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Closing the LLC Loophole

House makes needed changes

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Policy Matters Ohio

INTRODUCTION

Ohioans across the state use programs and services funded by the state every day – from the roads they drive on to the schools their children attend. The growing prominence of tax breaks in the state tax code has drained resources from things that help everyone in exchange for benefits to powerful special interests. One of the biggest culprits is a tax break that has come to be known as the LLC loophole.

The business income deduction to the Ohio income tax was first created in 2013 and since expanded to the point that it is now the state's second-largest tax break, worth more than $1 billion a year. The Ohio House took steps in its budget bill, House Bill 166, to rein in this deduction. This report reviews the deduction, including the response of the Ohio economy, who benefits from it, loopholes within it and how the tax break should be changed. It concludes that the House changes are appropriate, and that additional ones should be taken to further cut it back.

Ohio reduced taxes on business income from passthrough entities in 2013 and expanded this tax break since then (S Corporations, partnerships, limited liability companies and sole proprietorships are known as "passthrough entities" because their profits are taxed under the individual income tax as they pass through to their owners). This tax often is known as the LLC loophole, as owners of LLCs are among those who may benefit.

Today, a taxpayer does not have to pay Ohio income tax on the first $250,000 in passthrough income,[1] and only pays a 3% tax rate on such income over and above that—a rate lower than the 4.997% top income tax rate in Ohio. As a result, the LLC loophole drains more than $1 billion annually from state revenues, based on current rates.[2] The cost is even larger if you factor in the one-third reduction in tax rates since 2005.

THE BUSINESS INCOME DEDUCTION AND THE OHIO ECONOMY

This tax break was touted as a tool to spur creation of new firms and to create jobs, but it has not done so. The majority of those receiving the break save less than $1,000 a year, nowhere near enough to hire a new employee.[3] Data from the Internal Revenue Service shows (Chart 1) that the growth rate of new businesses, based on number of tax returns from sole proprietorships, partnerships and S corporations, was slower in Ohio than in the nation as a whole from 2012, just prior to the enactment of the tax break, to 2016.

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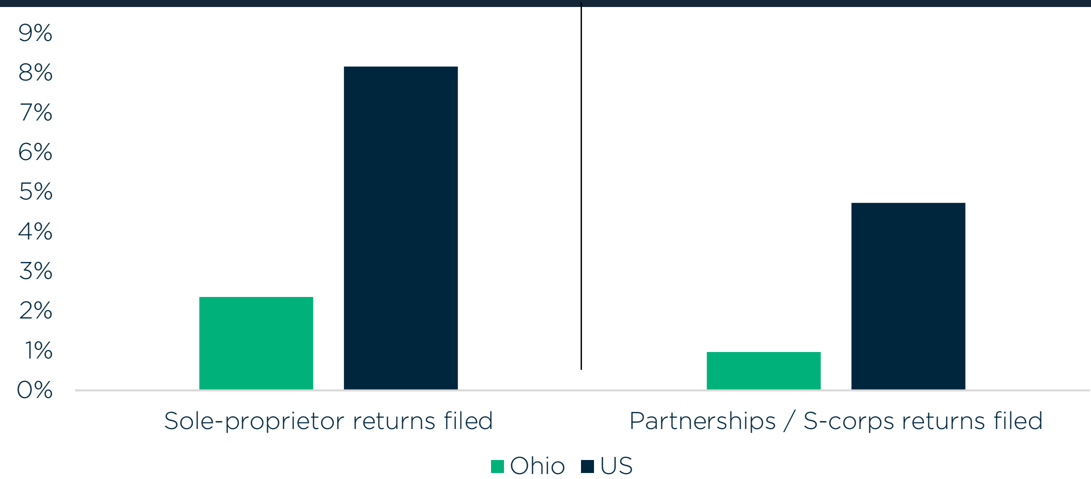
[1] The $250,000 is the amount of the deduction for single taxpayers and those who are married filing jointly. The amount is $125,000 for married taxpayers who file separately.

