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Revenue Committee, Nebraska Legislature
Sen. Lou Ann Linehan, Chair
State Capitol
PO Box 94604
Lincoln, Nebraska 68509-4604

Re: LB 1 of the 2024 First Special Session
Sections 52 and 53 as Introduced
Terminating the Application of Nebraska Section 77-2734.01, Which Includes in the Nebraska Taxable Income of Nebraska Residents Only Multi-State Pass-Through Income Which is Apportioned to Nebraska

Senators:

The purpose of this letter is to ask the Committee to remove through its Committee Amendments the language in Sections 52 and 53 of LB 1 that would terminate the provision for Nebraska resident shareholders of S corporations, and Nebraska resident members of limited liability companies ["LLCs"], which have active business operations in multiple states to include in their individual Nebraska taxable income only their proportionate share of the S corporation's or LLC's Nebraska source taxable income. [1]

In support of this request, this letter will (i) review the history and purposes of Nebraska's approach to the taxing multi-state pass-through income to Nebraska resident individuals, (ii) will discuss whether the proposed change would be constitutional under the federal constitution, and (iii) will respond to several misconceptions regarding Nebraska's existing tax policy.

I realize that this letter has become quite long, but with the high turnover among Senators, and members of the Revenue Committee, due to term limits, I feel that it will be helpful to at least some

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[1] There are actually three categories of LLCs for federal and Nebraska income tax purposes: (i) LLCs with two or more members that for federal income tax purposes are taxed as partnerships and are therefore also taxed as partnerships for Nebraska purposes except for apportionment of multi-state income, (ii) LLCs which have made a federal tax election to be taxed as corporations, and (iii) LLCs with only a single member that are "disregarded entities," i.e. they are treated as either proprietorships of their single individual member or as a division of their single corporation member. Disregarded entities do not file separate returns. Only the first category of LLCs are affected by Nebraska Section 77-2734.01. References to "LLCs" in this letter include only those category (i) LLCs.

of you for me to share my information in a comprehensive review of the history and purposes of the resident apportionment provision in our income tax.

How did we get here? - During the fall of 1986, I read an article in the Omaha World Herald announcing the relocation of a Nebraska business from North Platte to Torrington,Wyoming. The Company was not a client of the accounting firm where I was a partner at that time, and I had no personal knowledge of it. However, I was able to learn from a contact in western Nebraska that they did substantial business in Nebraska, Colorado, Wyoming, and South Dakota. My contact theorized that Torrington was likely more centrally located within their business operations than North Platte.

However, the relocation announcement was made shortly after the enactment of the federal Tax Reform Act of 1986. The Tax Reform Act included several very material incentives for larger, closely held corporations to make the Subchapter S election. A wave of Subchapter S elections were being made throughout the country during the brief period between enactment in October 1986 and December 31, 1986, to be effective January 1, 1987. [2]

Being aware of these developments, and Wyoming being a "no income tax state," I became curious whether the announced relocation to Wyoming was a state tax issue rather than simply being more centrally located within their business footprint.

Because the business was relocating to Wyoming, I studied how the choice of Wyoming might effect the state income tax of the shareholders if the Company were an S corporation. The result was my conclusion that if income was equally 25% in each of the four states, shareholders living in Wyoming would owe combined state taxes slightly less than half of the amount if they lived in Nebraska. I guessed that the state income taxes of the shareholders was probably the principal reason for the announced relocation. [3]

- As Wyoming residents, the shareholders would pay Nebraska tax on the S corporation's

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[2] Indeed, the incentives to make the S election were effective. A study of S corporation conversions from 1986 to 1987 by two Internal Revenue Service economists concluded that just over 144,300 C corporations converted to Subchapter S status between 1986 and 1987. The the newly converted S corporations were also on average materially larger than established S corporations. The average gross revenues of converted C corporations were over three and 1/3 times greater than average gross revenues of established S Corporations [$2,514,000 v. $748,000]. The average total assets of converted S Corporations were just over three times greater that those of established S corporations [$1.101,000, compared to $361,000]. [*"S Corporation Elections After the Tax Reform Act of 1986,"* by Susan M. Wittman and Amy Gill; IRS Statistics of Income Bulletin, Publication 1136, Spring 1998.]

