Municipal Income Tax Q&A for Real Estate Brokers and Agents

Disclaimer: The following Q&A is provided as a courtesy to members of the Ohio Association of REALTORS® to assist them with gaining a general understanding of how H.B. 5 may impact the filing and payment responsibilities of brokers and agents. These questions and answers are not intended to provide legal or tax advice, and should not be relied upon as such. Brokers and agents should consult their CPA or attorney about their particular facts and circumstances to determine how Ohio's new municipal income tax law will impact their reporting requirements and tax liabilities.

1. **Which cities and villages (also known collectively as "municipalities") in Ohio impose an income tax on individuals and businesses?**

   Approximately 550 or more cities and villages (municipalities) in Ohio impose an income tax on both resident and non-resident individuals that earn income in the taxing city or village. Those same municipalities also impose a tax on the net profit of any business that earns income within their borders, including sole proprietors, independent contractors, partnerships, C corporations, S corporation, and limited liability companies.

   The village of Indian Hills and city of Wyoming impose a municipal income tax only on resident individuals and the Questions and Answers contained here will generally not apply to these two municipalities.

   Ohio townships are not permitted to impose a local income tax, unless the township has created a Joint Economic Development District or Joint Economic Development Zone.

   To determine if a home you have sold is located in a municipality, JEDD or JEDZ that imposes an income tax, click on this link and enter the address of the property: https://thefinder.tax.ohio.gov/StreamlineSalesTaxWeb/default_municipal.aspx

2. **When are the H.B. 5 changes effective?**

   For most taxpayers, the H.B. 5 changes first apply to calendar year 2016 (i.e., for tax returns due in April 2017). However, the net operating loss provisions are not effective until calendar year 2017 (i.e., for tax returns due in April 2018).

3. **Did H.B. 5 change the filing and reporting requirements applicable to real estate brokers and agents?**

   H.B. 5 did not change the filing and reporting requirements for real estate brokers and agents when compared to prior law. Under prior law, brokers and agents were subject to tax by any municipality in which they performed services. H.B. 5 did clarify and simplify how the net profit (i.e., taxable income) of a broker or agent is "apportioned" among multiple municipalities from which real estate commissions are earned. However, this clarification is not materially different from prior treatment by most Ohio municipalities.

4. What is included in the taxable income of an *individual* for municipal income tax purposes?

For municipal tax purposes, taxable income of an individual includes all the following:

- salaries
- qualifying wages (FICA wages)
- commissions
- other compensation
- net profit of the individual, which generally includes the following:
  - Amounts received as an independent contractor or sole proprietor;
  - Amounts reported on federal schedules C, E and F;
  - In a taxpayer's municipality of residence, amounts reported to the **resident** as a distributive share of the net profit of a pass-through entity (such as partnerships, LLCs, and some S corporations, typically reported to the individual on federal schedule K-1s). Note also that under the new law, residents are now permitted to offset the net profit of one business against the losses from another business even if those businesses do not operate in the individual's home municipality.

5. How does a broker or agent calculate his or her net profit for municipal tax purposes?

As a general concept, net profit equals gross revenues minus expenses from this business activity during the year (i.e., the net income). Gross revenues of the broker or agent are calculated by including all commissions and any other earnings from this business activity. Deductible expenses generally include all ordinary and necessary expenses incurred with respect to the broker's or agent's business. Common deductible expenses for brokers and agents may include rent, depreciation, payroll, advertising, supplies, etc. Typically, the net amount reported by the broker or agent on his or her schedule C or business tax return (such as a federal Form 1120, 1120S or 1065) will be equivalent to net profit for municipal tax purposes. However, some types of income are not taxable. Therefore, brokers and agents should carefully complete the municipal tax returns or consult with their CPA or attorney to ensure that only taxable income is reported and only permitted expenses are claimed.

6. Is the total amount of the net profit generated by the broker or agent subject to tax in every municipality in which real estate was sold or leased during the year?

No, but some portion of the total net profit will be subject to tax in such municipalities and returns will need to be filed unless the Sole Proprietor Twenty-Day Rule applies (discussed in Question 10). If that rule does not apply, then the broker's or agent's total net profit for the year is allocated among the municipalities in which commissions were earned for the sale or lease of real estate. This is referred to as "*apportioning*" the net profit" (see Question 7 for more information on apportioning).

7. How does a real estate broker or agent "*apportion*" the business' net profit among the various taxing municipalities in which the broker or agent works during the tax year?

A broker or agent will apportion the total net profit among municipalities by multiplying it by the apportionment percentage for each municipality. The apportionment percentage is determined on a municipality-by-municipality basis and will likely be different each year.

The apportionment percentage for each municipality is calculated by dividing the amount of commissions received during the year for the sale, purchase, or lease of real estate located within the municipality by the total amount of commissions received during the year for the sale, purchase, or lease of real estate located everywhere.

