Ohio Legislative Service Commission

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Fiscal Note & Local Impact Statement

Bill: H.B. 328 of the 128th G.A.

Date: November 30, 2009

Status: As Introduced

Sponsor: Rep. S. Williams

Local Impact Statement Procedure Required: Yes

Contents: Authorizes an income tax deduction for eligible small business owners for certain reinvestments of undistributed profits

State Fiscal Highlights

STATE FUND	FY 2010	FY 2011	FUTURE YEARS
General Revenue Fund			
Revenues	- 0 -	- 0 -	Possible loss of state income tax revenue of tens of millions of dollars
Expenditures	- 0 -	- 0 -	- 0 -

Note: The state fiscal year is July 1 through June 30. For example, FY 2010 is July 1, 2009 – June 30, 2010.

- Additional income tax deduction for small businesses would reduce state personal income tax revenue, 94.1% of which goes to the GRF under permanent law (94.35% in the current biennium).
- Estimates of possible revenue losses to the state are highly uncertain but could range to tens of millions of dollars, possibly exceeding $100 million per year.

Local Fiscal Highlights

LOCAL GOVERNMENT	FY 2010	FY 2011	FUTURE YEARS
Local Government Funds			
Revenues	- 0 -	- 0 -	Possible loss of revenue from the state income tax of millions of dollars
Expenditures	- 0 -	- 0 -	- 0 -
School Districts			
Revenues	- 0 -	- 0 -	Possible loss of school district income tax revenue of millions of dollars
Expenditures	- 0 -	- 0 -	- 0 -

Note: For most local governments, the fiscal year is the calendar year. The school district fiscal year is July 1 through June 30.

- Reduction in state personal income tax revenues would reduce revenue to the local government funds, by 5.9% of the total revenue loss under permanent law (5.65% in the current biennium). Revenue losses could range to millions of dollars per year.
- School district income tax revenues would be reduced by the additional income tax deduction for small businesses. Revenue losses could range to millions of dollars per year.

Detailed Fiscal Analysis

The bill creates a new tax deduction that would benefit small business owners. Estimates of the potential revenue losses to the state and to local governments are highly uncertain but could be sizable, in the tens of millions of dollars, perhaps into the hundreds of millions of dollars, per year for the state and millions of dollars per year in total for units of local government. Information requirements to implement the provisions of the bill exceed the data currently included on federal or state tax forms, particularly for sole proprietorships.

Provisions of the bill

The bill requires an owner of an eligible small business to take a state personal income tax deduction for the undistributed net profit of the business, in the business' tax year that ends in the taxpayer's tax year. The following year, a small business owner who makes this deduction is required to add to income any excess of the previous year's undistributed net profit over the increase in the amount reinvested in the business. "Small business" is defined, for this section of the Revised Code, to include a sole proprietorship or pass-through entity (generally, a partnership or S corporation) with total income of $1 million or less. "Eligible small business" is one with net profit of more than 3% of total income, for federal income tax purposes, and that distributes to equity owners less than the excess of net profit over 3% of total income (in other words, the business retains more than 3% of total income). For a small business with more than one owner, an individual owner's tax deduction, and addition to taxable income the following year, are calculated using that taxpayer's distributive or proportionate share of the undistributed net profit and increase in investment. Owners may be trusts or estates as well as individuals. The deduction of undistributed profit is limited to 5% of the business' total income, as reported for federal income taxes. The amount added back in the following year is at most the amount deducted.

The increase in the amount reinvested in the business, as used above, is specified more precisely in the bill as "the increase in the business' reinvestment expenditures from that qualifying taxable year to the business' succeeding taxable year." Qualifying reinvestment expenditures include costs for employee training, research and development, and purchase of real or tangible personal property used in the business and chargeable to a capital account.

The meaning of total income is defined by the bill as the total income reported for federal income tax purposes. This term is not used on Schedule C, the federal form for reporting net profit from a sole proprietorship, or in the instructions for Schedule C. It is used on the federal returns for partnerships and S corporations, to refer to gross receipts or sales of the business less cost of goods sold, plus or minus certain other income or losses, but before deduction of other expenses of the business.

Implementation of the bill's provisions

Federal income taxes are owed by the owners of sole proprietorships and pass-through entities on their shares of the net profits of those businesses, without regard for retention of those profits in the business or distribution to owners. No federal reporting is required for retention of profits in sole proprietorships. Sole proprietors invest capital to grow their businesses, and that capital may come from a variety of sources. If part of the net profits are reinvested in the business, in assets eligible for federal tax purposes to be expensed or capitalized and depreciated, the expense would be recorded on a federal tax form filed with the owner's tax return. But beyond that, no record is generally created on federal tax forms of net profits of the sole proprietorship that are retained in the business and those that are distributed to the owner. Requiring Ohio owners of sole proprietorships to differentiate net profits into those retained in the business and those distributed to owners would require additional recordkeeping and reporting beyond that supported by federal income tax forms.

S corporations are the only type of pass-through entity with clear information on the amount of net profits that may have been retained by the business. They are generally required to identify for each tax year changes in retained earnings in their balance sheet. In addition, they produce a schedule that tracks changes in distributions to shareholders, and shareholder's undistributed taxable income previously taxed. This schedule may or may not be filed with the Internal Revenue Service depending on the level of assets. Although S corporations are not currently required to provide the corporate tax filing and all the schedules to all shareholders, any shareholder who required copies would generally receive them. If the bill becomes law, each S corporation with Ohio shareholders may have to include shareholders' pro rata shares of additional items required for the more extensive Ohio tax calculations required by the bill.

