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Office of Research and Drafting

Legislative Budget Office

H.B. 467
(l_133_1839-1)
133rd General Assembly

Fiscal Note & Local Impact Statement

Click here for H.B. 467's Bill Analysis

Version: In House Ways and Means

Primary Sponsor: Rep. Scherer

Local Impact Statement Procedure Required: Yes

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Highlights

Fund	FY 2021	FY 2022	Future Years
State General Revenue Fund			
Revenues	Possible $30.5 million loss	$0	$0
Expenditures	$0	$0	$0
Local Government and Public Library funds (counties, municipalities, townships, and public libraries)			
Revenues	Possible $1.1 million loss	$0	$0
Expenditures	Commensurate reduction	$0	$0

Note: The state or school district fiscal year runs from July 1 through June 30 and is designated by the calendar year in which it ends. For other local governments, the fiscal year is identical to the calendar year.

- The bill reduces the withholding tax rate for certain pass-through entities to 3%.
- Taxpayer liabilities would be unchanged. However, the rate reductions are estimated to give rise to a one-time revenue loss of $31.6 million in FY 2021, due to the timing of payments during the fiscal year.
- Lower GRF tax revenues in the fiscal year would reduce distributions through the Local Government Fund (LGF, Fund 7069) and the Public Library Fund (PLF, Fund 7065), by an estimated $1.1 million. The balance would be retained by the GRF.

Detailed Analysis

The bill reduces withholding tax rates to 3% on certain pass-through entities (PTEs). PTEs include partnerships, S corporations, and limited liability companies. PTEs "pass through" the liability to pay tax on their income to their investors, thereby avoiding a second layer of taxes at the business entity level. Although income taxes are not owed by the PTEs themselves but are due instead from the investors in the PTEs, payments referred to as withholding taxes are made by some PTEs for which the investors in those entities can claim refunds or credits against taxes owed. This withholding tax helps reduce tax avoidance.

For certain out-of-state investors in PTEs that are not individuals or are various financial institutions and some others, the withholding tax rate falls from 8.5% to 3%.[1] For out-of-state investors in PTEs who are individuals and for trusts with beneficiaries who are out-of-state individuals, the withholding tax rate falls from 5% to 3%. The 3% rate equals the rate on taxable business income.

No state personal income taxpayer's tax liability is changed by the bill. Taxpayers are eligible for refunds of withholding tax paid in excess of tax due. However, timing differences between when the tax is withheld and when the refunds are paid will result in a one-time tax revenue loss from the reduction in withholding tax rates that LBO estimates at $31.6 million in FY 2021. This estimate is based on data provided by the Department of Taxation. The loss occurs because refunds (or final settlements) are paid in arrears, for the prior tax year, so adjust more slowly than cash flows from changes in the withholding tax. This remains the case even if the taxpayer owes no tax on the income for which withholding tax was paid. For example, a taxpayer eligible to deduct business income from the PTE that totals less than the maximum allowed deduction of $125,000 for a married taxpayer filing separately and $250,000 for all other taxpayers would owe no tax on that income.

How such a loss would occur can be illustrated in the following way. Estimated withholding tax payments are due quarterly from PTEs affected by the bill, in the month following the end of the quarter. If, for example, the January 2021 payment, for PTE income received during the fourth quarter of 2020, is the first withholding tax payment affected by the bill, and if, for a specific investor, that payment (and each other quarterly payment) is reduced by $100, that investor's refund in the first half of 2021 would also be reduced by $100. The April withholding tax payment, for the 2021 first quarter, would not affect the investor's refund until 2022. In FY 2021 the state would receive $200 less for this investor, from the January and April withholding tax payments, and would refund $100 less, for a net revenue loss of $100. In FY 2022 and thereafter, assuming the change per quarter continues to be a reduction of $100,

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[1] This part of the bill, amending R.C. 5733.41, applies with certain exceptions to non-Ohio domiciled entities including other PTEs; financial institutions; financial holding companies; bank holding companies; savings and loan holding companies; persons directly or indirectly owned by one or more financial institutions, financial holding companies, bank holding companies, or savings and loan holding companies; persons that solely facilitate or service securitizations by these entities; certain affiliates of insurance companies; and estates and trusts subject to the personal income tax.

the state would receive $400 less for this investor, from the July, October, January, and April withholding tax payments, and would refund $400 less, for no net revenue loss.

These changes are shown in the table below, for calendar year (CY) 2020 to CY 2022. Withholding Tax in the first line of the table is paid to the state by the PTE on behalf of the investor. Refund is paid to the investor by the state, assumed in this example to be paid in the April-June quarter. Net to State is the difference between withholding tax and refund. The line labeled Fiscal Year aggregates payments in the Net to State line for the appropriate four quarters.

Illustrative Changes in Withholding Tax for and Refund Paid to Qualifying Investor								
	CY 2020		CY 2021				CY 2022	
	July-Sep.	Oct.-Dec.	Jan.-March	April-June	July-Sep.	Oct.-Dec.	Jan.-March	April-June
Withholding Tax	$0	$0	-$100	-$100	-$100	-$100	-$100	-$100
Refund	$0	$0	$0	-$100	$0	$0	$0	-$400
Net to State	$0	$0	-$100	$0	-$100	-$100	-$100	+$300
Fiscal Year	-$100				$0			

The bill specifies that the changes apply to qualifying taxable years ending on or after the effective date. If the timing of the bill's enactment results in reduction of the withholding tax starting in October 2020, such payments for the hypothetical investor would be reduced $100 in each of October, January, April, and each quarter thereafter. The October and January payment reductions would lower the investor's refund for tax year 2020 by $200. The state would receive $300 less in FY 2021 from withholding tax payments on behalf of this taxpayer, and would pay out $200 less in tax refunds, for a net revenue loss of $100, the same revenue loss as for the case in which the bill first affects withholding tax payments in January 2021. As with the previous case, the state would sustain no net revenue loss in subsequent fiscal years.[2]

In these simple illustrations, income and net taxes due are held unchanged from year to year. Actual withholding tax and refund amounts obviously would vary. As the illustrative cases show, the amount of the one-time revenue loss is invariant with respect to the timing of the bill's effective date, assuming it begins to affect withholding taxes by April 2021.

State tax revenue from the withholding tax on PTEs is treated as individual income tax revenue and so is part of GRF tax revenues. Consequently, the Local Government Fund (LGF) and Public Library Fund (PLF) would also lose revenue in that fiscal year. The LGF and the PLF each receive monthly distributions of a portion of GRF tax revenues in the previous month.

[2] Other scenarios related to the timing of the initial change in withholding may be possible, but lead to the same result of a $100 revenue loss in FY 2021.

Provisions of H.B. 166 of the 133rd General Assembly set the percentages at 1.68% for the LGF and 1.70% for the PLF in FY 2020 and FY 2021, or a total of $1.1 million on the estimated revenue loss in FY 2021.[3] All revenues to each fund are distributed in the month received to local governments, primarily municipalities, counties, and townships, and public libraries. The balance, $30.5 million, would be retained by the GRF.

Synopsis of Fiscal Effect Changes

The substitute bill reduces the withholding tax rate from 4% in the As Introduced version of the bill to 3%, and increases the estimated revenue loss in FY 2021 from $20.1 million to $30.5 million for the GRF, and from $0.7 million to $1.1 million in total for the LGF and PLF. It also clarifies the amount of withholding tax for PTE investors who are individuals.

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[3] The LGF and the PLF each receive monthly distributions of 1.66% of GRF tax revenues under codified law.