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Bill Analysis

Version: As Introduced

Primary Sponsors: Reps. Callender and T. Young

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SUMMARY

- Includes certain pass-through entity (PTE) taxes in the calculation of a PTE investor's Ohio income tax resident credit.
- Requires a PTE investor to add back certain PTE taxes imposed by another state that the investor deducts from federal adjusted gross income as a business expense.
- Applies the changes to taxable years ending on or after January 1, 2023, but allows taxpayers to apply, at their option, the provisions to the 2022 taxable year, by filing an amended or original return.

DETAILED ANALYSIS

Pass-through entity income taxes

Under federal law, an itemized income tax deduction is allowed for state and local taxes. That deduction was capped at $10,000 in 2017. As a result, many states, including Ohio, enacted laws allowing owners of pass-through entities (PTEs), i.e., entities that are disregarded for federal income tax purposes, such that their tax liability passes through to their owners, to pay a tax on the PTE's income at the entity level, with the cost of the tax passing through to its owners. According to IRS guidance issued after the $10,000 cap was enacted, these entity-level taxes are subject to deduction as business expenses and are not subject to the $10,000 cap. As a result, owners could claim their full share of the entity-level taxes as a federal income tax deduction.[1]

[1] R.C. 5747.38, not in the bill; See Internal Revenue Service (IRS) Notice 2020-75 (PDF), which may be accessed by conducting a keyword "Notice 2020-75" search on the IRS's website: www.irs.gov.

Ohio's PTE tax allows PTEs to elect to pay an entity-level tax, the cost of which is then passed through to each PTE owner as part of their distributive share of gains and losses. Each PTE owner is allowed an Ohio income tax credit equal to the cost of their distributive share of the tax liability, but the amount of that tax liability is deductible against the federal income tax, reducing the taxpayer's federal adjusted gross income (FAGI) and the tax liability calculated against it. In other words, the state PTE tax is cost-neutral to the taxpayer, but it reduces federal income tax liability.

FAGI is the basis for the Ohio income tax, and Ohio adjusted gross income (OAGI) is FAGI adjusted with various deductions and additions. When the Ohio PTE tax was enacted, a related provision requiring the addition of a taxpayer's proportionate share of the elective PTE entity tax discussed above that was deducted from federal taxes was also enacted. This avoids a scenario in which a taxpayer pays the state PTE tax designed to reduce federal-income tax liability, but receives the same amount of money back in a credit and then also reduces OAGI based on the Ohio tax that is completely credited to the taxpayer.

The bill makes several changes related to how Ohio's PTE tax and similar taxes levied in other states interact with other aspects of Ohio's income tax. First, the bill requires the addition to FAGI, when calculating OAGI (and Ohio taxable income in the context of estates and trusts), of any income taxes deducted from FAGI on the basis of a PTE entity tax designed to reduce FAGI pursuant to the IRS guidance discussed above that is levied by another state or the District of Columbia. As mentioned above, Ohio was among a group of states that enacted these types of PTE taxes, so FAGI could be reduced by any one of them.

Second, the bill specifies that the addition of both Ohio's and other states' PTE tax, to the extent it is related to an individual's "business income," is to be treated as such. Business income is relevant in various contexts of the income tax law, one of which is for a deduction allowed for $125,000 of business income for each spouse filing a separate return or $250,000 for other filers and another of which is a special 3% rate that applies to business income above that threshold. Thus, this provision clarifies how amounts added back are to be classified.[2]

Third, continuing law allows an income tax credit for the taxes residents pay to other states and the District of Columbia. The credit is applied against the amount of a taxpayer's OAGI, before applying any tax credits. The bill provides that, for purposes of the credit, a resident taxpayer's OAGI that is subject to an income tax levied in another state includes income that is subject in the other state, or the District of Columbia, to either (1) an entity-level tax imposed on a PTE and paid by the PTE through a composite return covering all PTE owners, with the cost of the tax passed on to the resident taxpayer as part of the taxpayer's distributive share of PTE gain and loss, or (2) a PTE tax, similar to Ohio's, adopted in response to the $10,000 cap on the federal deduction for state and local taxes. It also requires OAGI, for purposes of the credit, to be calculated by first deducting the business income deduction described above.

[2] R.C. 5747.01(A)(36), (40), and (S).

In other words, for purposes of the resident income tax credit for taxes paid to other states, the bill includes taxes paid to those states on account of the resident taxpayer's ownership of a PTE that paid taxes to the other jurisdiction on behalf of the taxpayer, either as part of a composite return or as part of a tax designed to avoid the $10,000 state and local tax deduction cap. But, the tax liability against which that credit is applied is first reduced because it is calculated with an OAGI that has been reduced by the business income deduction.[3]

The bill applies these changes to taxable years ending on or after January 1, 2023. Taxpayers may, however, apply them to taxable years ending on or after January 1, 2022, by filing an amended or original return for that year.[4]

HISTORY

Action	Date
Introduced	06-06-23

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[3] R.C. 5747.05, with conforming changes in R.C. 5747.11 and 5747.13.

[4] Section 3.