

PASS-THROUGH ENTITY INCOME TAX “WORKAROUND” S CORPORATION BANKS AND BANK HOLDING COMPANIES

The Nebraska Legislature adopted LB754 during the last session of the legislature which included a state pass-through entity income tax “workaround,” which will be of interest to Subchapter S corporation banks and bank holding companies and their QSub banks. Set forth below is a detailed analysis of the pass-through entity income tax “workaround” provisions.

The Nebraska state pass-through entity income tax “workaround” was embedded in LB754 enacted by the Legislature and signed by the Governor. The provisions for partnerships, and limited liability companies taxed as partnerships, are in Section 11 of the bill. The provisions for electing Subchapter S corporations are in Section 13. The provisions for partnerships and S corporations are identical.

The pass-through entity may make an annual election to pay state income tax at the entity level. It is an annual election; the pass-through entity may make the election in one year and not in the next. For 2023 and subsequent years, the election is made by including the election form in a timely filed return, including extensions, and paying the tax. The election is irrevocable, but the decision whether to make the election does not have to be made until all the facts for the year are known.

Even though the decision whether to make the new pass-through entity election isn’t made until the return is filed, pass-through entities should at least consider at the beginning of the year whether the election is likely to be made. If the election is made, then the pass-through entity will be treated as a corporation with respect to the payment of estimated taxes. Unless the pass-through entity knows that it will not make the election, it should be making estimated tax payments on the normal due dates for corporations, i.e. the 15th of April, June, September, and December.

Note, however, two special provisions:

- Estimated taxes are not required until 2024. Accordingly, no estimated tax is due in 2023 by pass-through entities that choose to make the election in their 2023 return.
- If an entity pays estimated taxes and then chooses not to make the election for that tax year, the estimated payments are treated as made on behalf of the partners or shareholders. The entity will “pass-through” the Nebraska estimated taxes paid with their Schedules K-1. That has a couple advantages; first it will serve to satisfy the partners’ or shareholders’ estimated tax obligations and avoid underpayment penalties, and second, it will not require the entity to wait on a refund of the estimates from the Department of Revenue.

The pass-through entity pays a flat tax on its Nebraska source taxable income at the maximum individual rate in effect for the year. As also enacted elsewhere in LB754, the maximum rates are 7.25% for 2023, 5.84% for 2024, 5.20% for 2025, 4.55% for 2026, and 3.99% for 2027.

The pass-through entity's federal return and federal Schedules K-1 will reflect taxable income *after* the deduction for state income tax. This is the taxable income that will be passed through to the partners or shareholders on their federal Schedules K-1 and is how the partners or shareholders realize the federal tax benefit for state income tax expense.

The entity's Nebraska return and state Schedules K-1 reflect its Nebraska source taxable income *before* the deduction for state income tax.¹ The entity pays tax on Nebraska source *pre-tax* income. This is consistent with the long-standing rule for all taxpayers, except C corporations, that Nebraska income tax is not deductible from Nebraska taxable income.

The entity allocates its tax payments among the partners or shareholders on its state Schedule K-1 as though it had made the payments on their behalf. The partners or shareholders include in their federal return the entity's *after-tax* income, consistent with the entity's federal Form 1065 or 1120S. On their Nebraska return, the partners or shareholders (i) include in Nebraska taxable income their share of the entity's Nebraska source *pre-tax* taxable income, but they also include in their estimated payments their share of the Nebraska tax paid by the entity.

In addition to simplicity, this has the advantage of every partner or shareholder paying net Nebraska tax at their actual individual rate. If their marginal rate on their share of Nebraska taxable income passed through from the entity is less than the maximum rate, the partner or shareholder will apply the difference paid on their behalf by the entity to Nebraska tax on other income, or they will request a refund on their individual Nebraska return.

Subchapter S banks and bank holding companies are eligible to make the pass-through election under LB754. Section 13(9) of LB754 defines an "electing small business corporation" and an "eligible small business corporation" as follows:

"(9) For purposes of this section:

"(a) Electing small business corporation means, with respect to a taxable period, an eligible small business corporation having an election in effect under subchapter S of the Internal Revenue Code that has made an election pursuant to subsection (8) of this section with respect to such taxable period; and

"(b) Eligible small business corporation means an entity subject to taxation under subchapter S of the Internal Revenue Code and the regulations thereunder."

