MUNICIPAL TAX REFORM BECOMES LAW!

After more than three years of effort, the Ohio Municipal Income Tax Reform bill, Am. Sub. H.B. 5 ("Am. Sub. H.B. 5" or "the Act") was signed into law by Governor John Kasich. The Act applies to taxable years beginning on or after January 1, 2016. The Act was sponsored by Rep. Cheryl Grossman and Rep. Michael Henne, and was strongly supported by the Municipal Tax Reform Coalition, a coalition of 33 business associations, led by The Ohio Society of CPAs, the Ohio Chamber of Commerce, and the National Federation of Independent Business-Ohio.[1]

The 167 page Act re-writes the most burdensome and anti-competitive municipal tax system in the country by mandating a five year carryforward of net operating losses and the ability of resident taxpayers to fully offset gains and losses generated in the current year. The cost of compliance will be reduced for taxpayers, especially smaller businesses that operate in multiple cities, by making the tax base more uniform, providing a 20 day occasional entrant safe-harbor for employees, and by mirroring many important federal and state tax law treatments, such as due dates and procedures. However, the Act does not contain many provisions sought by many taxpayers and tax practitioners, including centralized filing and collection of the tax, mandatory reciprocity to account for taxes paid to other cities, and elimination of the anti-business throwback rule.

Below is a general description of the Act's major provisions.[2] The Firm will provide an in-depth review of more significant aspects of the Act over the next several months.

1. <u>THE TAX BASE</u> – The calculation of municipal taxable income is made more uniform by the Act, but still depends on whether the taxpayer is a resident individual, non-resident individual, or a non-individual (i.e., a business entity).

   As a general rule, the tax base equals:

   (Income - Exempt Income) - Pre-Act NOLs = Municipal Taxable Income

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[1] Zaino Hall & Farrin LLC assisted the Municipal Tax Reform Coalition with this effort by advocating, negotiating and drafting the initial version of the new law.

[2] This Salt BUZZ provides a general discussion of the Act's provisions and should not be relied upon for specific taxpayer situations. Rather, the actual statute and any related government guidance should be considered in light of each taxpayer's facts and circumstances.

Resident Individuals: Income is essentially the resident's income as reported for federal tax purposes less any post-Act NOL that is carried forward from a prior year. Exempt Income is then subtracted, which includes, but is not limited to, intangible income, military pay, social security and railroad retirement benefits, pensions, excluded S corporation income, alimony, and child support. Pre-Act NOLs are then deducted to the extent allowed under current (pre-Act) ordinances, to finally determine municipal taxable income of the resident.

Non-Resident Individuals: Income is essentially all the non-resident's income as reported for federal tax purposes that was earned in the municipality, including wages or sole proprietor earnings. Income does not include the distributive share of income from pass-through entities owned directly or indirectly by the non-resident. Exempt Income that is attributable to the municipality is then subtracted from income, and then any pre-Act NOLs that are available to the nonresident individual pursuant to the nonresident municipality's pre-Act ordinance are also deducted.

Business Entity Taxpayers: Income equals the net profit of the business entity taxpayer. Net profit equals federal taxable income before NOL, calculated as if the entity were a C corporation (similar to current law). Any net profit of a pass-through entity owned by the business entity taxpayer is not included in the business entity taxpayer's net profit. Also, the business entity taxpayer's net profit is reduced by any available post-2016 NOLs carried forward from prior tax years (see description below). Exempt Income of the business is then subtracted from net profit, which includes, but is not limited to, intangible income, charitable income, and certain insurance proceeds. Pre-Act NOLs are then used to further reduce net profit to determine municipal taxable income before apportionment. The three factor formula is then used to calculate the municipal taxable income for each city in which the business entity taxpayer operates.

2. PASS-THROUGH ENTITY TREATMENT (OTHER THAN S CORPORATIONS) – The municipal net profits tax will be imposed on a pass-through entity ("PTE") at the entity level. The income that passes through to an individual owner is only taxable by the owner's municipality of residence. No PTE owner will be directly taxed on flow-through income by a municipality in which the owner is a nonresident. This treatment will not always apply to S corporations (see below).

3. S CORPORATION TREATMENT – S corporations will be taxed at the entity level and an S corporation owner's flow-through income will not usually be subjected to tax in hands of the owner. A major exception to this general treatment exists: municipalities that voted in 2002 or 2004 to tax S corporations at the shareholder level may continue to impose tax on a resident owner's distributive share of the S corporation income. Only 119 municipalities meet this exception. Under the Act, these 119 municipalities will also directly tax S corporations doing business within the municipality.

