Ohio Legislative Service Commission

Bill Analysis

Mackenzie Damon

S.B. 288

131st General Assembly
(As Introduced)

Sens. Eklund, LaRose, Seitz, Patton

BILL SUMMARY

- Removes the imposition of a direct tax on pass-through entities (PTEs) – which effectively causes them to "withhold" income taxes on the distributive shares of their nonresident investors – while maintaining the requirement that PTEs remit taxes on such investors' behalf.

- Lowers the tax rates at which PTEs must remit taxes on investor income to equal the tax rate that would apply if the investor filed an individual income tax return.

- Consolidates the two existing PTE filing options into one return.

- Repeals and consolidates multiple obsolete or duplicative provisions of the law governing pass-through entity investor taxation.

- Removes the imposition of a direct tax on trusts that causes them to withhold income tax on certain types of distributions made to nonresident beneficiaries.

- Modifies the apportionment method for the investment income of certain trusts.

- Makes nonrefundable, rather than refundable, the income tax credit that allows taxpayers that own a pass-through interest in a financial institution to offset the owner's share of the entity's financial institutions tax (FIT) liability.

- Repeals some expired provisions of the Corporation Franchise Tax and Income Tax Law.

CONTENT AND OPERATION

Pass-through entity taxation

The Ohio income tax applies to income received by an owner or investor in a pass-through entity (PTE) from the PTE's business activities in the state. (Pass-through entities include S corporations, partnerships, and limited liability companies treated for federal income tax purposes like S corporations or partnerships.) Under current law, in order to ensure collection of the tax from nonresident individuals and entities – which may not otherwise be required to file an individual tax return – a PTE is required to withhold the income tax due from its nonresident investors. This "withholding tax" is imposed directly on the PTE, even though the underlying tax liability belongs to the investors.

The bill makes several changes to the mechanism for collecting tax on PTE investor income. First, the bill maintains the requirement that PTEs remit taxes on behalf of nonresident investors, but removes language directly imposing a tax on PTEs as a means of "withholding" those investors' taxes. Accordingly, references in the Revised Code to a "pass-through entity withholding tax" are removed. Second, the bill lowers the rates at which PTEs remit taxes on investor income to equal the tax rate that would apply if the investor filed an individual return. Third, the bill repeals and consolidates multiple provisions in an effort to streamline the law governing taxation of pass-through entity income.[1]

Filing requirements

Under current law, a PTE required to file a tax return on behalf of its nonresident investors has a choice between two different returns – the IT 1140 (the income tax withholding return) or the IT 4708 (a composite return). The bill consolidates these two returns into one.[2] Because the bill eliminates the "withholding tax," the new return requirements more closely resemble the requirements for the existing IT 4708. The following table outlines the key features of the existing and new PTE income tax returns:

---

[1] R.C. 5747.01, 5747.059, 5747.03, 5747.08, 5747.082, 5747.11, 5747.13, 5747.132, 5747.14, 5747.15, 5747.20, 5747.21, 5747.212, 5747.22, 5747.231, 5747.28, 5747.30, 5747.331, 5747.40, 5747.41, 5747.42, 5747.43, 5747.44, 5747.45, 5747.451, 5747.98, and 5748.01 and Section 3.

[2] R.C. 5747.08, 5747.40, 5747.41, and 5747.42.

