



Ohio Legislative Service Commission

Bill Analysis

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Sub. S.B. 288* 131st General Assembly (As Reported by S. Ways & Means)

Sens. Eklund, LaRose, Seitz, Patton

BILL SUMMARY

- Makes various changes to the tax that requires pass-through entities (PTEs) to remit income taxes on behalf of their nonresident investors.
- Removes language referring to the tax as a "withholding tax," and instead labels the tax as a "complementary tax" to the individual income tax.
- 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.
- 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.

* This analysis was prepared before the report of the Senate Ways & Means Committee appeared in the Senate Journal. Note that the list of co-sponsors and the legislative history may be incomplete.

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 direct tax on PTEs, and thus the requirement that entities remit taxes on behalf of nonresident investors, but removes references to the tax as a "withholding tax." Instead, the PTE tax is simply referred to as a "complementary" tax to the individual income tax. 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 The requirements of the new return 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)	<p>Withholding tax return only.</p> <p>Both resident and nonresident investors still must separately file IT 1040 individual tax returns.</p>	<p>Composite tax return.</p> <p>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.</p>	<p>Composite tax return.</p> <p>Same as IT 4708.</p>
Who must file	<p>All PTEs with Ohio "nexus,"³ unless:</p> <p>(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).</p> <p>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.</p>	<p>No PTE is required to file an IT 4708. The return is optional.</p> <p>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.</p>	<p>All PTEs with Ohio nexus, unless:</p> <p>(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).</p> <p>Note: PTEs that are not required to file a composite tax return must instead file an informational return with the Department of Taxation, unless:</p> <p>(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 either (i) will not claim any business tax credits or</p>

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
			(ii) will only claim the credit for taxes paid by other PTEs. ⁴
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	<p>The total of investors' distributive shares of the PTE's net income, with some additions and deductions (known as the "adjusted qualifying amount").</p> <p>The withholding tax base does not include investment-type income earned by an "investment pass-through entity."⁵ However, such income is taxable on the investor's IT 1040 individual tax return.</p>	<p>Substantially similar to IT 1140 (but includes only the shares of investors reported on the composite return).</p> <p>N/A.</p>	<p>Substantially similar to IT 1140 and IT 4708.</p> <p>Substantially similar to IT 1140.</p>

⁴ The bill includes a special filing requirement for publicly traded partnerships (PTPs). Under the bill, a PTP must file either (1) the informational return, but such return need only include information with respect to investors with Ohio-sourced income of more than \$500, or (2) a federal tax form that includes certain information required on the state's informational return. This rule also applies to PTP-majority-owned LLCs and limited partnerships. R.C. 5747.40(E)(1)(c) and 5747.41(C).

⁵ R.C. 5733.401 (repealed) and 5747.221. 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
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.
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%.⁶ (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.)

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.⁷

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.⁸

⁶ R.C. 5747.40(A)(4).

⁷ 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).

⁸ R.C. 5747.42(C).

In this example, if Purple LLC claims the credit, the credit is reflected in the distributive shares of Jack and Jill, direct investors in Purple LLC and indirect investors in Blue LLC. If Purple LLC does not claim the credit, Jack and Jill may separately claim a credit for the taxes remitted by Blue LLC if they file individual returns.

Repeal of trust withholding tax

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 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.

The bill repeals a requirement that trusts withhold income tax on certain types of distributions made to their nonresident beneficiaries.⁹ (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.

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; consequently, the amount of a taxpayer's FIT credit may not exceed the taxpayer's tax liability for the year.

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.¹⁰

⁹ R.C. 5747.41 of current law.

¹⁰ R.C. 5747.01, 5747.65, and 5747.98.

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 2013.¹¹
- 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 2015.¹²
- 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 to both distributions and undistributed trust income (as it has since 2002).¹³

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.

Definition of related member

The bill also modifies the definition of "related member." This change relates to the rules that govern 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

¹¹ 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.

¹² R.C. 901.13, 5747.75, and 5747.98.

¹³ R.C. 5747.01(A)(6).



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

Bonus depreciation deduction

Federal tax law provides enhanced depreciation allowances for businesses that invest in certain depreciable business assets, i.e., tangible personal property and certain real property. Ohio income tax law requires a taxpayer to make special adjustments on the taxpayer's Ohio return if the taxpayer claims these federal "bonus" depreciation or enhanced expensing deductions. The adjustments are intended to smooth out the income-reducing effect (and resulting revenue-reducing effect) of the federal deduction by requiring most of the federal deduction to be added back when calculating the taxpayer's Ohio adjusted gross income (OAGI) in the year the deduction is claimed on the taxpayer's federal return. Then, in ensuing years, the add back is deducted when calculating the taxpayer's OAGI in increments, so at the end of the adjustment period the entire depreciation or expensing deduction is realized.

Current law states that a taxpayer is not allowed to receive a refund as a result of the operation of these deductions (e.g., if the deduction amount is greater than the taxpayer's federal AGI). The bill instead specifies that a taxpayer may receive a refund of amounts that could have been claimed as a deduction, but are in excess of the amount necessary to reduce the taxpayer's OAGI to zero. The bill also states that this change "is intended to clarify" existing law.¹⁶

Effective date

The bill applies to taxable years ending on or after January 1, 2017.¹⁷

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

¹⁵ R.C. 5747.01(DD)(2).

¹⁶ R.C. 5747.01(A)(21)(d) and Section 3.

¹⁷ Section 4.



HISTORY

ACTION

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Reported, S. Ways & Means

DATE

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