REPORT OF THE COMMITTEE TO STUDY STATE AND LOCAL TAXES

(Created in accordance with Amended Substitute Senate Bill 261 of the 124th General Assembly)

March 1, 2003

Members:
Tax Commissioner Thomas M. Zaino, Chair
Senator Bill M. Harris, Vice-Chair
Representative Charles R. Blasdel
Representative Edward S. Jerse
Representative Sally Conway Kilbane
Senator Eric D. Fingerhut
Senator J. David Goodman
Director Bruce E. Johnson, Department of Development
Director Thomas W. Johnson, Office of Budget & Management

COMMITTEE TO STUDY STATE AND LOCAL TAXES

February 13, 2003

Governor Bob Taft
Senate President White
House Speaker Householder
Senate Minority Leader DiDonato
House Minority Leader Redfern
Members of the Ohio General Assembly

It is our great privilege to provide this Report of the Committee to Study State and Local Taxes. The Committee was created by Am. Sub. S.B. 261. The Committee has met over the past seven months and has received testimony from a wide variety of national and local tax and fiscal experts, as well as many taxpayers and local government officials.

This Report identifies major obstacles to Simplicity, Equity, Stability, Neutrality and Competitiveness contained in Ohio's state and local tax system. It also provides many significant options to overcome those obstacles and improve Ohio's tax system in a revenue neutral manner, thereby ensuring Ohio's ability to promote economic development.

It is our sincere desire that serious consideration will be given to the options provided in this Report.

Respectfully yours,

Commissioner Thomas Zaino, Chair

Senator Bill Harris, Vice-Chair

Senator Eric Fingerhut

Senator David Goodman

Representative Sally Conway Kilbane

Representative Ed Jerse

Representative Charles Blasdel

Director Thomas Johnson, OBM

Director Bruce Johnson, Development

Report of the Committee to Study State and Local Taxes

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I. Introduction

This document constitutes the Report of the Committee to Study State and Local Taxes (the "Report").

The Committee to Study State and Local Taxes (the "Committee") was created in Amended Substitute Senate Bill 261 of the 124th General Assembly (Am. Sub. S.B. 261).[1] Section 5 of Am. Sub. S.B. 261 provides that the Committee shall:

1. Make a study of the current state and local tax structure, including a determination of how the current tax structure affects various sectors of the economy, such as business, industry and individuals;
2. Examine the current state and local tax structure with attention to its simplicity, equity, stability, neutrality, and competitiveness;
3. Identify aspects of the tax structure that present particular obstacles to simplicity, equity, stability, neutrality, and competitiveness;
4. Analyze who bears the ultimate tax burden with respect to any particular tax; and
5. Evaluate priorities in the tax structure.

The law requires the Committee to submit a report by March 1, 2003 to the Governor, the Speaker of the House of Representatives, the President of the Senate, and to the Minority Leaders of the House and Senate. The report is to summarize the Committee's review of the state and local tax structure. Any recommendations of the Committee are required to be revenue neutral in the aggregate. No appropriation was made to fund Committee operations.

The Speaker of the House of Representatives was required to appoint three members, no more than two of whom could be from the majority party. The President of the Senate was required to appoint three members, no more than two of whom could be from the majority party. The Director of the Office of Budget and Management, the Director of the Department of Development and the Tax Commissioner were also designated as members under operation of the law.

The members of the Committee were:

Sen. Eric D. Fingerhut	Rep. Sally Conway Kilbane	Dir. Bruce E. Johnson, Department of Development
Sen. J. David Goodman	Rep. Edward S. Jerse	Dir. Thomas W. Johnson, Office of Budget and Management
Sen. Bill M. Harris, Vice Chair	Rep. Kirk J. Schuring	Commissioner Thomas M. Zaino, Chair, Dept. of Taxation
	Rep. Charles R. Blasdel	

[1] The enabling language was amended into the bill at the urging of Rep. Kirk J. Schuring. Rep. Schuring served as a member of the Committee until January 2003. At that time, Rep. Schuring became a member of the Ohio Senate. Rep. Blasdel was then appointed and served on the Committee.

This Report outlines the procedures that the Committee utilized to gather information and includes a summary of the testimony given to the Committee. The Report also includes the options that the Committee believes will improve Ohio's tax system for both taxpayers and tax administrators in a manner that will be revenue neutral in the aggregate. It is important to remember that while any one specific option may cause a particular revenue effect, the options when considered cumulatively are intended to be revenue neutral.

The Committee conducted 16 public hearings, at which it received testimony from various groups during 12 of the hearings. Additionally, the Committee's Chair met with various industry groups and local officials to discuss Ohio's tax system and identify options for improvements. The following is a list of the Committee's public hearings and the speakers that provided testimony to the Committee.

July 16, 2002

- Organizational Meeting – Chair and Vice Chair selected by the Committee members.

August 6, 2002

- *Characteristics of a Good Tax System* - Professor William Fox, University of Tennessee
- *An Overview of Major Ohio State and Local Taxes, Part I* - Carol Bessey, Deputy Tax Commissioner, Ohio Department of Taxation (ODT)

August 13, 2002

- *Recommendations and Results of Previous Tax Studies in Ohio, Part I* - Richard Levin, Levin & Driscoll
- *An Overview of Major Ohio State and Local Taxes, Part II* - Frederick Church, Administrator, Tax Analysis Division, ODT

August 21, 2002

- *Ohio Taxes From a National Perspective* - Harley Duncan, Executive Director, Federation of Tax Administrators
- *The Emerging Economy and Tax Structure Issues* – Dr. Robert Tannenwald, Assistant Vice President and Economist, Federal Reserve Bank of Boston

August 27, 2002

- *Recommendations and Results of Previous Tax Studies in Ohio, Part II* - Richard Levin, Levin & Driscoll
- *Tax System in Comparison to Other States* - David Brunson, Legislative Service Commission (LSC)

September 3, 2002

- *Other Recent Tax Studies* - Professor Edward W. "Ned" Hill, Ph.D., Cleveland State University
- *Other Recent Tax Studies* - David Ellis, Ph.D., Federation for Community Planning

September 10, 2002

- *What is a Tax Incidence Study?* - Professor David Kraybill, Ph.D., The Ohio State University
- *Discussion on Tax Incidence Studies* – Doris Mahaffey, Ph.D., Legislative Service Commission

September 17, 2002

- *Trends and Issues in State and Local Taxation* - Dan R. Bucks, Executive Director, Multistate Tax Commission

September 24, 2002

- *Review of Real Estate Taxation and Recommended Changes* - Hal Yoder, Preble County Auditor
- *Administration of Local Property Taxes* - Dave Yost, Delaware County Auditor
- *Tax Incentive Review Councils* - Joseph W. Testa, Franklin County Auditor
- *Franklin County Tax Incentive Review Council Progress Report* - Joseph W. Testa, Franklin County Auditor
- *State and Local Tax Issues From a County Perspective* - Larry L. Long, Executive Director, County Commissioners Association of Ohio

October 1, 2002

- *Review of Property Tax and School Finance Policy Issues* - Howard Fleeter, Ph.D., Consultant, Education Tax Policy Institute representing the Ohio School Boards Association
- *West Clermont Local Schools* - Chuck Gossett, Treasurer/CFO
- *Property Tax Reform* - Charles Swindler, Superintendent, Western Reserve Local Schools
- *Municipal Revenue Sources: An Overview* - Susan J. Cave, Executive Director, Ohio Municipal League

November 12, 2002

- *Before the Commission to Study State and Local Taxes* - Daniel Navin, Managing Director of Legislative Affairs, Ohio Chamber of Commerce
- *Summary of Comments and Recommendations by Type of Tax* - J. Matthew Yuskewich, CPA, on behalf of the Ohio Society of CPAs
- *Testimony of Director Bruce Johnson*, Ohio Department of Development

November 19, 2002

- *Testimony of MCI WorldCom Regarding Proposed Ohio Telecommunication Tax Reform* - David Berger, Regional Director-Tax Legislative Affairs
- *Tax Reform and Guiding Principles* - J. Donald Mottley, Managing Director, Focused Capitol Solutions
- *Testimony of the Central Ohio Municipal Alliance* - Dave Lindimore, City Manager, City of Westerville
- *Written Testimony on the "Five Guiding Principles" of the Committee to Study State and Local Taxes* – Thomas Moeller, City Manager, City of Madeira, representing The Ohio Municipal Task Force and the Hamilton County Municipal League
- *Northeast Ohio Mayors and City Managers Association* – Mayor Bruce Akers, Pepper Pike, Ohio
- *Testimony to the Committee to Study State and Local Taxes* - Zach Schiller, Research Director, Policy Matters Ohio
- *Testimony on Income Tax Reform at the Municipal Level* - Lisa Larson-Shidler, Tax Commissioner, City of Perrysburg, representing the Northwest Ohio Income Tax Commissioners Association

November 26, 2002

- *Testimony on behalf of AT&T* - William A. Dvorak, Tax Director, External Tax Policy
- *Testimony* - Steven A. Dimengo, Esq., MT., C.P.A, Buckingham, Doolittle & Burroughs, LLP
- *Comments of the Ohio Cable Telecommunications Association*, Ed Kozelek, Executive Vice President
- *Comments of the Ohio Telecom Association*, Charlie Moses, President

December 3, 2002

- *Summary and Next Steps* – Tax Commissioner Thomas M. Zaino, Chair

January 29, 2003

- Presentation and discussion of Draft Report

February 13, 2003

- Final meeting and approval of Final Report

II. Elements of a Quality Tax System

Am. Sub. S.B. 261 directs the Committee to consider five elements of a quality tax system (simplicity, equity, stability, neutrality, and competitiveness) in making its recommendations. These five elements are widely accepted as the key elements of a quality tax system. While no tax system is perfect, the use of these principles of tax policy helps to achieve an effective and balanced tax system. The Committee recognizes that these five elements can conflict with each other and, therefore, the elements must be prioritized in order to achieve the best result. A summary of the five elements is provided below.

