Policy Matters Ohio

October 2018

Revenue & Budget

# Loopholes in a loophole

## Affluent Ohioans get tax credits intended for those who aren't

Zach Schiller
Wendy Patton

Policy Matters Ohio

Tens of thousands of upper-income Ohioans are qualifying for tax credits that seemingly are limited to those who have much lower incomes. It's all legal – and it's probably costing the state millions of dollars a year.

Ohioans are eligible for certain income-tax credits only if their income is below a certain level. Other credits and exemptions vary based on income, with a higher credit or exemption going to those below certain income cut-offs. However, upper-income Ohioans who claim the business income deduction – also known as the LLC loophole – are able to sidestep these limits and claim larger credits and exemptions even though they make far more than the eligibility thresholds seem to suggest. It all hinges around how "income" is defined.

For example, the $20 personal exemption credit is limited to taxpayers with income under $30,000 a year, including certain other additions and deductions, and the exemptions you get for yourself and your dependents. Yet 28,433 income-tax filers claimed a business income deduction of at least $100,000, and also claimed the $20 personal exemption credit in tax year 2016. How did these taxpayers manage it? Because since passage of the LLC loophole, the first form of which was approved in 2013, business income up to $250,000 is not included in the definition of income in determining who is eligible. These credits are figured based on what's called Ohio Adjusted Gross Income (OAGI), which is the amount you report for federal income tax purposes, along with certain additions and deductions.[1] These are reported on Schedule A of the tax form. Additions include federal interest and taxes subject to state taxation, for example. Deductions include qualifying Social Security benefits. One of the deductions is for business income up to $250,000, which is available to owners of businesses like limited liability companies, S Corporations and partnerships known as passthrough entities, so named because their income is taxed as it passes through to its owners.

Here's an example: A taxpayer with two dependents had business income of $150,000 and other, non-business income (say, wages from a job) of $30,000. In determining eligibility for the $20 credit, the taxpayer would deduct the $150,000. After then taking three personal exemptions, worth $2,250 each in 2016, income for the purpose of the credit would be just $23,250. The taxation department calls this amount – Ohio Adjusted Gross Income minus personal exemptions – the Ohio income tax base. This hypothetical taxpayer would be able to claim $60 in nonrefundable personal exemption credits ($20 each for the taxpayer and her two dependents).

**Which credits and exemptions are involved?**

The personal exemption credit is only one of many credits and deductions that high-income taxpayers can take because they can deduct up to $250,000 in business income. Others include:

- The retirement income credit and the $50 senior citizen credit,[2] both of which require an Ohio income tax base of less than $100,000;

[1] For a list of all these additions and deductions, see Schedule A of the Ohio IT 1040 Form.
[2] Also included are the lump sum retirement credit, when a taxpayer receives the entire balance of a pension, retirement or profit-sharing plan in one year, and the lump sum distribution credit, which is available for those over 65 who receive a lump sum distribution of a pension, retirement or profit-sharing plan. Each have similar income limitations.

- The joint filing credit available to the taxpayer and his or her spouse, which varies up to $650 based on Ohio income tax base but begins shrinking when income exceeds $75,000;
- The child and dependent care credit, which is based on a federal dependent care credit and provides credit for paying child care or dependent care expenses. The amount varies based on income, but is limited to those with adjusted gross income below $40,000; and
- The personal exemption, which in 2016 came to $2,250 for those with adjusted gross income of $40,000 or less; $2,000 for those with more than $40,000 in income but no more than $80,000, and $1,750 for those with income above $80,000 (figures are adjusted for inflation and have grown since then).

A table in the Appendix describes these credits and exemptions and eligibility for them.

The business income deduction is one of a variety of deductions that allow taxpayers to qualify for means-tested credits even when they have higher income. What's different about the business income deduction is how large it can be. Taxpayers can also deduct Social Security, reducing their stated income and allowing them to get other means-tested credits. But the business income deduction can be many times as large, allowing them to deduct far more and giving much wealthier filers access to credits meant for those with lower incomes.

**Who benefits and how much?**

In response to a request, the Ohio Department of Taxation provided the number of taxpayers who claimed both a business income deduction of more than $100,000 and these credits or exemptions in Tax Year 2016. Tens of thousands of taxpayers did. The number ranged from 1,093 for the child care and dependent care exemption to 87,339 for the personal exemption.