[2] The state taxation department pegged the value of the business income deduction, including the lower 3% rate paid on such income over $250,000, at $1.086 billion in Tax Year 2016. Conversation with tax department officials, Sept. 14, 2018. Separately, the department estimated the value of the deduction alone at $638.3 million for Fiscal Year 2019, $654.8 million for Fiscal Year 2020 and $666.3 million for Fiscal Year 2021 in its recent tax expenditure report (See Kenneth Frey, Tax Analysis Division, Ohio Department of Taxation, "Tax Expenditure Report FY 2020-2021: Business Investor Income Deduction," Memo to Gregory Siegfried, Executive Administrator, Tax Analysis & Legislation, April 17, 2018). However, these estimates do not include the additional value to taxpayers of the lower 3% rate. The department notes that is in a separate provision of the Ohio Revised Code and, "If the deduction no longer existed, the definition of business income and 3% rate on taxable business income would still exist." Email from Gary Gudmundson, Ohio Department of Taxation, May 3, 2019.

[3] Email from Ohio Department of Taxation, Ohio Personal Income Tax, Business Income Deduction, Taxable Year 2017, April 12, 2019. In fact, most of those seeking the deduction claim $20,000 or less in income. Even at the top income tax rate, which many in this group do not pay, that works out to less than $1,000 in tax savings.

Chart 1

Growth of passthrough entities in Ohio vs. the nation, 2012-16

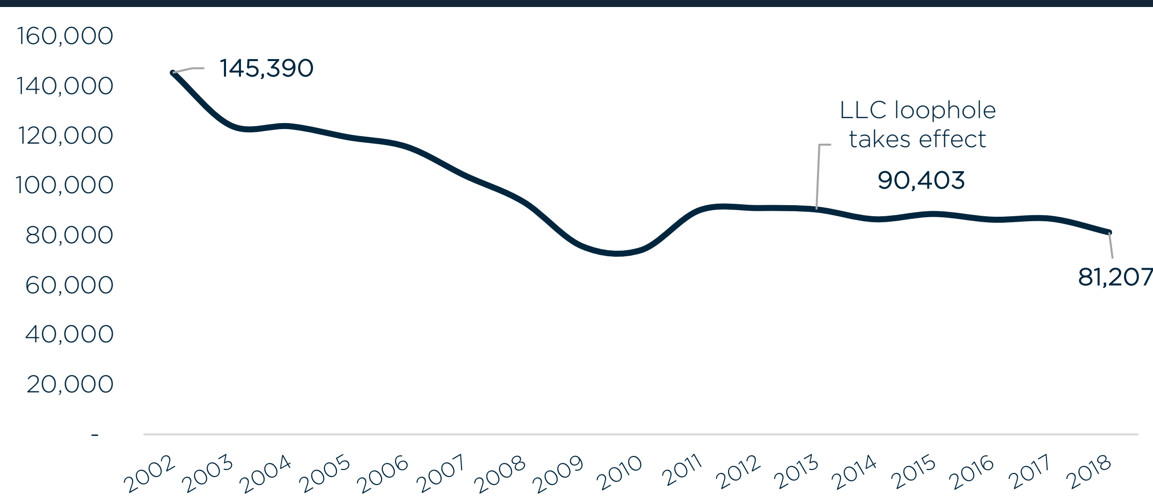


Source: Internal Revenue Service

Nor has employment at new Ohio businesses increased. Chart 2 shows new hires at Ohio businesses hiring for the first time. The trend line is flat since the tax break was enacted in June 2013. New hiring of this kind by Ohio businesses has declined in relation to that in the United States as a whole, falling from 2.87% of such U.S. hiring in the year ended June 30, 2013 (the tax break was enacted in June of that year) to 2.39% in the year ended in June 2018.[4]

Chart 2

First-time hires at new Ohio businesses, by fiscal year



Source: U.S. Bureau of Labor Statistics

[4] U.S. Bureau of Labor Statistics, Business Employment Dynamics, at https://www.bls.gov/web/cewbd/table9_1.txt and https://www.bls.gov/web/cewbd/oh_table9.txt

Data through 2016 – the most recent available – also show that the LLC loophole has not changed the downward slide in Ohio's share of small businesses, whether it be in the number of companies, establishments, employment or payroll. Chart 3 illustrates how these have continued to fall both before and after the creation of this giant new tax break.

