Ohio Tax Talk: Don't Miss the Ohio Business Income Deduction

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Categories:

Tax Law Defined™ Blog

It's that special time of year again, tax season.

When it comes to filing income taxes, many taxpayers and preparers focus their attention on federal income tax deduction opportunities, such as itemized deductions, business deductions, and others, while failing to take full advantage of state-level deductions and incentives. With tax season upon us, Ohio taxpayers should be aware of one special deduction that is too often forgotten or misunderstood – the Ohio Business Income Deduction (BID). The Ohio BID is a special deduction for Ohio taxpayers that can generate significant tax savings on an annual basis and, particularly, in years in which a taxpayer generated significant gains. However, the parameters for claiming the Ohio BID and categorizing certain income as "business income" is not always straight forward.

This article provides guidance on how to maximize the Ohio BID and the possible tax savings this special deduction offers. Taxpayers and preparers should be mindful of the Ohio BID when filing 2020 income taxes. They should also consider the potential benefits of amending any past year returns and claiming refunds for overpaid taxes before the statute of limitations period expires.

The Ohio Business Income Deduction

The state of Ohio taxes income from business sources and nonbusiness sources differently. "Nonbusiness income" is subject to a graduated income tax rate, with the highest current rate being 4.797%.[1] Alternatively, "business income" is taxed at a flat 3% rate. Further, not only is business income taxed at the preferential 3% rate, but such income can also be offset with the Ohio BID. By utilizing the Ohio BID, Ohio taxpayers filing jointly can deduct up to $250,000[2] of business income from their Federal Adjusted Gross Income (AGI) when calculating their Ohio taxable income. The excess amount of business income left after the BID is taxed at the 3% flat rate.[3] Simply put, you do not pay Ohio income taxes on your first $250,000 of Ohio business income if you file jointly or

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$125,000 if you are a single-filer.

As a hypothetical, consider Gabrielle who owns a 30% interest in ABC, LLC ("ABC"), an Ohio limited liability company that manufactures widgets. ABC is considered a partnership for federal income tax purposes. Gabrielle is an Ohio resident who files jointly with her husband. In 2020, ABC generated $1 million of net income from its sale of widgets in the ordinary course of business, thereby allocating $300,000 of income to Gabrielle (as a 30% owner). By claiming the Ohio BID on her Ohio taxes, the first $250,000 of income would be deducted and the remaining $50,000 would be taxed at a flat 3% rate. If, however, Gabrielle fails to claim the Ohio BID, the entire $300,000 is taxed at the standard, graduated rate on nonbusiness income. For simplicity's sake, that rate would be roughly 5%. In this hypothetical example, by not taking advantage of the Ohio BID, Gabrielle would pay roughly $14,000[4] extra on her Ohio taxes.

As the above illustration demonstrates, the Ohio BID can save Ohio taxpayers significant sums on their Ohio personal income taxes each year. The tax savings can be further amplified in the event of a business sale or large-scale transaction that generates a greater amount of business income. Unfortunately, many Ohio taxpayers are unknowingly missing this opportunity because of a lack of awareness. There is also conflicting authority from the Ohio Department of Taxation and Ohio courts on this topic. The remainder of this article will highlight the mechanics and legal foundation of Ohio business income.

Ohio Business Income v. Nonbusiness Income

The Ohio Revised Code ("O.R.C.") defines business income and nonbusiness income differently. Business income is defined in O.R.C. 5747.01(B) and generally includes income derived in the "regular course of a trade or business" and includes "income derived from the partial or complete liquidation of a business."[5]

Nonbusiness income, on the other hand, is defined in O.R.C. 5747.01(C) as "all income other than business income" and includes "compensation, rents and royalties from real or tangible personal

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property, capital gains, interest, dividends and distributions, patent or copyright royalties, or lottery winnings, prizes, and awards."

Proper categorization of income is vital to the determination of whether the Ohio BID can be utilized by the taxpayer. It is also important for determining whether Ohio even has jurisdiction to tax the income. Business income is apportioned (split amongst) the states in which the business generated the income, whereas nonbusiness income is generally allocated to the taxpayer's domicile or residence.

Ohio courts have generally recognized two tests for determining whether income is business or nonbusiness income under O.R.C. 5747.01: the "Transactional Test" and the "Functional Test." If either test is met, the income is business income. The Transactional Test is attributable to the language found in the first clause of the first sentence of O.R.C. 5747.01(B) (*i.e.*, "regular course of a trade or business") and focuses on the frequency or regularity of actions giving rise to the income; the more frequent the actions, the more likely the proceeds derived therefrom are business income.

The Functional Test is attributable to the second clause in the first sentence of O.R.C. 5747.01(B) (*i.e.*, "if the acquisition, rental, management, and disposition of the property constitute integral parts") and focuses on whether the property disposed of was used by the taxpayer in its regular trade or business operations.

Depending on a taxpayer's situation, applying these two tests can be challenging. Certain sources of income can be relatively easy to categorize as business or nonbusiness income. However, audits and disputes often arise on the issue of how to categorize the sale of a business.

