Pass-Through Entity & Trust Withholding Tax

House Bill 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. Beginning in 2005 the entity tax is being phased out for certain investors (see **Entity Tax Phase-Out for Qualifying Investors**, below). 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.

Entity Tax Phase-Out for Qualifying Investors (see also **Recent Legislation**)

Amended Substitute House Bill 66, 126th General Assembly, the Fiscal Year 2006-2007 biennium budget bill, phases out the pass-through entity tax for certain investors. Consistent with the franchise tax phase-out, the tax that a pass-through entity will pay on the distributive shares of its Ohio income passing through to its qualifying investors subject to the franchise tax phase-out also phases out as shown in the following table:

Pass-Through Entity's Taxable Year Ending in:	Pass-Through Entity's Tax Rate on its Ohio Income that Passes-Through to Its Qualifying Investors Subject to the Franchise Tax Phase-Out
2005	6.8% (80% x 8.5%)
2006	5.1% (60% x 8.5%)
2007	3.4% (40% x 8.5%)
2008	1.7% (20% x 8.5%)
2009 and thereafter	0.0% (0% x 8.5%)

Those qualifying investors that are listed below and are **NOT** subject to the phase-out rates must continue to compute the estimated tax at the rate of 8.5 percent:

- Financial holding companies as defined in the federal "Bank Holding Company Act."
- Bank holding companies as defined in the federal "Bank Holding Company Act."
- Savings-and-loan holding companies as defined in the federal "Home Owners Loan Act" that are engaging only in activities permissible under 12 United States Code (U.S.C.) 1843(k).
- Persons, other than persons held pursuant to merchant banking authority under 12 U.S.C. 1843(k)(4)(h) or 12 U.S.C. 1843(k)(4)(i), directly or indirectly "owned" by one or more financial institutions, financial holding companies, bank holding companies, or savings-and-loan holding companies, but only if those persons are engaged in activities permissible for a financial holding company under 12 U.S.C. 1843(k).
- Persons directly or indirectly "owned" by one or more insurance companies that are: (1) authorized to do the business of insurance in this state, and (2) paying the Ohio insurance premiums tax.
- Persons that solely facilitate or service one or more "securitizations" or similar transactions for financial institutions, financial holding companies, bank holding companies, savings-and-loan holding companies, insurance companies, or persons directly or indirectly "owned" by such businesses.

Definition of "owned" for this purpose: generally, a person "owns" another entity if the person . . .

- owns at least 50 percent of the entity's voting stock (corporations),
- owns at least 50 percent of the entity's membership interests (LLC's), or
- has a beneficial interest in the entity's profits, surpluses, losses, or distributions (partnerships, trusts, or other business interests).

Definition of "securitization" for this purpose: transferring one or more assets to one or more persons and then issuing securities backed by the right to receive payment from the asset or assets so transferred.

Many pass-through entities are not "qualifying" pass-through entities and therefore are not subject to this tax. Pass-through entities not subject to the tax include entities whose investors are limited to 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 2004. In tax year 2004 there were 8,208 pass-through entity tax returns filed. The liability from the 5.0 percent withholding tax component of the pass-through entity tax was $61.2 million. The 8.5 percent entity tax liability amounted to $15.3 million.

Thus, the total tax year 2004 pass-through entity tax liability was $76.5 million. In tax year 2003, the total liability was $73.9 million, resulting in a $2.6 million increase in 2004.

Revenue collected from the composite income tax paid on behalf of nonresident investors in pass-through entities in FY 2004 amounted to about $75.5 million.

Ohio 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 investors, other than investors that are C corporations (income passing through either directly or indirectly to C corporations cannot be included in form IT 4708).

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. 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's 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.

Taxpayer (Ohio Revised Code 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.

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 apportionment fraction.

Form IT 4708 —
The tax base is the sum of the allocated and apportioned distributive share income amounts for those qualifying investors for which the pass-through entity has not filed form IT 1140.

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

Form IT 1140 —
A 5.0 percent tax rate is applied to the sum of adjusted qualifying amounts for those qualifying investors who are individuals. An 8.5 percent tax rate is applied to the sum of adjusted qualifying amounts for those qualifying investors that are not individuals for years prior to 2005. However, see the phase-out rate table earlier in this chapter applicable to certain corporate investors for post-2004 years.

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

Form IT 4708 —
The applicable rate is the highest marginal tax rate, currently 7.185 percent.

