



Department of
Taxation



Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

Ohio Taxation of Individual Owners of Pass-Through Entities

Stephen M. Nechemias

Taft Stettinius & Hollister LLP

Nechemias@taftlaw.com

John S. Petzinger

Ohio Department of Taxation

Office of Chief Legal Counsel

john_petzinger@tax.state.oh.us

Nonbusiness Income: What is it?

R.C. 5747.01(B): “Business Income” means income, including gain/loss,

- Arising from transactions, activities, and sources in the regular course of a trade or business, (“Transactional Test”)
- From real, tangible, and intangible property if the acquisition, rental, management, and disposition of the property constitute integral parts of the regular course of a trade or business operation, (“Functional Test”)
- 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

Nonbusiness Income: What is it?

R.C. 5747.01(C): “Nonbusiness income” is

- All income that is not business income
- Possible examples:
 - Compensation,
 - Rents, royalties from real or tangible property
 - Capital gains,
 - Interest,
 - Dividends and distributions
 - Patent, copyright royalties

Nonbusiness Income: What is it?

Default Rule:

All income is business income.

Nonbusiness Income: What is it?

Nonbusiness income is like...



Nonbusiness Income: What is it?

Kemppel v. Zaino, 91 Ohio St.3d 420 (2001)

The Ohio Supreme Court recognized, without explicitly adopting, both the transactional and functional test.

However, it held that a liquidation followed by dissolution fit neither test.

- Hence, the last sentence of R.C. 5747.01(B).

Nonbusiness Income: What is it?

Kemppel v. Zaino, cont'd

Transactional Test: look to the nature, frequency, and regularity of the transaction

Functional Test: Was the property an integral part of the business? Did it contribute to business income in the past?

Nonbusiness Income: What is it?

Why does business vs. nonbusiness matter
to individual owners of PTE's?

Nonbusiness Income: What is it?

Two ways PTE owners report their distributive shares:

1. IT 1040, Individual Income Tax Return
2. IT 4708, Composite Income Tax Return for Certain Investors in a PTE

Nonbusiness Income: What is it?

Individual Income Tax Return, IT 1040

For multi-state PTE owners, the PTE's activities are reflected in either the resident or nonresident credit.

Remember: The IT 1040 begins with federal adjusted gross income, which will include all distributive shares.

Nonbusiness Income: What is it?

Composite Income Tax Return, IT 4708

- Filed by the PTE on behalf of one or more of the entity's investors other than C corporation
- Composite return satisfies each investor's required OH tax filing related to the investor's share of the PTE's income
- Tax base is the sum of the allocated and apportioned distributive shares of income for those investors included

Nonbusiness Income: What is it?

Under either reporting mechanism,

- Business income is apportioned based on the property, payroll and sales of the PTE,
and
- Nonbusiness income is allocated

Nonbusiness Income: What is it?

R.C. 5747.20:

Nonbusiness Income/Deduction Allocation

Residents: allocate all to Ohio

Nonresidents: method of allocation depends on the type of income/deduction

Nonbusiness Income: What is it?

Nonresidents, Allocation of Nonbusiness Income

Compensation for personal services: allocated to Ohio if the services were performed in Ohio.

Gains/losses/rents/royalties from real property: allocated to Ohio if the property was in Ohio

Gains/losses from sale of tangible personal property: allocated to Ohio if the property was in Ohio at the time of sale

- Rents/royalties: allocated to Ohio in proportion to the property's utilization in Ohio, based on # of days physically located in Ohio versus everywhere during the taxable year

Nonbusiness Income: What is it?

Nonresidents, Allocation of Nonbusiness Income, cont'd

Gains/losses from sale of intangible property: allocated to Ohio if the taxpayer's domicile was in Ohio at the time of sale.

- But, see R.C. 5747.212.

Patent/copyright royalties: allocated to Ohio in proportion to the utilization in Ohio.

- Patents: to the extent used in production, fabrication, manufacturing, processing in Ohio
- Copyrights: to the extent that printing or publication originates in Ohio
- If not possible to determine Ohio proportion, then allocated to Ohio if the taxpayer's domicile was in Ohio.

Nonbusiness Income: What is it?

Residual Income:

Any other item of income/deduction of a nonresident which is not specifically allocated or apportioned in R.C. 5747.20 through R.C. 5747.23, shall not be allocated to Ohio unless the taxpayer's domicile was in Ohio at the time the income was paid or accrued.

Nonbusiness Income: What is it?

