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Bill Analysis

Version: As Introduced

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SUMMARY

- Levies a tax on a pass-through entity's (PTE's) income apportioned to Ohio at a rate of 5% for taxable years beginning in 2022 and 3% for taxable years thereafter, but only if the PTE elects to become subject to the tax.
- Authorizes a PTE owner to claim a refundable credit against the owner's Ohio income tax liability equal to the owner's proportionate share of the tax paid by the PTE.
- Credits all tax revenue to the GRF.

DETAILED ANALYSIS

Pass-through entity income tax

Under current law, 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. (PTEs include partnerships, limited liability companies, and S corporations.¹)

In certain circumstances, PTEs may pay Ohio income tax on behalf of an investor. Under continuing law, a PTE is required to withhold the income tax due from its nonresident investors. Aside from their ownership of the PTE, nonresident investors are not required to file individual tax returns. This withholding tax is imposed directly on the PTE, even though the underlying tax liability belongs to the investors.²

¹ R.C. 5733.04(O).

² R.C. 5733.41 and 5747.41 to 5747.453.

Also under continuing law, a PTE may, but is not required to, file a composite return (Form 4708) covering any or all of its owners and paying tax for them at the highest of the graduated tax rates for nonbusiness income (3.99% currently).³

The bill authorizes a third option for a PTE to pay income tax by directly imposing an income tax on the PTE, but only if the PTE elects to be subject to the tax.⁴ The PTE's owners would then be able to claim a refundable credit on their individual income tax returns equal to their proportionate share of the income taxes levied on and paid by the PTE.⁵

A PTE may elect to be subject to the tax primarily to reduce the federal income tax liability of its owners. Federal law allows a taxpayer, in calculating the taxpayer's federal income tax liability, to deduct up to \$10,000 in property taxes plus either state and local income taxes or sales taxes paid by the taxpayer. This deduction is known as the state and local tax (SALT) deduction.⁶ (The SALT deduction is a "below the line" deduction, meaning it is applied after federal adjusted gross income (FAGI) is calculated and is only available if the taxpayer itemizes deductions, rather than taking the standard deduction.) Recent guidance published by the Internal Revenue Service confirms that taxes paid at the PTE level are an "above the line" deduction that do not count towards a PTE owner's \$10,000 SALT limitation. In other words, taxes paid by a PTE reduce the FAGI of its owners without being subject to the SALT limitation.⁷

For example, if an owner's Ohio income tax liability due to income arising from a PTE's business activities in Ohio equals \$15,000, the owner may only deduct \$10,000 in calculating the owner's federal income tax liability. If the PTE, however, elects to become subject to the tax authorized by the bill, all Ohio income taxes would instead be paid by the PTE, and would, as a result, reduce the owner's federal adjusted gross income (FAGI) by an amount equivalent to deducting the full \$15,000 in Ohio income taxes.

Election

A PTE may elect to be subject to the tax (referred to in the bill as an "electing PTE") by filing a form making the election with the Tax Commissioner by the deadline to file its return for the taxable year, which is April 15 of the year beginning after the end of its taxable year.⁸ (An electing PTE's taxable year for Ohio income tax purposes is the same year for federal income

³ R.C. 5747.08(D).

⁴ R.C. 5747.38.

⁵ R.C. 5747.39.

⁶ 26 United States Code (U.S.C.) 164.

⁷ R.C. 5747.38(E); Internal Revenue Service, *Notice 2020-75: Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes* (November 9, 2020), available at <https://www.irs.gov/pub/irs-drop/n-20-75.pdf>.

⁸ A cross-reference error requires the election be made by the date a return of estimated tax is due, but a corrective amendment has been prepared to fix this error.

tax purposes and may not necessarily be a calendar year.⁹) The election applies only to the taxable year for which it is made and, once made, is irrevocable for that year.¹⁰

An electing PTE is not required to withhold the income tax due from its nonresident investors for the taxable year that the PTE makes the election.¹¹ If the electing PTE already paid all or a portion of the withholding tax, the amounts paid may be applied to the electing PTE's income tax liability.¹²

Rate of tax

An electing PTE's tax liability equals all income situated to Ohio, less a few adjustments, multiplied by one of the following tax rates:

- For 2022, 5%;
- For each year thereafter, the income tax rate applicable to business income (i.e., 3%).¹³

This is the same rate structure that applies to certain nonresident PTE investor withholding taxes.¹⁴

Returns and payments

Similar to the withholding tax for nonresident PTE investors, an electing PTE must file an estimated tax return and an annual tax return and make estimated payments each quarter. Estimated taxes must be paid by the 15th day of the month after the end of each quarter.¹⁵ As mentioned above, the deadline to file the annual return and pay any additional tax shown due on the return is April 15 following the electing PTE's taxable year that ends in the preceding calendar year.¹⁶ Electing PTEs are entitled to refunds for overpayments and are subject to penalties and interest under continuing law for failure to file returns or pay the tax.¹⁷

Revenue from the income tax levied on electing PTEs is credited to the GRF.¹⁸

The bill permits a nonresident investor or trust to forgo filing an individual income tax return for the investor's or trust's taxable year if the investor or trust does not have any income

⁹ R.C. 5747.45.

¹⁰ R.C. 5747.38(C).

¹¹ R.C. 5733.41 and 5747.41.

¹² R.C. 5747.43(G).

¹³ R.C. 5747.38(A)(4) and (B).

¹⁴ R.C. 5747.41 and Section 3 of S.B. 18 of the 133rd General Assembly.

¹⁵ R.C. 5747.43.

¹⁶ R.C. 5747.42 and 5747.44.

¹⁷ R.C. 5747.11, 5747.13, 5747.132, 5747.14, 5747.15, 5747.451, and 5747.453.

¹⁸ R.C. 5747.03.

other than income from one or more electing PTEs. To claim the refundable income tax credit, though, the nonresident investor or trust must file an annual return.¹⁹

Refundable income tax credit

To claim the refundable income tax credit, an owner must first add back to its Ohio taxable income its proportionate share of the income taxes levied on and paid by the electing PTE. As noted above, the tax paid by the electing PTE reduces the owner's FAGI, which is the starting point for calculating a taxpayer's Ohio income tax liability.²⁰

Then, the owner may claim a refundable income tax credit equal to the amount of PTE taxes added back. The credit must be claimed for the owner's taxable year that includes the last day of the electing PTE's taxable year for which the tax was paid.²¹

Rules

The bill requires the Tax Commissioner to adopt rules to administer the income tax on electing PTEs, which must include guidance for owners to claim the income tax credit based on different ownership structures. Adoption of these rules are exempt from continuing law's requirement for the Commissioner to simultaneously repeal at least two other rules.²²

HISTORY

Action	Date
Introduced	10-05-21

S0246-I-134/ar

¹⁹ R.C. 5747.08.

²⁰ R.C. 5747.01(A)(36) and (S)(15).

²¹ R.C. 5747.39 and 5747.98.

²² R.C. 5747.38(F).