate restrictions, Nebraska has also recently redirected one quarter of one cent of the general sales tax revenue to a new roads fund. The proceeds generally go the Nebraska Department of Roads but a share of this additional fund also goes to cities and counties.

6) A strong audit and enforcement program should be maintained to protect the integrity of the tax base.

The authors' main concern here was the loss of revenue from mail order sales and out-of-state business purchases. Nebraska has a strong audit program with regard to businesses that make purchases from out-of-state vendors and Nebraska businesses overall are compliant with self-reporting of the use tax on such purchases. In 2004 Nebraska implemented a Tax Amnesty Program which allowed non-compliant taxpayers to come forward voluntarily and pay taxes plus interest but not penalties. The additional revenue was dedicated to hiring more auditors and enforcement staff for the Department of Revenue and to purchase new technology to aid the Department in identifying non-filers or under reporters.

The issue of "mail order" purchases, or what are now commonly referred to as remote sales, is addressed in the next section.

d. Sales and Use Taxes

ii. Sales Taxes and the Internet

History. In 1967 the U.S. Supreme Court ruled in *National Bellas Hess v. Department of Revenue*, 386 U.S. 753, 87 S.Ct. 1389 (1967), that Illinois could not require an out-of-state vendor to collect tax on its sales into the state if that vendor lacked a physical presence or "nexus" with the state. The decision has never been limited or overturned but it was heavily debated in the case of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

In that case, a mail-order stationary company was assessed sales tax by North Dakota on the basis of a licensed computer software program that some of its North Dakota customers used for checking Quill's current inventories and placing orders directly. It had no other physical presence in the state, as it conducted the rest of its sales by using catalogues, flyers, advertisements in national periodicals, and telephone calls. Deliveries were made by mail and common carrier from outside of North Dakota. The U.S. Supreme Court declined to overturn *Bellas Hess*, stating in part that if Congress wanted to allow states to impose a collection duty on vendors operating across state lines, it had the authority to do so under the Commerce Clause of the U.S. Constitution.

Streamlined Sales Tax Agreement. Since the decision in *Quill*, states have individually and collectively attempted to address the concerns expressed by the court, primarily that each state had its own rates, base, and local tax systems, which made it too burdensome under the Commerce Clause for out-of-state vendors to comply with the myriad state and local rules. Aided by advances in technology, a group of states ultimately convened what is now known as the Streamlined Sales Tax Governing Board beginning in March of 2000.

The result of this work is the Streamlined Sales and Use Tax Agreement. The purpose of the Agreement is to simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance. The Agreement focuses on improving sales and use tax administration systems for all sellers and for all types of commerce through all of the following:

- State level administration of sales and use tax collections;
- Uniformity in the state and local tax bases;
- Uniformity of major tax base definitions;
- Central, electronic registration system for all member states;
- Simplification of state and local tax rates;
- Uniform sourcing rules for all taxable transactions;
- Simplified administration of exemptions;
- Simplified tax returns;
- Simplification of tax remittances; and
- Protection of consumer privacy.

24 states to date have adopted the simplification measures in the Agreement (representing over 31 percent of the population) and more states are moving to adopt the simplification measure.[21]

Nebraska has been an active participant in the Streamlined project from the beginning and is one of the 24 full member states. Full members are those who are in "substantial compliance" with the terms of the Agreement, which includes adopting uniform definitions in state law, as well as the uniform sourcing rules and other provisions. For a more complete discussion of the uniform provisions under the Agreement please go to www.streamlinedsalestax.org.

Federal Legislation. Based on the general principles and specific uniform provisions of the Streamlined Agreement, federal legislation was drafted under the title of the Main Street Fairness Act. This bill would allow those states that

[21] www.streamlinedsalestax.org

are full members of Streamlined to begin requiring out-of-state vendors, without an in-state physical presence, to collect and remit sales tax on all sales into the member state. These states would be authorized to begin requiring collection and remittance six months after the bill's passage. The bill has passed the Senate and awaits action in this House as of this writing. The general consensus among Washington observers is that the House will not take action on the bill anytime in the near future. Please see the Appendix for a copy of the bill.

The amount of sales and use tax foregone by states and their local governments under the Bellas Hess and Quill decisions has been hotly debated. At one point the estimated loss for Nebraska was high as $140 million per year. More recent estimates put the loss much lower, in the range of $40-$50 million per year. One specific reason for the lower estimate is that many out-of-state vendors have already voluntarily registered through the Streamlined system and are remitting tax. For these vendors, eliminating the constant concerns over collection obligations is worth the cost of collection and remittance. The simplified system has reduced many of the burdens under the old systems. It allows them to operate their businesses across state lines without raising potential compliance issues and can make them more responsive to changes in consumer demands.