4. NET OPERATING LOSS CARRYFORWARDS (NOL) – The Act provides a mandatory and uniform 5 year carryforward period on all municipalities for net operating losses first incurred in taxable years beginning on and after January 1, 2017. As a result, for calendar year taxpayers, NOL carryforwards may first be used on the 2018 annual net profit returns (and on resident individual returns that also report

net profits) filed in April 2019. The NOL carryforward provision is phased in over a five year period, with a flat 50% per year limit beginning in taxable year 2018 and delaying full utilization of carryforwards until taxable year 2023.

Simplification is greatly enhanced because NOL carryforwards will be calculated and applied on a pre-apportionment basis, which eliminates the need to track NOL carryforwards on a municipality by municipality basis. However, unlike most current municipal ordinances, net operating losses will no longer include losses that are suspended for federal tax purposes (unutilized losses resulting from passive activity loss limitations, at-risk limitations, and basis limitations).

NOLs generated prior to 2017 ("Pre-2017 NOL's") will still be permitted to be carried forward as allowed by each municipal corporation's pre-2017 ordinances, if applicable, on a municipality by municipality basis.

The Act creates the *Municipal Income Tax Net Operating Loss Review Committee* to evaluate the actual impact the NOL changes will have on municipalities in the future, using actual data from the 2011 through 2013 tax years. The Committee is required to issue a report to the General Assembly and Governor describing the revenue impact of the carryforward provision on municipalities and proposing alternative solutions to address such impacts. Recommendations of the Committee may include, but are not limited to, the use of supplemental funds from the Local Government Fund to mitigate those shortfalls. The report must be issued by May 1, 2017, before completion of the state's biennial budget for FY2018 and FY2019.

5. <u>CURRENT YEAR GAIN AND LOSS OFFSETS</u> – Gains and losses that are generated by a resident taxpayer's different pass-through entities and such resident taxpayer's own net profit reported on schedules C, E & F may offset each other during the year in which such gains and losses were generated. The offset provision only applies to resident individuals. Qualifying wages may not be offset by these losses. Further, losses that are suspended for federal tax purposes (unutilized losses resulting from passive activity loss limitations, at-risk limitations, and basis limitations) are not permitted to be used to offset net profits.

6. <u>TWENTY-DAY OCCASIONAL ENTRANT RULE ("THE 20 DAY RULE")</u> – Current law provides a safe harbor that generally prevents compensation earned by a nonresident on 12 or fewer days within a municipality from being subjected to tax and withholding in that municipality. The Act modifies and expands this "occasional entrant rule" in a number of important ways.

- A twenty day threshold is adopted, by which an employer generally need not withhold tax for a municipality if the employee is working in the municipality on 20 or fewer days in the calendar year. Instead, the employer will be required to withhold tax for the municipality in which the employee's principal place of work is located (i.e., "the Principal Place of Work Municipality").
- Wages earned on the 20 or fewer days are exempt from tax in the municipality where the wages were earned unless the individual files a refund claim for the tax withheld by the employer to the Principal Place of Work Municipality.
- An employee may only be considered to have worked in one municipality on any single calendar day.

- Certain provisions will prevent businesses from rotating out employees in an effort to avoid withholding obligations at temporary worksite locations, including construction sites.
- Special rules to determine the Principal Place of Work Municipality apply to employers that have no office or operation in Ohio.
- Once an employee exceeds 20 days in a municipal corporation, the employer must withhold tax in that municipality from day 21 going forward. However, employers are permitted to retroactively elect to withhold taxes back to day one.
- If an employer reasonably expects its work at a construction site or temporary worksite will take more than 20 days, the employer must begin withholding on all its employees working at that worksite from the first day.

The only instance in which the 20 days covered by the rule would result in zero municipal tax being paid is if the wages are earned in a nontaxable jurisdiction by a resident of a nontaxable jurisdiction. As illustrated in the following example, in almost every case, all wages of an employee will be taxed to a municipality even if the 20 Day Rule applies.

EXAMPLE #1: Assume that Mickie works in Dublin for 10 days, has her principal place of work in Columbus, and resides in Gahanna. All these municipalities impose an income tax. Mickie's employer must withhold Columbus tax for the 10 Dublin days. Mickie will not owe any income tax to Dublin. However, if Mickie seeks a refund of the Columbus tax for those 10 days on the basis that she did not actually work in Columbus on those 10 days, then Mickie's wages for those 10 days automatically become taxable in Dublin. Of course, Mickie will also be subject to tax by Gahanna on all her income, but may receive a credit for taxes paid to the other municipalities.

