OHIO LEGISLATIVE SERVICE COMMISSION

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Office of Research and Drafting

Legislative Budget Office

H.B. 138
135th General Assembly

Fiscal Note & Local Impact Statement

Click here for H.B. 138's Bill Analysis

Version: As Introduced

Primary Sponsors: Reps. King and T. Young

Local Impact Statement Procedure Required: Yes

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Highlights

Fund	FY 2024	FY 2025	Future Years
State General Revenue Fund			
Revenues	Loss of up to $32.0 million	Loss of up to $33.9 million	Annual losses to grow about 6% per year
Local Government and Public Library funds (counties, municipalities, townships, and public libraries)			
Revenues	Loss of up to $1.1 million	Loss of up to $1.2 million	Annual losses to grow about 6% per year

Note: The fiscal year for the state, school districts, and certain other local governments runs from July 1 through June 30 and is designated by the calendar year in which it ends. For other local governments, the fiscal year is identical to the calendar year.

- Classifying certain guaranteed payments to pass-through entity investors as business income will reduce personal income tax (PIT) receipts by up to $33.0 million in FY 2024, as compared with tax administration under current law, assuming the bill would become law for tax year (TY) 2023. Revenue losses could be significantly below this upper bound. Revenue losses would increase to an amount up to $35.0 million in FY 2025. Due to data limitations, the upper bound estimate is rough.
- The GRF would bear most (96.68%) of the revenue losses under codified law, with the Local Government Fund and Public Library Fund bearing the remaining losses.
- The bill also includes a remedial provision that would apply to any transaction that is subject to an audit by the Department of Taxation on or after the effective date. The

provision likely has a fiscal effect, but it is not estimated in the above table because LBO does not have access to such confidential taxpayer data.

Detailed Analysis

The bill expands the definition of "business income" to include guaranteed payments that an individual receives from a pass-through entity (PTE) for services the individual renders to the PTE, regardless of the percentage of the individual's direct or indirect ownership interest in the PTE, provided:

1. The PTE is engaged in a trade or business;
2. The guaranteed payment is treated as net earnings from self-employment under section 1402 of the Internal Revenue Code and U.S. Department of the Treasury regulations issued thereunder; and
3. The taxpayer reports the guaranteed payment as self-employment income for federal income tax purposes.

LBO staff assumes the effective date will occur during tax year (TY) 2023, which would affect TY 2023 personal income tax (PIT) returns filed during FY 2024.

An uncodified provision of the bill states that it "is a remedial measure intended to clarify existing law and applies to any petition for reassessment or any appeal thereof and to any application for refund or any appeal thereof pending on or after the effective date of this section and to any transaction that is subject to an audit by the Department of Taxation on or after that date." LBO staff is aware of some audits currently being adjudicated by the Tax Department, but those are confidential matters, and the fiscal effect of this remedial provision is difficult to quantify.

Background

Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership's income. A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner. The individual partner reports guaranteed payments on Schedule E (Form 1040) as ordinary income, along with their distributive share of the partnership's other ordinary income.[1] However, this ordinary income differs from a regular salary because the PTE does not pay federal payroll taxes on behalf of the individual partner's guaranteed payments. Instead, the individual partner must pay all of the FICA (Federal Insurance Contributions Act) taxes (i.e., Social Security tax and Medicare tax) on their guaranteed payment income by filing Schedule SE (Form 1040).

Ohio taxpayers cannot simply report amounts from federal Schedules B, C, D, E, and F as business income on their state income tax form. The taxpayer must determine whether their income reported on these various schedules qualifies as business income. Presently, the Ohio Department of Taxation has a dedicated website for helping taxpayers make this determination. One of the questions answered by the website is "How do I determine if my compensation or guaranteed payment is business income?" Many Ohio taxpayers are likely reporting Schedule E

[1] Refer to Internal Revenue Service Publication 541 for a summary of guaranteed payments.

income from certain guaranteed payments as nonbusiness income on their PIT return. The instructions are explicit that taxpayers may only report guaranteed payments on their Schedule E as business income, if they have at least 20% ownership stake in the partnership.

