

Ohio's Five Year Tax Reform Package – HB 66

Frederick Church

Robert Cline

Federation of Tax Administrators

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Why Tax Reform?

- Weak economic growth in Ohio
 - Sense that the tax system was not aligned with Ohio's comparative advantage in manufacturing
 - Studies had pointed to Ohio's tax structure discouraging investment
- Sense that the tax system burden was not fairly distributed across sectors
 - Tax planning had contributed to the unfairness, favoring big companies with significant legal and accounting expertise

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Setting the Stage for Reform – Prior Studies

Committee to Study State and Local Taxes- March 2003

“The committee heard significant testimony indicating that the tangible personal property tax is a disincentive to investment. This tax particularly impacts Ohio’s capital-intensive businesses, such as manufacturing.” (p68)

Ohio’s Competitive Advantage: Manufacturing Productivity by Edward Hill -April 2001

“The tax code also provides disincentives to invest in capital, hurting productivity and income growth, and putting those portions of the state’s economy in which it has a natural and historical competitive advantage at a disadvantage.” (p96)

Economic Development Study Advisory Committee - May 1999

“At the top of the list of proposed state business climate improvements is the recommendation to reduce, and eventually, eliminate Ohio’s onerous Tangible Personal Property Tax, which deters business investment and job creation.” (p15)

Taxation and Economic Development: A Blueprint for Tax Reform in Ohio - October 1995

“A third concern is that the system is complicated, probably more than is necessary. The problem areas here are the real property tax, the net worth tax, the tangible personal property taxes and the municipal income tax.” (p15)

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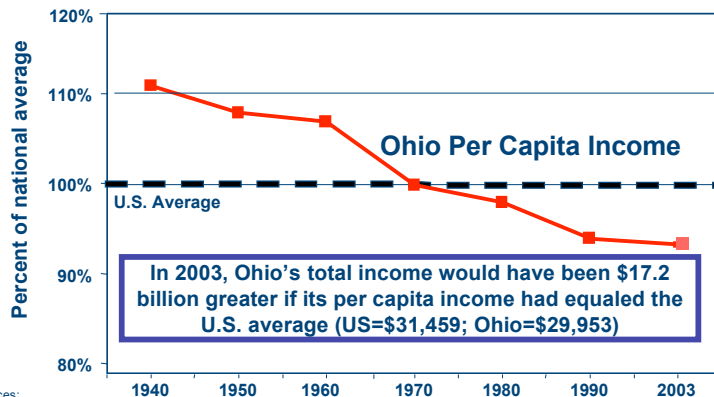
Ohio’s Economic Performance

Ohio’s economic performance has lagged the nation’s based on several indicators

- Per capita personal income
- Gross state product

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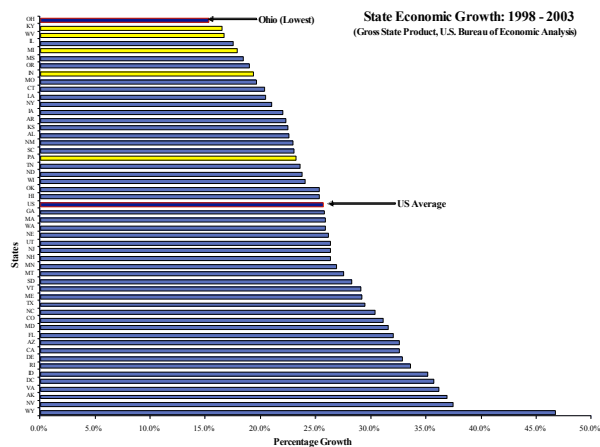
TRAILING THE NATIONAL AVERAGE Ohio's Income Growth



Sources:
U.S. Census Bureau
Department of Taxation
Office of Strategic Research

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Ohio Comes in Last



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Gross State Product

Ohio Economic Production vs. U.S. Economic Production – 1988-2003

	1977-1987	1987-2003
Ohio GSP Growth	97.01%	109.02%
U.S. GDP Growth	134.79%	133.97%
Ratio, OH growth to U.S. growth	0.71	0.81

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CHALLENGES:

- Tax laws are a roadblock to economic development and job creation.
- Combined state-local personal income tax rates are very high.
- Tangible personal property tax is one of the highest in the nation and penalizes investment in new equipment.
- Corporate franchise tax rates are high, but collections are low compared to other states.

