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DEPARTMENT OF REVENUE

Effects of Tax Cuts and Jobs Act on the State of Nebraska's Tax Revenue

Prepared by the
Nebraska Department of Revenue

February 7, 2018

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Pete Ricketts, Governor

February 7, 2018

Honorable Pete Ricketts
Governor of Nebraska

Senator Jim Scheer
Speaker of the Legislature

Senator Dan Watermeier
Chairperson of the Executive Board of the Legislative Council

Senator Jim Smith
Chairperson of the Revenue Committee

Senator John Stinner
Chairperson of the Appropriations Committee

Michael Calvert
Legislative Fiscal Analyst

Dear Governor, Speaker, Senators, et al.:

I am pleased to present you the report *Effects of Tax Cuts and Jobs Act on the State of Nebraska's Tax Revenue.*

The report is made pursuant to Neb. Rev. Stat. § 77-27,222, which requires the Department of Revenue to issue a report to the Governor, the Legislative Fiscal Analyst and select members of the Legislature within 60 days after a change in the Internal Revenue Code, detailing the changes to the IRC and the impact of the changes on state income tax revenues and on various classes and types of taxpayers. On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act. This report addresses its impact on the State.

Sincerely,

Tony Fulton

Tony Fulton
Tax Commissioner

The Impact of the Federal Tax Cuts and Jobs Act and Its Impacts on Nebraska Tax Receipts

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (TCJA), significantly changing the tax code for the United States. Nebraska is a state of rolling conformity to the federal tax code, hence any changes in the federal tax code can affect the Nebraska Revenue Act, thereby influencing Nebraska tax receipts. This report summarizes the major provisions of the TCJA and the impact on Nebraska tax receipts. First, the report discusses the changes from the TCJA that affect Nebraska individual income tax receipts. Second, the report discusses the changes in the TCJA that affect Nebraska corporate income tax receipts. Unless otherwise noted, the effective date of the provisions addressed in this report is January 1, 2018.

This report is made pursuant to § 77-27,222, which requires the Department of Revenue to issue a report to the Governor and Legislature within 60 days after a change in the IRC, detailing the changes to the IRC and the impact of the changes on state income tax revenues and on various classes and types of taxpayers.

Individual Income Tax

On the individual income tax side, the TCJA:

- Changes rates and brackets;
- Increases the standard deduction;
- Eliminates personal exemptions;
- Limits itemized deductions;
- Changes the inflation adjustment method;
- Increases the child tax credit;
- Creates a new dependent credit for dependents older than 17;
- Creates a new pass-through deduction;
- Allows immediate expensing of capital expenditures; and
- Increases the estate tax exemption amount.

Nebraska individual income tax starts with federal adjusted gross income (FAGI) and federal itemized deductions. As such, any changes to the federal tax code that change the component and/or computation of FAGI and itemized deductions will flow through to the Nebraska income tax, possibly impacting Nebraska's individual income tax receipts. This section examines each of the changes listed above and determines whether each item increases, decreases, or has no impact on Nebraska individual income tax receipts, and the resulting effects on Nebraska tax receipts.

Rates and Brackets

The TCJA keeps seven tax brackets as before, but reduces the rate for five of the seven brackets. The table below shows the rates for each of the seven brackets previously, as well as the new rate under the TCJA.

Bracket	Old Rate	TCJA Rate
First	10.0%	10.0%
Second	15.0%	12.0%
Third	25.0%	22.0%
Fourth	28.0%	24.0%
Fifth	33.0%	32.0%
Sixth	35.0%	35.0%
Seventh	39.6%	37.0%

The changes in the federal tax brackets and rates have no impact on Nebraska income tax receipts.

