



## Information Release

### **IT 2006-02– Inapplicability of Ohio Resident Credit with Kentucky Corporate Income Tax – Issued March, 2006**

The purpose of this information release is to address the inapplicability of the Ohio resident credit with respect to Kentucky corporation income tax paid by or for pass-through entities in which Ohio residents have an equity investment.

#### **INAPPLICABILITY OF THE OHIO RESIDENT CREDIT**

As this information release explains below, Ohio residents are not entitled to claim the Ohio Revised Code section (“R.C.”) 5747.05(B) resident tax credit with respect to the Kentucky corporation income tax imposed on single member limited liability companies (“LLCs”) disregarded for federal income tax purposes, LLCs treated as partnerships for federal income tax purposes, LLCs treated as S corporations for federal income tax purposes, S corporations, limited liability partnerships, and limited partnerships. This information release hereinafter refers to these entities as “KY-taxable PTE’s.” This credit is not available even if the Ohio resident elects to pay the Kentucky corporation income tax on behalf of the KY-taxable PTE. (1)

The credit is unavailable because of (i) the application of R.C. 5747.05(B)(4) and (ii) the application of R.C. 5747.05(B)(2) – either division by itself is sufficient to make the credit unavailable.

#### Kentucky Corporation Income Tax

Effective for taxable years beginning on or after January 1, 2005 the Kentucky corporation income tax base was expanded to include KY-taxable PTE’s. The Kentucky corporate income tax on KY-taxable PTE’s is a tax imposed on the business entity, itself. Kentucky law does not impose this tax on the investors, and the equity investors are not primarily liable for (but, per an administrative rule, can elect to become liable for) any unpaid Kentucky corporate income tax imposed on the KY-taxable PTE. For comparison, see Ohio form IT-4708 composite income tax return: under Ohio Revised Code section 5747.08 equity investors in pass-through entities can choose to have their pass-through entities pay the Ohio income tax otherwise due by the equity investors, but each equity investor remains personally liable for her/his unpaid Ohio individual income tax, if any.

#### R.C. 5747.05(B)(4)

This portion of Ohio law states that Ohio residents cannot claim the resident credit “ . . . to the extent that for any taxable year the taxpayer had directly or indirectly deducted, or was required to directly or indirectly deduct, the amount of income tax liability to another state or to the District of Columbia in computing federal adjusted gross income.” (2)

Internal Revenue Code (“IRC”) sections 165 and 212 allow the taxpayer to deduct, among other things, state income taxes. If the state income taxes are imposed either on an individual’s trade or business or on the individual’s property held for the production of rents and royalties, then the individual must deduct such state income taxes when s/he computes federal adjusted gross income. (3)

When a state imposes an income tax on a pass-through entity either conducting a trade or business or holding property for the production of rents and royalties, then each individual having a distributive share of income from that pass-through entity must deduct, when determining her/his federal adjusted gross income, her/his proportionate share of such income taxes. (4)

Because the Kentucky corporation income tax is imposed on the KY-taxable PTE itself, then each individual who has an equity investment in the KY-taxable PTE is required to deduct, when determining her/his federal adjusted gross income, her/his proportionate share of the Kentucky corporate income tax imposed on the KY-taxable PTE. As such, R.C. 5747.05(B)(4) applies to deny to the Ohio taxpayer the resident credit with respect to the Kentucky corporate income tax, imposed on the KY-taxable PTE, which the Ohio taxpayer directly or indirectly deducted, or was required to deduct directly or indirectly, when computing her/his federal adjusted gross income.

#### R.C. 5747.05(B)(2)

Because the Kentucky corporation income tax is imposed on the KY-taxable PTE, itself, and is not imposed

directly on the equity investors in the KY-taxable PTE, **Ohio residents who are equity investors in KY-taxable PTE's are not entitled to claim the R.C. 5747.05 resident credit with respect to the Kentucky corporation income tax for which the KY-taxable PTE is liable.** R.C. 5747.05(B) provides for a resident credit when (if) a portion of the Ohio resident's Ohio adjusted gross income is subjected to tax by another state. With respect to the Kentucky corporation income tax, it is the pass-through entity – and not the equity investor – which is subject to the tax.

