

**TESTIMONY REGARDING HOUSE BILL 467**

**Before the House Ways and Means Committee**

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Good afternoon Chairman Merrin, Vice Chairman LaRe, Ranking Member Rogers and members of the House Ways & Means Committee. My name is Dave Froling. I am a state and local tax partner with the law firm Vorys, Sater, Seymour and Pease LLP. I am testifying today on behalf of the Ohio Council of Retail Merchants. The Council appreciates the opportunity to address the Committee today regarding House Bill 467. We appreciate Rep. Scherer bringing this issue to the forefront.

The Council has been serving the interests of Ohio's retail and wholesale industries since 1922. The Council has over 7,000 members. Unquestionably, the retail industry is vitally important to Ohio's economy and enhances the standard of living for all Ohioans. Last year, the retail industry accounted for approximately \$39.2 billion of Ohio's annual Gross Domestic Product and supported 1.5 million jobs, which is roughly one in four of all Ohio jobs - - more than any other industry.

In the Council's opinion, H.B. 467, as written presently, falls short of the mark in correcting a significant tax problem that the Council has been trying to fix for almost five years. When we testified before the Senate Ways and Means Committee on September 23, 2015 in regards to S.B. 208, and this Committee on September 24, 2015 in regards to H.B. 326, the Council was the first trade association to alert the General Assembly to this tax inequity. Since then, the Council has

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been actively working to fix this problem. Everyone we have spoken to has acknowledged the problem and said it needs to be fixed, yet five years later the problem still exists.

### **General Summary of the Ohio Pass-Through Entity Withholding Tax**

Ohio has imposed a pass-through entity withholding tax since 1997. Generally, pass-through entities (“PTE”) are partnerships, S corporations, and limited liability companies. PTEs have to withhold Ohio income tax from a nonresident individual’s share of the PTE’s profits. Ohio law does not require PTEs to withhold anything from an Ohio resident’s share of the PTE’s profits. The withholding tax rate is a flat 5.0%. Ohio has not changed this withholding tax rate since Ohio enacted the tax.

### **The Problem with the Ohio PTE Withholding Tax under Current Law**

The amount a PTE withholds equals the “tax base” times the “tax rate.” The result of this mathematical equation needs to be reasonably close to the nonresident’s Ohio income tax liability when the nonresident files his/her Ohio income tax return.

The problems with current law are significant and two-fold:

1. The withholding “tax base” is too high, and in fact, artificial because the tax base does not allow the PTE to take into account the nonresident’s Ohio business income deduction (“BID”). This causes the PTE to withhold Ohio income tax on income that Ohio does not tax at all. In this regard, the BID exempts the nonresident’s first \$250,000 of business income from the individual income tax but the PTE withholding tax imposes withholding tax on the nonresident’s first \$250,000 of business income.
2. The withholding “tax rate” on income that Ohio does tax is too high. The withholding tax rate is a flat 5.0% which is two-thirds *greater* than the 3.0% tax rate on business income. When the General Assembly enacted the PTE withholding tax in 1997, the 5.0% withholding tax rate was one-third *lower* than the highest marginal income tax rate (i.e., 7.5%). This made sense in order for Ohio to effectively account for the nonresident’s federal income tax deductions that Ohio incorporated into the Ohio individual income tax (e.g., self-employment taxes, retirement contributions, etc.) See, Exhibit A (The Ohio PTE withholding tax base is effectively line 7a, while the starting point for the Ohio individual income tax is line 8b. As you can see, line 8b will be lower than line 7a because of the adjustments set forth at line 8a. Note, the Ohio BID is deducted from the amount reported on line 8b. As for the adjustments, see page 3 and lines 12, 14, 15, and 16).

For 2019, the Ohio BID allowed self-employed individuals to not pay Ohio income tax on the first \$250,000 of business income. Ohio residents get the benefit of the BID immediately because Ohio law allows residents to take into account their BID when the resident makes estimated income tax payments, thus residents can reduce their estimated income taxes by \$7,500 (e.g., \$250,000 x 3.0%).

Nonresidents are not so fortunate. Ohio puts nonresidents in a much worse position. The two problems cause the PTE to withhold up to \$12,500 from a nonresident when the nonresident's corresponding income tax liability is zero. More specifically, the nonresident's PTE will withhold \$12,500 from the nonresident's income and remit this to Ohio. Ohio will then hold the money for 18-24 months before refunding this money, interest free, to the nonresident. By the time Ohio gets around to refunding this money, the nonresident's interest free loan could be as much as \$25,000. See, Exhibit B.

What the General Assembly seemingly does not recognize is that “[W]ithholdings and estimated tax remittances are not taxes in their own right but methods for collecting the income tax.” See, *Baral v. United States*, 528 U.S. 431, 436 (2000). In the instant case, however, Ohio is withholding income tax from income that is never subject to tax. Taxation is the pretext for seizing funds of nonresidents. Ohio's scheme raises the question of whether the seized amounts are even properly characterized as tax withholdings. Further it raises a question as to whether Ohio's withholding tax scheme is legal under the Commerce, Equal Protection, and Due Process of Law clauses of the U.S. and Ohio Constitutions. Ohio has created a “taxing” scheme that requires nonresidents to provide a rolling \$12,500 to \$25,000 interest free loan to the State.

