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 that is otherwise due and payable by equity investors in qualifying pass-through entities. All of the revenue collected from pass-through entities is included in the income tax revenue amounts reported by the Office of Budget and Management (OBM) and shown in Table 1 in the **Individual Income Tax** section of this report. The income tax liability associated with pass-through entity withholding is included in statistical tables 4 through 15 only to the extent that the individual investors subject to withholding file an Ohio individual income tax return.

A pass-through entity is an S corporation, a partnership or a limited liability company (LLC) treated for federal income tax purposes as either a partnership or an S corporation. 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 withholding tax. See the **Special Provisions** section in this chapter for details.

Many pass-through entities are not "qualifying pass-through entities" and therefore are not subject to this withholding tax. Pass-through entities not subject to the withholding tax include entities whose investors are limited to full-year Ohio resident individuals or Ohio resident estates, for example. A more complete listing of exempt pass-through entities is available in the Exemptions and Exclusions section of this chapter.

The withholding 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 the qualifying pass-through entity completes and files with the Department of Taxation. Through the IT 1140, a tax of five 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, was phased out for most corporate investors as part of the phase-out of the corporation franchise tax, but still applies to most investors who are themselves a pass-through entity (see Entity Tax Phase-Out for Qualifying Investors). When completing their own tax returns (IT 1040), a qualifying investor may claim an income tax credit based on the investors' proportionate shares of the pass-through withholding and entity tax reported on 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 non-corporate 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.

The most recent data for tax collections from qualifying pass-through entities is from taxable year 2014 and fiscal year 2015. During taxable year 2014,14,038 pass-through entity taxpayers filed returns on form IT 1140. The total taxable year 2014 pass-through entity tax liability was approximately $241.4 million. In addition, 14,863 entities filed returns on the IT 4708 form for the composite income tax paid on behalf of nonresident investors in pass-through entities in taxable year 2014. Revenue from these returns amounted to about $199.8 million during fiscal year 2015.

Entity Tax Phase-Out for Qualifying Investors
(Ohio Revised Code 5733.41)

The entity tax that a qualifying pass-through entity must withhold was phased out for qualifying investors that were also subject to the phase-out of the corporation franchise tax.

Certain investors were not subject to the phase-out rates. For these qualifying investors, the pass-through entity must continue to compute the entity tax at the rate of 8.5 percent. These investors include:

- certain financial holding companies, bank holding companies and savings and loan holding companies;
- certain affiliates of these holding companies and certain affiliates of financial institutions;
- certain affiliates of insurance companies; and
- securitization companies.

The 8.5 percent entity tax rate also continues to apply to investors that are estates, trusts and other pass-through entities.

Taxpayer
(R.C. 5733.40, 5747.08)

A qualifying pass-through entity is generally an S corporation, a partnership or an LLC treated for federal income tax purposes as a partnership or S corporation. See the **Exemptions and Exclusions** section of this chapter 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 net sum of qualifying investors' distributive shares of the pass-through entity's income, gain, expense and loss apportioned to Ohio. This net sum is known as the "adjusted qualifying amount."

Form IT 4708

The tax base is the distributive shares of the pass-through entity's taxable income to qualifying noncorporate investors, to the extent that such income was not reported on form IT 1140.

Rates

(R.C. 5733.41, 5747.02, 5747.08, 5747.41)

Form IT 1140

A five percent withholding tax rate applies to adjusted qualifying amounts for those qualifying equity investors who are individuals. Before 2005, an 8.5 percent entity tax rate was uniformly applied to adjusted qualifying amounts for those qualifying equity investors that are not individuals. However, this entity tax is 0 percent on those "adjusted qualifying amounts" that pertain to qualifying investors subject to the phase-out of the corporate franchise tax.

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 was 4.997 percent for the 2015 taxable year and 5.333 percent for the 2014 taxable year.

Exemptions and Exclusions

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

Form IT 1140

The following are not qualifying pass-through entities:

- disregarded entities and qualifying subchapter S subsidiaries if the owner is filing, or is exempt from filing, with the Ohio Department of Taxation the appropriate income or franchise tax returns;
- 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;

The following investors are not qualifying investors:

- pension plans or charities;
- publicly-traded partnerships;
- colleges or universities;
- investors that are public utilities in Ohio and are required to pay the Ohio public utility excise tax;
- investors that 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;
- investors that are dealers in intangibles as defined in R.C.5725.01(B);
- real estate investment trusts, regulated investment companies and real estate mortgage investment conduits;
- non-resident individuals on whose behalf, and non resident estates on whose behalf, the qualifying pass through entity files Ohio form IT 4708, Composite Income Tax Return for Certain Investors in a Pass-through Entity, for the taxable year;
- investors that are financial institutions required to pay the Ohio corporation franchise tax;
- investors that are themselves qualifying pass-through entities if the qualifying pass-through entities' investors during the three-year period beginning 12 months before the first day of the investee entity's taxable year are limited to those investors set forth in any of the items, above (or any combination thereof);
- all subchapter C corporations, except for the relatively small number described in R.C. 5733.01(G)(1)(b);
- investors that are themselves pass-through entities, but only 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, Composite Income Tax Return for Certain Investors in a Pass-through Entity, and/or (iv) nonresident estates on whose behalf those other pass-through entities file Ohio form IT 4708, Composite Income Tax Return for Certain Investors in a Pass-through Entity, for the taxable year;
- investors that satisfy all the following:

  – 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;

  – the investor makes a good faith and reasonable effort to comply with the corporation franchise tax reporting and payment requirements; and

  – neither the investor nor the qualifying pass-through entity carries out any transactions either with any related members of the investor or with any related member of the entity where such transactions would result in a reduction or deferral of corporation franchise tax.