Chart 3

Ohio share of U.S. total, enterprises with less than 20 employees

Source: U.S. Census Bureau, Statistics of U.S. Businesses

Ohio's overall economic performance also remains subpar compared to the country as a whole, a trend that is expected to continue. Since the passthrough tax break was first enacted, Ohio jobs have grown by 6.3%, compared to 10.9% nationwide.[5] In Governor Mike DeWine's proposed budget, the Office of Budget & Management (OBM) noted that estimated Ohio employment growth in 2019 and 2020 would be slower than that of the nation.[6] The IHS/Global Insight forecast OBM uses says that growth in Ohio real gross domestic product, nominal personal income, nonfarm employment and retail and food service sales all will lag behind U.S. performance during Fiscal Years 2020 and 2021, while the unemployment rate will remain above the U.S. rate.[7]

While proponents of the tax break argue that reducing it will harm investment or economic growth, we've tried the business income deduction for nearly six years, and the results are in: This tax break does not rev up small business or Ohio's larger economy, while it's costing dollars that are badly needed to invest in education and public services.[8]

[5] U.S. Bureau of Labor Statistics, https://www.bls.gov/
[6] Mike DeWine, Governor of Ohio, and Office of Budget & Management, The State of Ohio Executive Budget, Fiscal Years 2020 and 2021, p. B-4.
[7] Kimberly Murnieks, OBM director, Testimony to the Senate Finance Committee, April 24, 2019, p. 8.
[8] Patton, Wendy, "An investment budget: Ohio resources for Ohio's People," Policy Matters Ohio, Feb. 22, 2019, at https://www.policymattersohio.org/files/research/investmentbudget2019-patton.pdf

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Advocates of the LLC loophole also argue that it was enacted to create tax parity between passthrough entities and other businesses, known as C Corporations. "Pass-through entities have to pay both the Commercial Activity Tax (CAT) and the Individual Income Tax, while C-Corps simply pay taxes on receipts under the CAT," said a number of business associations in a May 20 letter to members of the General Assembly.[9] That's not exactly right; owners of C Corporations will pay income taxes at one point or another on the returns they get in dividends and capital gains. In addition, the vast majority of small businesses either pay a flat $150 a year in CAT tax, if they have Ohio gross receipts over more than $150,000, or nothing at all, if their receipts are less than that.[10] However, if the different treatment is so burdensome, partnerships and limited liability companies can convert to being C corporations, while S Corporations can stop making the S Corp election. That some may not want to do so because they would have to give up the tax advantages they obtain at the federal level shows they are not so much interested in parity as in lower taxes.

WHO BENEFITS FROM THE LLC LOOPHOLE?

Benefits of the LLC loophole are highly concentrated. In 2017, just 7.4% of the tax filers who used the deduction, those claiming passthrough income of $200,000 or more a year, received 43.4% of these deductions—and that doesn't include the additional tax break for those making over $250,000.[11] Meanwhile, more than three-quarters of those using the deduction that year claimed less than $50,000; more than 86% claimed $100,000 or less. The savings per individual taxpayer depends on what rate they would have paid if the passthrough tax break didn't exist. However, it's easy to see that for most, it's not a large amount. Those claiming $20,000 or less in the deduction accounted for more than three-fifths of all claimants. Yet even assuming that they each would have paid an average tax rate of 4.5%, or close to the top income tax rate, none of this group received more than $900 in tax benefits. A very large share gained a few hundred dollars apiece, or even less.