Example: Partnership has \$1M net income plus \$200k capital gain on sale of tangible property located outside Ohio. Partnership has Ohio ratio of 0.500000. Partner A and Partner B each have 50% interest in profits/losses. Partner A is an Ohio resident, Partner B is a nonresident.

Nonbusiness Income: What is it?

Example, cont'd: If the capital gain is business income, then Partner A and Partner B will each have Ohio income of \$300k.

= \$1.2M business income * 0.500000 Ohio ratio * 50% partnership interest.

Nonbusiness Income: What is it?

Example, cont'd: If the capital gain is nonbusiness income, then Partner A has \$350k Ohio income and Partner B has \$250k Ohio income.

$$A = [\$1\text{M bus. Income} * 0.500000 * 50\%] + [\$200\text{k nonbus. Income} * 50\%]$$

$$B = [\$1\text{M bus. Income} * 0.500000 * 50\%] + [0]$$

Note: If the tangible property had been in Ohio, they would each have \$350k Ohio income.

Nonbusiness Income: What is it?

Example, cont'd:

Thus, the resident may wish to call the gain business income while the nonresident may wish to call the gain nonbusiness income.

Unitary PTE's & Nonresident Credits

Reporting Nonbusiness Income

Instructions for Form IT 4708 state that if any income is shown on Line 4, the pass-through entity should provide

- i. A schedule listing the type and amount of each item,
- ii. A statement explaining why each item is nonbusiness income, and
- iii. A list of states for which the pass-through entity treats the income as business income.

Unitary PTE's & Nonresident Credits

Does the Department have the authority to combine PTE's which are unitary?

(Do taxpayers?)

Unitary PTE's & Nonresident Credits

Consider the following scenario:

Two nonresident individuals (M_1 and M_2) operate an LLC outside Ohio (LLC_{EV}). This year the nonresidents organize in Ohio a separate LLC (LLC_{OH}). M_1 and M_2 share equally in profits and losses. LLC_{EV} is quite profitable, but LLC_{OH} has a small loss. The LLC's are unitary.

Unitary PTE's & Nonresident Credits

If each nonresident individual, when computing the nonresident tax credit, is not required to combine, then each nonresident will owe no Ohio income tax.

But if ODT has the authority to combine, then the nonresidents will owe Ohio income tax.

Unitary PTE's & Nonresident Credits

LLC_{EV}:

FAGI = \$1,000,000

Ohio ratio = 0.000000

Assume all business
income

LLC_{OH}:

FAGI = (\$100,000)

Ohio Ratio = 1.000000

Assume all business
income

Unitary PTE's & Nonresident Credits

If *not* combined, then M_1 and M_2 will each calculate their nonresident credit as follows:

From LLC_{EV} : $\$1M * 0.000000 * 50\% = \0 Ohio income

From LLC_{OH} : $(\$100,000) * 1.000000 * 50\% = (\$50,000)$, no Ohio income

Unitary PTE's & Nonresident Credits

If combined, then M_1 and M_2 will each calculate their nonresident credit as follows:

$$[1,000,000 + (\$100,000)] * 0.500000 * 50\% = \\ \$225,000 \text{ Ohio income}$$

The Ohio ratio of 0.500000 assumes the factors of each LLC are equally weighted.

Unitary PTE's & Nonresident Credits

If the facts are reversed (LLC_{EV} is a loss, LLC_{OH} is profitable), then it would be to the members' advantage to combine.

Unitary PTE's & Nonresident Credits

So... can ODT require taxpayers or may taxpayers, on their own volition, combine unitary pass-through entities for purposes of the nonresident credit?

R.C. 5747.21(C)

Unitary PTE's & Nonresident Credits

R.C. 5747.21(C):

If the allocation and apportionment provisions of sections 5747.20 to 5747.23 of the Revised Code or of any rule adopted by the tax commissioner, do not fairly represent the extent of business activity in this state of a taxpayer or pass-through entity, the taxpayer or pass-through entity may request, **which request must be in writing accompanying the return** or amended return, or the tax commissioner may require, in respect to all or any part of the business activity, if reasonable, any one or more of the following:

Unitary PTE's & Nonresident Credits

R.C. 5747.21(C), cont'd:

1. Separate accounting;
2. The exclusion of one or more factors;
3. The inclusion of one or more additional factors which will fairly represent the business activity in this state;
4. The employment of any other method to effectuate an equitable allocation of such business in this state.

An alternative method will be effective only with approval of the tax commissioner.

