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 or corporation franchise tax that is otherwise due and payable by equity investors in pass-through entities.

A pass-through entity is an S corporation, a partnership, or a limited liability company (LLC) treated as either a partnership or an S corporation for federal income tax purposes. 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 is completed and filed by the pass-through entity. In this sense, it is somewhat analogous to a W-2. Through this form, 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 certain corporate investors as part of the phase-out of the corporation franchise tax (see **Entity Tax Phase-Out for Qualifying Investors** below). When completing their own tax returns, each qualifying investor may claim an income tax credit or a corporation franchise tax credit based on the investor's 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 noncorporate 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 pass-through entity tax collections is from tax and Fiscal Year 2006. During taxable year 2006, some 11,391 pass-through entity taxpayers filed returns on form IT 1140. The liability from the 5 percent withholding tax component of these returns was $94.2 million. The entity tax liability amounted to $23.4 million. Thus, the total taxable year 2006 pass-through entity tax liability was $117.6 million.

During the 2006 taxable year, some 4,105 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 $104.4 million.

Entity Tax Phase-Out for Qualifying Investors:

The entity tax that a pass-through entity must withhold is also 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 Ending in:	Pass-Through Entity's Tax Rate on Ohio Income that Passes-Through to Its Qualifying Investors 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%)

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:

- Estates, trusts and other pass-through entities.
- 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 (USC) 1843(k).
- Persons, other than persons held pursuant to merchant banking authority under 12 USC 1843(k)(4)(h) or 12 USC 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 USC 1843(k).

- Persons directly or indirectly "owned" by one or more insurance companies, but only if those persons are authorized to do the business of insurance in this state.
- 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.

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 or S corporation 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 ratio.

Form IT 4708:

The tax base is the sum of the allocated and apportioned distributive share income amounts for those qualifying noncorporate investors for which the pass-through entity has not filed 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. But 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 2007 taxable year was 6.555 percent.

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

Form IT 1140:

Qualifying pass-through entities do not include the following:

- 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 (see "Check the Box" U.S. Treasury regulations);
- 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);
- 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 the investee 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 types of investors listed above;

- 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/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 cannot 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 apply 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 investment pass-through entity investor (or "deemed investor") in an 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 the adjusted qualifying amount which would otherwise pass-through to the investment pass-through entity and 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 FY 2006, 91.4 percent was deposited in the General Revenue Fund, 4.7 percent was deposited in the Library and Local Government Support Fund, 3.4 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 FY 2006, 95.4 percent was deposited in the General Revenue Fund, 3.5 percent was deposited in the Local Government Fund, 0.5 percent was deposited in the Local Government Revenue Assistance Fund, and 0.3 percent was deposited in litter tax funds and the Attorney General claims fund.

These distributions were in accordance with the freeze of local government funds that began in FY 2002 and was continued by subsequent budget bills. In House Bill 119, the FY 2008-2009 biennial budget bill enacted in 2007, the General Assembly revised the formula and the revenue accounting associated with the local government funds. Starting in January, 2008, all income tax and corporation revenue will be directed to the General Revenue Fund. For details on the local government fund changes, see the **Local Government Funds** chapter.

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

Am. Sub. H.B. 157, 127th General Assembly (effective Dec. 21, 2007).

Incorporated into Ohio's tax laws Internal Revenue Code changes made between Dec. 28, 2006 and Dec. 21, 2007.

Substitute H.B. 149, 126th General Assembly (effective April 4, 2007).

Granted a refundable credit to owners of historic buildings for the expenditures paid or incurred to rehabilitate certain historic buildings in Ohio. The credit, if approved by the Ohio Department of Development, equals 25 percent of the owner's "qualified rehabilitation expenditures" paid or incurred during the 24- or 60-month rehabilitation period shown on the taxpayer's tax credit certificate. Owners can claim the credit against the franchise tax, dealer in intangibles tax or income tax liability. Franchise taxpayers that are issued the certificate may claim the credit even if, because of the phase-out, the taxpayer is no longer subject to the franchise tax.

Table 1
Pass-Through Entity Tax Liability (Form IT 1140)
Tax Years 2003 - 2006

(figures in millions)

Tax Year	Withholding Tax (5.0%)	Entity Level Tax (8.5%)	Total Pass-Through Entity Tax Liability
2003	$62.6	$14.4	$77.0
2004	71.4	20.2	91.6
2005	91.2	37.9	129.1
2006	94.2	23.4	117.6

Table 2
Collections from the Composite Income Tax Paid on Behalf of Nonresident Investors in Pass-Through Entities (Form it 4708): Fiscal Years 2003 - 2006

(figures in millions)

Fiscal Year	Revenue Collected[1]
2003	$67.3
2004	75.5
2005	101.7
2006	104.4

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