SALT BUZZ HF

Proposed Ohio Pass-Through Entity Tax Reform Contains Some Surprises For 2017 Taxes

November 7, 2016

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Member

Substitute Senate Bill 288 (S.B. 288 or the Bill) proposes significant reforms to the Ohio pass-through entity (PTE) tax structure and some of its related provisions. All PTEs doing business in Ohio could be affected, including those that are owned in part by other pass-through entities.

The current PTE tax structure contains mandatory “withholding” by the PTE for Ohio income tax that is ultimately owed by the PTE’s non-resident investors. S.B. 288 effectively eliminates the PTE “withholding” tax and mandates that each PTE with non-resident investors must file a single composite return on behalf of its non-resident investors.

The Bill is intended to reduce the number of tax forms, modernize the current withholding tax rate to comply with the actual tax rate, and streamline some of the PTE provisions that exist in several Chapters of the Revised Code. However, the Bill also contains other provisions that could result in increased filing responsibilities. The more significant changes proposed in S.B. 288 are outlined below.

Rate Differences

- The “business income” tax rate of 3% will replace the current withholding rates of 5% and 8.5% for non-resident individual owners and non-resident upper-tier PTE owners. The tax and withholding rate of 3% mirrors the business income tax rate recently passed by Ohio lawmakers. Furthermore, the current PTE withholding rates had not been lowered to reflect reductions in the individual income tax rates and to reflect that the Ohio corporation franchise tax was phased-out several years ago.

  - o The 3% tax rate will also apply to estimated payments that the PTE makes on behalf of the investors and to the new composite return that the PTE is required to file for its owners, regardless of whether the PTE generates business income or non-business income. Recall that non-business income remains subject to the normal tax rate structure, with a highest marginal rate of 4.997%.

Filing and Compliance

- Each PTE owned by one or more non-residents of Ohio will be required to file a composite return and make certain adjustments to the PTE's income when computing the tax that is owed.

Publicly Traded Partnerships

- Publicly traded partnerships which were previously exempted from the Ohio PTE tax structure, will now have reporting requirements, including providing the Ohio Department of Taxation the names of their investors that have at least $500 of Ohio sourced income from the publicly traded partnership.

Trust Impact

- The Bill maintains much of the current Ohio trust income tax structure, but the proposal would eliminate the imposition of a direct tax on some trusts that currently causes the trust to withhold Ohio income tax on certain distributions made to non-resident beneficiaries.

  - o Note that the 3% business income tax rate does not apply to the trust income tax structure, thereby creating a disparate tax rate for business income generated by a trust as compared to business income generated by an S corporation, LLC, individual, or partnership.

Miscellaneous Changes

- Ohio partnerships and limited liability companies will now be subject to the "related member adjustment," thereby resulting in a tax increase on certain non-resident owners.

- The "related member adjustment" effectively disallows, as a deduction from the Ohio income tax base, certain expenses paid by one pass-through entity to another pass-through entity if the two pass-through entities are related to each other, based on common ownership of 40% or more. The adjustment requires those related party payments to be taxed in Ohio, based on the apportionment fraction of the payor pass-through entity, thereby causing a tax increase.

- A perceived loophole that currently exists for related party transactions would be closed, thereby causing a tax increase for certain taxpayers.

- The income tax credit for the Financial Institutions Tax (FIT) payments would become non-refundable and no carry-forward of any excess FIT credit would be permitted.

S.B. 288 may be addressed by the Ohio General Assembly in November and December following the election. The current version of S.B. 288 would apply, if enacted, to taxable years ending on or after January 1, 2017. Even if S.B. 288 is not addressed in the lame-duck session at the end of calendar year 2016, it is likely that some or all of the S.B. 288 proposed changes could be included in the Governor's budget bill proposal expected to be released in February of 2017. Accordingly, PTEs and their owners should thoroughly review these proposals.

Follow this link to the ohio department of taxation annual report, which describes the pass-through entity tax provisions that are in current law: http://www.tax.ohio.gov/Portals/0/communications/publications/annual_reports/2015_annual_report/2015_AR_Section_2_Pass-Through_Trust_Withholding_Tax.pdf

If you would like to discuss the impact of S.B. 288 on your individual or PTE tax situation, please contact Steve Hall at Zaino Hall & Farrin LLC.

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