Classifying Business Income Upon a Business Sale

Often selling a business will yield a significant amount of gain to investors. In these cases, it is important to properly classify that gain as business income or nonbusiness income. Ohio residents may have an incentive to classify such income as business income because of the Ohio BID and the preferential rate on business income (3% flat rate). Alternatively, Ohio nonresidents may have an

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incentive to classify their gains as nonbusiness income because, absent special circumstances, Ohio would not have the ability to tax the income properly allocated to another state.

The definition and classification of business income in the context of a business sale has evolved over time. In 2001, the Supreme Court of Ohio handed down its decision in *Kemppel v. Zaino*,[6] wherein the court held that the income resulting from the sale of intangible assets followed by a dissolution of an S corporation was not business income under O.R.C. 5747.01(B). In this case, the shareholders of the Ohio S corporation were Florida residents. Therefore, it was beneficial to the shareholders to categorize the business as nonbusiness income, since Ohio did not have any jurisdiction to tax that income.

In direct response to this decision, the Ohio General Assembly added the final sentence of the current definition of business income in 2002: "Business income includes income, including gain or loss, from a partial or complete liquidation of a business, including, but not limited to, gain or loss from the sale or other disposition of goodwill."[7] This addition, as part of 2002 Senate Bill 261, clarifies that gain from a complete business liquidation can be categorized as business income that is apportionable to Ohio. This updated definition does not distinguish between the liquidation of a business via an asset sale as compared to a stock sale.

In the same Senate Bill that amended O.R.C. 5747.01(B) to address the *Kemppel* case, the Ohio General Assembly also enacted O.R.C. 5747.212, which categorizes the proceeds from an interest sale of a pass-through or closely held business by a more than 20% interest holder as business income in certain circumstances. In *Corrigan v. Testa*,[8] the constitutionality and application of the new special statute – O.R.C. 5747.212 – was challenged. While the case centered on the special statute of O.R.C. 5747.212, it offered lessons on the definition of business income, generally.

Corrigan involved an out-of-state taxpayer, who held a 79% passive interest in an LLC that had its headquarters in Ohio. Upon the liquidation of the business, Corrigan argued that his capital gains on the sale of his equity interest were not apportionable business income to Ohio because he had no link to Ohio other than the

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business' dealings. He described his relationship with the company as "stewardship" as opposed to active management of the business. The Supreme Court of Ohio agreed with Corrigan, holding that, as-applied to Corrigan, O.R.C. 5747.212 was unconstitutional because Corrigan's relationship to the business was merely that of an investor; thus, there was no unitary relationship (or taxable "link") between Corrigan and the business such that Ohio could tax the gain as business income.

Based on the court's logic in *Corrigan*, it is understood that, had there been a unitary link (*e.g.*, active management of the business), the capital gain would have been apportionable business income. Determining whether a unitary relationship exists involves a fact-intensive inquiry into each individual case. Nevertheless, in short, one takeaway from *Corrigan* is that a taxpayer's relationship to the underlying business can determine how the gains generated from an equity sale (*i.e.*, stock sale) would be categorized. Based on the precedent of *Corrigan* and others, the gain generated by the sale of stock in business that is actively managed by the taxpayer would generate business income. On the other hand, the gain generated by a passive investment (*e.g.*, the retail investor's sale of GameStop stock) would generate *non*business income.

The Ohio Department of Taxation seems to ignore this nuance in its published guidance[9] and audit positions, by seeking to simply classify the gain generated by any equity sale as nonbusiness income. Meanwhile, the gain generated by assets sales is generally treated as business income. The Department's does not appear to appreciate the precedent set forth in *Corrigan* and other relevant case law on this issue. Because of this conflicting guidance, it can be difficult for taxpayers to properly categorize the income derived from a business sale.

Conclusion

The Ohio Business Income Deduction is an often-overlooked deduction that can generate significant savings in state income tax liability each year. However, determining whether income is business income that can be deducted can be challenging. For taxpayers whose situation is not straightforward, you may wish to

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seek the advice of a tax professional in order to ensure full compliance with Ohio law. In the event you think you or your client may have missed out on properly claiming the Ohio BID or otherwise classifying Ohio business income in past years, you may be entitled to a refund. The deadline to file an amended return and refund claim in Ohio is four years from the date the return was filed or required to be filed, whichever is later.[10]

For assistance navigating the Ohio Business Income Deduction and issues involving Ohio business income generally, please contact Edward I. Rivin, or any attorney in Frost Brown Todd's Tax Practice Group.

***Note:** This article was originally published by Law360 (February 9, 2021)*

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[1] The Ohio income tax rate table can be found here.

[2] $125,000 for taxpayers filing as single.

[3] O.R.C. 5747.02(A)(4)(a).

[4] ($300,000 * 5%) – ($50,000 * 2%) = $14,000.

[5] *See* O.R.C. 5747.01(B).

[6] *Kemppel v. Zaino*, 91 Ohio St. 3d 420, 423 (2001).

[7] *See* 2002 Ohio Senate Bill 261.

[8] 149 Ohio St. 3d 18, 23 (2016).

[9] *See e.g.*, Ohio Department of Taxation Information Release IT 2016-01 (Issued: October 7, 2016; Reissued: February 1, 2019).

[10] O.R.C. 5747.13.

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