



Ohio Council of Retail Merchants

TESTIMONY REGARDING HOUSE BILL 138

Before the House Ways and Means Committee

May 2, 2023

Good afternoon Chairman Roemer, Vice Chair Merrin, Ranking Member Troy and honorable members of the House Ways and Means Committee. My name is Dave Froling. I am a state and local tax partner with Vorys, Sater, Seymour and Pease LLP. I am pleased to offer this testimony today on behalf of the Ohio Council of Retail Merchants and their more than 7,500 members.

Since 1998, part of my practice has included representing individuals before the Ohio Department of Taxation (“Department”) during audits, and if need be, litigation before the Ohio Board of Tax Appeals and the Ohio Supreme Court. I can tell this Committee first hand that H.B. 138 is regrettably necessary and regrettably long overdue.

Back in 2013, under Governor Kasich’s leadership, the 130th General Assembly was bold and showed real vision in making Ohio less reliant on income taxes. One aspect of reducing Ohio’s reliance on income taxes was the adoption of the business income tax deduction (“BID”). The BID accounted for the Ohio tax disparities between large C corporations on the one hand, and the business owner that operated his/her business as a pass-through entity on the other hand. The BID also attempted to make Ohio competitive from an income tax perspective as compared to its

neighboring states. Since 2013, the General Assembly has amended the BID several times, principally to make the BID more robust and/or less vague.

It is self-evident from the Tax Commissioner's 2022 annual report that many small business owners have benefitted from the BID. From the Tax Commissioner's 2018 annual report: "Small businesses are the drivers of Ohio's economy. Small businesses make up roughly 98% of all Ohio businesses and they employ half of Ohio's private sector workforce." I have no reason to believe these statistics are any different in 2023.

Regrettably many small business owners are not realizing the full benefit of the BID. Why is that?

In the Fall of 2015, the Department stated individuals receiving "guaranteed payments" from a pass-through entity do not have "business income" for purposes of the BID unless the individual owns at least 20% of the pass-through entity. Despite stating its audit policy publicly for the first time, the Department stated it was applying its audit policy retroactive to January 1, 2013, the date when the BID became effective.

The Department's audit policy is not in accord with Ohio income tax law or federal income tax law. The Department's audit policy suggests the Department does not understand what constitutes a guaranteed payment for federal income tax purposes, ie., how federal income tax law applies to "guaranteed payments," and how Ohio law is hogtied to federal income tax law.

By way of background, Ohio personal income tax law requires individuals to calculate their "Ohio adjusted gross income."¹ The starting point in making this calculation is the individual's "federal adjusted gross income."² Ohio law presently sets forth thirty-six adjustments that the

¹ R.C. 5747.02(A)(3).

² R.C. 5747.01(A).

individual makes to his/her “federal adjusted gross income,” the net effect of which produces the individual’s “Ohio adjusted gross income.” One of those thirty-six adjustments is the BID.³

The BID allows an individual to deduct a portion of the individual’s “business income.” An individual that files “married filing separately” can deduct up to \$125,000 of his/her business income. Individuals who are not married, or who file “married filing jointly,” can deduct up to \$250,000 of their business income.

The Internal Revenue Code defines a “guaranteed payment” as a payment by a pass-through entity to an owner of the pass-through entity (i.e., an individual), the amount of which is (i) determined without regard to the income of the pass-through entity; and (ii) paid to the individual in exchange for services provided by the individual and/or for the use of the individual’s capital.⁴ When the pass-through entity is engaged in a trade or business, the individual treats this payment for federal income tax purposes as income the individual derived from carrying on a trade or business.⁵ More specifically, the guaranteed payment is self-employment income to the individual as if the individual were engaged in a trade or business as a sole proprietor.

Because the guaranteed payment is self-employment income to the individual, the individual pays federal income taxes and all federal employment taxes on the guaranteed payment. Correspondingly, the pass-through entity does not withhold federal income taxes from the individual’s guaranteed payment because federal income tax law does not require the pass-through entity to do so. The pass-through entity does not withhold federal employment taxes from the individual’s guaranteed payment because federal employment tax law does not require the pass-

³ The BID is currently set forth at R.C. 5747.01(A)(28).

⁴ See I.R.C. 707(c) and U.S. Treasury Regulations promulgated thereunder. To keep this testimony as simple as possible the term “pass-through entity” means legal entities treated as “partnerships” for federal income tax purposes (i.e., partnerships and limited liability companies). S corporations, C corporations, or any legal entity taxed as a corporation cannot make “guaranteed payments.” Id.

⁵ See Treas. Reg. Sections 1.1402(a)-1(a)(1) and 1.1402(a)-1(b).

through entity to do so. The pass-through entity does not pay the employer's share of federal employment taxes on the individual's guaranteed payment because federal employment tax law does not permit the pass-through entity to treat the individual as an employee. Federal income tax law and federal employment tax law are clear in this regard.

Self-employment income is business income for Ohio income tax purposes yet the Department says certain guaranteed payments are not business income. Stated differently, the Department says certain guaranteed payments are nonbusiness income and not eligible for the BID and the 3% business income tax rate despite the fact the guaranteed payment is self-employment income for federal income tax purposes and Ohio income tax purposes.

The Department relies upon R.C. 5733.40(A)(7) as the basis for its faulty audit policy. The General Assembly enacted this statute in 1997. R.C. 5733.40(A)(7) applies only to individuals that own at least 20% of a pass-through entity. R.C. 5733.40(A)(7) *recharacterizes* the individual's guaranteed payment as a "distributive share" of the pass-through entity's profits (which leads the Department to conclude such guaranteed payment is "business income" eligible for the BID). Thus, the individual uses the pass-through entity's apportionment factors for purposes of calculating the individual's Ohio income tax liability.

While the tax policy and the arbitrariness of R.C. 5733.40(A)(7) is questionable, this statute does not apply to individuals that own less than 20% of the pass-through entity. Accordingly, the Department says since R.C. 5733.40(A)(7) does not apply, the individual's guaranteed payment cannot be distributive share income and therefore it must be nonbusiness income. The Department is misreading the statute. The Department's logic is not correct. R.C. 5733.40(A)(7) does not convert such individual's self-employment income from engaging in a trade or business as a sole proprietor into nonbusiness income. The statute simply does not apply so instead the individual uses his/her sole proprietorship's apportionment factors for purposes of calculating the individual's

Ohio income tax liability. To be sure, by definition, self-employment income from engaging in a trade or business as a sole proprietor has to be “business income.”

The Department’s audit policy is not sustainable in a court of law and individuals should not have to incur the time and expense of protracted litigation to prove the Department wrong. Indeed, litigation has proven to be cost-prohibitive because there are no meaningful decisions from the Board of Tax Appeals. Accordingly, the General Assembly has to step in to help small business owners. The Council urges this Committee to pass H.B. 138.

Members of the Committee, this concludes my prepared remarks. The Council appreciates your time and attention to H.B. 138. On behalf of the Council, I would be happy to answer any of your questions.