

# PASS-THROUGH ENTITY TAX

House Bill 215 (122<sup>nd</sup> General Assembly) enacted an alternative 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, partnership, or a limited liability company treated as a partnership for federal income tax purposes.

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. In addition, entities that file the Ohio form IT-4708 on behalf of all their investors who are not full-year Ohio resident individuals or Ohio resident estates are not subject to the tax. (A more complete listing of exempt pass-through entities is available in the **Exemptions and Exclusions** section.)

For taxable years beginning after December 31, 1998, 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, based upon the investors’ share of the qualifying pass-through entity’s profits apportioned to Ohio. Qualifying investors can claim an income tax or corporate franchise tax credit based upon the investor’s proportionate share of the pass-through entity tax.

In tax year 2000, there were 6,334 pass-through entity tax returns filed. The liability from the 5.0 percent withholding tax component of the pass-

through entity tax was \$39.7 million. The 8.5 percent entity tax liability amounted to \$4.2 million in tax year 2000. Thus, the total tax year 2000 pass-through entity tax liability was \$43.9 million. In tax year 1999, the total liability was \$45.4 million, resulting in a 3 percent decrease in 2000.

## **TAX BASE (R.C. 5733.40, 5747.40, 5747.401):**

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.

## **RATES (R.C. 5733.41, 5747.41):**

A 5.0 percent tax rate is applied to the sum of adjusted qualifying amounts for those investors that 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.

## **EXEMPTIONS AND EXCLUSIONS (R.C. 5733.40, 5733.401, 5733.402, 5747.401):**

Pass-through entities not subject to tax:

1. Entities having no qualifying investors (see below for non-qualifying investors);
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 qualified sub-chapter 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 (ESBT's) **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. 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";
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 (i) individuals who are full-year residents of Ohio, (ii) estates domiciled in Ohio, (iii) nonresident individuals on whose behalf those other pass-through entities file Ohio form IT-4708, and (iv) nonresident estates on whose behalf those other pass-through entities file Ohio form IT-4708;

15. Investors which satisfy the following three requirements: (i) 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, (ii) the investor makes a good faith and reasonable effort to comply with the corporation franchise tax reporting and payment requirements, and (iii) neither the investor nor the qualifying pass-through entity carries out any transactions with any related members where such transactions would result in a reduction or deferral of corporation franchise tax;
16. Investors which are "investment pass-through entities";
17. Investors which are corporation franchise taxpayers but only if all the other investors in the qualifying pass-through entity are limited to: (i) other corporations which are paying the corporation franchise tax, and/or (ii) corporations which would be paying the corporation franchise tax if they were not eligible for an exemption set forth in RC section 5733.09.

#### **CREDITS (R.C. 5733.0611, 5747.059):**

A refundable Ohio individual income tax credit is available for qualifying investors subject to the tax. A nonrefundable Ohio corporation franchise tax credit is available for qualifying investors subject to the corporation franchise tax. Certain qualifying investors which are corporations exempt from corporation 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 IRS 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 corporation franchise tax return.

**SPECIAL PROVISIONS:**

1. Qualifying trusts are also subject to tax. A qualifying trust is generally any trust meeting all three of the following requirements: it must file the IRS form 1041 (U.S. Income Tax Return for Estates and Trusts); 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 nonresident beneficiary; and the distribution relates either to real estate located in Ohio or to tangible personal property located in Ohio. Thus, 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 distributions 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: (i) the investing entity is not an investment pass-through entity; (ii) the investing entity acknowledges that it has nexus with this state during the taxable year; (iii) the investing entity makes a good faith effort to comply with the 8.5 percent entity tax and 5.0 percent withholding tax; and (iv) 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 is defined as 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, 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 (i) the adjusted qualifying amount which would otherwise pass-through to the investment pass-through entity, (ii) multiplied by the percentage of the deemed investor's direct ownership in the investment pass-through entity.

**TAXPAYER (R.C. 5733.40):**

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. 5747.42, 5747.43, 5747.44):**

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 (IRS form 1065 or 1120S), then the qualifying pass-through entity has the same extension of time to file the Ohio tax return.

**DISPOSITION OF REVENUE:**

The revenue collected from the 5 percent withholding 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.

**RECENT LEGISLATION**

*Am. Sub. 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 they exceed five percent of the entity's net income.

**OHIO REVISED CODE CITATIONS:**

Chapters 5733 and 5747

<b>Table 56A</b> <b>Pass-Through Entity Tax Liability (Form IT-1140)</b> <b>Tax Years 1998 - 2000</b> (in million of dollars)			
Tax Year	Withholding Tax (5%)	Entity Level Tax (8.5%)	Total Pass-Through Entity Tax Liability
2000	\$39.7	\$4.2	\$43.9
1999	38.8	6.6	45.4
1998	35.8	3.9	39.7

<b>Table 56B</b> <b>Collections from the Composite Income Tax Paid on Behalf of Nonresident Investors in Pass-Through Entities (Form IT-4708)</b> <b>Fiscal Years 1999 - 2001</b> (in million of dollars)	
Fiscal Year	Revenue Collected*
2001	\$62.4
2000	53.1
1999	36.3

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