



March 2019

Tax Policy

Loopholes upon loopholes:

Ohio business owners can double benefits from some deductions

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Introduction

Ohio business owners are able to get double tax benefits out of certain deductions to their state income tax. Hundreds of thousands of Ohioans may be able to take advantage of the tax law in this way. Though the exact value is difficult to calculate, the practice, available since legislators changed the law in 2015, may be costing the state millions of dollars a year in revenue. This underlines that Ohio's income-tax break for business owners, often known as the LLC loophole, is itself riddled with special-interest loopholes unavailable to most Ohio taxpayers.

Policy Matters Ohio previously described how tens of thousands of affluent business owners who use the passthrough tax break are also claiming other deductions intended for those with lower incomes.¹ Another loophole allows tax filers who own 20 percent of a business to deduct the compensation they are paid, distorting and extending a tax break that is supposed to cover business profits, not salaries.²

The LLC loophole, first enacted in 2013 and expanded subsequently, exempts owners of partnerships, sole proprietorships, S Corporations and limited liability companies from state income tax on the first \$250,000 in earnings from such entities (they are known as "passthrough entities" because their owners are taxed on profits from them under the individual income tax as they pass through to them). Income over that amount is taxed at just 3 percent, lower than the nearly 5 percent rate they would otherwise pay. The Department of Taxation estimated the cost of the tax break at \$1.086 billion in 2016.³ Policy Matters has recommended its elimination.

While it is now the second-largest Ohio tax break, the LLC loophole has not produced economic results. The number of passthrough businesses in the state has grown more slowly than it has nationally.⁴ And first-time hiring by new Ohio businesses also has lagged behind the country.⁵ It deserves repeal. But quite apart from the issue of whether the LLC loophole is bringing economic results, it's a loophole that itself is riddled with loopholes. Legislators should move quickly to rein it in and eliminate these abuses.

¹ Schiller, Zach, "Loopholes in a Loophole," Policy Matters Ohio, Oct. 31, 2018, at <https://bit.ly/2HkZgCX>

² Schiller, Zach, Policy Matters Ohio, "Testimony on HB 334 before the House Ways & Means Committee," Oct. 24, 2017, at <https://bit.ly/2NLvUin>

³ The state 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 tax department officials, Sept. 14, 2018.

⁴ Between 2012 and 2016, the most recent year for which statistics are available, both the number of such businesses and income from them grew more slowly in Ohio than in the United States. See Internal Revenue Service, Statistics of Income, Tax Statistics, Historic Table 2, at <https://www.irs.gov/statistics/soi-tax-stats-historic-table-2>

⁵ U.S. Bureau of Labor Statistics, Business Employment Dynamics Data by States, Table 9, Ohio private sector establishment births and deaths, at https://www.bls.gov/web/cewbd/oh_table9.txt

How are double tax benefits possible?

Under the federal tax code, many owners of passthrough businesses are eligible to deduct certain expenses in calculating their Federal Adjusted Gross Income (FAGI). These include health insurance, contributions to certain retirement accounts, and half of self-employment taxes. In 2016, the latest year for which figures are available, hundreds of thousands of Ohioans took these deductions on their federal income tax.⁶ These deductions level the playing field by allowing passthrough business owners to avoid taxes on these payments just as wage earners effectively do when their employers deduct employee health insurance premiums, contributions to employee pension plans and the employee share of Social Security taxes so the value of these benefits is not included in employees' taxable income.

In determining the Ohio income tax, taxpayers begin with that same amount, Federal Adjusted Gross Income (FAGI). Thus, they benefit from these deductions in determining the starting point for their Ohio income tax. Taxpayers with passthrough business income separately figure out how much of that income is taxable, deducting the first \$250,000 in such income and paying a 3 percent rate on the rest. However, many taxpayers do not have to deduct these same expenses when determining the size of that business income deduction. In effect, they are getting the tax benefits twice - once when they deduct these expenses from their income, and then again when they take the business income deduction, from which these expenses have not been subtracted.

