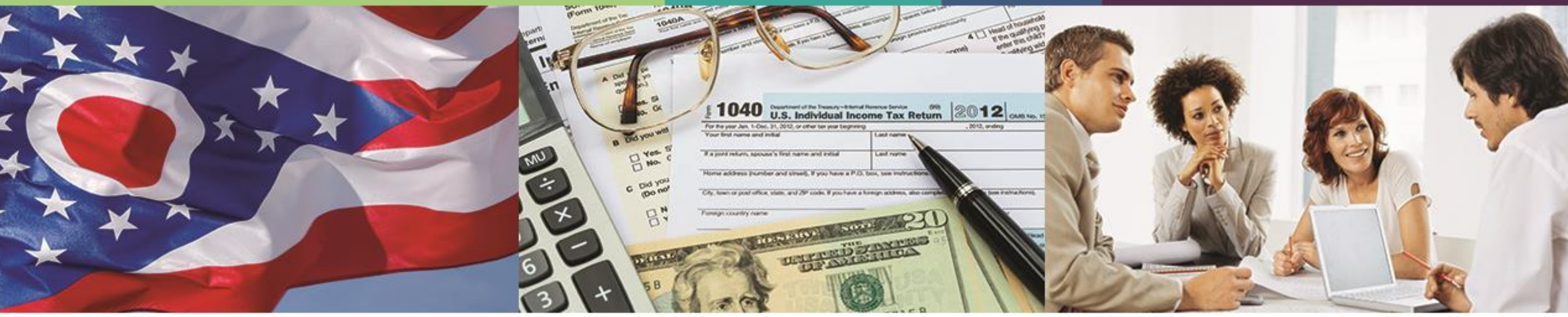


# Improving Ohio's Tax Climate

## Ohio Tax Reform Task Force

June 2016

THE
OHIO SOCIETY
OF CPAs
ADVANCING THE STATE OF BUSINESS

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ADVANCING THE STATE OF BUSINESS

June 20, 2016

Ohio 2020 Tax Policy Study Commission
The Ohio Statehouse
1 Capitol Square
Columbus, OH 43215

Members of the Ohio 2020 Tax Policy Study Commission:

Ohio has made great strides in recent years to improve its competitive standing and economic health, thanks to the vision and commitment of our state's elected leadership.

The Ohio Society of CPAs shares the vision of making our state a magnet for attracting successful enterprises that will prosper and create new jobs, and advance Ohio in the rankings of states where young professionals will choose to put down roots, raise families and remain long after they retire.

We have a long history of championing legislative and regulatory reforms that contribute to a healthy and sustainable business environment, make government operations more efficient and help Ohio families build financially stable futures.

But there is still work to be done to put Ohio on par with its more competitive neighbors.

A state's tax system is one vital sign measuring its ability to attract new business and meet public financial obligations.

That's why we formed the Ohio Tax Reform Task Force in 2015. It is comprised of CPA tax professionals who advise or work for businesses across every sector in Ohio. Over the past year, they have studied Ohio's tax policies closely, bringing together their collective tax knowledge into key recommendations for the Ohio 2020 Tax Policy Study Commission.

The enclosed report outlines The Ohio Society of CPAs' recommended approach for moving Ohio toward a simpler, more competitive tax structure while minimizing the effects or pain on any particular segment.

We are pleased to present these recommendations to the Ohio 2020 Tax Policy Study Commission and stand ready to assist Ohio in making our state a model for excellent tax policy.

William Chorba III, CPA, CGMA — Chair, Executive Board

Scott D. Wiley, CAE — President & CEO

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# PREFACE

The Ohio Society of CPAs (OSCPA) is a leading partner and influential voice for a thriving business environment. We are a community of 22,000 members and we represent 85,000 CPAs and accounting professionals statewide, leading important initiatives that protect the public and create a healthy and sustainable business climate in Ohio. Membership is comprised of CPAs and other financial experts working in a wide range of Ohio businesses and industries, CPA firms, government and education.

In keeping with its mission to support CPAs in serving as trusted advisors, OSCPA actively monitors and addresses legislative and regulatory issues that could impact CPAs, their clients and employers, the broader business community and Ohio taxpayers. Working closely with state legislators, the Accountancy Board of Ohio, state agencies and the media, OSCPA constantly advocates for a fair and equitable tax structure and a pro-business environment to help drive our state's economy.

In August 2015, the OSCPA Executive Board formed The Ohio Tax Reform Task Force (Task Force) to provide the State of Ohio with objective, third party CPA expertise and perspective to help Ohio's leaders evaluate our state's tax climate. This member-led Task Force met over several months to discuss a wide range of approaches, and also discussed factors that have a very real impact on Ohio's ability to be more economically competitive with other states, especially those bordering Ohio.

OSCPA looks forward to addressing these recommendations with the Kasich Administration and the Ohio General Assembly through the 2020 Tax Policy Study Commission. Our goal is to assist state leaders in identifying approaches that will enhance Ohio's competitive position from a tax perspective, making our state more attractive to job creators, highly qualified workers, and their families.

The Task Force is comprised of 19 member tax professionals (see attached list) from throughout Ohio who are objective tax professionals. They represent major Ohio employers from key business sectors and CPA firms of all sizes that collectively work with thousands of Ohio businesses of all types. Further, OSCPA's Executive Board of 13 additional CPA leaders voted to formally support this white paper. Each of these CPAs is committed to helping the State of Ohio become financially strong and economically competitive.

# INTRODUCTION

Among the primary reasons Ohio is evaluating its entire tax structure through the 2020 Tax Policy Study Commission is to stay competitive. Ohio aspires to be a state where businesses want to locate and expand, and where people want to live, work, raise families and remain after they retire.

There are many reasons why businesses choose to locate in Ohio, stay in Ohio, grow in Ohio, or leave Ohio. Taxation is just one of these – but it is one that is relatively easily measured, and easy to compare with other states. It is a major factor used by professional site selectors hired by business executives to help them narrow down a list of potential expansion or location sites, but it is far from the only factor. A major factor that is mentioned more often by the business community than tax concerns is the lack of available talent to hire. Others include the quality of our educational systems, quality of life, geographic location and readily available natural resources.

Five elements are widely accepted as key tenets of a quality tax system: *competitiveness, simplicity, stability, equity/fairness and neutrality*. Each of these was considered by Ohio's 2003 Committee to Study State and Local Taxes, which focused on making Ohio's tax system one that met the five guiding principles. Each of these principles are also contained in OSCPA's own Tax Policy Guidelines, which are referred to when deciding what position to take on relevant legislation. These principles of a quality tax system provide the basic standard for the consideration of reforming and modernizing Ohio's tax laws and each factor should be a key element as elected officials and other policymakers consider how best to design our state's tax structure for the future.

- **Competitiveness:** When evaluating Ohio's tax structure, we must keep in mind that Ohio faces competition not only from key states in our own country, but also across the globe. Businesses must imbed expenses—including state and local taxes—into the price of their products, which could put them at a disadvantage if an out-of-state competitor enjoys a more advantageous tax system.

- **Simplicity:** The simpler the tax, the greater the likelihood that taxpayers will comply. Ohio's current tax system is not consistently simple. However, one advantage Ohio offers businesses is the Commercial Activity Tax (CAT). It is one of the simplest business tax structures of any state and therefore a majority of Ohio businesses can comply with filing requirements without incurring added costs of a tax professional. Our sales tax is fairly straightforward as well, but Ohio's personal income tax has grown more complicated over time. While significant improvements were made to the municipal income tax system in the 130th Ohio General Assembly, complying with this form of local tax remains among the most complicated and frustrating for business owners and individual taxpayers.

- **Stability:** It is important to recognize that making changes to our tax system every year makes it very difficult for businesses and individual taxpayers to plan for the future. If desired changes cannot be made at one time, they should be implemented over a period of years in a manner that is clearly defined when the legislation is enacted, as was done with the tax reform package of 2005. Frequently tweaking the tax code is not optimal as it runs counter to predictability and stability. Without predictability and stability, many business owners will be reluctant to invest in growing their operations, limiting economic growth. For example, on the federal level, "extenders" were not passed by Congress until late December in each of the past several years, retroactive to the beginning of the tax year in question. This delay caused business executives to "freeze" many business decisions involving potential tax benefits. The Federal PATH Act passed in December 2015 worked to make many of the "extenders" permanent so that business decisions can be made earlier in the year instead of waiting for last-minute action by Congress.

In addition, Ohio must prepare itself for the next inevitable economic downturn by having adequate reserves in place and, wherever possible, consistent, stable sources of revenue to cover these costs.

- **Equity/Fairness:** Another option when looking at funding key state services is to take a close look at businesses providing goods or services. As new industries develop in our state, it is important to attract and retain the industries but also to ensure they are paying their fair share of tax for the privilege of doing business in Ohio. An equitable and fair tax system requires that businesses providing the same services pay comparable taxes.

- **Neutrality:** OSCPA has significant concerns about lowering one type of tax and paying for the reduced revenue by raising another type of tax. Doing so does not truly lower taxes for Ohioans, as is often the stated goal. Instead, it simply shifts the burden from one group of taxpayers to another, picking winners and losers rather than achieving a net economic benefit to Ohio.

While the focus of this white paper is on Ohio's state tax structure, OSCPA believes that government at all levels can achieve a more positive bottom line by pursuing the same best-practice approaches used in the private sector: cutting costs through efficiencies such as shared services across jurisdictional lines, streamlining operations through consolidation and addressing pension, healthcare and other employee costs. OSCPA's 2010 Ohio Budget Advisory Task Force Report offers comprehensive recommendations for these approaches.[1]

Turning back to a focus on taxation, after careful evaluation by our Task Force and emphasizing the five elements of good tax policy, this white paper outlines OSCPA's recommendations on each of the major forms of state and local taxation, and additional insights for consideration.

[1] http://ohiocpa.com/docs/default-source/advocacy/oscpa_ohio_budget_advisory_task_force_v-2-10.pdf?sfvrsn=4

# PERSONAL INCOME TAX

**Historical GRF Revenue from Personal Income Tax**[2]

| Actual FY 2012 | Actual FY 2013 | Actual FY 2014 | Actual FY 2015 | Actual FY 2016 |
|---|---|---|---|---|
| $8,432.9 | $9,507.8 | $8,064.9 | $8,506.7 | $7,799.3 |

## INTRODUCTION

Ohio's state personal income tax was first assessed in 1972, and was implemented as a progressive tax, with progressively higher tax rates designated for income within each of its six brackets. In 1982, two additional top brackets were created (for incomes of $80,000 and $100,000 respectively). In 1992, a final ninth bracket was added for incomes over $200,000. The current highest tax bracket impacts individuals with over $208,500 in adjusted gross income. The tax rate Ohioans pay has been fluctuating since 1982.[3] The highest marginal tax rate was in 1986 at 8.55%. Whereas, the current highest marginal tax rate is 4.997%.

When considering any change to the tax code, it is important to first focus on the desired outcome. Ohio's personal income tax discussions in recent years have centered on a variety of positive end goals for the business community rather than plugging a revenue shortfall. OSCPA's Task Force applauds this broader, best-practice approach. The most common themes mentioned to date include:

- Increase Ohio's competitiveness with bordering states and other key states by facilitating a growing business climate
- Encourage Ohio business owners to grow their operations and hire more employees
- Create a simpler, fairer and more predictable tax climate
- Attract and retain employers
- Attract and retain highly qualified workers
- Achieve improved tax rankings in national surveys

There are two main factors to consider with personal income tax: the tax rate itself, and the system used to collect revenue from taxpayers which includes allowable credits and deductions. Each factor can influence taxpayer behavior, including where to live and work, how and where to invest and where to locate or expand a business.