If a broker or agent derives net profit from other business operations (not just from the commissioned sale or lease of real property), a traditional three factor apportionment formula may need to be used to apportion that net profit among municipalities. To be certain, you should discuss this with your CPA or attorney.

8. I have been told that because of H.B. 5, I must now file tax returns in multiple municipalities, which I did not do in the past. Why did H.B. 5 change my filing requirements?

H.B. 5 did not change any filing requirements related to filing tax returns in multiple municipalities. Both pre-H.B. 5 and post-H.B. 5 versions of the law require brokers and agents to file income tax returns in all municipalities in which commissions were generated, unless the old Twelve-Day Occassional Entrant Rule or the new Sole Proprietor Twenty-Day Rule (discussed in Question 10) applies. Municipalities have recently become more aggressive at identifying and contacting businesses that have not been filing net profit tax returns. If you have not filed tax returns in the past, you may be subject to outstanding tax liabilities, including penalties and interest, because no statute of limitations will apply unless a return was filed. You should consult with your CPA or attorney to discuss your situation.

9. Does a broker or agent who pays W-2 employees need to track the locations where the broker's or agent's W-2 employees work to ensure the proper treatment of the municipal income tax that should be withheld on the employees' wages for work performed?

Yes, unless one of two exceptions apply (see below). All business entities, including brokers and agents, must track and withhold municipal income tax based on where their employees actually work. This is no different than the pre-H.B. 5 law.

Exceptions: Two exceptions may limit this requirement in some municipalities, depending on the facts and circumstances. See the discussions below regarding the Employer/Employee Twenty-Day Rule and the Small Employer Exception below.

10. If I earn a commission from the sale or rental of real property located in a municipality in which I was not present to perform services on more than 20 calendar days during the year, will I still need to file a net profit tax return in that municipality?

Yes, unless the Sole Proprietor Twenty-Day Rule applies. This rule will apply to you if you operate as a sole proprietor, you are not a resident of that municipality, and you did not work in that municipality on more than twenty-days during the year.

If you are a sole proprietor that performed services in that municipality for greater than twenty-days during the year, then you will need to report all your net profit for the year to that municipality regardless of whether you earned a commission for one property or multiple properties located in that municipality. In other words, once a sole proprietor exceeds the twenty-day limit, all of that individual's net profit is subject to tax in that municipality, after applying the apportionment ratio (discussed in Question 7).

Because this rule only applies to sole proprietors, if you are a broker that is organized as a business entity (partnership, corporation, LLC, etc.), the business entity will still need to report income to that municipality regardless of whether you, your agents, or your employees worked in that municipality on twenty or fewer days.

11. What is the "twenty-day occasional entrant" rule and how does it work?

There are essentially two "twenty-day occasional entrant" rules, but the term usually refers to the "Employer/Employee Twenty-Day Rule" which addresses withholding obligations of employers and the taxability of employees in those municipalities in which the employee works twenty or fewer "days" during the year. The other twenty-day rule is the "Sole Proprietor Twenty-Day Rule" discussed in Question 10 above.

The Employer/Employee Twenty-Day Rule determines to which municipality an employer must withhold municipal income tax on W-2 wages paid to employees. This rule only applies to a municipality in which an employee earns wages (i.e., performs services for the employer) in that municipality on 20 or fewer days during the calendar year.

The Employer/Employee Twenty-Day Rule has two benefits:

1. Employer Benefit: The employer does not need to remit municipal income tax to such municipality for the wages the employee earns in that municipality. However, the employer must still withhold municipal income tax on those wages and remit the tax to the municipality in which the employee's principal place of work is located (i.e., as if they were earned in the principal place of work location).
2. Employee Benefit: The employee is exempt from tax on those wages earned in that municipality (unless the employee is a resident of the municipality) and is instead subject to tax on such wages by the municipality in which the employee's principal place of work is located.

The *principal place of work* of an employee is the fixed location to which the employee is required to report for employment duties on a regular and ordinary basis. If no such

location exists, then the principal place of work is the temporary worksite in Ohio at which the employer provides services for more than twenty-days. If the employee is not required to report for employment duties to either a fixed location or temporary worksite in Ohio, then the employee's principal place of work is the location in Ohio at which the employee spends the greatest number of calendar days performing services for the employer.

12. Assume my office is in City A. If I work in City B for two hours and City A for six hours on a given calendar day, have I just used up one of my "twenty" days in City B for purposes of the two twenty-day rules?

The statute does not directly define what constitutes a "day" for purposes of the Sole Proprietor Twenty-Day Rule, but does define it for purposes of the Employer/Employee Twenty-Day Rule. As a result, a different answer exists for each rule:

a. **Sole Proprietor Twenty-Day Rule**: City B may consider one day as having been used up for purposes of this rule. However, City B may also adopt a definition of "day" into its own ordinance. You should check with City B's tax administrator or your CPA or attorney to determine whether City B has adopted a specific definition of "day."

b. **Employer/Employee Twenty-Day Rule**: For this rule, an employee is considered to have spent a day performing services in a municipality only if the employee spent more time performing services for or on behalf of the employer in that municipality than in any other municipality on that day. Therefore, you have not used up a day in City B for purposes of this rule because you spent most of your work time in City A on that given calendar day. Please note that special rules apply on travel time. You should consult your CPA or attorney for more information.

