

**THE OHIO LEGISLATURE REPEALS THE
EXCLUSION OF OHIO LAW AND LOBBYING
BUSINESSES FROM OHIO BUSINESS INCOME
DEDUCTION**

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DEBORA D. MCGRAW, JD, CPA, LLM
MEMBER

On November 6, 2019, Substitute Senate Bill 26 (“S.B. 26”) was signed by the Governor into law. S.B. 26 repealed the sales tax on feminine hygiene products (dubbed the “pink tax”) and allows educators to deduct up to \$250 annually on their income tax returns for unreimbursed expenses for classroom supplies and professional development starting with the 2020 tax return (a similar deduction is available against an educator’s federal income tax). The most talked about change among tax practitioners, however, allows owners of an Ohio law or lobbying firm to claim the Ohio Business Income Deduction and apply a 3% flat tax rate on business income (“BID”). Unfortunately, there has been some inaccurate and incomplete reporting of that change and this article aims to clarify the matter.

Background on Ohio’s BID

Ohio personal income is taxed at the state level at the highest marginal rate of 4.797%. Most closely-held businesses, such as S corporations, limited liability companies, and partnerships, are considered “pass-through entities” and their income (as reported on a federal Schedule K-1) is reported on the owner’s personal income tax return for federal income tax and Ohio personal income tax purposes. Likewise, income from a sole proprietorship would be reported on Schedule C and rental income would be reported on Schedule E of the federal Form 1040 of the owner. Thus, the businesses’ income is included in the owner’s federal income tax return and Ohio personal income tax return.

In 2013, the Ohio legislature first enacted the small business income tax deduction (“SBID”). At the time (and in subsequent years), the then-Governor John Kasich had been lobbying for a lower overall income tax rate for individuals. While the legislature reduced the tax rates on individual income, there were budgetary concerns and the

Republican legislature wanted to specifically encourage the growth of businesses. Likewise, there was an inequity in the tax applied to C corporations versus businesses that operated as pass-through entities, which included most closely-held businesses. The problem was that closely-held businesses that operated as pass-through entities can be subject to two state of Ohio taxes, the personal income tax and the Ohio Commercial Activity Tax (“CAT”). After the repeal of the corporation franchise tax, C corporations are only subject to the CAT. The SBID helped cure this inequity between the two types of taxpayers.

The amount of the deduction was increased over several years and the deduction was renamed the BID, since it applied to any closely-held business regardless of its size. The BID allows an individual that has income from a business included in his/her Ohio personal income tax return to deduct \$125,000 of his/her business income (a \$250,000 deduction for married filing jointly). Some news reports have erroneously described the BID as only applying to limited liability companies (“LLC”). The deduction can be claimed against any business income recognized on an individual’s Ohio income tax return, which includes income from a sole proprietorship reported on Schedule C, rental income reported on schedule E, and distributive share income reported on a Schedule K-1 from an S corporation, partnership, or LLC. The deduction is not and has not ever been available as a deduction against a person’s wages with one limited exception.

That exception relates to compensation paid to a twenty percent or greater owner of a pass-through entity. An existing provision in the Ohio Revised Code recharacterized the compensation as distributive share. That provision was established to prevent non-resident owners of a pass-through entity from avoiding the withholding provisions on pass-through entities, thereby, avoiding Ohio personal income tax by paying themselves wages. For a number of years, Ohio Department of Taxation (“ODT”) has taken the position that the statutory provision recharacterizing the compensation as distributive share applied to the entire individual income tax chapter which allowed ODT to ensure the taxation of many non-resident owners of pass-through entities. Consistent with that prior treatment, ODT has also allowed such owners to claim the BID against the compensation recharacterized as distributive share.

In 2015, the Ohio legislature also enacted a lower tax rate of 3% (versus the highest rate of 4.995% at the time) on business income, further mitigating the disparity between C corporations that pay only the CAT and no income tax compared to PTEs that must pay both CAT and personal income tax. The Ohio legislature’s continued goal was to stimulate business and investment in Ohio.

