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Budget

The $1 billion tax break burning a hole in Ohio's budget

Deduction for business income is larger than previous public estimates

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A tax break on business income first enacted in 2013 is now costing Ohio about $1 billion a year. That's far more than previous public estimates, which didn't attempt to account for the full value of the break. In light of the revenue shortfall that is affecting the two-year state budget, it underlines that legislators need to repeal this expensive giveaway.

Ohio Department of Taxation (ODT) estimates provided to Policy Matters Ohio show that the tax break was worth $943 million in tax year 2015, based on actual filings for that year (see Table 1).[1] The size of the deduction was increased further starting in tax year 2016, so it is likely that the amount of the tax break also grew for this past year. However, taxpayers who seek extensions may file returns as late as October so the total size of the break last year is not yet known. While data available so far do not show what role this deduction may be playing in the revenue shortfall compared to projections, it is a much larger drain on the budget than was publicly known.

Table 1

Ohio Personal Income Tax Savings for Business Owners (millions of dollars)	
Tax Year	Amount
2013	$350.6
2014	$560.8
2015	$943.4

Source: Ohio Department of Taxation. Estimated based on actual return data for each respective tax year.

The tax break permits owners of what are known as "passthrough" businesses such as partnerships and S Corporations to avoid paying any income tax at all on the first $250,000 in profits from those businesses (they're called "passthroughs" because their owners are taxed on the income when it passes through to them as individuals). Any additional profits are taxed at a flat 3 percent rate, well below the nearly 5 percent that would otherwise be paid on income over $210,600. First enacted in 2013, it was expanded since then to its current form.

[1] Emails from Gary Gudmundson, Ohio Department of Taxation, May 4 and May 16, 2017.

The estimate from the taxation department includes the savings that business owners reap from the 3 percent flat rate, which only became effective for tax year 2015. Earlier public estimates by the department showed that the tax break, while huge, was smaller.[2]

Though the tax break is often referred to as "the small business deduction," it is not just available to owners of small businesses. Partners in large law firms, owners of private equity firms, and investors in big companies that are organized as passthrough entities are equally able to qualify. According to the instruction form for the deduction, an entity could be set up to make money off investments, and the owner could transfer stocks, bonds and savings accounts into it, making up to $250,000 in dividends, capital gains and interest exempt from the Ohio income tax.

Separate ODT data show that most of the benefits of the tax break go to those with a large amount of business income.[3] A majority of filers claim less than $10,000. Some 434,429 taxpayers or more than 90 percent of those seeking the deduction for tax year 2016 so far claimed less than $100,000. Yet the 9.4 percent who claimed more than $100,000 accounted for 55 percent of the total claimed, as of an April 24 data run by the department.

The biggest reason why state revenues are coming in short of projections is the underperformance of the state income tax, which in the 10 months through April had brought in $554 million less than what was originally anticipated. The largest share of this was a result of larger than expected refunds, which totaled $353 million more than projected. In previous years, according to the Office of Budget & Management, some taxpayers had not taken the deduction into account when making estimated payments during the year, thus overpaying and claiming large refunds afterward. As a result, it's possible that the deduction is a major factor in the unexpectedly large refunds. However, refund amounts on tax returns are not allocated by deduction, so it isn't known how much this deduction contributed. Asked how much the income-tax shortfall versus projections relates to an unexpected increase in claims for the deduction, the taxation department said: "We are only part way through the filing season for Tax Year 2016. There is no part-year estimate for comparison."[4] The amount of business income deductions claimed as of April 24 remained below the full year total for 2015. Thus, it remains a tantalizing question how much the business-income deduction contributed to this underage.

However, one thing is clear: The deduction has not resulted in better job growth. Ohio's job gains of 4.7 percent since June 2013, when the tax break was first enacted, have trailed way behind the national average of 7.2 percent. New employment at Ohio private businesses hiring employees for the first time has not picked up. In the first three quarters of 2016, new hires at such businesses were below the same

[2] In its biennial tax expenditure report, which is included in the governor's budget proposal, ODT estimated that including All Funds, the deduction was worth $626.72 million for Fiscal Year (FY) 2015 and $474.2 million for FY2016. It estimated the impact on the General Revenue Fund at $580.9 million in FY2018 and $599.7 million in FY2019. But the $943.4 million estimate for Tax Year 15 is based on actual filings, so it is more accurate, the taxation department said. Those estimates from the tax expenditure report also did not include the effect of the 3 percent flat rate on income over the threshold amount (now $250,000), and from 2016 on, used a 3 percent rate to figure the revenue loss on the deduction claimed (the decline between FY2015 and FY2016 estimates is not a result of a real reduction in the cost of the deduction. Rather, it reflects the use of the 3 percent rate to calculate the cost, instead of the higher rates that applied before the 2015 enactment of the 3 percent rate).

[3] Emails from Gary Gudmundson, Ohio Department of Taxation, April 21 and April 25, 2017. These figures do not include the value of the 3 percent flat rate on business income over $250,000.

[4] Gudmundson email, May 16, 2017.

period in 2012, before the tax break was approved, while employment grew at such companies across the nation.

Most business owners claiming this tax break don't get nearly enough from it to make a sizeable investment, much less hire a new employee. Nor is there any requirement that they employ anyone (Oregon, one of the few states with such an exemption, requires that the business employ at least one person who is not an owner, member or limited partner of the entity, and that the taxpayer must materially participate in the business). When a form of this tax break was first proposed in Ohio in 2013, tax expert Michael Mazerov of the Center on Budget and Policy Priorities explained in detail to the House Finance Committee why it was unlikely to improve Ohio's economy. It's no surprise that the advent of this big tax break has not shown any evidence doing so.

Yet it could encourage taxpayers to reclassify their earnings as business income just to get the tax advantage. An employee who converts into an independent contractor doing the same work could enjoy the benefits of the deduction, for instance. A recent study of an even more extensive tax break in Kansas found that the primary effect, while modest, was to induce taxpayers to recharacterize their income as business income.

We don't know yet how much of that is happening in Ohio. Nor do we know exactly how much the deduction will cost. However, the $943 million claimed for tax year 2015 is likely to grow, since the deduction was expanded from 75 percent of the first $250,000 in business income that year to 100 percent in tax year 2016.[5] That's money that is badly needed for education, health care, human services and local governments across Ohio. From bringing down the cost of college education to responding to the opioid crisis, our unmet needs call for this giant, unproductive tax break to be repealed.

[5] The taxation department agrees that all else being equal, that should lead to a larger total for tax year 2016. It notes, however, that part of this increase was absorbed already because the General Assembly set progressive brackets for taxable business income for tax year 2015 (Gudmundson e-mail, May 16, 2017). That lowered tax rates for certain filers that year.