Simplicity – The tax system should facilitate taxpayer compliance by being easy to understand and easy to administer. Taxpayers, both businesses and individuals, pay two distinct "costs" with respect to tax compliance. The first cost, of course, is the expense of the actual tax. The second cost is the compliance cost of comprehending and properly complying with the tax system. By reducing a taxpayer's compliance cost, the taxpayer's overall tax burden is effectively reduced with no impact on government revenues. Finally, a simple tax system reduces the taxing authority's cost of administering the tax.

Equity – Two types of equity exist: Horizontal Equity and Vertical Equity. Horizontal Equity exists when the tax system imposes similar burdens on similarly situated taxpayers. Vertical Equity exists when the tax system recognizes differing abilities of various taxpayers to pay. For example, wealthy individuals are generally able to pay more taxes than less wealthy individuals.

Stability – The tax system exists to fund essential government services and should provide adequate revenue to fund those services in both good and bad economic times. For example, an economic downturn may force a business to lay off employees due to decreased demand for its products. However, a bad economy generally creates new demands for state services. Therefore, a stable funding of government services is essential.

Neutrality – The tax system should not unduly influence economic behavior. The economy and the marketplace, not the government's tax policy, should drive business decisions.

Competitiveness – The tax system is a meaningful part of a state's living, working, and business environment. It should not impose an excess burden on taxpayers, particularly as compared to the tax systems of other states and, more and more, as compared to other parts of the world.

III. Basic Overview of Ohio's Tax System

The attached presentation was presented to the Committee in testimony by Deputy Tax Commissioner Carol Bessey and Frederick Church, Tax Analysis Administrator, of the Ohio Department of Taxation. It provides a basic overview of Ohio's current tax system, along with valuable charts and statistics.

An Overview of Major Ohio
State and Local Taxes

Ohio Department of Taxation
August 6, 2002

Purposes

1. Present an overview of the combined **state/local tax profile**

2. Present a **tax/revenue profile by subdivision**

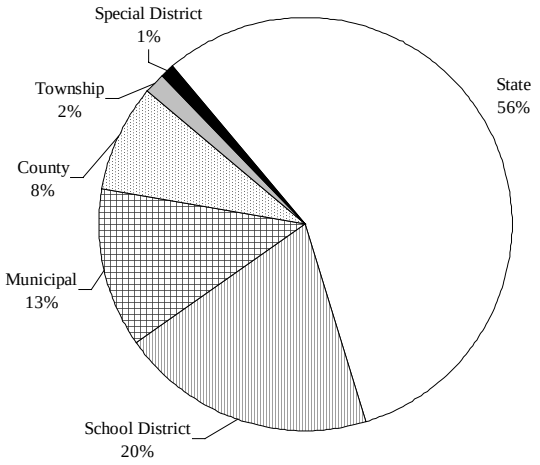
3. Continue with an **overview** of primary taxes

1. State/Local Tax Profile

State/Local Profile: Taxes Levied

- Admissions
- Alcoholic Beverages
- Cigarettes and OTP
- Corporation Franchise
- Dealers in Intangibles
- Estate
- Grain Handling
- Horse Racing
- Income
- Insurance
- KWH
- Manufactured Home
- MCF
- Motor Fuel
- Motor Fuel Use
- Motor Vehicle License
- Lodging
- Parking
- Property (Real, Tangible, Utility)
- Public Utility Excise
- Real Estate Transfer
- Car Rental
- Resort Area
- Sales and Use
- Severance
- Tire fee

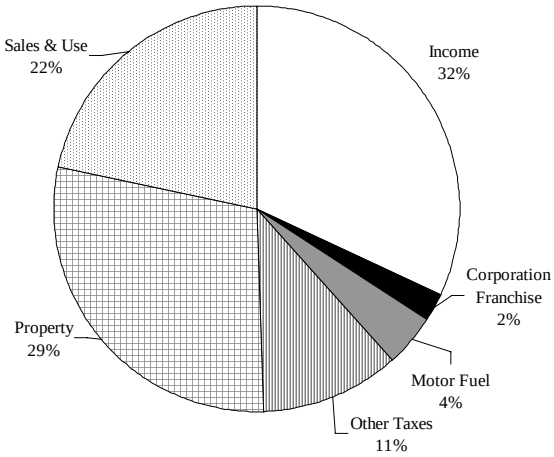
State/Local Profile: Taxes by Jurisdiction



State	$16,417.8 m
School Districts	5,772.1 m
Municipalities	3,659.6 m
Counties	2,410.8 m
Townships	471.7 m
Special Districts	333.5 m
Total	$29,065.5 m

Source: US Bureau of Census
Local govt's - CY 96; State - FY 97

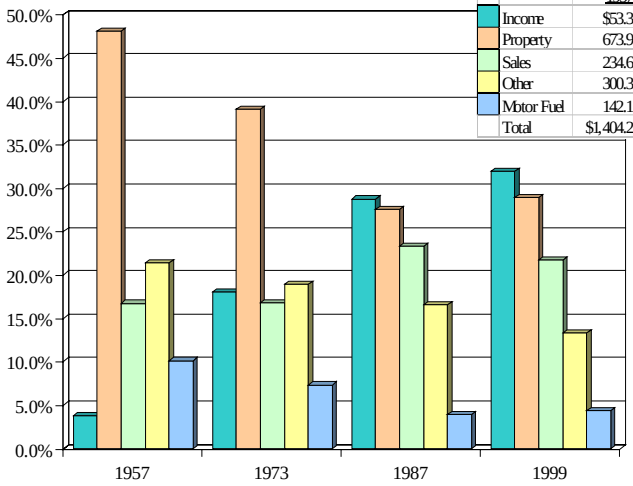
State/Local Profile: By Tax Type



Income	$10,288.4 m
Property	9,334.4 m
Sales & Use	7,001.9 m
Other Taxes	3,547.2 m
Motor Fuels	1,378.0 m
Corporate Franchise	751.6 m
Total	$32,301.5 m

Source: US Bureau of Census.
Note: Local govt's - CY 98; State FY 99

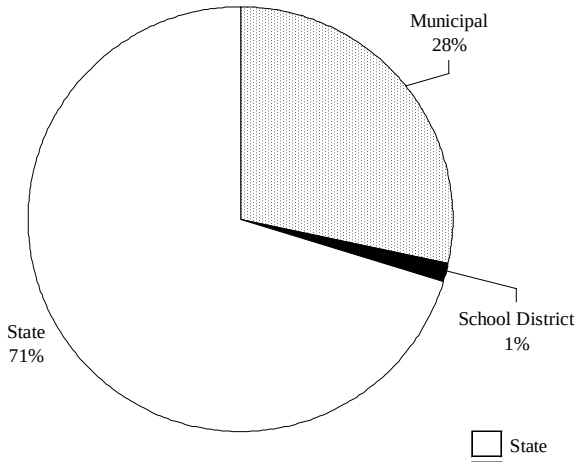
State/Local Profile: Over Time



	In Millions			
	1957	1973	1987	1999
Income	$53.3	$917.1	$4,684.8	$10,288.4
Property	673.9	1,994.4	4,484.1	9,334.4
Sales	234.6	854.8	3,802.5	7,001.9
Other	300.3	964.2	2,690.7	4,298.8
Motor Fuel	142.1	371.2	641.8	1,378.0
Total	$1,404.2	$5,101.7	$16,303.9	$32,301.5

Note: Order of taxes in legend is from left to right in chart (Income, Property, Sales, Other, and Motor Fuel)
Source: US Bureau of Census

State/Local Profile: Income Tax



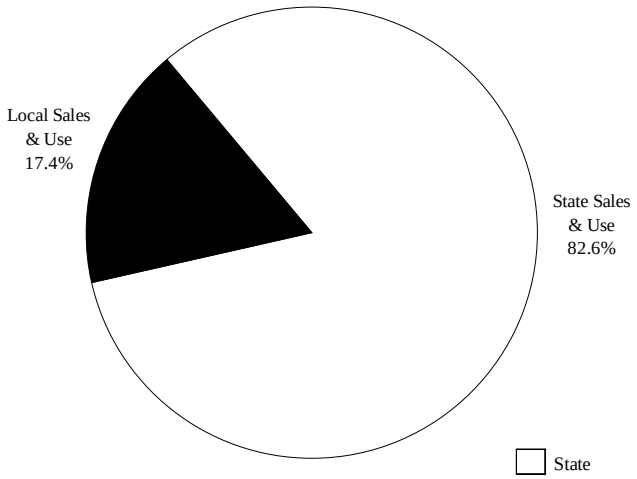
State	$8,116.4 m
Municipal	3,279.2 m
School District	147.9 m
Total	$11,543.5 m

Source: Records of the Ohio Department of Taxation and Ohio Budget & Management Central Accounting System (CAS) reports.
Note: Municipal income CY 2000; State and School District for FY 2001.