13. What is the "small employer" exception and when might it apply to a broker or agent?

The "small employer" exception allows a business that has no more than $500,000 of revenue (from all sources and locations) during the preceeding calendar year to be permitted to withhold municipal income tax for its employees only to the municipality in which the fixed location of the employer is located.

The fixed location of the employer is the permanent place of doing business in Ohio that is owned or controlled by the employer, such as an office, storefront or similar location. If the fixed location is located in an area with no municipal income tax, then no withholding is required.

14. If I operate my brokerage or agency as a C corporation, are there any unique concerns I need to know about my municipal tax filing obligations?

The same general rules described above apply to C corporations, including the filing of returns and apportioning of net profit among multiple Ohio municipalities. Also, the

owners of a C corporation are not directly subject to municipal income tax on the net profit generated by the C corporation.

15. If I operate my brokerage or agency as an S corporation (including an LLC taxed as an S corporation), are there any unique concerns I need to know about my municipal tax filing obligations?

Unless you live in or operate your business in one of the 119 Ohio municipalities that are permitted to tax an S corporation shareholder at the individual level, there are no unique concerns and the S corporation is generally treated as a C corporation for municipal income tax purposes.

If you live in one of the 119 Ohio municipalities that tax S corporation income at the owner level, your flow-through income from the S corporation may be taxed at the individual level in your home municipality.

If own a business that operates in one of these 119 Ohio municipalities, then you may also be individually subject to that municipality's income tax on your share of the net profits that are passed-through to you as an owner.

No central database exists that identifies these 119 municipalities and the application of the tax in these 119 Ohio municipalities is very special. Therefore, to determine whether a municipality is included in this list of 119 and how that may impact your filing obligations, you should contact your CPA or attorney.

16. If I operate my brokerage or agency as a partnership (including an LLC taxed as a partnership), are there any unique concerns I need to know about my municipal tax filing obligations?

The same general rules described in other questions apply to partnerships, including the filing of returns and apportioning of net profit among multiple Ohio municipalities.

One important difference for partnerships is that partners who are individuals may only be directly taxed on the pass-through net profit by their municipality of residence. Further, non-individual partners (i.e., corporations, LLCs, other partnerships, etc.) may not be directly taxed on the net profit passed-through to such partners from the partnership. Instead, the partnership itself will be taxed by each municipality in which the business derives net profit. (Under the prior law, both individual and non-individual partners could be directly taxed by any municipality and be required to file tax returns in all municipalities from which the business derived net profit.)

17. What are some of the more significant changes that H.B. 5 made with respect to brokers and agents when compared to the old municipal tax law?

- The law now simplifies the apportionment factor calculation and provides clarity that the net profit of a broker and agent is apportioned solely based on commissions earned in each municipality (see Question 7, above). Under prior law, some municipalities required the use of the three factor formula, which included taking into account the location of the property and payroll of the entity, as well as commissions. Now, a broker or agent that receives commissions will only have to track the location of the property for which the commission relates. As a result, the broker or agent will generally not have to track the time spent in each location where he or she may have actually worked in generating the commissions related to the sale or lease of real estate.

- The old "twelve-day occasional entrant" rule to limit withholding on employees working in multiple municipalities was expanded by adding two new rules: The Employer/Employee Twenty-Day Rule and the Sole Proprietor Twenty-Day Rule. As an example, the old law provided only 12 days of protection and the new law provides for 20 days of protection. Also, a "day" is defined for purposes of the Employer/Employee Twenty-Day Rule and specific tests are provided for determining whether a day has been incurred. This will help simplify the employer's duties for withholding tax on employees that generally, but not always, work in the same location. However, tax must still be withheld for the municipality in which the principal place of work is located. Ask your CPA or attorney how these changes will impact your withholding responsibilities.

- Brokers and agents that have net profits or losses from multiple pass-through entities or business operations (such as multiple schedule C's) are now permitted to offset the net profits of one operation/entity against the losses of another operation/entity when filing tax returns with their resident municipality. Under prior law, most municipalities limited a resident's ability to offset gains and losses from multiple entities.

- The new law mandates a five year net operating loss carryforward provision. The new provision becomes effective for the 2017 calendar year and is phased in over the following five years. Under prior law, many municipalities did not permit a net operating loss carryover.

18. Did House Bill 5 change the manner in which real estate rental income is taxed?

No. As in prior law, net profit derived from real estate rents may be taxed only by the municipality in which the property generating the rents is located and by the municipality in which the individual taxpayer that receives the rents resides.