	IT 1140 (R.C. 5747.42)	IT 4708 (R.C. 5747.08(D))	Proposed law
Type of return(s)	Withholding tax return only. Both resident and nonresident investors still must separately file IT 1040 individual tax returns.	Composite tax return. Resident investors, and nonresident investors with other Ohio income, are still required to file IT 1040 individual tax returns. Nonresident investors with no other Ohio income may, but are not required to, file an IT 1040 individual tax return.	Composite tax return. Same as IT 4708.
Who must file	All PTEs with Ohio "nexus," unless: (a) The PTE files an IT 4708 for all of its nonresident investors, (b) all of the PTE's investors are residents or are not subject to the income tax (e.g., corporations), or (c) all of the PTE's investors are other PTEs with investors described in (b).[3] Some forms of PTEs do not have to file, including mutual funds, REITs, REMICs, nonprofit organizations, pension plans, colleges and universities, public utilities, publicly traded partnerships, and insurance companies.	No PTE is required to file an IT 4708. The return is optional. **Note:** A PTE may file an IT 1140 for some investors and an IT 4708 for the other investors in the same taxable year. Also, a person invested in two PTEs may be listed on an IT 1140 by one PTE and on an IT 4708 by the other PTE.	All PTEs with Ohio nexus, unless: (a) All of the PTE's investors are residents or (b) all of the PTE's investors are persons other than other PTEs or entities not subject to the income tax (e.g., corporations). **Note:** PTEs that are not required to a file a composite tax return must instead file an informational return with the Department of Taxation, unless: (a) None of the PTE's investors is subject to the income tax or (b) all of the PTE's investors are residents and the PTE will not claim any business tax credits.

[3] "Nexus" is not defined by current statute or the bill. In the context of the income tax, it has been construed by courts to be a threshold level of contacts between the taxing state and a person or entity sufficient to permit the state to tax the person's or entity's income derived from business activity in the state. See *Agley v. Tracy*, 87 Ohio St.3d 265 (1999).

	IT 1140 (R.C. 5747.42)	IT 4708 (R.C. 5747.08(D))	Proposed law
Investors included on return	All investors, other than full-year residents and specified exempt entities, such as nonprofit organizations, pension plans, colleges and universities, public utilities, publicly traded partnerships, and insurance companies. Nonresident investors are not included if the PTE includes those investors on an IT 4708.	The PTE may include all investors other than C corporations or other PTE investors that have a C corporation as an investor.	All investors.
Tax base	The total of investors' distributive shares of the PTE's net income, with some additions and deductions (known as the "adjusted qualifying amount"). The withholding tax base does not include investment-type income earned by an "investment pass-through entity."[4] However, such income is taxable on the investor's IT 1040 individual tax return.	Substantially similar to IT 1140 (but includes only the shares of investors reported on the composite return). N/A.	Substantially similar to IT 1140 and IT 4708. N/A.
Limitations	N/A. Because each individual investor is required to file an IT 1040 individual return, the investor may claim the small business income deduction, personal exemptions, and nonbusiness credits on that form.	Investors cannot claim the small business income deduction, personal exemptions, or nonbusiness credits unless the individual investor files an IT 1040 individual return.	Same as IT 4708.

[4] R.C. 5733.401. An "investment pass-through entity" is a PTE that has 90% of its assets in the form of intangible assets and that receives 90% of its gross income from investment-related activity (dividends, interest, capital gains, management fees, loan fees, financing fees, and similar forms of income).

	IT 1140 (R.C. 5747.42)	IT 4708 (R.C. 5747.08(D))	Proposed law
Payment threshold	No payment due if "adjusted qualifying amount" is less than $1,000.	N/A.	No payment due if the amount of tax due after application of business credits is less than $250.
Quarterly estimated taxes	Required if total "adjusted qualifying amounts" exceed $10,000.	Required if total tax due exceeds $500. (The same threshold applicable to individual income taxpayers.)	Same as IT 4708.

Tax rates

Current law

Under current law, different tax rates apply to pass-through entity income depending on the annual form the PTE files:

Form 1140: If a PTE files an IT 1140 withholding tax return, the PTE must withhold tax on its investors' "adjusted qualifying amount" at the rate of 5% for individuals and 8.5% for trusts and investors that are themselves pass-through entities. Both of these rates are higher than the statutory tax rate on business income, which, for 2016, is 3%. However, because each individual investor is required to file an IT 1040 individual tax return, the individual may calculate the individual's business income tax rate at 3% on that return and receive a refund for any difference between the amount withheld and the amount actually due.

Form 4708: If a PTE files an IT 4708 composite return, the PTE must remit tax on the investor's taxable business income at "the highest tax rate" specified in the Income Tax Law, which, for 2016, is the highest nonbusiness income tax rate of 4.997%. Individual investors included on the IT 4708 may file an IT 1040 individual tax return to receive a refund of any difference between the amount paid on the IT 4708 and the amount actually due.