Standard Deduction

The TCJA nearly doubles the federal standard deduction from its current level. Specifically, for tax year 2018, the standard deduction for filing statuses of single; married, filing jointly; married, filing separately; head of household; and widower are as follows:

Filing Status	Before TCJA	TCJA
Single	$6,500	$12,000
Married, Filing Jointly	$13,000	$24,000
Head of Household	$9,550	$18,000
Married, Filing Separately	$6,500	$12,000
Widower	$13,000	$24,000

The increase in the federal standard deduction affects the Nebraska Revenue Act and receipts in the following ways. First, Nebraska's standard deduction is calculated to match what the federal standard deduction would have been in 2018 and beyond, since Nebraska's standard deduction and the federal standard deduction use the same base and have used the same inflation adjustment method. However, Nebraska's standard deduction does not increase as a result of the increase in the federal standard deduction outside of the increase in the yearly inflation adjustment. Thus, there is no direct affect on individual income tax receipts as a result of the increase in the federal standard deduction.

However, a resulting gap is created between the federal and Nebraska's standard deduction for each filing status since the federal standard deduction nearly doubled and the Nebraska standard deductions remains unchanged. Under Nebraska Revenue Act, if the taxpayers choose the standard deduction for their federal tax returns, they must also take the Nebraska standard deduction. Thus, many taxpayers who would be better off itemizing rather than claiming the lower Nebraska standard deduction will not have that opportunity, resulting in an increase in their Nebraska tax liability, thereby increasing Nebraska individual income tax receipts.

Personal Exemption

Under the current Internal Revenue Code, individuals prior to tax year 2018 received a deduction from FAGI, known as the personal exemption, for each person in the household for which the taxpayer is providing more than 50% of their support. The TCJA suspended that personal exemption until 2025. Nebraska Revenue Act allows for a personal exemption credit, equal to the amount of the credit multiplied by the number of exemptions on the federal return. The repeal of the personal exemption under the TCJA effectively eliminates the number of exemptions on the federal return. As a result, Nebraska's personal exemption credit, which is $134 per exemption for tax year 2018, and indexed for inflation beyond 2018, would be eliminated. Thus, the TCJA effectively repeals this credit in Nebraska resulting in an increase in Nebraska's individual income tax receipts.

Itemized Deductions

Those who itemize for federal income tax purposes may, for Nebraska tax purposes, take either the federal itemized deductions or the Nebraska standard deduction. The TCJA changed the landscape for itemized deductions. Specifically, the TCJA capped the state and local tax deduction at $10,000. These taxes included state and local income, sales, real estate, and property taxes. The cap is not indexed for inflation in future years. The cap in the deduction results in more income becoming subject to tax, effectively increasing Nebraska's tax receipts.

The TCJA also changes the medical expense deduction. Prior to the TCJA, taxpayers could deduct their unreimbursed medical expenses that exceeded 10% of their FAGI. Under the TCJA, taxpayers may deduct their unreimbursed medical expenses that exceed 7.5% of their FAGI. The TCJA made this change retroactive to January 1, 2017. This change results in a higher medical expense deduction for those taxpayers who itemize, which may result in a decrease in Nebraska's tax receipts.

The deduction for mortgage and home equity loan interest is also affected by the TCJA. Under the TCJA, for mortgages entered into after December 15, 2017, taxpayers can only deduct the interest on the first $750,000 of eligible mortgage debts. For mortgages taken out prior to December 15, 2017, taxpayers can deduct all interest on eligible mortgage debts. The TCJA also repeals the interest deduction for all home equity loans after 2017. The restricted deduction on mortgage interest increases the amount of income subjected to tax, and will likely result in a small increase in Nebraska's income tax receipts.

The TCJA raises the limit for the charitable contributions deduction from 50% to 60% of FAGI. The increase in the limit could result in more deductions, and consequently less taxable income, reducing Nebraska's income tax receipts.

The TCJA also repeals the overall limitation for itemized deductions. That is, under the TCJA, itemized deductions would no longer be phased-out for high-income taxpayers. The federal phase-out amount determines the income at which Nebraska's added tax provision applies. For high income earners, the added tax provision slowly adds back in the tax benefit of the lower tax rate on the first three tax brackets. Effectively, at a certain high income level, taxpayers pay the full top individual income tax rate for all of their taxable income due to the added tax provision. Thus, the repeal of the phase-out threshold for itemized deductions at the federal level effectively repeals Nebraska's added tax provision, reducing Nebraska's individual income tax receipts.