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Three Problem Areas – Targets for Reform

- Personal Income Tax
- Corporate Franchise Tax
- Tangible Personal Property Tax

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Targets for Reform – Income Tax

- High marginal income tax rates put Ohio at a competitive disadvantage in attracting and keeping high-paying jobs.
 - Ohio's top marginal state tax rate of 7.5% was 13th highest in the nation in 2004
 - Ohio's combined 7.5% state top rate and 1.7% weighted average municipal rate was 5th highest in the nation in 2004
 - Firms may have to pay higher wages to compensate for relatively high income taxes

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Targets for Reform – Income Tax

State	Top State Marginal Tax Rate	Rank
MONTANA	11.0	1
VERMONT	9.5	2
DIST. OF COLUMBIA	9.5	3
CALIFORNIA	9.3	4
OHIO (state and municipal)	9.2	5
OREGON	9.0	5
IOWA	8.98	6
MAINE	8.5	7
HAWAII	8.25	8
NORTH CAROLINA	8.25	9
MINNESOTA	7.85	10
IDAHO	7.8	11
NEW YORK	7.7	12
OHIO (state only)	7.5	13

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Targets for Reform – Corporate Franchise Tax

- The Corporate Franchise Tax is perceived as uncompetitive because the top marginal rate is relatively high
 - Ohio's combined state and local top marginal rate was 2nd highest in the nation in 2004 (state rate of 8.5% plus weighted average municipal rate of 1.7%)
- The tax is unproductive and inequitable due (at least in part) to a proliferation of tax planning schemes
- Highly concentrated tax with excessive variability – 75% of the tax paid by top 2% of taxpayers

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Targets for Reform – Corporate Franchise Tax

State Top Marginal Corporate Tax Rates in 2004		
State	Top State Marginal Tax Rate	Rank
IOWA	12.0	1
OHIO (state and municipal)	10.2	2
PENNSYLVANIA	9.99	2
DIST. OF COLUMBIA	9.975	3
MINNESOTA	9.8	4
VERMONT	9.75	5
MASSACHUSETTS	9.5	6
ALASKA	9.4	7
NEW JERSEY	9	8
RHODE ISLAND	9	9
WEST VIRGINIA	9.0	10
MAINE	8.93	11
CALIFORNIA	8.84	12
DELAWARE	8.7	13
INDIANA	8.5	14
NEW HAMPSHIRE	8.5	15
OHIO (state only)	8.5	16

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Targets for Reform – Tangible Property Tax

- Ohio's TPP tax is a barrier to investment in the state and a competitive disadvantage – adds to high overall taxes on capital (real property, CFT, sales tax on a portion of capital purchases)
- Nationwide cross-state comparisons are not as simple as under the personal income tax or corporate franchise tax, but research shows that Ohio's TPP tax is onerous compared to surrounding states
 - Ohio's tpp tax collections per capita in tax year 2000 were \$237, higher than all our surrounding states
 - IN \$179, WV \$165, MI \$113, KY \$50, PA \$0, IL \$0

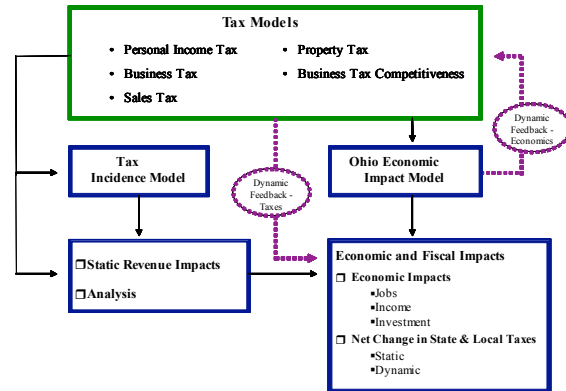
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<i>* plus local option</i>	PERSONAL INCOME TAX Revenues raised per capita	CORPORATE FRANCHISE TAX Revenues raised per capita	TANGIBLE PERSONAL PROPERTY Revenues raised per capita
OH	PROGRESSIVE- 7.5%* COLLECT- \$730	RATE- 8.5% COLLECT- \$56	\$237
MI	FLAT- 3.95%* COLLECT- \$609	RATE- 1.9% COLLECT- \$240	\$113
IN	FLAT- 3.4%* COLLECT- \$575	RATE- 8.5% COLLECT- \$152	\$179
KY	PROGRESSIVE- 6%* COLLECT- \$654	RATE- 8.25% COLLECT- \$76	\$50
WV	PROGRESSIVE- 6.5% COLLECT- \$573	RATE- 9.0% COLLECT- \$120	\$165
PA	FLAT- 3.07%* COLLECT- \$546	RATE- 9.99% COLLECT- \$138	\$0

Principles of Tax Reform

- Encourage capital investment and job creation.
- Tax consumption rather than investment.
- Broaden the tax base and lower the tax rates.
- Create a tax structure that grows as the economy grows.
- Do not unfairly shift the tax burden to either businesses or individuals or unduly burden any one business sector or size of business.
- Meaningful tax reform cannot be accomplished unless it is coupled with significant spending restraints.