While personal income tax is just one piece of Ohio's economic development puzzle, it's one that is often at the center of discussions. Certainly it is more complicated than it should be, but is Ohio's personal income tax handcuffing our economic growth? A good way to answer this question is by studying other states – comparing those that are flourishing to those that are not.

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[2] Source: Legislative Service Commission. (Data are shown as $ in millions.)
[3] http://www.tax.ohio.gov/portals/0/taxeducation/history/individual_income.pdf

# PERSONAL INCOME TAX

**A Look at Other States**

According to the Tax Foundation, in 2015, 43 states levied an individual income tax. Of those, 41 states taxed wages and salary income, and two states (New Hampshire and Tennessee) exclusively taxed dividend and investment income. Seven states levied no tax at all: Arkansas, Florida, Nevada, South Dakota, Texas, Washington and Wyoming.[4] Some of these states can avoid levying a personal income tax because they have extremely lucrative natural resources (e.g. massive oil fields in Alaska and Texas, or a thriving tourism industry in Florida) that provide significant tax revenue. Whatever its resources, it is important to keep in mind that every state, even those without a personal income tax, receives revenue from its individual residents and businesses in some form or fashion to support essential state and local services. Some of this revenue comes from traditional sources like personal income tax on wages, but there are many other sources as well.

Of those states taxing wages, eight have a flat-tax structure whereby a single rate applies to all taxable income, including three of Ohio's neighbors (Indiana, Pennsylvania and Michigan). Thirty-three states have a multi-bracketed system, ranging from as few as two rates (in Kansas, Nebraska and Oregon) to two states (California and Missouri) with 10 brackets.

**How Does Ohio Compare?**

Ohio's graduated personal income tax system has **nine** income tax brackets, along with numerous credits and deductions to reduce the amount of taxes due by targeted taxpayers. Multi-bracketed tax systems are progressive in nature, meaning the more you earn, the higher the tax rate. When evaluating states for competitiveness and planning for business expansion, most organizations and tax professionals look at just the highest rate rather than the average rate paid by taxpayers in states with multiple brackets. In Ohio, the highest rate on non-business income of 5.33% was reduced to 4.997% for 2015 and beyond. Another factor influencing tax liability is the income level at which each successive higher tax rate becomes effective. For example, Ohio's highest rate is imposed at an income level of $208,500 and higher, while in Kentucky taxpayers making $75,000 or more will pay the state's highest rate of 6%. Most Ohio residents earn much less than $208,500 in annual income so they pay at a rate indicated by one of Ohio's eight lower tax brackets.[5]

As lawmakers evaluate Ohio's personal income tax system, recognition must be given to our state's unique role of having over 600 cities and villages that also assess an income tax of up to 3.0% (Parma Heights), in addition to the state income tax. The average local add-on income tax rate for all municipalities is 1.89%.[6] Reciprocity credit ranges from 0% to 100%, meaning a number of Ohioans pay taxes to both the municipality where they work *and* the municipality where they live. In addition, as of January 2016, 191 Ohio school districts also assessed an income tax ranging from 0.25% to 2.0%. Collectively, this means that Ohio taxpayers could pay

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[4] Source: State Individual Income Tax Rates and Brackets for 2015 by Jared Walczak, Policy Analyst, April 2015.

[5] http://www.tax.ohio.gov/Portals/0/ohio_individual/2015%20Income%20Tax%20Tables%20II%20and%20III.pdf

[6] Used Ohio AGI for taxing districts.

more in local income tax than they pay in state income tax.[7] Only 10 other states permit municipalities to assess income tax to both where a person works and lives. Other than Pennsylvania, most have very few cities that do so.

**Ohio's Personal Income Tax Credits and Deductions**

When the Ohio personal income tax was first implemented in 1972, the tax return form was the size of a postcard. By 2003, Ohio's long form was two pages and its EZ form option was one page. By 2015, Ohio's long form had grown to six pages in length plus a mandatory form for listing dependents and the EZ form was eliminated. Between 2005 and 2015, the number of personal income tax expenditures—credits and deductions—has increased from 21 to 36. While some are broad in their coverage, such as deductions for dependents, others are much narrower in scope. Tax credits and deductions often are created to influence taxpayer behavior or to benefit one or more special interest groups. Many impact a limited-time event or limited number of people, and all reduce revenue that otherwise would have been generated by the personal income tax.

Reducing the tax rate will have a corresponding reduction in revenue to the State of Ohio. One of the best ways to fund the related loss in tax revenue is to look at credits and deductions that also reduce personal income tax revenue. States with a low, flat tax rate have relatively few credits or deductions, because a lower overall rate enjoyed by all taxpayers alleviates the need for targeted tax credits or deductions and allows for needed revenue generation. This cleaner approach also makes the tax more transparent.

**Business Income Deduction (BID) Review**

While every Ohio taxpayer is impacted by our state's personal income tax policy, it is also of key importance to the business community because a significant number of businesses, including sole proprietorships, partnerships, limited liability partnerships, limited liability companies and S corporations are taxed on the owner's individual income tax return(s) (e.g. pass-through income). In Ohio, the tax on that pass-through income has been largely mitigated by the new Business Income Deduction (BID) and for 2015 and thereafter the reduced 3% income tax rate that applies to pass-through entity business income. The BID, first implemented in 2013 with a 50% deduction of up to $250,000 in pass-through income, was increased to a 75% deduction for tax years 2014 and 2015, and as of tax year 2016 will provide a 100% deduction for qualifying business income up to $250,000. In addition, a flat 3% tax for business income above $250,000 took effect starting in tax year 2015. This 3% top rate also created a significant tax savings for business owners who otherwise would be paying at the top bracket of 4.997% on that income for 2015.

The intention of the BID and reduced income tax rate on business income for taxpayers that receive income from pass-through entities allows business owners to reinvest more of their own money in expanding their Ohio footprint, buying new equipment, hiring more workers, etc. and to put pass-through entities on the same taxation level as other forms of business such as C

[7] Effective municipal income tax rates could equal or exceed 4% because of the absence of full reciprocity. School district taxes would be in addition to the municipal income tax.

corporations.[8] However, while just about every small business owner who is eligible for this generous tax benefit will likely take it once they are aware of it, it will be difficult to directly correlate the level of increased business investment in response to this tax expenditure.

According to the U.S. Bureau of Labor Statistics, 55.6% of businesses[9] employ a staff of one to four employees. The Great Recession and the Affordable Care Act implemented in 2010 forced many business owners to run leaner operations. As a result, many have learned to operate more efficiently and are comfortable keeping their operation simple and small. The primary reason business owners will grow their market share for their product or service is to become more profitable through a good return on investment. The Ohio General Assembly and the Administration should consider these questions: Is the BID and the accompanying 3% income tax rate—expected to cost Ohio well over $500 million each year in foregone income tax revenue—spurring economic growth in Ohio? Alternatively, should the Legislature consider an overhaul of the entire personal income tax system for all taxpayers, not just for business owners? While we strongly support the goal of helping small business owners in Ohio thrive, we also encourage a careful evaluation to determine if the desired economic growth is taking place with this important group of business owners.

This recommendation to evaluate the results of the BID and the new 3% maximum income tax rate is consistent with OSCPA's past encouragement of our state leaders to carefully and periodically evaluate **all** tax expenditures to ensure they are meeting their intended goals.

**Comparing Ohio to Other States**

When comparing Ohio's personal income tax policy to other key states, it's important to remember that factors beyond the rate itself also impact total revenue collected. When looking at the three states bordering Ohio that have a flat income tax (Indiana, Michigan and Pennsylvania), you will see that their state rates—not counting local income taxes—range from 3.07% to 4.25%. (Ohio's top state rate of 4.997% is now closer to the national average high state rate of 4.65%[10].)

Further, each state treats standard deductions and personal exemptions differently, meaning the amount of income subject to taxation varies.

As Indiana, Michigan, Pennsylvania and other states have found, the most logical approach to paying for an income tax rate reduction is through the avoidance of related tax expenditures. Therefore, in reviewing Ohio's own multitude of personal income tax credits and deductions, it is important to understand how other states—particularly those viewed as chief competitors of Ohio—treat that same category. For example, while most states provide for but have widely varying personal, spousal and dependent exemptions, far fewer provide tax expenditures related to adoptions, trust income or insurance premiums. Looking specifically at all states

[8] OSCPA supports and has testified in favor of further reform to Ohio's pass-through entity tax, currently pending as S.B. 288 (131st GA).

[9] http://www.bls.gov/web/cewbd/table_g.txt

[10] Source: Federation of Tax Administrators, 2014-2015 State Income Tax Rates.

surrounding Ohio, as well as key competitors with an income tax, variations become evident. (See Appendix 1.)

**A Lower Tax Rate May Not Equal a Lower Tax Bill**

Some states include a standard tax deduction (a flat amount taxpayers can deduct with no questions asked), and ensure that all taxpayers have at least some income that is not subject to the state's income tax. Other states vary: some allow only a standard deduction, others allow only personal exemptions and some allow both. Ohio allows only personal exemptions. Some states allow itemized deductions from the federal income tax return. At the federal level, the standard tax deduction can be taken in lieu of itemizing deductions. As you can see, there is no consistency from state to state, which clearly makes national comparisons difficult and sometimes misleading.

Further complicating comparisons is the reality that not all states use federal adjusted gross income ("AGI") as their starting point.[11] Where competitiveness is concerned, it is important to also note that when you are comparing Ohio's personal income tax to that of another state, be sure to make an apples-to-apples comparison—e.g., as with Pennsylvania, look at whether the state uses federal AGI as the starting point for taxable income or uses some other formula. Review any applicable standard deductions or personal exemptions. Does the state have a marriage penalty? What additional tax credits and deductions are available in a given state? Does that state have a local income tax or school district income tax that is assessed on top of its state income tax?

Simply having a stated low tax rate does not necessarily mean taxpayers will pay less tax, as the optics of a low tax rate with almost no offsets to income are far different than a higher tax rate with many offsets. In summary, you need to look beyond the gross marginal tax rates to find the actual effective tax rate to make a valid comparison. Nevertheless, states tout their low tax rate structure when courting business to their state. (See Appendix 2.)

**How Does Ohio Rank?**

There are several entities that rank states for their economic strengths and weaknesses, including some that focus exclusively on national tax climate rankings. Ohio has been working hard to become a destination for job creators, and has been rewarded with positive economic development ratings by groups such as *Site Selection* magazine. In 2013 and again in 2015, *Site Selection* ranked Ohio #2 in the country for economic development projects. But other

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[11] Pennsylvania is a prime example as our neighbor to the east does not use federal AGI at all. Instead, it requires taxpayers to first sort income into one of eight classes (compensation, net profits, net gains, rents/royalties, dividends, interest, gambling/lottery winnings and estate/trust income). Once classified, taxpayers must determine the amount of income/loss that is taxable for Pennsylvania personal income tax purposes because Pennsylvania has not adopted the Internal Revenue Code (IRC) as of a certain date but, rather, has conformed to select IRC sections. It should be noted that income and losses from one class of income cannot be used to offset income and losses of another class. Further, Pennsylvania does not provide a standard deduction or allow for personal exemptions. However, Pennsylvania does allow a deduction against compensation for unreimbursed employee business expenses and a deduction from total taxable income for contributions made to 529 plans. The result: most in Pennsylvania pay from their first dollar earned, meaning many in Pennsylvania will pay more in income tax than if they resided in Ohio, despite the apparent lower rate. Further, Pennsylvania also has an onerous pass-through entity filing requirement for its resident owners, even if the entity does not do business in that state.

national organizations, particularly the Tax Foundation, have been highly critical despite recent tax code improvements when comparing our state tax structure to other states.

