



Nebraska Society of Certified Public Accountants

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MEMORANDUM

TO: State Senator LouAnn Linehan

FROM: Erica Parks, Chairman, Nebraska Society of CPAs Taxation Committee on behalf of the Taxation Committee

DATE: January 22, 2024

SUBJECT: Proposed Modifications to LB1059

Thank you for introducing LB1059. The Nebraska Society of CPAs supports this bill and greatly appreciates the effort and dedication you have shown in addressing issues critical to Nebraska taxpayers. We would like to propose some additional modifications for your consideration and believe these changes will enhance the bill's effectiveness and impact.

Nebraska Pass-through Entity Tax - Proposed Changes

The Tax Cuts and Jobs Act (Pub. L. No. 115-97) amended IRC § 164 to limit the deduction individuals can claim for state and local taxes ("SALT") to \$10,000 (\$5,000 for married individuals filing separately) from 2018 through 2025. Many states have enacted legislation for individuals with income from a pass-through entity to shift the state income tax burden from the individual to the entity level. The purpose of shifting the income to the entity level is to reduce the impact of the federal SALT cap. Out of the 41 states that impose an individual income tax, nearly all have implemented a pass-through entity tax ("PTET") as a SALT cap workaround.

In May of 2023, LB754 was signed by Governor Pillen and Nebraska joined the list of states with a PTET election. The pass-through entity ("PTE") claims a Federal tax deduction for state income tax payments made by the pass-through entity on its taxable income in lieu of the individual's state income tax obligation on the same income. The PTET is revenue-neutral for the state but reduces the impact of the federal SALT cap for many Nebraska taxpayers.

There are a few minor changes that have the potential to dramatically improve the state's PTET to benefit Nebraska taxpayers while remaining revenue-neutral for the state:

1. Add language to 77-2727(6)(a) to exclude certain types of "ineligible" partners from Nebraska pass-through entity tax (PTET) elections:

The existing statute requires a partnership that makes a Nebraska PTET election to apply such election on behalf of all partners in the partnership. Certain types of partners are unable to benefit from the election, or worse the election may be detrimental to such partners. Some partnerships are put in the position of choosing between the benefits to one partner against the burden imposed on another partner.

- C corporation Partners – C corporations are already able to deduct state income tax without the PTET election. If a C corporation pays the state income tax directly, they are not required to add back state income tax payments to calculate Nebraska taxable income. However, a C corporation partner in an electing PTET must add back the PTET to calculate their Nebraska taxable income. C corporation partners are subject to additional Nebraska state income tax due to the partnership's PTET election.

- Individual Retirement Accounts (“IRA”), 401(k) and certain other tax-exempt partners generally do not have a Federal or state income tax filing obligation. If an IRA is a partner in an electing partnership, they will have a new filing obligation to claim a refund for the PTET paid on their behalf. If a refund claim is filed for tax paid on behalf of an IRA, there is a risk the refund could cause a nonqualified distribution and result in early withdrawal penalties.¹
 - Many other states have similar exclusions from the PTET for certain types of partners.²
2. Section 77-2727(6)(h)(i) permits partnerships to make a retroactive PTET election for the 2018 – 2022 tax years. The statute provides that the form and manner of the retroactive election shall be prescribed by the Tax Commissioner.

The procedure implemented by the Tax Commissioner involves claiming the retroactive credit attributable to state income tax from 2018 – 2022 against the current year Nebraska state income tax (generally 2023 – 2025). The mismatch in timing has the potential to cause a federal income tax burden in subsequent years for certain partners.

Although the IRS and Treasury Department committed to issuing Treasury Regulations regarding Federal income tax implications of state PTET elections in November 2020, such guidance still has not been issued.³ The issue of taxability of state income tax refunds has been raised in the Tax Court leaving uncertainty regarding the Federal taxability of state tax refunds resulting from PTET credits.⁴ There is a risk that some taxpayers will be hit with an unexpected Federal income tax bill several years down the road based on the current statute.

It would be valuable to provide the option to claim the credit for the 2018 – 2022 tax years on an amended individual income tax return to protect certain taxpayers who are at risk for a future Federal income tax burden as a result of state income tax refunds from a retroactive PTET election.

3. Section 77-2734.01(8)(h)(i) permits S corporations to make a retroactive PTET election for the 2018 – 2022 tax years, similar to the corresponding provision for partnerships in Sec. 77-2727(6)(h)(i).

S corporation shareholders would benefit from a similar option to file an amended 2018 – 2022 individual income tax return to claim credits from retroactive PTET elections.

¹ IRC §72(t)

² Arizona, California, Colorado, Georgia, Kansas, Massachusetts, Michigan, Minnesota, New Mexico, North Carolina, New York, Rhode Island, South Carolina, Utah, and Virginia all exclude C corporations from PTET elections. Arizona, California, Kansas, Massachusetts, New Mexico, New York, Virginia, and Wisconsin exclude tax-exempt partners from PTET taxable income.

³ IR News Release 2020-252, Notice 2020-75, Sec. 3.02, November 10, 2020

⁴ David J. Maines, et ux. V. Commissioner, 144 TC 123, March 11, 2015