Other, narrowly used, deductions eliminated under the TCJA include: deduction for unreimbursed employee expenses, tax preparation fees, other miscellaneous, and theft and personal casualty losses deductions. The elimination of these deductions increases taxable income and thus will also minimally increase Nebraska's income tax receipts.

Inflation Adjustment

The TCJA abandons using the Consumer Price Index (CPI) for inflation adjustments, in favor of the chained CPI, which grows more slowly compared to the CPI. Chained CPI is a measurement of inflation that accounts for consumers' willingness to substitute between goods when prices increase. Accounting for the substitutionary effect reduces the rate of growth on the price level using the Chained CPI compared to the CPI. Nebraska uses the Internal Revenue Code inflation adjustment method to adjust the personal exemption credit, the standard deduction, and the income tax brackets. It follows then, that using the chained CPI to index Nebraska's tax parameters will result in a slower growth in those parameters, compared to using the CPI. Hence, the immediate impact on Nebraska's individual income tax receipts would be minimal, but this change will have an increasingly positive effect on tax receipts over time.

Child Tax Credit

The TCJA increases the child tax credit from $1,000, which included $600 as a refundable credit and a $400 non-refundable credit, to $2,000 per child, which includes $1,400 as a refundable credit and $600 as a non-refundable credit. The phase-out threshold for the credit is increased to $400,000 of FAGI for married, filling jointly taxpayers. The increase in the child tax credit does not impact Nebraska's individual income tax receipts.

Dependent Credit

The TCJA adopted a $500 nonrefundable credit for qualifying dependents other than children. This new credit does not impact Nebraska's individual income tax receipts.

Deduction for Pass-Through Income

The TCJA allows for a 20 percent income deduction for pass-through businesses. Pass-through businesses which include S corporations, LLCs, partnerships, and sole proprietorships, are allowed to deduct 20 percent "qualified income" from their federal taxable income. Service businesses such as law firms, doctors' offices, and investment offices may only take the 20 percent deduction if their income is less than or equal to $315,000 for married couples. Since the 20 percent deduction of "qualified income" is taken after itemized or standard deductions, it does not affect Nebraska's tax liability. The deduction only affects federal taxable income.

Immediate Expensing

The TCJA allows immediate expensing of most capital expenditures until 2027, affecting individual returns of sole proprietors and pass-through entities. The TCJA also increased the threshold for IRC Section 179 expensing to $1 million for "qualified property" placed in service in tax years beginning after 2017, with a phase-out beginning at $2.5 million. The TCJA also expands the definition of "qualified property" for purposes of Section 179 expensing to include certain depreciable personal property used to furnish lodging, and improvements to nonresidential real property. This change in the TCJA results in less taxable income for owners of pass-through businesses, which results in a decline in Nebraska tax receipts.

Estate Tax

The TCJA doubles the threshold for the estate tax from $5.5 million ($11 million for married couples) to $11 million ($22 million for married couples). The increase in the estate tax threshold does not affect Nebraska's tax receipts since Nebraska no longer has an estate tax.

Estimates for Nebraska's Individual Income Tax Receipts Due to the TCJA

The Department employed various data sources to analyze the impact of the TCJA on Nebraska individual income tax receipts. The data the Department utilized included the Department's internal individual income tax data, IHS macroeconomics forecasting service, data from the U.S. Department of Census, data from the Bureau of Economic Analysis, and estimates of the impact on the federal tax receipts done by the Joint Committee on Taxation (JCT). Using the listed data sources, the Department estimates the impact of the TCJA on Nebraska individual income tax receipts for tax year 2018 through 2021 as follows:

Tax Year	Increase in NE Individual Income Tax Receipts - $ Million
2018	$227
2019	$240
2020	$278
2021	$305

The Department estimates the following increase in cash flow on a fiscal year basis:

Fiscal Year	Increase in NE Individual Income Tax Receipts - $ Million
FY18-19	$327
FY19-20	$256
FY20-21	$289

Internal individual income tax data for tax year 2015 was applied to perform the decile analysis for both before and after the TCJA. Table 1 below, consisting of approximately 854,000 returns, is the decile analysis for all resident returns and all filing statuses for tax year 2015.

