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Tax break for business owners won't help Ohio economy

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The Kasich administration has proposed a major new income-tax break for owners of Ohio businesses. These include a variety of different kinds of businesses – S Corporations, limited liability companies, partnerships and sole proprietorships – that have one thing in common: Ohio does not tax the businesses directly on their profits, but rather as the profit passes through to the individual income tax returns of the owners. Hence, they are called "passthrough entities."

Key findings

- The new tax break would be the second largest in Ohio.
- Most qualifying business owners do not employ anyone except themselves; a tax cut is unlikely to change that
- Since the 2005 income-tax cuts, Ohio small businesses have not grown as much as their counterparts across the nation.
- One-fifth of the new break would go to out-of-state investors.
- It would create a new avenue for tax avoidance.

This new tax break is unlikely to generate new jobs. A recent study by Michael Mazerov of the Center on Budget and Policy Priorities finds that state income-tax cuts won't help small businesses create jobs.[1] This brief, which should be read together with the Mazerov study, provides Ohio data relevant to the Kasich proposal.

The proposed business-income tax exclusion would allow owners to exempt from taxation half of their share of income from passthrough entities, up to a maximum of $750,000 a year. Each individual owner of the business would be eligible for a tax break of this size. Overnight, this would create the second largest exemption in Ohio's tax system, costing more than $600 million annually.[2] The tax break won't work for the following reasons, while it could create new problems:

- Most qualifying taxpayers don't employ anyone besides their owner now, and are unlikely to hire new workers merely because they get a tax cut;
- Since the 21 percent reduction in state income taxes approved in 2005, Ohio has underperformed the nation in small-business growth. There is little reason to believe that another round of tax cuts will produce a different result;
- The vast majority of business owners who benefit will get too little tax savings to add employees in any meaningful way;

[1] Mazerov, Michael, "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, at http://bit.ly/YDQrTw.
[2] The State of Ohio Executive Budget, Fiscal Years 2014 – 2015, Book Two, Tax Expenditure Report, at http://media.obm.ohio.gov/OBM/Budget/Documents/operating/fy-14-15/bluebook/budget/Tax_14-15.pdf.

- One-fifth of the tax savings will go to investors outside Ohio who own stakes in Ohio businesses, many of whom are likely to be passive investors in the business without any authority to decide whether the firm creates new jobs;
- While billed as a cut in taxes for small business, it would go also to owners of big businesses, as well as hundreds of partners in Ohio's largest law firms and other partnerships. This is misdirected and doesn't help small businesses;
- It opens up the potential for new abuse of the tax system, since it will create an incentive for the owners of passthrough businesses to reclassify their income as "profit" – half of which will go untaxed – rather than "salary."

Testifying before the House Finance and Appropriations Committee on Feb. 12, Tax Commissioner Joe Testa said that 717,003 tax returns included business income that would be covered by the exclusion. The average income for these taxpayers, Testa said, was $28,645. This means the average recipient of this tax break will be able to exclude $14,323. If all of this income were taxed at the maximum rate – which it won't be, because many owners will not have other total income over $208,500, when the maximum rate kicks in – the owner would get a tax reduction worth $849. Under the same assumption, the 20 percent rate cut would save another $170, for a total savings of just over $1,000.[3] While this is a nice little windfall for these businesses and deprives the state of revenue needed for essential services, it is clearly insufficient to mean much for hiring or the Ohio economy. The maximum savings for any individual owner is $26,663, and even that amount barely funds one job.