Compensation is regarded as nonbusiness income, and it is taxed at progressive, PIT rates up to 3.99%. Guaranteed payments are considered compensation[2] (i.e., compensation for labor that is to be paid even if the partnership has no net income) except when they are received by a partner with at least a 20% ownership stake in the partnership. Therefore, under the bill such guaranteed payments would be classified as business income instead of nonbusiness income. The distinction is relevant because the business income deduction (BID) enables a taxpayer to exclude (i.e., there is a 0% tax rate on that income) the first $250,000 of business income earned by those filing "Single" or "Married filing jointly," from state income taxation. For taxpayers who file "Married filing separately," the first $125,000 of business income is 100% deductible. Any remaining business income above these thresholds is then taxed at a flat 3% rate.

Fiscal effect

As noted above, some guaranteed payments are already regarded as business income. The bill expands the definition of business income for those guaranteed payments that meet all three enumerated conditions. One such stipulation is that a taxpayer report the guaranteed payment as self-employment income on their federal income tax. In practice, this entails filing federal Schedule SE (Form 1040) and reporting the taxpayer's income from Line 14a, "Net earnings (loss) from self-employment," as listed on their federal Schedule K-1 (Form 1065). The Ohio Department of Taxation receives federal tax forms from the Internal Revenue Service (IRS) on behalf of Ohio state income taxpayers, inclusive of Schedule K-1 (Form 1065), but the level of detail does not include disclosures from Ohio taxpayers' Line 14a. In the absence of Ohio taxpayer data, it is not possible to evaluate how much of these earnings are currently classified as nonbusiness income. Therefore, another source must serve as the basis for this fiscal effect, which is unavoidably rough.

The Congressional Budget Office (CBO) published a report on the general topic of self-employment in 2012 that studied taxpayer information from TY 2001 and TY 2004. It concluded that about one-fourth of the Schedule SE (Form 1040) tax base was income attributable to individuals in partnerships and 21% of that partnership income was derived from guaranteed payments.[3] If those percentages are still applicable in the present day, approximately 5.25% of income reported on Line 3 of federal Schedule SE (Form 1040) would be attributable to guaranteed payment income. For TY 2020, all U.S. taxpayers reported a combined $686.92 billion in self-employment income on Schedule SE. Assuming 5.25% of this total is guaranteed payments,

[2] Partners in a partnership (including certain members of a limited liability company, or "LLC") are considered to be self-employed, not employees, when performing services for the partnership. If an individual is a general partner or limited partner of a partnership (or the equivalent in an LLC) that carries on a trade or business, their net earnings from self-employment includes their guaranteed payments. Individuals must pay self-employment tax on guaranteed payments per the IRS.

[3] Refer to Table 2 and Table 3 in The Taxation of Capital and Labor Through the Self-Employment Tax, found on the CBO website, cbo.gov.

U.S. taxpayers received an estimated $36.06 billion from guaranteed payments as self-employment income for TY 2020.

IRS statistics show that Ohio taxpayers paid approximately 2.81% of the total self-employment tax in TY 2022. Therefore, it is plausible that Ohio taxpayers reported $1.01 billion in guaranteed payment income (where $1.01 billion is 2.81% of $36.06 billion). General trends suggest Ohio income grows about 6% per year, so it is possible that Ohio taxpayers will report $1.20 billion in guaranteed payment income as self-employment earnings for TY 2023.

By assuming Ohio taxpayers would otherwise pay an effective PIT rate of 2.75% on this income under the progressive, nonbusiness tax table, the PIT revenue loss would be up to $33.0 million (where $1.20 billion is multiplied by 2.75%), if all of this income was subsequently excluded from taxation due to the BID. It is possible that some taxpayers would pay the 3% flat PIT rate on portions of this business income under the bill, but LBO does not have a reliable basis for estimating how much would be above the existing BID threshold. For this and several other reasons related to data availability, this revenue estimate is unavoidably rough, but likely serves as an upper bound.

Under codified law, the GRF would bear 96.68% of the annual revenue loss while the Local Government Fund (LGF) and Public Library Fund (PLF) would each bear 1.66% of the annual revenue loss.

As cited earlier, LBO cannot provide a separate fiscal estimate to the remedial provision in Section 3 of the bill. Taxpayer audits are a confidential matter, but whatever state revenue loss that may occur because of Section 3 will be in addition to the annual PIT losses estimated for TY 2023 and years thereafter.

FNHB0138IN-135/zg