Exemptions and Exclusions (R.C. 5733.40, 5733.401, 5733.402, 5747.08(D), 5747.401):

Form IT 1140 —
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);
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); and
7. Any pass-through entity if all the equity investors are: (1) Ohio corporation franchise taxpayers, and/or (2) corporations exempt under R.C. 5733.09 from the Ohio corporation franchise tax.

A qualifying investor is any investor other than 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 public utility 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;
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 that are themselves pass-through entities, but only if the owners of those other pass-through entities are limited to:
    (1) individuals who are full-year residents of Ohio,
    (2) estates domiciled in Ohio,
    (3) nonresident individuals on whose behalf those other pass-through entities file Ohio form IT-4708, and
    (4) nonresident estates on whose behalf those other pass-through entities file Ohio form IT 4708;
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; or
16. 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.

Form IT 4708 —

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 Internal Revenue Service 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 the 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.

Special Provisions

Form IT 1140 —

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,
    (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 is 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

* Phase-out rates apply, per the table earlier in this chapter that lists those phase-out percentages, for those qualifying investors that are subject to the phase-out rates.

(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 the items and income, listed below, which are earned by 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 from one or more of the sources 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., 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.

Form IT 4708 —

1. The pass-through entity cannot claim nonbusiness exemptions or nonbusiness credits, such as the personal exemption credit. 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 that taxable year.

Filing and Payment Dates (R.C. 5747.08, 5747.09, 5747.42, 5747.43, 5747.44, and Ohio Administrative Code 5703-7-01):

Form IT 1140 —

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.

Form IT 4708 —

The return is generally due on April 15 of the calendar year immediately following the calendar year in which the pass-through entity's taxable year ends. 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 Ohio return on form 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 form IT 4708 tax is treated as individual income tax revenue, with 91.2 percent deposited in the General Revenue Fund, 4.9 percent deposited in the Library and Local Government Support Fund, 3.4 percent deposited in the Local Government Fund, and 0.5 percent deposited in the Local Government Revenue Assistance Fund.

Revenue collected from the 8.5* percent entity tax is treated as corporation franchise tax revenue, with 94.6 percent deposited in the General Revenue Fund, 3.7 percent deposited in the Local Government Fund, 0.5 percent deposited in the Local Government Revenue Assistance Fund, and 1.2 percent deposited in litter tax funds and the Attorney General claims fund.

These distributions are in accordance with the freeze of local government funds at FY 2001 levels that began in 2002 and have been continued by subsequent budget bills.

Administration:

The Tax Commissioner administers the tax and the distribution of revenue to the various funds.

Ohio Revised Code Citations:

Chapters 5733 and 5747.

Recent Legislation

Substitute H.B. 66, 126th General Assembly (FY 2006-2007 biennium budget bill, effective June 30, 2005 for taxable years ending on or after July 1, 2005).

Pass-Through Entity Tax Phase-Out for Qualifying Investors

The phase-out of the pass-through entity tax on distributive shares of income that passes through to certain corporate qualifying investors subject to the corporation franchise tax phase-out begins on the 2005 form IT 1140. The phase-out rate is calculated by the 20 percent reduction beginning on the 2005 return, a 40 percent reduction for 2006, 60 percent reduction for 2007 and an 80 percent reduction on the 2008 return. Thereafter, there is no pass-through entity tax on distributive shares of income that pass through to the certain corporate qualifying investors. Instead, those taxpayers are subject to the full amount of commercial activity tax (CAT).

* Phase-out rates apply, per the table earlier in this chapter that lists those phase-out percentages, for those qualifying investors that are subject to the phase-out rates.

Table 1
Pass-Through Entity Tax Liability
(Form IT-1140)
Tax Years 2001 - 2004
(figures in millions)

Tax Year	Withholding Tax (5.0%)	Entity Level Tax (8.5%)	Total Pass-Through Entity Tax Liability
2001	$48.7	$7.3	$56.0
2002	52.6	10.5	63.1
2003	59.7	14.2	73.9
2004	61.2	15.3	76.5

Table 2
Collections from the Composite Income Tax Paid on Behalf of Nonresident Investors in Pass-Through Entities
(Form IT-4708)
Fiscal Years 2001 - 2004
(figures in millions)

Fiscal Year	Revenue Collected*
2001	$62.4
2002	49.4
2003	67.3
2004	75.5

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