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To: All Tax Preparers

From: Diane Haas, Tax Administrator, Village of Ottawa Hills

Business Income, Netting and Loss Treatment for Resident Taxpayers

Business sources of income are now under new rules as to taxability, netting with current year business losses and reduction by prior year losses. Business incomes for individuals will all tie to amounts reflected on the front page of the Federal 1040, and supported by schedules within the 1040, which now must be attached to the local return. Individuals must include Federal 1040, Schedules C, E (pages 1 and 2 if both apply), F, Farm Rental 4835, ordinary gains reflected on the 4797, as well as income reflected on Line 21 of the 1040 (1099-MISC, Fiduciary fees, Gambling/Lottery winnings, taxable portions of HSA distributions, etc.). Supporting schedules may also be necessary in various cases. For Ottawa Hills, a full listing of all the pass-through entities (whether on Schedule E page 2 or a supplementary schedule) is necessary to ensure all S-Corp effects are excluded; these entities are treated as corporations, therefore, their income or loss is not passed to the owners for the Village return.

Resident individuals are now permitted to net business incomes and losses, even between spouses on joint returns, as well as using prior year losses. Wages are not considered business income, and cannot be reduced by either current or prior year losses. In the interest of simplifying the use of prior year Village losses for tax years 2016 and future, the primary/secondary loss categories currently on our system will be compressed into a single remaining loss amount per year. This remaining loss amount is then available for use against business income earned by either the taxpayer or spouse. Spouses wishing to file separately, will be assigned a separate account to preserve each taxpayer's losses.

While capital gains and losses as shown on the Schedule D continue to be exempt from local tax, ordinary gains relating to 1245 and 1250 property as reflected on the 4797 are taxable and must be included when they are related to business income taxed by the Village. In the event these ordinary gains or losses originate from an S-Corp, documentation of the connection will allow for netting out those gains.

2106 Deductions for Employee Business Expenses

Wages can be reduced by federally deductible employee business expenses reflected on Form 2106, reduced by the 2% AGI on the Schedule A. To qualify for the 2106 deduction, attach copies of the 1040 (pages 1 & 2), Schedule A, and the 2106 form with any worksheets verifying expenses. Significant expenses taken may require backup schedules to substantiate valid deductions. Use of the Standard Deduction on the 1040 will disqualify the 2106 expense deduction. Reduction of wages for 2106 expenses also requires reduction of the credit on the tax withheld.

Adjusting Credits

The Village continues to provide credit to residents for other city tax withheld or paid up to ½ the lower rate. Income reduced by losses or deductions require reducing the other city credit accordingly. Verification of the tax paid or withheld must be attached to the return (W-2s and/or city returns). For business source netting, income and loss sources in the same city are first netted. All incomes/losses not attributable to another city or lacking verification of tax paid will be netted in the no city column. Groupings with net losses and use of prior year losses will first be applied to no city net incomes, then city incomes whose city rate is less than 1.5%, and then finally, any remaining losses will be used to reduce incomes for cities with 1.5% or greater. Any reduction of other city income with losses will reduce eligible credits.

Attachments to the Village Return

As stated above, Federal returns are required attachments to the local returns. Individuals are to attach the 1040 to the Village return, with any additional schedules, forms, or worksheets pertaining to and verifying earned income and losses subject to local taxes to avoid requests for missing information. Partnership and trust K-1s are no longer required to be attached, but can be requested to verify work city credits, deductions, and the like. Businesses are to attach the applicable federal return.

Non-Resident Businesses

Beginning with tax year 2017, non-resident businesses required to file net profit returns in cities where they conduct business will *record their losses at the gross amount for carry forward*. While this will cause complexities on the 2018 and subsequent returns when using losses recorded prior to 2017 (Pre-2017 losses), this will be temporary until the pre-2017 losses are either used or expire. These complexities will be explained prior to the 2018 return filings.

Partnership Resident City Filing on Behalf of All Partners

It is now mandated that partnerships file and pay local tax at the entity level in the partnership's resident city. This tax is then to be allocated to each partner for his/her share of city tax paid. It is no longer optional to decide whether the entity will file and pay, or whether the partners will file and pay; the partnership is required to file and pay tax where the partnership is located, as well as where it is conducting business.

Review of Employer Withholding Rules

ORC 718 has set forth rules for when employers with employees working in various cities must withhold local tax for the city where the employee is working. The rules provide a small employer exemption from withholding at work site locations, and define various locations used for determining the preponderance of a day and the 20-day exemption. Below is a brief summary of these rules.

Small Employer Exemption

Small employers, defined as having prior year gross revenue of less than \$500,000, qualify for exemption from withholding requirements for employees working in various municipalities. Cities where the employees are working may require the employer to provide a copy of the prior year's business return for verification of this exemption. Small employers are to withhold the local tax on their employees where the business is residing (fixed location), but are not required to track and withhold local tax for other cities where the employees are working. A small employer residing in the township is not required to withhold any local tax. The employees may be working in a city for more than the preponderance of a day and for more than 20 days, but the employer is not required to withhold that city's tax. Employers may withhold the employee's resident tax, if they choose to.

Preponderance of a Day Rules

For employees working in various locations, the city where the employee works for the preponderance of the day is counted for that city. All travel times between jobs, delivery of materials, and the like are attributed to the principal place of work (the location where the employee is required to report each day). Therefore, to meet the preponderance of a day, an employee must be performing work in a work city for a longer time than the time spent in any other work city, as well as exceeding all the travel time plus time spent at the business location (principal place of work).

20 Day Rule

When the preponderance of a day has been reached for an employee for a day in a work city, the employer may not be required to withhold work city tax until the employee has reached the preponderance of a day for more than 20 days. Once the preponderance of a day is reached for the 21st day, the employer is required to begin withholding work city tax starting on the 21st day. The first 20 days are exempt under these rules. Exceptions to the 20-day rule include situations when the employer knows from the beginning that the job is expected to last more than 20 days (presumed worksite – employer is required to withhold from the first day), or if the worksite qualifies for a principal place of work for the employee, meaning that the employee is required to report for work to the worksite each day. As stated above, the city where the employer resides will require withholding on all employees working in the city. There is no small employer exemption for the business' resident city, nor will the 20-day rule apply. The only time the business' resident city tax is not withheld on an employee is if the employer is required to withhold another city's tax per the preponderance of a day and 20-day rules.

Non-Resident Refund Claims for Local Work City Tax Withheld

Employees who work outside the business' resident city (fixed location) may request refund of this city's withholdings. However, if the employee worked in another Ohio city, he/she could then be required to file and pay tax for each of those cities where the work was performed, even if the employer was not required to withhold to those cities. Information sharing is permitted among the cities. In essence, the employee is to pay tax to either the city he/she worked in or the city the business resides in. If work was performed in a township or outside of Ohio, the employee's withholdings can be refunded without triggering additional tax or filings elsewhere.