State/Local Profile: “Business” Income Taxes

- State corporation franchise tax
- State income tax
- Municipal income tax

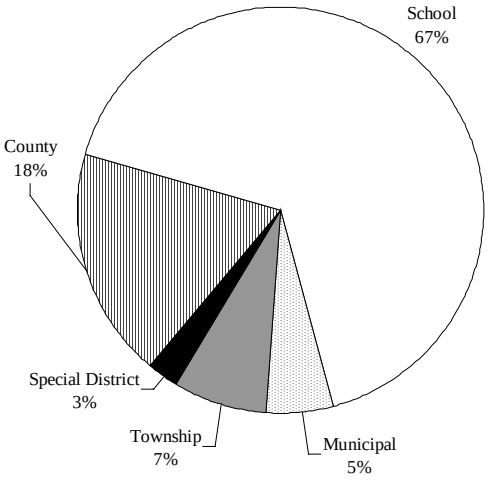
State/Local Profile: Sales and Use Tax



State	$6,341.2 m
Local Sales & Use Tax	1,334.6 m
Total	$7,675.8 m

Source: Ohio Budget & Management, FY 2002 Central Accounting System report.
Local data represents amounts actually distributed to counties and transit authorities during fiscal year 2002.

State/Local Profile: Property Taxes by Subdivision



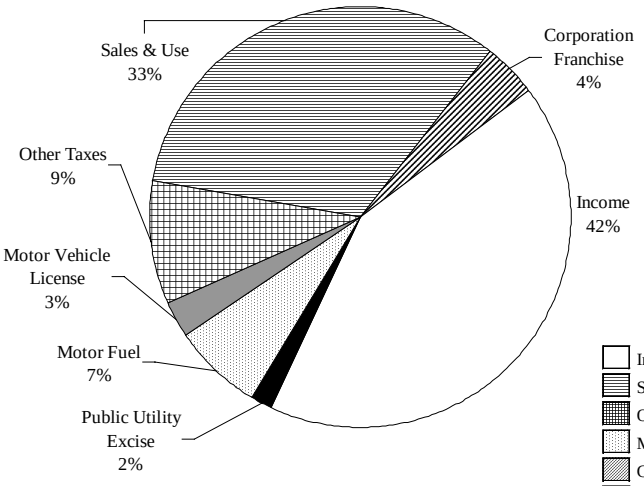
School	$7,579.7 m
County	2,085.0 m
Township	836.6 m
Municipal	610.7 m
Special District	299.3 m
Total	$11,411.3 m

Source: Tax Year 2000 property tax abstracts prepared by county auditors and submitted to the Ohio Department of Taxation

2. Profile By Taxing Jurisdiction

- State
- School districts
- Municipal corporations
- Counties
- Townships

State Profile: Taxes Levied



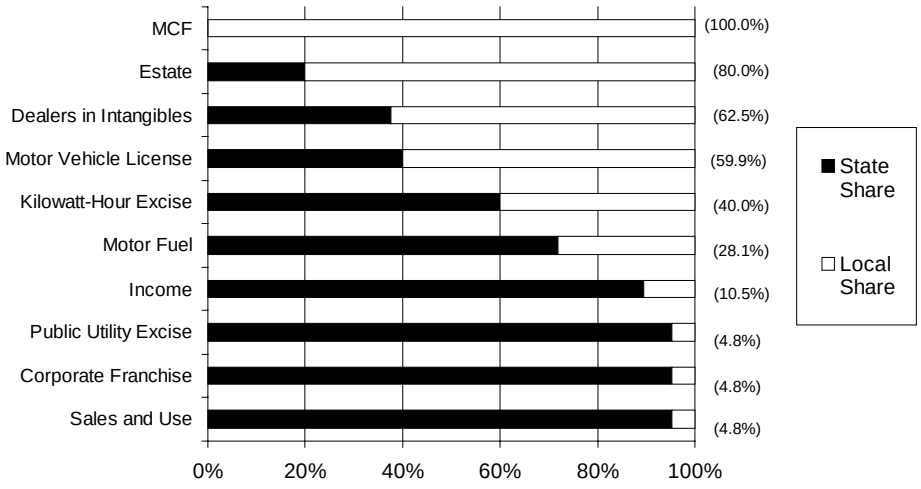
Income	$8,157.1 m
Sales & Use	6,343.5 m
Other	1,804.6 m
Motor Fuels	1,383.3 m
Corporate Franchise	774.4 m
Motor Vehicle License	528.5 m
Public Utility Excise	300.0 m
Total	$19,291.4 m

Source: FY 2002. From records of the Ohio Department of Taxation, and Ohio Budget & Management, Central Accounting System reports.

State Profile: Taxes

- 75% of state tax revenues come from two taxes: income and sales and use
- 10% of state taxes come from motor vehicle related levies and are dedicated to highway purposes
- Remaining 15% from an array of levies including insurance, corporation franchise, cigarette and alcohol excises, public utility excise, and estate

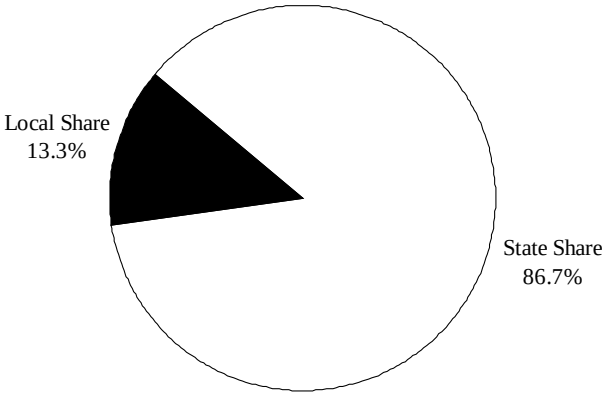
State Profile: Tax Sharing



Note: The percentages for motor vehicle license and motor fuel are based on fiscal year 2002 revenue distributions.

Source: Records of the Ohio Department of Taxation and Ohio Budget & Management, Central Accounting System reports.

State Profile: "Dedicated" State Tax Revenues



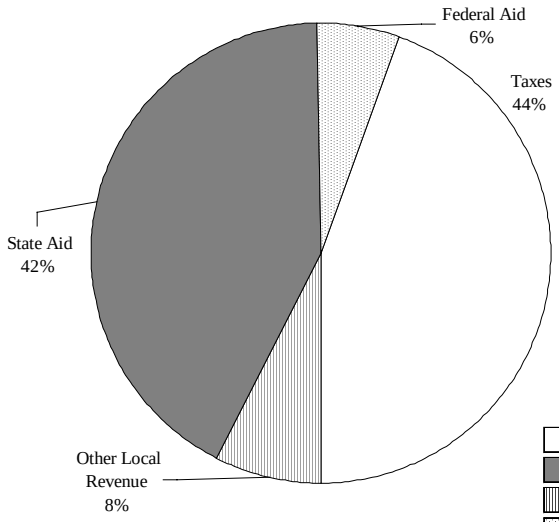
State	$16,011.2 m
Local	2,466.3 m
Total Shares	$18,477.5 m

Source: FY 2002. Ohio Budget & Management, Central Accounting System report.

