

# **Ohio substitute bill proposes substantial reforms to municipal taxation**

*November 14, 2013*

## **In brief**

The Ohio House of Representatives passed Substitute House Bill 5 (H.B. 5) on November 13, 2013. H.B. 5 would implement substantial modifications to Ohio's municipal income tax law. Key modifications address NOL carryovers, consolidated return elections, alternative apportionment methods, treatment of pass-through entity taxation, compliance and appeal rules, and other municipal tax matters. Unless otherwise noted, H.B. 5 would be effective for tax years beginning on or after January 1, 2015. The bill now moves to the Ohio Senate for consideration. [[Substitute Ohio House Bill 5](#)].

## **In detail**

If enacted, H.B. 5 would make modifications to multiple areas of Ohio municipal taxation. The bill is the result of several years of collaborative compromises - in particular between several House Representatives and the Municipal Tax Uniformity Coalition, which consists of 30 Ohio business associations. As currently drafted, H.B. 5 would historically be one of the most comprehensive reforms to Ohio municipal tax law.

Key modifications are summarized below.

### **Five-year net operating loss (NOL) carryforward**

Currently, a municipality has the option to allow an NOL carryforward deduction. H.B. 5 defines an NOL as a loss

incurred in the operation of a trade or business including unutilized losses from basis, at-risk or passive activity limitations. The bill would provide for a five-year NOL carryforward deduction for all Ohio municipalities for NOLs incurred in taxable years beginning after 2015. Such NOL carryforward deduction would be applied on a pre-apportionment basis and would be limited to 50% for taxable years beginning in 2017 through 2021 for all taxpayers. Pre-2016 NOL carryforwards, if allowed by the municipality, would be deducted first using the carryforward rules existing in the years the NOLs were generated. A net operating loss review committee would be created to evaluate the potential future impact of the new five-

year NOL carryforward by May 1, 2015.

### **Election to file consolidated net profits tax return**

A taxpayer filing a federal consolidated tax return may elect to file a 'full' consolidated, pre-apportionment municipal income tax return based on its US federal consolidated group so long as one member of the group is subject to the municipal tax. Such election is binding for five years. A taxpayer may discontinue such election after five years, otherwise it continues. A tax administrator may force a taxpayer to file a consolidated return if the administrator determines by a preponderance of evidence that intercompany transactions are not being conducted at arm's length or if

there has been a distortive shifting of income or expense. Such consolidation is permanent unless permission to discontinue is granted.

Certain rules regarding the preparation of consolidated returns are codified, but generally such returns should be prepared in the same manner as required under the US Treasury consolidated return regulations. Additionally, if the income or loss of a pass-through entity (PTE) is included in the affiliated group's consolidated federal taxable income, the taxpayer shall either include or exclude the PTE's income/loss and related apportionment factors. If the PTE is included, then such entity is not subject to taxation as a separate municipal taxpayer. If the PTE is excluded, then it is subject to taxation. Also, certain incumbent local exchange carriers should not be included in the consolidated tax return with its affiliates.

Consolidated return elections made before January 1, 2015, similar to what is provided by H.B. 5, shall continue in such manner until the taxable year beginning before January 1, 2020. Taxpayers that elect to file a consolidated tax return on an amended return must notify the tax administrator separately prior to filing.

#### ***Pass-through entity taxation***

Under H.B. 5, a PTE generally includes a partnership, S corporation, or any other entity given pass-through treatment for federal income tax purposes, but it does not include a trust, estate, grantor trust, or disregarded entity. Generally, tax would be imposed on a PTE's net profits or losses at the entity level with some nuances for individual vs. corporate owned PTEs, as well as special treatment for PTEs owned by a US federal consolidated group filing a

consolidated municipal net profits tax return – see separate discussion below. Net profit or loss continues to be defined as adjusted federal taxable income adjusted for certain modifications, which is then subject to tax based on apportionment rules that are essentially the same as under current law.

#### *Individual Owners of PTEs*

Ohio individual municipal residents are also subject to tax on their entire distributive share of PTE income or loss, but a municipality may grant a credit to residents for all or a portion of the taxes paid directly or indirectly by themselves or the PTE on such income to other municipalities in Ohio or elsewhere. Residents may offset different PTEs income and loss amounts during the year. Wages may not be offset by PTE losses. Nonresident individual owners are not subject to PTE taxation at the individual level.

S corporation income or loss taxation is treated differently and H.B. 5 preserves current treatment. Current law precludes municipalities from taxing S corporation income at the individual owner level, except for residents of certain municipalities that taxed part of all of such income prior to 2015.

#### *Corporate / Business Owners of PTEs*

A PTE that is owned by someone other than an individual is generally subject to tax at the entity level on its net profits or loss, and H.B. 5 provides that such owners should exclude a PTE's net profit or loss from such owner's net profit or loss. The bill does not specify if such owners should also exclude the PTE's apportionment factors, but a technical correction is anticipated to provide for such treatment. An exception to the preceding is provided for PTEs owned by a US federal consolidated group

making an election to file a consolidated municipal net profits tax return – see separate discussion above.