Policy Matters estimated the cost of these credits and exemptions in Table 1 below. Though some can't be precisely estimated, the cost altogether could add up to more than $4.9 million. Estimates are generally based on the average amounts that claimants for each credit received for Tax Year 2016.[3] For example, the estimate for the $20 personal exemption credit is based on each of the 28,433 filers with a $100,000 business income deduction receiving a $20 credit for themselves and their dependents; separate data from the taxation department shows that the average filer had 1.84 personal exemptions. So the estimated total cost of that credit is $1,046,334. For more detail on how we figured the savings for other means-tested credits and exemptions, see the Appendix.

[3] See Ohio Department of Taxation, Tax Data Series, Individual Income Tax: 2016 IT-1040 Tax Returns, by Income Class, at https://www.tax.ohio.gov/tax_analysis/tax_data_series/individual_income/publications_tds_individual/Y1TY16.aspx

| Table 1 | | |
|---|---|---|
| **Taxpayers claiming a business income deduction greater than $100,000 who also claimed other means-tested credits, Tax Year 2016** | | |
| **Credit or exemption** | **Number claiming credit of those who claim business income deduction over $100,000** | **Estimated savings to taxpayers; cost to state** |
| Child care and dependent care credit | 1,093 | $295,810 |
| Retirement income/lump sum credit* | 5,867 | $1,040,630 |
| $20 personal and dependent exemption credit | 28,433 | $1,046,334 |
| $50 senior citizen/lump sum credit* | 8,319 | $415,950 |
| Personal exemption | 87,339 | $261,584 |
| Joint filing credit | 30,546 | $1,844,673 |
| Total | -- | **$4,904,981** |

*Source: Policy Matters Ohio. Number of those claiming credits based on data provided by Ohio Department of Taxation in e-mail Feb. 8, 2018. Savings estimated based on taxation department data on average savings of filers claiming these credits. Savings on personal exemption based on conservative 1 percent tax rate. See appendix for details on savings estimate methodology.*
**Includes those receiving the lump sum credits that complement the retirement income and $50 senior citizen credits, respectively*

The estimates shown in Table 1 could overstate the savings these taxpayers saw (and the cost to the state) for a couple of reasons. All of the credits are nonrefundable, so they only mean something if the taxpayer has tax liability. If a taxpayer doesn't owe enough to the state to fully take advantage of these credits, not all of them would be used.[4] For instance, if a taxpayer has only business income and is able to deduct all of it, she would have no income tax against which to claim any of these means-tested credits. Secondly, nonresident taxpayers may claim these credits. They get a credit for the state income tax they pay, and it might wipe out their Ohio tax liability anyway. While these factors could reduce the amount of savings, tax filers with more than $100,000 in business income plainly are benefiting from means-tested credits and exemptions, probably to the tune of millions of dollars a year.

The use of these credits and exemptions by those making at least $100,000 a year badly undercuts the General Assembly's moves to limit these exemptions and credits to those with more modest income. The legislature specifically limited the $20 personal exemption credit in 2013 and the retirement income and $50 senior citizen credits in 2015. This means-testing applies to wage earners but if you own a limited liability company or an S Corporation, no such limits apply. Is that what the General Assembly had in mind? One has to wonder.

[4] Similarly, if a taxpayer has no other income besides the business income he or she is deducting, they would not have any use for the personal exemption.

### The homestead exemption

Affluent business owners also are able to take advantage of at least one other exemption in the state tax code because the business income deduction is considered in determining eligibility for it: The homestead exemption, which shields up to $25,000 of the value of a home from local property tax. In tax year 2018, only those with Ohio Adjusted Gross Income of $32,200 or less are eligible for this exemption.[5] However, as with the other credits cited above, that definition of income means those earning far more than the $32,200 in business income are eligible for the exemption. A property owner could earn $282,000 and still qualify for the homestead exemption. If you had business income of $250,000, you could still qualify for the homestead exemption because only $32,000 of it would count. A household with $70,000 in business income and $20,000 in other, earned income would also qualify. No one tracks how many people are able to claim the homestead exemption this way or what their savings amounts to, but they could be sizeable.

