PASS-THROUGH ENTITY 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 tax is not so much a separate tax but rather a mechanism designed to collect Individual Income tax or Corporate 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 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 the **Special Provisions** section).

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 Corporate 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 Corporate Franchise tax. (A more complete listing of exempt pass-through entities is available in the **Exemptions and Exclusions** section).

In tax year 2001, there were 6,306 Pass-Through Entity tax returns filed. The liability from the 5.0 percent withholding tax component of the Pass-Through Entity tax was $31.4 million. The 8.5 percent entity tax liability amounted to $3.7 million during tax year 2001. Thus, the total tax year 2001 Pass-Through Entity tax liability was $35.1 million. In tax year 2000, the total liability was $43.9 million, resulting in a 20 percent decrease in 2001.

Revenue collected from the composite income tax paid on behalf of non-resident investors in pass-through entities in Fiscal Year 2002 amounted to about $49.4 million.

GENERAL INFORMATION:

Entities are not subject to the Pass-Through Entity 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 non-resident investor has met their filing and payment obligation with respect to that income, and need not file a separate return unless having 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 their share of the business credits.

TAX BASE (R.C. 5733.40, 5747.02, 5747.08, 5747.40, 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 an investor's distributive share of the income, gain, expense, or loss of a pass-through entity, multiplied by the Corporate Franchise tax apportionment fraction.

Form IT-4708 –

The tax base is the income of those investors for which the pass-through entity has not filed Form IT-1140, and includes the net sum of each investor's distributive share of the income, gain, expense or loss of the pass-through entity, multiplied by the Corporate Franchise tax apportionment fraction.

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 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 below.

Form IT-4708 —

The highest marginal tax rate, which is currently 7.5 percent.

EXEMPTIONS AND EXCLUSIONS (R.C. 5733.40, 5733.401, 5733.402, 5747.08(0), 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); 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 Electing Small Business Trusts (ESBTs) **but only if the ESBT does not qualify as a grantor trust;**
3. Investors which are publicly-traded partnerships;
4. Investors which are colleges or universities;
5. Investors which are public utilities in Ohio and required to pay the Ohio gross receipts excise tax;
6. 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;
7. Investors which are dealers in intangibles;
8. Investors which are real estate investment trusts, regulated investment companies, and real estate mortgage investment conduits;
9. Investors who are individuals and residents of Ohio for the pass-through entity's entire taxable year;
10. Investors which are estates that are residents of Ohio for the pass-through entity's entire taxable year;
11. Non-resident 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;"
12. Investors that are financial institutions required to pay the Ohio Corporation Franchise tax;
13. 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 12 above;
14. Investors which are themselves pass-through entities 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) non-resident individuals on whose behalf those other pass-through entities file Ohio Form IT-4708, and (4) non-resident estates on whose behalf those other pass-through entities file Ohio Form IT-4708;
15. 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 Corporate 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 Corporate 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;
16. 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 receipents 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, <u>but only</u> 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 be withholding tax as required under the R.C. sections 5747.41 through 5747.453.
17. Investors which are "investment pass-through entities;" and
18. 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 Corporate Franchise tax, and/or (2) corporations which would be paying the Corporate Franchise tax if they were not eligible for an exemption set forth in R.C. 5733.09.

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 a pass-through entity to the extent that any direct or indirect investor in the second 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):

Form IT-1140 —

A refundable Ohio Individual Income tax credit is available for qualifying investors subject to the tax. A non-refundable Ohio Corporate Franchise tax credit is available for qualifying investors subject to the Corporate Franchise tax. Certain qualifying investors which are corporations exempt from Corporate Franchise tax are able to take a refundable credit. The credit is based upon the investor's proportionate share of the 5 percent withholding tax or the 8.5 percent entity tax, which was paid on the qualified investor's investment in the qualifying pass-through entity. In order to claim these credits, 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 deducts its proportionate share of 5.0 percent withholding tax or 8.5 percent entity tax from its federal income, it must add back such tax as income on the Ohio Individual Income tax return or Corporate Franchise tax return.

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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):

Form IT-1140 —

1. Qualifying trusts are also subject to tax. A qualifying trust is generally any trust meeting all three of the following requirements—(1) it must file the I.R.S. 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, and it makes a distribution to a non-resident beneficiary; and (3) 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 non-residents 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; (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" on certain types of income listed below. An investment pass-through entity has at least 90 percent of its assets represented by intangible assets, and 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, designated 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 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 any Individual Income tax exemptions or credits. However, the pass-through can claim their distributive share of business credits (e.g., the credit for purchases of manufacturing machinery and equipment, the credit for increasing export sales, etc.).

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 a limited liability company 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):

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 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 (I.R.S. 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 Corporate 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:

Amended Substitute Senate Bill 261; 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 owns a share of an entity must add back 5/6 of the corporation's share of the bonus depreciation deduction passed through 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 now include the sum of the income, gain, expense, or loss of a disregarded entity. As a result, a disregarded entity single member Limited Liability Company 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.

Amended Substitute House Bill 94; Effective September 5, 2001. R.C. 5733.401 –
Disallows the exclusion of net management fees from an investment pass-through entity's withholding tax base if the fees exceed five 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.
- **PIT 2001 - 03 —** "Certain Estimated Tax Payments Due September 16, 2002," July 3, 2002.

Table 1
Pass-Through Entity Tax Liability
(Form IT-1140)
Tax Years 1998 - 2001

Tax Year	Withholding Tax (5%)	Entity Level Tax (8.5%)	Total Pass-Through Entity Tax Liability
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 Non-Resident Investors in Pass-Through Entities (Form IT-4708)
Fiscal Years 1999 - 2002
(in millions of dollars)

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

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