

Pass-Through Entity and Trust Withholding Tax



.B. 215, 122nd General Assembly, enacted a method for the collection of tax on the distributive shares of income earned by qualifying investors from their investment in any qualifying pass-through entity doing business in Ohio. The pass-through entity and trust withholding tax is not so much a separate tax but rather a mechanism designed to collect individual income tax or corporation franchise tax, which is otherwise due and payable by pass-through entity investors pursuant to Ohio tax law. A pass-through entity is an S corporation, a partnership, or a Limited Liability Company (LLC) treated as a partnership for federal income tax purposes.

For taxable years beginning after December 31, 1997, each qualifying pass-through entity doing business in Ohio or otherwise having nexus with Ohio under the Constitution of the United States is subject to the pass-through entity tax. (Qualifying trusts are also subject to the tax – see **Special Provisions**).

The tax is a 5.0 percent withholding tax on income of qualifying individual investors, and an 8.5 percent entity tax on income of qualifying investors that are not individuals. The tax is based upon each investor's share of the qualifying pass-through entity's profits apportioned to Ohio. This tax is calculated on Form IT-1140. Each qualifying investor can claim an income tax or corporation franchise tax credit based upon the investor's proportionate share of the pass-through entity tax.

Many pass-through entities are not "qualifying" pass-through entities and are therefore not subject to this tax. Pass-through entities not subject to the tax include entities whose investors are entirely comprised only of full-year Ohio resident individuals, Ohio estates, and/or corporations that pay the Ohio corporation franchise tax. (A more complete listing of exempt pass-through entities is available in **Exemptions and Exclusions**).

The most recent data for pass-through entity tax collections is from fiscal and tax year 2002. In tax year 2002, there were 5,752 pass-through entity tax returns filed. The liability from the 5.0 percent withholding tax component of the pass-through entity tax was \$35.6 million. The 8.5 percent entity tax liability amounted to \$5.1 million. Thus, the total tax year 2002 pass-through entity tax liability was \$40.7 million. In tax year 2001, the total liability was \$35.1 million, resulting in a \$5.6 million increase in 2002.

Revenue collected from the composite income tax paid on behalf of nonresident investors in pass-through entities in FY 2002 amounted to about \$49.4 million.

Entities are not subject to the pass-through entity and trust withholding

tax if they file Ohio Form IT-4708 on behalf of all their investors who are not full-year Ohio resident individuals or Ohio resident estates.

Form IT-4708 is another mechanism for collection of Ohio income tax due on an investor's share of pass-through entity income. Form IT-4708 is a composite return filed by the pass-through entity on behalf of one or more of the entity's investor(s), except for investors that are C corporations (income passing through either directly or indirectly to C corporations cannot be included in Form IT-4708). Payment of the tax due is made by the pass-through entity with Form IT-4708.

The primary benefit of filing Form IT-4708 is that the composite return constitutes each investor's Ohio return with respect to the pass-through entity income. Thus, by being included in Form IT-4708, each nonresident investor has met their filing and payment obligation with respect to that income and need not file a separate return unless they have other Ohio-source income. The tax is calculated at the highest tax rate for the taxable year for which the return is filed. The pass-through entity using Form IT-4708 cannot claim individual income tax credits but can claim the business credits.

TAX BASE (R.C. 5733.40, 5747.02, 5747.08, 5747.40, 5747.401):

Form IT-1140 —

The tax base is the sum of the "adjusted qualifying amounts" of the entity's qualifying investors. The "adjusted qualifying amount" is the net sum of each qualifying investor's distributive share of the income, gain, expense, or loss of a pass-through entity, multiplied by the corporation franchise tax apportionment fraction.

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The tax base is the sum of the allocated and apportioned distributive share income amounts for those investors for which the pass-through entity has not filed Form IT-1140.

RATES (R.C. 5733.41, 5747.08, 5747.41):

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A 5.0 percent tax rate is applied to the sum of adjusted qualifying amounts for those investors who are individuals. An 8.5 percent tax rate is applied to the sum of adjusted qualifying amounts for those investors that are not individuals.

No tax is due if the total adjusted qualifying amount is \$1,000 or less.

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The highest marginal tax rate, currently 7.5 percent.