Most of those with passthrough business income do not employ anyone. A national study in 2011 by researchers at the U.S. Treasury Department found that only 11% of taxpayers reporting business income – and 2.7% of all income-tax payers – own a bona fide small business with employees other than the owner.[12] In Ohio, fewer than 250,000 companies pay unemployment tax, which essentially means that they employ someone.[13] Yet Internal Revenue Service data indicate that there were more than 1 million passthrough businesses in the state in 2016-2017.[14]

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[9] Letter to members of the Ohio Legislature, May 20, 2019, from the Ohio Chamber of Commerce and other business associations, available through Gongwer News Service

[10] Data from the Ohio Department of Taxation show that in Fiscal Year 2018, 103,419 or 65.9% of businesses with CAT liability had receipts of between $150,000 and $1 million, which means they were liable for a flat $150. However, after credits that some received, taxpayers in this group averaged just $83.94 in CAT liability. See https://www.tax.ohio.gov/Portals/0/tax_analysis/tax_data_series/CAT/CAT12FY18.pdf. While the taxation department says it does not have current data on the number of companies with less than $150,000 in annual receipts (Email from Gary Gudmundson, May 24, 2019), there is reason to believe it is much larger. Data from Tax Year 2011 presented in 2015 by then Tax Commissioner Joe Testa (see testimony to the House Finance Committee, Feb. 15, 2015, Attachment B) together with department data on CAT liability (https://www.tax.ohio.gov/tax_analysis/tax_data_series/cat/publications_tds_cat.aspx) indicate that there were more than 900,000 passthrough entities with receipts of less than $150,000. Thus, most small businesses in Ohio are paying a very modest CAT tax or none at all.

[11] Email from Ohio Department of Taxation, op. cit., April 12, 2019

[12] Calculations by Michael Mazerov in "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, (https://www.cbpp.org/sites/default/files/atoms/files/2-19-13sfp.pdf) based on data from Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce and Richard Prisinzano, "Methodology to Identify Small Businesses and Their Owners," Office of Tax Analysis, U.S. Department of the Treasury, August, 2011.

[13] http://ohiolmi.com/ces/LMR.pdf

[14] Internal Revenue Service Data Book, 2017, p.5, at https://www.irs.gov/pub/irs-soi/17databk.pdf (data from federal fiscal year 2017), and IRS Statistics of Income, Tax Year 2016 Historic Table 2, at https://www.irs.gov/statistics/soi-tax-stats-historic-

As Michael Mazerov, a senior fellow with the Center on Budget and Policy Priorities in Washington, D.C., told the Ohio House Finance Committee in testimony when the tax break was first being considered in 2013, "The vast majority of people reporting income from a pass-through business on their personal income tax returns are people who might earn a small amount of income from self-employment on the side. Or they're passive investors in investment partnerships that themselves are passive investors in other businesses, again, with no authority over job-creation decisions by those businesses. Or they're owners of real businesses, but they're entirely self-employed as plumbers, lawyers, and so on and have no intention, need, or desire to hire anyone else." Moreover, as he noted, "Only a tiny share of new businesses are seeking to develop a new product, service, technology or business model that has the potential to be the next Google, Facebook or Amazon. So tax cuts for everyone is a very expensive way to try to help the very few that are even in a position to create a meaningful number of jobs."[15]

It's not surprising that the advent of this new tax break has not led to an upsurge in Ohio small business or employment. While no doubt it has been helpful to some individual business owners, it reflects a misunderstanding of why most businesses grow. Business owners expand when they anticipate greater demand for their products or services, not because they have a few hundred dollars more in their wallets. And ironically, some of the fastest-growing young businesses don't benefit from this tax break at all, because often such businesses don't have any profits, as they are investing in research, sales and new employees.

Among those who do qualify are attorneys who are partners at large law firms. A lawyer making $500,000 would save more than $15,000 a year, though this would do little to help the Ohio economy. The tax break also discriminates in favor of contractors vs. employees, though they may perform identical work. A single landscape architect making the state-wide median wage for that occupation, $59,892 in 2018, would pay $1,465 in state income tax. Yet by setting up a limited liability company and doing the same work as a contractor, he or she would pay nothing.

