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As detailed in a previous brief and in a recent opinion piece in the Omaha World-Herald, Nebraska will automatically conform to the tax changes in the federal CARES Act, and unless the Legislature decouples from some or all of the provisions, will forgo $250 million in tax revenue over the next three years.
The state would have received this revenue -- including $125 million in FY21 alone[1] -- but for the CARES Act changes. This revenue loss does not occur in a vacuum, but rather represents a tradeoff with providing crucial services and support to Nebraskans during a global pandemic.

The most expensive tax change -- accounting for roughly 75% of the three-year total revenue loss[2] -- is temporarily allowing passthrough business owners to use business losses to offset their non-business income above the previous limit of $250,000 for single filers and $500,000 for married couples filing jointly.

Passthroughs and tax losses

Passthrough entities are businesses whose owners pay tax on their profits through the individual income tax, such as S-corporations, partnerships, and LLCs.

Tax losses occur when a business' total expenses -- including tax deductions -- are greater than its total revenues for a tax year.

How the CARES Act excess business loss provision works

Prior to the CARES Act, losses from passthrough entities could not be used to deduct more than $250,000 (single) or $500,000 (married filing jointly) of non-business income. The CARES Act suspends this limit for tax years 2018, 2019, and 2020, meaning that passthrough business owners can now deduct the full extent of tax losses from their and their spouses' other ordinary income (wages and investment income) for those years. The suspension does not benefit taxpayers with incomes below those thresholds, while providing tax breaks that become increasingly larger as taxpayers acquire more income.

To illustrate, imagine an owner of an S-corporation (married filing jointly) that owns and manages apartment buildings. In 2018, she received $5 million in rent from leasing apartments and spent $2 million on staffing, maintenance and other expenses, resulting in a $3 million positive cash flow. But because the properties generated an additional $6 million in tax deductions due to asset depreciation, the investor didn't pay income taxes on that $3 million in cash and instead will report $3 million in losses for the year. Let's assume the investor and her spouse also had $3 million of non-business income for 2018, such as capital gains. When filing her 2018 tax return, the investor was only able

[1] Nebraska Department of Revenue, "Effects of the Coronavirus Aid, Relief, and Economic Security Act on the State of Nebraska's Tax Revenue," accessed at https://revenue.nebraska.gov/sites/revenue.nebraska.gov/files/doc/research/CARES_Act/CARES_Act_Report_5-27-2020.pdf on July 19, 2020.
[2] Fred Knapp (NET Nebraska), "Estimate of GF Revenues Impact of CARES Act," accessed at https://twitter.com/fredmknapp/status/1272907799530475522 on July 19, 2020.

to deduct $500,000 of the $3 million in losses from the real estate business from her capital gains income, meaning that she owed tax on $2.5 million. The CARES Act, however, allows the investor to retroactively modify her 2018 tax return and deduct the remaining $2.5 million dollars of real estate losses against her capital gains income, meaning she will have no 2018 taxable income rather than the initial $2.5 million. Despite acquiring $6 million in 2018 cash income ($3 million from the real estate business and $3 million in capital gains), the investor will have zero 2018 income tax liability and will get a hefty refund for income taxes paid in 2018 due to the CARES Act. Even if Nebraska opts to decouple from this provision, the investor will still get a refund for federal income taxes paid in 2018.

Removing the income limit on excess business losses shifts money away from the current and pressing needs of regular Nebraskans

Because this change affects tax years beginning in 2018 and 2019, the high-income beneficiaries will receive cash refunds in 2020 based on tax losses they incurred long before the COVID-19 crisis hit. Furthermore, the people benefiting most from the change will be those with the highest incomes (those who have the most income to deduct under this provision) and taxpayers who are able to show the largest tax losses through asset depreciation and other on-paper losses that are entirely unrelated to decreased revenue streams due to the pandemic. Nor does it incentivize investment during the pandemic recovery, as investors making decisions in 2018, 2019, and into the first quarter of 2020 did so with the understanding that their deductions would be limited. Retroactively providing previously disallowed deductions means that the investments will be more profitable for those claiming the losses but it doesn't necessarily provide a reason for such taxpayers to invest back into Nebraska and help the state's economy amid the pandemic. The virus has already taken a large toll on our economy and national economists project states will experience pandemic-related revenue losses of at least 10%.3 Because Nebraska must balance its budget, revenue losses of this magnitude will almost certainly result in cuts to vital state services like K-12 and higher education. As poor and middle-class Nebraskans struggle with the health and economic effects of the pandemic, it's important for policymakers to consider the tradeoffs of funding a large tax cut for the wealthy rather than supporting vital state services or other priorities such as property tax relief.