EXEMPTIONS AND EXCLUSIONS (R.C. 5733.40, 5733.401, 5733.402, 5747.08(0), 5747.401):

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Pass-through entities not subject to tax:

1. Entities having no qualifying investors (see below for a list of investors that do not qualify);
2. Pension plans and charities;
3. Publicly-traded partnerships;
4. Real estate investment trusts, regulated investment companies, and real estate mortgage investment conduits;
5. Any entity treated as a “disregarded entity” for federal income tax purposes (see “Check the Box” U.S. Treasury regulations); and
6. Qualified Subchapter S subsidiary corporations (if the parent S corporation has qualifying investors, the parent S corporation is a pass-through entity which must compute the tax on a consolidated basis with all its qualifying subchapter S subsidiaries).

A qualifying investor does not include the following:

1. Investors which are pension plans or charities;
2. Investors which are publicly-traded partnerships;
3. Investors which are colleges or universities;
4. Investors which are public utilities in Ohio and required to pay the Ohio gross receipts excise tax;
5. Investors which are insurance companies, fraternal corporations, beneficial corporations, bond investment corporations, health maintenance organizations, or any other corporation required to file an annual report with the Ohio Superintendent of Insurance;
6. Investors which are dealers in intangibles;
7. Investors which are real estate investment trusts, regulated investment companies, and real estate mortgage investment conduits;
8. Investors who are individuals and residents of Ohio for the pass-through entity’s entire taxable year;
9. Investors which are estates or trusts that are residents of Ohio for the pass-through entity’s entire taxable year;
10. Nonresident individuals on whose behalf the qualifying pass-through entity files Ohio Form IT-4708, “Annual Composite Income Tax Return for Investors in Pass-Through Entities;”
11. Investors that are financial institutions required to pay the Ohio corporation franchise tax;
12. Investors which are themselves qualifying pass-through entities if those qualifying pass-through entities’ investors during the three-year period beginning 12 months prior to the first day of the taxable year are limited to those investors listed in items 1 through 11 above;
13. Investors which are themselves pass-through entities if the owners of those pass-through entities are limited to the investors listed in items 1-11 above;
14. Corporate investors which satisfy the following three requirements: (1) the investor submits a written statement to the qualifying pass-through entity stating that the investor agrees that the investor has nexus with Ohio and is liable for corporation franchise tax with respect to the investor’s distributive share of income attributable to the pass-through entity, (2) the investor makes a good faith and reasonable effort to comply with the corporation franchise tax reporting and payment requirements, and (3) neither the investor nor the qualifying pass-through entity carries out any transactions

that would result in a reduction or deferral of corporation franchise tax;

15. Investors that are either trusts or funds whose beneficiaries are limited to the following during the taxable year of the qualifying pass-through entity: (1) persons that are or may be beneficiaries of a pension plan trust, profit-sharing trust, a stock bonus plan trust or similar retirement trust, or (2) persons that are or may be beneficiaries of or the recipients of payments from a trust or fund that is a nuclear decommissioning reserve fund, a designated settlement fund, or any other similar trust or fund established to resolve and satisfy injury claims, or (3) persons who are or may be the beneficiaries of a complex trust, but only if the trust irrevocably agrees in writing that, for the taxable year during or for which the trust distributes any of its income to any of its beneficiaries who are individuals residing outside Ohio, the trust will withhold tax as required under R.C. 5747.41 through 5747.453;
16. Investors which are corporation franchise taxpayers, but only if all the other investors in the qualifying pass-through entity are limited to: (1) other corporations which are paying the corporation franchise tax and/or (2) corporations which would be paying the corporation franchise tax if they were not eligible for an exemption set forth in R.C. 5733.09; and
17. Investors which are “investment pass-through entities;” but only if the investment pass-through entity provides to the qualifying pass-through entity the name, address, and social security number of each person who has invested in the investment pass-through entity.

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These entities cannot be investors included in Form IT-4708:

1. C corporations subject to the tax imposed by R.C. 5733.06;
2. An investor that is a trust to the extent that any direct or indirect, current, future, or contingent beneficiary of the trust is a C corporation subject to the tax imposed by R.C. 5733.06; and
3. An investor that is itself a pass-through entity to the extent that any direct or indirect investor in that pass-through entity is a C corporation subject to the tax imposed by R.C. 5733.06.

CREDITS (R.C. 5733.0611, 5747.08, 5747.059):

A refundable Ohio individual income tax credit is available for qualifying investors subject to the Ohio individual income tax. A nonrefundable corporation franchise tax credit is available for qualifying investors subject to the corporation franchise tax. Certain corporate qualifying investors exempt from corporation franchise tax are able to claim a refundable credit. The credits described above are based upon the investor’s proportionate share of the 5.0 percent withholding tax or the 8.5 percent entity tax paid on the qualified investor’s distributive share of income from the qualifying pass-through entity. In order to claim this credit, the qualifying investor must provide a copy of IRS Form K-1, indicating the amount of the 8.5 percent entity tax paid and/or 5.0 percent withholding tax paid which is attributable to the qualifying investor.