Even looking at Ohio's newly reduced lower top tax rate and much higher income amount for that bracket's impact, the Tax Foundation ranked Ohio's personal income tax 47th – almost the worst in the nation and 17 spots lower than Kentucky, which has a higher top income tax rate. Their analysis appears to negatively rate states with many brackets (Ohio has nine brackets while Kentucky has six) and for making the top rate kick in at higher income levels.

The Tax Foundation favorably reviewed North Carolina's business tax climate in 2013 when the state changed its personal income tax system from three brackets (with rates ranging from 6% to 7.75% and dozens of credits and deductions) to a flat rate with far fewer tax expenditures. The state also reformed its corporate income and, to a lesser degree, its sales tax system at the same time. Of note, North Carolina was ranked 14th best business climate in 2015 despite its 5.75% flat tax rate. In 2014, North Carolina jumped 29 spots (from 44th to 15th). It is scheduled to further reduce to 5.499% in 2017.

So what is the primary difference between Ohio's and North Carolina's income tax system now? We believe it's the complexity caused by our nine brackets and dozens of deductions and exemptions. When North Carolina moved from three brackets to one, it eliminated most credits and deductions. Taxpayers responded positively, until they realized the impact of losing their longstanding credits and deductions. Since its initial move to a flat tax, North Carolina has restored the deduction for medical costs and further reduced its rate, but in exchange for sales tax on several construction and repair-related services.[12]

This evaluation indicates costs associated with a complicated income tax system could be even more important than a moderately higher rate, at least as viewed by the Tax Foundation. Just as OSCPA advocated to simplify the compliance burden associated with Ohio's municipal income tax system, we see significant merit to reducing the number of Ohio tax brackets and reducing the number of deductions, credits and exemptions.

**Fewer Tax Brackets and Fewer Deductions/Credits Provide Simplicity**

A simpler and more predictable state income tax will bode well for compliance with tax laws and ease of administration. Further, the Task Force believes a straightforward, simple tax system with very few credits or exemptions and optimally three but no more than five brackets as opposed to the current nine brackets is even more beneficial.

For years, many Ohio leaders have been frustrated by the formulas used by some national taxation think tanks that harshly rank Ohio's personal income tax system. Other than Ohio's municipal income tax system, most criticized are Ohio's multiple tax brackets and, surprisingly, the relatively high income level needed to trigger the highest tax bracket application. However, as Ohio Office of Budget and Management Director Tim Keen pointed out in February 2015 during a House Finance Committee hearing, the Tax Foundation's methodology of penalizing

[12] http://dornc.com/taxes/sales/impnotice0222_march1changes.pdf

the number of progressive tax brackets over the absolute rate of the highest and lowest bracket is "highly flawed." We agree.

Having said that, good tax policy dictates that the simpler and more predictable a tax, the easier it is for taxpayers to comply and for the Ohio Department of Taxation (ODT) to administer. That reality is a main reason every major business organization in Ohio so strongly supported municipal income tax reform in the 130th Ohio General Assembly. A state taxation system with fewer brackets and fewer credits and deductions would allow for greater simplicity.

However, there is one area where an additional tax expenditure should be considered: fixing Ohio's marriage tax penalty. Currently, married couples filing a joint Ohio income tax return may qualify for a tax credit. To qualify for this credit each spouse must have qualifying Ohio adjusted gross income of at least $500 after adjustments. Qualifying Ohio adjusted gross income does not include social security, interest, dividends, capital gains, rents, royalties and other passive income. The credit is limited to a maximum of $650, an amount that has not been adjusted since 1989. *(*See Appendix 3.)

The Joint Filing Credit was created to offset the tax penalty created for married couples as a result of Ohio's single tax rate table, but usually does not fully cover the additional tax due. In Ohio, a married couple filing a joint tax return pays a higher income tax than a married couple filing separately or two single individuals with the same amount of income. Ohio requires the filing status on the Ohio return to be consistent with the federal filing status but again only provides one rate schedule. Our neighboring states either allow a different filing status than the one used for federal purposes or have a single tax rate both of which mitigate the inequity of the marriage tax penalty.

The current joint filing credit in some cases requires extra documentation, typically does not rectify the inequity between two single filers and a married couple filing joint and can create additional filing complexities for individuals.

Consideration should be given to either allowing a different filing status for Ohio from the federal status or creating a new tax table for married filing joint returns and eliminating the credit.

**Flat Tax Considerations**

There is no doubt that having a single income tax bracket is even simpler than having three to five brackets. However, most states with a flat tax have had it in place for years, and often from the time the tax was first created. North Carolina is a distinct exception, but their single rate is much higher than what most Ohio taxpayers now pay.

Moving from our current nine brackets to a flat tax likely will be a very painful process for those taxpayers who currently benefit from existing credits and deductions, and therefore for elected officials charged with developing the new tax system.

Any thoughts of moving to a flat tax in Ohio should be done with an acute awareness of the realities of the situation, and the strong likelihood of the challenges it will cause. For example, let's assume Ohio wants to achieve a flat tax of 3.75%.

# PERSONAL INCOME TAX

For tax year 2013,[13] individuals filing Ohio individual income tax returns reported total federal adjusted gross income of approximately $384.6 billion. Based on the amount reported, a 3.75% flat tax would generate approximately $14.4 billion of Ohio tax liability before credits and deductions as opposed to $12.8 billion of liability that was imposed under the current nine bracket progressive tax system. Applying the 31 personal income tax credits and deductions allowable in tax year 2013 against Ohio's tax liability resulted in a net collection $7.9 billion. (There were 34 personal tax expenditures in place for tax year 2015, including the new BID.) The net cost of the credits and deductions in tax year 2013 was $4.8 billion.

If a flat tax were imposed based on 2013 total personal taxes collected after deductions to total federal adjusted gross income, the resulting effective rate would be 2.08%.

1) Moving to a flat tax has the obvious impact of those now paying at an effective rate of more than 3.75% owing less in tax, and those now at an effective rate lower than 3.75% owing more in tax.
2) Since it is likely not intended for individuals who are currently subject to a tax rate of lower than 3.75%, some sort of hold-harmless provision should be created, and sustainably funded, to protect those taxpayers.
3) Care must be taken to ensure the selected flat tax rate is not so low that the revenue it produces is not reasonably sustainable in the next economic downturn and beyond. For example, Ohio should learn from the mistakes made by the State of Kansas by not being too aggressive with rate reduction or too optimistic with projected job growth.

OSCPA has previously expressed significant concern about efforts to pay for a lower personal income tax rate by raising other taxes paid by business owners (CAT rate increases) or through approaches that would impair Ohio's competitiveness through new sales taxes on services that can be easily purchased in another state without such a tax. Other major business organizations (e.g., Ohio Chamber of Commerce, Ohio Association of REALTORS, NFIB-Ohio, Ohio Council of Retail Merchants, Ohio Chemistry Technology Council and the Ohio Farm Bureau Federation) have agreed in the past with this position.

**PERSONAL INCOME TAX RECOMMENDATIONS**

1) **Reduce the income tax brackets from nine to preferably three, but no more than five brackets**. Reducing the number of brackets should bring greater simplicity to the personal income tax structure. It also will make Ohio more competitive with surrounding states according to groups such as the Tax Foundation.

2) **Review income tax credits and deductions**. A thorough review of Ohio's income tax credits and deductions can determine if the credit or deduction can be eliminated or reduced, allowing more revenue to flow into the GRF and help pay for any income tax rate changes necessitated by bracket reductions. By reducing the number of brackets and the possible related changes in rate, many existing credits and/or deductions may not be necessary. It is important to examine whether the stated purpose of each credit

[13] Tax year 2013 information is the most recent tax data available from the Ohio Department of Taxation. Tax Year 2014 data will be available in late June 2016.

and deduction has resulted in the intended goal. If it is viewed as important to retain preferential treatment in a particular area, consideration should be given to using a grant to enable a more simplified income tax system and to have greater control over revenue impact.

3) **Avoid creating new revenue from other sources of taxation**. To compensate for projected losses from income tax rate reductions, do not increase the CAT or expand the sales tax base, as the state is merely shifting the burden and reallocating the tax obligation, thereby picking winners and losers. This violates the tenet of good tax policy. Instead, look to fund such losses by looking to expenditures within that specific area of taxation, in addition to the traditional projected economic growth or savings through efficiencies.

4) **If pursued, ensure that moving to a flat tax will not result in unintended consequences that bring financial hardship to the state.** As previously noted, moving to a flat tax can be misleading and even financially risky if modifications are made to Ohio's tax structure that result in instability and/or reduced collections, a problem in an economic downturn.

# MUNICIPAL INCOME TAX

## INTRODUCTION

The Ohio Constitution allows municipalities to assess an income tax in two ways: 1) on individuals living and working within its boundaries (individual income tax), and 2) on businesses providing goods or services within its boundaries (net profits tax). Toledo became the first city to assess this local tax in the 1940's, and over 600 others have since followed their lead. There are two main costs associated with Ohio's municipal income tax system: the tax itself that must be remitted and the cost of compliance. For years, Ohio CPAs identified Ohio's municipal income tax system as the worst in the country due to the compliance nightmare it presented for business and individual taxpayers who work in multiple jurisdictions.

The Ohio General Assembly achieved significant improvements in 2014 with the passage of House Bill (H.B.) 5, which took effect for taxable years beginning on or after January 1, 2016. As a result of the new law, most of Ohio's 600 plus municipalities now follow the same definitions for income, have the same filing due dates, will have consistent net operating loss treatment starting in 2017, and apply the same taxpayer rights when issues arise. These changes will help cut compliance costs for business owners.

Despite those significant improvements, additional changes are needed to help Ohio be as taxpayer friendly as other states, particularly where business filers are concerned. Ohio is still at a significant disadvantage regarding municipal income taxes since only 10 other states have a system whereby cities and villages can assess tax both where you work and live. Unfortunately, Ohio businesses still point to this system as a significant cost-of-doing-business burden due to the sheer volume of Ohio cities where a business may have to file net profits returns. Additionally, in 2016 the Tax Foundation is still calling Ohio's municipal income tax system the worst in the nation.[14] We agree with that assessment.

OSCPA's primary concern is not the amount of tax charged by cities and villages to their residents, but rather the compliance cost associated with filing in multiple jurisdictions, particularly since some municipalities are getting much more aggressive with their collection efforts.

### Payroll Withholding and Net Profits Tax

It is important to note that there are two separate forms of municipal income taxation: the payroll withholding tax and related filing requirements processed by businesses for individuals they employ (plus any payments due directly from individuals who are self-employed), and the net profits tax assessed on business entities. The withholding portion and related individual filing requirement burdens were eased considerably through H.B. 5 by increasing the 12-day occasional entrant provision to 20 days, plus by defining that a "day" is allocated to whichever jurisdiction a worker spent the preponderance of his or her work hours. These changes took effect for taxable years beginning on or after January 1, 2016 and largely mean that, at worst, an individual worker who travels a great deal in Ohio for his or her job might have to file

[14] http://taxfoundation.org/blog/cleveland-considers-hike-worst-municipal-income-tax-system-country

individual municipal tax returns in up to 12 municipalities and a business would have to generate up to 12 W-2 forms for that employee.

The 20-day rule, however, does not apply to net profits filings required of Ohio businesses. While H.B. 5 did eliminate the need for businesses to send payments of less than $10 (or to receive refunds of less than $10), they must still incur the administrative costs to prepare and file the returns whether a payment accompanies it or not. Having an employee work just a single day in a municipality can require the business to file a net profits tax return for that jurisdiction even though no tax likely would be due because of the $10 de minimis requirement.

