

OHIO HOUSE PASSES MUNICIPAL TAX REFORM BILL!

After two years of discussions, hearings and negotiations, the Ohio House of Representatives passed the Municipal Income Tax Reform bill, Substitute House Bill 5 ("Sub. H.B. 5" or "the bill") today. The bill was sponsored by Rep. Cheryl Grossman and Rep. Michael Henne, and adopted by the Ways and Means Committee under the leadership of its Chairman, Rep. Peter Beck, CPA. The bill was supported by the *Municipal Tax Uniformity Coalition*, a group of 30 major Ohio business associations representing nearly 300,000 employers (see our previous SALT Buzzes for more background on how this bill developed).

Sub. H.B. 5 was passed by the House on a bipartisan basis, with a vote of 56-39. The bill will now go to the Senate for consideration. The Coalition would like to see the bill enacted this year. If enacted, the bill will be effective beginning January 1, 2015. Below is a description of the bill's major provisions.

1. **PASS-THROUGH ENTITIES OTHER THAN S CORPORATIONS** – The municipal net profits tax will be imposed on a pass-through entity ("PTE") at the entity level, but municipalities may tax the income that passes through to a resident individual owner. 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).
2. **S CORPORATION TREATMENT** – The bill preserves the current-law exemption from taxation at the individual shareholder level, which exists in most Ohio cities. In other words, S corporations will be taxed at the entity level and S corporation owners' flow-through income will not usually be subjected to tax in the residency city. A major exception allows municipalities that voted in 2002 or 2004 to tax resident owners at the shareholder level to continue that treatment. About 120 cities have enacted this provision.
3. **NET OPERATING LOSSES (NOL)** – Approximately two-thirds of Ohio's cities and villages that impose an income tax allow some carryforward of NOLs. H.B. 5 provides a mandatory and uniform 5 year carryforward period on all municipalities for net operating losses first incurred in tax year 2016. As a result, NOL carryforwards may first be used on annual net profit returns (and on resident individual returns that report net profits) due in April 2018 for the 2017 tax year. The NOL carryforward provision is phased in over a six year period, with a flat 50% per year limit beginning in 2017 and delaying full utilization of carryforwards until tax year 2022. NOL carryforwards will be calculated and applied on a pre-apportionment basis, which significantly simplifies compliance for taxpayers by eliminating the need to track NOL carryforwards on a city by city basis. NOLs generated prior to 2016 will still be permitted to be carried forward, if applicable, as provided by each municipal corporation's current ordinances, on a city by city basis.

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A *Municipal Income Tax Net Operating Loss Review Committee* is created 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 Commission is required to issue a report to the General Assembly and Governor describing the revenue impact of the carryforward provision on cities and proposing alternative solutions to address such impacts. Recommendations of the Committee may include, but is 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, 2015, before completion of the next state of Ohio biennial budget.

4. **CURRENT YEAR GAIN AND LOSS OFFSETS** – Gains and losses that are generated by a resident individual taxpayer's different pass-through entities or such taxpayer's own efforts may offset each other during the year in which such gains and losses were generated. This approach helps ensure that resident taxpayers will not experience a tax increase as a result of the bill's changes. 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 (unused losses resulting from passive activity loss limitations, at-risk limitations, and basis limitations) are not permitted to be used to offset net profits.
5. **TWENTY-DAY OCCASIONAL ENTRANT RULE** – Current law provides a safe harbor that generally prevents compensation earned by a nonresident on 12 or few days within a municipality from being subjected to tax and withholding. The bill modifies this "occasional entrant rule" in a number of important ways.

A twenty day threshold is adopted, by which an employer need not withhold tax for a city if the employee is working in the city on 20 or fewer days. Instead, the employer will be required to withhold tax for the city in which the employee's principal place of work is located. The bill also defines a day, which means that an employee can only be considered to have worked in one city on any single calendar day. Provisions have been adopted that will prevent businesses from rotating out employees in an effort to avoid withholding obligations at temporary worksite locations, including construction sites. The occasional entrant rule will generally not apply to employers that have no office or operation in Ohio.

