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7-27-2023

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Nebraska Approves Pass-Through Entity Tax Bill

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July 27, 2023

CAP Series 23-0701

In 2023, the Nebraska Legislature passed a bill that allows a partnership or S-Corp to elect to pay its state income taxes. Previously, because the income from the partnership or S-Corp is passed through to the owner, the owners of the entity paid the taxes at their own individual tax level.

In 2018, the federal government passed the Tax Cuts and Jobs Act (TCJA), which limited the itemized deduction for state and local taxes in the individual's return to \$10,000. This prompted many states to adopt laws like the new Nebraska law to work around this limitation. Federal tax law allows entities to deduct state income taxes paid as an ordinary business expense, but for most states this has only been allowed for C-corporations since they are the only entity to pay their own taxes. The pass-through entity tax law expands that option.

A pass-through entity can make a binding election each year, by the due date of the tax return, to pay the state income taxes for its owners. The tax is calculated at the highest individual tax rate (currently 6.84%). The owners then receive a credit for this tax paid, which they will report on their individual return. The benefit comes because there is a federal tax deduction for the state tax paid. The drawback is the entity will need to make estimated tax payments (even if it is a farming partnership), starting Jan. 1, 2024, if they decided to make this election. The amount of the benefit will vary depending on the individual's federal tax rate.

Example:

Let's assume you have a land-owning partnership with taxable income of \$150,000. If you make the election to have the entity pay the state tax, there would be a bill of \$10,260. The individuals would not owe state tax and, when they calculate federal taxable income, it would be lower by the \$10,250 (\$150,000 - \$10,260 or \$139,740). Depending on the individual's federal liability, the savings would range from 0% - 36% of the \$10,260.

The deduction will be an add-back on the state return (as all state tax deductions are), so there will be no tax savings on the state level.

Tax years 2018 – 2022

The Nebraska law allows this election to be made retroactively for tax years 2018 – 2022. The law charges the Tax Commissioner to come up with a way to retroactively make this election. The complexity of this method, the level of profitability and income brackets of the individuals will all play a role in the decision of whether to go back and make the election. For example, if you have 20 partners and they all must amend four years of state tax returns to get refunds of the tax paid, that will require tax prep fees on 80 tax returns. Even if it's a simple process, repeating it that many times will be costly.

The federal tax deduction will be deductible when it's paid, so if those four years' tax is paid in 2024, that's when the deduction will be claimed. This means there should be no need to amend any federal returns for 2018-2022.

The deadline to make the election for 2018-2022 is Dec. 31, 2025. We don't expect to be able to make this election retroactively until 2024, when the form is expected to be released.

Going forward

For out of state partners, filing the election removes the requirement for the individuals to file a Nebraska state return if they have no other Nebraska income. This could be a benefit to many out-of-state owners. On the other hand, if the entity is not going to have taxable income, there is no reason to make the election.

Owners with a filing requirement will report their share of the income on their Nebraska return and receive a credit for their share of the taxes paid by the entity. If their tax rate is lower than the maximum, the owner will receive the difference as a refund or payment on their other liability.

The filing requirements for an annual election should not be extensive. The biggest change for entities will be the required estimated tax payments by the entity, rather than letting the individuals work it out on their own. For farming entities who are not used to paying their taxes until the following year, the new schedule will be an adjustment.

Should you have an entity now?

The big question coming from this tax law will be if those who do not currently have a pass-through entity should form one now. The answer is the age-old best tax answer: It depends!

Whether or not this could benefit you will depend on your profitability level, your current structure, the size of your operation, etc. For example, if you are a profitable farming operation that currently files a Schedule F over the self-employment (SE) limit, it may be good to look at an S-Corp that could limit your SE tax liability and make your state taxes deductible.

If you are organized as a joint venture with FSA to get two payment limitations as a husband and wife, an S-Corp would limit your eligibility to one payment limitation. The tradeoff of tax savings could be less than the loss of future government program payments.

If instead you formed a partnership to get the entity tax deduction, you would still be eligible for two payment limitations (assuming a 50/50 partnership with a husband and wife), but you could be opening yourself to additional self-employment taxes.

Some of these questions could be answered when we receive instructions from the state as to how this will be administered but it will be important to talk with your tax advisor about your unique situation. As with any new law, the details are still being worked out.

Cite this work:

Barrett, T. "Nebraska Approves Pass-Through Entity Tax Bill." *CAP Series 23-0701*, Center for Agricultural Profitability, University of Nebraska-Lincoln, July 27, 2023. DOI: [10.32873/unl.dc.cap009](https://doi.org/10.32873/unl.dc.cap009).