**MUNICIPAL TAX REFORM RECOMMENDATIONS**

There are three specific recommended changes that Ohio CPAs believe would significantly improve the time, cost and effort involved with multiple net profit return filings. All are related to changing how tax payments are collected and administered, and would result in greater compliance by taxpayers as well as reduce business and municipal administrative costs.

1) **Centralize Tax Collection and Administration**. Ohio should adopt some form of centralized collection and administration for business filers, through either a very small number of "regional council of governments" organized under R.C. 167.01 (the Regional Income Tax Authority (RITA) already represents up to 254 municipalities, and the Central Collection Agency (CCA) has 89 full, special and JEDD members) or the State of Ohio via the Ohio Business Gateway. While H.B. 5 did limit the number of municipalities where withholding payments must be filed (through the 20-day occasional entrant provision impacting payroll filings, and exempted businesses with under $500,000 in total revenue), all businesses, even the businesses with under $500,000 of total revenue, must still make net profits filings to each city or village where they have provided a service or good, even if a single employee worked there for just one day.

   Optimally, for net profits filings the Ohio Business Gateway would enhance its software to allow a business to enter all municipalities where taxes are due, calculate the amount due, and remit payments through the Gateway in one single action. The State of Ohio would then be responsible for routing payments to the intended city or village. Alternatively a similar approach could be used by a very small number of regional entities.

   Because 75% to 90% of a municipality's income tax revenue typically is derived from employee withholding as opposed to business net profits filings, the potential savings to cities for these third party transactions could be significant, and would almost certainly cost less than the administrative personnel expenses currently incurred by the cities to process the filings. Cities should be permitted to maintain their own audit function if they choose to do so.

2) **Eliminate Municipal throwback rules.** A number of Ohio municipalities currently use a "throwback" rule. This rule states that sales of goods shipped to a customer in another tax jurisdiction where the seller does not have an employee that regularly engages in the

solicitation of sales (e.g., internet sales companies likely do not have any employees that solicit sales at a physical location other than over the internet) so all sales are "thrown back" to the jurisdiction from which the goods are shipped. This has a costly impact on distribution centers and other types of online businesses where goods are shipped out, because the amount of "sales" in the three-factor apportionment formula increases significantly, thus increasing taxes owed to the home city. The state of Ohio does not have a throwback requirement, but is negatively impacted by lost economic development opportunities, particularly for businesses that are considering sites near the state line.[15] The Toledo Chamber of Commerce stated during H.B. 5 debates that it was having difficulty getting a distribution center to locate in that area because the sought-after business could locate just a few miles away in Michigan and avoid this local tax. The business ultimately selected Michigan. As a result, the Ohio city is missing out on payroll taxes for those employees who would have been working in the facility, and the state of Ohio misses out on related personal income tax for those individuals.

3) **Consideration of Credit for Taxes Paid to other Municipalities.** Our last consideration is the broader issue of double taxation. Ohio is one of just 11 states that allow its municipalities to tax individuals both where they work and live. Many cities and villages give 100% reciprocity credit for taxes already paid to the municipality where the employee works, but far too many do not. Cities are getting more aggressive, as evidenced by the over 9,000 lawsuits filed by RITA in 2015 against taxpayers on behalf of villages and cities.[16] For the 10 other states with a local tax system similar to Ohio's, most charge non-residents a lower income tax rate, recognizing that the individual does not live in the jurisdiction and therefore does not use city services to the degree that residents do. To the best of our knowledge, no Ohio city provides a lower rate for non-residents. Even worse, some Ohio municipalities give no credit for taxes already paid to another Ohio municipality. For example, if a person lives in Marysville (1.5% income tax rate) and works in Columbus (2.5% income tax rate), the individual would owe not 1.5% or 2.5%, but 4% in total municipal taxes because Marysville provides no credit for taxes paid to another Ohio city. With each passing year, more Ohio cities are moving to a reduced reciprocity credit for its taxpayers, no doubt in response to the need or desire to generate additional tax revenue. When the Ohio General Assembly looks for ways to make Ohio competitive, consideration should be given to addressing this growing problem.[17] As more cities join this movement, it absolutely will have an impact on the economic viability of a business to remain competitive in our state, as well as on the amount of disposable income in the pockets of impacted residents.

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[15] Other states such as Indiana have eliminated throwback requirements in recent years. See S.B. 441 of the First Regular Session of the 119th Indiana General Assembly.

[16] http://www.10tv.com/content/stories/2016/05/30/how-to-avoid-a-lawsuit-for-back-taxes.html

[17] See *Thompson v. City of Cincinnati*, 2 Ohio St. 2d 292 (1965).

# COMMERCIAL ACTIVITY TAX

**Historical Revenue from Commercial Activity Tax**[18]

| GRF FY 2012 | Total CAT FY 2012 | GRF FY 2013 | Total CAT FY 2013 | GRF FY 2014 | Total CAT FY 2014 | GRF FY 2015 | Total CAT FY 2015 | GRF FY 2016 | Total CAT FY 2016 |
|---|---|---|---|---|---|---|---|---|---|
| $417.1 | $1,656 | $790 | $1,595.1 | $794.2 | $1,685.8 | $854 | $1,751.7 | $1,255.3 | $1,674 |

**INTRODUCTION**

The CAT, which was implemented in 2005 to replace both Ohio's tangible personal property tax (TPP) and corporation franchise tax (CFT), is not a transactional tax but rather a tax on the privilege of doing business in Ohio.[19] This tax was projected to raise $1.8 billion and intended to "hold harmless" local governments from losing revenue through the elimination of the TPP and CFT until their share was initially scheduled to be phased out in 2010, with all revenue going to the state after that period. But for nearly the first 10 years of its existence, only half of the CAT revenue actually went to the state. In 2015, H.B. 64 increased the percentage of CAT revenue credited to the General Revenue Fund (GRF) from 50% to 75% as of July 1, 2015, and reduced the percentages credited to the School District Tangible Property Tax Replacement Fund from 35% to 20% and the Local Government Tangible Property Tax Replacement Fund from 15% to 5%.

Though the amount of CAT revenue going into the GRF is not what was originally intended, the total amount of revenue being derived from this tax has been consistently stable and predictable which is important for government budgeting purposes.

The only taxes in other states that are even remotely similar to the CAT are the Texas Franchise (Margin) Tax, the Washington Business & Occupation Tax and Nevada's new commerce tax. Other than these three states—the CAT stands on its own nationally—there is nothing else like it. However, it is important to note that unlike Ohio, none of these three states (Nevada, Texas, nor Washington) also impose a personal income tax.

OSCPA has a longstanding position that the CAT is effective as long as the following criteria remain intact: the rate is low, the base is broad, the exemptions are few and compliance is simple. Each is discussed below along with recommendations.

**CAT Rate Must Remain Low.** The primary benefit of Ohio's approach is the uniform, low rate of 0.26%. By contrast, Washington has over 40 different industry classifications with rates ranging from 0.13% to 3.30%. Texas recently enacted an overall 25% rate cut effective as of January 1, 2016, which resulted in the general rate dropping from 1% to 0.75% and the special

[18] Source: Legislative Service Commission. (Data are shown as $ in millions.)

[19] *Ohio Grocers Assn. v. Levin*, 123 Ohio St.3d 303, 2009-Ohio-4872.

rate for taxpayers primarily engaged in retail or wholesale trade dropping from 0.5% to 0.375% – still significantly higher than Ohio's rate.

If Ohio bifurcates or increases its rate, the effect would become even more burdensome. The CAT was intended as an exchange for eliminating the Tangible Personal Property Tax and Corporate Franchise Tax, and Ohio should not want to bring those taxes back. Ohio will also be receiving more CAT revenue in FY 2016 because of the increase from 50% to 75% going to the GRF—the $854 million deposited to the GRF in FY 2015 represented only half.

The main concern by some with the CAT has always been its pyramiding effect. However, the low rate mitigates the concern about pyramiding. The higher the rate, the more dramatic the problem is with the CAT's pyramiding structure.

Prior to 2014, the Annual Minimum Tax (AMT) was a flat $150 for all taxpayers with gross receipts over $150,000. The tiers were added in the budget bill, H.B. 59 (130th GA), which essentially phased out the benefit of the $1 million exclusion for larger businesses for tax periods beginning on or after January 1, 2014. The current AMT graduated brackets are:

| Taxable Gross Receipts | Annual Minimum Tax |
|---|---|
| $150,000 or less | $0 |
| More than $150,000 up to $1 Million | $150 |
| More than $1 Million up to $2 Million | $800 |
| More than $2 Million up to $4 Million | $2,100 |
| More than $4 Million | $2,600 |

Although the AMT structure changed in 2014, the 0.26% rate continues to be imposed on the taxable gross receipts greater than $1 million. For example, for a business with $3 million in Ohio receipts, the AMT would be $2,100, plus $5,200 for the additional CAT liability (0.26% x ($3 million gross receipts - $1 million exclusion) for a total of $7,300 (a tax increase of $1,950).

**Base Must Remain Broad.** A major reason why the CAT rate has remained low is that the base is very broad, as intended from inception. The effect of the CAT is most often felt by brick and mortar businesses such as retailers and wholesalers – i.e., those with low gross profit margins that rely heavily on high sales volume. At the other end of the spectrum are businesses like call centers that can be located anywhere.

However, three cases currently pending before the Ohio Supreme Court could create a big hole in the CAT revenues from out-of-state businesses. They are challenging the "bright-line presence" standards for substantial nexus established in R.C. 5751.01(I) – specifically the statutory sales threshold of at least $500,000 per year in taxable gross receipts. Oral arguments were held on Tuesday, May 3, 2016 and it is unknown when a decision will be issued by the Supreme Court.[20]

**Exemptions Must Be Limited.** Tax expenditures are affecting CAT revenues, which despite commitments to a broad base, limited exclusions and a low rate when the tax was first passed in 2005. The total cost of the exclusions has doubled in the past 10 years from approximately $300 million of CAT revenue to over $600 million currently. Since 100% of the CAT revenue is not yet going into the GRF, carve-outs exacerbate the problem. OSCPA has consistently fought to eliminate and oppose exemptions, as well as resist additional carve-outs.

**Ease in Administration, Compliance and Enforcement.** The CAT is a simple tax to administer, yet improvements can be made in the areas of administration, compliance and enforcement. As a result, there are several revisions that could be made to improve the CAT.

**COMMERCIAL ACTIVITY TAX RECOMMENDATIONS**

1) **Simplify the definition of gross receipts.** It should be consistently tied in some way to the definition of federal gross income (Internal Revenue Code § 61) to create a more objective standard for applying the CAT. While we believe the CAT definition of gross receipts is statutorily tied to federal tax definitions and concepts,[21] ODT will not consistently adopt this view, especially if this leads to lower CAT revenue. This has resulted in litigation and uncertainty for both taxpayers and the government.

2) **Eliminate or revise CAT exemptions.** Unless there is a valid public policy reason for creating the exemption, each CAT carve-out should be separately reviewed and, unless there is a compelling reason for granting an exemption, it should be eliminated.

3) **CAT administration earmark.** As CAT filings are required to be completed electronically for both quarterly and annual filers, the 0.85% of CAT revenue (about $15 million) that is earmarked for CAT administration expenses could be significantly reduced or eliminated and redirected elsewhere.

