



Pass-Through Entity and Trust Withholding Tax

The pass-through entity and trust withholding tax, enacted in 1998, is not so much a separate tax as it is a mechanism designed to collect individual income tax and corporation franchise tax that is otherwise due and payable by equity investors in qualifying pass-through entities.

A pass-through entity is an S corporation, a partnership, or a limited liability company (LLC) treated for federal income tax purposes as either a partnership or an S corporation. Each qualifying pass-through entity doing business in Ohio or otherwise having nexus with Ohio is subject to the pass-through entity withholding tax. Qualifying trusts are also subject to the tax; see **Special Provisions** for details.

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 resident estates, 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 tax is primarily collected through the use of two forms: form IT 1140 and form IT 4708. An explanation of each follows:

IT 1140 – The IT 1140 is a withholding form that the qualifying pass-through entity completes and files. In this sense, the form is somewhat analogous to an IRS W-2. Through the IT 1140, a tax of 5 percent is withheld from the income of all qualifying individual investors, and an entity tax is calculated on the income of qualifying investors that are not individuals. The entity tax, historically 8.5 percent, is being phased out for most corporate investors as part of the phase-out of the corporation franchise tax (see **Entity Tax Phase-Out for Qualifying Investors**). When completing their own tax returns, qualifying investors may claim an income tax credit or a corporation franchise tax credit based on the investors’ proportionate share of the pass-through withholding tax and entity tax withheld through the IT 1140.

IT 4708 – This form is a composite return completed and filed by the pass-through entity on behalf of one or more of the entity’s investors for whom income tax has not been previously withheld. This form is somewhat analogous to an IT 1040; by being included in form IT 4708, nonresident non-corporate investors meet their filing and payment obligation with respect to that income and need not file a separate individual income tax return unless they have other Ohio-source



income. On the IT 4708, the tax is calculated at the highest individual income tax rate for the taxable year for which the return is filed. Note: Investors that are C corporations may not be included on the form.

The most recent data for qualifying pass-through entity tax collections is from tax and fiscal year 2007. During taxable year 2007, 10,108 pass-through entity taxpayers filed returns on form IT 1140. The liability from the 5 percent withholding tax component of these returns was \$107.8 million. The entity tax liability amounted to \$23.2 million. Thus, the total taxable year 2007 pass-through entity tax liability was \$131 million.

During the 2007 taxable year, 4,429 IT 4708 returns were filed for the composite income tax paid on behalf of nonresident investors in pass-through entities. Revenue from these returns amounted to \$136.7 million.

Entity Tax Phase-Out for Qualifying Investors

The entity tax that a qualifying pass-through entity must withhold is being phased out for qualifying investors that are also subject to the phase-out of the corporation franchise tax. The phase-out schedule is shown in the following table:

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

Note: Fiscal year filers must use the rate in effect on the last day of the taxable year.

Certain qualifying investors are **not** subject to the phase-out rates. For these investors the pass-through entity must continue to compute the entity tax at the rate of 8.5 percent.

These investors include:

- certain financial holding companies, bank holding companies and savings and loan holding companies;
- certain affiliates of these holding companies and certain affiliates of financial institutions;
- certain affiliates of insurance companies; and
- securitization companies.

The 8.5 percent entity tax rate also continues to apply to estates, trusts and other pass-through entities.

Taxpayer

(Ohio Revised Code 5733.40, 5747.08)

A qualifying pass-through entity is generally an S corporation, a partnership, or an LLC treated for federal income tax purposes as a partnership or S corporation. 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 net sum of qualifying investors' distributive shares of the pass-through entity's income, gain, expense, and loss apportioned to Ohio. This net sum is known as the "adjusted qualifying amount."

Form IT 4708

The tax base is the distributive shares of the pass-through entity's taxable income to qualifying noncorporate investors, to the extent that such income was not reported on form IT 1140.

Rates

(R.C. 5733.41, 5747.02, 5747.08, 5747.41)

Form IT 1140

A 5 percent withholding tax rate applies to the sum of adjusted qualifying amounts for those qualifying equity investors who are individuals.