#### ***Throwback***

Existing law provides a sales factor throwback rule requiring certain property sales to be sourced to their origination when the taxpayer does not regularly solicit or promote with its own employees at the place where delivery is made. H.B. 5 originally proposed the elimination of throwback when the bill was introduced in January. However, substitute H.B. 5 includes the existing throwback rule, except that the need for an 'employee' to perform the solicitation or promotion is eliminated.

#### ***Alternative apportionment***

H.B. 5 proposes that a tax administrator may require, or a taxpayer that has notified the tax administrator in advance of filing may use, an alternative apportionment method on an originally filed or amended return if it is determined 'by a preponderance of evidence' that the standard three-factor method does not "fairly represent the extent of the taxpayer's business activity" in the municipality. An alternative apportionment could include separate accounting, the inclusion or exclusion of one or more factors, or a modification of one or more of the factors.

Existing alternative apportionment agreements appear to remain intact. Note that certain individuals will be allowed to use separate accounting upon request to report rental activities if used for five years in all the Ohio cities within which they file.

#### ***Occasional entrant withholding and taxation extended to 20 days***

A municipality would be prohibited from taxing or requiring municipal

income tax withholding on employees who work 20 (currently 12) or fewer days in the municipality during a calendar year. An employer is required to withhold for an employee's principal place of work location instead. A withholding day has been defined so that an employee can only have one work city for which an employer must withhold on any one day. Special withholding agreements may be made between an employer and a municipality upon request. A 'small business employer' (business with overall gross receipts under \$500,000) exception for withholding from only one fixed location municipality is also provided.

#### ***Certain board of director and nonqualified deferred compensation taxation***

Compensation that is not a qualifying wage paid to a board of director member that is not a resident of the municipality in which personal services were performed on not more than twenty days in a taxable year is not taxable. Nonqualified deferred compensation or employee stock option-related compensation would continue to be taxable unless exempted by a resolution or ordinance adopted before January 1, 2015. The exclusion for pension and certain retirement income payments has been codified with language that is intended to allow current litigation to control the tax treatment, especially regarding Supplemental Employee Retirement Plan income.

#### ***Domicile/residency requirements***

H.B. 5 codifies 11 factors to be used by municipalities and individuals for determining domicile, and thus residency, for individual income tax purposes. The tax administrator may also consider other relevant factors. Accordingly, it may be possible for an individual to be a resident for municipal income tax purposes even though the individual is not a resident

for Ohio individual income tax purposes.

#### ***Federal and state law conformity clause***

H.B. 5 establishes a conformity clause providing that any term used that is not otherwise defined has the same meaning as used under the US federal or Ohio state tax laws, with US federal law controlling overall.

#### ***Other compliance and appeal provisions***

H.B. 5 provides for a number of appeal and compliance proposals that taxpayers should be aware of, including the following:

- Tax withholding semi-monthly, monthly, and quarterly deposit requirements are revised.
- Tax return compliance original and extended due date provisions are refined to make the 15<sup>th</sup> day of the fourth month after the taxable year end the municipal original return due date, and make the last day of the month following the month of the federal return extended due date the municipal return extended due date.
- Penalties and interest rules have been revised, and the interest rate for assessments, delinquent taxes, and refunds is set at the federal short-term rate plus 5%.
- A taxpayer can request an opinion from a municipality's tax administrator.
- A municipality's board of review must consist of three members, two of which are appointed by the municipality legislative authority, but may not be employees, elected officials, or contractors with the city within the past five years.

#### ***The takeaway***

Reforming Ohio's municipal tax system is a concern to any taxpayer doing business in Ohio due to the administrative burdens relating to over 550 municipal income tax filing obligations, and the taxation complexities related to different legal structures and business fact patterns. The substitute version of H.B. 5 is similar in many ways to H.B. 5 as originally introduced in January ([click here](#) for our summary of H.B. 5 as introduced), but there are a number of important differences for taxpayers to understand for compliance and planning purposes.

The important differences include (1) the 50% NOL utilization limitation that will apply to all taxpayers from 2017 to 2021, (2) the retention of the sales factor throwback rule, (3) the establishment of tax administrator forced consolidation and alternative apportionment powers, (4) the availability to amend prior year returns to reflect consolidation and alternative apportionment without advance approval, (5) rules allowing individual taxpayers to freely offset their PTE income and losses, and (6) the retention of S Corporation exclusion for individual residents in most municipalities.

Open issues regarding the bill include: (1) how tax administrators will apply the subjective 'distortion' and 'preponderance of evidence' forced consolidation and alternative apportionment provisions, (2) how taxpayers with previously elected consolidated return methods that differ from the new 'full' consolidation method will be treated going forward, (3) whether the election available to taxpayers filing a consolidated return to include or exclude PTE income or loss and apportionment factors should be available to other taxpayers not electing consolidation, and (4) whether the phrase 'place where

delivery is made' should be replaced with "purchasers' place of business" within the sales factor throwback rule.

Taxpayers are encouraged to closely review and possibly take action

regarding the changes proposed by H.B. 5 to determine the effect it will have on their municipal current and deferred tax liabilities, especially considering that the bill may be enacted by year end.

## ***Let's talk***

If you have any questions regarding Ohio's H.B. 5, please contact any of the following individuals:

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