Increased enforcement of state tax rule for private equity and portfolio companies

The Ohio Department of Taxation’s Commercial Activity Tax (CAT) audit division has increased efforts to identify noncompliant out-of-state taxpayers that are not including all required members of consolidated or combined groups. This enforcement activity has identified many private equity groups and portfolio management companies.

Increased risks for groups
Entities held in a large ownership structure, such as private equity groups and portfolio management companies, face higher risk of being discovered by the department, because auditors have numerous ways to find them. For example, an auditor uniformly requests information regarding the taxpayer’s ownership structure and the identities of related entities. Such requests have revealed noncompliant private equity groups and portfolio management companies that may not be including all the correct entities. The division is also finding that these entities are not updating consolidated elections to reflect recent acquisitions and disposals or other changes to the corporate structure.

The CAT is a tax based on Ohio-sourced gross receipts. A company does not need to have a large Ohio presence to be subject to the tax and potentially have a significant liability.

Combined versus consolidated filings
A group of commonly controlled taxpayers that does not elect to file as a consolidated group for CAT will default to combined filing status. A combined taxpayer will not be permitted to eliminate intercompany gross receipts, but will pay tax only on the taxable receipts of the members that have substantial nexus in Ohio. Combined taxpayers must have more than 50 percent of the value of their ownership interest controlled by “common owners” included in the group.

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1. OHIO REV. CODE ANN. § 5751.012.
2. OHIO REV. CODE ANN. § 5751.012(A), (C).
3. OHIO REV. CODE ANN. § 5751.012(A).
Increased enforcement of state tax rule for private equity and portfolio companies (continued)

Alternatively, a group having at least 80 percent common ownership or having at least 50 percent of the value of its ownership interests owned or controlled, directly or constructively through related interest — by common owners during all or any portion of the tax period, together with the common owners can elect to file as a consolidated taxpayer. The group may elect to either include or exclude all foreign corporations meeting the elected ownership test. The election to file as a consolidated group must be made with the tax commissioner prior to the beginning of the first calendar quarter to which the election applies, and it will remain effective for at least the next eight calendar quarters. Under a consolidated filing, the group agrees to pay tax on all of the group’s taxable gross receipts even if one or more members in the group do not have substantial nexus with the state. A consolidated taxpayer can exclude gross receipts between its members, as well as gross receipts from most CAT-exempt entities.

To determine the identity of combined and consolidated groups, common ownership is determined by both vote and value. Consolidated taxpayers must have either at least 80 percent common ownership or 50 percent of the value of their ownership interest controlled by “common owners.” As companies are assessing the combined and consolidated rules, “control” is much more important than value when determining combination or electing consolidation.

Further, because the CAT is imposed on most businesses — regardless of the type of business organization (e.g., sole proprietorships, partnerships, LLCs, single-member LLCs, S corporations, qualified S corporation subsidiaries, corporations, trusts and other entities) — it can be complicated to determine whether a business that has noncorporate entities meets the common ownership tests. For corporations, only classes of stock with voting rights are used to determine ownership percentages. However, for limited partnerships, only the ownership of the general partnership interests will be considered. For partnerships and entities with membership interests or beneficial interests, ownership values are determined by the fair market value of the voting interest in these entities.

A member of a filing group can request to file separately, with the approval of the primary taxpayer in the group. If the request is granted by the tax commissioner, the member may file a separate CAT return but will not be entitled to any of the group’s $1 million exclusion from taxable gross receipts and will remain jointly and severally liable for the group’s tax liability. The election does not allow for separate group filings, only separate entity filings.

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4 OHIO REV. CODE ANN. § 5751.011. Contrast this standard with the more than 50 percent ownership threshold required for mandatory combined filing under OHIO REV. CODE ANN. § 5751.012(A).
5 OHIO REV. CODE ANN. § 5751.011(A)(1).
8 OHIO REV. CODE ANN. § 5751.011(C).
9 OHIO ADMIN. CODE § 5703-2902(D)(1).
10 OHIO ADMIN. CODE § 5703-2902(D)(2).
11 OHIO ADMIN. CODE § 5703-2902(D)(3).
If a member or subset of members is filing CAT returns but has not properly included all members within the controlled group, such member or subset of members could be considered noncompliant and would be liable for any additional taxes that may be owed. If a group of members had been filing under a consolidated election, the election could possibly be held out as being impermissible, since all members were not included and the election was incomplete. This would result in the requirement to pay tax on previously eliminated receipts. If multiple subsets of members within a larger controlled group have been filing CAT returns, all exclusion amounts taken (the $1 million in taxable gross receipts) would be disallowed, because only one exclusion of $1 million is permitted per taxpayer group. While the elimination of the $1 million exclusion amount in isolation may not appear to yield a material amount of CAT liability, large private equity funds with numerous separate filing groups may be significantly affected upon combination.

Management fees paid to private equity owners
An additional area of risk can result if a group of companies does not make a proper consolidation election. Any intercompany transactions — including management fees, royalties and franchise fees — would not be allowed to be eliminated because of the incorrect election and, as a result, could be subject to the CAT. This can be a significant problem because management fees are sourced based on where the benefit is received. A management fee paid to a parent company with Ohio operations may be an Ohio taxable receipt for Ohio CAT purposes.

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