School District Profile: Taxes Levied

- Property taxes
- School district income taxes

School District Profile: Revenues



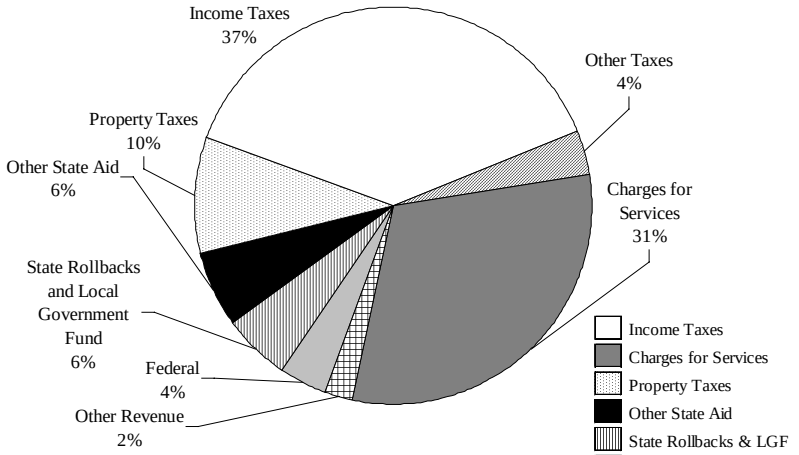
Taxes	$6,394.0 m
State Aid	6,057.6 m
Other Local Revenue	1,085.8 m
Federal Aid	829.9 m
Total	$14,367.3 m

Source: National Center for Education Statistics, US Department of Education, FY 99

Municipal Profile: Taxes Levied

- Income taxes
- Property taxes
- Admission taxes
- Lodging taxes
- Motor vehicle license
- Parking, car rental taxes (less common)

Municipal Profile: Revenues



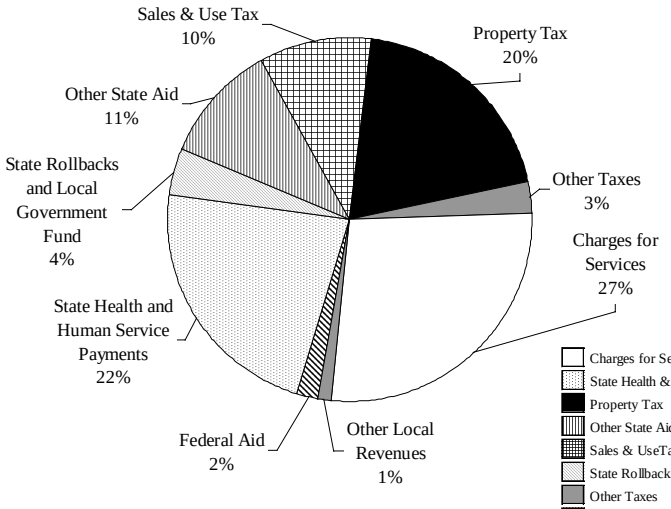
Income Taxes	$2,713.0 m
Charges for Services	2,177.8 m
Property Taxes	675.9 m
Other State Aid	427.7 m
State Rollbacks & LGF	396.9 m
Federal	278.1 m
Other Taxes	270.6 m
Other Revenue	160.4 m
Total	$7,100.4 m

Source: US Bureau of Census, CY 1996

County Profile: Taxes Levied

- Property taxes
- Sales and Use taxes
- Real estate transfer taxes
- Motor vehicle license
- Lodging taxes
- Permissive cigarette and alcohol taxes

County Profile: Revenues



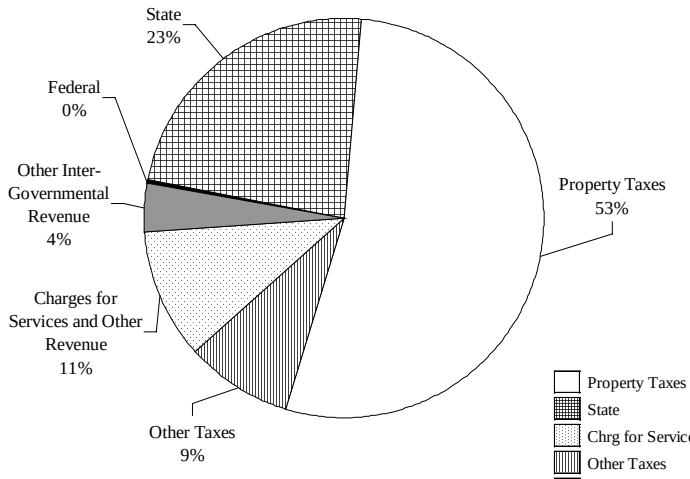
Charges for Services	$2,001.4 m
State Health & Human Service Payments	1,664.8 m
Property Tax	1,456.1 m
Other State Aid	775.1 m
Sales & UseTax	756.8 m
State Rollbacks & LGF	304.3 m
Other Taxes	197.9 m
Federal Aid	136.9 m
Other Local Revenues	88.1 m
Total	$7,381.4 m

Source: US Bureau of Census, CY 1996

Township Profile: Taxes Levied

- Property taxes
- Motor vehicle license
- Lodging taxes

Township Profile: Revenues



Property Taxes	$406.3 m
State	179.0 m
Chrg for Services/Other Rev	80.9 m
Other Taxes	65.4 m
Other Inter-Gov't Rev	28.6 m
Federal	1.9 m
Total	$762.1 m

Source: US Bureau of Census CY 1996

Profile: Review

- Income and sales and use taxes are shared by multiple levels of government
- State levied taxes often include shares that are dedicated to local jurisdictions and that become a significant part of the local revenue picture
- State levied taxes also support various state subsidies to local governments and schools

3. Overview of Primary Taxes

- Income
- Property
- Sales and Use
- Motor Fuel
- Corporation Franchise

Overview: Income Taxes

- Tax on income
- "Newest" of primary taxes
- First levied by municipal corporations [Toledo: 1946]
- Now levied by state, municipal corporations, and school districts
- Largest single revenue source for the state and municipal corporations
- Business income aspect

Overview: State Income Tax

- **Tax base:** wage, salaries, dividends, interest
- **Rates:** marginal rates increase with income to maximum of 7.5%
- **Who pays:** residents and nonresidents earning income in Ohio
- **How collected:** through withholding, estimated payments and annual returns
- **Who administers:** ODT

Overview: State Income Tax

- Begin calculation with Federal AGI
  - Does not take into account itemized deductions
- Personal exemptions indexed to inflation
- Brackets to be indexed beginning in 2005
- Tax revenues increase as incomes increase
- Revenues can be sensitive to economic downturn
- Average effective tax rate was 2.86% in tax year 2000

Overview: State Income Tax

- The income of unincorporated businesses (partnerships, sole proprietorships) and S-corporations is taxed through the income tax.
- Income “flows through” to the owners, and is taxed on their income tax returns.

Overview: State Income Tax

- Residents are taxed on all income, with credit given for income taxed by other states.
- Nonresidents are taxed on income earned in Ohio.

Overview: State Income Tax Basic Changes

	Bottom Rate	Top Rate	Number of Brackets		Personal Exemptions	Lines on Return
1972	.5%	3.5%	6		$500/ $3000 maximum	9 on short form; 11
1975	Same	Same	Same	Same	$650 (no max)	16 / 42
1982	.625%	6.25%	8	Add:	Same	17 / 47
1984	.95%	9.5%	Same	Same	Same	23 / 56
1988	.743%	6.9%	Same	Same	Same	25 / 56
1993	Same	7.5%	9	Add:	Same	24 / 59
1996	.693%	7.004%	Same	Same	$750/$850	24 / 60
2001	.743%	7.5%	Same	Same	$1150	27 / 62

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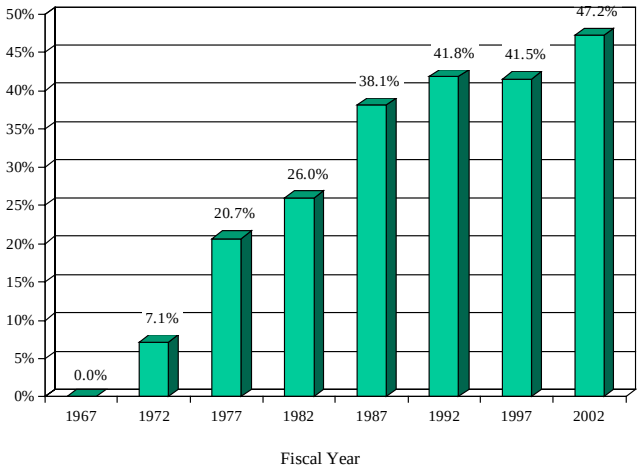
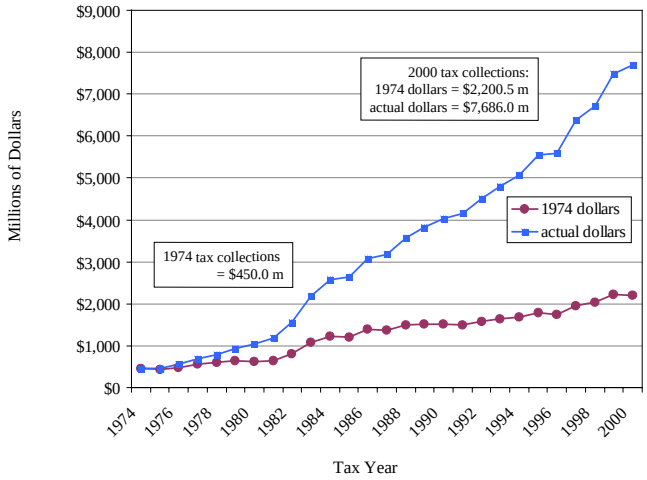
Overview: State Income Tax Historical Share of GRF



For 1972 - 1987, tax revenues transferred to the Local Government Fund are assumed not to be General Revenue Fund taxes.
Source: Ohio Budget & Management, Central Accounting System reports.