Exclusion of Ohio Licensed Attorney and Ohio Registered Lobbyists from the BID and Lower Tax Rate on Businesses

Amended Substitute House Bill 166, the biennial budget bill for 2019 and 2020, (the “ Budget Bill”) was signed into law on July of 2019 and would have been effective for tax year 2020. Specifically, the recent Budget Bill would only have allowed the BID

and lower tax rate to be applied to “eligible business income” for tax years beginning on or after January 1, 2020.

“Eligible business income” was defined to mean business income **excluding** income from a trade or business that performs either or both of the following:

(a) Legal services provided by an active attorney admitted to the practice of law in this state or by an attorney registered for corporate counsel status under section 6 of rule VI of the Ohio supreme court rules for the government of the bar of Ohio;

(b) Executive agency lobbying activity, retirement system lobbying activity, or actively advocating by a person required to register with the joint legislative ethics committee under section 101.78, 101.92, or 121.62 of the Revised Code.

For purposes of this article, we will refer to this statutory language as the “Budget Bill 166 Ohio Lawyer/Lobbyist Exclusion.”

Repeal of the Budget Bill 166 Ohio Lawyer/Lobbyist Exclusion

Senate Bill 26 repeals the Budget Bill 166 Ohio Lawyer/Lobbyist Exclusion from the BID and the lower tax rate on business income by repealing the “eligible business income” definition described above. In addition, S.B. 26 also includes language that would require that taxpayers provide the North American Industry Classification System (“NAICS”), a code used by the Internal Revenue Service to chart the industry of a business. By gathering this information, the legislature may be pathing the way to re-enact the law for lawyers, lobbyists, and other professions.

Rationale for Repeal of the Budget Bill 166 Ohio Lawyer/Lobbyist Exclusion from the BID and Lower Tax Rate on Business Income

The Ohio legislature does not report its legislative intent. Some news sources quoted House Speaker Larry Householder as having said that denying the BID and lower tax rate on business income to attorneys and lobbyists could not be enforced because the Ohio personal income tax return does not list a person’s occupation. Another representative acknowledged that there were considerable constitutional problems and issues with the application of the tax.

Some of the opposition directed at the Budget Bill 166 Ohio Lawyer/Lobbyist Exclusion of Ohio licensed attorneys and Ohio registered lobbyists included:

1. **Discriminated Against Ohio Businesses:** The Budget Bill 166 Ohio Lawyer/Lobbyist Exclusion denied the BID and lower rate to Ohio licensed lawyers or Ohio registered lobbyists for tax years beginning on or after January 1, 2020. However, a non-Ohio lawyer that filed a pro hoc vice motion to represent a

client in an Ohio matter could continue to claim the BID and lower tax rate, thereby paying less than an Ohio licensed attorney. The discrimination of Ohio licensed lawyers or Ohio registered lobbyists may have been unconstitutional.

2. **Impact in Mixed Businesses:** Nothing in the Budget Bill 166 Ohio Lawyer/Lobbyist Exclusion language required that the primary activity of the trade or business be the provision of legal or lobbying services, or that it derives income from such activity. While it is our understanding that the exclusion of attorneys and lobbyists was intended to only impact law firms and lobbying firms, the language could have been read to eliminate the BID for any businesses that have in-house legal counsel or use a lobbyist, including manufacturers, wholesalers, retailers, accountants, and any other business or service providers.
3. **Discriminated Against Lawyers and Lobbyists:** The Budget Bill 166 Ohio Lawyer/Lobbyist Exclusion language treated law firms and lobbyists differently than any other closely-held taxpayers, which seemed unfair to many and potentially unconstitutional. Like other businesses, lawyers and lobbyist have well-paid employees, pay for office space, and supplies. There was no stated rationale for treating lawyers and lobbyists different than other closely-held businesses.
4. **Corporate Counsel Language Unworkable:** Finally, it was unclear how to apply the Ohio registered corporate counsel language. The Budget Bill 166 Ohio Lawyer/Lobbyist Exclusion language did not explain how to measure these legal services since a corporate counsel would not typically have income included in its employer's taxable income. Thus, it was unclear whether the law intended to treat the amount the employer deducted as the corporate counsel's wages as not qualifying because the statute did not contain such language or use some other income in the employer's income. One reading of the statutory language would be that all the income of a business with an Ohio registered corporate counsel was not eligible for the BID or the lower tax rate on business income, which would cover a lot of Ohio based closely-held businesses. Another alternative reading was that this portion of the statute did not apply to most businesses with an Ohio registered corporate counsel because there is no income from such legal services in the employer's income.