The trend toward doing business in S corporation form has continued to the point that nationally the number of S corporation returns now exceeds the number of C corporation returns.

Along with greater size came more multi-state operations, larger shareholder groups, and more nonresident shareholders.

[3] I never attempted to verify the information, but years later a different individual from Western Nebraska told me that the S election was made and the relocation to Wyoming was quietly abandoned. I had guess correctly.

Nebraska source income, would pay Colorado tax on Colorado source income, and would pay no tax on Wyoming and South Dakota source income.

- As Nebraska residents, the shareholders would pay Nebraska tax on the corporation's Nebraska source income, would also pay Nebraska tax on both Wyoming and South Dakota source income, and would pay Colorado tax on Colorado source income plus a Nebraska tax premium on Colorado source income because Nebraska's tax rate exceeded Colorado's rate.

Under the Nebraska statute before the adoption of Section 77-2734.01, a Nebraska resident shareholder was required to include in Nebraska taxable income 100% of his/her proportionate share of the S corporation's federal taxable income, regardless of source,. The resident was then allowed a credit for nonresident taxes paid to other states where the S corporation had taxable income. However, because Wyoming and South Dakota had no income tax, the credit was zero. The credit for taxes paid to Colorado would be less than the Nebraska tax on Colorado source income because Nebraska's rate was higher than Colorado's rate.

I concluded that because (i) we had two "no income tax" border states, and (ii) all of the four other border states had lower individual tax rates than Nebraska, we were exposed to a serious out-migration of business owners if we did not eliminate the difference in the tax on S corporation income. The "resident apportionment" concept in what became Nebraska Section 77-2734.01 eliminated the difference.

The Legislature's Revenue Committee was in the process of assembling the provisions of both LB 773 of 1987 to overhaul Nebraska's individual income tax in response to the massive changes made by the federal Tax Reform Act and LB 775 to adopt Nebraska's first focused economic development incentives. I presented my research to the Revenue Committee and its Counsel, and to others who were assisting with those two legislative projects.

Section 77-2734.01 was included by the Revenue Committee in LB 773. LLCs were added to that section in the original Nebraska Limited Liability Company Act in 1993. LLC businesses were expected to be more similar to S corporation businesses than to the historical "tax shelter" real estate and energy partnerships. [4]

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[4] Partnerships were not included in the Section 77-2734.01 for one simple reason. Prior to the 1986 Tax Reform Act, Nebraska residents had invested millions of dollars in various tax shelter partnerships, principally real estate projects and energy developments. Virtually none of these partnerships had any Nebraska operations. Nevertheless, pursuant to the existing law at the time, Nebraska residents had deducted their allocated share of the partnership losses from their Nebraska taxable income. As a result of the federal Tax Reform Act, most of those partnerships were expected to unwind in the following five to ten years. As the partnerships disposed of their assets and dissolved, the previous excess loss deductions would reverse into federal taxable income. If partnerships had been included in Section 77-2734.01, the reversal of the previously deducted losses would not have been Nebraska source income and would not have been subject to Nebraska tax. Sen. David Landis and I both felt strongly that because Nebraska had allowed the deductions, the reversal of those deductions should be included in Nebraska taxable income.

Purposes of Section 77-2734.01 - The "resident apportionment" of S corporation and LLC income has four distinct purposes:

1. To establish parity between the state taxes paid by Nebraska residents and nonresidents on the multi-state income passed through by S corporations and LLCs.

   Under the "resident apportionment" approach adopted in 1987, Nebraska resident and nonresident shareholders or LLC members pay the same state tax on the entity's income. Both Nebraska resident shareholders and nonresident shareholders pay tax on the pass-through income once, to the state of source, at the rate and according to the law of that state.

   In the above example, both Nebraska resident and nonresident shareholders will pay no tax on South Dakota and Wyoming source income, will pay the Colorado tax on Colorado source income, and will pay the Nebraska tax on Nebraska source income.

2. To establish parity between the Nebraska tax on the multi-state taxable income of C corporations and of S corporations and LLCs.

