



# OHIO LEGISLATIVE SERVICE COMMISSION

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## Bill Analysis

Mackenzie Damon

### **H.B. 334**

132nd General Assembly  
(As Introduced)

Rep. Scherer

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#### **BILL SUMMARY**

- Specifies that a pass-through entity (PTE) investor who is paid wages or guaranteed payments by a professional employer organization hired by the PTE may claim the business income deduction and apply the 3% flat tax rate with respect to such income, provided the investor holds at least a 20% interest in the PTE.
  - States that the bill is intended to clarify existing law and that, therefore, the bill's changes apply retrospectively to taxable years beginning in or after 2013 – the first year the business income deduction was allowed.
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#### **CONTENT AND OPERATION**

##### **Business income deduction for PEO-paid compensation**

The bill provides that the compensation, including guaranteed payments, paid to a pass-through entity (PTE) investor by a professional employer organization (PEO) hired by the PTE is considered business income, and therefore is eligible for the business income deduction and 3% flat tax on business income, provided that the investor holds at least a 20% interest in the PTE.<sup>1</sup>

Continuing law allows a taxpayer to deduct the first \$250,000 of the taxpayer's business income each year.<sup>2</sup> The deduction is available to individuals who own or

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<sup>1</sup> R.C. 5733.40(A)(7). A guaranteed payment generally is a payment made by a PTE to an investor that does not depend on the PTE's income. Guaranteed payments can function as compensation to an investor for services the investor performs for the PTE. See 26 U.S.C.A. 707(c).

<sup>2</sup> The deduction for married individuals filing separately is \$125,000 for each spouse. R.C. 5747.01(A)(31).

invest in sole proprietorships or PTEs such as limited liability companies, S corporations, and partnerships. Any business income in excess of \$250,000 is taxed at a flat rate of 3%, instead of the graduated rates, up to 4.997%, that apply to "nonbusiness" income such as wages and pensions and any interest, dividends, rents, royalties, or capital gains not received in the ordinary course of business.

For PTE investors, the deduction is available for income generated by the business that is passed through to the investors as a "distributive share." In addition, the Department of Taxation has determined that investors who hold a 20% or greater interest in the PTE may also deduct any guaranteed payments or other compensation paid by the PTE to the investor.<sup>3</sup>

In the course of business, some PTEs might outsource certain human relations tasks to a professional employer organization (PEO), including the management of payroll and employee benefits. In such cases, when an individual who holds a 20% or more interest in a PTE is paid wages or other compensation by the PEO, rather than directly by the PTE, the Department of Taxation has determined that such income is not considered business income, and therefore not eligible for the business income deduction or 3% flat tax.<sup>4</sup>

The bill specifically allows guaranteed payments and other compensation paid by a PEO to such 20% investors to qualify for the business income deduction and 3% flat tax. In addition, the bill states that its new language is intended to clarify existing law and that, therefore, the language applies to taxable years beginning on or after 2013 (the first year the business income tax deduction was allowed).<sup>5</sup>

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<sup>3</sup> The basis for this standard is found in the PTE withholding tax. This tax requires PTEs to withhold tax on the distributive share income of its nonresident investors, who otherwise may not be required to file a tax return in Ohio. Under current law, taxes must be withheld on any guaranteed payments and other compensation paid by the PTE to such investors, but only when the investor holds at least a 20% interest in the PTE. R.C. 5733.40(A)(7).

<sup>4</sup> This determination is based on the language of the statute, which requires withholding on amounts "paid by" the PTE. R.C. 5733.40(A)(7).

In September of 2017, the Department issued a statement declaring that, in light of this pending legislation, it has suspended all existing audit cases related to the income of such investors.

<sup>5</sup> Section 3.

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## HISTORY

ACTION

DATE

Introduced

08-30-17

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