Models Used in the Reform Effort



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HB 66 Tax Reform – Personal Income Tax

- Main feature of tax reform is a 21% cut for all nine brackets
- Phased in over 5 years at 4.2% per year
- Also included a low-income tax credit that eliminates liability for taxpayers whose Ohio Taxable Income is at or below \$10,000
- Note that some current income tax and franchise tax credits migrate to the new Commercial Activity Tax (CAT), which is paid by both C-corporations and pass-through entities

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HB 66 Tax Reform - Personal Income Tax

Income Tax Rates - 2004 rates vs. 2009 rates after HB 66

Ohio Taxable Income		Old Tax Rates 2004	New Tax Rates 2009
Lower Limit	Upper Limit		
\$0	\$5,000	0.743%	0.587%
\$5,000	\$10,000	1.486%	1.174%
\$10,000	\$15,000	2.972%	2.348%
\$15,000	\$20,000	3.715%	2.935%
\$20,000	\$40,000	4.457%	3.521%
\$40,000	\$80,000	5.201%	4.109%
\$80,000	\$100,000	5.943%	4.695%
\$100,000	\$200,000	6.900%	5.451%
\$200,000		7.500%	5.925%

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HB 66 Tax Reform - Personal Income Tax

- Bracket indexing will be suspended until 2010 when rate cuts are fully phased in

Comparison of HB 66 Rate Cuts and Bracket Indexing
(amounts in millions of \$)

	Savings to Taxpayers		
	Bracket Indexing	Rate Cuts	Rate Cuts Minus Indexing
FY 2006	\$75	\$400	\$325
FY 2007	\$135	\$825	\$690
FY 2008	\$195	\$1,290	\$1,095
FY 2009	\$255	\$1,790	\$1,535
FY 2010	\$315	\$2,340	\$2,025

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HB 66 Tax Reform – Personal Income Tax

- Savings to taxpayers – examples of 21% cut for family of four at different income levels (assume family takes joint filer credit, use 2004 exemption levels)

FACT	\$30,000	\$50,000	Ohio median \$63,000	\$80,000	\$100,000	\$150,000
Tax Before Credits - Current Law	\$659.73	\$1,586.85	\$2,262.98	\$3,147.15	\$4,297.16	\$7,697.40
Tax Before Credits - After 21% Cut	\$521.21	\$1,253.63	\$1,787.80	\$2,486.33	\$3,394.86	\$6,081.05
Dollar Change	(\$138.53)	(\$333.22)	(\$475.18)	(\$660.82)	(\$902.30)	(\$1,616.35)
% Change	-21.0%	-21.0%	-21.0%	-21.0%	-21.0%	-21.0%
Tax After Credits - Current Law	\$463.79	\$1,280.82	\$1,964.68	\$2,760.43	\$4,006.30	\$7,236.53
Tax After Credits - After 21% Cut	\$352.97	\$997.59	\$1,537.02	\$2,165.70	\$3,149.12	\$5,700.99
Dollar Change	(\$110.82)	(\$283.23)	(\$427.66)	(\$594.73)	(\$857.19)	(\$1,535.53)
% Change	-23.9%	-22.1%	-21.8%	-21.5%	-21.4%	-21.2%

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HB 66 Tax Reform – Personal Income Tax

- 5.3 million Ohio taxpayers will see a personal income tax cut
- Savings to taxpayers from the rate cuts and the new credit exceed \$2 billion by FY 2010
- The average Ohio family of four will see their state personal income tax and sales tax burden reduced annually by \$555
- About 550,000 low-income Ohioans will have their income tax burden eliminated
- 300,000 flow-through businesses (S-corporations, LLCs, partnerships, etc.) will see their tax rate cut

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HB 66 Tax Reform - Tangible Personal Property Tax (TPP Tax)

- All components of the TPP tax – inventory, manufacturing machinery and equipment, and furniture and fixtures – will be phased out over 4 years
 - Telephone company property will also become general business property and will be exempt by tax year 2011 (5 year phase-out)
 - The phase-out does not apply to TPP owned or used by public utilities – absolute magnitude of property tax paid and other taxes paid by utilities created challenges for reform

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HB 66 Tax Reform - Tangible Personal Property Tax (TPP Tax)

