Pass-Through Entity and Trust Withholding Tax

Ohio's tax laws include a provision, effective in 1998, 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 corporation franchise tax which pursuant to Ohio tax law is otherwise due and payable by pass-through entity investors.

Taxpayer

Qualifying pass-through entities and qualifying trusts are subject to this tax.

Tax Base

The sum of the "adjusted qualifying amounts" of a qualifying pass-through entity's qualifying investors. A pass-through entity is an "S" corporation, partnership, or a limited liability company treated as a partnership for federal income tax purposes. (Many pass-through entities are not subject to the tax; see **Major Exemptions**). The "adjusted qualifying amount" is the net sum of the qualifying investor's distributive share of the pass-through entity's income, gain, expense, and loss apportioned to Ohio.

Rates

- 5.0% withholding tax on the adjusted qualifying amount of qualifying investors who are individuals.
- 5.1% entity tax on the adjusted qualifying amount of qualifying corporate investors that are not individuals and that are subject to the corporation franchise tax phase-out reduction (60%) for the taxable year beginning in year 2006; 40% for 2007; 20% for 2008; and 0.0% for 2009 and thereafter.
- 8.5% entity tax on the adjusted qualifying amount of qualifying corporate investors that are not individuals and that are not subject to the corporation franchise tax phase-out reduction.
- No tax is due if the total adjusted qualifying amount is $1,000 or less.

Major Exemptions

Pass-through entities not subject to tax include (but are not limited to) the following:

- Any pass-through entity if all the equity investors are
  (i) Ohio corporation franchise taxpayers, and/or
  (ii) corporations exempt from the Ohio corporation franchise tax under Ohio Revised Code 5733.09.
- Entities having no qualifying investors.
- Pension plans and charities.
- Real estate investment trusts, regulated investment companies, and real estate mortgage investment conduits.

A qualifying investor does not include the following:

- Individuals who are residents of Ohio for the entire year.
- 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."
- Investors that are "investment pass-through entities."

(This is not a complete listing; there are many other types of investors not included in the above discussion of "qualifying investor.")

The entity 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 (the "investing entity"), as long as certain conditions are met.

Revenue (In Millions)

5.0% withholding tax(1)(2):

Fiscal Year	Total Tax
2002	$48.7
2003	55.0
2004	62.6
2005	71.4
2006	91.2

8.5% entity tax(1)(3):

Fiscal Year	Total Tax
2002	$7.3
2003	10.8
2004	14.4
2005	20.2
2006	37.9

7.5% composite income tax (2) of nonresident investors in pass-through entities (Form IT-4708):

Fiscal Year	Total Tax
2002	$49.4
2003	67.3
2004	75.5
2005	101.7
2006	104.4

Notes : *(1) These figures represent the tax liabilities reported-for each tax year, according to the fiscal year payment associated with the tax year. For example, the liability for tax year 2004 was predominantly paid during FY 2005, so the tax year 2004 tax liability data is reported as FY 2005 revenue in this table. (2) This revenue is counted as individual income tax. (3) This revenue is counted as corporation franchise tax.*

Disposition of Revenue

5.0% withholding and 7.5% composite income tax revenue:

89.5% to the General Revenue Fund, 5.7% to the Library and Local Government Support Fund, 4.2% to the Local Government Fund, and 0.6% to the Local Government Revenue Assistance Fund.

8.5% entity tax revenue:

95.2% to the General Revenue Fund, 4.2% to the Local Government Fund, and 0.6% to the Local Government Revenue Assistance Fund.

For fiscal years 2002 and 2003, the two local government funds were frozen and each received the same amount of corporation franchise tax revenue as they received in fiscal year 2001. The remainder was deposited in the General Revenue Fund. This freeze was continued in fiscal years 2004 and 2005 and again in the biennium budget for fiscal years 2006 and 2007.

During fiscal years 2006 and 2007, each of the three local government funds receive the same amount of revenue as they received during fiscal year 2005.

Payment Dates

Qualifying pass-through entities whose total adjusted qualifying amounts exceed $10,000 must make estimated quarterly tax payments. The payments are due on the 15th day of the month following the last day of each quarter of the taxpayer's taxable year. For taxpayers with a January 1 - December 31 taxable year, payments are due on April 15, July 15, October 15, and January 15 of the following calendar year.

The annual pass-through entity tax return must be filed by the15th 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 of the following calendar year. If the entity has an extension of time to file its federal tax return, the qualifying pass-through entity has the same extension to file the pass-through entity tax return. However, there is no extension of time to pay.

Credits/Special Provisions

Each qualifying individual investor may claim a refundable tax credit in a pass-through entity against their Ohio individual income tax. The credit equals the qualifying investor's proportionate share of the withholding tax and entity tax, if any.

A nonrefundable tax credit may be claimed by qualifying non-individual (corporate) investors against their Ohio corporation franchise tax. The credit equals the investing corporation's proportionate share of the entity tax.

If, for federal income tax purposes, the investor deducts the investor's proportionate share of the withholding tax or the entity tax, the investor must add back such tax on the Ohio individual income tax return or corporation franchise tax report.

Sections of Ohio Revised Code

5733.40 – 5733.41 and 5747.40 – 5747.45

Responsibility for Administration

Tax Commissioner.

History of Major Changes

1998 • Tax became effective at a rate of 5.0% on individual qualifying investors and 8.5% on non-individual qualifying investors.
- Certain pass-through entities that are part of multi-tier structures exempted from tax.
- Investment pass-through entities exempted from tax on investment income.

2001 • If net management fees exceed 5.0% of an investment pass-through entity's net income, such fees are subjected to tax.

2002 • Each partner in a partnership and each member of a Limited Liability Company (LLC) must add back 5/6 of the partner's/member's share of the bonus depreciation deduction passed through from the entity to the partner/member.
- Definition of "business income" amended to include gains and/or losses from partial or complete liquidation of a business, including, but not limited to, the gain or loss from the disposition of goodwill.
- Distributive shares expanded to include the sum of the income, gain, expense, or loss of a disregarded entity.

2003 • A partner in a partnership and a member of an LLC must add back 5/6 of the partner's/member's share of "qualified Internal Revenue Code section 179" depreciation.
- Sales factor amendments: cost of performance standard replaced with market-theory approach for sales other than sales of inventory (tangible personal property and real estate).

2005 • Tax rate phase-out began for the qualifying corporate investors not listed below. 8.5% tax rate applicable only to distributive shares of income passing through to qualifying investors, other than individuals, listed below:
  - 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 "Homeowners 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 but only if those persons
  (i) are authorized to do the business of insurance in this state, and
  (ii) are paying the 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.

Comparisons with Other States (as of 05/07)

The Ohio pass-through entity tax is essentially a withholding tax on the distributive shares of income of qualifying investors (generally corporations and nonresident investors).

The states with a tax most closely approximating the Ohio pass-through entity tax are those requiring withholding tax on the pass-through entity income of nonresident investors.

These states include **California, Indiana, New Jersey, New York, Pennsylvania,** and **West Virginia.** (This listing does not reflect taxes imposed by many states on certain types of income, such as the capital gains, built-in gains, and excess net passive income of "S" corporations, or any other type of entity-level tax.)