Unitary PTE's & Nonresident Credits

Form IT 2023:

“Income Allocation and Apportionment,
Nonresident Credit and Part-Year Resident
Credit”

Unitary PTE's & Nonresident Credits

Instructions for IT 2023 state that the form assumes that the taxpayer has either

- i. A distributive share from only one PTE, or
- ii. Distributive shares from multiple PTE's that are unitary.

Agenda

- Resident Credit for pass-through entity income tax paid to another state
- Sales of Ohio businesses by Nonresident Owners: R.C. 5747.212
- Nonbusiness Income: What is it?
- Application of Unitary Principles to Combine Pass-Through Entities For Purposes of the nonresident Credit

Ohio Revised Code Section 5747.212



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- Impacts the calculation of the nonresident credit when there is a sale of a closely-held business
- Impacts the calculation of the tax on form IT-4708 (but not IT-1140) when there is a sale of a closely-held business.

Ohio Revised Code Section 5747.212



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- The law requires that gain (loss) from the sale/exchange of debt and equity of closely-helds is apportioned to Ohio based upon the last three years' apportionment ratio of the business.
- “Closely-held” = directly or indirectly owning 20% of the “equity voting rights” at any time during the three-year period ending on the last day of the taxable years.

Dissecting Revised Code Section 5747.212



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- Applies to the sale of an investment in a business such as stock in a corporation or a membership interest in an LLC
- Does not apply to a sale of assets by the business entity itself

Dissecting Revised Code Section 5747.212



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- (B) A taxpayer, directly or indirectly, owning at any time .
..
- R.C. 5747.212 is silent on the meaning of “directly or indirectly”
- Does a taxpayer “indirectly” own stock actually owned by a spouse or child? Under federal tax law, this would be “constructive” ownership.

Dissecting Revised Code Section 5747.212



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- R.C. 5747.221, which describes allocation and apportionment for an “investment pass-through entity” expressly provides that an indirect investment includes constructive ownership under IRC sections 267, 318 and 1363.
- What conclusion is reached from the omission of this language in R.C. 5747.212?
- If H owns 19% and W 1% does R.C. 5747.212 apply to either or both of them?

Dissecting Revised Code Section 5747.212



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- (B) . . . “at any time during the three-year period ending on the last day of the taxpayer’s taxable year at least twenty percent of the equity voting rights of a section 5747.212 entity”
- So if T owned 100% before 2007, sold 85% in 2007 and sold the remaining 15% in 2009, R.C. 5747.212 would apply to both the 2007 and 2009 sales.

Dissecting Revised Code Section 5747.212



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- Note: For R.C. 5747.212 to apply, T must own at least 20% of the equity with voting rights.
- If T owns only 10% of the voting rights R.C. 5747.212 does not apply even if ownership of nonvoting equity causes him to own a large proportion of total equity.
- But if the 20% voting threshold is met, then gain on sale of both nonvoting equity and debt are swept in.

*Dissecting Revised Code Section
5747.212*



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- (B) . . . Shall apportion any income, including gain or loss . . . as prescribed in this section.”
- Apportionment using the average of the entity’s apportionment fractions for the current year and two previous years.
- If the entity was not in business for one or more of those years, such years are excluded in calculating the average.

What is a Section 5747.212 Entity?

- (C)(1) . . . Any qualifying person if, on at least one day of the three-year period ending on the last day of the taxpayer's taxable year, any of the following apply:
 - (a) the qualifying person is a pass-through entity.
 - (b) five or fewer persons directly or indirectly own all the equity interests, with voting rights, of the qualifying person.
- So, under (b) R.C. 5747.212 can apply to the sale of stock in a C corporation.

Dissecting Revised Code Section 5747.212



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- (c) One person directly or indirectly owns at least fifty percent of the qualifying person's equity interests with voting rights.
- This can also include a C corporation.

- Example: During 2007, 2008 and 2009 T, a nonresident of Ohio, owned 20% of the voting stock of X Corp. The remaining 80% was owned by 80 unrelated individuals each of whom owned 1%. In 2009 T sold his stock in X Corp. Does R.C. 5747.212 apply?
 - Yes, if X Corp. was an S corporation at any time during the 3-year period.
 - No, if X Corp. was a C corporation throughout the 3-year period (because it was not a “Section 5747.212 entity”).

*Dissecting Revised Code Section
5747.212*



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- (C)(2) A “qualifying person” is any person other than an individual, estate or trust.

Is R.C. 5747.212 Unconstitutional?

