Testimony on House Bill 334
Before the House Ways and Means Committee
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Proponent Testimony on behalf of NAPEO
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Chairman Schaffer, Vice Chairman Scherer, Ranking Member Rogers and members of the House Ways and Means Committee, thank you for providing me this opportunity to speak on behalf of NAPEO regarding H.B. 344.

I am Steve Hall, attorney and member/owner of the Columbus law firm Zaino Hall & Farrin, LLC. Our firm specializes in state and local tax matters. Earlier in my career, I worked as Assistant Counsel to the Ohio Tax Commissioner at the Ohio Department of Taxation.

I am here today to provide some perspective on the policy of the small business deduction (SBD), now known as the business income deduction (BID), and the special Ohio provision of law for 20% or more owners of pass-through entities who receive wage income from the pass-through entity. You have already heard from Melissa Kelly with NAPEO about what PEOs are and why PEOs and their clients are important. I will focus on the Ohio tax issue that is implicated.

Ohio policy-makers enacted the BID/SBD largely to incentivize small-business owners to locate their businesses in Ohio and generate business income in Ohio. Since most small-businesses are structured as "pass-through" entities, the decision was made to provide the deduction for "business income."[1] A "pass-through" entity is an entity where the income "passes through" the entity and is taxed in the hands of the owners. Some examples are LLCs, Partnerships, and S Corporations.

Income generated by a pass-through entity and therefore "passing through" to the owners is often referred to as "K-1 income," since the K-1 is the federal income document which reports the income to the owner for the owner to report on his personal income tax return. K-1 income is generally treated as "business income." In short, K-1 income generally qualifies for the SBD/BID. W-2 income,

[1] Another policy reason was that the commercial activity tax and the personal income tax would both apply to a pass-through entity, whereas if the entity were structured as a C corporation, only the commercial activity tax would apply.

on the other hand, generally does not qualify for the SBD/BID because wages are generally treated as “non-business income.”[2]

However, a special provision of Ohio law treats the W-2 income as though it were K-1 income, if the recipient of the income owns 20% or more of the pass-through entity paying the compensation. The special provision of Ohio law is in R.C. 5733.40(A)(7) and provides that if an owner of a pass-through entity owns 20% or more of the entity, the W-2 compensation paid to the owner will be *treated* as the income of the pass-through entity (and treated as K-1 income passing to the owners). The easiest way to understand this is to merely treat the W-2 income as though it has been “re-characterized” as K-1 income to the recipient. The amount does not change; it is merely the character of the amount that changes.

As you have already heard, PEOs perform an important role by assisting small businesses with employment law issues, administration of retirement plans, insurance and other administrative issues, and tax compliance issues. Because of the way PEOs operate, if wages are paid to an employee of the client of the PEO, the FEIN of the PEO is used, as opposed to using the FEIN of the client pass-through entity. This wage reporting discrepancy is part of the reason for the need for clarifying language.

The language proposed is needed to clarify that a 20% or more owner of the client pass-through entity who uses a PEO structure is not disadvantaged by using a PEO, and that such 20% or more owner is permitted to use the BID/SBD with respect to the wages paid to the owner. The owners are focused on running their businesses. The PEO is focused on assisting its clients with administrative issues. The use of the PEO structure should not eliminate this important tax deduction, which is targeted at small business owners, whether or not a PEO structure is used.

NAPEO strongly supports this clarifying legislation that will allow 20% or more owners of pass-through entities that use a PEO structure to utilize the business income deduction on their Ohio tax returns with respect to the wages paid to the owners. We salute both Representative Scherer and Senator Peterson for their leadership in helping to clarify this provision of Ohio law. Mr. Chairman, I would be happy to answer any questions you may have about the Bill and why it is so important to all small business owners in Ohio that utilize a PEO structure and important to the PEOs as well.

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[2] “Business income” vs. “non-business income” issues can be much more complex and can relate to constitutional issues, such as which state or states may tax income earned in several jurisdictions, but this document focuses on the Ohio personal income tax issue at hand.