Ohio | Department of Taxation

TAXPAYER NOTICE – Released March 29, 2017

Personal Income & Pass-Through Entity Tax: Meaning of "Indirect" Ownership

Introduction

Some of Ohio's income tax statutes, most notably those relating to the calculation of a taxpayer's distributive share of income from a pass-through entity, refer to "direct or indirect" entity ownership. *See e.g.* R.C. 5733.04(I)(12)(c), 5733.40(A)(3), 5733.40(A)(7), 5747.01(A)(20), 5747.01(BB)(5), and R.C. 5747.212. Of note, R.C. 5733.40(A)(7) (an Ohio corporation franchise tax provision made applicable to Ohio's income tax) states:

> For the purposes of Chapters 5733. and 5747. of the Revised Code, guaranteed payments or compensation paid to investors by a qualifying entity… shall be considered a distributive share of income of the qualifying entity. [This division] applies only to such payments or such compensation paid to an investor who at any time during the qualifying entity's taxable year holds **at least a twenty per cent direct or indirect interest** in the profits or capital of the qualifying entity.

The phrase "direct or indirect interest" is not expressly defined in Ohio law, nor is there any case law directly on point regarding the meaning of these terms. Most of the confusion regarding this provision stems from the meaning of the word "indirect"; it is generally accepted that "direct ownership" refers to an investor owning an interest in an entity.

> **Example 1:** Individual forms an LLC as its sole owner. Thus, the individual investor directly owns 100% of PTE A.

Conclusion

Based upon a reading of Ohio law and the analysis below, **the phrase "indirect ownership" must refer to a situation where the investor owns an interest in a PTE that owns an interest in another PTE**. "Indirect" ownership **does not** refer to a situation where an individual "constructively" owns an entity based on attribution rules contained in the Internal Revenue Code ("IRC").

> **Example 2:** Individual investor owns 100% of PTE A. PTE A owns 15% of PTE B. Thus, the individual investor directly owns 100% of PTE A, and indirectly owns 15% of PTE B (via PTE A).

Example 3: M and S are married. M owns 100% of PTE A. M directly owns 100% of PTE A. While S constructively owns 100% of PTE A, S **does not** indirectly own any portion of PTE A.

Analysis

Since "indirect ownership" is not expressly defined under relevant Ohio law, the analysis must turn to how the phrase is used in other applicable contexts. Of particular relevance is R.C. 5733.04(I)(12)(c).

This provision uses "directly" and "indirectly" but also includes the terms "beneficially" and "constructively." Furthermore, this provision expressly references attribution rules contained in IRC §318. Based on these facts, if the term "indirectly" is read to include the IRC attribution rules in addition to intermediate entity ownership, then it would encompass both indirect and constructive ownership, leaving the word "constructively" devoid of any meaning.

Thus, to give meaning to each of the words in R.C. 5733.04(I)(12)(c), "constructively" must mean "via the attribution rules of section 318" and thus "indirectly" cannot also have that same meaning. The unique meaning of "indirectly" must instead be the situation from Example 2, above. This meaning can then be applied to other similar provisions of Ohio's income tax code, such as R.C. 5733.40(A)(7), as the term "indirect" is from the same chapter that interplays with the same taxes (the corporation franchise tax and the income tax). Furthermore, it is important to note that R.C. 5733.40(A)(7) does not reference any provision of the IRC in any way, while other statutes that aim to make use of those provisions do refer to the IRC.

The Department would interpret the term "indirect"/ "indirectly" in this manner in any situation pertaining entity ownership contained in Ohio's income tax.

Guidance

While conducting audits of 2013 and 2014 individual income tax returns, it has come to light that, in the explanation of the small business investor deduction (the "SBD", applicable to tax years 2013 and 2014), an incorrect statement was made in publications and public presentations, as to the meaning of "indirect." It was stated that "indirect" would include IRC attribution rules, including those contained in IRC §318 and §1563. This was not correct. Several taxpayers and tax practitioners relied upon this guidance when filing said returns.

The Department did correct this guidance in presentations and publications. Of note, the instructions pertaining to Ohio's business income deduction (the "BID", applicable to tax years 2015 to present) have always stated that IRC provisions are inapplicable when determining if an individual "indirectly" owns an interest in an entity.

To rectify this situation, and with an equitable result in mind, the Department provides the following guidance:

- If a taxpayer has already filed an individual income tax return for tax years 2013 or 2014, and claimed the SBD based on reliance to the initial guidance related to the term "indirect" and IRC attribution, the Department will not challenge the filing position of the taxpayer.
- If a taxpayer has paid a bill or an assessment for additional tax liability resulting from that guidance, the taxpayer may file a refund claim as to this issue. Such refund claim must be filed within four years of the date the bill or assessment was paid.
- If a taxpayer files an original, or amended, return to claim the SBD for tax years 2013 or 2014, the term "indirect" is to be correctly interpreted in accordance with the analysis and conclusion detailed above.
- If a taxpayer files an original, or amended, return to claim the BID for tax years 2015 and beyond, the term "indirect" is to be correctly interpreted in accordance with the analysis and conclusion detailed above.