

TO BE OR NOT TO BE SUBJECT TO THE OHIO FINANCIAL INSTITUTION TAX AS A “SMALL DOLLAR LENDER”?

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DEBORA D. MCGRAW, JD, CPA, LLM
MEMBER

The Ohio Financial Institution Tax (“FIT”) is generally imposed on regulated financial institutions, their holding companies, and consolidated subsidiaries and certain other legal entities. Many taxpayers may not realize that the FIT can also be imposed on certain non-bank lending and financial services entities known as “small dollar lenders.” The application of the “small dollar lender” definition is in dispute for certain industries, such as the small dollar lending industry. Further, changes in an entity’s operations can create unforeseen complexities.

Non-Bank Lending and Financial Services Entities Background

Many non-bank lending and financial services entities were subject to the Ohio Dealer in Intangibles Tax (“DIT”) in prior years, which was imposed on net worth. The DIT was repealed resulting in most former DITs becoming subject to the Ohio Commercial Activity Tax (“CAT”) starting in calendar year 2014. Many of these non-bank entities have only more recently had their CAT returns audited by the Ohio Department of Taxation (“ODT”). These CAT audits identify controversies and deficiencies in the imposition of the CAT on non-bank lending and financial services entities. Because the CAT is imposed on gross receipts, the CAT may be imposed on the principal on the sale of certain loans generating a significant CAT liability even though there may

be little to no profit on the sale of the loans. Further, ODT has argued that the exclusion for repayment of principal on a loan does not apply to an entity that purchases a loan or other debt obligations from the originator. If successful, ODT's position would result in the repayment of principal being considered a taxable CAT gross receipt for any loans purchased in the secondary market. While ODT's position could impact a variety of financial services entities, the position has been a significant issue for the former Ohio Credit Service Organizations ("CSO") who were contractually obligated to purchase loans in default and then sought to collect from the borrower.

"Smaller Dollar Lender" FIT Taxpayer Versus CAT Taxpayer

Some of these taxpayers have considered whether the entities are subject to the FIT, specifically as a "small dollar lender," rather than to the CAT. Taxpayers subject to the FIT are exempt from CAT for the corresponding taxable year. Because the FIT is imposed on net worth versus gross receipts, some taxpayers may pay considerably less under the FIT, particularly considering ODT's positions on the application of the CAT described above. The issue has been the application of the term "small dollar lenders," which is defined as: "any person engaged primarily required in the business of loaning money to individuals, provided that the loan amounts do not exceed five thousand dollars and the duration of the loans do not exceed twelve months. A 'small dollar lender' does not include a bank organization, credit union, or captive finance company." R.C. 5726.01(O).

Specifically, there is an ongoing controversy over whether an Ohio CSO meets the "small dollar lender" definition. Under prior Ohio law, a CSO was treated as providing services versus originating loans. The CSO was contractually obligated to purchase the loan in certain situations. For these reasons, the CSO may have been treated as originating the loan for certain financial accounting and federal income tax purposes.

Impact of the Change in the Ohio CSO Law

Another wrinkle for the industry involves Ohio's repeal of the CSO law, which requires changes in operations in the middle of 2019. Some entities may begin originating loans, which should be qualifying activity for the "small dollar lender" definition. A complexity will be the timing of changes in the business operations since the definition requires that the taxpayer be "primarily engaged in the business of lending money" as determined in a taxable year. For example, an entity who begins originating loans may not generate enough revenue to meet the "primarily" in the first year or, potentially in subsequent years, if its business operations are a mix of loan originations and servicing.

Another complexity is the interplay between the FIT and the CAT. The FIT is a lien date tax so that the 2020 tax report is imposed based on the prior taxable year of 2019. A taxpayer paying the FIT for the 2020 tax year would be exempt from CAT for the 2019 taxable year. Thus, a taxpayer with changing business operations may not know until the end of 2019, substantially later than when the first through third quarter CAT returns for 2019 are due, whether or not it satisfied the “primarily” test and is subject to the FIT or the CAT. Likewise, a taxpayer that previously originated loans and filed as a FIT may be surprised when it determines it is no longer subject to the FIT for the 2020 tax year and, therefore, has a delinquent CAT liability for the 2019 taxable year.

Companies in the small dollar lending and similar industries should carefully review their operations and consider the application of the CAT and the FIT.

If you would like more information, do not hesitate to contact [Debora D. McGraw](#).

ZAINO HALL & FARRIN LLC

ATTORNEYS AT LAW

WWW.ZHFTAXLAW.COM

614-326-1120

855-770-1120 (toll-free)

RON AMSTUTZ

(non-attorney professional)
614-782-1545 (Direct)
330-347-3533 (Mobile)
ronamstutz@zhfconsulting.com

RICHARD S. BITONTE

(non-attorney professional)
614-782-1555
rbitonte@zhfconsulting.com

RICHARD C. FARRIN

614-349-4811 (Direct)
614-634-3130 (Mobile)
rfarrin@zhftaxlaw.com

STEPHEN K. HALL

614-349-4812 (Direct)
614-284-1253 (Mobile)
shall@zhftaxlaw.com

DEBORA D. MCGRAW

614-349-4813 (Direct)
614-595-5560 (Mobile)
dmcgraw@zhftaxlaw.com

JOHN R. TRIPPIER

(non-attorney professional)
614-349-4815 (Direct)
614-203-4173 (Mobile)
jtrippier@zhftaxlaw.com

JASON W. WALKER

(non-attorney professional)
614-349-4817 (Direct)
916-533-1626 (Mobile)
jwalker@zhftaxlaw.com

STEVE C. AUSTRIA

(non-attorney professional)
614-349-4820 (Direct)
937-609-8355 (Mobile)
saustria@zhftaxlaw.com

DAN DODD

614-782-1554 (Direct)
740-973-5930 (Mobile)
dandodd@zhfconsulting.com

ADAM L. GARN

614-349-4814 (Direct)
agarn@zhftaxlaw.com

PHILLIP L. LAWLESS

(non-attorney professional)
614-349-4821 (Direct)
614-565-6098 (Mobile)
plawless@zhftaxlaw.com

BRAD W. TOMLINSON

(non-attorney professional)
614-349-4818 (Direct)
btomlinson@zhftaxlaw.com

JENNIFER R. TURNER

614-782-1642 (Direct)
502-594-9297 (Mobile)
jturner@zhftaxlaw.com

THOMAS M. ZAINO

614-349-4810 (Direct)
614-598-1596 (Mobile)
tzaino@zhftaxlaw.com