Jun 03, 2022

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Tax Law Defined™ Blog

Authors:

Raghav Agnihotri
Patrick W. Thomas

Ohio Bill Modifies Tax Treatment for Sale of Equity or Ownership Interests

On June 1, 2022, the Ohio Senate unanimously passed House Bill (HB) 515, which specifies two situations where income from the sale of ownership interest in a business will be considered "business income" as opposed to "individual income" for Ohio income tax purposes, subjecting it to preferential treatment under the business income deduction and a 3% flat rate.[1] HB 515 also changes the reporting and payment period for the Ohio sports and gaming tax. Effective January 1, 2023, HB 515 will require that sports gaming proprietors file monthly tax returns, instead of daily returns, at brick-and-mortar locations, on the internet, and on mobile devices.

Background

Under current law, the treatment of income from the sale of an ownership interest depends on whether the seller is an Ohio resident or nonresident. For Ohio residents, if the sale of an ownership interest is considered individual income, then income from the sale is not eligible for the business income deduction (BID) of $250,000 (or $125,000 for spouses filing separate returns), nor is it eligible for the flat 3% tax on business income exceeding the BID thresholds. For tax years beginning on or after January 1, 2021, the individual income tax rate for Ohio can be as high as 3.99%. Nonresidents in Ohio, on the other hand, are not generally subject to Ohio's individual income tax on the sale of their ownership interests, notwithstanding certain exceptions,[2] since nonbusiness or individual income from the sale of intangible property is allocated to the seller's domicile—which for nonresidents is necessarily outside of Ohio.[3] However, income from the sale of an ownership interest could potentially be apportioned and taxed by Ohio as business income if the taxpayer is actively managing the business.

Recent rulings of the Ohio Supreme Court created substantial uncertainty regarding the treatment of income from the sale of an ownership interest. In *Corrigan v. Testa*, 73 N.E.3d 381 (Ohio 2016), the court stated in dicta that capital gain from the sale of an equity

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interest would be "nonbusiness income" and implied that only capital gain from an asset sale would qualify as "business income." This contradicted an earlier opinion of the Ohio Board of Tax Appeals in *T. Ryan Legg Irrevocable Trust v. Testa*, 2015 WL 2169402 (Ohio Bd. Tax App. May 5, 2015), which was later overturned by the Ohio Supreme Court, but on a different issue. Yet, the Ohio Department of Taxation, in its instructions to Ohio Form IT 1040, cited *Corrigan* for the proposition that an equity ownership sale was categorically not "business income."

Modifications under HB 515

HB 515 clarifies this unsettled grey area of Ohio tax law, as the Ohio Legislative Service Commission explains in its report on the previously passed House Bill. It outlines two situations where the sale of an ownership interest will now be considered business income:

- Where a seller "materially participates" in the activities of the business within five taxable years preceding the interest being sold; [4] or
- Where a sale is treated as a sale of assets for federal income tax purposes

Thus, the law clarifies that the BID deduction and rate apply in *either* an asset or equity sale. In situations where the above conditions are satisfied, income from the sale of an ownership interest would be eligible for the preferential treatment under the BID deduction of $250,000 in business income ($125,000 for spouses filing separate returns) for personal income tax purposes. Any additional business income above that amount is subject to a 3% flat tax.

Significance & Tax Implications

HB 515 has been proposed as a remedial measure to Ohio's current income taxes to clarify existing law. As such, its changes will apply to any audits, refund applications, petitions for reassessment, and appeals pending on or after the bill's 90-day effective date. If enacted, the new provisions will likely result in a significant reduction of the state's personal income tax receipts almost

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immediately. Although the fiscal revenue loss is difficult to calculate, the Ohio Department of Taxation estimated the revenue loss from the retroactive component of the bill may potentially be in the lower hundreds of millions of dollars, and the Ohio Legislative Budget Office has estimated a loss totaling several tens of millions of dollars.[5] Potential revenue gains also exist where the capital gains received by nonresidents may become taxable where they are not currently.

Given the uncertainty about when the sale of an equity or ownership interest is considered individual income or business income, HB 515 will be significant in clarifying the treatment of income from the sale of an ownership interest. Ohio resident owners of businesses or nonresident owners of businesses with operations in Ohio should ensure they understand the implications of HB 515 prior to closing the sale of their business.

Frost Brown Todd will continue to monitor the development of HB 515 as it will be presented to Governor Mike DeWine for signature. For more information regarding the tax implications of HB 515, contact Patrick Thomas, Raghav Agnihotri, or any member of Frost Brown Todd's Tax practice group.

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[1] O.R.C. § 5747.01(A)(28); see also O.R.C § 5747.02(A)(4)(a).

[2] See O.R.C. § 5747.20. Ohio nonresidents may be subject to an income tax on any realized gains in the sale of closely held business interests or pass-through entities.

[3] O.R.C. § 5747.212.

[4] IRS rules for material participation generally consider the number of hours a taxpayer spent participating in the business, either on their own or in relation to other business participants. *See* Treas. Reg. § 1.469-5T.

[5] HB 515 Fiscal Note & Local Impact Statement – Ohio Legislative Service Commission, (last visited Jun 3, 2022).

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