### How can we fix this?

The best way to fix this would be to eliminate the business income deduction, which is costing the state nearly $1.1 billion a year in revenue with few visible positive results.[6] The growth rate in the number of new businesses continued to lag behind the national rate after enactment of the giant new tax break in 2013, while first-time hires at new Ohio businesses have remained flat.[7] Though sometimes called a "small business deduction," an outsized share of the benefits from the LLC loophole go to a small share of those with the greatest business income. According to the Department of Taxation, 48,465 taxpayers, or just 7.4 percent of the total, claimed at least $200,000 in Tax Year 2016.[8] Collectively, their deductions accounted for 43 percent of the total. And many of this group get the additional benefits of a lower, 3 percent tax rate on such business income over $250,000. Meanwhile, 397,238 tax filers who claimed the deduction, or more than 60 percent of the total, claimed $20,000 or less. They received just 8.7 percent of the total.

While ending this unneeded tax break would be the best solution, there is also an easy way that the General Assembly could at least stop those who deduct business income from taking advantage of other means-tested income-tax breaks. In the definition of each means-tested credit or exemption, a sentence could be added to the Ohio Revised Code that says: "For the purposes of this section, the definition of income shall include Ohio Adjusted Gross Income plus Business Income Deduction."

Will legislators step up the plate and make this change?

---

[5] See Ohio Revised Code 323.151. To be eligible, an owner had to be 65, permanently and totally disabled, or at least 59 and the surviving spouse of a deceased taxpayer who previously received the exemption. Taxpayers who received the exemption as of Tax Year 2013, before the new income requirement was enacted, continue to receive the exemption, too. See Ohio Department of Taxation, Annual Report, Fiscal Year 2017, p. 126, at https://www.tax.ohio.gov/Portals/0/communications/publications/annual_reports/2017AnnualReport/AR2017.pdf#page=67 See also https://www.tax.ohio.gov/real_property/faqs/homestead_exemption_faqs/tabid/3074/Default.aspx?QuestionID=2820&AFMID=9554

[6] The taxation department pegged the value of the business income deduction, including the lower 3 percent rate paid on such income over $250,000, at $1.086 billion in Tax Year 2016. Conversation with taxation department officials, Sept. 14, 2018.

[7] See Zach Schiller and Wendy Patton, "Overhaul: A Plan to Rebalance Ohio's Income Tax," Policy Matters Ohio, June 25, 2018, pp. 5-6, at https://www.policymattersohio.org/research-policy/quality-ohio/revenue-budget/tax-policy/overhaul-a-plan-to-rebalance-ohios-income-tax

[8] Ohio Department of Taxation, Ohio Personal Income Tax, Business Income Deduction, Taxable Year 2017, Sept. 18, 2018.

Policy Matters Ohio

## Appendix

Table 2 below shows basic eligibility for each of the means-tested credits and exemptions discussed in the report. AGI is Ohio Adjusted Gross Income, which is Federal Adjusted Gross Income plus additions and deductions in Schedule A of the Ohio IT 1040 income tax form. The homestead exemption is not included because data aren't available on the number of filers who receive the business income deduction and also take that exemption.

| Table 2 | | | |
|---|---|---|---|
| 2016 means-tested credits and exemptions | | | |
| **Credit or exemption** | **Number who claimed credit AND business income deduction over $100,000** | **Income cut-off, if any** | **Calculated how?** |
| Child care and dependent care credit | 1,093 | Adjusted gross income below $40,000 | 25% of federal credit; 100% of federal credit if AGI is below $20,000 |
| Retirement income/lump sum credit | 5,867 | AGI of less than $100,000, minus personal exemptions | Depends on retirement income, based on a schedule. Maximum $200 credit for those with more than $8,000 in such income |
| $20 personal and dependent exemption credit | 28,433 | AGI of less than $30,000, minus personal exemptions | $20 for each personal and dependent exemption |
| $50 senior citizen/lump sum credit | 8,319 | AGI of less than $100,000, minus personal exemptions | $50 if 65 or older; only one credit if both filer and spouse are 65 |
| Personal exemption | 87,339 | No cut-off; varies based on AGI | Exemption of $2,250 for OAGI of $40,000 or less; $2,000 for income between $40,000 and $80,000; $1,750 if more than $80,000 |
| Joint filing credit | 30,546 | No cut-off; varies based on income ranging from $25,000 or less to $75,000 or more | Percentage of Ohio tax after other credits; maximum credit of $650 |

*Source:* Policy Matters Ohio, based on Ohio Revised Code, 2016 Ohio IT 1040 Individual Income Tax Return, and 2016 Ohio IT Instructions; Ohio Department of Taxation

### How we estimated the savings

We estimated the amount of these means-tested credits and exemptions for those claiming a business income deduction of more than $100,000 using data for Tax Year 2016 from the Ohio Department of Taxation.[9] We figured the estimates based on the average amounts claimed by filers. For the senior credit, that's $50. With the retirement income credit and the

[9] Ohio Department of Taxation, Tax Data Series, Individual Income Tax, Op. Cit.

child and dependent care credit, we estimated amounts based on the average credit received for filers below the income threshold allowed for each credit.

