Ohio Tax Reform

Fiscal year 2005 saw the most sweeping changes in over 30 years to the tax code administered by the Ohio Department of Taxation (ODT). These changes have a direct effect on tax filing in calendar year 2005 for both individual and business taxpayers.

Much of the change was initiated by Gov. Bob Taft in his annual State of the State address in January 2005 and all was eventually enacted by the General Assembly in House Bill 66, the biennium budget bill for Fiscal Years 2006-2007. The law took effect July 1, 2005, the beginning of Fiscal Year 2006.

The major tax components of H.B. 66 provided for tax relief and a revision of the business tax code. These tax reforms were designed to improve the climate for business investment in Ohio.

H.B. 66 substantially modernizes state tax laws, and provides measurable tax relief with cuts to the state income and sales taxes. As well, the budget bill phases out two major business taxes – **corporation franchise** and **tangible personal property** – and phases in the new **commercial activity tax (CAT)** on businesses.

The new **CAT** is a tax on the privilege of doing business in Ohio, structured with a broad base and a low rate. The tax is applied against taxable gross receipts received in an annual or calendar quarter time period. The **CAT** is being phased in over five years beginning July 1, 2005. The **CAT** is imposed on taxable gross receipts in excess of $150,000 accrued in a calendar year.

Most types of businesses are subject to the **CAT,** including sole proprietors, partnerships and corporations.

As enacted in H.B. 66, the **CAT** has a broad base meant to encompass most types of business activity. The following types of businesses will pay the **CAT**:

- Service providers, including medical professionals, attorneys, and accountants.
- Persons engaged in the sale or rental of any type of property.
- Out-of-state businesses that meet any of the following criteria:
  - have more than $500,000 in taxable gross receipts in Ohio.
  - have more than $50,000 in real or personal property in Ohio.
  - expend more than $50,000 in payroll for work in Ohio.
  - conduct more than 25 percent of business activity in Ohio.

The **CAT** has a low rate to discourage tax planning:

- Businesses will pay – when the tax is fully phased in by tax year 2010 – a rate of 0.26 percent on annual gross receipts over $1.0 million.
- Annual gross receipts from $150,001 - $1,000,000 are subject to a minimum $150 tax.
- Businesses with annual gross receipts of $150,000 or less are not subject to the **CAT.**
- The **CAT** rate for the first tax period from July 1 to December 31, 2005 is 0.06 percent.
- The **CAT** rate is subject to adjustment by the Tax Commissioner if revenue collections of the tax are 10 percent or more – greater or lesser – than projections.

The **CAT** has a limited number of exceptions, listed below:

- Nonprofit organizations.
- Financial institutions.
- Insurance companies.
- Affiliates of financial institutions and insurance companies.
- Dealers in intangibles.
- Certain receipts by public utilities that are subject to the public utility excise tax.
- Foreign trade zone areas within one mile of the boundary of an international airport.
- Sales of motor fuel are exempted from gross receipts for two years.

The basis of the tax, a business' gross receipts, is defined as follows:

- The total amount realized, without deduction for the cost of goods sold or other expenses incurred, from activities that contribute to the production of gross income.
- Examples are:
  - sales.
  - performance of services.
  - rentals or leases.
- The calculation for gross receipts is based on what the taxpayer is required to use for federal income tax purposes, i.e., accrual or cash basis.
- There is a deduction for bad debt.

A number of business expenses and profits are not considered to be gross receipts. Examples are:

- Employee compensation, i.e., wages and benefits.
- Interest, dividends, federally-defined capital gains, and distributions.
- Proceeds from loans, stocks, bonds, mutual funds, trusts, pension plans, or certificates of deposit.
- Damages received from litigation.
- Property, money, or other compensation received by an agent in excess of commissions or fees.

Taxpayers will be able to take four credits against payment of the **CAT**. The following credits, which have been part of the **corporation franchise tax**, are allowable beginning July 1, 2008:

- Job Creation Tax Credit.
- Job Retention Tax Credit.
- Credit for Qualified Research Expenses.
- Credit for Research and Development Loan Payments.

Businesses subject to the **CAT** at the time of its enactment were required to register by Nov. 15, 2005. Businesses that subsequently qualify as **CAT** taxpayers are also required to register. Registration includes a one-time refundable fee of $15 for registering on-line or a $20 fee for paper registration. The fee is credited back on the first **CAT** return filed. On-line (electronic) registration was available July 1, 2005 at the Ohio Business Gateway (**obg.ohio.gov**); paper applications are available on the ODT Web site (**tax.ohio.gov**). All registered taxpayers are scheduled to receive information on filing and payment of the **CAT.**

The first **CAT** returns were due Feb. 10, 2006.

The two current business taxes the **CAT** replaces are being phased out while the **CAT** is being phased in.

- The **corporation franchise tax** is phased out in equal increments over five years beginning in tax year 2006, when the rate will be 80 percent times the liability. The last year of payment of the tax, at a rate of 20 percent times the liability, will be 2009.
- The **tangible personal property** (**TPP**) **tax** on most businesses' inventory, manufacturing machinery and equipment, and furniture and fixtures is phased out over four years at about 25 percent of the rate annually beginning in tax year 2006, when the total rate will be 18.75 percent. Most new manufacturing machinery and equipment that would have been first taxable in tax year 2006 and thereafter will not be subject to **TPP tax**. The last year of payment of the tax, at a total rate of 6.25 percent, will be 2008.

Two key provisions of H.B. 66 provide across-the-board taxpayer and consumer relief.

- The **individual income tax** rate is cut for all tax brackets in increments of 4.2 percent for tax year 2005 (from 2004 rates) and an additional 4.2 percent each year through 2009 for a total cut of 21 percent. Annual incomes of $10,000 or less are exempt from tax.
- The state **sales tax** rate was cut from 6.0 to 5.5 percent. Vendors can still receive a 0.9 percent discount, however, for timely filed and paid sales tax returns.

Other provisions of H.B. 66 increased business property taxes and the tax some consumers pay. Estate taxpayers, however, also received partial relief.

- The **10 percent property tax rollback** on most commercial and industrial real property was eliminated. The rollback remains in effect for residential and agricultural real property.
- A **cigarette excise tax** increase of $.70 was enacted, bringing the total tax to $1.25 per pack of 20 cigarettes. Cigarette wholesalers and retailers must pay the additional 70 cents per pack on cigarettes that were previously taxed but still in inventory at the end of business on June 30, 2005.
- Ohio's additional **estate tax** (sponge tax) is eliminated. The Ohio basic estate tax remains in effect.

A detailed description of how H.B. 66 affects each of the current business and other taxes is contained in the appropriate chapters of this report.

Tax Commissioner William W. Wilkins noted after the passage of H.B. 66 that the challenge to the department was to educate taxpayers and help them understand and adapt to the many changes in the tax code. In total, more than a million pieces of mail were sent out to affected business taxpayers to explain the new tax provisions.

A new tax division was created to administer the **CAT**, and included an initial staff of 13 tax commissioner agents dedicated to responding to telephonic inquiries.