Ohio Legislative Service Commission

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Fiscal Note & Local Impact Statement

Bill: S.B. 288 of the 131st G.A.

Date: April 12, 2016

Status: As Introduced

Sponsor: Sen. Eklund

Local Impact Statement Procedure Required: No

Contents: Revises law governing reporting and payment of tax on income from pass-through entities

State Fiscal Highlights

- The bill updates pass-through entity (PTE) law for recent changes in the tax rate on business income and elimination of the corporate franchise tax.
- The reduction in the income tax rate paid by PTEs appears likely generally to be revenue neutral, but certain other changes in this update to PTE law may add to or reduce GRF tax revenue.
- The bill's provisions would not go into effect until 2017.

Local Fiscal Highlights

- To the extent that GRF revenue is increased or decreased by provisions of the bill, revenue sharing distributions to local governments and libraries through the state's Local Government Fund (Fund 7069) and Public Library Fund (Fund 7065) would be enhanced or diminished.

Detailed Fiscal Analysis

The bill reorganizes and updates law pertaining to pass-through entities (PTEs), which include partnerships, S corporations, and limited liability companies. It repeals a number of Revised Code sections of corporate franchise tax law and eliminates cross-references in other sections to those laws. Ohio's corporate franchise tax ended for tax year (TY) 2014 and thereafter under a provision of H.B. 510 of the 129th General Assembly. Under the bill, a PTE is still obligated to file and pay on behalf of nonresident individuals and certain nonindividual investors. The bill repeals other out-of-date references in the Revised Code, as detailed in LSC's Bill Analysis. It changes somewhat the basis on which a PTE computes the tax, and lowers the rate of tax owed by those PTEs required to pay the tax to 3%, in line with the lower rate on business income enacted by H.B. 64 of the 131st General Assembly,[1] i.e., PTEs would remit taxes on investor income equal to the tax rate that would apply if the investor filed an individual income tax return.

Summary of fiscal effects

This lower income tax rate is expected generally to have no net fiscal effect, because taxpayers are entitled to refunds of taxes overpaid on their behalf by pass-through entities, in current law as well as under the bill. Changes made by the bill apply to taxable years ending on or after January 1, 2017.

The following changes in PTE law in the bill may have fiscal effects. For PTEs that are financial institutions, the bill's change in these credits to nonrefundable from refundable would alter the timing of payments, which may add to state revenues initially. A change in the minimum amount below which a PTE is not required to remit taxes would not alter tax obligations but could result in reduced state collections. Elimination of an exemption from filing and tax payment requirements for PTEs qualifying to be investment PTEs under current law would not alter tax obligations but may facilitate tax collection. Repeal of a requirement that trusts withhold tax on nonresident beneficiaries likewise would not change tax liabilities but could impede compliance.

To the extent that these various fiscal effects result in net increases or decreases in GRF revenues, the Local Government Fund (LGF, Fund 7069) and the Public Library Fund (PLF, Fund 7065) may gain or lose revenue.

[1] Reference in line 4004 of the bill to division (A)(2)(b) of R.C. 5747.02 is here assumed to instead reference division (A)(4)(b).

Pass-through entities

The tax liability associated with the income of a business designated as a PTE is "passed through" to the investor in the PTE, and taxed once at the investor level so avoiding a second layer of taxation, for federal (but not Ohio) tax purposes, at the corporate level. For out-of-state investors in Ohio PTEs, however, a tax (dubbed "withholding tax" in current law) has been required to be remitted by the PTEs as a way of providing greater assurance that the tax would be paid. A PTE is required to withhold the income tax due from its nonresident investors. The tax is imposed directly on the PTE, even though the underlying tax liability belongs to the investors; and investors in PTEs have been entitled to refundable credits for the taxes paid by the PTEs. Under current law, a PTE required to file a return has a choice between two different returns – the IT 1140 (income tax withholding return) or the IT 4708 (a composite return). The first tax return has a rate of 5% for individuals and 8.5% for trusts and investors that are themselves PTEs, while the second tax return has a tax rate of 4.997%.

Under the bill, credits for the taxes paid by the PTEs would continue to be refundable for investors in PTEs, with the exception of investors in PTEs that are financial institutions. For these investors, the credits would be nonrefundable but could be carried forward indefinitely against future tax liability until used. The net amount of tax revenue would generally be unchanged but the timing of payments would differ.

Tax calculation

Under the bill, a PTE must remit taxes on behalf of the investors at the business income tax rate of 3%, (though a nonresident individual investor may elect to file an individual income tax return in order to claim, for example, a personal exemption and any nonbusiness credits). Calculation of the tax to be paid by a PTE under the bill is similar, but not identical, to that under current law. The PTE is to aggregate the distributive shares of all its direct investors that are PTEs, estates, trusts, or nonresident individuals. Various adjustments are specified in the bill to the resulting aggregate amount. The end result of these calculations is to be multiplied by the tax rate on business income, 3%. This compares with rates under current law of 4.997%, 5%, and 8.5% depending on the investor and the tax form filed by the PTE. The lower tax rate in the bill would result in both smaller tax payments by PTEs and smaller refunds to investors, generally resulting in the same net tax revenues to the state, i.e., no fiscal effect apart from timing. PTEs that are not required to make a payment must file an informational return.

No payment of tax due from the PTE is required under the bill if the tax liability is under $250. This requirement compares with the minimum specified in current law, which waives payment if the "adjusted qualifying amount" is less than $1,000. This corresponds to a tax liability of $30 at the rate in the bill, and to approximately $50 to $85 at the rates in current law. The higher minimum potentially could result in loss of tax revenues from out-of-state investors with no connections to Ohio other than ownership interests in Ohio PTEs. Any such loss plausibly would be modest since the minimum remains small.

The bill eliminates separate treatment for investment PTEs, which derive 90% or more of income from investment transaction fees and hold at least 90% of book value in intangibles, and are exempted from withholding tax requirements. Under the bill, these entities would be responsible for meeting the same filing and tax payment requirements as other PTEs. Although tax liabilities would not be altered by this change, tax compliance might be facilitated.

The bill repeals a current law requirement that trusts withhold tax on nonresident beneficiaries.[2] This change will not alter tax liabilities but may reduce compliance by out-of-state beneficiaries with no other nexus to Ohio.

Effect on political subdivisions

The LGF and the PLF will, beginning FY 2017, each receive monthly distributions of 1.66% of GRF tax revenues in the previous month under current law.[3] State tax revenue from the tax on PTEs is treated as individual income tax revenue and so is part of GRF tax revenues. To the extent that the changes made by the bill result in net increases or decreases in GRF tax revenues, distributions to the LGF and PLF would be increased or decreased.

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[2] R.C. 5747.41.

[3] H.B. 64 enacted a provision in temporary law, set to expire at the end of FY 2016, under which the PLF receives 1.70% of GRF tax revenue.