Beware non-Ohio residents:
If you sell debt or equity of an Ohio business, be prepared to pay tax on the gain!

Surprisingly, Ohio has a *Rule* that has the potential to be very costly to non-Ohio residents. Specifically, the *Rule* applies to the sale of debt or equity in certain Ohio businesses. The non-Ohio resident who sells either a closely-held pass-through entity or closely-held C corporation is expected to pay a hefty tax to Ohio on the capital gain in Ohio. The *Rule*, which is partially contained in Ohio Revised Code Section 5747.212, is the subject of much debate among Ohio tax practitioners. There are many details to the *Rule*, which is described in this Alert, but suffice it to say, the *Rule* should be thoughtfully considered by any non-resident who is considering the sale of an Ohio entity that is a "section 5747.212" entity.

The following example demonstrates how the *Rule* works:

Assume you are a Florida resident who owns 100% of an S corporation that is doing business in Ohio. You, as an individual, have never set foot into Ohio. Your S corporation, however, generates income that is treated as Ohio-sourced income because some of the S corporation's property, payroll, and sales are in Ohio. For purposes of this example, assume that the S corporation's income, on average, for the last three years was sitused 80% to Ohio and 20% to other states.

A potential purchaser approaches you to inquire if you are interested in selling 100% of your S corporation stock. If the transaction closes, you expect to generate a capital gain of $10 million on the sale of such S corporation stock. As a non-resident of Ohio, you would ordinarily assume that the capital gain from the sale is only taxed to the state of residence. Since Florida does not impose a personal income tax, you probably assume that you will not owe any state income tax on the capital gain from this sale of stock.[1]

Unfortunately, the *Rule* requires that you pay personal income tax to Ohio as though you earned 80% of the capital gain in Ohio (based on the S corporation's business presence in Ohio over the last three years, assumed as 80% for this example). Accordingly, unless certain planning is accomplished prior to the sale, you would owe approximately $480,000 of personal income tax to Ohio ($10 million x 80% x Ohio tax rate of approximately 6%).

Closely-Held *Rule* Analysis

Rule only applies to Non-Ohio residents

The *Rule* only applies to non-residents of Ohio.[2] Recall, that if you are a resident of Ohio for personal income tax purposes, you will owe Ohio personal income tax on 100% of the capital gain on the sale of stock, prior to Ohio credits, if any.

Target entity that will be sold by a shareholder – is it a "section 5747.212 entity"?

The first step of the analysis is to determine if the target entity is a "section 5747.212 entity." Any pass-through entity (for example an S corporation, partnership, limited liability company, and other forms of flow-through business entities treated as pass-through entities for Ohio tax purposes) is considered a "section 5747.212 entity." Certain closely held C corporations are also considered as "section 5747.212 entities." A "section 5747.212 entity" includes a C corporation which either:

(1) Has five or fewer owners of all the equity voting rights, or

(2) Has one owner that holds 50% or more of the equity voting rights of the entity.

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If you determine that the target entity is a "section 5747.212 entity," then you move to the next step of the analysis of the *Rule*.

Are you a Tainted Shareholder?

The second step of the analysis is to determine if you, as the purported seller of debt or equity of the "section 5747.212 entity," are a tainted shareholder.[3] Any person that, at any time in the last three years, owned, directly or indirectly, at least 20% of the equity voting rights of a "section 5747.212 entity," is a tainted shareholder.[4]

Which stock sold is subject to the *Rule*?

If you have determined that the target is a "section 5747.212 entity," and that you are a tainted shareholder, then you are subject to the *Rule* and you will be required to pay Ohio tax on the capital gain from the sale of any of the tainted shareholder's stock in the "section 5747.212 entity," including capital gain on the non-voting stock and including even de minimis amounts of stock sold.

How is the Ohio taxable share of the capital gain from the sale of the stock computed?

The portion of the gain that is taxable to Ohio is computed by reference to the target entity's Ohio apportionment fractions for the last three years. The Ohio apportionment fraction is a technical state tax term of art, which seeks to measure the amount of a business' presence in Ohio, by measuring the business' property, payroll, and sales in Ohio as compared to the business' property, payroll, and sales everywhere. In Ohio, the sales factor is most heavily weighted, making the location of the target's customers most relevant to the computation of the entity's apportionment fraction in most circumstances.

For example, assume that the Ohio apportionment fraction for the business was 70%, 80%, and 90% for the last three years, respectively. The *Rule* looks to the average of those three fractions (80%) and requires that the tainted shareholder's sale of stock in a "section 5747.212 entity" be treated as though the tainted shareholder earned 80% of the capital gain from the sale of that stock in Ohio. The shareholder is therefore required to effectively pay income tax to Ohio on 80% of the capital gain relating to the sale of any of the shareholder's stock in the "section 5747.212 entity."

How is the Ohio tax related to the application of the *Rule* computed on the Ohio income tax return?

The Ohio tax is effectively computed under the Ohio non-resident credit computation, by reference to the Ohio Tax Form 2023 and the Ohio Tax Form IT-1040.

Potential solutions

There are certain planning options that may reduce the Ohio tax impact of the *Rule*. Prior to taking any action regarding the analysis above, you should ensure that all aspects of the *Rule* and any planning alternatives have been explored.

Conclusion

Our attorneys have experience in tax planning and tax controversy related to the *Rule* and how the Ohio Department of Taxation interprets the *Rule*.

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[1] Compare a Florida individual that sells stock of ACME Corp, a publicly traded company that is not subject to the *Rule*. Even though ACME Corp has Ohio property, Ohio sales, and Ohio payroll, the Florida individual would not owe Ohio tax on the capital gain relating to the sale of the ACME Corp. intangible because generally the sale of an intangible is only taxed, for state tax purposes, by the individual's state of residence.
[2] The determination of whether an individual is a non-resident of Ohio for personal income tax purposes is complex and is not the subject of this Alert.

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[3]The term “tainted shareholder” is not used in the Ohio Revised Code, but is used here for simplicity.
[4]It is not clear under Ohio law whether attribution rules apply such that a husband and wife that each own 10% would be deemed to own 20%. Other complex issues arise with respect to the proper interpretation of the term “directly or indirectly” in the context of the Rule.

If you have questions about how this *Rule* may impact the sale or purchase of a company, please contact:

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or any of our multistate tax or mergers and acquisitions attorneys by clicking on the links below:

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