4) **Address the "estimation" procedures as they are inadequate for large multistate companies** (see Information Release CAT 2007-01).[22] Large multistate companies find it very difficult, if not impossible, to determine **actual** gross receipts broken down on a state-by-state basis by the second week of February of the subsequent year, let alone on a subsequent quarter basis. The accumulation and processing of state and local apportionment data simply does not happen that fast.

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[20] See *Crutchfield, Inc. v. Testa* (2015-0386); *Newegg, Inc. v. Testa* (2015-0483); *Mason Cos., Inc. v. Testa* (2015-0794).

[21] Federal income tax method of accounting is followed for CAT per Ohio R.C. 5751.01(F)(4).

[22] http://www.tax.ohio.gov/commercial_activities/information_releases/cat200701.aspx

# COMMERCIAL ACTIVITY TAX

5) **Address the Research & Development (R&D) credit within the CAT as it has created complexity with filers.** There's a Research & Development (R&D) credit allowed within R.C. 5751.51. The statute's language is clear but complexity is created by OAC 5703-29-22(C)(2). The rule requires the Ohio R&D credits to be calculated on a calendar year basis regardless of the federal tax year end. The rule also requires taxpayers to claim the credit in the annual report due in February of each year. Both of these provisions add complexity and cost into the compliance process. In claiming the credit, it should follow the company's federal tax year and not a calendar year. In addition, instead of having a February due date, the company should be able to claim the credit in the quarter that it files its federal income tax return but have it apply for the entire year's CAT. This would allow the Ohio R&D compliance process to piggy back on the federal R&D credit calculation and timing, thus reducing the complexity and cost for many companies.

6) **Amend the combined (mandatory) and consolidated (elective) filing methods for commonly owned persons**. These provisions have presented traps that were not intended by the General Assembly. The CAT combined provisions under R.C. 5751.012 and consolidated provisions under R.C. 5751.011 should be revised, and the rules need technical corrections. For example, it is virtually impossible for private equity firms to fully comply with CAT audit requirements. The current ownership and control provisions set percentages, forcing some companies to combine/consolidate that do not share financial information. The forced combination/consolidation usually adds little from a revenue standpoint to the State of Ohio, but ODT still pursues this because that is what the law requires. This is a potential area where ODT could transition its compliance resources elsewhere. There have been audits of private equity firms with numerous hours invested by ODT's audit staff with little to show in return in the way of tax collected. The problems with consolidated elections/common ownership could be fixed by allowing some sort of late filing relief on consolidated elections similar to that offered for federal income tax purposes through "9100 relief" by using voluntary disclosure if the taxpayer has not made an election. If a statutory fix is preferred then some sort of "Unitary Test" could be added to the ownership test for mandatory combination. Most states define a unitary business as a business whose activities or operations, which are of mutual benefit, dependent upon, or contributory to one another, individually or as a group. It is characterized by unity of ownership, functional integration, centralization of management, and economies of scale. If this principle would be applied it would reduce the compliance burden for many private equity firms, free up a significant number of CAT auditor hours to focus on other non-compliant companies, and accomplish this goal with very little impact to the CAT revenue.

7) **Adopt provisions that put private equity firms on par with commonly owned corporate groups**. As it now stands, consolidated filing is, as a practical matter, unavailable for certain taxpayers solely on the basis of being owned by private equity firms v. being publicly traded, etc.

8) **Add additional funding for the Ohio Board of Tax Appeals (BTA)** to more quickly address its current case backlog—on CAT or any other tax dispute before the BTA—and to avoid future lengthy hearing delays.

9) **Pursue out-of-state companies more aggressively.** Ohio should continue to pursue additional revenues by aggressively going after out-of-state companies that have nexus with Ohio and should be paying the CAT.

# SALES & USE TAX

**Historical Revenue from Sales and Use Tax**[23]

| Actual FY 2012 (Rate 5.5%) | Actual FY 2013 (Rate 5.5%) | Actual FY 2014[24] (Rate 5.5-5.75%) | Actual FY 2015 (Rate 5.75%) | Actual FY 2016 (Rate 5.75%) |
|---|---|---|---|---|
| $8,087 | $8,444.9 | $9,165.8 | $9,960.2 | $10,348 |

## INTRODUCTION

Like most taxes, Ohio's sales and corresponding use tax can be divided into four main areas of discussion: (1) tax rate, (2) exemptions, (3) tax base and (4) compliance and enforcement. OSCPA guidelines dictate that Ohio's tax laws and regulations should adhere to the following principles: competitiveness, simplicity, stability, equity/fairness and neutrality.

### Ohio's Tax Rate, Including the Local Add-ons at the County Level

The imposition of the Ohio sales tax began in 1935 at a 3% tax rate. The corresponding use tax was imposed a year later. As with most taxes, the sales and use tax rate has fluctuated over the years and the state sales and use tax rate is currently 5.75%. In addition to this state rate, Ohio counties and certain transit authorities are authorized to impose an additional sales and use tax on top of the 5.75% state sales and use tax rate. All 88 Ohio counties currently impose an additional sales and use tax with the add-on county rates ranging from an additional 0.75% to 2.25%, resulting in a total sales and use tax burden of 6.5% to 8%.[25]

In comparing the sales and use tax rate to other states, the 5.75% state sales and use tax rate ranks Ohio in the middle of the pack of all states (27th). However, when the average county and transit authority local sales tax rate of 1.39% is added, Ohio jumps to the 19th highest combined sales and use tax rate in the country and the highest among our neighboring states. Three of our neighboring states, Indiana, Kentucky, and Michigan only impose tax at the state level and do not have a local add-on. Provided below is information comparing Ohio's total rate to other nearby states, both with and without the local rate being included.

23 Source: Legislative Service Commission. (Data are shown as $ in millions.)

24 The current Ohio sales and use tax rate, 5.75%, was established on Sept. 1, 2013.

25 http://www.tax.ohio.gov/portals/0/tax_analysis/tax_data_series/sales_and_use/salestaxmapcolor.pdf

# SALES & USE TAX

| State Rate Ranking (Highest to Lowest)[26] | | Overall Highest Combined Tax Rate with Local Average Add-On | |
|---|---|---|---|
| Indiana: | 7.00% (2nd) | Tennessee: | 9.46% = 7.00% plus 2.46% (1st) |
| Tennessee: | 7.00% (2nd) | Ohio: | 7.14% = 5.75% plus 1.39%(19th) |
| Pennsylvania: | 6.00% (16th) | Indiana: | 7.00% = 7.00% plus 0.00%(22nd) |
| West Virginia: | 6.00% (16th) | North Carolina: | 6.90% = 4.75% plus 2.15% (25th) |
| Michigan: | 6.00% (16th) | Pennsylvania: | 6.34% = 6.00% plus 0.34%(32nd) |
| Kentucky: | 6.00% (16th) | West Virginia: | 6.20% = 6.00% plus 0.20% (34th) |
| Ohio: | 5.75% (27th) | Michigan: | 6.00% = 6.00% plus 0.00% (37th) |
| North Carolina: | 4.75% (35th) | Kentucky: | 6.00% = 6.00% plus 0.00% (37th) |

By having the highest combined tax rate among our neighboring states and with Ohio counties bordering these states, Ohio risks losing revenue from residents and businesses that will intentionally cross to a border state to purchase large items for the sales tax savings. For example, a resident of Toledo (Lucas County) pays a 7.25% tax rate for an Ohio purchase, whereas the individual could drive across the Michigan border and pay a 6% tax rate on the same purchase. Residents of Cleveland have the highest rate in Ohio (Cuyahoga County at 2.25%), paying 8% in sales tax.

Similarly, a recent Wichita State University study found that some Kansas residents left the state to purchase their groceries. Kansas currently subjects food to a 6.5% sales tax, whereas its neighbors Nebraska and Colorado do not tax groceries, and Missouri taxes food at 1.225%. As a result, Kansas lost $345.6 million in food sales in 2013 (when its rate was 6.15%) – costing the state $21.2 million in lost sales tax revenue.[27]

**Sales Tax Exemptions in Ohio**

The current exemptions for sales tax in Ohio are in line and generally consistent with surrounding states (see the Tax Expenditure Report: The State of Ohio Executive Budget Fiscal Years 2016-2017). It is important that exemptions are competitive so that businesses and consumers will not turn to other states for those services or goods. For example, the manufacturing exemption is critical to keep Ohio competitive, as essentially all states with a sales tax provide for it. In general, sales tax exemptions should apply to a broad base that has a real impact on driving economic development in our state rather than granting carve-outs for small niche industries.

**Expanding the Sales Tax on Services will Drive Business Away**

During the past two biennial budget proposals, OSCPA has strongly opposed the expansion of the Ohio sales and use tax base to include professional services. OSCPA applauds the General Assembly for declining to expand the tax base to include these services. Four states have

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[26] Source: www.taxfoundation.org

[27] Source: http://www2.ljworld.com/news/2016/jan/18/report-kansas-residents-buy-groceries-out-state-du

enacted a sales tax on professional services in the past—Florida, Maryland, Massachusetts, and Michigan—and all four states quickly repealed their laws before or shortly after they went into effect. The only three states having a broad sales/gross receipts tax base that includes many services are Hawaii, New Mexico, and South Dakota. Ohio also has a broad gross receipts tax on services – the CAT.

The challenges are many when expanding the sales tax to include professional services. One factor to consider is the disadvantage small businesses would face compared to larger companies: small businesses typically cannot afford to have full-time legal, accounting or other professional staff so they must hire firms to provide those services. Any sales tax imposed on those services would put them at a competitive disadvantage when compared to a larger business with its own in-house professionals, which are essentially “sales-tax-free” service providers. Another challenge is the reality that many services are highly mobile in nature, meaning they can be easily provided digitally or electronically from virtually anywhere in the world. Ohio should avoid driving business away from our state.

As Ohio seeks to address its shortage of qualified workers, it is important to keep in mind that a sales tax on consulting services in particular—generally a highly mobile sector due to widespread clients—will serve to drive away potential businesses from our state to locations without such a tax. Ohio needs to focus on approaches that will entice the best and brightest to stay when they graduate or are early in their careers, not face the tough decision of moving away when their employer relocates a consulting practice.

Sales tax on services is further complicated because sourcing rules present a significant challenge. For example, if auditing services performed by a CPA become taxable it is difficult to determine where the benefit of the service is received which is typically the standard in determining where a sale occurs for sales and use tax purposes. If the CPA is performing auditing services to a publicly traded company with locations around the world, would the benefit of the CPA's services be received at the company's headquarters or at the other locations around the world? Further, if the CPA actually performs services as part of the audit, such as inventory counts, in another country, should those services be sourced to Ohio because the company is headquartered in Ohio? If Ohio adopts a sales tax on services and our neighboring states do not, consumers and businesses will be even more incentivized to look outside of the state for services. This is an especially significant issue for border cities such as Cincinnati, Cleveland, Toledo and Youngstown.

Another major consideration is that any expansion of the base to encompass services should exclude sales between affiliated companies, which could cost millions of dollars for a single taxpayer. As an example, R.C. 5739.01(B)(3)(e) currently excludes business-to-business inputs for “intercompany sales” between affiliated companies.[28]

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[28] Such transactions that occur between members of an affiliated group are not sales. An ‘affiliated group’ means two or more persons related in such a way that <u>one person owns or controls the business operation of another member of the group. In the case of corporations with stock, one corporation owns or controls another if it owns more than 50% of the other corporation’s common stock with voting rights.</u>

Adding sales or use tax to sales on professional services or between affiliated companies will significantly drive up the cost of goods made in our state, as well as services provided by professionals in Ohio. Either of these changes will make Ohio-based business operations less competitive when compared to almost all other states.