Ohio

Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- *Meadwestvaco Corp. v. Illinois Dept. of Revenue* 128 (S.Ct. 1498 (2008)).

Facts in Mead

- Parent company Mead based in Ohio.
- Lexis management team in Illinois.
- Mead sold its Lexis/Nexis division (not subsidiary) at capital gain of \$1B.
- Illinois sought to tax an apportioned part of Mead's gain in sale.
- Mead argued that gain was nonbusiness income not taxable in Illinois.

Supreme Court Holding in Mead



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- Illinois cannot tax Mead's gain on sale unless the businesses of Mead and Lexis were unitary.
- This is so even though Lexis obviously transacted substantial business in Illinois.

How Might Mead Apply to R.C. 5747.212?



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- For Ohio to tax a nonresident's gain on sale of an ownership interest in a business must there be a unitary relationship between the nonresident and the business?
- If Yes, under what set of facts might this relationship exist?

Is R.C. 5747.212 Unconstitutional?

- Nonresident conducting a Sole Proprietorship business which is Unitary with the business of the entity being sold.
- Nonresident conducting no personal business and mere investor in business of the entity being sold.

Resident Credit For Pass-Through Entity Income Tax Paid To Another State

Resident Credit



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- R.C. 5747.05(B) allows credit for amount of adjusted gross income “subjected to an income tax in another state”.

Resident Credit



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- The tax paid to another state must be an income tax or a tax measured by net income.
- Michigan Single Business Tax Held Not Income Tax or Tax Measured by Income: Ardire v. Tracy, (1997) 77 Ohio St. 3d 409.

Resident Credit

- Credit is computed with respect to income “subjected to” tax, need not be amount actually taxed.
- Brachman v. Limbach, (1990) 52 Ohio St. 3d 1.

Resident Credit

- Application of Credit to Investors in Pass-Through Entities.
- Information Release IT 2006-02 Regarding Credit For Kentucky Income Tax.

Resident Credit



Department of
Taxation

Taft/

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- To receive credit, tax must be imposed on the taxpayer by another state, R.C. 5747.05(B)(2).
- Information Release holds that under Kentucky PTE tax effective in 2005 (and repealed effective 2007) the tax was imposed on the entity.

- The Information Release Incorrectly Interprets the Kentucky Law
- Distributive shares continue to be subject to Kentucky income tax in hands the investor and the investor receives a credit for his share of the tax paid by the entity. Thus, except for a small rate differential, the Kentucky scheme is a standard withholding system.
- Kentucky law further provided that the investor could file an agreement to be personally liable for the tax.

- Information Release also denies the credit under R.C. 5747.05 (B)(4)

(B)(4) No credit shall be allowed . . . if the taxpayer, when computing federal adjusted gross income, has directly or indirectly deducted, or was required to directly or indirectly deduct, the amount of that income tax.

Resident Credit



Department of
Taxation

Taft /

Taft Stettinius & Hollister LLP

Cincinnati / Columbus / Cleveland / Dayton / Indianapolis / Northern Kentucky / Phoenix / Beijing

- The Information Release Incorrectly Concludes that, under federal income tax law, the Kentucky tax is required to be deducted on a Form 1065 or 1120S.

- Treasury Regulation 1.62-IT(d) provides in relevant part:

To be deductible for the purposes of determining adjusted gross income expenses must be those directly, and not those merely remotely, connected with the conduct of a trade or business. For example, taxes are deductible in arriving at adjusted gross income only if they constitute expenditures directly attributable to a trade or business or to property from which rents or royalties are derived. Thus, property taxes paid or incurred on real property used in a trade or business are deductible but state taxes on net income are not deductible even though the taxpayer's income is derived from the conduct of a trade or business.

Resident Credit

- Although not cited in the Information Release, the Release appears to be based upon Revenue Ruling 58-25 involving Cincinnati income tax.
- The ruling holds that Cincinnati income tax imposed on a sole proprietor was not deductible from adjusted gross income in accordance with the regulation.
- But because the Cincinnati tax applied at the entity level to a partnership the partnership could deduct it as an expense on the partnership tax return.

- The better view is that the state tax paid by a partnership should be treated as a “separately stated item” on the partnership return, not deducted as an expense.
- Treasury Regulation 1.702-1(a)(8)(ii) provides

Each partner must also take into account separately the partner’s distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner does not take the item into account separately.
- Taking the deduction on the partnership return reduces the partner’s AGI whereas separately stated it is an itemized deduction.

Resident Credit

- Comparable provisions for separately stated items are in S Corporation statutes.