   Both (i) the threshold for apportionment (i.e. whether the entity is a multi-state taxpayer) and (ii) method of apportionment (the single sales factor), are identical for determining the "source state" of C corporation income and pass-through income. [5]

3. To establish parity between the state taxation of multi-state business income of C corporations and of income passed through to Nebraska residents by S corporations and LLCs. In each case, the income is taxed once by the state of its source, at the rate in effect in that state, and according to the laws of that state.

   Under the Nebraska law before 1987, Nebraska residents paid state tax at the *greater* of (a) the rate in effect in the state in which it was earned, or (b) the rate in effect in Nebraska. Except for pass-through income apportioned to states with individual tax rates higher than Nebraska's, Nebraska was effectively taxing part or all of the non-Nebraska source income passed through by S corporations to Nebraska resident shareholders.

   Nebraska neither taxed C corporation income earned in non-tax states, nor did Nebraska tax a premium on non-Nebraska C corporation income sourced in other states with C corporation rates lower than Nebraska's rate.

Because LLCs were a brand a new entity with no tax shelter history, the reason for different partnership rules did not apply to LLCs.

[5] As noted again below, a C corporation, an S corporation, and an LLC which does not have nexus in another state, and is therefore not subject to tax in another state, are all 100% taxable in Nebraska.

4. To establish parity between the Nebraska taxation of C corporations with no Nebraska operations and no Nebraska source income and the Nebraska taxation of Nebraska resident S corporation shareholders of S corporations with no Nebraska operations or income.

   Under the Nebraska law before 1987, Nebraska would tax part or all of the taxable income of an S corporation allocated to a Nebraska resident shareholder even if the S corporation had no operations in Nebraska and no Nebraska source income. For example, assume that a Nebraska resident was a shareholder in an S corporation located in South Dakota and did business only in South Dakota. Under the pre-1987 law, the Nebraska resident would owe Nebraska tax on all of the South Dakota source income because there is no individual income tax in South Dakota.

   No C corporation that similarly had no operations in Nebraska would be taxable in Nebraska.

   It is my experience that the importance of this purpose of Section 77-2734.01 has grown substantially as time has passed and shares of remote S corporations have been inherited by family members resident in Nebraska. I have been asked to confirm this result by Nebraska CPAs more than once, most recently this summer.

There are two other "affects" of apportionment that were important policy considerations in 1987, and which are still relevant today.

- Under Section 77-2734.01, out-of-state losses by S corporations and LLCs are not deductible in Nebraska. For example, suppose that a Nebraska resident is a shareholder in an S corporation located in another state, and which does not do any business in Nebraska. Suppose further that the Nebraska resident's share of the S corporation's loss is $250,000. Under the law prior to 1987, that $250,000 loss would be deductible in Nebraska. After 1987, that out-of-state loss is not deductible in Nebraska, as it should not be.

- A related effect that was little understood is that resident apportionment prevents the possibility of a double tax benefit for out-of-state losses of multi-state S corporations.

  Assume that a Nebraska S corporation has a $500,000 loss. The corporation does half of its business in Nebraska and half in another state that has an individual state income tax. Under the law through 1986, the Nebraska resident shareholder would report a $500,000 loss in the Nebraska resident return, and would also report a $250,000 loss in the nonresident return to the other state. Assuming that the shareholder has other Nebraska income exceeding the $500,000 loss, the shareholder would receive a full Nebraska tax benefit for the $500,000 loss. In addition, if either (i) the Nebraska resident had at least $250,000 of other taxable income in that state, or (ii) the other state allows a net operating loss carryback or carryforward, the individual would also recognize a tax benefit in that state for the $250,000 S corporation loss. The combined tax benefit would be on $750,000, not the $500,000 actual loss.

Resident apportionment prevents this scenario. The Nebraska resident shareholder has a $250,000 Nebraska source loss in the Nebraska resident return and a $250,000 loss in the nonresident return to the other state. The total possible tax benefit is on $500,000, as it should be.

Is the taxation of multi-state pass-through income proposed in LB 1 constitutional under the "dormant commerce clause" of the US constitution?