Before 2005, an 8.5 percent entity tax rate was uniformly applied to the sum of adjusted qualifying amounts for those qualifying equity investors that are not individuals. However, this entity tax is being phased out for those "adjusted qualifying amounts" that pertain to qualifying investors subject to the phase-out of the corporation franchise tax. For details and exceptions, see **Entity Tax Phase-Out for Qualifying Investors**.

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 individual income tax rate, which for the 2008 taxable year was 6.24 percent.

Exemptions and Exclusions

(R.C. 5733.40, 5733.401, 5733.402, 5747.08(D), 5747.401)

Form IT 1140

The following are not qualifying pass-through entities:

- entities having no qualifying investors (see below for a list of investors that do not qualify);
- pension plans and charities;
- publicly-traded partnerships;
- real estate investment trusts, regulated investment companies, and real estate mortgage investment conduits;
- any entity treated as a "disregarded entity" for federal income tax purposes;
- qualified subchapter S subsidiary corporations (if the parent S corporation has qualifying investors, the par-

ent S corporation is a pass-through entity which must compute the tax on a consolidated basis with all its qualifying subchapter S subsidiaries);

- any pass-through entity if all the equity investors are a combination of Ohio corporation franchise taxpayers or corporations exempt under R.C. 5733.09 from the Ohio corporation franchise tax.

A qualifying equity investor is any investor other than the following:

- pension plans or charities;
- publicly-traded partnerships;
- colleges or universities;
- public utilities required to pay the Ohio public utility excise tax;
- 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;
- dealers in intangibles;
- real estate investment trusts, regulated investment companies, and real estate mortgage investment conduits;
- individuals who are residents of Ohio for the qualifying pass-through entity's entire taxable year;
- estates or trusts that are residents of Ohio for the qualifying pass-through entity's entire taxable year;
- nonresident individuals on whose behalf the qualifying pass-through entity files Ohio form IT 4708;
- financial institutions required to pay the Ohio corporation franchise tax;
- investors that are themselves qualifying pass-through entities if those entities' investors, during the three-year period beginning 12 months prior to the first day of the taxable year, are limited to the types of qualifying investors listed above;
- investors that are themselves pass-through entities, but only if the owners of the investor 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/or (4) nonresident estates on whose behalf those other pass-through entities file Ohio form IT 4708 for the taxable year;
- corporate investors that 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;

- 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;
- “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 an equity investment in the investment pass-through entity.

Form IT 4708

The following investors may not be included in form IT 4708:

- C corporations subject to the corporation franchise tax;
- 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 corporation franchise tax;
- 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 corporation franchise tax.

Special Provisions

(R.C. 5747.08)

Form IT 1140

Qualifying trusts – Qualifying trusts are also subject to the 5 percent withholding tax. A qualifying trust is generally any trust that meets all four of the following tests:

- it is required to file IRS form 1041;
- it has at least one beneficiary who is neither a full-year Ohio resident individual nor an Ohio resident estate;
- it makes a distribution to a nonresident beneficiary; and
- 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 or Ohio resident estates, then it is not a qualifying trust and is not subject to the pass-through entity tax. The filing, payment, and credit provisions that apply to qualifying pass-through entities and investors also apply to qualifying trusts and beneficiaries.

Pass-through to pass-through – The 8.5 percent withholding tax does not apply to any pass-through entity to the extent that the pass-through entity’s distributive shares of income and gains pass through from that entity to another pass-

through entity (referred to as the “investing entity”), as long as four conditions are met by the investing entity:

- it is not an “investment pass-through entity” (see below);
- it acknowledges that it has nexus with Ohio during the taxable year;
- it makes a good faith effort to comply with the 8.5 percent entity tax and 5 percent withholding tax; and
- it includes in its apportionment factors its proportionate share of each lower-tiered pass-through entity’s property, payroll, and sales.

