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Tax break for business owners won't help Ohio economy

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Key findings

- The new tax break would be the second largest in Ohio.
- Most qualifying business owners do not employ anyone except themselves; a tax cut is unlikely to change that
- Since the 2005 income-tax cuts, Ohio small businesses have not grown as much as their counterparts across the nation.
- One-fifth of the new break would go to out-of-state investors.
- It would create a new avenue for tax avoidance.

The Kasich administration has proposed a major new income-tax break for owners of Ohio businesses. These include a variety of different kinds of businesses, but they have one thing in common: Ohio does not tax the businesses directly on their profits, but rather as the profit passes through to the individual income tax returns of the owners. Hence, they are called "passthrough entities."

A recent study by Michael Mazerov of the Center on Budget and Policy Priorities explains that state income-tax cuts won't help small businesses create jobs, and this one is unlikely to, either. This brief, which should be read together with the Mazerov study, provides Ohio data relevant to the Kasich proposal.[1]

The proposed business-income tax exclusion would allow owners to exempt from taxation half of their share of income from such passthrough entities as S Corporations, limited liability companies, partnerships and sole proprietorships, up to a maximum of $750,000 a year. Each individual owner of the business would be eligible for a tax break of this size. Overnight, this would create the second largest exemption in Ohio's tax system, costing more than $600 million annually. The tax break could create new problems. It also won't work for the following reasons:

- Most qualifying taxpayers don't employ anyone besides their owner now and are unlikely to in the future merely because they get a tax cut.
- Since the 21 percent reduction in state income taxes approved in 2005, Ohio has underperformed the nation in small-business growth. There is little reason to believe that another round of tax cuts will produce a different result.
- The vast majority of business owners who benefit will get too little tax savings to add employees in any meaningful way.

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[1] Mazerov, Michael, "Cutting State Personal Income Taxes Won't Help Small Businesses Create Jobs and May Harm State Economies," Center on Budget and Policy Priorities, Feb. 19, 2013, at http://bit.ly/YDQrTw.

- One-fifth of the tax savings will go to investors outside Ohio who own stakes in Ohio businesses, many of whom are likely to be passive investors in the business without any authority to decide whether the firm creates new jobs.
- While billed as a cut in taxes for small business, it would go also to owners of big businesses, as well as hundreds of partners in Ohio's largest law firms and other partnerships. This is misdirected and doesn't help small businesses.
- It opens up the potential for new abuse of the tax system, since it will create an incentive for the owners of passthrough businesses to reclassify their income as "profit" – half of which will go untaxed – rather than "salary."

The proposed tax break also would further tilt Ohio's state and local tax system in favor of the most affluent. According to an analysis by the Institute on Taxation and Economic Policy, a nonprofit research group, more than half of the income-tax cut going to Ohioans would flow to those in the top 1 percent of taxpayers, who make more than $335,000 last year.[2]

The proposed business-profit exclusion will do little for Ohio's economy, while draining more than $600 million a year from public services. The General Assembly should remove it from the budget.

[2] Schiller, Zach, "Kasich tax proposal would further tilt tax system in favor of Ohio's affluent," Policy Matters Ohio and Institute on Taxation and Economic Policy, February 7, 2013. www.policymattersohio.org/tax-policy-feb2013.