Excess business losses often don't reflect expenditures or actual losses, many of which were accelerated under the CARES Act

Business losses often don't reflect actual expenditures or monetary losses. For example, a property purchased for $50 million could generate $2 million or more in depreciation

[3] NCSL, "COVID-19: Fiscal and Economic Issues," accessed at https://readytalk.webcasts.com/viewer/event.jsp?ei=1294001&tp_key=f22e395e39 on April 8, 2020.

deductions4 per year, even if the assets are appreciating in overall value as property often does.5

Another example is the deductibility of interest expenses on a loan, even if the loan is structured so that interest doesn't need to be paid until a later date. If an investor owes $1 million in interest on a loan for the $50 million property they purchased, the accrual of expenses allows for a $1 million deduction even if they don't have to pay that interest for another five or ten years.6

Furthermore, many other business deductions were accelerated in recent years. For example, office furniture, computers, construction equipment, and most manufacturing equipment were previously deductible over the course of 5-20 years but are now fully deductible in the purchase year meaning that a large real estate developer or manufacturer who buys millions of dollars' worth of furniture or equipment can immediately write the entirety off as a business expense, despite simply converting their cash into assets that will generate income over a long period of time.

In summary, a passthrough business owner could be making millions in cash profits, but if their deductions due to depreciation and interest expenses exceed those profits, they have business losses. Thanks to the allowance of unlimited passthrough business loss deductions in the CARES Act, such losses can now be fully used to offset their other income, reducing state revenues by a large amount while benefiting only a small subsection of wealthiest taxpayers. The congressional Joint Committee on Taxation has estimated that suspension of the cap on business losses will provide an average tax benefit of $1.6 million to just 43,000 taxpayers already earning over $1 million.7

Nebraska doesn't have to decouple wholesale from the CARES Act tax changes

The Legislature doesn't have to take an all-or-nothing approach to decoupling from the federal tax code, but rather can focus on specific, big-ticket changes. There is precedent for doing so, as the state decoupled from specific 2017 federal tax changes, such as restoring the personal exemption credit that was effectively repealed by the federal Tax Cuts and Jobs Act, while staying coupled to other provisions and maintaining automatic conformity to future changes.8 Other states, including North Carolina and Georgia, which share Nebraska's reputation for being business friendly, have decoupled from

[4] Depreciation allows business owners to reduce the value of an asset over time due to its age, wear and tear, or decay. The reduction in value may be taken as a deduction against taxable income, decreasing the tax obligation of a business without affecting its cash flow or cash balance.

[5] Clint Wallace, "The Troubling Case of the Unlimited Pass-Through Deduction: Section 2304 of the CARES Act," accessed at https://lawreviewblog.uchicago.edu/2020/06/29/cares-2304-wallace/ on July 19, 2020.

[6] Clint Wallace, "The Troubling Case of the Unlimited Pass-Through Deduction: Section 2304 of the CARES Act," accessed at https://lawreviewblog.uchicago.edu/2020/06/29/cares-2304-wallace/ on July 19, 2020.

[7] JCT letter to Senator Sheldon Whitehouse and Representative Lloyd Doggett, April 9, 2020, accessed at https://www.whitehouse.senate.gov/imo/media/doc/116-0849.pdf on July 20, 2020.

[8] Nebraska LB 1090 (2018), accessed at https://nebraskalegislature.gov/bills/view_bill.php?DocumentID=34666 on July 19, 2020.

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some provisions of the CARES Act -- including the suspension of the limits on excess business losses -- to avoid budget shortfalls without forgoing the CARES changes entirely.

Like North Carolina and Georgia, Nebraska lawmakers don't have to decouple from the tax changes in their entirety. For example, they could consider decoupling from the modification of excess business losses, which provides an $187 million tax break for some wealthy Nebraskans, while maintaining other provisions such as ensuring that forgiven PPP loans are not included in taxable income and waiving required minimum distribution rules for certain retirement plans for calendar year 2020.

Conclusion

As the excess business loss provision only benefits taxpayers with high incomes and has little to no relation to revenue losses incurred during the pandemic, it's important for policymakers to consider whether this is the best possible way to allocate $187 million of taxpayer dollars or if the state should decouple from this provision in order to use the revenue in ways that will better address state needs.