Jean J. Botomogno

Fiscal Note & Local Impact Statement

Bill: S.B. 186 of the 132nd G.A.

Status: As Reported by Senate Ways & Means

Sponsor: Sen. Peterson

Local Impact Statement Procedure Required: Yes

Subject: To classify wages paid to certain business owners through PEOs as business income

State & Local Fiscal Highlights

	FY 2018	FY 2019	FUTURE YEARS
General Revenue Fund			
Revenues	Loss up to $1.9 million; additional losses from refunds to taxpayers	Loss up to $1.9 million; additional losses from refunds to taxpayers	Loss up to $1.9 million; additional losses from refunds to taxpayers
Local Government and Public Library Funds (counties, municipalities, townships, and public libraries)			
Revenues	Loss up to $0.1 million; additional losses from refunds to taxpayers	Loss up to $0.1 million; additional losses from refunds to taxpayers	Loss up to $0.1 million; additional losses from refunds to taxpayers

Note: The state or school district fiscal year is July 1 through June 30. For example, FY 2018 is July 1, 2017 – June 30, 2018. For other local governments, the fiscal year is the calendar year.

- The bill increases the amount of wages and other compensation that would qualify for the small business deduction under the personal income tax (PIT) and thus decreases state income tax revenue. This decrease might be up to $2 million per year on an ongoing basis. Additionally, the bill's language applies to taxable years beginning on or after 2013 (the first year the business income tax deduction was allowed). This provision could increase PIT refunds by up to $10 million. The refunds would be to taxpayers that have paid income taxes on qualifying amounts not deducted since 2013.
- The state income tax revenue loss would be shared by the General Revenue Fund (GRF, 96.66%), the Local Government Fund (LGF, 1.66%) and the Public Library Fund (PLF, 1.68%). Funds deposited into the LGF and PLF are distributed to counties, municipalities, townships, and public libraries according to statutory formulas and decisions by county budget commissions.

Detailed Fiscal Analysis

The bill provides that the compensation, including guaranteed payments, paid to a pass-through entity (PTE) investor by a professional employer organization (PEO)[1] 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.

Under current law, an individual who owns or invests in sole proprietorships or PTEs (such as limited liability companies, S corporations, and partnerships) can deduct the first $250,000 of the taxpayer's business income each year.[2] 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. In addition to pass-through income or net profits, an investor who holds a 20% or greater interest in the PTE may also deduct as business income any wages, guaranteed payments, or other compensation paid directly by the PTE to that investor.

However, when an individual who holds a 20% or more interest in a PTE is paid compensation by a PEO hired to manage payroll and employee benefits for the PTE, the Department of Taxation has determined that such income is not considered business income for purposes of the small business deduction, and therefore not eligible for the deduction or 3% flat tax. 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. The bill specifies that this provision applies to taxable years beginning on or after 2013 (the first year the business income tax deduction was allowed).

LSC has no publicly available data on the number of PTEs that contract with PEOs for human resources services. In addition, no information is available on wages and other compensation paid through PEOs to those taxpayers who may be qualifying investors in PTEs. Finally, income taxes that might have been paid on such amounts not deducted in tax returns is uncertain. According to an official of the Department of Taxation, a preliminary analysis of data available to the agency suggests a potential annual revenue loss to the GRF of up to $2 million from the bill; and the retroactive provision in the bill could provide for potentially up to $10 million in refunds to qualifying taxpayers that did not, in previous years, exclude from taxation wages and other compensation paid to them through PEOs. Please note, however, it is possible that actual refunds could be considerably less than this estimate, depending on the number

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[1] PEOs provide to firms various services related to human resources management, such as payroll processing, benefits management, and regulation compliance. PEOs would generally operate in a co-employment relationship with their clients by including the clients' workers on their own payrolls. In such a relationship, the PEO becomes the employer of record for tax and insurance purposes.

[2] The deduction for married individuals filing separately is $125,000 for each spouse.

of amended returns and refund claims filed by qualifying taxpayers. In September 2017, the Department of Taxation suspended audit activities related to individuals who received compensation from a PEO that they do not own, and who claimed the business income deduction. Ultimately, the potential revenue loss from the bill due to refunds would depend on unknown amounts assessed and already paid by taxpayers, and the resolution of existing audits that have not yet reached an assessed status or billings.

In the current biennium as prescribed by H.B. 49 (the main operating budget act), the GRF would retain 96.66% of PIT revenue, and distributions to the LGF and PLF would be 1.66% and 1.68%, respectively.[3] Therefore, the majority of the annual revenue loss, up to $1.9 million, would be borne by the GRF, and up to $0.1 million would be borne by the LGF and PLF. Of potential refunds, the revenue loss to the GRF would be up to $9.7 million. Potential losses to the LGF and PLF would total up to $0.3 million. The timing of revenue losses from the tax refunds is uncertain, as they would depend on taxpayers filing refund claims. The revenue loss to the LGF would reduce receipts to counties, municipalities, and townships statewide, according to statutory formulas and decisions by county budget commissions. The revenue loss to the PLF would reduce receipts primarily to public libraries statewide.

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[3] In codified law, the PLF and GRF shares are 1.66% and 96.68%, respectively. These shares would resume beginning in FY 2020 if the General Assembly does not enact any changes to them before then.