Proposed law

Under the bill, a PTE must remit taxes on behalf of the investors included on the return at the business income tax rate of 3%.[5] (Nevertheless, nonresident individual investors may elect to file an IT 1040 individual return in order to claim the small business income deduction, a personal exemption, and any nonbusiness credits.)

[5] R.C. 5747.40(A)(4). (Note that the bill includes an erroneous cross-reference to the applicable tax rate.)

Look-through provisions

Current law

Under current law, a PTE is not required to remit tax on the distributive shares of income that pass through to another PTE if the other, "investor" PTE irrevocably acknowledges that it has nexus with the state for the entire taxable year. For example:

> Blue LLC is owned 100% by Purple LLC. Purple LLC is owned 100% by Jack and Jill. Blue LLC would not be required to remit tax on behalf of Purple LLC (if Purple LLC irrevocably acknowledges it has nexus with Ohio); Purple LLC would remit the tax.[6]

Proposed law

Under the bill, a PTE with an investor that is also a PTE is required to remit the tax due on the distributive share of the investor PTE, and the investor PTE may claim a credit for taxes paid by the lower-tier PTE. For example:

> Blue LLC is owned 100% by Purple LLC. Purple LLC is owned 100% by Jack and Jill. Blue LLC would remit the tax due on the income passed-through to Purple LLC. When Purple LLC files its annual return, it may claim a credit for the tax paid by Blue LLC.[7]

In this example, Jack and Jill, direct investors in Purple LLC and indirect investors in Blue LLC, also may claim a credit for the taxes remitted by Blue LLC, but only if Purple LLC does not claim the credit.

Taxation of trusts

Under continuing law, an individual may be liable for income tax on the distributions the individual receives as the beneficiary of a trust to the extent included in the individual's federal adjusted gross income, and trusts are taxed on the portion of

---

[6] R.C. 5733.402. An exception to this rule applies to investment pass-through entities. If an investment PTE owns all or part of another PTE, that other PTE is required to remit the tax on behalf of the investment PTE (and, accordingly, the investment PTE's investors) – but only if the investment PTE provides to the other PTE the contact information of its investors. R.C. 5747.401.

In the above example, if Purple LLC is an "investment pass-through entity," then Blue LLC would be required to remit the tax on behalf of Purple LLC (if Purple LLC provides Blue LLC with the contact information of Jack and Jill).

[7] R.C. 5747.42(C).

the trust's undistributed taxable income that is apportioned or allocated to Ohio. The trust tax is computed by multiplying the allocated and apportioned income of the trust by the personal income tax rates.

Repeal of trust withholding tax

The bill repeals a requirement that trusts withhold income tax on certain types of distributions made to their nonresident beneficiaries. (As with the pass-through entity withholding tax, the purpose of the trust withholding tax is to ensure collection of the tax from beneficiaries who might otherwise not be required to file an individual Ohio tax return.) The withholding tax applies to distributions that directly or indirectly relate to either real estate located in Ohio or tangible personal property located in Ohio.

Apportionment of certain trust investment income

In general, there are three methods of apportioning or allocating trust income, depending on the source of income: (1) capital gains (or losses) from the sale of certain assets ("the qualifying trust amount") are apportioned based on the proportion of the value of the asset located in Ohio as compared to everywhere, (2) business income – excluding such capital gains or losses – is apportioned under a three-factor formula (sales, property, and payroll), and (3) nonbusiness income – excluding such capital gains or losses – is allocated to Ohio to the extent the income is produced by trust assets that compose the Ohio resident part of the trust under trust residency rules.

The bill removes an exception to this general rule for certain types of investment income. Under current law, the exception applies to certain investment income received by a trust that was in existence before June 5, 2002 (the date the tax on undistributed trust income took effect) or that, if it did not then exist, was composed almost entirely (80%) of assets owned by related persons or another trust satisfying certain criteria. In general, current law requires that such income be apportioned in the same manner as business income (under the sales, property, and payroll three-factor formula), rather than being allocated as nonbusiness income, if the income is attributable to the trust's ownership of a "qualifying investment pass-through entity." An "investment pass-through entity," for this purpose, is a PTE that has 40% of its assets in the form of intangible assets, that receives 40% of its income from investment-related activity, and that was also formed before June 5, 2002.[8] The effect of the bill's change is to cause a trust's income that currently is regarded as qualifying investment income to be apportioned or allocated in the same manner as the trust's business income and nonbusiness income, depending on whether the investment income is business or nonbusiness income.

