Understanding the Pass-Through Loss Limitation in Conformity

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This year, the federal CARES Act and COVID Relief Act will prompt a number of changes to Idaho's tax code, should policymakers approve full or partial tax conformity. Conformity is when Idaho aligns its tax code with Federal tax code changes. While policymakers have consistently approved conformity changes in the past, an accurate and reasonable estimate of the cost of these tax changes are important to understand so lawmakers can ensure that other budgetary decisions made this year are sound and fiscally prudent. The costliest potential change of conformity would be the elimination of the pass-through loss limitation. The following is a discussion of the major considerations of this provision should conformity be approved.

How the Pass-through Loss Limit Works in Practice

The 2017 Tax Cuts and Jobs Act (TCJA) set the pass-through loss limit at $250,000 for people with a pass-through business filing an individual tax return and $500,000 for people with a pass-through business filing a joint tax return with a spouse. The CARES Act removed this limitation and made it retroactive to tax years 2018, 2019, and 2020. Idaho policymakers could choose to allow three years of retroactive tax breaks for pass-through entities if the state conforms to CARES.

Pass-through entities are businesses, such as S-corporations, partnerships and LLCs, whose owners pay taxes for pass-through entities on their individual income tax.

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

In practice, lifting the pass-through loss limit is a significant tax break for both profitable and struggling businesses. For example, a married Idaho S-corporation owner who manages and operates a successful storage facility business may benefit from the lifting of the pass-through loss limit. If the storage facility owner has $1 million in profits and $2 million in tax deductions due to asset depreciation (a paper loss), the business owner could deduct the full $2 million in losses and would receive a significant state tax refund. On the other hand, if Idaho does not conform with this portion of the CARES Act, this S-corporation could only deduct $500,000 of losses on their Idaho state taxes, resulting in taxes paid on $500,000 of the corporation's profits.

According to the most recent data available in Idaho, there are about 63,000 pass-through entities, 4,000 of which earn profits of half a million dollars or more after accounting for losses.

Pass-through Loss Limit Could Cost as Much as $99.4 Million Over Two Years

The biggest revenue losses will likely occur in the current fiscal year (2021), since that is when 2020 returns and amended returns for tax years 2018 and 2019 will likely be filed if conformity with this provision is approved. Idaho can expect smaller, additional revenue losses in fiscal year 2022 due to late and amended filers.

For FY21, the Idaho Tax Commission provided a weighted estimate of the total cost of conformity (including the loss limit loss change and other potential tax changes) of $60 million. In FY22, the Commission estimates the weighted cost of conformity would be $55 million. The change in the pass-through loss limitation is more than half of the total cost of conformity and the estimates for this change vary widely. In FY21, the Tax Commission estimates that the cost of lifting the loss limit could be anywhere between $24 and $53 million. If costs fall on the high side of the estimate, the total cost of full conformity could rise to $79.6 million in FY21. Similarly, in FY22, the loss limit is estimated at between $21 and $46 million, and the total cost of full conformity could rise to $72 million if the pass-through loss limit cost is at the high end of the range.

These cost estimates also may be low because they do not include Idaho residents who invest in pass-through entities that operate in another state.

Estimates from other states on the cost of conforming to the pass-through loss limitation show overall higher estimates on this provision alone. Nebraska and Montana are of particular interest, as they are similar in size to Idaho and have similar numbers of pass-through entities reporting over half a million dollars. As of 2018, Nebraska had 4,470 such entities and Montana had 2,590 compared with Idaho's roughly 4,000.[1]

Estimated Revenue Loss From Conformity to CARES Act's Suspension of Pass-Through Loss Limitation[2]

	FY20	FY21	FY22
Colorado		$73 million	$18 million
Maryland	$21 million	$115 million	$4 million
Michigan	$208 million	$179 million	
Montana		$47 million	$41 million
Nebraska		$83 million	$54 million
Oregon	$98 million		

Source: See Footnote #2

Nationally, the Joint Committee on Taxation estimates that 82 percent of the households, or 43,000 taxpayers, that will benefit from this tax break earn more than $1 million annually. For this small group of taxpayers, their average tax payments would fall by about $1.6 million.[3]

Additional Considerations

The CARES Act provision applies to two tax years prior to the pandemic and recession and therefore is not targeted to pass-through entities hurt by these events. Congress did not require beneficiaries of these tax cuts to use these funds to support the economy or respond to the pandemic in some other way. There is no requirement that businesses reinvest any of the tax savings from this provision into the business.

In practice, only a small portion of the tax savings from conformity with this provision will likely be reinvested in the pass-through businesses because the tax savings directly benefit the business's owners, not the business itself.

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Many pass-through businesses have multiple owners who would have to agree among themselves to reinvest their savings from the tax break into the business. Reaching such an agreement would be difficult if the tax savings differ significantly among a business's owners, as they likely often will. And the businesses may be located in states other than those in which some (or even all) of their owner-managers reside. So lost state revenue in Idaho from conforming to this provision may receive little or no direct economic benefit to communities in Idaho.

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1. Internal Revenue Service, "SOI Tax Stats – Historic Table 2, accessed on January 25, 2021 at: https://www.irs.gov/statistics/soi-tax-stats-historic-table-2

2. Colorado Legislative Council, Final Fiscal Note on HB20-1420 (decoupling bill), July 28, 2020,

http://leg.colorado.gov/sites/default/files/documents/2020A/bills/fn/2020a_hb1420_f1.pdf; Maryland Comptroller Peter Franchot, "60-day report" letter to Governor Larry Hogan, Senate President William C. Ferguson IV, and Speaker of the House Adrienne A. Jones, June 12, 2020,

https://www.marylandtaxes.gov/reports/static-files/revenue/federalimpact/CARES_Act_60_Day_Report_Final_2020.pdf; Michigan Dept. of Treasury, Office of Revenue and Tax Analysis, "Estimated Revenue Impact of the CARES Act," unpublished table (available from the author), April 24, 2020; Montana State Legislature, Legislative Fiscal Division, "Revenue Outlook 2023 and Beyond," September 2020,

https://leg.mt.gov/content/Committees/Interim/2019-2020/Revenue/Meetings/September-2020/LFD-Sept-update.pdf; Nebraska Dept. of Revenue, "Estimates of GF Revenue Impact of CARES Act," unpublished, undated table; see

https://twitter.com/fredmknapp/status/1272907799530475522 (Twitter post of Fred Knapp, reporter for Nebraska Public Radio and Television, June 16, 2020); Oregon Legislative Revenue Office, "Coronavirus Aid, Relief, and Economic Security (CARES) Act (H.R. 748), Tax and Revenue Related Provisions," May 2020,

https://olis.leg.state.or.us/liz/2019I1/Downloads/CommitteeMeetingDocument/222068.

3. Joint Committee on Taxation, Letter to Senator Sheldon Whithouse and Representative Lloyd Doggett," April 9, 2020, Accessed at: https://www.whitehouse.senate.gov/imo/media/doc/116-0849.pdf