Overview: State Income Tax Revenue Trend Line



Source: Income tax returns filed with the Ohio Department of Taxation.

Overview: Municipal Income Tax

- Originally enacted without state law
- State law enacted in 1957 to require voter approval for taxes above 1% and to provide some uniformity; still many variations
- May be levied on residents and employees working in a municipal corporation
- Various practices with respect to credits

Overview: Municipal Income Tax

- Currently levied by 541 municipal corporations
- Most large cities levy at 2% rate
- Flat tax

Overview: Municipal Income Tax

- Source of some controversy regarding complexity
- Much complexity stems from variations in the base
- Treatment of flow-through businesses varies
- Some municipal corporations contract for administration, others administer in-house

Overview: School District Income Tax

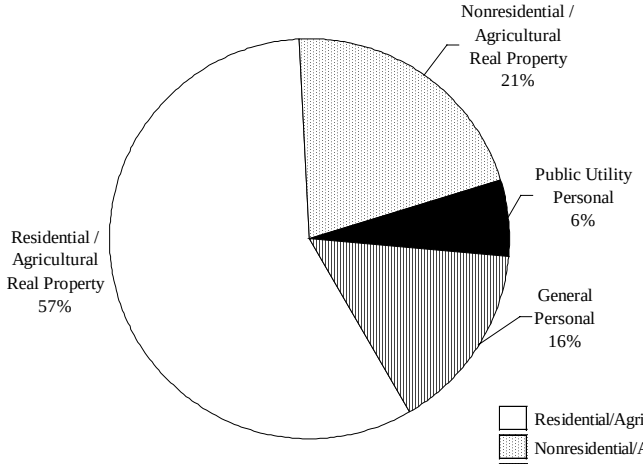
- Authorized in 1982; repealed with grandfather in 1983; re-enacted in 1989
- Currently levied by 123 school districts, typically rural, with exceptions
- Levied only on residents
- Uses state income tax law as a starting point
- Administered by the Ohio Department of Taxation

Property Taxation Overview

- Two basic types of property- real and tangible
- Real property consists of land and buildings
- Tangible property consists of machinery, equipment, inventories, furniture, and fixtures used in business

Overview: Property Taxes By Property Class

Tax Year 2001



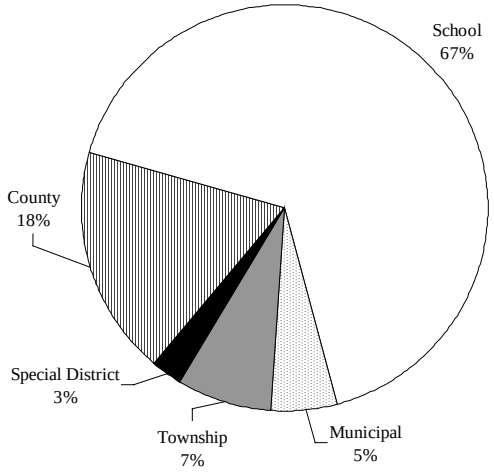
Residential/Agricultural Real	$6,719.3 m
Nonresidential/Agricultural Real	2,464.1 m
General Personal	1,802.5 m
Public Utility Personal	715.3 m
Total	$11,701.2 m

Source: Property tax abstracts prepared by county auditors and submitted to the Ohio Department of Taxation

Property Taxation Overview

- Property taxes used only by local governments
- Primary source of revenue for schools and townships and important source for others
- Nearly two-thirds of property taxes go to schools

Overview: Property Taxes by Subdivision



School	$7,579.7 m
County	2,085.0 m
Township	836.6 m
Municipal	610.7 m
Special Districts	299.3 m
Total	$11,411.3 m

Source: Property tax abstracts prepared by county auditors and submitted to the Ohio Department of Taxation

Real Property Tax

Tax Year 2000 Taxes Net of Rollbacks--$7,640 million

- **Tax Base**: 35% of the market value of land and buildings
- **Tax Rate**: Varies by locality; average effective TY 2000 rate was 45.5 mills
- **Who Pays**: Owners of real property in the state
- **How Collected**: Through semi-annual payments to county treasurer
- **Who Administers**: County auditors with oversight from ODT

Real Property Tax-Brief History

- Was major source of state and local revenue through 1800s
- No longer used for state general fund starting in 1902
- 10-mill limit set for unvoted levies in 1934
- 10% rollback and homestead exemption enacted in 1971

Real Property Tax-Brief History

- HB 920 enacted in 1976, generally preventing voted levies from generating more revenue due to reappraisal and update
- 2.5% rollback enacted in 1979
- Classification of property began in 1980
- No major structural changes or programs enacted since 1980

Business Tangible Property Tax

Tax Year 2001 Taxes --$1,802.5 million

- **Tax Base**: 25% of depreciated value of machinery & equipment and furniture & fixtures and 24% of average monthly inventories (in 2002)
- **Tax Rate**: Varies by locality; average TY 2001 rate was 75 mills

Business Tangible Property Tax

- **Who Pays**: Owners of tangible property used in business in the state
- **How Collected**: Annual or semi-annual payments to county treasurer
- **Who Administers**: County auditors for taxpayers operating in a single county; ODT for taxpayers operating in multiple counties

Tangible Property Tax-Brief History

- Tangible property separated from real property and limited to property used in business in 1931
- Assessment rates lowered gradually from 1967 to 1992
- First $10,000 of taxable value exempted in 1983
- Inventory assessment rate lowered gradually beginning in 2002

Personal Property Assessment Rates

1967 - 2002

Tax Year	Machinery & Equipment	Manufacturer's Inventories	Merchant's Inventories	Furniture & Fixtures
1967	50 %	50 %	70 %	70 %
1972	50 %	49 %	49 %	66 %
1977	48 %	43 %	43 %	48 %
1982	38 %	35 %	35 %	38 %
1987	31 %	31 %	31 %	31 %
1992	26 %	26 %	26 %	26 %
1997	25 %	25 %	25 %	25 %
2002	25 %	24 %	24 %	25 %

Public Utility Tangible Property Tax

Tax Year 2001 Taxes --$715.3 million

- **Tax Base**: Assessed value of public utility tangible property
- **Tax Rate**: Varies by locality; average TY 2001 rate was 73.6 mills
- **Who Pays**: Public utilities with tangible property in the state
- **How Collected**: Semi-annual payments to the county treasurer
- **Who Administers**: Returns are filed with ODT who then certifies taxable values to county auditors

Public Utility Reform

- Responsibility for assessing real property of utilities switched from ODT to county auditors in 1982
- True value of most utility tangible property based on composite allowances and assessed at 88 percent based on Utility Tax Task Force recommendations beginning in 1990
- There has been a gradual movement of assessment rates for utility tangible property to the assessment rate for general business tangible property

Public Utility and Business Tangible Property

- Public utility property valued company-wide and apportioned; business tangible valued at the location of the property
- Public utility property valued by the Department of Taxation; business tangible self-reported
- Public utility assessment rates range from 25% to 88%; business tangible assessment rate is 25%

Assessment Rates for Public Utility Tangible Property

Assessment Rate	Type of Property
25 %	Electric and rural electric except transmission & distribution, natural gas, railroad, inter-exchange telephone, local exchange telephone put in service beginning in 1994, water transportation
50 %	Rural electric transmission & distribution property
88 %	Electric transmission & distribution property, waterworks, pipelines, heating, and local exchange telephone property put into service before 1994

History of Assessment Rate Changes

- Assessment rate for rural electrics reduced from 100% to 50% in 1941
- Assessment rates of railroads reduced from 100% to 25% in 1979
- All inter-exchange property and new local exchange property assessment rates reduced from 88% to 25% in 1995
- All natural gas property assessment rates reduced from 88% to 25% in 2001

History of Assessment Rate Changes

- Electric production property assessment rate reduced from 100% to 25% in 2001
- Other electric property (except transmission and distribution) assessment rate reduced from 88% to 25% in 2001
- Rural electric property (except transmission and distribution) reduced from 50% to 25% in 2001

Sales and Use Tax: Overview

- Enacted during the 1930s
- Tax on consumption
- Exclusions for certain “necessities”
- A primary state and county revenue source

State Sales and Use Tax: Overview

Fiscal Year 2001 Revenue--$6.23 Billion

- **Tax Base:** Retail sales and rental of tangible personal property as well as selected services
- **Tax Rate:** 5%
- **Who Pays:** Generally paid on a transactional basis by individual and business consumers
- **How Collected:** From vendors and sellers
- **Who Administers:** ODT

Sales & Use Tax: What is Taxable

- The transfer, use, or storage of all tangible personal property (goods)
- Goods are considered taxable unless explicitly exempted
- Services are not taxable unless specifically subjected to the tax
- Services are a relatively recent addition

Sales & Use Tax: What is not Taxable

- There are approximately 60 exemptions
- Two exemption characteristics:
  - Based on the item purchased (e.g. prescription drugs or food for human consumption off premises)
  - Based on either the use or the purchaser (e.g. manufacturer used in the manufacturing process, a farmer used in agriculture, or a charitable organization)

Sales & Use Tax: What is the Use Tax?

