

SHOULD BUSINESS OWNERS BE PENALIZED FOR STAYING OHIO RESIDENTS? A REVIEW OF OHIO LAW

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The Ohio Business Income Deduction and Lower Tax Rate

The term “business income” is used nationally in state statutes to describe the type of income that is taxed across multiple states, often referred to as apportionable income. Alternatively, income that does not meet the definition of “business income” is considered “nonbusiness income,” which is allocated to and taxed in one state. As a general rule, most of the income of a business is considered “business income.” Historically, the Ohio Department of Taxation (“ODT”) has taken a broad view of the definition of “business income.”

In 2013, the Ohio legislature first enacted the small business income tax deduction (“SBID”). The amount of the deduction was increased over several years and the deduction was renamed the Business Income Deduction (“BID”), which allows a \$250,000 deduction. In 2015, the Ohio legislature also enacted a lower tax rate of 3% (versus 4.995%) on business income. The Ohio legislature’s continued goal was to stimulate business and investment in Ohio.

Whether the Sale of a Business Generates Business Income

Many years ago, controversy arose related to whether the gain or loss on the sale of a business is considered “business income” or “nonbusiness income” in Ohio.

The question was important because if such income was “nonbusiness income,” the owner could merely move out of state and eliminate any Ohio tax on the sale of an Ohio business. This tax planning strategy was effectively ratified in *Kemppel v. Zaino*, 91 Ohio St. 3d 420 (2001), in which the Ohio Supreme Court held that the gain on the sale of assets in liquidation of an entity was “nonbusiness income.” In response to the *Kemppel* decision, the Ohio legislature amended the statutory definition of “business income” in ORC 5747.01(B) to include gain from a complete or partial liquidation of a business.

ORC 5747.212 was also enacted to require that a nonresident with a 20% or more ownership interest in a business apportion the gain or loss on the sale of the ownership interest to Ohio based on the business’ prior activity in Ohio and pay Ohio tax on the Ohio portion. This treatment effectively treated the gain or loss as apportionable business income. Thus, the statute was intended as another way to prevent an owner from moving out of Ohio to avoid income tax on the sale of a business. In 2016, however, the Ohio Supreme Court determined that R.C. 5747.212 was unconstitutional as applied to the taxpayer, a nonresident who was determined to be a mere investor in the Ohio business and, therefore, the gain on the sale of the business was not taxable in Ohio. *Corrigan v. Testa*, 149 Ohio St.3d 18, 2016-Ohio-2805.

As we discussed in a previous SALT BUZZ issued on February 6, 2017, ODT issued an information release indicating that capital gain relating to the disposition of a business interest is “nonbusiness income” and an Ohio resident would, therefore, not be eligible for the BID. Information Release 2016-01. Thus, not only will an Ohio resident be subject to tax on 100% of the gain from the sale of a business interest, the Ohio resident will likely be taxed at the higher rate of 4.995%. While unintended, this dichotomy in how the sale of a business interest is taxed creates an economic policy likely encouraging business owners to leave Ohio.

Recent Modification in Information Release

The difficulty is the uncertainty in the law after the decision in *Corrigan*, which was focused on the constitutionality of R.C. 5747.212, which does not apply to residents. The Ohio Supreme Court issued a second decision in 2016 that also muddied the waters. In *T. Ryan Legg Irrevocable Trust v. Testa*, 149 Ohio St.3d 376, 2016-Ohio-8418, the Ohio Supreme Court upheld imposition of the income tax on the trust related to the sale of a business. Contrasting the decision in *Corrigan*, the Ohio Supreme Court noted that the grantor was a resident of Ohio at the time the trust was created and was a founder and involved in the day-to-day operation of the business. This language may provide a situation where the sale of a business interest is “business income,” making a resident eligible for the BID and a lower tax rate. The difficulty is that neither decision specifically addresses the treatment of a resident in such a situation.

In February of 2019, the Department revised Information Release 2016-01, acknowledging that “Income from the sale of an intangible asset can be business income, ‘if the acquisition, rental, management, and disposition of the property constitute integral parts of the regular course of a trade or business operation.’ “ The example of a founder involved in the day-to-day management of the business as described in *T. Ryan Legg* may potentially qualify but because that case considered a different tax, the answer is unclear. The Information Release does not describe any examples of when such a requirement may be met. ODT has indicated that the change in Information Release 2016-01 is consistent with their prior policy but that certain practitioners felt that the language was necessary so that auditors understood that an exception may exist in certain factual situations. ODT should be applauded for trying to work with practitioners to try to provide clarity. It is also important to acknowledge that ODT may feel constrained by the uncertainty in the law.

Future Ohio Legislative Change?

The sale of a business interest has typically been subject to more favorable tax treatment than other types of income. For example, gain on such a sale is typically subject to a substantially lower tax rate on capital gains for federal income tax purposes. The federal government periodically lowers the tax rate to spur additional economic development. The Ohio legislature should consider legislation that would remedy the Ohio tax impact on resident business owners. Keeping Ohio business owners in Ohio after they sell their business is an important policy that because those sales proceeds can be used to invest in growing additional Ohio businesses. Likewise, those business owners have business experience that can be leveraged in new and existing Ohio businesses.

Without further clarifications, business owners may be faced with staying in Ohio and paying tax on the gain at a rate of 4.995% or leaving Ohio and paying zero tax. A compromise approach may be to tax the gain at 3%, either as capital gain income or as business income in order to incent a business owner to stay in Ohio. In fact, under current law, we believe that some situations exist whereby the sale is business income and should be taxed at 3%.

If you would like to discuss these or any other state and local tax issues, please contact Deb McGraw or any other ZHF professional.

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