LOOPHOLES IN A LOOPHOLE

Moreover, this unproductive LLC loophole is itself riddled with special-interest loopholes unavailable to most Ohio taxpayers. Policy Matters Ohio previously has reported on some of these giveaways:

- Tens of thousands of affluent business owners who use the passthrough tax break are also claiming other deductions intended for those with lower incomes.[16] These include the $20 personal exemption credit, which is supposed to be limited to those with income under $30,000 a year; the retirement income and senior citizen credits, which go to those with income below $100,000; the homestead exemption to local property taxes, which in 2018 went to those with income of $32,200 or below, and other means-tested credits and exemptions. Ohioans with far greater incomes that are allowed to qualify for these tax breaks are able to sidestep such limits because their business income up to $250,000 is not included in determining eligibility.

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table-2 (data from tax year 2016). See also Joe Testa, Ohio Tax Commissioner, Testimony to the House Finance Committee, Feb. 15, 2015, Attachment B.

[15] Mazerov, Michael, "Testimony to House Finance & Appropriations Committee on HB 59 Income Tax Plan," March 19, 2013, at http://www.policymattersohio.org/wp-content/uploads/2013/03/MazerovHB59_Mar2013.pdf

[16] Schiller, Zach, Loopholes in a Loophole, Policy Matters Ohio, Oct. 31, 2018, at https://www.policymattersohio.org/research-policy/quality-ohio/revenue-budget/tax-policy/loopholes-in-a-loophole

- Another loophole allows tax filers who own 20% 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.[17] Under federal income-tax law, owners of S Corporations must pay themselves a salary to prevent payroll tax evasion. Compensation is excluded under the sections of Ohio law that created the business income deduction. However, because of an unrelated section of state law that predated the deduction, the taxation department has allowed filers who own 20% of a business to claim compensation anyway. Compensation is not the same thing as profits, and shouldn't eligible for this deduction.
- Hundreds of thousands of Ohio business owners may be able to get double tax benefits out of certain deductions to their state income tax.[18] Business owners can take tax deductions for health insurance, retirement contributions and half of the self-employment tax they pay. But in many instances, they don't need to subtract these amounts when figuring their out their business income. That means that their business income is larger than it would otherwise be – and since they can deduct up to $250,000 of such income, it means they're effectively getting the benefit of these deductions twice.

The first of these special-interest loopholes is eliminated in the House bill. In a commendable move, the House took steps in its budget bill to fix the tax code so that affluent business owners are no longer able to take advantage of income-tax credits and exemptions meant for lower-income Ohioans. However, it separately approved a provision that will open up a new way for some of those business owners to do the same thing. If their total income is below $122,500, they will be able to pay no Ohio income tax, just like tax filers with income below $22,500 (See box for more details). This should be corrected.

REINING IN THE LLC LOOPHOLE

As unproductive and loophole-ridden as it has been, the LLC loophole should be scrapped. However, short of that, the steps taken by the House represent a good start. Most importantly, this includes reducing the deduction from $250,000 to $100,000, and to eliminating the special 3% rate for income over that amount.

In 2017, only 13% of all those claiming the deduction claimed more than $100,000. Yet this group accounted for 63% of the total amount claimed. If the deduction were limited to $100,000, in other words, that would have no impact on almost 87% of those getting it.[19] Those claiming more than $100,000 would still be able to claim up to that amount. Based on 2017 figures from the taxation department, this would reduce the total amount of income deducted by 31%. With this reduction in the deduction, those with business income above $100,000 would still receive nearly half of the benefits from the deduction they do now.

