# Ohio Legislative Service Commission

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# Fiscal Note & Local Impact Statement

**Bill**: S.B. 288 of the 131st G.A. (L_131_2206-2)

**Date**: November 30, 2016

**Status**: In Senate Ways & Means

**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.
- Reduction in the tax rate paid by PTEs on their income 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 go into effect in tax year 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 pertaining to Ohio's corporate franchise tax, phased out six years ago for most corporations, and eliminates cross-references in other sections to those laws. 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 The bill repeals other out-of-date references in the Revised Code, as detailed in LSC's Bill Analysis.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 lowers the rate of tax owed by those PTEs required to pay tax to 3%, in line with the lower rate on business income enacted in H.B. 64 of the 131st General Assembly.

## 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 PTEs, 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. 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. For PTEs that are financial institutions, the bill's change in credits for financial institutions tax payments to nonrefundable from refundable may add to state revenues. Repeal of a requirement that trusts withhold tax on nonresident beneficiaries likewise would not change tax liabilities but could impede compliance and reduce state collections.

To the extent that these 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.

## Pass-through entities

The obligation to pay tax associated with the income of a business electing tax treatment as a PTE is "passed through" to the investor in the PTE, and taxed once at the investor level. This avoids a second layer of federal taxation, at the corporate level. Ohio's corporate franchise tax on financial institutions was ended in tax year (TY) 2014 and thereafter, replaced by the financial institutions tax, by H.B. 510 of the 129th General Assembly. The corporate franchise tax was phased out in 2006-2010 for nonfinancial corporations under a provision of H.B. 66 of the 126th General Assembly. 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 is that of the investors; and investors in PTEs are 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%.

## Tax calculation

Under the bill, a PTE must remit taxes on behalf of the investors at the business income tax rate of 3%. 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 not required to make a payment are in some cases required to file an informational return.

No payment of tax due from the PTE is required under the bill if the tax liability is under $250.[1] This requirement compares with the minimum specified in current law, which waives payment if the "adjusted qualifying amount" is less than $1,000.[2] 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.

A refundable credit against income taxes owed by investors in PTEs that pay the financial institutions tax, for the taxpayer's proportionate share of the lesser of the financial institutions tax due or paid, is made nonrefundable by the bill.[3] The order in which the taxpayer may claim this credit relative to other credits is also changed by the bill, from 27th to 15th.[4] Changing the credit to nonrefundable may add to state income tax receipts, if some taxpayers are unable to use all of these credits. The fiscal effect of the change in the order in which credits may be claimed appears uncertain.

The bill repeals a current law requirement that trusts withhold tax on nonresident beneficiaries[5] (which had been required as a way of providing greater

1 R.C. 5747.42.

2 R.C. 5747.41.

3 R.C. 5747.65.

4 R.C. 5747.98.

5 R.C. 5747.41.

assurance that the tax would be paid). This change will not alter tax liabilities but may reduce compliance by out-of-state beneficiaries with no other nexus to Ohio and potentially reduce tax collections.

## Effect on political subdivisions

The LGF and the PLF will each receive monthly distributions of 1.66% of GRF tax revenues in the previous month beginning in FY 2018 under current law.[6] 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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[6] H.B. 64 of the 131st General Assembly enacted a provision in temporary law, set to expire at the end of FY 2017, under which the PLF receives 1.70% of GRF tax revenue.