Estimating the cost of the personal exemption is more problematic. That is a three-tiered exemption, under which in Tax Year 2016 filers were allowed to deduct more if their income was below $40,000, somewhat less if it was between $40,000 and $80,000, and less still if it was over $80,000. There is no way to know precisely how much the business income deduction allowed filers to reduce their income and which tier they fell into. However, we do know that 28,433 of them filed for the $20 personal exemption credit, which is only available to those with an Ohio income tax base below $30,000. It is reasonable to assume that each of these filers was able to deduct an additional $500 because they fell into the lowest tier for the personal exemption. They could take this for each dependent; as noted above, the average taxpayer has 1.84 such exemptions. However, we also don't know exactly what tax rate they would have paid on each $500 exemption. Using a very conservative tax rate of 1 percent, the cost of the personal exemption was $261,584, The actual rate would almost certainly be higher than that; based on the amount of income tax and taxable income reported by the taxation department, the rate might have been twice that or even higher.[10]

The cost of the joint filing credit is even more difficult to peg with any precision. There is no income limit for this credit, but the amount is based on the amount of Ohio tax after other credits, with a maximum credit of $650. Those with an Ohio income tax base of $25,000 or less get a credit worth 20 percent of Ohio tax; if you make between $25,000 and $50,000, it's 15 percent. For those with an income tax base of $50,000 to $75,000, it's 10 percent, while for those with more than $75,000, it's just 5 percent. Among all filers, the average filer for the joint filing credit claimed $185.90. Some 30,546 filers with a business income deduction of over $100,000 also claimed the joint filing credit. However, we don't know how many of those filers fall into each income category. As with the personal exemption, we know that overall, 28,433 of those filers claiming a business income deduction of more than $100,000 also claimed the $20 personal exemption credit, and that's available only to those with an Ohio income tax base below $30,000. That works out to 32.5 percent of those who claimed a business income deduction of more than $100,000. Assuming a similar percentage of the 30,546 filers claimed that $20 credit, 9,923 of them would show an income tax base below $50,000.

That would mean those in this group were able to qualify for a 15 percent joint filing credit instead of the 5 percent credit they would have gotten if the business income deduction was not a factor. Assuming members of this group got three times the average credit (15 percent divided by 5 percent) instead of the average credit, that would mean they each got $557.70, or $371.80 more, on average, than they would have gotten That works out to a total of $3,689,345. However, some of these high-income filers are already receiving the $650 maximum, so they wouldn't gain additional savings. We don't know how many such filers there are, but it's unlikely to be a large share of the total, since those getting just a 5 percent credit would have to have an Ohio income base over more than $309,000 before they were eligible for the maximum $650.[11] In order to be conservative, we assume that the total savings

[10] Ohio Department of Taxation, Tax Data Series, Individual Income Tax, Op. Cit.
[11] Leaving aside other credits and exemptions, someone with an Ohio income tax base of $309,207 would be liable for $13,000 in tax, or the requisite amount before they would qualify for the maximum joint filing credit of $650. We don't have data specifically on how much income these filers had, but we do know from taxation department data that only 11 percent of those with overall Federal Adjusted Gross Income of more than $100,000 had FAGI of more than $300,000. See Ibid.

are only half as great, or $1,844,673. Admittedly, there are other factors that could change the amount; for instance, those claiming a business income deduction of more than $100,000 and the joint filing credit may be currently receiving a joint filing credit that is less than the average $185.90. However, even apart from this one estimate, it's probable that millions of dollars more in credits and exemptions are going to these higher-income Ohioans because the business income deduction is factored into the equation. And that doesn't include the homestead exemption.

In the data it gave us on filers receiving these credits and also claiming a business income deduction of more than $100,000, the taxation department included the lump sum credits that complement the retirement income and senior citizen credits, respectively. The number of claimants for these lump-sum credits is a fraction of those who claim the retirement income and senior citizen credits. Our estimates for these credits

**For funding that made this work possible, we thank the George Gund Foundation and the Ford Foundation.**