From a fairness standpoint, it is easy to see why vendors who operate through a physical presence support the passage of the bill. It would effectively level the playing field for them and treat all in state purchases equally, regardless of the location of the vendor. The ability to require out-of-state vendors to collect Nebraska sales tax would also lead to greater stability and balance in the sales tax system, as it makes the system more reflective of actual economic activity. It is recommended that Nebraska amend its sales and use tax laws as necessary to ensure it is in compliance with all aspects of the Streamlined Agreement and the Main Street Fairness Act.

A final note on sales taxes and the Internet. In 1998, Congress passed the Internet Tax Freedom Act. This was an effort to protect the "fledging" worldwide web from "discriminatory" state and local taxes on Internet access, multiple taxes on electronic commerce and from Internet-only taxes such as bit taxes, bandwidth taxes, and email taxes. States with an existing tax on Internet access were grandfathered in under the Act. Nebraska was not one of those states and as a result we are still prohibited from taxing Internet access charges.

d. Sales and Use Taxes

v. Findings

1) Like all states with a sales tax, Nebraska exempts a significant number of business to business or intermediate transactions to avoid pyramiding of the tax. These exemptions constitute approximately 83 percent of the amount exempted;

2) Nebraska's general sales tax share use of 21.67 percent of total taxes is slightly below the national average use of 22.52 percent;

3) Nebraska has done an adequate job in expanding its base to include consumer services from only 49 in 1996 to 77 by 2007. This puts Nebraska relatively ahead of most states, both nationally and regionally, except those with an expansive services tax. No additional services have been added since 2007;

4) Nebraska continues to tax repair and replacement parts for agricultural machinery and equipment, which is exempt in most border states;

5) Nebraska taxes residential utilities which is exempt in all border states; and

6) Nebraska has positioned itself well in terms of availing itself of any future Congressional action regarding tax collection by remote sellers.

VI. Recommendations

a. Property Tax

1) Increase the state aid commitment to schools to offset property tax use and reduce property taxes as a share of total state and local taxes;
2) Reduce agricultural land value percentages to reduce the rate of tax on this value;
3) Raise homestead exemption program income guidelines to increase the number of low-income households who would qualify;
4) Offset the regressivity of the property tax by providing relief to households having a higher burden of property tax on their household income. Consider circuit breaker programs for renters, high property tax burden households, and farm owner operators; and
5) Recommend further study and analysis of residential valuation classification.

b. Income Taxes

1) The income bands within the income tax brackets should be adjusted annually for inflation;
2) While Nebraska's top marginal rate is high, the effective rate or tax burden is comparable to other states, both regionally and nationally. Accordingly, no adjustment to rates is recommended at this time. This is a policy matter for further analysis and discussion;
3) The provisional income thresholds used to calculate taxable Social Security benefits should be raised to exclude more Social Security income for low income taxpayers. Further study of any additional exemption of retirement income is recommended; and
4) The first corporate tax bracket should be adjusted from $100,000 to $250,000 of taxable income at the rate of 5.58 percent. The top bracket rate of 7.81 percent would apply to the excess over $250,000. A threshold of $5 million net Nebraska taxable income should be established to recapture the benefit of the lower rate on the first $250,000 of taxable income.

c. Sales and Use Taxes

1) Repair and replacement parts for agricultural machinery and equipment should be exempt from sales and use tax. This recommendation was originally made by the Syracuse Study and should be implemented to make Nebraska more competitive with its surrounding states;
2) Further review and analysis should be conducted to determine the appropriate consumer services to be added to the sales tax base. No business to business services should be taxed;
3) Nebraska is the only one of the surrounding states that taxes residential utilities. It is recommended that a refundable credit be implemented through the income tax system to offset the tax paid by low-income households; and
4) It is recommended that Nebraska amend its sales and use tax laws as necessary to ensure it is in compliance with all aspects of the Streamlined Agreement and the Main Street Fairness Act.

While all of the Tax Modernization Committee members may not agree on each and every one of these recommendations, the following members do support the work of the Committee and this report.

Galen Hadley, Chair

Paul Schumacher, Vice-Chair

Kate Sullivan

Heath Mello

Kathy Campbell

John Harms

Burke Harr

Tom Hansen

Jeremy Nordquist

Kate Bolz