Ohio Tax Talk: How Small Business Relief Would Work

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After making its way through the Ohio Senate Ways and Means Committee, on March 16, the Ohio Senate approved legislation that would give tax relief to small businesses that are set up as S corporations, partnerships and limited liability companies. Senate Bill 246, sponsored by state Sen. Mike Rulli of Salem, R-33, and Sen. George Lang of West Chester, R-4, passed in a 30-0 vote. S.B. 246 essentially creates an additional option for a pass-through entity, or PTE, such as an S corporation, partnership or LLC to pay income tax by opting to directly impose an income tax on the PTE.

This, in turn, would then allow owners of a PTE to claim a refundable credit on their individual income tax returns, ensuring that they are not double-taxed at the state level. In other words, this would allow the owners of PTEs to reduce their federal income tax liability. The introduction of S.B. 246 appears to be in response to the federal Tax Cuts and Jobs Act, which put a $10,000 cap on the state and local tax deduction and on recent Internal Revenue Service guidance regarding the SALT deduction.

While federal law caps the SALT deductions — e.g., property taxes plus either state and local income tax or sales tax — at $10,000, any taxes paid at the PTE level under the newly proposed opt-in option in S.B. 246 would not count toward this cap. Specifically, the IRS guidance confirmed that taxes paid at the PTE level would be considered "above the line," and reduce the federal adjusted gross income tax of its owners, whereas the SALT deduction is "below the line."

How the Proposed Bill Works

A PTE may elect to be subject to the tax, which is referred to in the bill as an "electing PTE" — by filing a specific form making the election with the Ohio tax commissioner by the deadline to file its return for the taxable year, which is April 15 of the year following its

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taxable year. Electing to be subject to the tax applies only to the taxable year for which it is made and, once made, is irrevocable for that year.

Currently, Ohio applies a 3.99% tax rate on PTE income. Under the proposed structure in S.B. 246, an electing PTE's tax liability equals all income sitused to Ohio, minus applicable adjustments, multiplied by one of the following tax rates: (1) for 2022, 5%; (2) for each year thereafter, the income tax rate applicable to business income, which is 3%.

To claim the refundable income tax credit, a taxpayer or owner must first add back to its Ohio taxable income its proportionate share of the income taxes paid by the electing PTE, which reduces the taxpayer's federal adjusted gross income. The taxpayer/owner may then claim a refundable income tax credit equal to the amount of PTE taxes added back.

Proponents and Opponents

Since the TCJA, which impacted small businesses' bottom line due to the SALT deduction limitation, at least 22 other states have implemented similar PTE tax laws and four others are considering the same. Proponents of the bill include: the National Federation of Independent Business Inc.; the Ohio Society of CPAs; and S Corporation Association. According to its proponents, S.B. 246 would positively impact tens of thousands of small businesses after those businesses were negatively affected by the federal TCJA. Proponents of the bill also state that Ohio taxpayers remain at a competitive disadvantage when compared to C corporations operating in Ohio to businesses operating in the 22 other states. This bill would presumably change that.

But there is at least one opponent that has voiced concern over the bill: Policy Matters Ohio. As Policy Matters Ohio points out, and as confirmed by the finance analysis performed by the Legislative Service Commission and the Ohio Department of Taxation, the bill is estimated to reduce the state's general revenue fund by approximately $900,000 in fiscal year 2022, $74.8 million in fiscal year 2023 and $77.5 million in fiscal year 2024.

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Additionally, the bill would reduce revenue to the local government fund and the public library fund. The revenue loss is primarily driven by the 3% rate that PTE would pay starting in tax year 2023, compared to the current 3.99%. Currently, the municipal income tax system in Ohio is already imposed at an entity level and S.B. 246 would provide an opportunity for taxpayers to get similar treatment for state income taxes. The bill will likely head to the Ohio House of Representatives for consideration and may still undergo further changes.

At bottom, the proposed bill would be a win for business owners who elect to take advantage of the direct imposition of taxes on their PTE and subsequently claim a reduction on the federal income taxes. Because the PTE election is optional, rather than mandatory, the bill would provide greater flexibility for taxpayers to choose which option suits them best.

While Ohio's PTE tax regime appears straightforward at initial glance, there are many planning issues that may arise when business owners are considering an election.

Tax Planning Considerations

To determine if a PTE election is favorable, Ohio taxpayers should evaluate the effect that S.B. 246 may have in both their specific tax structure and in the tax structure of the individual owners. In some cases, existing taxpayers or owners may benefit disproportionately if an election is made. Moreover, despite the potential benefits, pass-through businesses with multistate operations or owners residing in multiple states may confront more compliance challenges and should proceed with caution when making any PTE election.

Electing to pay tax at an entity level in one state may have an effect on the tax returns of each taxpayer or owner in other jurisdictions where a business is required to file, especially when claiming credits for PTE taxes paid to another state. Taxpayers should also plan for withholding and anticipated tax payments, which may involve asking for refunds for overpayment of taxes previously paid by individual owners and how credits may be carried forward if utilized by the

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individual owner in the tax year paid by the company. Additionally, while filing Schedule K-1, business organizations making the election may be subject to additional compliance considerations.

For more information regarding the tax implications of Senate Bill 246, contact Yazan Ashrawi, Raghav Agnihotri, or any member of Frost Brown Todd's Government Services and Tax practice groups.

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