As illustrated in this example, in almost every case, all wages of an employee will be taxed 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 cities 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 cities.

The only instance in which the 20 days 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.

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.

Once an employee exceeds 20 days in a municipal corporation, the employer need only withhold tax in that city from day 21 going forward. However, employers are permitted to retroactively elect to withhold taxes back to day one.

6. **SMALL BUSINESS EXCEPTION FOR WITHHOLDING** – The bill authorizes a simplified approach to employee tax withholding for *small business employers*. The provision provides that small business employers need only withhold municipal income tax to their fixed location city, without regard to the twenty day rule. A small business employer is a business that has overall gross receipts of less than \$500,000. A fixed location is defined to mean a permanent place of doing business in Ohio, such as an office, warehouse, storefront, or similar location owned or controlled by an employer.
7. **DOMICILE/RESIDENCY** – Currently, it is possible for an individual to be treated as a nonresident of Ohio for state tax purposes, but be treated as a resident of an Ohio city for local tax purposes. The reason is that the state uses a bright-line residency test and the municipalities use a common law domicile test. The bill codifies 11 common law tests to be used by cities and individuals to determine domicile. The tax administrator and taxpayer may also consider other relevant factors. This provision does little to address the possibly diverse determination of residency for state and local tax purposes.
8. **DEDUCTIONS** – Form 2106 expenses, unreimbursed employee business expenses, are deductible to the extent deducted for federal tax purposes. Also, gambling losses and expenses are deductible by those who qualify as professional gamblers for federal tax purposes.
9. **EXEMPT & INTANGIBLE INCOME**

Minors – The taxation of minors under the bill will be governed by each municipal corporation's current ordinances.

Schedule C, E, F and 4797 Income – Intangible income reported on Schedules C, E, F and Form 4797 remains exempt as under current law. This provision ensures that royalty and other intangible income remains exempt from tax even if earned by a pass-through entity or sole proprietor.

Corporate Directors – The current law's 12 day occasional entrant rule (described above) applies broadly to all compensation for services, not just qualifying wages. As a result, members of corporate boards, which generally receive 1099 income, are protected by the 12 day rule. This policy kept Ohio attractive for

corporate board meetings. The new 20 day rule, however, is limited to qualifying wages and does not apply to 1099 earnings. Therefore, the definition of exempt income provides that a nonresident board member is exempt on any board compensation that is earned in a city on twenty or fewer days during the taxable year.

10. **THROWBACK RULE** – The bill retains the sales factor “throw-back” rule, requiring property shipped from a place within the municipal corporation to purchasers outside the municipal corporation to be situated to that originating municipal corporation unless the taxpayer is regularly engaged in the solicitation or promotion of sales at the place where delivery is made. However, unlike current law, the bill eliminates the need for such solicitation or promotion to be performed by employees of the taxpayer.

11. **OTHER APPORTIONMENT-RELATED PROVISIONS**

Alternative Apportionment – The bill provides that a taxpayer may request, or a tax administrator may require, the use of an alternative apportionment method, but only if it can be shown by a preponderance of the evidence that the statutory apportionment factors do not fairly represent the extent of a taxpayer's business activity in the municipal corporation. 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 – A clarification is added to ensure that real estate commissions are situated to the municipal corporation in which the underlying property is located.

Rental Activity – The bill also provides that 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 taxpayer/owner resides.

12. **SUPPLEMENTAL EMPLOYEE RETIREMENT PLAN TREATMENT** – The House-passed version exempts "pensions" from tax and uses language that reserves the current environment as it relates to the pending litigation on whether SERP benefits constitute exempt pension income.