---

[8] R.C. 5747.01(BB), 5747.011, 5747.012, and 5747.02.

Refundability of income tax credit offsetting FIT liability

Continuing law allows an individual, estate, or trust that owns a pass-through interest in a financial institution to claim an income tax credit that offsets the owner's share of the entity's financial institutions tax (FIT) liability. The FIT is a business privilege tax on financial institutions, e.g., banks.

Under current law, the tax credit is refundable; so, if the credit amount allowed for a year exceeds the taxpayer's tax liability for that year, the taxpayer may receive a refund of the excess. The bill makes the credit nonrefundable; however, if the credit exceeds the taxpayer's liability for a particular year, the bill allows the excess to be carried forward to future tax years until fully used.

The bill also requires that, if the credit amount is affected by a change in the entity's FIT liability, the taxpayer must report the change within 60 days. If the change is not reported before that deadline, the Tax Commissioner may assess the taxpayer for the difference.[9]

Repeal of expired provisions

The bill removes language in the Revised Code that:

- Required PTEs with a business presence in Ohio to withhold corporation franchise taxes on the distributive shares of nonresident investors. The withholding tax is no longer required, as the corporation franchise tax was completely phased out in 2013.[10]

- Authorized an income tax credit for investment in a certified ethanol production plant. The last year in which the credit could be awarded was 2012, and – due to a three-year carryforward allowance – the last year in which the credit could be claimed was 2015.[11]

- Required an adjustment to a trust beneficiary's adjusted gross income when the beneficiary received an accumulation distribution. This language was relevant only for taxable years before 2002, when the income tax applied only to trust distributions to beneficiaries, rather than

[9] R.C. 5747.01, 5747.65, and 5747.98.

[10] R.C. 5733.01, 5733.04, 5733.057, 5733.0611, 5733.09, 5733.12, 5733.40, 5733.401, 5733.402, 5733.41, and 5733.98.

[11] R.C. 901.13, 5747.75, and 5747.98.

to both distributions and undistributed trust income (as it has since 2002).[12]

Miscellaneous changes

The bill makes various changes to move definitions and other language among different Revised Code sections – for example, moving definitions for "related member," "qualifying controlled group," "disregarded entity," "distributive share," "investor," and language prescribing computation of the three-factor formula for apportioning business income – and makes numerous changes to conform existing law to the bill's substantive amendments.

Regarding the definition of "related member," the bill makes a slight change but declares that it "is intended to clarify and be declaratory of" current law's definition.[13] The change is to the rules governing how ownership of stock or other ownership interests are to be attributed to individuals, PTEs, estates, trusts, or corporations for the purpose of determining whether any two such persons are related. In the PTE taxation provisions of the bill and current law, the ownership relation between persons affects the computation of the tax base on which PTEs must remit tax. The tax base ("adjusted qualifying amount") includes two adjustments intended to discount the effects of transactions between two related members: one effectively negates deductions for excess expenses paid to a related member and the other negates losses incurred from transactions between related members. (Either kind of transaction can be used to shift net income between related persons.) Current law states that, for the purpose of the tax base adjustments, an ownership interest will be attributed to a person in some cases if that person owns 40% or more of an entity.[14] The bill applies different attribution rules to those cases (I.R.C. sec. 318) that specify a 50% ownership threshold.[15]

Effective date

The bill applies to taxable years ending on or after January 1, 2017.[16]

---

[12] R.C. 5747.01(A)(6).

[13] Section 3.

[14] R.C. 5733.042(A)(6) and 5733.40(P).

[15] R.C. 5747.01(DD)(2).

[16] Section 4.

HISTORY

ACTION	DATE
Introduced	03-02-16

S0288-I-131.docx/ks