The PTE withholding tax as written currently creates unnecessary tax compliance costs to the PTE, the nonresident, and the Ohio Department of Taxation. The magnitude of this problem is significant as to the number of nonresidents affected and the magnitude of the loan. In this

regard, Exhibit C is instructive. This document was circulated last spring when the House and Senate were debating whether to repeal the BID. The Department of Taxation prepared this document. While the document is not entirely clear on its face, some reasonable assumptions can be made. For taxable year 2017, 49,454 nonresidents filed an Ohio personal income tax return and collectively claimed \$5.4B of BIDs. \$5.4B times the 5% withholding tax rate equals \$270M of tax that was not owed by the nonresidents. This suggests that in one form or another, nonresidents potentially made \$270M of interest free loans to the State (note the asterisk on Exhibit C). It is hard to say how many of the 49,454 nonresidents should not have filed an Ohio personal income tax return. The Council suspects an overwhelming majority did not owe any tax and therefore Ohio should not have required them to file a return. Yet they did, and the Ohio Department of Taxation processed them, and the Ohio Treasurer of State issued them a refund, without interest. Exhibit D further illustrates the wastefulness here. This comes from the Tax Commissioner's annual report. For fiscal 2018, which overlaps taxable year 2017 in part, the Department of Taxation collected \$510M from PTE's via either the PTE withholding tax return or the PTE composite income tax return. Of that \$510M, Exhibit C suggests the Department granted refunds of somewhere between \$171M and \$270M.

Simply put, Ohio should not knowingly and intentionally be requiring a segment of the public to make interest free loans to the State. The General Assembly simply cannot allow this inequity to continue any longer. Certainly the General Assembly would not tolerate the extent of this over-withholding for purposes of the employer withholding tax as to an employee's wages.

#### **Questions raised during the Committee's February 4 hearing**

During the Committee's hearing on February 4, a few questions were raised that the Council would like to comment on.

1. ***Are nonresidents upset by having to make interest free loans to Ohio?*** Yes! Certainly nonresidents that reside in states that do not have an income tax, like Florida, Tennessee, and Texas, have voiced their frustrations. But equally loud have been the nonresidents that reside in states that do have an income tax. These nonresidents owe tax to their state of residence so they can least afford to make interest free loans to Ohio.
2. ***Does the PTE withholding help reduce tax avoidance?*** Undoubtedly yes but the perceived potential for tax avoidance by allowing nonresidents to opt out is way overblown. So too is the number of anticipated non-filers.
  - a. According to the I.R.S., roughly 5.0% of all Americans fail to file federal income tax returns. There is no reason to think this percentage is any different with respect to Ohio. 47,500 nonresidents should not have to make a significant interest free loan to Ohio because 2,500 nonresidents might not file a return.
  - b. It is folly to think that a person will fail to make estimated tax payments or file a tax return when the Department has the person's name, address, and social security number. Certainly, a small number will think the Department will not track them down but that thinking exposes the person to significant tax penalties. The number and percentage of nonresidents failing to file should be infinitely small and certainly not sufficient to put law abiding nonresidents in such an unfavorable tax position.
  - c. Concerns over tax fraud fails to acknowledge that the General Assembly allowed C corporations to "opt out" of the PTE withholding tax when the General Assembly enacted it in 1997. See, R.C. 5733.40(I)(7). This provision has worked perfectly fine. It did not produce fraud and it did not drain Ohio's tax revenues.
  - d. The General Assembly did not enact the PTE withholding tax to combat tax fraud. In 1997, the law was unsettled as to whether nonresidents owed Ohio income tax on PTE income derived from PTEs doing business in Ohio. The General Assembly enacted the PTE withholding tax to aid the Department's audit policy. In 1999, the Ohio Supreme Court answered this legal question in Ohio's favor when the Court decided *Dupee v. Tracy* (1999), 85 Ohio St.3d 350; and, *Agley v. Tracy* (1999), 87 Ohio St.3d 265.

**H.B. 467 falls short of the mark.**

H.B. 467 reduces the withholding tax rate from 5% to 4%, thus H.B. 467 reduces the interest free loan by 20%. H.B. 467 does not allow nonresidents to opt out of withholding either so H.B. 467 perpetuates the unnecessary requirement of having PTE's withhold Ohio tax on the first \$250,000 of the individual's income in spite of the BID exempting this income from tax.

### **The Council's proposed amendments**

1. The Council proposes a flat 2.0% withholding tax rate. A withholding tax rate that was one-third lower than the highest marginal individual income tax rate served Ohio well from 1997 until Ohio capped the tax rate on business income at 3.0%. The Council advocates for maintaining the ratio that Ohio adopted in 1997.
2. The Council proposes allowing nonresidents to pay estimated income taxes in lieu of having the PTE withhold a 5% tax. In other words, Ohio should allow nonresidents the right to "opt out" of PTE withholding if they so choose. Other states allow this already. See, Exhibits E, F, and G. The House included the Council's proposal in H.B. 166 as passed by the House so LSC should have language that this Committee can drop into H.B. 467. See, Exhibit H.

### **Concluding Comments**

What started out as a simple oversight in 2015 has become a major inequity for nonresident taxpayers. Ohio does not need its nonresidents to make annual interest free loans of \$12,500 for 18-24 months, nor does Ohio need these nonresidents to provide Ohio with a revolving line of credit of \$12,500 to \$25,000.

The Council is not aware of any other state that requires nonresidents to make an interest free loan, let alone an interest free loan of this magnitude. Nonresidents make significant contributions to Ohio's economy. Since 2013, Ohio has been taking advantage of nonresidents that do business in our State. The idea that Ohio is going to correct its mistake by reducing the problem by just 20% is not fair to these taxpayers. The General Assembly must do better for them.

Members of the Committee, this concludes my prepared remarks. The Council appreciates your time and attention to H.B. 467. On behalf of the Council, I would be happy to answer any of your questions.