Here's an example. Consider a fictional lawyer with \$100,000 in business income. He also has taxable interest of \$10,000, qualified dividends of \$10,000 and capital gains of \$50,000, for total income of \$170,000. Then, this filer turns to deductions, and deducts \$7,000 for half of the self-employment tax he paid, \$10,000 in retirement contributions, and \$8,000 in self-employed health insurance costs. That amounts to \$25,000 in deductions on his federal tax form, so his Federal Adjusted Gross Income is \$145,000.

Now, he turns to his Ohio tax forms. He starts by entering the \$145,000 from the federal form, thus using the federal deductions described above. But these deductions are nowhere to be found on the Ohio Schedule IT BUS, the form for business income. He looks at the Ohio Department of Taxation web site, and in its Frequently Asked Questions on the business income deduction it says this:

"21. Are the federal deductions for self-employment tax, self-employed health insurance, contributions to SEP/SIMPLE/qualified plans and domestic production activities included as business income on the IT BUS?"

No, these deductions are personal income tax adjustments claimed on an individual's federal income tax return. As such, they are not considered items of business gain or loss and are not included in the calculation of business income on the IT BUS."⁷

This taxpayer thus is able to include the full \$100,000 in business income as a deduction, without reducing that amount. His tax is accordingly lower, because he has \$25,000 in

⁶ IRS, Statistics of Income, op. cit.

⁷ Ohio Department of Taxation, Business Income Deduction FAQs, <https://bit.ly/2EVBj3A>. The department recently updated the language on its website so it is not exactly the same as what is shown here, but nothing has changed (Email from Gary Gudmundson, Ohio Department of Taxation, March 6, 2019). The deduction for domestic production activities was ended by the 2017 federal Tax Cuts and Jobs Act.

deductions that were not subtracted from his business income. There is one important caveat: State law does not allow the deduction for business income to be any higher than Federal Adjusted Gross Income.⁸ This is known as “the FAGI Limitation.” However, for this taxpayer and many others, this does not limit his business income deduction, because of all of his nonbusiness income.

So when he figures his income before any Ohio-specific additions or subtractions, he gets the deductions. And then when he figures his business income and deducts it from what is taxable, he effectively gets them again. Wouldn't other taxpayers love to be able to get tax benefits twice in this way? But how appropriate is that?

When the LLC loophole was first enacted, such double tax benefits were not allowed. Language in the state law specifically said that “Ohio small business investor income” was defined as “...the portion of Ohio's adjusted gross income that is business income reduced by deductions from business income...”⁹ And tax forms for 2013 and 2014 included a line for Keogh, SIMPLE IRA, SEP, self-employment tax and self-employment health insurance deductions that had to be subtracted from the business income deduction.¹⁰ However, in 2015, with the passage of the biennial budget bill (and a corrective bill later that same year, Senate Bill 208), the law was changed, and that line on the form disappeared. It's not clear how that came about. The taxation department did not take a position on it.

In response to questions from Policy Matters Ohio, a lawyer for the taxation department noted in an email that in figuring the business income deduction, taxpayers are limited by Federal Adjusted Gross Income (the FAGI limitation). The department says that it does not consider these deductions “to be business “gain or loss” and thus they are not “business income”” under the definition of that in the law. “These are personal, federal income tax deductions that individuals claim on their Federal 1040. They are certainly not “losses” related to a business,” the department said.¹¹

The language that once reduced business income by such deductions is no longer in the statute, it went on. The department said it is adhering to Ohio Supreme Court rulings in following the words in the statute, and the words are no longer there.

However, the taxation department lawyer acknowledged, “...I would say that this issue is not black and white. I believe the Department's FAQs, instructions and other materials are “square” with one interpretation of the law as written. While I certainly see the argument for netting business income against these deductions, I think that reasonable minds can differ as to what was intended by the Ohio General Assembly.”

