Ohio General Assembly
Ohio House of Representatives
Representatives Jim Hoops and Craig Riedel

May 31, 2022

Chairman Blessing, Vice-Chairman Roegner, Ranking Member Williams and Senators of the Senate Ways and Means Committee, thank you for the opportunity for Representative Riedel and myself to provide sponsor testimony on H.B. 515, which aims to keep entrepreneurs in Ohio by clarifying the applicability of the "Business Income Deduction" ("BID") to the sale of a business.

The BID, first enacted in 2013 and fully phased in during 2015, provides that a taxpayer's first $125,000/$250,000 of business income is fully deductible, while the remaining amount of business income is taxed at a flat rate of 3% (now, approximately 1% less than the highest marginal tax rate of 3.99%). While the definition of the term "business income" has remained unchanged in the Revised Code since 2002, the Ohio Department of Taxation changed their interpretation of the word in 2018. Following the Ohio Supreme Court's Corrigan v. Testa decision (2016), after decades of applying the definition of "business income" as broadly as possible to ensure nonresidents pay Ohio personal income tax upon the sale of businesses with Ohio operations, the Ohio Department of Taxation ("ODT") changed its approach as to what constitutes business income in certain circumstances.

For example, ODT began making distinctions between a legal sale of assets versus a legal sale of an ownership interest; (a sale of assets is generally treated as generating business income). In many cases, the sale at issue is deemed an asset sale for federal income tax purposes even though it is actually the sale of the ownership interest. Since the adoption of the Ohio income tax in 1972, it had been ODT's practice to recognize federal tax treatment and elections, including Section 338(h)(10) which was enacted in 1982; this was until 2018, when ODT reversed this long-time practice and began to ignore this federal income tax election's impact on sellers (but not buyers) of a business.

ODT's new approach disadvantages Ohio-resident business owners, because its position may result in many sales being excluded from the BID – meaning that residents may be subject to a higher tax rate of almost 4.0% when selling their business, rather than the 3% flat tax rate (after deduction). ODT's approach has also provided nonresidents with a tool to assert that gains from the aforementioned type of sale are not taxable in Ohio at all. As a result, many Ohio business owners planning to sell their businesses are now being advised to become Ohio nonresidents, thereby potentially eliminating all tax on the sale of the business.

The current approach can also result in inconsistent treatment of a seller and buyer of the same business within the same transaction. For example, if Bob or Betty Buckeye sold the stock of an S corporation and made a federal election to treat the sale as a sale of assets, they would not get sale of asset treatment for Ohio purposes (i.e., BID treatment) even though the gain is measured as if it is an asset sale. However, ODT recognizes the federal election's impact on the buyer, who does get sale of asset treatment for Ohio tax purposes. This approach is not in line with the spirit of the BID and means that BID treatment depends on the legal structure of the sale, rather than the substance of the transaction. If someone sells their business one way—they will pay 33% more tax than if they sold it a different way. Why should our fellow Ohioans selling a business be forced to face a fat tax bill because they chose to remain a resident of the state we all know and love, rather than moving elsewhere prior to the sale?

A fix is before you today in H.B. 515. The language in front of you provides clarifying guidance to ODT and taxpayers that the BID treatment applies to both:

• A sale by a person who was actively involved in managing the business during the year of sale or previous five years; and

• A sale that is treated as an asset sale for federal tax purposes. This bill is simple and impactful. The passage of this bill would mean that at tax time, Ohio-resident business owners will not face an unexpected 33% increase in taxes.

The bill's passage would also protect those under audit or appeal, individuals likely unaware of ODT's 2018 change in interpretation and the resulting 60% increase in Ohio income tax (based on pre-2021 tax rates when the top rate was nearly 4.8% or higher) – this eliminates an incentive for business owners currently considering the sale of a business to move out of Ohio before selling.

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Thank you for the opportunity to testify today. We would be happy to answer any questions at this time.

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