Table 1 – Decile analysis for all resident returns and all filing statuses[1]

Decile Analysis for All Resident Returns				
Deciles	Total Nebraska Tax Liability Net of Non-Refundable Credits (Base)	Total Nebraska Tax Liability Net of Non-Refundable Credits (TCJA)	TCJA - Base	Percent Increase
1st	$843,172	$950,075	$106,903	12.68%
2nd	$2,244,815	$4,091,421	$1,846,606	82.26%
3rd	$11,097,138	$18,364,162	$7,267,024	65.49%
4th	$25,914,382	$38,615,656	$12,701,274	49.01%
5th	$47,969,723	$65,272,066	$17,302,343	36.07%
6th	$82,649,988	$104,129,385	$21,479,397	25.99%
7th	$131,344,987	$158,046,109	$26,701,122	20.33%
8th	$202,588,044	$234,991,119	$32,403,075	15.99%
9th	$331,412,182	$369,180,087	$37,767,905	11.40%
10th	$1,086,781,233	$1,123,780,334	$36,999,101	3.40%
Total	$1,922,845,664	$2,117,420,414	$194,574,750	10.12%

The column titled "Total Nebraska Tax Liability Net of Non-Refundable Credits (Base)" (Base) is the total computed Nebraska tax liability net of non-refundable credits using 2015 actual individual income tax returns with 2018 tax brackets and personal exemption credit amounts prior to the TCJA.

The column titled "Total Nebraska Tax Liability Net of Non-Refundable Credits (TCJA)" is the total computed Nebraska tax liability net of non-refundable credits using 2015 actual individual income tax returns with 2018 tax bracket with the following major provisions from the TCJA:

- Suspension of the deduction for personal exemptions

[1] For tax year 2015, there are approximately 854,000 resident returns.

- Repeal of the overall limitation on itemized deductions
- Increase in the federal standard deduction
- Alternative inflation measure
- Elimination of or limits on itemized deductions on federal schedule A

The last column, titled "Percent Increase", calculated the percent increase of the tax liability net of non-refundable credits from the base to the new tax provisions under the TCJA.

Similarly, Table 2 and Table 3 below represent the decile analysis that demonstrates the difference between the Base and the TCJA changes with respect to the Nebraska tax liability net of non-refundable credits for each decile. Table 2 is the decile analysis for resident married, filing jointly returns. Table 3 is the decile analysis for resident single returns.

Table 2 – Decile Analysis for Resident Married, Filing Jointly Returns[2]

Decile Analysis for Resident Married, Filing Jointly				
Deciles	Total Nebraska Tax Liability Net of Non-Refundable Credits (Base)	Total Nebraska Tax Liability Net of Non-Refundable Credits (TCJA)	TCJA - Base	Percent Increase
1st	$715,325	$1,225,269	$509,944	71.29%
2nd	$4,847,060	$12,649,663	$7,802,603	160.98%
3rd	$17,692,267	$30,898,570	$13,206,303	74.64%
4th	$41,240,107	$55,754,884	$14,514,777	35.20%
5th	$63,997,045	$79,063,892	$15,066,847	23.54%
6th	$90,216,144	$105,976,271	$15,760,127	17.47%
7th	$120,999,220	$137,303,920	$16,304,700	13.48%
8th	$160,162,157	$177,742,799	$17,580,642	10.98%
9th	$228,335,485	$246,438,644	$18,103,159	7.93%
10th	$707,160,570	$720,241,726	$13,081,156	1.85%
Total	$1,435,365,380	$1,567,295,638	$131,930,258	9.19%

[2] For tax year 2015, there are approximately 353,000 married, filing jointly returns

Table 3 – Decile Analysis for Resident Single Returns[3]