The administration does not know how many business owners covered by the proposal have employees now, nor has it made estimates of the jobs that would ostensibly be created because of this or other proposed tax cuts, according to the taxation department.[4] But cutting taxes necessitates cutting public spending, and cutting such spending means there will be fewer jobs for teachers, police officers, and others who provide public services. Like most states, Ohio must balance its budget, so every dollar in taxes that is cut will mean a dollar not spent on public services or a dollar increase in some other tax.[5]

The majority of the business owners who would benefit from the governor's proposal do not employ anyone now. More than half are sole proprietors, and, nationally, 85 percent of sole proprietors have no employees. The other beneficiaries are owners of partnerships and S corporations. National data

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[3] Those figures are based on the *average* income for beneficiaries of the tax cut. That's considerably more, however, than most will receive. According to the Ohio Department of Taxation, the *median* amount of taxable business income that will be excluded under the new exemption – meaning the typical amount, so half of those eligible will have more such income to exempt, half less – is $3,103 (Based on 2009 data. Gary Gudmundson , Ohio Department of Taxation, email to the author, March 1, 2013) If all of this income were taxed at the current top income-tax rate of 5.925 percent, that would mean a tax reduction for the typical business owner of less than $200 a year. Even adding in the Kasich administration's proposal to cut income-tax rates by 20 percent, this does not amount to enough to meaningfully affect Ohio jobs.

[4] Gary Gudmundson, Ohio Department of Taxation, email to the author, March 1, 2013.

[5] Some may argue that the tax cut will "pay for itself" by generating new tax revenue on additional economic growth that it will bring about. This is a fanciful notion. When the Taft administration proposed a major tax overhaul in 2005, for instance, it commissioned an analysis of the economic and fiscal impact, which concluded that additional revenue from the tax cuts "only offset a small proportion of the direct revenue losses; therefore, these tax changes lead to net loss of revenues." REMI Consulting Inc., The Dynamic and Fiscal Impact of the Ohio Administration's Proposed Changes to the Commercial Activity Tax, Corporate Franchise Tax, Personal Income Tax, Tangible Personal Property Tax, and Sales Tax, Prepared for Ohio Department of Development and the State of Ohio, April 18, 2005, p. 1. Moreover, this report did not take into account spending cuts that the tax changes required.

show that 76 percent of partnerships have no employees, and 49 percent of S corporations have no employees.[6] Table 1 shows the type of business entities that are the sources of income that will be excluded under the new proposed tax break. While some owners have interests in more than one business, it's clear that sole proprietorships make up the largest share of businesses covered.

Table 1

Most covered business owners are sole proprietors

Ohio resident individual-income taxpayers eligible for proposed business income exclusion (tax year 2009)

Number of owners/investors by business income source(s)

Income source*	**Number of taxpayers who reported income***
S Corporation and partnership income (1040, line17)	319,209
Sole proprietor income (1040, line 12)	472,132
Other, unidentified business structure (1040, line 18)	30,449
Total	821,790

*Source: Ohio Department of Taxation. The taxation department explains that, "Each individual can have income from more than one source. As a result there is some double counting in the totals. (Example: A taxpayer may have income from both a sole proprietorship and an S Corporation. That one taxpayer would be counted in both totals.)"

A recent national study by researchers at the U.S. treasury department found that only 11 percent of taxpayers reporting business income – and 2.7 percent of all income-tax payers – own a bona fide small business with employees other than the owner.[7] Be they plumbers, consultants, artists or financial planners, many taxpayers reporting business income have no interest in hiring others.

Ohio's experience with tax cuts

Nearly eight years ago, the Ohio General Assembly approved a 21 percent cut in the income tax, phased in over five years, along with a restructuring of the business tax system that reduced taxes.[8] Like wage earners, business owners experienced a 21 percent rate cut. Although proponents hailed the cut as a tonic for business, including small-business owners because they are taxed under the income tax, Ohio has underperformed the nation since then in small-business growth.[9] If a cut in tax rates was as much of an economic growth tonic as supporters claimed, we would have seen some relative improvement.

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[6] 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 Treasury, August 2011, Table 8; http://1.usa.gov/X94bJk. Those limited liability companies that do not choose to be taxed as C corporations are included with partnerships in the Treasury data.

[7] Ibid., Table 14.