If the investor has deducted its proportionate share of 5.0 percent withholding tax or 8.5 percent entity tax from its income, the investor must add back such tax as income on the Ohio individual income tax return or corporation franchise tax return.

If an investor is required to file another return (e.g., IT-1040) and make payment of taxes on account of the investor's income not included in the pass-through entity's return, then the investor is entitled to a refundable credit equal to the investor's proportionate share of the tax paid by the pass-through entity on behalf of the investor. This credit is claimed for the investor's taxable year in which or with which ends the taxable year of the pass-through entity.

SPECIAL PROVISIONS (R.C. 5747.08):

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1. Qualifying trusts are also subject to tax. A qualifying trust is generally any trust meeting all four of the following tests: (1) it is required to file IRS Form 1041 (U.S. Income Tax Return for Estates and Trusts), (2) it has at least one beneficiary who is neither a full-year Ohio resident individual nor an Ohio resident estate, (3) it makes a distribution to a nonresident beneficiary, and (4) the distribution relates either to real estate located in Ohio or to tangible personal property located in Ohio. If an entity is a trust whose beneficiaries are limited to full-year Ohio resident individuals and/or Ohio resident estates, then it is not a qualifying trust and not subject to the pass-through entity tax. Qualifying trusts are subject to the
 5. 0 percent withholding tax on distribution of certain types of income to individuals who are nonresidents of Ohio. The filing, payment and credit provisions that apply to qualifying pass-through entities and investors also apply to qualifying trusts and beneficiaries.
2. The 8.5 percent tax does not apply to any pass-through entity to the extent the pass-through entity's distributive shares of income and gain pass through from that entity to another pass-through entity (referred to as the "investing entity"), as long as four conditions are met: (1) the investing entity is not an investment pass-through entity, as defined in item 3, below, (2) the investing entity acknowledges that it has nexus with this state during the taxable year, (3) the investing entity makes a good faith effort to comply with the 8.5 percent entity tax and 5.0 percent withholding tax, and (4) the investing entity includes in its apportionment factors its proportionate share of each lower-tiered pass-through entity's property, payroll and sales.
3. Neither the 8.5 percent entity tax nor the 5.0 percent withholding tax applies to an "investment pass-through entity." An investment pass-through entity is a pass-through entity having at least 90 percent of its assets represented by intangible assets, and having at least 90 percent of its gross income comprised of the types of income listed below:
 - dividend income, interest income, net capital gains from the sale or exchange of intangible property, certain fees, and all types and classifications of income attributable to distributive shares of income from other pass-through entities.
4. An investor (termed the "deemed investor") in an investment pass-through entity, as defined in item 3 above, shall be deemed to be an investor in any other qualifying pass-through entity in which the investment pass-through entity is a direct investor. Each deemed investor's portion of such qualifying pass-through entity's adjusted qualifying amount will be the product of: (1) the adjusted qualifying amount which would otherwise pass-through to the investment pass-through entity, and (2) the percentage of the deemed investor's direct ownership in the investment pass-through entity.

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1. The pass-through entity cannot claim exemptions or credits. However, the pass-through can claim its distributive share of business credits (e.g., the credit for purchases of manufacturing machinery and equipment).
2. The election to file a composite return applies only to the taxable year for which the election is made. Unless the Tax Commissioner provides otherwise, this election is binding and irrevocable for the taxable year for which the election is made.

TAXPAYER (R.C. 5733.40, 5747.08):

A qualifying pass-through entity is generally an S corporation, a partnership, or an LLC treated as a partnership for federal income tax purposes. See **Exemptions and Exclusions** for a list of pass-through entities excluded from the definition of a qualifying pass-through entity.

FILING AND PAYMENT DATES (R.C. 5747.08, 5747.09, 5747.42, 5747.43, 5747.44, and Administrative Code 5703-7-01):

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Qualifying pass-through entities whose total "adjusted qualifying amounts" exceed \$10,000 must make estimated quarterly tax payments.

The annual Pass-Through Entity and Trust Withholding Tax Return (IT-1140) must be filed by the 15th day of the fourth month following the end of the entity's taxable year. For taxpayers with a January 1 – December 31 taxable year, the return is due on April 15. If the entity has an extension of time to file its federal tax return (IRS Form 1065 or 1120S), then the qualifying pass-through entity has the same extension of time to file the Ohio tax return. However, there is no extension of time granted for payment.