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[17] Schiller, Zach, Testimony on HB 334 before the House Ways & Means Committee, Oct. 24, 2017, at https://www.policymattersohio.org/research-policy/quality-ohio/revenue-budget/tax-policy/testimony-on-hb-334-before-the-house-ways-means-committee

[18] Schiller, Zach, Loopholes upon Loopholes, Policy Matters Ohio, March 12, 2019, at https://www.policymattersohio.org/research-policy/quality-ohio/revenue-budget/tax-policy/loopholes-upon-loopholes

[19] Email from Ohio Department of Taxation, op. cit., April 12, 2019

One loophole closes, another opens

The Ohio House of Representatives took steps in its budget bill to improve the tax code so that affluent business owners are no longer able to take advantage of income-tax credits and exemptions meant for lower-income Ohioans. However, it separately approved a provision that will open up a new way for some of those business owners to do the same thing. If their total income is below $122,500, they will be able to pay no Ohio income tax, just like tax filers with income below $22,500.

Here's how it works: Under the current business income deduction, owners of S Corporations, partnerships, sole proprietorships and limited liability companies pay no income tax on the first $250,000 in business income. They pay a special low rate of 3% on business income over that amount.

The House appropriately acted to reduce the amount of this deduction to $100,000 and eliminated the special 3% rate. The House also lowered income-tax rates by 6.6% and eliminated two of the bottom income-tax brackets, raising the threshold at which Ohioans pay tax to $22,500.

In addition, it required those taking the business income deduction to add back in to their income the amount of that deduction in figuring eligibility for a variety of exemptions and credits that are only available or provide more benefits to taxpayers below certain income levels. These include the personal exemption, the joint filing credit, the $20 personal exemption credit, the $50 senior citizen credit, the retirement income credit and the homestead exemption to the property tax, among others. Policy Matters Ohio found in an October 2018 report that tens of thousands of business owners with more than $100,000 were qualifying for such credits and exemptions, probably costing the state millions of dollars a year.

But the House didn't adopt the same limitation on that zero tax rate for business owners as it did for all of these other means-tested exemptions and credits. This means that a business owner with, say, $120,000 in business income will get a deduction for the first $100,000 in income. And then, he or she falls under the $22,500 threshold at which tax is paid. Thus, they will pay no income tax. Their $100,000 business income deduction is not added back in, as it will be for the other credits and exemptions favoring lower-income Ohioans. Business owners with more than $122,500 in business income will pay income tax, but at lower rates on their income over $100,000 than wage earners without business income pay.

This new defect could be fixed much as the others were: By requiring those receiving the business income deduction to add back in the amount of that deduction when figuring the rest of their income tax. That way, all taxpayers will pay the same rates, leaving aside the $100,000 deduction for business income.

A second key piece of the House bill would eliminate the 3% rate that is charged to those who claim the business income deduction on income over $250,000. Only a fraction of the 693,370 tax filers claiming the deduction as of Tax Year 2017 would be affected by such a move—altogether, they represent about less than 1% of all Ohio tax filers. Almost none of these tax filers would be small business people. According to the Institute on Taxation and Economic Policy (ITEP), a Washington, D.C., based nonprofit with a sophisticated model of the state and local tax system, more than 90% of the tax increase from eliminating the 3% rate would be paid by tax filers who make more than $496,000 and thus are among the top 1% of Ohio earners.[20]

The Legislative Service Commission estimated that taking these two steps – reducing the maximum business income deduction to $100,000 and scrapping the special 3% rate – would save about $528 million a year.[21] ITEP found that more than four-fifth of the additional taxes would be paid by those in the top 1% of the income spectrum, those making over $496,000 a year. Virtually all of the rest would be paid by people in the next 4%, those making between $208,000 and $496,000. Altogether, ITEP found, just 1% of Ohio taxpayers would pay more under the main provisions of the House plan, including also the reductions in rates and brackets.

RECOMMENDATIONS

At the very least, the Senate should pass a budget that includes the House's reforms to the business income deduction. First described as a boon to small business, the LLC Loophole was supposed to help small business grow and add jobs. "We believe the small-business tax cut will help directly grow jobs in the immediate future," said Senate President Keith Faber after the deduction was approved in 2013.[22] As we have seen, it has not spurred significant growth of small business or employment by new businesses.

