Policy Matters Ohio

POLICY BRIEF
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Taxes & Budget

Ohio legislators need to plug a hole in the tax system

The state should decouple from federal tax breaks for affluent business owners

Zach Schiller

Last spring, Congress approved some costly income-tax breaks that will give a generous boost to a small group of the most affluent taxpayers. And if Ohio's legislators don't act soon to decouple the Ohio tax code from the tax giveaways made in the CARES Act, those tax breaks also will ripple through Ohio's personal income tax collections to cause tens of millions of dollars in losses for the state's already wobbly budget. The Ohio Department of Taxation estimates that the cost will be $158.2 million in the current fiscal year, and another $49.2 million next year.[1] That's money that instead should be going to keeping the budget in balance, covering the costs of the pandemic and expanding opportunity for all Ohioans.

Here's what happened: Under the Coronavirus Aid, Relief and Economic Security (CARES) Act approved last March, Congress suspended restrictions on the ability of businesses and their owners to use business losses to reduce tax liability that had been put in place by the Tax Cuts and Jobs Act (TCJA) passed in 2017. Before the TCJA was enacted, an owner of a partnership, an S Corporation, sole proprietorship or limited liability company (known as passthrough businesses because their owners pay personal income taxes on profits as they pass through to them) could deduct an unlimited amount of losses from those businesses to offset investment income. The TCJA limited that to $250,000 for an individual and $500,000 for a married couple, but the CARES Act suspended those limits – and did so retroactively for 2018 and 2019 as well as for 2020. This change exclusively benefits affluent taxpayers. The Joint Committee on Taxation estimated that almost 82% of that would go to 43,000 taxpayers with incomes over $1 million,[2] who on average would get a tax cut of $1.6 million.

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[1]Estimates based on emails received Oct. 30, 2020, and Nov. 9, 2020, from Gary Gudmundson, Ohio Department of Taxation (ODT), in response to requests. ODT's estimates rely on estimates from the U.S. Joint Committee on Taxation.
[2] Barthold, Thomas A., Joint Committee on Taxation, Letter to Sen. Sheldon Whitehouse and Rep. Lloyd Doggett, Apr. 9, 2020, at https://www.whitehouse.senate.gov/imo/media/doc/116-0849.pdf

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Tens of millions at stake

Because the Ohio General Assembly passed House Bill 197 last March conforming to the CARES Act provisions, the loosening of these limits will directly reduce how much the state collects in personal income tax over the next couple of years. The taxation department estimated the cost of this provision alone at $134.6 million in Fiscal Year 2021 and another $41.9 million next fiscal year. When the General Assembly acted, within days of when the CARES Act was signed into law, it did not have these estimates of the cost of conforming.[3]

Among those who will benefit from this provision are hedge fund investors and real estate developers who are able to report losses that exist only on paper. As one tax expert explained, one example "involves real estate investors who collect a tidy profit on rental income but report losses as a result of deductions for interest payments on debt and deductions for "depreciation" even though the properties they own are actually appreciating in value."[4] A business owner who pays themselves a high salary could then report a loss for the business, and use it to take advantage of this new tax break.

Two other related provisions in the CARES Act also will drain Ohio's public revenue. One allows corporate and passthrough business losses to be used to offset profits in past years. This means losses in the current year can be used to offset prior-year profits. And refunds are allowed for taxes paid going back to 2013. The other lifts a cap imposed under TCJA on how much of corporate and passthrough business losses may be used to offset profits in future years. TCJA had limited such carryforwards to 80% of current year profits, but the CARES Act removed that limit. Owners of a business that had a loss last year will be able to deduct all of that loss against profits this year. That means owners of a business that did poorly last year but recovered to make money in 2020, during the pandemic, will be beneficiaries. Are these the business owners who are truly in need of tax relief? The Ohio taxation department estimated the cost of these two provisions at $23.5 million this fiscal year and $7.3 million next year.

Since all three of these provisions are retroactive to 2018 and 2019, this means that millions of dollars of refunds may be paid out for losses that have nothing to do with

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[3] See Ohio Legislative Service Commission, Fiscal Note & Local Impact Statement, H.B. 197, 133rd General Assembly, As Enacted, March 31, 2020, at https://www.legislature.ohio.gov/download?key=13596&format=pdf. The state taxation department confirmed that the ODT estimates were not finalized prior to HB 197 passage. It noted that HB 197 was effective on March 27, while the U.S. Joint Committee on Taxation's first publication of estimated revenue effects of the CARES Act (see https://www.jct.gov/publications/2020/jcx-11-20/) is dated March 26. Email from Gary Gudmundson, Nov. 9, 2020.

[4] Wamhoff, Steve, "The CARES Act Provision for High-Income Business Owners Looks Worse and Worse," Institute on Taxation and Economic Policy, Apr. 24, 2020, at https://itep.org/the-cares-act-provision-for-high-income-business-owners-looks-worse-and-worse/

Covid-19. While it's dense to follow, the fact is Ohio is going to lose tens of millions of dollars of badly needed revenue in the short term mostly to the richest taxpayers, some of it for losses that aren't even real.

Expanding on the $1 billion LLC Loophole

Ohio doesn't have a state corporate income tax, so it won't suffer some of the revenue losses other states do. However, owners of passthrough businesses will benefit. These are not small corner stores or neighborhood dry cleaners. In fact, Ohio already has a special state tax break for passthrough business owners under which they don't have to pay income tax on the first $250,000 in such income, and pay a lower rate than they otherwise would on business income over that amount.[5] This break, often known as the LLC Loophole, already is costing the state more than $1 billion a year.

The Ohio Department of Taxation pegged losses from these provisions at $158.2 million this fiscal year, which is when those who benefit from refiling their taxes for 2018 and 2019 are likely to receive the extra boost.

Act fast to save millions

If the General Assembly acts with dispatch, it may be able to prevent some of those losses, since many such taxpayers only file such returns by Oct. 15 and the taxation department hasn't likely processed all of them yet. If these CARES Act changes are disallowed retroactively, filers could amend their returns again and repay the money. That's fair: These filers were happy to file an amended return when it benefited them. The General Assembly could offer a three-year payback plan for anyone affected, so they wouldn't have to repay immediately, and do so without any interest or penalties.

Even if it doesn't crack down early enough to prevent the losses in this year's tax filings, the legislature should plug these loopholes to cut losses in Fiscal Year 2022. The taxation department estimated losses next fiscal year at $49.2 million. In fact, decoupling from the federal law will not deny a large number of these taxpayers from benefiting from these deductions in future years. Losses in 2018, 2019 and 2020 affected by decoupling from the federal law can be carried forward as deductions against future profits or investment income in future years. Legislative action will prevent these losses now, when the state can least afford them.

Ohio budget director Kimberly Murnieks said Nov. 5, "Economists are not expecting state revenues to recover to Calendar 2019 levels till probably 2023 or 2024. That is

[5] Schiller, Zach, "Closing the LLC Loophole," Policy Matters Ohio, May 29, 2019, at https://www.policymattersohio.org/research-policy/quality-ohio/revenue-budget/tax-policy/closing-the-llc-loophole

a long time. We will be dealing with the effects of COVID for several years. It will be a rocky ride."[6] Ohio can ill afford to give tens of millions of dollars away for these tax breaks now. Five states – Colorado, Georgia, Hawaii, New York and North Carolina – have decoupled from these provisions of the CARES Act already. Ohio lawmakers weren't fully aware of the consequences when they acted in March. They should now follow the lead of these states and decouple immediately.

[6] Comments at Impact Ohio conference, Nov. 5, 2020