I am not an attorney, but my experience suggests to me that the U.S. Supreme Court decision in *Comptroller of Maryland v. Wynne* [May 2015] may ultimately affect the federal constitutionality of the proposed reversion to the pre-1987 taxation of multi-state pass-through income. Ever since the *Wynne* decision was issued by the U. S. Supreme Court, I have been expecting some high income individual (probably from New York, New Jersey, or California because they are such high income tax states) to challenge their state's approach to multi-state income on the basis that it subjects income already taxed in another state to a second layer of tax in the resident state.

Maryland has for many years had a two-part personal income tax; a state tax that goes to the state treasury, and a county "surcharge" that goes to the county of residence. The county surcharge ranges up to 50% of the state tax. Nonresidents with Maryland source income are not subject to the county tax but must pay a "special nonresident tax" in lieu of the county tax.

Maryland residents who pay income tax to another jurisdiction for nonresident source income are allowed a credit against the state tax for taxes paid to nonresident states, but not against the county tax.

The Wynnes were Maryland residents. They were shareholders of a multi-state S corporation that filed returns in 39 states. The Wynnes challenged the disallowance of the credit for taxes paid to nonresident states against the county tax.

The U. S. Supreme Court held that Maryland's disallowance of a credit against the county tax violates the "dormant commerce clause" of the federal constitution. [6] The dormant commerce clause precludes States from "discriminating between transactions on the basis of some interstate element." At one point in the decision, the Court states:

> "Nor may a State impose a tax which discriminates against interstate commerce either by providing a direct commercial advantage to local business, or by subjecting interstate commerce to the burden of 'multiple taxation.' *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U. S. 450, 458 (1959) "

[6] The Maryland Supreme Court had also held that the disallowance of the credit against county taxes was unconstitutional. The State appealed to the U. S. Supreme Court, which affirmed the Maryland court's decision.

A bit later in the decision, we find this paragraph:

> "In *J. D. Adams Mfg. Co.* v. *Storen*, 304 U. S. 307 (1938), Indiana taxed the income of every Indiana resident (including individuals) and the income that every nonresident derived from sources within Indiana. *Id.,* at 308. The State levied the tax on income earned by the plaintiff Indiana corporation on sales made out of the State. *Id.*, at 309. Holding that this scheme violated the dormant commerce clause, we explained that the "vice of the statute" was that it taxed, "without apportionment, receipts derived from activities in interstate commerce." *Id.*, at 311. If these receipts were also taxed by the States in which the sales occurred, we warned, interstate commerce would be subjected "to the risk of a double tax burden to which intrastate commerce is not exposed, and which the commerce clause forbids."

On the subject of corporation taxation compared to individual taxation, the Court states:

> "For its part, petitioner [the State of Maryland] distinguishes *J. D. Adams*, *Gwin, White*, and *Central Greyhound* on the ground that they concerned the taxation of corporations, not individuals. But it is hard to see why the dormant Commerce Clause should treat individuals less favorably than corporations."

I observe repeated emphasis on three concepts; (i) a state tax may not impose a greater burden on interstate transactions than on intrastate transactions, (ii) a state may not expose either its residents or nonresidents to potential double taxation of interstate income, and (iii) individuals are as protected by the dormant commerce clause as corporations.

Maryland has had the two-part state and county tax for many years. It was already in place when I lived there in the early 1970s. The credit was not allowed against the county tax then. The long established practice did not have any affect on the decision. It was not even mentioned.

I am not an attorney, but based on my experience, I believe the Section 77-2734.01 is relatively "safe" within the Court's decision in *Wynne*. Nebraska maintains parity between interstate and intrastate transactions, and between residents and nonresidents. Nebraska avoids the double tax issue that was struck down by the Court in *Wynne.*

On the one hand, "double taxation" is not as obvious in the LB 1 proposal as in the Maryland case. By disallowing a credit for the Maryland county tax, Maryland was obviously levying the county tax on income that had already been taxed, and the tax paid, in the nonresident state. In the LB 1 case, Nebraska would be collecting an additional tax on the income that had either not been taxed in the source state or had been taxed at a lower rate in the source state. There is not a tax on income for this tax has already been paid in the source state.