Limit the LLC loophole to only those who actually run businesses and hire workers. In keeping with its heralded purpose and in addition to taking the steps the House has in its version of HB 166, the General Assembly should make sure that the tax break goes only to those who actually run businesses and hire workers. This would exclude passive investors. Ohio could emulate Oregon, one of the few other states with a passthrough income tax break. Its law requires that those receiving the tax break materially participate[23] in the business, and that their company employs at least one non-owner for 1,200 hours during the year, worked in weeks of at least 30 hours each.[24] In effect, that means the business owner has to have a full-time employee or something close to it. While it's hard to say exactly how much this would reduce the cost of the tax break, it would limit it appropriately.

The LLC loophole should be limited to those who qualify for the new federal passthrough income tax break, Section 199A of the Tax Cuts & Jobs Act of 2017, and income that qualifies under that tax break. Congress included in that bill a new 20% tax break for owners of qualified passthrough businesses. This new tax break, like the Ohio one, needs to be repealed. It is heavily tilted to the wealthiest; some 61% of the tax benefits from it in 2024 will

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[20] Data received from Institute on Taxation and Economic Policy, May 10, 2019. This estimate assumes that the deduction has been reduced to $100,000.
[21] Legislative Service Commission, Main Operating Appropriations Bill, HB 166, As Passed by the House, Comparative Document, Department of Taxation, p. 4, at https://www.lsc.ohio.gov/documents/budget/133/MainOperating/HP/CompareDoc/TAX.pdf
[22] Siegel, Jim, "Ohio business tax break falls short on revenue, job growth," The Columbus Dispatch, June 11, 2017, at https://www.dispatch.com/news/20170611/ohio-business-tax-break-falls-short-on-revenue-job-growthIbid.
[23] The Oregon law defines material participation as the Internal Revenue Service does. The taxpayer must be involved in the operations of the activity on a basis which is "regular, continuous and substantial." See https://www.law.cornell.edu/uscode/text/26/469
[24] See Oregon Revised Statutes, Section 316.043, subsection (6), at https://www.oregonlegislature.gov/bills_laws/ors/ors316.html

go to the top 1%, according to figures from the Joint Committee on Taxation.[25] It saps needed revenue, and, as the Center on Budget & Policy Priorities put it, "invites rampant gaming of (the) tax system."[26]

Still, it is on the books for now. And its provisions exclude from receiving the tax break a number of those who likely qualify for the Ohio state deduction, including highly paid partners in large law firms. The federal break requires that the income be effectively connected with a U.S. trade or business.[27] Beginning at $315,000 for those married filing jointly (half that for single filers), it reduces the size of the deduction for those in businesses involving "health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, trading, dealing in certain assets or any trade or business where the principal assets is the reputation or skill of an employee or owner."[28] At $415,000, the deduction disappears entirely for these taxpayers. For other filers with more than $315,000 in income (half that for single filers), the deduction is capped at 50% of wages paid by the business or 25% of wages and 2.5% of qualified business property. Under the U.S. tax break, amounts received as reasonable compensation from an S Corporation or guaranteed payments from a partnership – amounts that would probably be eligible for Ohio's business income deduction if the claimant owns at least 20% of the business – do not qualify. As sieve-like as the U.S. law may be, this demonstrates that the Ohio law is even more generous than the new federal tax law in allowing certain high-income earners to qualify for special tax treatment. By limiting the Ohio tax break to those who are eligible for the federal tax break, and income that qualifies for it, some of the most egregious legal tax evasion can be avoided.

Adding limitations based on the Oregon law and the 2017 federal tax law should not substitute for the reduction of the deduction to $100,000 and the elimination of the 3% rate.[29] As an ineffective, costly tax break, it should be scrapped altogether. Adding these restrictions could limit the use of the deduction to tax filers who actually run businesses and who employ at least one worker. The full package of changes – those the House has already taken and these additional ones – would target the business income deduction from its current scattershot effects. It would significantly cut the cost of the deduction, providing more revenue to be invested in better educating Ohioans and providing services that are badly needed.