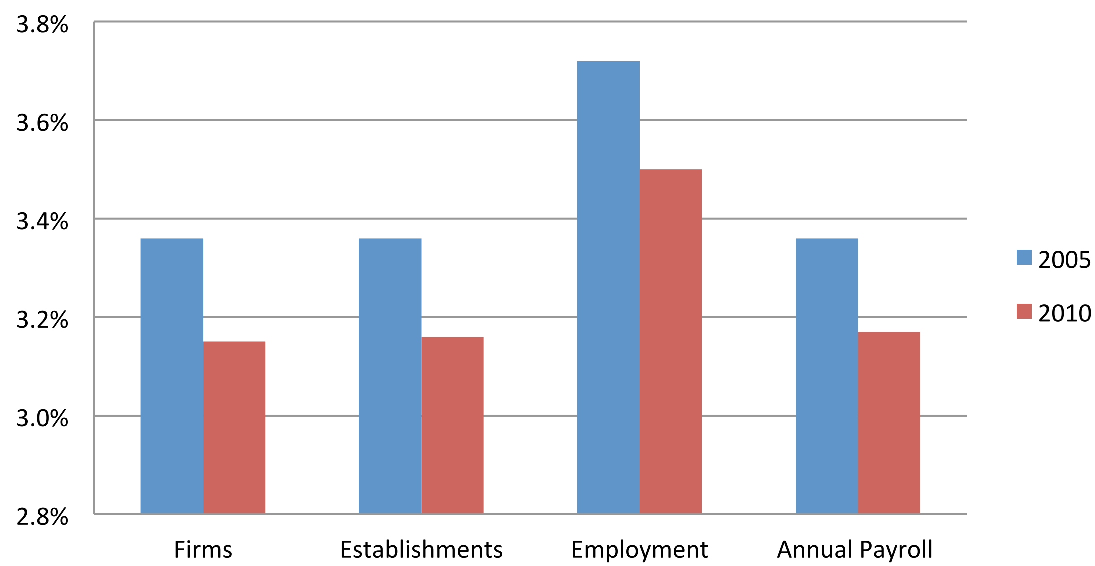
[8] Four years of income-tax cuts were implemented, and then the last year was postponed for two years in 2009-2010 to deal with the state's budget crisis. It went into effect in 2011. Altogether, the 2005 tax overhaul has reduced annual taxes by $2.5 billion a year, according to a 2011 estimate by the Ohio Department of Taxation. "Understanding the Commercial Activity Tax in the Context of the 2005 Tax Reform Package," Testimony of Deputy Tax Commissioner Frederick Church, Legislative Study Committee on Ohio's Tax Structure, Aug. 24, 2011, p. 21.

[9] Gov. Bob Taft wrote in a 2005 op-ed piece supporting his tax proposal that the state income tax "penalizes the more than 300,000 Ohio small businesses to whom we must turn to create most of our new jobs." He argued that the tax proposal "will boost our economy and attract new jobs through business investment and expansion." Dayton Daily News, "Bob Taft: Tax System Frozen in Time," March 8, 2005

Between 2005 and 2010, the most recent year for which data are available, Ohio's share of the national total of firms, establishments, employment and annual payroll all fell, whether it was all firms, those with under 500 employees, or those with under 20 employees.[10] Figure 1 shows how Ohio's share fell by all these measures, for enterprises with fewer than 20 employees.

Figure 1

Enterprises with fewer than 20 employees
Ohio share of U.S. total



Source: Policy Matters Ohio analysis of U.S. Census data.