Those definitions clearly include S electing banks and bank holding companies and their QSub banks.

The bank will continue to pay its deposits tax as it has historically done. If the bank or bank holding makes the pass-through election, it will also pay Nebraska income tax at the maximum individual rate on its taxable income.

Its federal Form 1120S will reflect taxable income *after* the deduction for both the deposits tax and the Nebraska income tax. Its Nebraska income tax return will reflect taxable income *after* the deduction for the deposits tax but *before* the deduction for state income tax. It will continue to pass through to the shareholders the existing credit for the deposits tax, and it will also pass through the allocation of its Nebraska income tax payment.

A nonresident partner or shareholder is not required to file a Nebraska tax return if the pass-through income is the individual's only Nebraska source income, or the only Nebraska source income of the partner or shareholder and spouse if a joint federal return is filed. However, notice the wording that a return is not "required." A nonresident may file a return if doing so would result in a downward adjustment to Nebraska tax.

A net operating loss must be passed through by the entity to the partners or shareholders. It cannot be carried forward by the entity.

There are other miscellaneous provisions that address tiered pass-through entities,

Retroactive Elections - The Nebraska Pass-Through Entity Tax (PTET) includes an ingenious way to compensate Nebraska partners and shareholders for the delay in adopting a Nebraska PTET provision.²

First, the PTET amendment is retroactive to taxable years beginning on or after January 1, 2018, which is the effective date of the federal limitation on the itemized deduction of state and local taxes. Retroactive elections for the years 2018 through 2022 may be made anytime between now and December 31, 2025.

Second, unlike most changes to previously filed returns which are made on amended returns for the year of change, the statute only requires that the pass-through entity file a Form to be provided by the Department of Revenue and pay the tax. Note that the paragraph in the amendment on making retroactive elections does not make any mention of an amended return except indirectly in the very last phrase that there will be no other change to the past return. That was intentional. The following is the provision for S corporations, but the provision for partnerships is identical:

“(h)(i) For tax years beginning or deemed to begin on or after January 1, 2018, but prior to January 1, 2023, the electing small business corporation must make the election under this subsection on or after January 1, 2023, but before December 31, 2025, *in the form and manner prescribed by the Tax Commissioner* for all years for which the election under this subsection is made on behalf of the electing small business corporation. *The Tax Commissioner shall establish the form and manner*, which shall not include any changes to the past returns other than those that are directly related to the election under this subsection.” [italics added]

No amended Nebraska return is required by the electing pass-through entity or by the partners or shareholders because there is no change to the entity's taxable income, or the partners' or shareholders' taxable income for the prior year for which the election is made.³

The process for a retroactive election is very simple and efficient.

- The Department of Revenue will develop a Form for making the retroactive election and related instructions.
- The pass-through entity will file the election Form during 2023, 2024, or 2025, and pay the tax.
- The entity will deduct the prior years' tax payments in its federal return for the year during

which the payments were made, i.e. 2023, 2024, or 2025.

If the entity is a cash method taxpayer, the year of payment is the proper deduction year. If the entity is an accrual method taxpayer, the year that the election is filed is the proper deduction year because that is the first year during which the obligation became fixed and determinable.

The partners or shareholders realize the federal tax benefit from the entity's election through the reduced federal taxable income passed through *for the year during which the retroactive election is filed and payment is made.*

- The entity will pass through the tax payments to its partners or shareholders in the state Schedules K-1 for the year during which the election is made and the tax is paid.
- The partners or shareholders will claim a credit in their Nebraska returns for that year similar to an estimated tax payment. The credit may be applied to offset the partner's or shareholder's Nebraska tax on other income during the year. If the credit for the entity's tax payments exceeds the Nebraska tax liability for that year, the amendment specifically provides for the balance to be a refundable credit.

The entire process is simple, with minimal filings for both taxpayers and the Department of Revenue, and minimal cost to either the taxpayers or Department.

¹ The election has no effect on traditional apportionment of income when the pass-through entity has nexus both in Nebraska and in some other state or states. The same apportionment formulas that have heretofore applied to pass-through entities, as well as to C corporations, continue to apply to electing pass-through entities.

² I understand that the Nebraska amendment follows the Colorado approach, which is also retroactive to 2018.

³ Because there is no change in the taxable income for the prior year, there is also no need for a federal amended return by either the entity or the partners or shareholders.

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