Benefit of the BID

Some organizations and opponents of the BID have referred to the BID generally as an "LLC Loophole." As described above, the BID applies to a whole host of closely-held businesses, not just LLCs. These same organizations argue that the BID hasn't increased the growth of new businesses or first time hiring by businesses, although they didn't cite any specific reports or studies on the BID.

In contrast, the Ohio Society of CPAs recently polled their membership on whether they thought the SBID/BID was helpful to businesses. Certified Public Accountants

("CPAs") are often self-employed and work as partnerships, LLCs, and sole proprietorships and also have many, many business owners as clients. The CPA membership responded that the BID was helpful in growing their businesses and their clients' businesses as well. Many of the participants described how they used the saved funds to enhance health insurance and retirement benefits of their employees, bonuses to their employees, additional equipment and software for their offices, etc. These are important expenses to first-time businesses and the expansion of existing businesses.

The Future

As ODT begins to collect the NAICS information on 2019 tax returns next year, there will likely be additional discussion on the benefits of the BID and whether certain professions are more worthy than other groups. There seems to be a bias in the media and some policy makers against service industry jobs, including lawyers and lobbyists. It is important that these industry groups communicate to the legislature and other policy makers the benefits of the BID, and how it creates a level playing field for PTEs when compared to C corporations. It is also important these groups emphasize that service industry positions tend to provide higher salaries and benefits and are the type of positions that all states want to increase, along with manufacturing and retail jobs.

If you would like to discuss BID issues, please contact Debora (Dardinger) McGraw, Richard Farrin or any other ZHF professional.

ZAINO HALL & FARRIN LLC

A T T O R N E Y S A T L A W

WWW.ZHFTAXLAW.COM

614-326-1120

855-770-1120 (toll-free)

RON AMSTUTZ

(non-attorney professional)
614-782-1545(Direct)
330-347-3533 (Mobile)
ronamstutz@zhfconsulting.com

STEVE C. AUSTRIA

(non-attorney professional)
614-349-4820 (Direct)
937-609-8355 (Mobile)
steveaustria@zhfconsulting.com

RICHARD S. BITONTE

(non-attorney professional)
614-782-1555
rbitonte@zhfconsulting.com

DAN DODD

614-782-1554 (Direct)
740-973-5930 (Mobile)
dandodd@zhfconsulting.com

RICHARD C. FARRIN

614-349-4811 (Direct)
614-634-3130 (Mobile)
rfarrin@zhftaxlaw.com

STEPHEN K. HALL

614-349-4812 (Direct)
614-284-1253 (Mobile)
shall@zhftaxlaw.com

PHILLIP L. LAWLESS

(non-attorney professional)
614-349-4821 (Direct)
614-565-6098 (Mobile)
plawless@zhftaxlaw.com

DEBORA D. MCGRAW

614-349-4813 (Direct)
614-595-5560 (Mobile)
dmcgraw@zhftaxlaw.com

BRAD W. TOMLINSON

(non-attorney professional)
614-349-4818 (Direct)
btomlinson@zhftaxlaw.com

JOHN R. TRIPPIER

(non-attorney professional)
614-349-4815 (Direct)
614-203-4173 (Mobile)
jtrippier@zhftaxlaw.com

JENNIFER R. TURNER

(non-attorney professional)
614-782-1642 (Direct)
502-594-9297 (Mobile)
jturner@zhftaxlaw.com

JASON W. WALKER

(non-attorney professional)
614-349-4817 (Direct)
916-533-1626 (Mobile)
jwalker@zhftaxlaw.com

THOMAS M. ZAINO

614-349-4810 (Direct)
614-598-1596 (Mobile)
tzaino@zhftaxlaw.com