Decile Analysis for Resident Single Filers				
Deciles	Total Nebraska Tax Liability Net of Non-Refundable Credits (Base)	Total Nebraska Tax Liability Net of Non-Refundable Credits (TCJA)	TCJA - Base	Percent Increase
1st	$160,167	$185,083	$24,916	15.56%
2nd	$63,002	$76,588	$13,586	21.56%
3rd	$1,002,949	$1,457,856	$454,907	45.36%
4th	$4,010,997	$7,460,249	$3,449,252	85.99%
5th	$10,011,785	$14,773,236	$4,761,451	47.56%
6th	$17,690,205	$22,919,744	$5,229,539	29.56%
7th	$28,984,559	$34,503,755	$5,519,196	19.04%
8th	$46,078,953	$51,929,032	$5,850,079	12.70%
9th	$78,023,169	$84,617,637	$6,594,468	8.45%
10th	$214,207,669	$222,519,433	$8,311,764	3.88%
Total	$400,233,455	$440,442,613	$40,209,158	10.05%

Corporation Income Tax[4]

The TCJA also reformed the tax code for corporations. The TCJA greatly reduces the corporate tax rate from 35 percent to 21 percent. It also switched to a territorial tax system rather than the worldwide taxation system for multinational corporations. At the same time, the TCJA greatly expanded the tax base for corporations. In this section, the Department discusses the following major items related to the changes in the taxation of corporations under the TCJA and how it would impact Nebraska's corporation income tax receipts.

- Reducing the rate
- International
  - Repatriation of deferred foreign income
  - 100% deduction of dividends received by domestic parents of foreign subsidiaries
- Cost Recovery – IRC Section 179 expensing and immediate expensing
- Limitation on business interest expense deduction
- Limitation on Net Operating Loss (NOL) deduction
- Repeal of deduction for income attributable to domestic production activities
- Cash accounting for small businesses

[3] For tax year 2015, there are approximately 393,000 resident returns filed as single.
[4] Some of the descriptions come from the H.R.1 Section-by-Section Summary https://www.taxadmin.org/assets/site/HR1%20setion%20x%20section%20110217.pdf

Reduced Rate

As mentioned above, the TCJA reduces the corporate tax rate from 35 percent to 21 percent. Under the Nebraska Revenue Act, a corporation can subtract from federal taxable income a portion of the income earned by a corporation subject to the IRC that is actually taxed by a foreign country or one of its political subdivisions at a rate in excess of the maximum federal tax rate for corporations. Prior to the TCJA, there was only one country that had a corporate income tax rate higher than 35 percent; hence the deduction to taxable income under the Nebraska Revenue Act was seldom applicable. However, since the TCJA reduced the rate from 35 percent to 21 percent, there are many more countries having a corporate tax rate higher than 21 percent. The Department anticipates more utilization of this deduction, resulting in lower corporation income tax receipts for Nebraska. However, the Department does not have enough data or information available for a reliable estimate of the revenue impact.

International Items

Repatriation of deferred foreign income or a transition tax – The TCJA requires U.S. multinationals to claim untaxed profits from foreign subsidiaries since 1986. This deferred income is reported on the last return of the U.S. shareholder for a year beginning on or before December 31, 2017, which is taxable at a rate of 35%. The corporation is subject to a deduction that is equivalent to applying a 15.5% rate on earnings and profits in cash or cash equivalents or 8% on earnings and profits in all other types of assets. The tax is payable over eight years. Because this net amount is recognized as taxable income in 2018, this change will have a positive impact on Nebraska's corporation income tax receipts, all else being equal.

100% deduction of dividends received by domestic parents of foreign subsidiaries – Under the TCJA, the U.S. will shift to the territorial taxation system from the worldwide taxation system. The move to the territorial taxation system will result in a decrease in Nebraska's corporation income tax receipts, all else being equal.

Cost Recovery

Prior to TCJA, businesses could immediately expense up to $500,000 of the cost of any "section 179 property" placed in service each taxable year. If the business places in service more than $2 million of section 179 property in a taxable year, then the amount available for immediate expensing is reduced by the amount by which the cost of such property exceeds $2 million.