For partnerships, a schedule is given each year to each partner that provides an analysis of each partner's capital account, including information on capital contributed that year to the business as well as withdrawals and distributions. This information ties to the partnership's federal tax filing, which totals the same information for all partners. However, the information included on these forms does not differentiate among sources of the capital. The capital for investment in the business may be from net profits from the operation of the business and distributed to partners, but it may also be from other sources of capital, such as partners' savings or borrowings. In short, the data indicate how much was invested in the business, but not whether the capital was from net profits retained from the operations of the business.

The increase in investment deductible under the bill includes tangible personal property used in the business and chargeable to a capital account. The phrase "chargeable to a capital account" may include purchases of such a nature that they would have been eligible to be capitalized and depreciated but that were instead expensed (so-called Section 179 deductions). The maximum amount of such deductions is subject to limitations, so that it generally benefits smaller businesses.

The bill appears to be advantageous to small businesses irrespective of whether they increase their spending for the three types of reinvestments eligible for deduction under the bill. If, for example, an eligible small business had undistributed profit and reinvestment that remained unchanged from year to year, so did not increase, none of the reinvestment could be deducted, in the second year, from undistributed profit of the previous year that is added back in that second year in calculating income to be taxed. In the first year, the owner would deduct the undistributed profit and consequently pay less tax. In the second year, the owner would add back to income the first year's undistributed profit but deduct the second year's undistributed profit, assumed in this hypothetical example to be equal in amount to that of the first year. The amount of taxes paid would remain unchanged in that year from what it would have been in the absence of the bill. The owner could continue to defer tax until the last year of the calculation, perhaps following sale of the ownership interest, when the owner would owe additional tax. Because of the time value of money, deferring taxes owed for years is advantageous to the business owner.

Furthermore, this opportunity to gain from tax deferrals would appear to be available to the business owner even if the amount of qualifying business reinvestment was minimal. Only the increase, not the level, of the qualifying reinvestment enters into the calculation, and the owner benefits from tax deferral even if no deduction is taken for such an increase. Since no penalty is imposed for a decrease in qualifying reinvestment, a business could gain by bunching investments, alternating years of large increases in qualifying investments with years of large decreases. If the business was growing, or qualifying reinvestment increased from year to year, taxes would be reduced in years subsequent to the first year, as well as in the first year, and the extra taxes owed in the last year would be less than the sum of tax savings in earlier years.

Estimate of the bill's cost to the state

Federal tax statistics show net profits less losses in 2006 of $278 billion for sole proprietorships, $667 billion for partnerships, and $386 billion for S corporations.[1] In Ohio, sole proprietorship net profits less losses in 2007 were $8.3 billion, but similar information for partnerships and S corporations does not appear to be published for Ohio. If Ohio's share of the nation's profits at sole proprietorships was similar to that for partnerships and S corporations, total net profits of these three types of businesses in Ohio in 2006 may have been on the order of roughly $40 billion. Profits vary widely from year to year, and 2006's profits may not be representative of future profits. Some of these profits were earned at businesses that would not have met the bill's definition of small business. Most of the net profits of sole proprietorships probably were earned

[1] 2006 is the most current year for which these statistics are published on the IRS web site for all three forms or organizations. The figures for sole proprietorships exclude farm income.

at businesses that would be deemed small businesses under the definition in the bill, but much less of the profits of S corporations and partnerships were from small businesses. Some were earned at businesses with net profits of 3% of total income or less, that would not qualify for the benefits of the bill, and some of these net profits exceeded the 5% maximum deduction permitted by the bill. Some of these profits were distributed to owners and not retained.

In view of these numbers and qualifications, the potential exists for the Ohio profits eligible for the tax deduction in the bill to amount to hundreds of millions or possibly billions of dollars per year. If the average marginal Ohio income tax rate applicable to these deductions is 3% to 4%, potential tax savings to small business owners, and revenue losses to the state, could be in the tens of millions of dollars per year, possibly more than $100 million per year. Most of the loss of state personal income tax receipts would reduce GRF revenues. For each dollar of reduction in state personal income tax revenue, the loss to the GRF is 94.1 cents under permanent law (94.35 cents under temporary law in the current biennium).

Estimate of the bill's cost to local governments

The Local Government Fund and the Public Library Fund receive a combined total of 5.9% of state tax revenue under permanent law (5.65% under temporary law in the current biennium). A loss of state personal income tax revenue in the tens of millions of dollars, and possibly hundreds of millions of dollars, would reduce revenue to the local government funds by millions of dollars.

For business owners residing in school districts with school district income taxes, calculation of their school district income taxes owed starts with their Ohio taxable income. Some school districts have enacted income taxes that apply to earned income only. Self-employment income from a sole proprietorship or partnership would be subject to this tax. Profits from an S corporation would not be. School district income tax collections have recently been somewhat more than 3% of state personal income tax collections. A loss of state personal income tax revenue in the tens of millions of dollars, and possibly hundreds of millions of dollars, would reduce school district income tax revenue by millions of dollars.

Effective date of the bill

The bill's provisions go into effect in a taxpayer's taxable year beginning on or after the effective date of the bill. The bill does not declare an emergency, therefore would not go into effect until tax year 2011, principally affecting the state and school districts in fiscal year 2012 and thereafter.

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