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Business Income Deduction Changes May Impact Professional Services Firms

PROFESSIONAL SERVICES, STATE AND LOCAL TAX
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On May 9, the Ohio House of Representatives passed House Bill 166 ("HB 166") by a significant margin. If ratified by the Ohio Senate and signed by Governor DeWine as currently written, HB 166 could have a far-reaching impact on Ohio taxation. HB 166 formally adopts the economic nexus standards contained in the United States Supreme Court's Wayfair decision. Specifically, HB166 provides that beginning on July 1 of this year, remote sellers with gross annual receipts of \$100,000 or more (or 200 or more separate transactions in the state on an annual basis) for the current or preceding tax year would have economic nexus for purposes of the Ohio sales and use tax. Previously the substantial nexus threshold applied to sales in excess of \$500,000.

The bill also proposes a tentative reduction of the Pass-Through Entity Tax from 5% to 3%, which would eliminate possible over-withholding in light of the 3% tax rate currently applied to business income (assuming a favorable rate remains in place). Additionally, it creates a mechanism to avoid withholding at the pass-through level altogether. The legislation would bring Ohio statutes to conformity with the federal centralized partnership audit regime rules that went into effect January 1, 2018. In certain situations, these rules can lead to an assessment of tax at the partnership level rather than taxing the respective partners.

Other changes proposed in HB 166 include the introduction of an Ohio Opportunity Zone Credit, other tax credits and reductions to individual income tax for certain taxpayers. Specifically, Ohioans with less than \$22,250 of income would be exempt from personal income tax altogether.

Of all the provisions in the bill, the proposed changes to the Ohio Business Income Deduction ("BID") may have the most lasting impact on the professional services industry. Architectural firms, engineering companies, law firms and others in this arena are often structured as partnerships or S corporations for tax purposes. Owners become subject to Ohio personal income tax on business income allocated to them by the underlying pass-through entities when these companies transact business in the state. Under current law, the first \$250,000 of Ohio business income is exempt from personal income tax; any remaining business income is taxed at a flat 3% rate rather than the applicable rate from the tax tables. For example, under the current system, a taxpayer with \$300,000 of Ohio business income (for illustrative purposes, assume no other income, deductions or credits) would pay a state tax of \$1,500 (\$250,000 excluded BID and \$50,000 taxed at 3%). Under the proposed rules, the deduction would apply only to the first \$100,000 of business income.

Additionally, lawmakers are considering eliminating the favorable 3% tax rate on business income. If both proposals are ultimately passed (assuming no other changes), that same taxpayer would now have a \$12,461 liability and an effective tax rate of 4.15% (from 0.5%). Such an increase would not only mean that owners of professional services firms doing business in Ohio would have larger tax bills, but also that they would need to set aside more cash for tax distributions. Many observers, including the Ohio Society of CPAs, have criticized this component of HB 166 and it remains to be seen how this provision will change in the Ohio Senate.

The tax provisions in House Bill 166 are meaningful and will impact many taxpayers doing business in Ohio. Please contact your tax professional at Schneider Downs to receive more detailed information about this legislation, or if you have questions about any other statutory or administrative changes that may impact you and your business.

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