- Enacted the year after the sales tax as a complementary tax to counter tax avoidance
- Applies to all taxable purchases on which sales tax has not been paid
- Most effective way to collect is by the seller

Sales & Use Tax: What is the Use Tax?

- Represents 12% (FY99) of total sales and use tax revenue being collected
- Businesses pay on a regular basis
- Many out-of-state sellers already remit taxes on sales to Ohio consumers

Sales & Use Tax: Details

- Historical rate changes:
  - Enacted at 3% in 1935
  - Increased to 4% in 1967
  - Increased to 5% in 1981

Sales & Use Tax: Details

- Historical base expansions:
  - Repairs and other selected services in 1981
  - Business data processing services in 1983
  - Long distance telecommunications service in 1987
  - Lawn care, landscaping, private investigation, and security services in 1991
  - Building cleaning and maintenance, exterminating, employment agency and personnel supply services, physical fitness facilities, and recreation and sports club memberships in 1993

Sales and Use Tax – County and Transit Authority

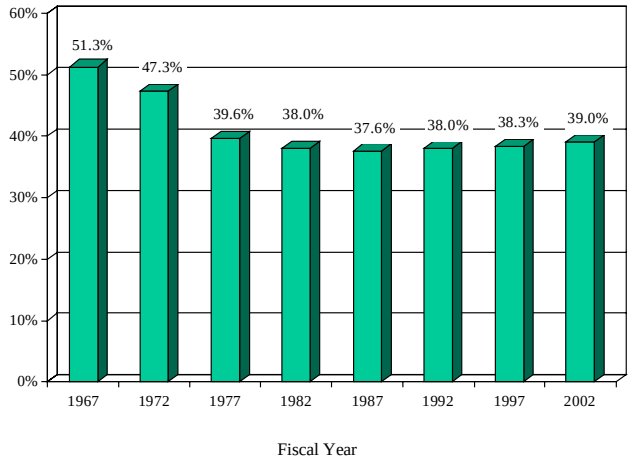
Fiscal Year 2002 Revenue -- $1,334.6 million

- Authorized in 1967 for counties and 1974 for transit authorities
- The same tax base applies as the state sales and use tax
- Administered by ODT and distributed to the counties
- Currently levied by counties and transit authorities up to a maximum combined levy of 2% (3% is the maximum allowed by law)

Sales and Use Tax – County and Transit Authority

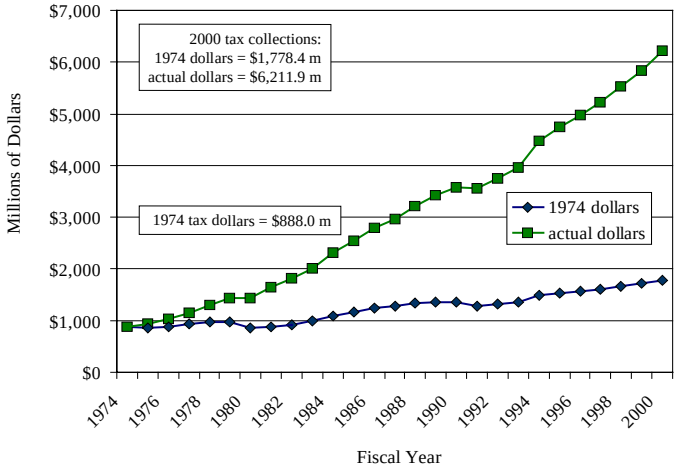
- Currently all 88 counties have county or transit authority sales and use tax levies in place, ranging from 0.25% (Stark) to 2.0% (Cuyahoga)
- Levies are generally voted
  - transit authority levies are voted
  - general county levies are unvoted if unanimous by county commissioners
  - additional county levies are voted

Details: State Sales Tax Historical Share of GRF



For 1972 - 1987, tax revenues transferred to the Local Government Fund are assumed not to be General Revenue Fund taxes.
Source: Ohio Budget & Management, Central Accounting System reports.

Details: Sales & Use Tax Revenues Trendline



Source: Sales tax returns filed with the Ohio Department of Taxation.

Corporation Franchise Tax: Overview

- One of the older state taxes (1902)
- Originally a tax on wealth; income element added in 1972; tax on net worth capped at $150,000 in 1999
- Conceptual origin as a “privilege” tax

Corporation Franchise Tax: Overview

Fiscal Year 2002 Revenue --$774.4 million

- **Tax Base:** Two alternative bases – net worth and net income (taxpayer calculates both and pays higher of the two)
- **Tax Rates:**
  - **Net worth**: 4.00 mills (0.4%) on the taxable value of the corporation, $150,000 maximum liability
  - **Net income**: 5.1% on first $50,000 of Ohio taxable income + 8.5% on Ohio taxable income in excess of $50,000

Corporation Franchise Tax: Overview

- **Who Pays:** For profit corporations doing business in Ohio
- **How Collected:** Three estimated tax payments and annual return
- **Who Administers:** ODT

Corporation Franchise Tax: Definition of Tax Base

- **Net Worth:** Net value of stock (excluding pollution control facilities and similar facilities) X apportionment formula = Ohio taxable value
- **Net Income:** Begins with federal taxable income; then calculations done to reflect the amount of federal taxable income that should be allocated and apportioned to Ohio

Corporation Franchise Tax: Definition of Tax Base

- **Allocation:** Allocable income is allocated either entirely within Ohio or entirely outside of Ohio based on the location of the business activity
  - Example: Rental income from real property located in Ohio is allocated entirely to Ohio
  - Example: Capital gain income is allocated either in or out of Ohio

Corporation Franchise Tax: Definition of Tax Base

- **Apportionment:** Apportioned income is apportioned partially to Ohio and partially out of Ohio based on a formula (property, payroll, and sales) used to reflect the corporation's presence in Ohio and elsewhere
  - Example: Profit from the sale of product

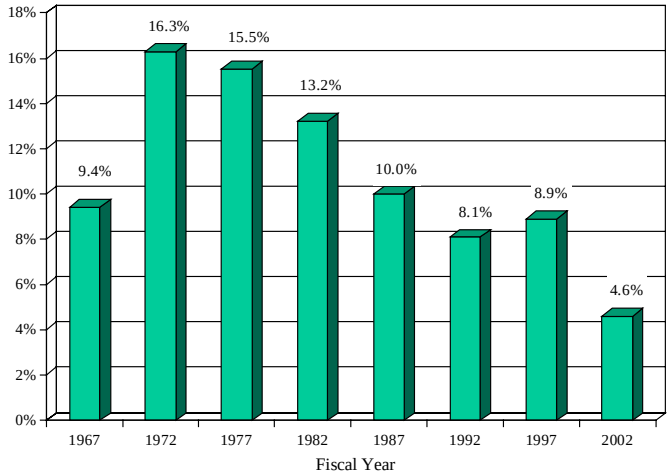
Corporation Franchise Tax - Financial Institutions

- Pay a franchise tax limited to the net worth calculation, at 13 mills (1.3%) of net worth
- Different net worth base than regular corporation franchise taxpayers

Corporation Franchise Tax - Financial Institutions

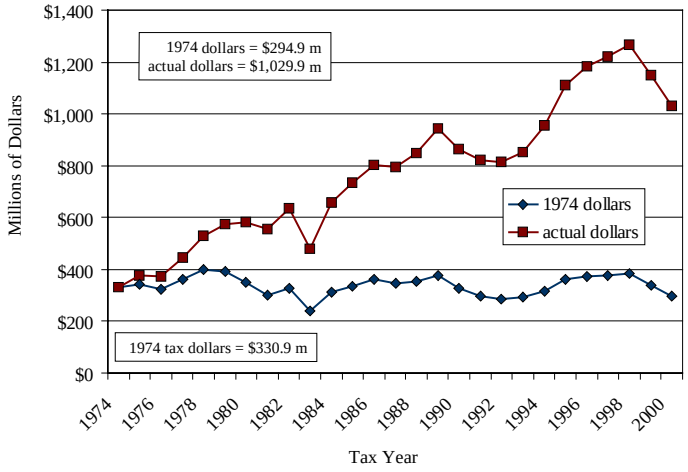
- Special apportionment formula – uses "market" approach with respect to situsing income (based on customer location)
- Intangibles tax repealed and financial institutions became subject to the corporation franchise tax at 6.5 mills (0.65%) beginning in tax year 1982

Details: Corporate Tax Historical Share of GRF



For 1972 - 1987, tax revenues transferred to the Local Government Fund are assumed not to be General Revenue Fund taxes.
Source: Ohio Budget & Management, Central Accounting System reports.