7. **SOLE PROPRIETORS AND THE 20 DAY RULE** – By exempting compensation for services performed in a municipality on 20 or fewer days, the Act essentially applies the 20 Day Rule to compensation earned by a sole proprietor that is reported on schedule C, unless either of the following apply:
    - The individual's base of operation is located in the municipal corporation; or
    - The compensation is earned as a professional athlete, professional entertainer, or public figure.

Similar to the 20 Day Rule for wages, however, the compensation must be treated as earned in the municipality containing the individual's base of operation (i.e., the owned or rented office, storefront or similar facility to which the individual regularly reports and performs personal services for compensation). If the individual does not have a base of operation, then the compensation is deemed earned where the individual is domiciled.

8. **SMALL EMPLOYER EXCEPTION FOR WITHHOLDING** – In addition to the 20 Day Rule, the Act offers a much more simplified approach to employee tax withholding for *small employers.* Small employers need only withhold municipal income tax to their Fixed Location municipality, without regard to the 20 Day Rule. A small employer is a business or sole proprietorship that has overall gross receipts of

less than $500,000. A Fixed Location is the permanent place of doing business in Ohio, such as an office, warehouse, storefront, or similar location owned or controlled by an employer.

9. **Domicile/Residency** – The Act codifies 25 common law-type tests to be used by municipalities and individuals to determine domicile. The tax administrator and taxpayer may not consider any other factors to determine residency. While this provision is not as "clear" as Ohio's bright-line residency test, it does add a layer of certainty because a tax administrator or a taxpayer may not add other factors. Therefore, taxpayers must be careful to consider these factors when making changes in their domicile.

10. **Deductions** – Form 2106 expenses, unreimbursed employee business expenses, will be deductible to the extent deducted for federal tax purposes. Also, gambling losses and expenses will be deductible by those who qualify as professional gamblers for federal tax purposes, similar to the Ohio treatment.

11. **Exempt & Intangible Income**

Minors – The income of minors is presumed taxable under the Act, but permits municipalities to exempt all or a portion of such income by local ordinance.

Schedule C, E, F and 4797 Intangible Income – Intangible income reported on Schedules C, E, F and Form 4797 is generally exempt. This treatment ensures that royalty and other intangible income remains exempt from tax even if earned by a pass-through entity or sole proprietor. However, to the extent a municipality voted to tax intangibles during the November 8, 1988 election, such amounts may continue to be taxed.

Pensions – The Act exempts pensions from the municipal income tax.

12. **Throwback Rule** – The unique current law sales factor throwback rule remains in place. Therefore, property shipped from a place within the municipal corporation to purchasers outside the municipal corporation continues to be sitused to that originating municipal corporation unless the taxpayer is regularly engaged through its own employees in the solicitation or promotion of sales at the place where delivery is made.

13. **Other Apportionment-Related Provisions**

Alternative Apportionment – The Act provides that a taxpayer may request, or a tax administrator may require, the use of an alternative apportionment method if the statutory apportionment factors do not fairly represent the extent of a taxpayer's business activity in the municipal corporation. The taxpayer request to use alternative apportionment must be made in writing and must accompany the original or amended tax return, or an appeal of an assessment. A denial of a taxpayer's request to use alternative apportionment, or a decision of the tax administrator to require the use of alternative apportionment, may be appealed.

Real Estate Brokers and Agents – Real estate commissions are sitused to the municipal corporation in which the underlying property is located.

Rental Activity – Under the Act, net profit from rental activity of an individual is subject to tax only by the municipal corporation in which the property is located and the municipal corporation in which the individual owner is domiciled.

14. **Supplemental Employee Retirement Plan ("SERP") Treatment** – The Act does nothing to address the taxation of SERPs. As a result, the Act leaves it to the courts to decide whether a SERP is a "pension" (and, therefore, exempt) or not a pension (and, therefore, taxable).

15. **Consolidated Tax Returns** – The Act authorizes corporate taxpayers that file federal consolidated tax returns to also elect to file using a federal consolidated group for municipal net profit tax purposes. A taxpayer may opt out of the consolidated filing election after 5 years. A tax administrator may force taxpayers to file consolidated returns in certain circumstances. Under the Act, a forced combination is only permitted if the tax administrator can show both of the following:

    a.) Intercompany transactions have not been conducted at arm's length; and
    b.) There has been a distortive shifting of income or expenses with regard to allocation of net profits to the municipal corporation.

    If the taxpayer intends to file an amended consolidated return, or to amend its type of return from a separate return to a consolidated return, the taxpayer must notify the tax administrator prior to filing such amended return.

    The consolidated group has the option to include or exclude an 80% or more owned pass-through entity's income and apportionment factors from the consolidated tax return of the group. Incumbent local exchange carriers primarily engaged in the business of providing local exchange telephone service in Ohio are not permitted to be included in the consolidated group of related corporations.

