Policy Matters Ohio

Executive Summary
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Ohio's LLC loophole: Public dollars, private benefits

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While most Ohioans pitch in for each other by funding our kids' education, public transit systems and programs that care for our aging neighbors, in 2013, state lawmakers approved a tax break that rewards many of the state's wealthiest residents just for being rich. Fully phased-in in 2016, the Business Income Deduction — also known as the LLC loophole — allows individuals who make profits via the ownership of certain business entities to avoid paying income taxes on their first $250,000 of income and to pay a low flat tax rate above that. Lawmakers didn't tie the subsidy to job creation or positive social outcomes. Nor did they restrict the loophole to strategic economic sectors. It is simply a giveaway to those who can maneuver their income into a specific legal form. It is among Ohio's most expensive tax breaks; it disproportionately rewards a small number of high-income individuals; its benefits to small business owners are marginal at best; and it has negligible overall economic impact.

The LLC loophole can be applied to any Ohio-based business income made by the owners of S corporations, partnerships, certain limited liability companies, and sole proprietorships, which are collectively known as passthrough entities. Often, these entities are legal constructs from which to conduct activities such as passive investing, hobbies and financial manipulations. According to U.S. Department of Treasury research, almost half of passthroughs do not engage in "businesslike" activities and 86%, the vast majority, do not create jobs for anyone other than their owners.

Overall, according to Ohio Department of Taxation data, the top 7% of those who claimed business income in tax year 2020 — claiming at least $240,000 of business income — received 39% of the total value of the deduction. This is without calculating the additional benefits accrued by individuals making more than $250,000 of business income who pay only 3% on income over that amount, instead of the 3.99% they would otherwise pay. Meanwhile, more than half (58.7%) of those who claimed business income in tax year 2020 — representing roughly 381,000 tax returns — claimed less than $20,000 and received less than 7.6% of the total value of the deduction. They each benefit by less than $800 a year, and often much less: not nearly enough to influence hiring or expansion decisions.

There is no clear relation between the loophole and increased job growth or economic progress in Ohio. The giveaway has not slowed Ohio's slide in the national share of employment and of business establishments, neither has it helped Ohio catch up to the national average in terms of net job creation. Instead, it will cost the state about $1 billion in tax year 2022 — dollars that could have been used instead to better educate Ohioans, improve public health, provide transit options, and support all manner of other public services. Which is to say, over the years Ohio policymakers have missed out on countless opportunities to improve public education, foster public health, update infrastructure, and create the prosperous community that could be a true basis for renewed economic vitality.

Recommendations

Lawmakers should scrap the LLC loophole. The LLC loophole is an expensive handout to wealthy Ohioans. It contributes to economic inequality, and, in draining resources from needed state-provided social and economic services, it is an obstacle to a thriving Ohio. The LLC loophole should be abolished.

At the very least, lawmakers should restrict who gets the tax break. The incentive should be available only to those who actually run businesses and hire workers. Ohio could emulate Oregon, which requires that those receiving the incentive "materially participate" in the business and employ at least one qualifying in-state worker. For this to be possible, lawmakers must require accurate and transparent reporting of the forms of business activity claiming this deduction. Currently, Ohio does not collect this type of data.

Even the Tax Cuts & Jobs Act of 2017, passed under President Trump, requires filers to meet a minimum of eligibility criteria to receive the federal passthrough income tax break. It has provisions that require the qualifying income to be associated with a U.S. trade or business. This means that income sources such as capital gains, dividends, and interest are excluded.[30] Also, the deduction decreases in size 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 asset is the reputation or skill of an employee or owner." These requirements are by no means foolproof, but if they were adopted by Ohio, some of the most egregious forms of legal tax avoidance could be disrupted.