Use proceeds from shrinking the LLC loophole to make investments Ohio needs. In fact, the House bill falls down by taking the funds from cutting the LLC Loophole – and more – and applying them to other tax cuts. Most of the poorest Ohioans are not aided by these changes,

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[25] Cited in Center on Budget & Policy Priorities, "Pass-Through Deduction Benefits Wealthiest, Loses Needed Revenue, and Encourages Tax Avoidance," Updated March 27, 2019, at https://www.cbpp.org/research/federal-tax/pass-through-deduction-benefits-wealthiest-loses-needed-revenue-and-encourages

[26] Ibid. For more detail, see "The Games They Will Play: Tax Games, Roadblocks and Glitches Under the 2017 Tax Legislation," by David Kamin et al., Minnesota Law Review at http://www.minnesotalawreview.org/wp-content/uploads/2019/02/5Kamin_FINAL.pdf

[27] Internal Revenue Service, Tax Cuts and Jobs Act, Provision 11011 Section 199A – Qualified Business Income Deduction FAQs, at https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs

[28] Ibid. The IRS says: "The principal asset of a trade or business is the reputation or skill of its employees or owners if the trade or business consists of the receipt of income from endorsing products or services, the use of an individual's image, likeness, voice, or other symbols associated with an individual's identity, or appearances at events or on radio, television, or other media formats."

[29] Some have argued that it's inappropriate for the General Assembly to reduce the LLC Loophole for the full 2019 year (See Greg Saul, Director of Tax Policy for the Ohio Society of CPAs, Testimony to the House Finance Committee, May 6, 2019). However, there was little objection in 2013 when the original business income deduction was retroactive, nor in 2015 when the lower 3% rate was retroactive. Apparently, retroactivity is only a problem only sometimes. If legislators should view this as a significant, they can make the changes effective July 1; this argument should not stand in the way of enactment.

as Policy Matters has detailed previously.[30] And middle-income Ohioans will barely notice the tax cuts they receive. As noted above, the House plan also opens a new way for business owners to benefit from tax provisions intended for poor Ohioans, something that needs correcting. Most important, funds from reducing the business income deduction would be better invested in a refundable Earned Income Tax Credit, which would do more to aid the poorest residents, while leaving significant funds for needed investments. Some of these are itemized in the table below:

Essential investments for Ohio
• Maintain the Medicaid expansion without freezes or barriers to coverage and care. • Make the state Earned Income Tax Credit refundable to reach the poorest Ohioans. • Raise eligibility for public child care aid to 200% of poverty, starting in this budget, and ensure stable funding for a higher quality public childcare system. • Keep seniors safe at home by boosting funds for adult protective services to $10 million a year. • Rebuild revenue sharing with Ohio's local governments. Start with restoration of the Local Government Fund's municipal distribution. • Base school foundation funding on a formula that ensures rich and poor communities have equally good schools, regardless of local property wealth. • Reduce the high cost of college tuition with more funding to the State Share of Instruction. Index it to inflation so Ohio's system of public higher education is not eroded by inflation again. • Boost need based aid - the Ohio College Opportunity Grant - by an additional $106 million annually. Use it to support community college and regional campus students. • Fully fund Ohio foodbanks' request for an additional $10 million a year in food aid. • Fund voluntary SNAP Employment & Training program at $4 million a year to secure matching federal funds for training so Ohioans can meet work requirements, get training, and get the food they need.

The House has taken much-needed steps to rein in this costly, unproductive tax break. Now the Senate should finish the job by approving the House changes and adding more accountability to the business income deduction.

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- **Michael Mazerov, the Center on Budget and Policy Priorities**
- **Daniel Hauser of the Oregon Center for Public Policy**
- **Policy Matters staff Ben Stein, Wendy Patton and intern Katherine Burns**

[30] Schiller, Zach and Wendy Patton, "The Good and the Bad in the House Tax Plan," Policy Matters Ohio, May 15, 2019, at https://www.policymattersohio.org/research-policy/quality-ohio/revenue-budget/tax-policy/the-good-and-the-bad-in-the-house-tax-plan