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The return is due on or before the 15th day of the fourth month following the end of the taxable year. If the pass-through entity has an extension of time to file its federal tax return, then the pass-through entity has the same extension of time to file the IT-4708.

The pass-through entity must make estimated tax payments on Form IT-4708ES if the pass-through entity's tax due for the current year is more than \$500.00.

DISPOSITION OF REVENUE:

The revenue collected from the 5.0 percent withholding tax and the IT-4708 tax is treated as individual income tax revenue, with 89.5 percent deposited in the General Revenue Fund, 5.7 percent deposited in the state Library and Local Government Support Fund, 4.2 percent deposited in the state Local Government Fund, and 0.6 percent deposited in the state Local Government Revenue Assistance Fund.

Revenue collected from the 8.5 percent entity tax is treated as corporation franchise tax revenue, with 95.2 percent deposited in the General Revenue Fund, 4.2 percent deposited in the state Local Government Fund, and 0.6 percent deposited in the state Local Government Revenue Assistance Fund.

OHIO REVISED CODE CITATIONS:

Chapters 5733 and 5747.

RECENT LEGISLATION:

Am. Sub. H.B. 95, 125th General Assembly (effective June 26, 2003).

R.C. 5733.04(I) (17) and 5747.01 (A) (20) –

A corporation that is a partner in a partnership or is a member of an LLC must add back 5/6 of the corporation's share of the "qualified section 179 depreciation." Qualified section 179 depreciation is the difference between (1) the depreciation allowable to the pass-through entity under Internal Revenue Code (I.R.C.) section 179 in effect for the taxable year and (2) the depreciation that would be allowable to the pass-through entity under the version of I.R.C. section 179 in effect on December 31, 2002.

Am. Sub. S.B. 261, 124th General Assembly (effective June 5, 2002).

R.C. 5733.04(I) (17) and 5747.01 (A) (20) (a) –

A corporation that is a partner in a partnership or is a member of an LLC treated as a partnership for federal income tax purposes must add back 5/6 of the corporation's share of the bonus depreciation deduction passed through from the entity to the corporation.

R.C. 5747.01 (B) –

The definition of "business income" was amended to include gains and/or losses from a partial or complete liquidation of a business, including, but not limited to, the gain or loss from the disposition of goodwill.

R.C. 5733.40(S) and 5733.41–

Distributive shares include the sum of the income, gain, expense, or loss of a disregarded entity. As a result, a disregarded entity single member LLC is subject to the pass-through entity tax on its Ohio apportioned income. If the corporation files the required franchise report, pays the franchise tax, and agrees to nexus in Ohio, then the pass-through entity tax does not apply to the single member LLC.

Am. Sub. H.B. 94, 124th General Assembly (effective September 5, 2001).

R.C. 5733.401 –

Disallowed the exclusion of net management fees from an investment pass-through entity's withholding tax base if the fees exceed 5 percent of the entity's net income.

RECENT INFORMATION RELEASES:

PI & CFT 2002-02 — "Ohio Bonus Depreciation Adjustments and the Internal Revenue Code's Passive Activity Loss, Basis Limitation and At-Risk Rules," Nov. 7, 2002.

PI & CFT 2002-01 — "Depreciation Deductions for Taxable Years Ending in 2001 and Thereafter," July 31, 2002.

Table 1
Pass-Through Entity Tax Liability
(Form IT-1140)
Tax Years 1998 - 2002
(figures in millions)

| Tax Year | Withholding Tax (5%) | Entity Level Tax (8.5%) | Total Pass-Through Entity Tax Liability |
|-----------------|-----------------------------|--------------------------------|--|
| 2002 | \$35.6 | \$5.1 | \$40.7 |
| 2001 | 31.4 | 3.7 | 35.1 |
| 2000 | 39.7 | 4.2 | 43.9 |
| 1999 | 38.8 | 6.6 | 45.4 |
| 1998 | 35.8 | 3.9 | 39.7 |

Table 2
Collections from the Composite Income Tax Paid on
Behalf of Nonresident Investors in Pass-Through Entities
(Form IT-4708)
Fiscal Years 1999 - 2002
(figures in millions)

| Fiscal Year | Revenue Collected * |
|--------------------|----------------------------|
| 2002 | \$49.4 |
| 2001 | 62.4 |
| 2000 | 53.1 |
| 1999 | 36.3 |

* Includes estimated tax payments (Form IT-4708 ES).