⁸ Ohio Department of Taxation, 2018 Ohio Schedule IT BUS, Line 9, at <https://bit.ly/2IWslXg>

⁹ See Ohio General Assembly, 130th Session, House Bill 59, Section 5747.01(A)(1), at <https://bit.ly/2EWrcLC>

¹⁰ Ohio Department of Taxation, IT SBD - Small Business Investor Income Deduction Schedule, Tax Year 2014, Line 9a, at <https://bit.ly/2NQbrZR> SIMPLE plans are savings match plans for employees, written agreements that provides an employer and their employees with a simplified way to make contributions to provide retirement income. SEP stands for Simplified Employee Pensions, which allow an employer to make contributions for their own and their employees' retirement without getting involved in a more complex qualified plan.

¹¹ Email from Gary Gudmundson, Ohio Department of Taxation, Dec. 31, 2018.

How much does this cost?

Figuring out the cost of these double tax benefits is difficult for a host of reasons. The state taxation department has not done analysis and has no data on how many filers are benefiting from the three federal deductions that are not deducted from Ohio business income.¹²

Publicly available statistics do not break out the amounts of deductions taken by owners of different types of passthrough businesses. It is not known exactly how many of those who might be able to take these deductions have business income, and if so how much. In addition, one would need to know the tax rate they would pay to calculate how much any individual filer might benefit. Even with all that, some out-of-state residents would be able to claim credits separately, reducing the total of such benefits. Filing status could also affect the amount.

However, data from the Internal Revenue Service does tell us how many taxpayers take these federal deductions, and how much they take. According to the IRS Statistics of Income for 2016, 115,410 Ohioans claimed the self-employed health insurance deduction for a total amount of \$831,519,000. Some 29,870 taxpayers claimed a total of \$653,624,000 in “Self-Employed (Keough) retirement plans.” And 600,840 Ohioans reported self-employment tax totaling \$1,681,771,000 that year, half of which is deductible. Altogether, such deductions added up to more than \$2.3 billion. That amounts to an upper limit of how much Ohioans could be taking in double tax benefits, though it is likely a great deal less than that.

That also doesn’t tell us the amount they are saving. If taxpayers would have had to pay an average rate of 2.5 percent on those deductions, that would amount to \$58 million. While we don’t know what share of that taxpayers are saving, these double tax benefits may well be costing the state millions of dollars in annual revenue.

As noted, of the three deductions, by far the most taxpayers took advantage of the deduction for self-employment taxes. The Institute on Taxation and Economic Policy, which has a model of the federal and Ohio tax systems, roughly estimates that 330,000 of the Ohio taxpayers who had business income and took the self-employment tax deduction also had non-business income of at least \$10,000 from wages, capital gains, interest or dividends. Some 260,000 had such nonbusiness income of at least \$25,000.¹³ Once again, it’s impossible to know exactly how many of these taxpayers are taking advantage of the double tax benefit. But it’s possible that hundreds of thousands of Ohio taxpayers are doing so.

¹² Email from Gary Gudmundson, Ohio Department of Taxation, Feb. 13, 2019

¹³ Email from Aidan Davis, Institute on Taxation and Economic Policy, Feb. 12, 2019

Recommendations

The LLC loophole is an unproductive tax break that costs the state more than \$1 billion a year. It should be repealed. Short of that, it should be tightened up so that business owners are unable to use it in ways that would dumbfound ordinary taxpayers without such artifices available to them. That includes the double tax benefits highlighted in this report. The General Assembly should restore the limitation on this practice that existed until 2015. Then, the additional revenue will be available to make investments¹⁴ that Ohioans badly need.

We are grateful to the Ford, Saint Luke’s and George Gund Foundations for funding that enables us to study Ohio tax policy. For assistance with research or for deeper insight on this issue we thank Paul E. Veit, CPA; Aidan Davis of the Institute on Taxation & Economic Policy; Anne Zimmerman, president of Zimmerman & Co., CPAs, Inc., Michael Mazerov of the Center on Budget and Policy Priorities, and Policy Matters intern Katherine Burns.

¹⁴ See Wendy Patton, “Investing in Ohio and Ohioans,” Policy Matters Ohio, Feb. 22, 2019, at <https://www.policymattersohio.org/research-policy/quality-ohio/revenue-budget/budget-policy/investing-in-ohio-and-ohioans>