On the other hand, the method proposed by LB 1 clearly treats residents differently from nonresidents. A South Dakota or Wyoming resident shareholder would clearly pay less tax on the

income from a South Dakota or Wyoming transaction than would a Nebraska resident. In addition, a Nebraska resident would clearly be assessed a second layer of state tax the income from a transaction sourced in a lower tax state, such as Colorado or North Dakota.

I believe that there is enough risk involved that I would hope Senators would not change to the LB 1 model without first obtaining a thorough legal analysis and advice of independent counsel.

Misconceptions regarding the apportionment of pass-through income by Nebraska residents.

Termination of Section 77-2734.01 is an opportunity to collect more tax from nonresidents. I have heard some variation of this comment several times, apparently based on the perception that bringing excluded non-Nebraska source income into Nebraska taxable income will add to the Nebraska taxable income of nonresident shareholders.

This is not the case. Section 77-2734.01 applies only to Nebraska residents. Any additional tax will all be collected from Nebraska resident shareholders or LLC members.

Nonresident shareholders currently include only Nebraska source income in their nonresident Nebraska returns, and that would not change if the application of Section 77-2734.01 is terminated.

Apportionment results in "no where income." I have frequently heard some variation on this theme that resident apportionment results in income not being taxed in any state, generally in the context of the Department of Revenue's annual statistics of income which includes the aggregate non-Nebraska source income excluded from Nebraska resident returns.

Indeed, under Nebraska's approach, income sourced in non-tax states is not taxed in any state whether it is earned by a C corporation or an S corporation. It would, however, have been taxed if the source state had chosen to impose an individual income tax. The income is not really "no where income" in the context of tax avoidance; it is simply earned in a state that chooses not to impose an income tax.

The last time termination of Section 77-2734.01 was seriously considered by the Legislature, it was alleged that Nebraska residents were avoiding tax on the total of the amounts of pass-through income excluded from all resident returns multiplied by Nebraska's maximum tax rate; i.e. 6.84%. That was manifestly not true. Except for income sourced in a non-tax state [in Nebraska's case probably principally South Dakota, Wyoming, and Texas], Nebraska residents have paid nonresident taxes to the other states. It is not "no where income" simply because it is excluded from the Nebraska resident returns. [7]

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[7] In fact, the maximum potential additional revenue to Nebraska would have been the Nebraska tax rate times the non-resident source income excluded from the returns, *minus* the nonresident taxes paid by Nebraska residents to other states on that income. Unfortunately, that amount was not available because no credit for that tax is allowed and the information is not included in Nebraska returns. That same issue applies to estimates of projected revenue from the

"Resident apportionment" is more subject to abuse than the pre-1987 approach to multi-state pass-through business income.

There are guardrails which are effective to prevent the abuse of apportionment to avoid Nebraska tax.

- Section 77-2734.01 only applies to S corporations and LLCs which have nexus and are taxable in a state other than Nebraska. Similar to C corporations, a pass-through entity that does not have taxable operations in another state is 100% taxable in Nebraska. The pass-through entity cannot simply apportion its Nebraska income to states where it happens to make sales but has no taxable nexus and avoid state tax altogether on that income.

- Section 77-2734.01 only applies to S corporations and LLCs which are conducting an active trade or business, and then only to the income of that active business. Nebraska residents are not permitted to use an investment S corporation or LLC to move investment income out-of-state to a non-tax state.

- Finally, Section 77-2734.01(1) specifically requires a Nebraska resident shareholder to include in their Nebraska taxable income "adequate compensation" for services rendered to the S corporation or LLC. A Nebraska resident is not permitted to move compensation for services rendered from Nebraska to another state, or a non-tax state, by turning it into apportioned net income.

Nebraska is the only state that uses 'resident apportionment," or at least is a minority outlier among the states.

First of all, one of the most elementary principles of state taxation is that every state adjusts its tax structure to fit the facts and its needs. In most cases, if a tax provision responds to the facts that affect the state, is fair to residents, and is reasonable tax policy, then whether other states use the same approach is more or less irrelevant. Every state with which I am familiar has some unique provision to its tax structure that is not common among other states.

In the case of multi-state pass-through income, resident apportionment is more fair to Nebraska residents than the approach that is used by many other states, is responsive to the State's interest given that two of our border states are non-tax states, and represents good tax policy. If other states do not have the same facts and choose another approach, that should not cause Nebraska to adopt a plan that is not consistent with our circumstances.