Ohio's share of the nation's business births also is lower than it was just prior to the approval of the 2005 tax cuts, according to data from the U.S. Bureau of Labor Statistics. Though the share has increased recently, Ohio produced 2.68 percent of the country's business establishment births in the first half of 2012, compared to 2.76 percent during the first half of 2005. The same pattern holds true for employment at those establishments.[11]

Recent data also show that the number of Ohio companies with employees has fallen as a share of the national total. Private employers with employees must pay taxes to cover unemployment compensation.[12] According to data from the U.S. Department of Labor, the number of such establishments in Ohio has declined slightly since the second quarter of 2005, to 268,272 as of the second quarter of last year.[13] Figure 2 shows Ohio's share of private employers compared to the

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[10] U.S. Census Bureau, Statistics of U.S. Businesses, Historical Data Tabulations by Enterprise Size, at http://www.census.gov//econ/susb/data/susb2010.html

[11] Bureau of Labor Statistics, Business Employment Dynamics Data by States, at http://1.usa.gov/13M3jzt and U.S. data at http://www.bls.gov/web/cewbd/table9_1.txt.

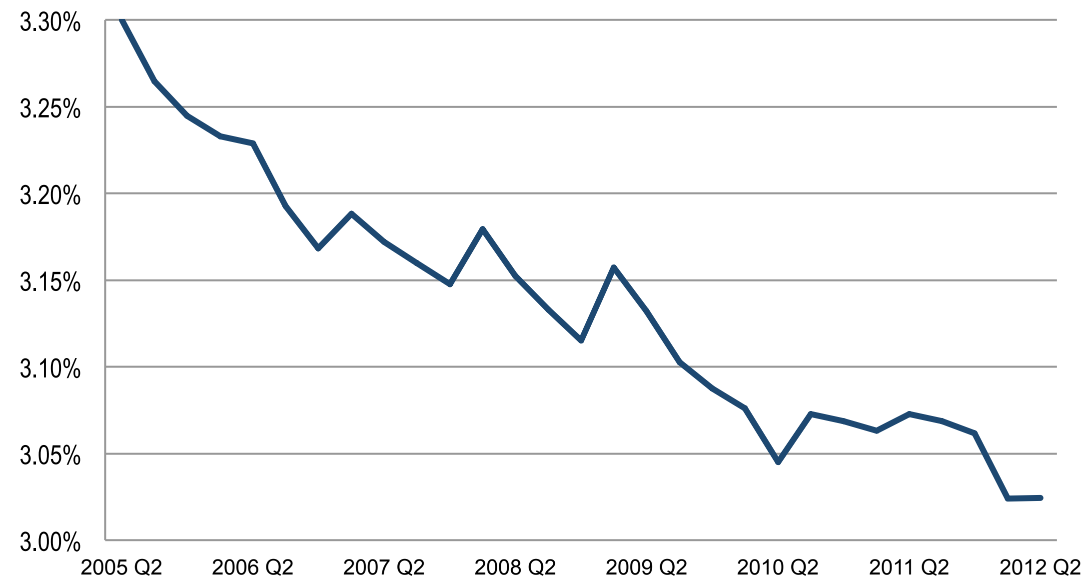
[12] This data, collected under the Quarterly Census of Employment and Wages, covers employers that pay at least one employee for 20 weeks in a year or have payroll of $1,500 in a quarter, and agricultural businesses paying $20,000 or more or employing at least 10 individuals in the current or preceding year, with some modest exceptions.

[13] Bureau of Labor Statistics, Quarterly Census of Employment and Wages, data received by email from U.S. DOL. Employers report for each establishment they have. Secretary of State Jon Husted has reported that the number of new

country as a whole from the second quarter of 2005 (the tax changes were approved in June 2005) through the second quarter of 2012.

Figure 2

Ohio private employers as a share of the U.S. total



Source: Policy Matters Ohio analysis of data from the U.S. Department of Labor.

These data show that since the Ohio General Assembly approved the 21 percent reduction in income-tax rates, Ohio small businesses taken as a whole have not gained ground.

A case of mislabeling

Though the proposal for the new tax break is billed as a small-business tax cut, it would go also to owners of big businesses, passive investors in hedge funds, as well as hundreds of partners in Ohio's largest law, accounting, architecture and other firms set up as partnerships. A partner with, say, $300,000 in annual income will be able to avoid paying income tax on $150,000 of that. This break would go to the individual, not the firm.