**Sales Tax Regulatory Reform-Automatic Data Processing and Electronic Information Services**

In the area of automatic data processing (ADP) and electronic information services (EIS), auditors at ODT have been aggressively interpreting the law and expanding the sales or use tax base. An example of this expansion became obvious when ODT recently released revisions to Information Release 1999-04—On-line Services and Internet Access—which includes ADP and EIS.[29] The revisions create a guilty until proven innocent environment. While we applaud the General Assembly for ensuring that digital advertising is exempt,[30] there are a number of additional services used via an electronic format, such as webinars, that have been identified by ODT as now taxable. Ohio should adopt language similar to current law contained in R.C. 5739.012(B)(2) to clarify that taking a nontaxable service and performing it using the web, internet, or cloud infrastructure does not render the otherwise nontaxable service taxable. With such an approach, the statute would not likely need to be amended for every new service. The approach would also avoid an interpretation that a service is somehow taxable since it was not specifically exempt under R.C. 5739.01.

**Sales Tax on Employment Services**

Another area where reform is warranted involves Ohio's sales or use tax on employment services.[31] Only 10 states currently impose sales or use tax on employment services. Of our neighboring states, only Pennsylvania and West Virginia tax these services. The most significant difference between Ohio and Pennsylvania's law is that Pennsylvania only imposes the tax on the fee charged by the service provider and not the labor component (salary or wages). The imposition of sales or use tax on employment services is one of the most contested areas of Ohio tax law.

Despite a significant body of case law, there are still numerous debates on how or if the tax should apply. Sales or use tax is not imposed on employment services if a contract for a period of greater than one year exists and the personnel are permanently assigned. The facts, referred to as performance, must be consistent with the contract. Ohio's current definition of permanent employment is a significant issue because a lack of guidance exists. Whereas, Pennsylvania's law does not differentiate between permanent versus temporary employment services and taxes all employment services but at the lower tax base (Pennsylvania uses the term help supply services to define employment services). Further, ODT has argued if one individual included in

[29] http://www.tax.ohio.gov/Portals/0/sales_and_use/information_releases/ST%201999-04%20Online%20Services%20and%20Internet%20Access%2012-2015%20final.pdf

[30] See H.B. 466 (131st GA).

[31] See H.B. 343 (131st GA) for proposed legislation on employment services reform.

a contract fails the performance test, the entire contract (which may include thousands of other individuals) is tainted and sales or use tax should be imposed on the entire contract. This is commonly referred to as the "one bad apple" position. Unlike the other taxes on services, the tax does not have a personal or professional services exception which results in significant tax on engineering and information technology services. Many of these service providers are small businesses located in Ohio. Because of the plethora of service providers for these services across the globe, companies can avoid the tax by hiring personnel to provide those same services outside of the state. Finally, the statutory provision providing audit protection to a vendor receiving an exemption certificate from a purchaser does not include any of the exclusions to the tax on employment services available under R.C. 5739.01(JJ). The General Assembly should reform the taxation of employment services in Ohio.

**Compliance and Enforcement**

Compliance is an issue for both sales and use tax, but especially use tax. In 2011, Ohio established an eighteen month use tax amnesty program as a tool to educate taxpayers of potential filing requirements for the use tax. At that time, ODT estimated approximately 300,000 taxpayers had an account with ODT (i.e. withholding, CAT, sales) but did not have a use tax account. Less than 4,000 taxpayers chose to participate in the amnesty process. Thus, there is a potential that many taxpayers do not realize that a use tax obligation exists.

Ohio is unique in that it requires taxpayers to file a separate return for sales and use tax purposes. Many states, such as Michigan, allow taxpayers to file a sales and use tax return on one form. Ohio could change its filing method to allow taxpayers to file both tax types on one form. However, significant considerations must be given to the impact on the statute of limitations because a taxpayer that does not currently file a return may be audited for a period of up to ten years.

There are opportunities for Ohio to significantly improve compliance and enforcement among businesses through the Business Gateway, sales or use tax reporting, remote sellers, refunds, and payment plans.

**SALES AND USE TAX RECOMMENDATIONS**

1) **Explore expanding the definition of sin tax to allow for economic development purposes.** Since 1990, Cuyahoga County has been the only county in Ohio authorized to collect a special excise tax on alcohol and cigarettes. The proceeds from the “sin taxes” have been used by the county for maintenance and upgrades to the professional sports stadiums in Cleveland.

2) **Review the sales tax on business fixtures under R.C. 5701.03.** Real property improvements are exempted from sales or use tax, but business fixture installation is subject to sales or use tax for both materials and labor. Clarification is needed so as to clearly delineate the difference between realty and business fixtures, especially since the

last revision to ODT's Amended Bulletin No. 290 to county auditors occurred on December 18, 2007.

3) **Review vendor discounts.** Vendor discounts were instituted in 1981 to offset costs to businesses for resetting cash registers after rate changes. Today, electronic cash registers have largely reduced this burden. The discount is currently ¾ of 1% (0.75%) with no limit, which amounts to a projected annual loss to the state of $68.2 million in FY 2016 and $71 million in FY 2017. Consideration should be given as to whether the discount should be reduced. The most recent budget bill (Am. Sub. H.B. 64 of the 131st GA) sought to cap the discount at $1,000 per month but that provision was removed from the final version. Other states such as Indiana offer a tiered discount depending on the amount of tax; this could be an alternative solution to reduce the discount.

4) **Eliminate the exemption for tangible personal property used in storing, preparing, and serving food.** This exemption costs the state approximately $33 million per fiscal year and is problematic from an auditing perspective because few if any other states have this exemption.

5) **Automatic Data Processing and Electronic Information Services.** Adopt language similar to current law contained in R.C. 5739.012(B)(2) to clarify that taking a nontaxable service and performing it using the web/internet/or cloud infrastructure does not render the otherwise nontaxable service taxable.

6) **Streamline sales or use tax on employment services.** As described above, the General Assembly should explore defining the term permanent, eliminating the "one bad apple" position, providing an exemption for personal or professional services, giving a vendor audit protection by allowing a vendor to rely on an exemption certificate provided in good faith by its customer, and Pennsylvania's limitation of the tax base to only include the mark-up, and not labor, charges.

7) **Ohio Business Gateway (OBG) Upgrade.** Invest adequate resources to upgrade the Ohio Business Gateway to sufficiently handle all pertinent sales/use tax filings, as well as all of the other sources of tax revenue to the state and local governments.

8) **Cash vs. Accrual Basis.** Sales tax reporting for small business remittance should be collected on a cash basis. Ohio's current rule on sales tax is accrual, so we recommend that if a taxpayer is on cash basis for federal income tax purposes, then the taxpayer should be on cash basis for Ohio sales tax reporting purposes. For federal income tax purposes, a business entity can use the cash basis method of accounting so long as its average annual gross receipts are $5 million or less (see IRS Pub 538) OR the business provides services that do not carry inventory.

   Accrual accounting for sales tax can require a business to remit sales tax dollars to the State that the business has not collected yet from customers. This requirement can place an undue cash flow burden on a business as it remits money to Ohio but must wait to receive payment from its customer which can be months later. Since the business is merely acting as an agent for the State, this creates an unfair burden and the problem weighs most heavily on small businesses.

9) **Remote Sellers.** Since the legislature recently enacted both click-through and affiliate nexus, Ohio could be more aggressive with out-of-state sellers, collecting tax that is currently due under existing law because remote sellers should be collecting tax. In the previous budget bill (H.B. 64), R.C. 5741.01 (Q), (R), and (S) were added to define a remote sale and assert nexus over the remote seller. Ohio may want to review the activities of other states such as Colorado or New York to impose new requirements on remote sellers. In addition, ODT could expand audit resources to audit out-of-state sellers for sales or use tax.

10) **Payment Plans.** Permit taxpayers to enter into a payment plan with the ODT. A permit fee could be charged to taxpayers wishing to pursue this remedy to pay an outstanding tax liability. Under current rules, taxpayers who need to pay their assessments over time must pay ODT and after a certain period the debt is turned over to the Attorney General's office (AG). This adds additional fees and penalties that are burdensome. If taxpayers are willing and able to resolve an outstanding tax obligation with ODT, the taxpayer should not be referred to the AG, which may refer the case to a private "special counsel" that involves a collection fee for the special counsel.

    The AG's office could disclose the number of taxpayers that currently have a payment plan with Ohio to determine the total cost of funding an initiative for ODT to administer taxpayer payment plans instead of the AG.

11) **Reduce Interest Payments.** Other states such as Kansas require all sales or use tax refunds to be processed within 120 days. Currently, ODT does not have a time limitation on processing refund claims. The General Assembly could require that ODT process refunds within a certain timeframe to reduce Ohio's interest cost.

12) **Combine Sales/Use Tax Filing.** Combine the reporting of sales tax and use tax on the same form, and start the statute of limitations with the filing of both. To the best of our knowledge, Ohio is the only state that requires two separate forms.

13) **Zappers.** Several states recently enacted legislation to eliminate automated sales suppression devices, commonly referred to as "zappers." Kentucky's law made it a felony to have a zapper in a retail establishment. Zappers give retailers the ability to cheat tax departments out of owed sales taxes through the falsification of electronic records of point-of-sale (POS) systems – i.e. computerized cash registers. Ohio should enact legislation to ban them.

# SEVERANCE TAX

**Historical Revenue from Oil and Gas Severance Tax & Cost Recovery Assessment**[32]

| Revenue Base | Actual FY 2012 | Actual FY 2013 | Actual FY 2014 | Actual FY 2015 |
|---|---|---|---|---|
| Natural Gas | $2,458,828 | $2,724,239 | $3,984,135 | $17,253,141 |
| Oil | $934,223 | $1,135,774 | $1,305,149 | $3,077,393 |
| Total | $3,393,051 | $3,860,012 | $5,289,284 | $20,330,534 |

## INTRODUCTION

This section does not provide a historical background or commentary on the current state of Ohio's severance tax because the Ohio 2020 Tax Policy Study Commission already received a 52-page report on October 22, 2015 entitled "Recommendations and Information Collected by the Informal Working Group on Ohio's Oil and Gas Industry and Severance Tax." [33]

Instead, OSCPA's recommendations in the severance tax section are focused primarily on issues impacting administration of the tax in various approaches. We do not have a position on the rate that should be charged.

## SEVERANCE TAX RECOMMENDATIONS

1) **Base the tax on the price when the product is sold per period and not on the value of the product at the time of extraction per period.** Companies could report to the state and remit taxes monthly, but depending on their size (if a smaller producer) it could be quarterly or yearly.

   Benefits:
   (a) Fairer to the producer because it eliminates the problem of line loss (cost of burning some of the gas produced during the process) – no one currently gets the benefit except the state. Equipment ratings often overstate the loss so it is difficult to accurately measure without an electronic measurement, which is costly.
   (b) Looks at third party sales/remittance agreements instead of charts produced internally by the producing companies.
   (c) Follows cash and volume, and there is no timing difference in production. Companies usually post revenues two months after the oil/gas comes out of the ground. They would file one Ohio Form 6 and Form 10 based on what has been extracted, and then file amended ones based on what was paid. Most states have a "production"

[32] Source: Recommendations and Information Collected by the Informal Working Group on Ohio's Oil and Gas Industry and Severance Tax, page 4. (Data are shown as $ in millions.)

[33] http://www.gongwer-oh.com/public/130/severanceworkgroup.pdf

report and a "severance tax" report; they are independent of each other and this greatly aids in audit function.

(d) The reconciliation process could be made easier for both the state and the producer alike if it's based on what is sold. The goal is to get production reports and use them as a high level check, so both production and severance tax reports should be required as mentioned above in (c).

