Bill Analysis

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H.B. 139

123rd General Assembly
(As Introduced)

Reps. Jerse, Allen, Barrett, Bender, Boyd, Britton, Corbin, DePiero, Flannery, Ford, Hartley, Hartnett, James, Jones, Krupinski, Metelsky, D. Miller, Ogg, Opfer, Perry, Schuler, Smith, Sullivan, Sutton, Sykes, Pringle, Beatty

BILL SUMMARY

- Extends the personal income tax to electing small business trusts that own shares of an S corporation.
- Requires nonresidents who sell shares of an Ohio S corporation to apportion the capital gain or loss to Ohio.
- Applies to taxable years beginning on or after January 1, 1999.

CONTENT AND OPERATION

Taxing electing small business trusts

(secs. 5733.40(I)(1), 5747.01(N), and 5747.454)

Nature of electing small business trusts

An electing small business trust is one of only a few kinds of trusts that may own shares in an S corporation.[1] They were authorized by Congress to permit more than one beneficiary to receive S corporation income through a trust. For example, such a trust might be established to distribute (or accumulate) income from a family-held S corporation among various family members. Interests in the trusts cannot be acquired by purchase; interests may only be acquired by gift, bequest, or other nonpurchase means. The federal tax treatment of such trusts,

[1] *An S corporation is a corporate form of business organization that is taxed in a manner similar to partnerships--i.e., the shareholders, rather than the corporation, are taxed on income from the corporation.*

explained below, applies to taxable years beginning on or after January 1, 1997. (See I.R.C. 1361(e).)

Federal tax treatment

Under federal law, electing small business trusts are taxed on their S corporation distributive shares.[2] Since the trust is liable for tax, a beneficiary's federal adjusted gross income does not include income from the S corporation portion of the trust--thus, the beneficiary is not liable for federal tax on distributions from the trust. The trust pays the federal income tax at the highest federal marginal tax rate applying to trusts and estates. (I.R.C. secs. 641 and 1361.)

Current Ohio tax treatment

Currently, trusts are not subject to the state's personal income tax; only individuals and estates are taxed. Since, under federal law, the federal adjusted gross income of a beneficiary of an electing small business trust does not include income from an S corporation that is passed through (or accumulated by) the trust, beneficiaries do not have to pay Ohio income taxes on that income.

The interaction of federal and Ohio law currently has the tax effects diagrammed below:

Federal taxation	**Flow of income**	**Ohio taxation**
	S Corporation	
	V	
Trust pays tax }	$$ distributive shares $$	{ Trust pays no tax
	V	
	Electing Small Business Trust	
	V	
Beneficiary } pays no tax	$$ distributions $$	{ Beneficiary pays no tax
	V	
	Beneficiaries	

[2] *This analysis considers only distributions of ordinary earnings and profits by an S corporation to an electing small business trust; distributions that represent a return of capital to the trust may not incur any tax liability.*

Proposed Ohio tax treatment

The bill generally would treat electing small business trusts in the same way they are treated under federal law--i.e., the portion of the trusts that consist of S corporation stock would be taxed as entities, and the beneficiaries would continue to avoid taxes on S corporation income passed through (or accumulated by) such a trust. All income received by a trust from an S corporation would be taxed at the highest marginal tax rate, as under federal law, and the trusts could claim all of the business credits that any S corporation shareholder may claim.

The bill distinguishes between two kinds of electing small business trusts--resident and nonresident--for the purpose of allocating a trust's income to Ohio. A resident trust is defined as one whose creator was a resident of Ohio (for income tax purposes) at any time within the three years preceding the creation of the trust or the most recent amendment to the trust. In the case of an existing trust to which S corporation stock is contributed, this residency test applies to the person who contributes the stock to the trust. Any trust that does not satisfy the definition of a resident trust is considered to be a nonresident trust. Trusts would be presumed to be resident trusts unless the trustee can show, by a preponderance of evidence, that the trust is a nonresident trust. Resident trusts could claim the resident credit for income taxed by another state, and nonresident trusts could claim the nonresident credit for income not properly allocable to Ohio.

Withholding taxes on S corporations with ESBT investors

(sec. 5733.40(I))

Currently, certain pass-through entities must withhold and pay Ohio income taxes on income the entity or trust distributes to nonresident owners.[3] Taxes have to be paid only on account of so-called "qualifying investors." Certain classes of investors are exempted from being considered as qualifying investors, including electing small business trusts (recall that these trusts may legally invest in S corporations). Thus, under current law, S corporations do not have to withhold and pay Ohio income taxes on account of electing small business trusts, since the trusts currently are not subject to income taxes.

The bill would eliminate the tax withholding and payment exemption for electing small business trusts, since the trusts would become taxable under the bill.

[3] *A pass-through entity is a partnership, S corporation, limited liability company, or other form of business organization that generally is not itself taxed under federal income tax law; the entity's income and loss items are passed through to the owners and retain the same character that they had, for tax accounting purposes, at the entity level (e.g., a capital gain earned by the entity is reportable as a capital gain by the individual owners).*

Thus, S corporations would have to withhold and pay Ohio income taxes on account of electing small business trusts that own shares in the corporation.

Assigning capital gains, losses from selling pass-through entity stock

(sec. 5747.20(B)(2)(c))

The bill would require nonresident taxpayers who own at least 5% of a pass-through entity doing business in Ohio, and who sell (or otherwise dispose of) their interest in the entity, to apportion the capital gain or loss to Ohio for income tax purposes. (Apportionment determines what portion of certain kinds of a person's income that the state will tax.) Currently, a taxpayer must allocate all capital gains or losses to Ohio from the sale of intangible property (such as stock) only if the taxpayer is domiciled in Ohio when the property is sold.

Under the proposed apportionment method, a nonresident taxpayer's capital gain would be taxed in proportion to the S corporation's business presence in Ohio over the preceding three years. Business presence is measured by the weighted average of the corporation's sales, property, and payroll in Ohio as compared to everywhere over the three-year period. This weighted average is multiplied by the capital gain (or loss) to determine the portion of the gain (or loss) that is considered for Ohio income tax purposes.[4] The apportionment requirement would apply regardless of whether the taxpayer owned the interest directly, or indirectly through a related person or entity.

Effective date

(Section 3)

The bill would apply to taxable years beginning on or after January 1, 1999.

HISTORY

ACTION	DATE	JOURNAL ENTRY
Introduced	02-02-99	p. 166

H0139-I.123/rss

[4] *The weights employed in the weighted average are the same that apply in apportioning a corporation's income to Ohio--sales are weighted most heavily at 60%, while property and payroll each are weighted at 20%.*