Investment pass-through entities – Neither the 8.5 percent entity tax nor the 5 percent withholding tax applies to the items and income, listed below, that 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 following sources: dividend income, interest income, net capital gains from the sale or exchange of intangible property, certain fees, and all types and classifications of income and gain attributable to distributive shares of income and gain from other pass-through entities.

Investment pass-through entity investors – An investor in an investment pass-through entity is 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

A pass-through entity cannot claim nonbusiness exemptions or nonbusiness credits, such as the personal exemption credit. However, the pass-through can claim a proportionate share amount of business credits (such as the job training credit) for those investors that are included on the pass-through entity’s return.

Also, the election to file a composite IT 4708 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.

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 on Form IT 1140 ES.

The 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 Jan. 1 through Dec. 31 taxable year, the return is due on April 15. If the entity has sought an extension of time to file its federal tax return (IRS form 1065 or 1120 S),

then the qualifying pass-through entity has the same extended time to file the Ohio tax return. The payment deadline, however, will not be extended.

Form IT 4708

The pass-through entity must make estimated tax payments on Form IT 4708 ES if the pass-through entity's tax due for the current year is more than \$500.

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 sought an extension of time to file its federal tax return, then the pass-through entity has the same extended time to file the Ohio return on Form IT 4708.

Disposition of Revenue

The revenue collected from the 5 percent withholding tax and the form IT 4708 tax is treated as individual income tax revenue. In fiscal year 2007, 91.5 percent was deposited in the General Revenue Fund, 4.7 percent was deposited in the Library and Local Government Support Fund, 3.3 percent was deposited in the Local Government Fund, and 0.5 percent was deposited in the Local Government Revenue Assistance Fund.

Revenue collected from the 8.5 percent entity tax is treated as corporation franchise tax revenue. In fiscal year 2007, 95.6 percent was deposited in the General Revenue Fund, 3.7 percent was deposited in the Local Government Fund, 0.5 percent was deposited in the Local Government Revenue Assistance Fund, and 0.2 percent was deposited in litter tax funds and the Attorney General claims fund.

Administration

The Tax Commissioner administers the tax and the distribution of revenue.

Ohio Revised Code Citations

Chapters 5733 and 5747.

Recent Legislation

House Bill 458, 127th General Assembly (effective Dec. 30, 2008).

Incorporated into Ohio's tax laws all Internal Revenue Code changes made between Dec. 21, 2007 and Dec. 30, 2008.

House Bill 554, 127th General Assembly (effective Sept. 9, 2008).

The bill amended R.C. 5747.76 to limit the historic building rehabilitation tax credit, a refundable credit of up to \$5 million against either corporation franchise, dealers in intangibles, or individual income tax liability. The bill amended the statute to limit the amount that can be refunded and applied to tax liability in a single taxable year. If the credit allowed in a taxable year exceeds the tax due after all other allowed credits, the sum of the amount refunded and the amount applied to reduce tax otherwise due cannot exceed \$3 million. If the taxpayer is a pass-through entity, the refund cannot exceed the taxpayer's distributive or proportionate share of \$3 million. The taxpayer can carry forward any balance of the credit for not more than five years, but must deduct the amount claimed for any year from the amount claimed in an ensuing year.

Table 1

Pass-Through Entity Tax Liability (Form IT-1140), Tax Years 2004-2007 (figures in millions)			
Tax Year	Withholding Tax (5.0%)	Entity Level Tax (8.5%)	Total Pass-Through Entity Tax Liability
2004	\$71.4	\$20.2	\$91.6
2005	91.2	37.9	129.1
2006	94.2	23.4	117.6
2007	107.8	23.2	131.0

Table 2

Collections from the Composite Income Tax Paid on Behalf of Nonresident Investors in Pass-Through Entities (Form IT-4708), Fiscal Years 2004-2007 (figures in millions)	
Fiscal Year	Revenue Collected¹
2004	\$75.5
2005	101.7
2006	104.4
2007	136.7

1 Includes estimated tax payments (form IT 4708 ES).