- All new manufacturing machinery and equipment installed on or after January 1, 2005 is immediately exempt
- HB 66 includes a definition of manufacturing machinery and equipment (MME) to distinguish it from other TPP
 - To qualify, the property must be used in a manufacturing facility

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HB 66 Tax Reform - Tangible Personal Property Tax (TPP Tax)

- Elimination of the TPP tax is a radical change from the current policy of granting numerous selective tax exemptions
 - Enterprise Zone (EZ) TPP exemptions
 - Foreign trade zone inventory exemptions (eight FTZs and 11 sub-zones in Ohio)
 - Exemption for TPP used in agriculture
 - Exemption for TPP shipped into Ohio “for storage only” and shipped out
 - Exemption for patterns, jigs, dies, and drawings

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HB 66 Tax Reform - Tangible Personal Property Tax (TPP Tax)

- In Ohio, TPP tax is only a local tax, and is a significant revenue source for school districts and local governments
- State will reimburse schools and local governments for the loss in TPP revenue
- For tax years 2006-2010, there will be full reimbursement to schools and local governments relative to prior law

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HB 66 Tax Reform - Tangible Personal Property Tax (TPP Tax)

- Beginning in tax year 2011 (FY 2012), these reimbursements will be gradually phased out, ending in tax year 2017 (2018 for telephone property)
- Reimbursement mechanism is patterned after the mechanism that was used for Ohio's utility restructuring
 - Losses will be calculated using values for a base year (tax year 2004)
 - Levies eligible for reimbursement will be those in existence for tax years 2004 or 2005 or voted before September of 2005, to be levied in tax year 2006

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HB 66 Tax Reform - Tangible Personal Property Tax (TPP Tax)

- School district reimbursements are phased out also, but with two important differences
 - Only the direct payments are phased out, whereas the additional foundation aid provided because of lower chargeoff valuations continues
 - The total amount of revenue going to school district property tax replacement from the new CAT will be constant or growing, but the amount that goes back to the district of origin will be phased down, and the General Assembly will choose some mechanism for distributing the remaining dollars in the fund

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HB 66 Tax Reform - Tangible Personal Property Tax (TPP Tax)

- Savings to taxpayers will reach \$1.7 billion by tax year 2011
- About 60,000 Ohio businesses will no longer pay the TPP tax when fully phased out
- Ohio becomes one of a minority of states that do not tax general business TPP (according to a 2002 survey, 44 states impose tax on TPP)
- There is concern among both some taxpayers and some school districts about replacing the decentralized TPP tax with a state-level tax

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HB 66 Tax Reform - Corporate Franchise Tax

- Tax eliminated over 5 years, except for limited class of corporations
 - Financial institutions (FIs) continue to pay corporate franchise tax of 13 mills on net worth
 - Various holding companies, including bank holding companies, financial holding companies, S&L holding companies, continue to pay the CFT
 - Corporations owned by a combination of FIs and holding companies cited above continue to pay the CFT
 - Corporations owned by insurance companies continue to pay the CFT
 - “Securitization companies” continue to pay the CFT

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HB 66 Tax Reform - Corporate Franchise Tax

- Tax eliminated over 5 years, except for limited class of corporations
 - The great majority of remaining CFT revenue is expected to come from financial institutions
 - There are some opportunities for tax planning as a result of these corporations staying under the CFT

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HB 66 Tax Reform - Corporate Franchise Tax

- The phase-out is accomplished by multiplying liability, after non-refundable credits, by declining percentages (80%, 60%, etc.)
- As with the personal income tax, some credits migrate to the new CAT
 - Job retention credit
 - Qualified research expenses credit
 - Qualified R&D loan payment credit
 - Job creation credit (refundable)

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HB 66 Tax Reform - Corporate Franchise Tax

- Other points
 - The phase-out does not apply to the \$50/\$1,000 minimum tax
 - The machinery and equipment credit is disallowed for purchases after June 30, 2005, and for taxable years ending after that date (credits can still be claimed on 2006 CFT report)
 - M&E credit is replaced with a grant because of the Supreme Court decision in *Cuno v Daimler-Chrysler*

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HB 66 Tax Reform - Corporate Franchise Tax

- Savings to taxpayers reach \$1.1 billion by FY 2010
- Ohio joins Washington, Nevada, Wyoming as states without corporate income taxes (arguably Michigan as well, since the Single Business Tax is not truly a corporate income tax)

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HB 66 Tax Reform - How is the tax relief paid for?