The TCJA increased the section 179 expensing limitation to $1 million and the phase-out threshold to $2.5 million. The TCJA also allows for immediate write-off of qualified property placed in service after 9/27/2017 and before 2023. The change in the TCJA regarding capital expensing will result in a decrease in Nebraska corporation income tax receipts, all else being equal.

Limitation on Business Interest Expense Deduction

Prior to the TCJA, s interest paid generally was allowed as a deduction in the taxable year in which the interest was paid or accrued. The TCJA limits the deduction for interest paid to no more than 30% of adjusted taxable income plus business interest income. This provision increases the taxable income for the corporation and, therefore, increases Nebraska corporation income tax receipts, all else being equal.

Limitation on Net Operating Loss (NOL) Deduction

Prior to the TCJA, a net operating loss generally was the amount by which a taxpayer's current-year business deductions exceeded its current-year gross income. NOLs could not be deducted in the year generated, but could be carried back two years and carried forward 20 years to offset taxable income in those years.

The TCJA will now allow taxpayers to deduct an NOL carryover or carryback only to the extent of 80 percent of the taxpayer's taxable income (determined without regard to the NOL deduction). The TCJA will also generally repeal all carrybacks but provide a special one-year carryback for small businesses and farms in the case of certain casualty and disaster losses. However, taxpayers can carry unused NOLs forward indefinitely.

The change on the limitation of the NOL deduction would generally increase Nebraska's corporation income tax receipts, all else being equal.

Repeal of Deduction for Income Attributable to Domestic Production Activities

Prior to the TCJA, taxpayers could claim a deduction equal to 9 percent of the lesser of the taxpayer's qualified production activities income or the taxpayer's taxable income for the tax year. The TCJA repeals the deduction for domestic production activities for tax years beginning after 2017. The repeal of this provision will increase Nebraska's corporation income tax receipts, all else being equal.

Cash Accounting for Small Businesses

The cash accounting method of accounting generally allows a business to recognize income and deduct expenses when the cash is received and paid, rather than having to accrue income and expenses. Prior to the TCJA, businesses structured as sole proprietorships, partnerships (without a corporate partner), and S corporations generally could use the cash accounting method. Businesses structured as corporations and partnerships with a corporate partner could only use the cash accounting method if its average gross receipts do not exceed $5 million for all prior years. Farm corporations and farm partnerships with a corporate partner could only use the cash accounting method if their gross receipts did not exceed $1 million in any year. An exception allowed certain family farm corporations to qualify if their gross receipts did not exceed $25 million.

The TCJA increases the $5 million threshold for corporations and partnerships with a corporate partner to $25 million. The increase of the threshold to $25 million also applies to farm corporations and farm partnerships.

The change in the threshold for the use of the cash accounting method will decrease Nebraska tax receipts, all else being equal.

Estimates for Nebraska's Corporation Income Tax Receipts Due to the TCJA

Nebraska corporation income tax starts with Federal taxable income (FTI), and most, if not all, of the changes under the TCJA affect FTI. The Department does not have in-house data to analyze the fiscal impact of these changes. For that reason, the Department derived its estimates by utilizing the estimates provided by the Joint Committee on Taxation (JCT). The Department analyzed which provisions would impact the State the most and used the estimated fiscal impact at the federal level provided by the JCT. The Department then analyzed the tax base at the federal level relative to the Nebraska tax base to derive its estimates. The estimated increase in Nebraska's corporation income tax receipts for tax years 2018 through 2021 due to the TCJA are as follows.

Tax Year	Increase in NE Corporation Income Tax Receipts - Million $
2018	$33
2019	$7
2020	$10
2021	$31

The Department estimates the following increase in cash flow on a fiscal year basis:

Fiscal Year	Increase in NE Corporation Income Tax Receipts - $ Million
FY18-19	$8
FY19-20	$18
FY20-21	$14

Summary

This discussion highlights the areas of the TCJA that contribute most significantly to Nebraska's tax receipts; however, this report does not include all changes made by the TCJA. For a complete list of those changes, please refer to the federal legislation. Furthermore, this report does not include any analysis of federal tax liability.