(e) Some states already use the sell methodology. Louisiana uses production volumes as the basis for severance tax on gas, but it's much more complicated and creates arguments about what is taxable production.

2) **Create two rate structures.** One rate for low producing wells, and a standard rate for wells which do not qualify as "low producing" or "marginal." The lower rate will encourage production on marginal or stripper wells.

(a) Require an application process for lower rates, and verify the volumes and rates via audit. Once the well is qualified then the producer would be at the lower rate until production goes above that amount for a certain number of months. An application gives the state an enforcement or fallback position in the event of a mistake. The other option is to create a production threshold in lieu of an application.

(b) Most of the marginal production in Ohio is only reported once a year. Production declines over time, so the producer may hold for acreage positions until prices rebound and buy underlying production. If the state wants to have this as an incentive, then the rate should not change by the month. Perhaps set an average over 3 months, or production below 200 Mcf would be at a lower rate. Texas has a low producing well incentive but it is complicated because it's based on a monthly combination of production and pricing.

3) **Apply the tax to both horizontal and traditional vertical wells.** Therefore, all drills (any drilling at all – not formation specific) get the same tax treatment.

(a) Oklahoma recently changed its production severance tax language to apply to vertical or horizontal wells at any location. They went to a 2% standard rate across all wells for the first 36 months. Ohio could apply the standard rate to new wells or all, but the state should want consistency and a level playing field across the state. Application of the tax from "X" date forward on all wells makes the most sense.

(b) Different formations that are depleted could get new life with new approaches, such as the Clinton formation and Berea. The state does not want to box producers into having disproportionate reasons to produce in one area vs. another, nor does the state want to disincentive producers from trying new approaches.

4) **Natural gas liquids (NGL's) such as propane, butane, ethane, etc.** The state should not tax NGL's on volume as they come out of the ground because they are embedded in the wet gas stream as they go through the measurement points. NGL's are removed via "cryogenic" or "lean oil" processing and in smaller circumstances via refrigeration units.

(a) Establish a tax rate for oil, gas, or liquid. It varies depending on the state, but again this is where a value tax makes sense – a percentage of the value/proceeds similar to oil/gas. For example, if a producer gets $100,000 in payment for NGL's and the tax rate is 5%, then the producer pays $5,000 in tax associated with the NGL's.

(b) Takes away confusion on how liquids will be taxed, and also gives clarity to landowners because the checks are complicated now. It would be helpful if they could read the check and compare it to what is being reported to the state.

(c) Louisiana says liquids are taxed as a gas. Other states tax on the value of the liquids at the gas rate.

5) **Prevent double taxation.** Michigan allows producers subject to its severance tax to exclude income from oil and gas activities from its income tax.

(a) For example, a 2% severance tax would receive a credit against the 5% income tax. If a full 100% credit is not granted, some percentage would be helpful. Many producers are C corporations so double taxation on income tax and severance tax is an issue.

(b) A CAT credit is not as beneficial because a lot of oil leaves the state. It would only stay in Ohio if it goes to an Ohio refinery.

6) **A percentage of value model is the best, based on proceeds from the sale.** A volume based tax is indirectly tied to pricing. For example, Louisiana in July will publish a new gas tax rate per unit of volume to be effective for the next year, indirectly tied to prior year pricing. However, Ohio should go with a value based tax instead of the volume method. The advantage is its simplicity to administer.

(a) The only concern is the full fair value gives the producer the option to play with pricing, selling to a subsidiary, partner, etc. Other major producing states have similar issues. Enforcing rules around "non-arms-length" contracts is important in this situation.

(b) If a state goes to a gross receipts tax, the legislation would need to mandate that companies must disclose non-arms-length contracts/transactions.

(c) When royalty reports are submitted to the federal government, there are two sides – non arms-length vs. arms-length. The taxpayer must distinguish between the two contract types when using a value based tax and the state must strictly enforce it under audit. The state should make this a field on the severance tax reports (contract type: "arms" or "non-arms").

(d) If the state taxes on value, then it needs to tax oil, gas, and liquids on value.

7) **Enact a price per unit trigger mechanism.** North Dakota has two taxes: a production tax at 5% and an extraction tax at 6.5%, so the effective rate is 11.5%. However, North Dakota ties a trigger to the price per barrel. If the average price falls below $90/barrel for 5 consecutive months, the rate shifts between 6.5% and 5% on the extraction tax. If the state goes to a tiered tax system, the rate change should be marginal and the price trigger somewhat high. A trigger might be more effective in Ohio because not as much of its budget is dependent on production.

# SEVERANCE TAX

**GENERAL OBSERVATIONS**

1) **RUMA (Road Use Maintenance Agreement).** Under RUMA, companies are obligated to post a bond to pay for road repairs. Some companies actually resurface the roads and install water infrastructure that goes to the local government. The severance tax does not need to pay for all of these costs – RUMA alleviates the costs to local governments.

2) **Valuation of mineral properties.** Every year in February, the state tax commissioner issues a report on how mineral properties will be valued. Since all these Ohio wells fall under it, landowners already pay about a 1 – 1.5% tax (which is essentially a real estate tax). This should be taken into account when setting a severance tax rate.

3) **Add a couple layers of pricing.** Louisiana recently changed their incentives to phase out when oil/gas prices increase. However, adding too many layers is burdensome for not only producers but for the state to police. Too many layers can also lead to changing interpretations and big gray areas resulting in costly litigation. Interpretations will change over time and impact producers, encouraging them to shift to another state.

4) **Impact on leases and royalties.** A class action in Columbiana County involved post-production taxes – producers cannot pass along the bifurcated fee. As a result, the state must plan for what happens if X change is made and producers pass on costs to landowners. In Pennsylvania, there is a minimum royalty of 12.5% that goes to the landowner.

# OTHER STATE TAXES

**INTRODUCTION**

While Ohio's personal income tax, CAT and sales tax generate the majority of revenue for government operations, there are a number of other taxes in our state that result in increased government revenue, as well as increased compliance and financial cost to Ohioans.

For all forms of taxation, there should be consistent treatment within each category, meaning that exemptions should be avoided, particularly when it benefits one class of business over other direct competitors. Highlighted below are additional taxes levied by the state and recommendations to keep Ohio competitive while maintaining economic fairness and stability.

**Cigarettes and other tobacco products**

In July 2015, Ohio raised the cigarette tax from $1.25 to $1.60 per package of 20. Proponents argue that a cigarette tax is a predictable, reliable and steady source of revenue for the state with the added benefit of helping to reduce smoking, particularly amongst Ohio's youth. Opponents argue that increasing the cigarette tax helps to drive business across state borders and that states such as Kentucky, with a significantly lower tax, become the financial winners when Ohioans cross the border to purchase cigarettes from their vendors.[34]

**Lottery**

While OSCPA does not have a position on the appropriate breadth and scope of gambling in Ohio, we do have concerns where the impact on state revenues is concerned and, in the case of casinos and racinos, the impact on funding for Ohio schools and local governments.

As highlighted by the Ohio General Assembly's Permanent Joint Committee on Gaming and Wagering's 2015 Annual Report, Ohio is one of 26 states that permits commercialized gaming facilities (other than tribal gaming). Promotional spend, also known as promotional play or promotional gaming credits, is a commonly used marketing tool whereby casinos and racinos offer customers "free money" to wager, with the goal being to entice them to enter their facility and gamble. Of those 26 states, eight tax every dollar of promotional spend, nine cap the amount of tax-free promotional spend, and the remaining nine, including Ohio, exempt all promotional spend from taxation.

Since Ohio casinos began operating in 2012, over $383 million in tax-free promotional spend has been redeemed by casino customers. That figure climbs to $807 million when Ohio's seven racinos are added. Casinos and racinos deduct the amount of promotional play used in their facilities from gross revenue before tax is assessed per current law. Roughly one-third of this amount is foregone tax revenue that otherwise would have been received by Ohio's primary and secondary schools and local governments.

We understand and agree with operators of Ohio's casinos and racinos that promotional spend is a marketing tool that entices some citizens to enter their facilities and gamble, and that other states around Ohio currently also have promotional spend – including unlimited promotional

[34] http://taxfoundation.org/article/cigarette-taxes-and-cigarette-smuggling-state-2013-0

spend in Pennsylvania. But the question remains: is this tax-free benefit now being provided to Ohio's casinos and racinos reasonable?

If Ohio gaming facilities are receiving a greater benefit through promotional play and taxation rates than facilities in other states, changes should be made. While Ohio CPAs fully support free enterprise, we also support ensuring that the parameters of the casino program Ohioans voted to approve several years ago is indeed the one that is operating in our state, and that the gaming industry is paying its fair share for the privilege of doing business in Ohio.

**Unemployment Compensation Tax**

We support the intent of the federal-state unemployment compensation insurance partnership program, namely to financially support Ohioans for a reasonable period of time when they lose their jobs through no fault of their own. However, there are improvements that should be made to protect Ohio employers, protect Ohio workers, and protect the State of Ohio.

We applaud the Legislature and Kasich administration for adopting a plan, through Sub. H.B. 390 (131st GA), to pay off Ohio's remaining federal Unemployment Compensation Trust Fund loan, thereby saving millions in unnecessary penalties and interest. Going forward, we encourage the legislature in taking steps to ensure Ohio's unemployment compensation fund is fiscally sound long into the future.

**OTHER STATE TAXES RECOMMENDATIONS**

1) **Take steps now to ensure the future solvency of the Unemployment Compensation Fund.** Few if any would argue that the existing funding formula can properly prepare our state for future high rates of unemployment and the related drain on resources that will surely result. The reality is that Ohio's economy, and that of every other state, most likely will go through yet another downturn. We applaud the Ohio General Assembly for its efforts to find a solution to this significant problem. Ultimately, compromises by both the business community (in terms of what they pay into the Fund) and by employees (on what they are eligible to receive) are necessary to have a financially solvent Fund.

   As different approaches are reviewed, consideration should be given to the creation of a stabilization fund whereby businesses would pay more until adequate reserves are in place.

   Alternatively, consideration could be given to an approach Oregon is using. That state institutes a higher rate on employers when the economy is good and their budgets are more flexible, and lowers the rate when a downturn occurs and employers are less fluid.

2) **Make nicotine taxation fair and consistent.** However Ohio officials choose to tax nicotine products, OSCPA believes the key factors at hand are fairness and consistency of treatment. We encourage the Ohio General Assembly to consider equalization of our state's cigarette tax to other nicotine products. However, when using fairness as a best

practice measurement, Ohio should not assess the tax on tobacco-oriented products that do not contain nicotine.

3) **Compare promotional spend to other states.** We urge the Ohio General Assembly to make an apples-to-apples comparison when examining this issue for possible changes. Specifically:

   (a) Are Ohio's casinos and racinos taxed at the same effective rate as in other states? If Ohio's effective tax rate is lower, the argument that Ohio facilities would be harmed is less compelling. For example, while Pennsylvania gaming facilities also enjoy unlimited tax-free promotional spend, they pay a 55% effective tax rate compared to Ohio's 33% tax on gross gaming revenues.[35]

   (b) Compare Ohio to the eight states that tax promotional spend and the additional nine that cap the amount of tax-free promotional spend. To continue promotional play, there should be empirical evidence that casinos providing tax-free promotional spend generate more tax revenue than those that do not enjoy tax-free promotional spend.

