Ohio Department of Taxation Issues Favorable Guidance for 20% or More Owners of Pass-Through Entities

Under the most recently enacted Ohio budget bill, signed by Governor John Kasich on June 30, 2013, owners of pass-through entities and sole proprietorships were granted a deduction equal to one-half of the Ohio business income generated by these businesses for taxable years 2013 and following. Pursuant to a recent interpretation by the Ohio Department of Taxation ("ODT"), this deduction could also be computed by including compensation paid to 20% or more owners of these Ohio businesses.

Background on the "Ohio small business deduction"

For taxable years beginning on or after January 1, 2013, an individual taxpayer filing Ohio Form IT-1040 is permitted to claim a deduction amounting to fifty percent (50%) of the taxpayer's "Ohio small business investor income" of up to $250,000. The deduction may not exceed $62,500 for each spouse filing separately or $125,000 for all other taxpayers (married filing jointly and single filers). "Ohio small business investor income" is defined as the portion of a taxpayer's adjusted gross income that is business income reduced by deductions from business income and apportioned or allocated to Ohio (to the extent not otherwise deducted or excluded in computing federal or Ohio Adjusted Gross Income for the taxable year). A pass-through entity investor or sole proprietor will be able to claim the deduction with respect to that "small business investor income." The net business income as reported on the taxpayer's Federal Form 1040 Schedules C, E, and F will generally be the basis of the taxpayer's deduction.

Ohio business owners could realize an Ohio tax savings of up to $6,777 for 2013 tax returns ($125,000 multiplied by the highest marginal rate of 5.421%). While the statutory language authorizing the deduction seems to limit the deduction to amounts reported on a taxpayer's Federal Form 1040 Schedule C, E, or F, recent guidance from ODT extends the deduction to also include compensation paid to 20% or more owners of pass-through entities. This broad interpretation could significantly increase the benefit of the deduction for many business owners that primarily earned W-2 wages from a pass-through entity.

Why compensation paid to 20 percent or more owners qualifies for the deduction

A law was enacted several years ago to mitigate a perceived tax-planning tool used by non-Ohio residents that owned pass-through entities doing business in Ohio. The planning called for the owner to be paid "compensation" for services performed outside Ohio, preferably in a state with no personal income tax, such as Florida. The provision "deems" compensation paid to a 20% or more owner of a pass-through entity to not be compensation and instead to be treated, for Ohio income tax purposes, as a distributive share of income of the pass-through entity. Specifically, RC 5733.40(A)(7) provides, in part that:

> "guaranteed payments or compensation paid to investors * * * by * * * [certain pass-through entities] shall be considered a distributive share of income of the [pass-through entity] * * * [if the compensation is] paid to an investor who at any time during the qualifying entity's taxable year holds at least a twenty per cent direct or indirect interest * * * ."

As a result of this "add-back," the compensation paid to an individual owning 20% or more of a pass-through entity is effectively taxed by Ohio.

Because the Ohio law add-back effectively treats compensation paid to 20% or more owners as pass-through business income, the Ohio Department of Taxation has concluded that such compensation paid to a 20% or more owner of a pass-through entity is eligible for the Small Business Deduction.

Does the Small Business Deduction make Ohio Form IT-4708 obsolete in many circumstances?

Because the small business deduction may only be claimed on an Ohio personal income tax return (Form IT-1040), most non-Ohio investors should carefully consider whether the investors wish to file an Ohio Form IT-1040 instead of participating in the filing of an Ohio Form IT-4708 (Ohio composite income tax return for non-resident owners of Ohio pass-through entities). There may be valid reasons for investors to file the Ohio Form IT-4708, but the newly enacted small business deduction may not be claimed on the Ohio Form IT-4708.

If you would like to better understand how this treatment might impact your business or personal tax situation, please contact a Zaino Hall & Farrin professional.

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