The administration noted in its budget proposal that non-Ohio residents would save $140,325,000 under the business-income exclusion, one fifth of the expected total of $701,625,000.[14] Will these out-of-state residents use this windfall to invest in Ohio? Nothing guarantees that they will.

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entities filing to do business in Ohio was the highest in history in 2012 (see http://bit.ly/YmQVwu). However, as the releases notes, "Filing as a business in Ohio does not guarantee the company will begin operations, be profitable or create jobs."

[14] The administration notes that the $701 million is larger than the amount scored elsewhere for the business-income tax exclusion because of the loss associated with the deduction gets smaller as the tax rates are decreased. See The State of Ohio Executive Budget, Fiscal Years 2014 – 2-15, Reforms Book, p. 42, at http://1.usa.gov/13M567z.

One thing the business-profit exclusion could do is lead to wasteful restructuring of business operations to take advantage of new opportunities for tax avoidance.[15] This could create new, unproductive jobs for lawyers and accountants, but it doesn't help Ohio's economy. Half of business income would not be taxed. Thus, other income that is converted into business income would get a tax break. An individual working as an outside contractor for a company to perform the same job as an employee could exclude half of his or her income, because for them, it would be "business income." The tax break would encourage misclassification of employees as independent contractors, which is already a major problem.[16]

The proposed business–income exclusion will do little for Ohio's economy, while draining more than $600 million a year from public services. The General Assembly should remove it from the budget.

Where would the new tax break go? Mostly to the affluent

Gains from the business-profit exclusion will be concentrated among the wealthiest Ohioans. According to an analysis of the Kasich tax plan by the Institute on Taxation and Economic Policy, a research group based in Washington, D.C., 53 percent of the gain going to Ohioans would flow to those in the top 1 percent of the income spectrum, who made more than $335,000 in 2012. Another 26 percent would go to those in the next 4 percent, who made between $143,000 and $225,000.[i] This would further reinforce the regressive nature of Ohio's state and local tax system, under which low- and middle-income taxpayers pay a larger share of their income in such taxes than affluent Ohioans do.[ii]

As Jon Honeck of the Center for Community Solutions has noted, the proposal also would mean that taxpayers with the same income would pay vastly different amounts of taxes, based on whether they received it as a salary or as business income. A taxpayer with $50,000 in salary income would pay $1,441 in in 2012 income tax, while someone with the same income through a passthrough entity would pay just $512, or 64.5 percent less.[iii]

[i] "Kasich tax proposal would further tilt tax system in favor of Ohio's affluent," Policy Matters Ohio, Feb. 7, 2013, at www.policymattersohio.org/tax-policy-feb2013.
[ii] See "Ohio's state and local taxes hit poor and middle class much harder than wealthy," Policy Matters Ohio, Jan. 30, 2013, at www.policymattersohio.org/income-tax-jan2013.
[iii] Testimony of Jon Honeck, Director of Public Policy, Center for Community Solutions, Hearing on House Bill 59, Ohio House of Representatives Ways & Means Subcommittee, March 12, 2013, at http://bit.ly/XCbvhY. Calculations exclude the 20 percent rate-cut proposal.

[15] The use of passthrough entities to take advantage of tax loopholes is hardly unknown in Ohio. Just last year, the Kasich administration proposed and the General Assembly approved the closing of a loophole that allowed buyers of boats, planes, motor vehicles or other recreational property to avoid paying the sales tax if the transaction was structured as the sale of ownership in a passthrough entity. Now, the ownership transfer of such a company is taxable when its sole assets are such recreational property used primarily by the entity's owners. 129th General Assembly, House Bill 508, Section 5739.01.
[16] See for instance Sarah Leberstein, "Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries," National Employment Law Project, Updated August 2012, at http://bit.ly/10t3ppo.