

NEW OHIO DEPARTMENT OF TAXATION PROGRAM SEEKS INFORMATION ON SCHEDULE D GAINS LISTED AS “BUSINESS INCOME”

FEBRUARY 14, 2020



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MEMBER

Starting in November and December of last year, the Ohio Department of Taxation’s (“ODT”) personal income tax (“PIT”) unit started sending out hundreds of letters seeking information on federal Schedule D gains that were listed as “Business Income” on the PIT return Form IT BUS. “Business Income” is eligible for the Business Income Deduction (“BID”) and the lower flat tax rate on business income. The Schedule D portion of a taxpayer’s federal income tax return, Form 1040, contains information on the capital gains and losses claimed by the taxpayer, which could include sales of stock and other business interests.

ODT seeks factual information, such as a copy of the federal Schedule D and any supplemental schedules that support the amounts claimed on the Ohio Form IT BUS. ODT’s letter also requests a detailed explanation of each transaction that generated the capital gain/loss, including a description of the underlying asset(s), the nature of the sale or disposition, and the party who acquired the asset(s). Finally, ODT’s letter requests explanations of why the capital gain is business income under R.C. 5747.01(B).

In some cases, such as certain sales of business assets, ODT may be satisfied that the income has been properly characterized on the Form IT BUS. In many instances, however, additional discussion and analysis will likely be required. We have written previously regarding the uncertainty in the law and ODT’s reliance on case law related to a different issue (i.e., the constitutionality of Ohio taxing a nonresident’s gain on the sale of a business interest under a statutory provision that only applies to nonresidents, R.C. 5747.212). Specially, in *Corrigan v. Testa*, 149 Ohio St.3d 18 (2016), the Ohio Supreme Court determined that the application of R.C. 5747.212 to treat the sale of a limited liability company (“LLC”) as “business income” was unconstitutional because the taxpayer’s lack of a unitary relationship with the business resulted in insufficient contacts between the gain from the disposition and the state of Ohio,

as required to satisfy the Due Process Clause.

ODT issued Information Release 2016-01 to provide guidance on the *Corrigan* decision. It states, in part, that “[t]o the extent an individual taxpayer recognizes a capital gain relating to the disposition of an interest in a business entity to which R.C. 5747.212 does not apply, that gain is **generally nonbusiness income**. See R.C. 5747.01(C). * * * A nonbusiness gain is allocable to the taxpayer’s state of domicile under R.C. 5747.20(B)(2)(c). Additionally, since **this gain is considered nonbusiness income, it is not eligible for Ohio’s Small Business Deduction** for tax years 2013 and 2014, or Ohio’s Business Income Deduction for tax years 2015 and forward. R.C. 5747.01(A)(31).” (Emphasis added). The practical implication of this paragraph is that ODT believes that the gain realized when a resident sells a business interest will generally be considered nonbusiness income and not entitled to the BID. Although not mentioned in the Information Release, the gain would also be ineligible for the lower tax rate on business income.

ODT’s position that the gain on the sale of a business interest is nonbusiness income can create a significant tax issue for Ohio residents that sell a business and remain in Ohio. A nonresident will not pay Ohio tax on similar gains that are considered nonbusiness income (because the nonresident’s commercial domicile is outside of Ohio). If the decision in *Corrigan* applies, the fact that the Ohio Supreme Court did not find the statute to be unconstitutional on its face suggests that a gain on the sale of a business interest may be business income in certain situations. Mr. Corrigan was determined to be an “investor who bought companies with the intention of providing financing and strategic expertise to grow the company for an eventual exit via a sale to a third party.” *Corrigan v. Testa*, 149 Ohio St.3d 18 (2016). The Ohio Supreme Court relied heavily on the finding that Corrigan did not run the day-to-day operations of the entity. Thus, where a taxpayer runs the day-to-day operations of the business entity, the gain on the sale of a business interest may be considered business income. ODT appears to acknowledge this issue: “The Court found that R.C. 5747.212 was unconstitutional **as applied** to Mr. Corrigan. The Court declined to find the statute unconstitutional **on its face** (i.e., the statute was not stricken down as unconstitutional in all situations; instead, it was found to be unconstitutional only in *this* situation.)” ODT’s Information release acknowledges that: “Income from the sale of a 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.’ “ Thus, whether the gain is business or nonbusiness income likely depends on the facts.

ODT has also indicated that it will treat a sale of a disregarded entity or an IRC Sec. 338(h)(10) election as the sale of a business interest ineligible for the BID or lower tax rate, contrary to the federal income tax treatment. Accountants and other advisors working with taxpayers that receive the notices should analyze this area carefully and should consider seeking the advice of legal counsel. Accountants and other advisors are also cautioned to be careful of the procedural issues related to such notices. For example, depending on the type of notice being sent, the matter may be transferred to the Appeals Division of ODT upon the receipt of additional information. There is an opportunity to request a hearing at the Appeals Division, but such appeals and hearings must be taken seriously in order to achieve the best

results.

If you would like to further discuss how to respond to these types of ODT requests, please contact Debora McGraw or one of our other ZHF professionals.

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