Policy Matters Ohio

Tax & Budget

CLOSING THE LLC LOOPHOLE

HOUSE MAKES NEEDED CHANGES

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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 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 so 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 it in. This report finds that the tax break has not produced job gains its backers promised, and that Ohio's economic performance remains subpar. The LLC loophole should be scrapped. Admirably, the House took steps to shrink it, but more can be done.

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. Today, most business owners do not have to pay Ohio income tax on the first $250,000 in passthrough income, and only pay a 3% tax rate on such income over and above that—a rate lower than the 4.997% top income tax rate in Ohio. The LLC loophole drains more than $1 billion annually from state revenues, based on current rates.

Since the tax break was adopted in 2013, first-time hiring by new businesses has not increased. Growth of new businesses and small business jobs and payroll continue to lag behind the nation. Overall growth of Ohio jobs, income and output also has trailed the U.S., and is expected to continue doing so, according the economic forecast the state uses. The results are in: This tax break does not rev up small business or Ohio's larger economy, and it's costing dollars that are badly needed to invest in education and public services.

Benefits from the business income tax break go heavily to the most affluent Ohioans — the 7.4% of tax filers using the deduction who claimed $200,000 or more a year received 43.4% of the deduction in 2017 – and that doesn't include the additional tax break for those making over $250,000. Yet most of those who claim it benefit by less than $1,000 a year, and don't employ anyone. The tax break also discriminates in favor of contractors vs. employees, though they may perform identical work. Proponents argue without the tax break, passthrough businesses will pay both individual income tax and the commercial activity tax (CAT), but most small businesses in Ohio are paying a very modest CAT tax or none at all.

Special-interest loopholes within the LLC loophole include:

- Tens of thousands of affluent business owners use the passthrough tax break to claim other deductions intended for those with lower incomes;

- Another loophole permits tax filers who own 20% of a business to deduct compensation they are paid, and
- Permitting business owners to get double benefits from tax deductions they make for health insurance, retirement contributions and half of self-employment tax they may pay.

The House budget made positive steps to fix the first of these special-interest loopholes, so 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 new provision that allows 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. This should be corrected.

The House will reduce the deduction from $250,000 to $100,000 and eliminates the special 3% rate for income over that amount. Figures from 2017 show that if the deduction were limited to $100,000, it would have no impact on almost 87% of those getting it. Those with business income above $100,000 would still receive nearly half of the benefits they do now.

According to the Institute on Taxation and Economic Policy (ITEP), more than 90% of the tax increase from eliminating the 3% rate alone would be paid by filers who make more than $496,000 and thus are among the top 1% of Ohio earners. The Legislative Service Commission estimated that taking both steps – reducing the maximum business income deduction to $100,000 and scrapping the special 3% rate – would save about $528 million a year. ITEP found that more than four-fifths of the additional taxes would be paid by those in the top 1% of the income spectrum. 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 reductions in rates and brackets.

The General Assembly should also make sure the tax break goes only to those who actually run businesses and hire workers. Ohio could emulate Oregon, one of the few other states with such a tax break. Its law requires that those receiving the tax break materially participate 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. The legislature could also limit the LLC loophole to income that qualifies for the new federal passthrough income tax break under the Tax Cuts & Jobs Act of 2017. Though that new federal tax break is heavily tilted to the wealthiest, is too easily gamed, and needs to be repealed, its provisions in some respects are still less generous than the Ohio tax break. Short of closing the LLC loophole entirely, these changes should be made in addition to, not in exchange for the House's reforms.

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, as Policy Matters has detailed previously. And middle-income Ohioans will barely notice the tax cuts they receive. 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. These include overhauling the K-12 school funding formula, making college affordable, providing broader eligibility for public child care aid, and rebuilding revenue sharing with Ohio's local governments, to name just some.

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.