Investors that are either trusts or funds whose beneficiaries are limited to the following during the taxable year of the qualifying pass-through entity:

- beneficiaries of a pension plan trust, profit-sharing trust, a stock bonus plan trust or similar retirement trust;
- 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
- 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.

Investors that are "investment pass-through entities" (defined below), but only if the investment pass-through entity provides to the qualifying pass-through entity the name, address and Social Security number or federal employer identification number (FEIN) of each person who has an equity investment in the investment pass-through entity.

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:

- files the IRS form 1041, U.S. Income Tax Return, for Estates and Trusts;
- has at least one beneficiary who is neither a full-year Ohio resident individual nor an Ohio resident estate;
- makes a distribution to a nonresident beneficiary; and
- makes a distribution to a nonresident beneficiary, and the distribution directly or indirectly 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 entity 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:

- is not an "investment pass-through entity" (see below);
- acknowledges that it has nexus with Ohio during the taxable year;
- makes a good faith effort to comply with the 8.5 percent entity tax or the 5 percent withholding tax, as applicable; and
- 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 applies 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:

- transaction fees earned in connection with the acquisition, ownership or disposition of intangible property;
- loan fees;
- financing fees;
- consent fees;
- waiver fees;
- application fees;
- net management fees (management fees that the pass-through entity earns or receives from all sources reduced by the management fees that the pass-through entity incurs or pays to any person), but only if such net management fees do not exceed 5 percent of the pass-through entity's profit;
- dividend income;
- interest income;
- net capital gains from the sale or exchange of intangible property;
- 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 equity investor in an investment pass-through entity is deemed to be an equity 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 is the product of the adjusted qualifying amount that would otherwise pass-through to the investment pass-through entity, multiplied by 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 entity 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 January 1 through December 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 1120S), 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 by 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 IT 1140 withholding tax and the form IT 4708 tax is treated as individual income tax revenue.

Administration

The Tax Commissioner administers the tax and the distribution of revenue.

Ohio Revised Code Citations

Chapters 5733 and 5747.

Recent Legislation

House Bill 19, 131st General Assembly, Internal Revenue Code (IRC) conformity.

The bill adopted IRC amendments enacted by Congress from March 22, 2013 (the effective date of SB 28's amendment to R.C. 5701.11) through April 1, 2015 (the effective date of HB 19's amendment of R.C. 5701.11).

Senate Bill 28, 130th General Assembly, Internal Revenue Code (IRC) conformity and federal law changes.

The bill adopted IRC amendments enacted by Congress from Dec. 20, 2012 (the effective date of H.B. 472's amendment to R.C. 5701.11) through March 22, 2013 (the effective date of SB 28's amendment of R.C. 5701.11).

The bill incorporated into Ohio's tax laws all IRC changes made between March 22, 2013 and April 1, 2015.

History of Major Changes

1998	General Assembly enacts tax at a rate of 5 percent on individual qualifying investors and 8.5 percent on non-individual qualifying investors.
2002	Ohio decouples from federal accelerated depreciation laws, requiring a 5/6 add-back for bonus depreciation.
2003	House Bill 127 revises Ohio's method of situsing sales in Ohio as part of the sales factor for apportioning corporation and trust income. In determining the situs of sales in Ohio for sales factor apportionment, the "cost of performance" standard is replaced with a "market-theory" approach based on where the taxpayer's customer enjoys the benefit of the taxpayer's sale.
2005	House Bill 66 launches a gradual phase-out of the 8.5 percent entity withholding tax rate for that portion of adjusted qualifying amounts pertaining to investors subject to the phase-out of the corporation franchise tax. The phase-out is complete in 2009.

Comparisons with Other States

(as of July, 2015)

The Ohio pass-through entity tax is a withholding tax on the distributive shares of income of qualifying 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 **Georgia, Indiana, Kentucky, Michigan, North Carolina, 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.

Table 1

Pass-Through Entity Tax Liability (Form IT-1140), Tax Years 2010-2014 (in millions)

Tax Year	Total Pass-Through Entity Tax Liability
2010	$126.2
2011	139.6
2012	190.5
2013	185.3
2014	241.4

Source: Ohio Department of Taxation records

Table 2

Collections from Composite Income Tax Paid on Behalf of Nonresident Investors in Pass-Through Entities (Form IT-4708) Fiscal Years 2010-2015 (figures in millions)

Fiscal Year	Revenue Collected
2010	$114.5
2011	156.9
2012	155.6
2013	205.6
2014	168.2
2015	199.8

Source: Ohio Department of Taxation records