Details: Corporation Franchise Tax Revenues Trendline



Source: Income tax returns filed with the Ohio Department of Taxation.

Motor Vehicle Fuel Tax: Overview

- State tax that is shared with local governments
- Tax on consumption
- Tax earmarked for roads with constitutional restrictions
- Additional fuel use tax levied on trucking industry

Motor Vehicle Fuel Tax: Overview

- **How Collected:** Monthly tax returns paid by the last day of the month for the preceding month's liability
- **Who Administers:** ODT

Motor Vehicle Fuel Tax: Overview

Fiscal Year 2002 Revenue -- $1.49 billion

- **Tax Base:** Gallons of gasoline, diesel fuel, ethanol, and propane used as motor fuels sold in Ohio
- **Tax Rates:** Twenty-two cents per gallon (five separate levies)
- **Who Pays:** Wholesale dealers who distribute fuel in Ohio

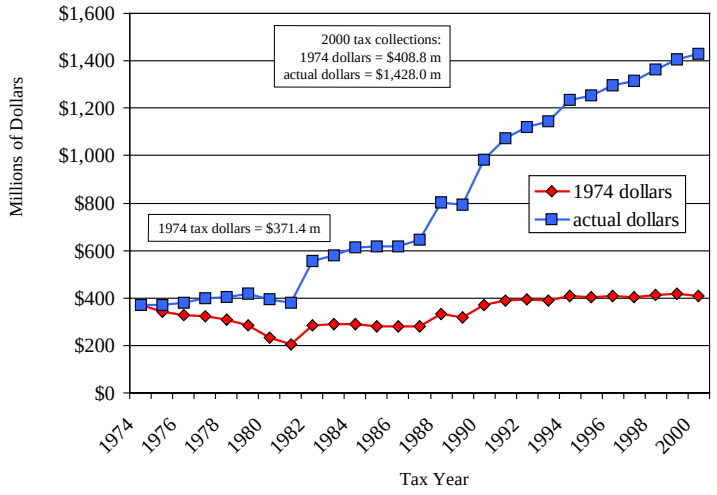
Motor Vehicle Fuel Tax: Details

- **Taxable fuels:** Gasoline, diesel fuel, ethanol, propane
- **Nontaxable fuels:** Electricity, compressed natural gas
- **Exemptions:** Federal government
- **Non-taxable uses:** Off-road use of fuel

Motor Vehicle Fuel Tax: Details

- Inflation-adjustment formula for "cents-per-gallon" rate discontinued effective FY 1994, with rate at 15 cents (of 22 cents total)
- In real (inflation-adjusted) terms, revenue was stagnant from FY 1994 ($409.9 million) through FY 2000 ($408.8 million)

Details: Motor Fuel Tax Revenues Trendline



Source: The Ohio Department of Taxation.

IV. Comparison of Ohio's Tax System to Other States' Tax Systems[2]

When comparing Ohio's tax system to other states, it is important to look at the combined state and local tax system, because states do things very differently. For instance, Ohio has a very broad local tax system, while many other states limit local authority to impose many taxes.

Many experts describe an ideal tax system as a three-legged stool of sales, income and property taxes. Ohio uses all three of those legs in fairly equal proportions and, therefore, Ohio's state and local tax revenues reflect a very balanced tax system.

State and Local Revenues

State and local revenues combined: For Ohio versus the rest of the country, Ohio's individual income taxes are 32% of total state and local revenues, compared to 23% for the nation on average. Ohio's property taxes are 29% of total state and local revenues, matching the national average. Ohio's sales taxes (general and selective) are 31% of total state and local revenues, compared to 36% for the rest of the country. Finally, other taxes (which include the corporation franchise tax) make up 8% of Ohio's total state and local revenues, compared to 12% for the rest of the nation. The portion of Ohio's revenues generated by the corporation franchise tax on income is lower than the national average (2% in Ohio versus 4% across the nation).

State-only revenue in Ohio versus U.S. average: Ohio's individual income tax provides 40% of state-level revenue, the sales taxes (including selective sales taxes) provide 47% of state-level revenue, and other taxes (including the corporation franchise tax and dealers in intangibles tax) make up the remaining 13% of state-level revenue.

On average, most states get only 35% of their state-level revenue from income taxes. Ohio's share of revenue from state-level sales tax and selective sales taxes are about at the national average, while the share of revenue from corporation franchise tax on income is below the national average. On average, states get 2% of their revenue from state-level property taxes, while Ohio receives zero from state-level property taxes. Also, Ohio is below the national average on other taxes.

LSC data show that an average taxpayer in Ohio pays the same tax as a percentage of income as a taxpayer in the rest of the country. But when talking about individual taxpayers, results will be different.

[2] This discussion is primarily based on testimony to the Committee by David Brunson of the Legislative Service Commission, supplemented with testimony received from Harley Duncan of the Federation of Tax Administrators and Professor Bill Fox of the University of Tennessee. Charts contained in this section were provided by the Legislative Service Commission. Generally, the most current data in the presentations were from 1999.

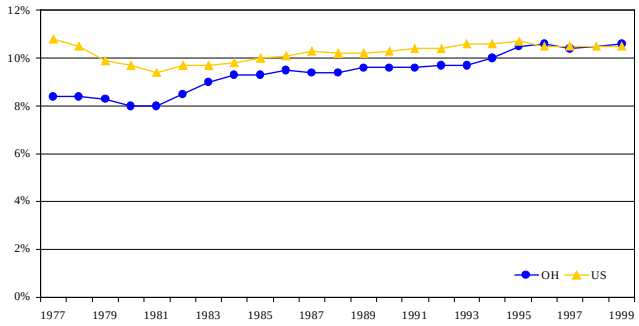
Local-only revenue in Ohio versus U.S. average: Ohio local government gets 66% of its revenue from property taxes compared to 73% on average for the nation. Individual income tax provides 22% of local revenue in Ohio versus 5% for the nation. Sales tax provides 9% of local revenue compared to 16% for the nation. Other taxes provide 3% of local Ohio revenue compared to 6% for the nation. Ohio has very few selective sales taxes at the local level compared to other states.

Ohio's local governments use all three legs of the tax revenue stool, using broad-based taxes, and making little use of smaller taxes. Using all three legs may take some pressure off these other categories.

As a percentage of income, property taxes are about the same for Ohio as they are across the nation.

Historical comparisons of Ohio and U.S. average state and local taxes as a percentage of income: The following chart compares state and local taxes as a percentage of income in Ohio versus the national average since 1977. Ohio started out as a low tax state in 1977, narrowed the gap during the recession of the 1980s through increased income and sales taxes, and closed the gap during the past five years, making Ohio identical with the U.S. average at this time.

State and Local Taxes
as a Percentage of Income



State-only taxes in Ohio continue to be lower than the national average. However, since 1995, local taxes in Ohio have exceeded the national average.

Comparing Ohio with its neighbors and other selected states: When comparing Indiana, Kentucky, Michigan and Ohio, Michigan has consistently been a much higher tax state (when comparing state and local taxes as a percentage of income). Since 1977, Indiana, Kentucky and Ohio started out as low tax states, but their percentages gradually increased to match Michigan and the U.S. average by 1999. When comparing West Virginia,

Pennsylvania and Illinois to Ohio, Ohio starts out as a low tax state in 1977, but gradually catches up, principally during the early 1980s. Since then, these four states have been in the same area. West Virginia has been a little higher than these states most consistently since 1977.

Since 1979, the spread between total taxes, as a percentage of income, of Ohio, its neighbors, and Illinois was 2.5% of income. Over time, it gradually narrowed to 1.3% for all these states. Michigan was highest for four of five years selected. Ohio was the lowest in 1979 and 1994. West Virginia is currently the highest at 11.3% and Indiana is currently the lowest at 10.0%. Ohio is currently at 10.6%.

The following chart compares total state and local taxes as a percentage of income for Ohio and its neighboring states for five years during the 1979 – 1999 period.

State and Local Taxes
as a Percentage of Income

Year	OH	MI	IN	KY	WV	PA	IL
1979	8.3%	10.8%	8.4%	9.3%	10.1%	9.9%	9.6%
1984	9.3%	11.6%	8.8%	8.7%	10.8%	9.8%	9.6%
1989	9.6%	10.9%	9.6%	9.7%	10.1%	9.4%	9.7%
1994	10.0%	11.1%	10.0%	10.4%	10.6%	10.3%	10.1%
1999	10.6%	10.8%	10.0%	10.6%	11.3%	10.3%	10.1%

When examining a breakdown of state-only and local-only taxes as a percentage of income, local taxes as a percentage of income have tracked the U.S. average pretty tightly for many years, but the ratio of Ohio to the U.S. average has increased during the last five. Currently, Ohio's local taxes as a percentage of income are about 0.5% above the national average.

