Policy Matters Ohio

TESTIMONY
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Tax & Budget

Testimony on HB 334 before the House Ways & Means Committee

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Good morning, Chairman Schaffer, Ranking Member Rogers and members of the committee. My name is Zach Schiller and I am research director of Policy Matters Ohio, a nonprofit, nonpartisan organization with the mission of creating a more prosperous, equitable, sustainable and inclusive Ohio. Thank you for the opportunity to testify. The business income deduction should not be expanded.

We now have more than four years of experience with this deduction. It has not delivered on its promise of creating new jobs. Ohio job growth has been mediocre at best. Since the deduction was first enacted in June 2013, Ohio jobs have grown by 5.5 percent, compared to the national average of 7.6 percent. The state gained just 61,600 jobs in the past 12 months, a number that doesn't match most years since the recession and is far from the rates we saw in the mid-1990s. New employment at new businesses hiring for the first time is *lower* than it was before the deduction was approved in June 2013. Yet while such hiring fell by 4.9 percent in Ohio between 2012 and 2016, according to figures from the U.S. Bureau of Labor Statistics, it rose by 6.6 percent across the country. This unproductive tax break costs over $1 billion a year, money that is badly needed to invest in programs that truly build a stronger and more prosperous Ohio.

According to the Legislative Service Commission, House Bill 334 would cost up to $2 million a year, while the retroactive provision in the bill could potentially cost up to $10 million. Figures we received from the Department of Taxation similarly show it will cost $1 million to $2 million per year, and $4 million to $8 million for its retroactive provision. Tax reductions are not free. The millions of dollars that the state will not receive could allow it to reimburse counties and transit agencies for more of the revenue they will lose because of the end of the Medicaid managed care organization sales tax, allow more children to receive early education, or aid more students to afford a college education, to cite just a few of our unmet needs.

There is an alternative course to what is proposed in House Bill 334: Making clear that compensation is not covered by the business income deduction. That is what was understood from the outset: Compensation is excluded under Sections 5747.01(C) and (D) of the revised code that created the business income deduction. However, because of an unrelated section of the code that pre-dated the business income deduction, the taxation department has allowed 20 percent (or greater) owners to claim compensation anyway. This has only recently come to light publicly because of the non-uniform treatment of compensation paid by passthrough businesses using professional employer organizations (PEOs) to handle their payroll, which the proposed legislation aims to address. The taxation department is following the law with its interpretation. But rather than reducing revenues further by allowing owners of passthroughs using PEOs to claim the same deduction, this loophole should be closed and the compensation deduction should be eliminated.

The business income deduction was supposed to cover profits, not compensation paid to business owners. Some might argue that's an artificial distinction; what's to prevent a business owner from simply cutting his or her salary to $1 and classifying their compensation as profit? However, under federal income-tax rules, S Corporation owners must pay themselves a reasonable salary to prevent payroll tax evasion. Profits are not the same thing as compensation, and extending this deduction to compensation bends the concept of business income beyond recognition.

When President Trump proposed recently to reduce the federal income tax on passthrough entities, the proposal also included the idea that measures would be adopted "to prevent recharacterization of personal income into business income to prevent wealthy individuals from avoiding the top personal tax rate." That shows a fundamental weakness in such tax breaks: The incentive they provide to reclassify income in this fashion, with a benefit only to the taxpayer, not to the economy.

The General Assembly should repeal the business income deduction. But short of that, it should make clear that the deduction is indeed for business income, not compensation. Thank you for this opportunity to testify.