- Tight state spending
 - FY 06/07 General Fund spending growth is lowest in 40 years
- New Commercial Activity Tax (CAT) will generate \$1.3 billion to \$1.5 billion by FY 2010 full phase-in
- Sales Tax
 - Retain 0.5% of “temporary” 1.0%, generate about \$0.8 billion by FY 2010
- Cigarette Tax
 - Increase from \$0.55 per pack to \$1.25 per pack, generate about \$0.4 billion by FY 2010
- Real Property Tax Rollback
 - No longer allow 10% tax credit (rollback) on commercial and industrial property, generate about \$0.4 billion by FY 2010

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New Commercial Activity Tax: Theory and Operation

- A new broad-based, low rate tax (0.26%) on gross receipts from business activity in Ohio
- A business privilege tax, not a transactional tax (sales tax law and rules don't apply)
- A business privilege tax, not an income tax (PL 86-272 restrictions don't apply)

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New Commercial Activity Tax: Theory and Operation

- Tax applies to Ohio-generated gross receipts
 - Tax applies to imports of goods and services – modest “use tax” or “anti-sham tax” on some business purchases brought into Ohio
 - Tax does not apply to exports of goods and services
- Theory is that tax should be commensurate with “economic presence,” or degree to which a business utilizes the Ohio market as measured by in-state sales
- Tax is designed to benefit manufacturing, creating a favorable “platform for production” in Ohio

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New Commercial Activity Tax: Theory and Operation

- Taxpayers with less than \$150,000 in taxable gross receipts are not subject to the CAT
- Rate structure of the tax:
 - Pay \$150 minimum tax on first \$1 million in receipts
 - Receipts above \$1 million, pay \$150 plus 0.26% on amount in excess of \$1 million
- Legislature and Governor rejected business proposal for a per-entity cap on the CAT – business concern over future tax increases

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New Commercial Activity Tax: A few things to keep in mind

- The bill provides clear guidance on when an out-of-state business with taxable gross receipts in this state is required to register and remit the gross receipts tax (“bright line nexus” test) – similar to MTC nexus concept
- ODT is still working on rules for situsing services in and out of Ohio

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New Commercial Activity Tax: “Bright-line Presence”

- Bright-line nexus is a non-sales tax nexus standard
- Person has “bright-line presence” for quarter and remainder of year if any of the following applies:
 - Property of at least \$50,000 within state
 - Payroll of at least \$50,000 within state
 - Annual taxable receipts of at least \$500,000
 - Has at least 25% of total property, payroll, or receipts in this state
 - Is domiciled in this state (commercially or legally)

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New Commercial Activity Tax – Summary of Impacts

- Estimated 250,000 – 300,000 taxpayers will pay only \$150 minimum tax
- Another 60,000 taxpayers will pay \$150 plus 0.26% of gross revenues in excess of \$1 million
- CAT is expected to raise at least \$1.3 billion by FY 2010 (with no rate adjustments)
- Challenges of estimating a new tax base

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Overall Impact of HB 66 Tax Reform

- By FY 2010, taxpayers will see a total of \$3.7 billion in tax relief (state and local taxes)
 - Even compared to baseline where state sales tax rate is 5.0%, tax relief is \$2.0 billion
 - Tax relief from income tax cuts and TPP eliminations are \$3.8 billion; remainder of the changes are roughly neutral

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Reform Process from the Business Perspective – Why Did It Happen?

- Strong (& vocal) business support for reform to “grow the economy” -- leadership of the Ohio Business Roundtable (almost 2-yr. effort)
- Convergence of key factors: recession’s impact, cover from prior studies, Ohio’s non-competitiveness, develop. director becomes Lt. Governor, Governor’s support for significant reform, need to deal with the loss of \$1.5b in temporary sales taxes, “trial balloons”
- Importance of relaxing the balanced-budget constraint -
- state rebounds from the steep recession
- Business evaluation of dynamic impact of alternatives

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Reform Process from the Business Perspective (cont.)

- Business “mixed” view of the CAT
 - pyramiding was analyzed and debated, but the low rate seemed to reduce opposition
 - most large, multistate firms ultimately supported the package because of high current Ohio business taxes,
 - but argue that they are opposed to the spread of gross receipts taxes to other states
 - muted opposition from professional service firms
- Vocal opposition of low-margin, high-volume firms

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Reform Process from the Business Perspective – Questions to Ponder

- Is the CAT a consumption tax?
- Are GRTs going to spread? Ohio, NJ AMA, Washington, NM, SBT alternative base, health care taxes (Maine, MN)
- Is the CAT an interim step to the next state value-added tax?
- Will business become more proactive in advancing state tax reform?

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