To my knowledge, Nebraska was the first state to adopt the resident apportionment approach to multi-state pass-through income. However, Nebraska has some followers. Unfortunately, I have not

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termination of the applications of Section 77-2734.01 by LB 1.

been able to locate a published table that addresses the approach in each state with an individual income tax, but I am aware of at least four other states which generally follow Nebraska's plan. One of those is neighboring Iowa.

I am not aware of any state which has adopted resident apportionment and later repealed it.

Oklahoma - Oklahoma adopted Nebraska's approach shortly after Nebraska made the change. Interestingly, I received a phone call from a lawyer in the Oklahoma Department of Revenue to discuss Nebraska's legislation. I was told that they were going to propose similar legislation in the next session of their Legislature because of the out-migration which they were experiencing of S corporation shareholders across their southern border to the Denton or Dallas/Fort Worth metroplex.

The Oklahoma instructions to their individual return include the following paragraph:

> "An Oklahoma resident individual is taxed on all income reported on the federal return, except income from real and tangible personal property located in another state, *income from business activities in another state*, or the gains/losses from the sales or exchange of real property in another state." [italics added]

Oklahoma residents reduce federal adjusted gross income by out-of-state pass-through income on Line 4 of the return, and add to federal adjusted gross income out-of-state losses on line 2 of Schedule 511-B.

Michigan - The Michigan individual return instructions are similar to Oklahoma and Nebraska. Michigan residents determine the Michigan apportionment of their proportionate share of the S corporation's income based on the sales within and without Michigan. Michigan residents reduce or increase their federal adjusted gross income by the reciprocal of the Michigan apportionment percentage times the net income or loss passed through to them by the pass-through entity.

Iowa - Iowa has taken a different approach to resident apportionment than Nebraska, Oklahoma, or Michigan, but their objective is the same. Iowa requires residents to include 100% of the S corporation or LLC multi-state income passed through to them in Iowa taxable income, but then Iowa allows a calculated credit to the tax liability which is generally intended to eliminate the Iowa tax on out-of-state source income. My experience is that the offset is not perfect, but it comes reasonably close to the Nebraska or Oklahoma result. The Iowa Department of Revenue explains their approach as follows:

> "While C corporations are allowed to apportion income before taxation in Iowa, shareholders are required to include all income from the S corporation in calculating taxable income under the individual income tax, even if some of that income results from sales outside of Iowa. The S Corp Tax Credit attempts to equalize apportionment treatment of income between C corporations and S corporations. *The S Corp Tax Credit is structured so that the owners of the S corporation effectively*

> *pay tax only on the income attributable to Iowa* under the single sales factor. *Thus the tax credit should result in a similar fiscal impact as if Iowa were to allow S corporations to apportion income prior to pass-through to shareholders*." [italics added]

Iowa goes one step farther. S corporation shareholders are allowed to elect either the calculated "S Corp Tax Credit" or a credit for the actual nonresident tax paid to other states, whichever has the more favorable result.

Tennessee - Tennessee is a bit different because it has no individual income tax except on investment income. Accordingly, the pass-through of net income from the active businesses of S corporations and LLCs is not taxed at the individual shareholder or member level.

However, Tennessee imposes franchise and excise taxes on S corporations and LLCs. The tax is the greater of (i) an excise tax based on the entity's apportioned Tennessee net income or (ii) a franchise tax based on the greater of the entity's Tennessee property or apportioned net worth. Tennessee does not tax a multi-state S corporation or LLC on either its out-of-state income or out-of-state property and net worth.

Tennessee's tax approach is more complex, but Tennessee achieves the exact same result for its resident shareholders and members of S corporations and LLCs by only burdening their pass-through income with a tax on Tennessee source income or Tennessee source property and net worth.

I would be happy to answer any questions. Please reach out to me. You are welcome to call me on the phone, but if you do so, my cell phone is a more reliable way to reach me than the office land line. I sometimes work at home. Almost all of my calls on the land line are "robo" calls, and when I am in the office, I do not normally answer the land line unless I hear someone leaving the message.

John Cederberg