    The Act does not authorize nexus combined tax returns. However, corporations and affiliates that made an election or entered into an agreement with a municipality before January 1, 2016 to file a consolidated or a nexus-combined tax return are grandfathered and may continue to file consolidated or combined tax returns in accordance with such election or agreement.

16. **Assessment and Appeals** –Under the Act, an assessment by a tax administrator that triggers appeal rights must be sent to taxpayers by certified mail and have the words "ASSESSMENT" at the top of the correspondence. As a general rule, if these requirements are not met, then the 60 day appeal period is not triggered. Assessments may be appealed to the Local Board of Tax Review. The Act improves the make-up of these boards by prohibiting two of the three board members from being employees, elected officials or contractors with the municipal corporation.

To deny refunds on amended tax returns, a tax administrator must issue an assessment, which can then be appealed. As a result, such denial must be sent by certified mail. However, if the tax administrator denies a refund claimed on an original tax return, the tax administrator must simply notify the taxpayer of his or her right to request an appealable assessment.

17. <u>TAXPAYER BILL OF RIGHTS AND OTHER PROGRAMS</u> – The Act contains a number of provisions that mirror federal and state law programs, including the following:
   - Taxpayer Bill of Rights – similar to provisions applying to state tax law;
   - Audit Rights – similar to provisions apply to state tax law;
   - Offers in Compromise Program – similar to the state and federal programs;
   - Innocent Spouse Program – similar to the state and federal programs; and
   - Opinion of the Tax Administrator – similar to the state-level process.

18. <u>PAYMENT OF WITHHELD TAXES</u> – The Act provides a uniform schedule for remitting withholding taxes, as follows:

   Taxes must be remitted *<u>monthly</u>* if:
   - Collected taxes exceeded $2,399 in the previous calendar year; or
   - Collected taxes in any month during the previous calendar quarter exceeded $200.

   If these thresholds are not met, then the tax must be remitted *<u>quarterly</u>*.

   Municipal corporations are permitted to enact an ordinance requiring taxes be remitted *<u>semimonthly</u>* if withheld taxes exceed the following:
   - $11,999 during the prior calendar year; or
   - $1,000 during any month during the prior calendar year.

19. <u>DUE DATES AND RETURN EXTENSIONS</u> – The Act adopts language very similar to current law, providing that the initial due date of all returns for calendar year taxpayers is April 15th. An extension request is automatic if a federal extension has been filed. However, the Act offers no method of obtaining an extension if no federal extension request is made by the taxpayer. The extended due date is the 15th of the tenth month after the taxable year (i.e., October 15th for calendar year taxpayers).

20. <u>MINIMUM TAX PAYMENT THRESHOLDS</u> – Income and net profit taxpayers will not be required to remit tax due that is less than $10. Likewise, tax administrators will not be required to refund tax amounts that are less than $10. Unfortunately, even if the tax due is less than $10, taxpayers must still file the tax return.

21. <u>ESTIMATED TAX PAYMENTS</u> – The Act provides uniform estimated tax payment thresholds, as follows:

- Estimated taxes will only be required if the estimated tax due is $200;
- Municipalities have the option to not require any estimated payments by taxpayers;
- The Mailbox Rule applies for timely receipt of estimated payments;

No penalty will be due if the taxpayer's estimated payments fits into one of the following safe harbors:

- 90% of current year tax liability;
- 100% of prior year tax liability (assuming a full year); or
- The taxpayer was not domiciled in the municipal corporation on January 1st of the taxable year.

22. **PENALTIES & INTEREST** – Penalties are discretionary at the option of the municipal tax administrator. Tax administrators are also given the ability to later abate those penalties, upon appeal.

    The Act requires a uniform interest rate to be charged on assessed or delinquent taxes, as well as paid on refunds (unless the refunds are paid within 90 days after the final filing date of the annual return or 90 days after the completed return is filed, whichever is later). The interest rate is established to be the federal short-term rate plus 5% (cf. Ohio's interest rate of the federal short-term rate plus 3%).

23. **MUNICIPAL INCOME TAX REVENUE REPORTING STUDY COMMITTEE** – A committee is established to study the feasibility of requiring municipal corporations to separately report the portion of the income tax revenue derived from resident individuals and the portion derived from nonresident individuals. The committee's report is due on May 1, 2015.

The Act contains many details and provisions not fully described above, all of which may be important to you or your client's tax treatment. Over the next year, taxpayers should evaluate facts and filing positions in light of all the changes made by the Act.

If you would like to better understand how the Act might impact your business or how you might impact the legislative process, please contact a Zaino Hall & Farrin professional.

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