AGRICULTURAL ECONOMICS

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Cornhusker Economics

Pass-Through Entity Tax Deduction

In 2023, the State of Nebraska became the 36th state to implement a Pass-Through Entity Tax (PTET) Deduction law. This law is in response to a change made by the federal Tax Cuts and Jobs Act of 2018 which limited the state and local tax deduction eligible for itemized deductions to $10,000. This new state law allows partnerships and s-corporations to pay the state income tax on behalf of their owners which qualifies it for a federal tax law deduction. The individuals will then receive a credit on their individual return for the tax paid on their behalf.

Benefits to the system:

1. You get a federal tax deduction for your state income tax paid without having to itemize your deductions.
2. The deduction is an ordinary business deduction so partnerships subject to self-employment taxes will also receive the benefit of reducing this tax.
3. Partners and shareholders who live outside of Nebraska with no other Nebraska income will no longer have to file a state return to report their income.

Drawbacks:

1. Electing partnerships will be subject to estimated tax penalties if estimates are not paid, starting in the 2024 tax season. For farmers, this means a change to quarterly estimated tax payments. For non-farmers, this will just shift the individual requirement to the entity level.
2. For entities whose owners are changing, the timing of the taxes paid can impact current owners more favorably than owners at the time of the income was taxed.

Example:

Farm Partnership Owned equally by 3 Brothers that makes $120,000 in 2023.

The partnership must make an election to pay the PTET. They will pay at the highest state rate (6.64% in 2023), so they write a check to the State of Nebraska for $7,968. If they pay this as an estimated tax payment in December of 2023, it is a deduction on the 2023 return. If they wait and pay the tax with the return, it will be a 2024 deduction. This is important because the deduction, and credit, comes on the return for the year which the tax is paid, not necessarily for the tax year.

When the 2023 return is filed, the $120,000 of income is reduced by the $7,968 state tax expense on the Federal return. The state income is still $120,000 (no deduction allowed on the state return). Each partner would recognize 1/3 of the income so the following results would mean a total savings of $1,923 for all owners.

	No PTET	PTET
Federal Taxable Income	$40,000	$37,344
Self-Employment Taxes	$5,652	$5,277
Income Taxes	$1,230	$964
Total Taxes	$6,882	$6,241
	$641	

The savings will obviously depend on the income of the entity and if the income is subject to self-employment taxes. While there are compliance requirements, the election is a remarkably simple process so there should not be a significant impact on professional fees going forward.

The estimated tax penalty for 2023 has been waived so this year you have option to pay in the 2023 year or pay with the tax return in March of 2024 but remember if you pay in March of 2024, the individual owners will not see the credit on their individual tax return until the 2024 return is filed in 2025, which could be a full 12 months of cash flow pinch. If you pay in December of 2023, the credit will be available when the individual files their return in early 2024.

Starting in 2024, the entity must make estimated tax payments in April, June, September and December, or penalties will be assessed.

2018 – 2022 Reach Back

Nebraska and Colorado are the only two states to make this law retroactive to 2018. Several states have a couple of years of experience under their belts, but it is an interesting twist to be able to go back and claim this deduction.

Nebraska made this about as simple as they could have for us. No amended tax returns will need to be filed but for entities that did not have owners that live outside of the state in 2018, a return will have to be filed with Nebraska before claiming the retroactive deduction. In 2019, the state started requiring all returns to be filed with them, so it will not be an issue for other years.

One form can be filed to elect the PTET for 2018 – 2022 or you can file it twice if you want to split up the payments. This will need to be determined on a case-by-case basis and may have more to do with cash flow than tax benefits. The form calculates the Nebraska taxable income for each year and will multiply it by the highest Nebraska rate. The entity will then pay that amount. It will become a federal tax deduction in whatever year you pay the tax. The credit will be allocated to current owners (not necessarily the same owners that originally paid the tax) and then the current owners will get that credit applied to their state tax payment.

Example:

Let us assume we have an S-Corp with 5 owners. A = 35%, B = 30%, C = 10%, D = 20% and E = 5%

	2018	2019	2020	2021	2022
Federal Taxable Income	$100,000	$100,000	$100,000	$100,000	$100,000
State Income Taxes	$6,840	$6,840	$6,840	$6,840	$6,840
Check Written	$34,200				
	A	B	C	D	E
Credit per Owner	$11,970	$10,260	$3,420	$6,840	$1,710

Even though each owner paid their taxes on this income in the appropriate year and the only income included on their 2023 tax return will be the 2023 annual amount, they will receive a credit to offset their current tax liability (and be refunded if excess) equal to their ownership percentage of the past tax.

This will create a cash flow issue for many entities since they must pay the tax before the individuals can get it back although in the end it will just move the money from the entity to the individuals. You have until December 31st, 2025, to file the election for the retroactive years so you have time to plan how this will work best for you. Some operations may also want to split the years to spread out the cash flow.

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