13. **CONSOLIDATED TAX RETURNS** – The bill authorizes corporate taxpayers to 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. (The As Introduced version only permitted a taxpayer to opt out after obtaining permission from the tax administrator.) A tax administrator may force taxpayers to file consolidated returns if it is determined that intercompany transactions have not been conducted at arm's length or that there has been a distortive shifting of income or expenses with regard to allocation of net profits to the municipal corporation. The grant of this broad power to tax administrators will be of great concern to many taxpayers. Also, if a taxpayer intends to file an amended tax return that elects

consolidated tax treatment, the taxpayer must first notify the tax administrator. This is a separate requirement, and filing the actual amended return does not satisfy this notice requirement.

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 income and apportionment factors attributable to a pass-through entity owned by the consolidated group may be included or excluded in the consolidated tax return of the group, at the option of the group.

14. **ASSESSMENT AND APPEALS** – The bill provides that a written ruling by a tax administrator that triggers appeal rights and is in response to a written request by a taxpayer, must be sent to taxpayers by certified mail and have the words "WRITTEN DETERMINATION" in at least 18 point type at the top of the correspondence. As a general rule, if these requirements are not met, then the 60 day appeal period would not be triggered.

Unfortunately for taxpayers, the definition of "written determination" does not include all written findings of the tax administrator regarding the taxpayer's municipal income tax liability, including tax, penalty, or interest (i.e., an assessment by a tax administrator). So, a taxpayer could lose appeal rights if the taxpayer does not realize the correspondence has triggered the appeal period.

The bill provides a watered-down version of the state's taxpayer bill of rights and an offers in compromise process similar to the state and IRS process.

15. **PAYMENT OF WITHHELD TAXES** – Withheld taxes are uniformly scheduled to be remitted as follows:

Taxes must be remitted *monthly* 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 *quarterly*.

Municipal corporations are permitted to enact an ordinance requiring taxes be remitted *semimonthly* if withheld taxes exceed the following:

- \$11,999 during the prior calendar year; or
- \$1,000 during any month during the prior calendar year.

Under the bill, withheld taxes must be remitted electronically on the *following business day* once the total amount of unremitted taxes is at least \$100,000.

16. **DUE DATES AND RETURN EXTENSIONS** – The bill 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, but the tax administrator must be notified of the extension by filing a copy of the federal extension directly with the tax administrator or through the *Ohio Business Gateway*. If a taxpayer does not obtain a federal extension, a taxpayer may request an extension from the tax administrator directly or through the *Ohio Business Gateway*; it is unclear whether this would be an automatic extension. The extended due date is the last day of the month following the month containing the federal extended due date. A tax administrator may deny an extension in a variety of circumstances, including when the taxpayer owes any delinquent income tax, penalty, interest, or other charge for the late payment or nonpayment of income tax.
17. **MINIMUM TAX PAYMENT THRESHOLDS** – Income and net profit taxpayers will not required to remit tax due that is less than \$10, under the bill. Likewise, tax administrators will not required to refund tax amounts that are less than \$10. However, even if the tax due is less than \$10, taxpayers must still file the tax return.
18. **ESTIMATED TAX PAYMENTS** – The bill provides that estimated taxes must be paid if the estimated tax payable will exceed \$100 for the year.
19. **PENALTIES & INTEREST** – Penalties are mandated to be imposed, rather than discretionary. However, the tax administrators will have the ability to abate the penalties. Under current law, many municipalities impose 18% interest or more on assessed or delinquent taxes. However, such high interest is not necessarily paid on refunds. The bill requires a uniform interest rate to be charged on assessed or delinquent taxes, as well as on refunds. The interest rate is established to be the federal short-term rate plus 5%.

The Senate will present new challenges and renewed efforts by municipalities to further mitigate the benefits of uniformity. The Coalition will also likely seek to improve the bill. If you would like to better understand how this bill might impact your business or how you might impact the legislative process, please contact a Zaino Hall & Farrin professional.

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