4) **Cut red tape and expand efficiencies through consolidation**. Currently, Ohio businesses are audited at the state level by the Ohio Unemployment Compensation Fund (ODJFS) and the Ohio Bureau of Workers' Compensation (BWC), and at the federal level by the IRS as it relates to payroll tax compliance. These agencies essentially look at the same payroll items and in some cases act on behalf of each other (ODJFS and IRS). There are efficiencies to be gained by both government agencies undertaking these audits and for the businesses that must expend untold hours of staff time to gather the needed paperwork and work with the agencies. We encourage policy makers to consider consolidating the two state government payroll audit functions for a more common-sense approach. The Ohio Department of Jobs and Family Services (ODJFS) collects unemployment tax and the BWC collects premiums, not tax. Because the ODT collects payroll taxes and has far more experience with the tax audit function, we suggest that ODJFS's unemployment tax division be transferred to ODT, and ODT work with BWC to find a more common sense approach. This approach could include more modern audit techniques and sampling.

5) **Evaluate credits and deductions**. As previously discussed in this report, credits and deductions are significant components of each of the Ohio taxes and the entire financial structure of the tax system. In many cases the credits and deductions no longer (a) provide the desired benefit to the targeted group, (b) are simply outdated in today's economy, (c) unfairly benefit a specific audience, and/or (d) cost substantial sums. Certain credits and deductions may provide significant tax benefits to non-residents thus indirectly increasing the tax for Ohio residents. Periodically, these credits and deductions need **independent** evaluation as to their direct cost, utilization, and direct and indirect

[35] http://gaming.unlv.edu/jurisdictions.html

benefits to the Ohio economy. This information can then be used to determine the need to extend or renew these credits and deductions.

# POTENTIAL SOURCES OF TAX REVENUE

**INTRODUCTION**

While OSCPA is reluctant to call out any particular class of taxpayer, there are several areas where a closer look could be taken to determine if there should be more fairness in tax treatment and application. Some are areas where technology advances have opened the door for efficiencies; others where some industries have generous exemptions that may no longer make sense.

**RECOMMENDATIONS**

**Review certain areas for appropriate tax treatment consideration including the following:**

1) **Promotional spend for Ohio's casinos and racinos**. As mentioned earlier in this section, the approximately $807 million in tax-free promotional spend equals a loss to Ohio's schools and local governments of one-third of that amount. While it may have made sense when the facilities were first operational, it may no longer be a good move for Ohio taxpayers.

2) **Certain Medicaid facilities.** With 52% of Ohio's budget dedicated to Medicaid expenditures, lawmakers should closely evaluate whether benefitting Ohio facilities are paying their fair share for the privilege of doing business in our state. Virtually all states have enacted health care provider taxes, including Ohio. Many of these taxes are somewhat broader than Ohio's[36] and have increased in recent years. The revenue is generally used to offset the cost of state-provided Medicaid funding. All states must ensure their approach is in accordance with federal rules governing this area.

   Adding complexity is the reality that a significant portion of the medical infrastructure is owned by nonprofits, which are fairly profitable and are not subject to other taxes that flow into the state (or municipal) general revenue funds. These nonprofits also have expanded by purchasing physician practices, thereby transferring to the nonprofit sector activities previously in the for-profit sector. For these reasons it is prudent to examine changes that would add more revenue from the healthcare industry to the state's general fund to help offset state expenditures.

3) **Sales tax vendor discount.** Per the FY16-17 Blue Book, in Fiscal Year 2017 Ohio is expected to have $71 million in foregone revenue due to a .75% discount provided to vendors for Ohio sales, and to out-of-state vendors who collect use tax, for timely filing of sales and use tax to the State of Ohio. Since its enactment in 1981, technology has significantly eased the burden on vendors re-keying cash registers for changes in sales tax rates. No other type of Ohio tax has a related discount for timely filing taxes due. Other states providing for this discount generally cap the amount vendors can receive or have other limits.

4) **Nicotine Products.** Using the guiding principle of equity/fairness, consideration should be given to equally taxing all nicotine products, including the nicotine-laced liquids in e-

[36] See National Conference of State Legislatures, "Health Provider and Industry State Taxes and Fees." Website: http://www.ncsl.org/research/health/health-provider-and-industry-state-taxes-and-fees.aspx

cigarettes, if the Legislature determines that vapor products are to be classified as tobacco products. As of March 2016, Minnesota, North Carolina, Louisiana, Kansas, and the District of Columbia have each taxed vapor products, using different methods of taxation.[37] Potential revenue gain: $100 million.

5) **User Fees.** Ohio could join the many other states that place heavier emphasis on permanent fee increases in place of taxes imposed on all, even those who do not benefit from a given program, facility or service. In other words, reduce or eliminate GRF allocations for the targeted service and replace the tax expenditure with fees on those who use the given service. We are in no way implying that additional taxes should be paid in the form of user fees, but rather that the form of payment could shift from a broad tax to a user-fee-based structure when appropriate.

6) **Business Income Deduction.** This expensive new deduction merits additional study to ensure it is achieving its stated goal: largely, reinvestment of these tax savings by business owners into their operation(s). We look forward to evaluating the numbers developed by the Office of Budget and Management on the total impact on FY 15/16. One possible change is to implement some level of testing a business owner must use to show that they are reinvesting the tax savings into their company through purchase of new equipment, hiring more employees, other forms of expansion, etc.

[37] http://taxfoundation.org/article/vapor-products-and-tax-policy

# SUMMARY

Striving to make the state of Ohio a magnet for employers to locate and grow their businesses, and for skilled workers to live and raise their families, is critical to ensuring economic competitiveness. Reducing the tax burden on businesses and individuals alike is an important part of that equation, but is far from the only factor to be considered. Ohio's workforce is also of critical importance, both ensuring that our future workers are prepared to enter the job market and our state is attracting and retaining skilled workers for our key industries. A major concern expressed by employers is the lack of a ready workforce to fill the jobs that are available now.

Any efforts to update Ohio's tax system need to focus on the major tenets of good tax policy: competitiveness, simplicity, stability, equity/fairness and neutrality, and the recognition that there are *two* key cost components associated with tax policy: the tax rates themselves and the compliance costs impacting both taxpayers and government entities receiving tax dollars.

While every state is different, it is helpful to learn from successes and failures in other states. Significant research should first be done—particularly in view of recent major income tax reforms—to ensure that any further significant proposed tax changes likely will result in meaningful job and economic growth without hurting the state financially. Significant research should also be done on the dozens of Ohio tax credits, deductions and exemptions, including Ohio's new Business Income Deduction. One of the best ways to reduce a rate and simplify compliance at the same time is to eliminate tax expenditures that are not critical to our state's economy.

Where the major taxes are concerned, OSCPA believes that moving to a reduction in the number of personal income tax brackets, coupled with relatively few credits and deductions, should be considered by policy makers to make Ohio's tax system appear more competitive with surrounding states. Optimally, Ohio would have no more than three brackets, as the fewer the better for simplicity. OSCPA also believes that moving to a flat rate likely is too financially challenging over the long term—depending on the rate, of course. Sustainable funding of key government services is crucial.

Moving to fewer brackets and/or lower rates likely will result in a loss of revenue to the state, giving rise to the related challenge of how to offset those losses. The fairest and most appropriate way to fund this shortfall, beyond cuts in government spending, is through the elimination of related personal income tax credits and deductions. Creating new revenue from a completely different source of taxation, such as the CAT or the sales tax, does not achieve the goal of reducing the Ohio tax burden—it simply reallocates it by increasing another tax, thereby picking winners and losers. We strongly discourage such an approach as it violates the fairness tenet of good tax policy.

Recognizing that reducing the cost of compliance is also important, we have recommended a number of possible changes to each of the major Ohio taxes. Some will be considered controversial, while others are more technical in nature.

The Ohio Society of CPAs stands ready to work with members of the Ohio General Assembly and the Kasich Administration on the important, ongoing effort to make Ohio a destination state for employers, as well as the skilled workers they need to thrive.

# APPENDICES

**APPENDIX 1 (*See 'Comparing Ohio to Other States', pgs. 8-9)***

**STATE-BY-STATE COMPARISON OF TAXATION FACTORS[38]**

| State | Brackets | Top Rate As Of 1/1/15 | Income Triggering Top Rate | Standard Deduction | Personal Exemption | Married Exemption | Dependent Exemption (Each) | Uses Federal AGI | Personal Credits/ Deductions **** | Business Credits/ Deductions **** |
|---|---|---|---|---|---|---|---|---|---|---|
| OH | 9 | 4.997% | $208,500 | N/A | $2,200[39] | $4,400 | $2,200 | Yes | 34 | 16 |
| IN | 1 | 3.3% | N/A | N/A | $1,000 | $2,000 | $1,500[40] | Yes | 38 | 21 |
| KY | 6 | 6% | $75,000 | $2,440/ $2,440 | $20 | $40 | $20 | Yes | 32 | 26 |
| MI | 1 | 4.25% | N/A | N/A | $4,000 | $4,000 | N/A | Yes[41] | 28 | 3 |
| PA | 1 | 3.07% | N/A | N/A | N/A | N/A | N/A | No | 6 | 10 |
| WV | 5 | 6.5% | $60,000 | N/A | $2,000 | $4,000 | $2,000 | Yes | 25 | 12 |
| IL | 1 | 3.75% | N/A | N/A | $2,125 | $4,250 | $2,125 | Yes | 28 | 26 |
| NC | 1 | 5.75% | N/A | $7,500/ $15,000 | N/A | N/A | N/A | Yes | 12 | 9 |

[38] Source: All States Quickfinder Handbook 2015.
[39] Bracketed based on income.
[40] Can be taken only if dependents meet certain qualifications.
[41] Uses modified AGI.

**APPEXDIX 2 (*See 'A Lower Tax Rate May Not Equal a Lower Tax Bill', pg. 9)***

**Comparison of Actual Income Tax Paid in Key States***

| State | Married Couple with AGI $224,742.00 | Effective tax rate at $224.742 AGI | Married Couple with AGI $71,908.00 | Effective tax rate at $71,908 AGI |
|---|---|---|---|---|
| OH | $ 8,177.00 | 3.6384% | $ 1,657.00 | 2.3043% |
| PA | $ 6,144.00 | 2.7338% | $ 2,208.00 | 3.0706% |
| NC | $ 11,491.00 | 5.1130% | $ 3,272.00 | 4.5503% |
| MI | $ 9,212.00 | 4.0989% | $ 2,716.00 | 3.7770% |
| KY | $ 9,673.00 | 4.3040% | $ 3,051.00 | 4.2429% |
| IN | $ 7,251.00 | 3.2264% | $ 2,307.00 | 3.2083% |
| IL | $ 8,247.00 | 3.6695% | $ 2,350.00 | 3.2681% |

Scenario: A married couple with no children and 100% of income from wages at two amounts of Adjusted Gross Income.

*A basic comparison of actual taxes due in each state for a married couple with no children, measured at two different adjusted gross income levels. No additional credits or deductions are calculated.

**APPENDIX 3 (*See 'Fewer Tax Brackets and Fewer Deductions/Credits Provide Simplicity', pgs. 10-11)***

**Ohio Joint Filing Credit for Married Couples[42]**

| Ohio Income Tax Base (IT 1040 line 5): | Your Credit: |
|---|---|
| $25,000 or less | 20% of line 12 |
| $25,001- $50,000 | 15% of line 12 |
| $50,001- $75,000 | 10% of line 12 |
| $75,000 or more | 5% of line 12 |

*Credit is limited to a maximum of $650

[42] Source: Ohio Department of Taxation.

# OHIO TAX REFORM TASK FORCE MEMBERS

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# OHIO TAX REFORM TASK FORCE MEMBERS

A separate subcommittee of four oil and gas tax professionals crafted the severance tax chapter.

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