Granted, the Ohio resident who is an equity investor in a KY-taxable PTE will include in his/her Ohio adjusted gross income his/her proportionate share of the income which, in the hands of the pass-through entity, was subject to Kentucky corporate income tax (just as the Ohio resident who is an equity investor in a C corporation which is doing business in Kentucky and which has a dividend pay-out ratio of 100% will include in his/her income a proportionate share of the C corporation's income that was subject to Kentucky corporate income tax). But it is not the Ohio resident's income which is subject to the Kentucky corporate income tax; rather, it is the entity's income which is subject to the Kentucky corporate income tax.

Kentucky law also provides that partners, members, and shareholders of the KY-taxable PTE's shall continue to report and pay Kentucky individual income tax on the distributive share of net income, gain, loss, or deduction determined as merely as practicable in a manner identical to that required for federal income tax purposes except to the extent required by differences between Kentucky income tax law and federal income tax law and regulations. These partners, members, and shareholders will receive a Kentucky income tax credit based upon their proportionate share of the Kentucky corporate income tax which the KY-taxable PTE paid. See Kentucky Revised Statutes 141.010 and 141.420.

To the extent Ohio residents remain liable for any Kentucky individual income tax after allowance of all Kentucky credits (both nonrefundable and refundable credits other than withholding tax and estimated income tax payments) and to the extent that division R.C. 5747.05(B)(4) does not apply (see discussion above), the Ohio resident may claim the resident credit equal to the lesser of the following two amounts:

- ➔ The amount of Ohio income tax otherwise due on such portion of the resident taxpayer's Ohio adjusted gross income subjected to Kentucky income tax. However, the amount shall not exceed the portion of total Ohio tax due that the amount of the resident taxpayer's Ohio adjusted gross income subjected to Kentucky income tax bears to the total Ohio adjusted gross income of the resident taxpayer. See R.C. 5747.05(B)(1).
- ➔ The amount of Kentucky income tax liability reduced by all Kentucky credits (nonrefundable and refundable other than estimated income tax and withholding tax). The credit computed under this provision shall not exceed the amount of Ohio income tax otherwise due before application of any credits. See R.C. 5747.05(B)(2). Note that if the Ohio resident taxpayer elects, under the provisions of 103 KAR 15:020E, to pay the Kentucky corporation income tax, or any portion of that tax, otherwise due by the KY-taxable PTE in which the Ohio resident taxpayer is an equity investor, then such payment **is** part of the "amount of Kentucky income tax liability." However, to the extent that R. C. 5747.05(B)(4) applies (see discussion, above), the Ohio resident cannot claim the resident credit.
- ➔ Ohio resident taxpayers who claim the resident credit with respect to Kentucky corporate income tax paid by, or on behalf of, the KY-taxable PTE will be subject to assessment for unpaid tax, failure-to-pay penalties, and interest. For those taxpayers who have filed their Ohio income tax return before April 1, 2006 and they have claimed the credit, they can avoid failure-to-pay penalties if by October 15, 2006 they file an amended Ohio income tax return (Ohio form IT-1040X) and pay the additional tax and interest (at an annual interest rate of 6.0 percent).

For any questions regarding this matter, please contact the Taxpayer Services Division at (800) 282-1780, the Individual Income/School District Income Tax Division at (614) 387-0224, or e-mail questions to ODT via "Contact Us" on the department's home page at [tax.ohio.gov](http://tax.ohio.gov).

ENDNOTES:

(1) See 103 KAR 15:020E.

(2) Note that R.C. 5747.01(A) uses the phrases "federal adjusted gross income" and "Ohio adjusted gross income." "Federal adjusted gross income" means the IRC section 62(a) definition of "adjusted gross income." "Ohio adjusted gross income" means federal adjusted gross income as further adjusted by the amounts set forth in divisions (A)(1) through and including (A)(21) of R.C. 5747.01.

(3) See IRC section 62. IRC section 62(a)'s "general rule" states as follows: "For purposes of this subtitle, 'adjusted gross income' means, in the case of an individual, gross income minus the following deductions:" This provision does not provide that the taxpayer has the option to forego any deduction listed in that section; rather, this provision sets forth the definition of "adjusted gross income." To comply with the definition, each individual must deduct, and is required to deduct, the amounts set forth in IRC sections 62(a)(1) through and including 62(a)(18).

(4) See IRC sections 702(a), 1363, and 1366.