Personal Income Taxes

In the area of personal income taxes, the following should be noted:

- Seven states have no income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming;
- Two states tax dividends and interest only: New Hampshire and Tennessee; and
- Forty-one states, plus Washington, D.C., have broad-based income taxes.

Six states have a single (flat) income tax rate. They are Colorado, Illinois, Indiana, Massachusetts, Michigan, and Pennsylvania. Three of Ohio's neighbors have flat income tax rates. By comparison, 35 states plus Washington D.C. have a graduated income tax system. The number of brackets ranges from two (Connecticut) to ten (Missouri and Montana). Ohio has nine brackets, as does Iowa. Two states base their income taxes on a percentage of federal tax liability: Rhode Island (25% rate) and Vermont (24% rate).

Of those states with graduated tax systems, four states have their lowest bracket below one percent: Iowa has the lowest rate at 0.36%, while Ohio's lowest rate is 0.743%. Eight states plus Washington D.C. have their highest bracket at 8% or more, and Montana has the highest at 11%.

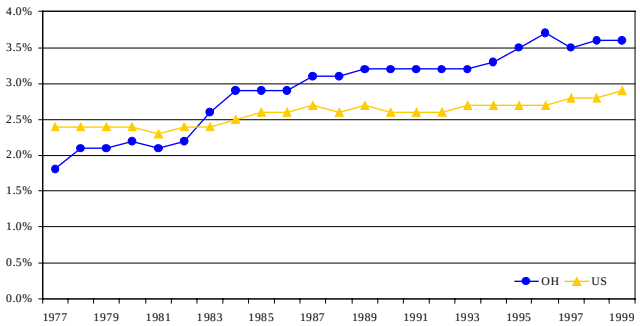
In looking at the maximum rates, nine states (including Washington D.C.) have rates of 8% or more. In addition, the two states that base their tax on federal tax liability have a maximum effective rate within this range. Six states have maximum rates from 7% to 8%, Ohio's top rate being 7.5%. However, this comparison is misleading because very few states have broad-based local income taxes like Ohio and, therefore, taking Ohio's 7.5% top rate along with an average local rate of 1.5% and a possible school district income tax, puts Ohio into a much higher category of higher rate states. Eleven states have maximum rates from 6% to 7%. The median maximum rate for all states is in this range. Seven states have maximum rates from 5% to 6%, with one of the seven being a flat-rate state. Seven states have maximum rates less than 5%, with five of the seven being flat-rate states.

Twenty-six states (including Ohio and Washington D.C.) use federal adjusted gross income (FAGI) as the starting point for their income taxes. Nine states use federal taxable income, which is FAGI minus personal exemptions and deductions. Two states use federal tax liability. Only five states use their own definitions of taxable income. Thus, states are often affected by federal law changes.

The nine states that use federal taxable income have a substantially narrower tax base than the 26 states that use federal adjusted gross income. Therefore, these states need a tax rate that is 41% higher than the tax rate used by those 26 other states in order to produce the same revenue.

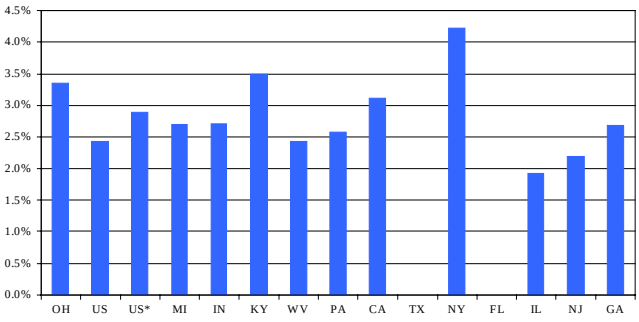
<u>State and local income taxes (including corporate income taxes) as a percentage of income</u>: As illustrated in the chart below, in 1977, Ohio was below the national average, but with the recession of the early 1980s, Ohio moved above the national average where it has remained.

State and Local Income Taxes (including Corporate) as a Percentage of Income



Comparing Ohio with several specific states: The following two charts compare Ohio individual income taxes to selected states, to the average for all states and to the average for only those states that have income taxes. In 1999, Ohio's state and local individual income tax as a percentage of income was about 3.4%. The national average for all states was 2.4%, while the national average for only those states with income taxes was 2.9%. Ohio exceeds both of these averages. Michigan, Indiana, West Virginia, Pennsylvania, California, Illinois, New Jersey and Georgia were lower than Ohio. Kentucky is almost equal to Ohio.

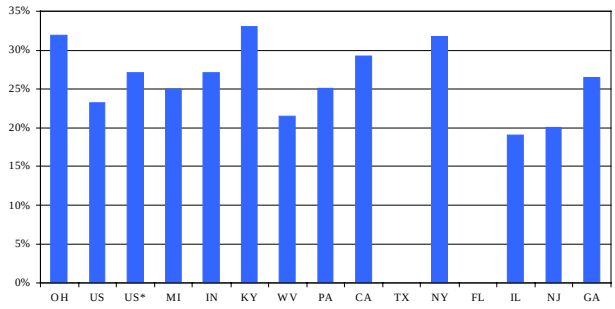
State and Local Individual Income Taxes as a Percentage of Income, 1999



*The US average based only on states with income taxes

When comparing state and local individual income taxes as a percentage of tax revenue, Ohio's percentage is around 32%, compared to the U.S. average for all states of 23% and U.S. average for states with income taxes of 27%. Neighboring states are in the range of the U.S. average, but only Kentucky and New York exceeded Ohio (of the states presented). The percentage for all of Ohio's neighbors, except Kentucky, is below Ohio's percentage and close to the U.S. average. Ohio's percentage also exceeds California, Illinois and Georgia. Of the states presented, only the percentages for New York and Kentucky exceeded Ohio's percentage.

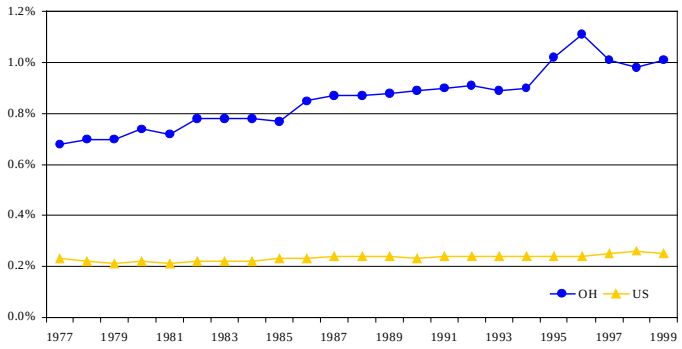
State and Local Individual Income Taxes
as a Percentage of Tax Revenues, 1999



*The US average based only on states with income taxes

In regard to just local income taxes, the 1977 U.S. average local income tax (including corporate) as a percentage of income was 0.2% of income, while Ohio was at 0.7%. Today, Ohio's local income taxes (including corporate) are about 1% of income while the national average has stayed at about 0.2%. Ohio's neighboring states generally have lower local income taxes than Ohio. Ohio is clearly different from the national norm in this area and local income taxes make up 10% of Ohio's total state and local tax burden when measured as a percentage of income.

Local Income Taxes
(including Corporate) as a Percentage of Income



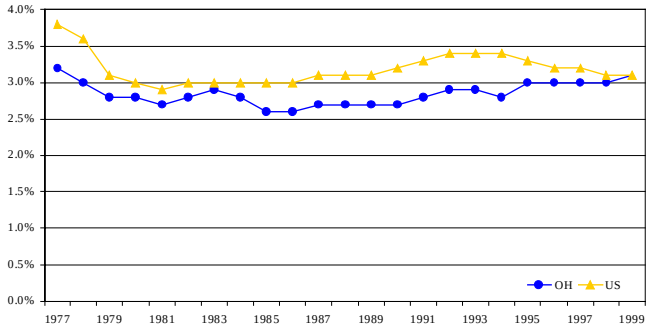
Mitigating circumstances for this deviation may include that Kentucky and Pennsylvania at least have some local income taxes. Further, in Ohio, these taxes are enacted by the vote of city councils and residents, and Ohio municipalities have a choice between property tax and income taxes. Their tax of choice seems to be the income tax.

Property Taxes (Real Property and Tangible Personal Property)

In 1999, Ohio property taxes generated 28.9% of total state and local tax revenue as compared to the U.S. average of 29.4%. Also, property taxes in Ohio produced $829 per capita as compared to the U.S. average of $881 per capita. Total Ohio property taxes collected in 1999 were over $9 billion. Two-thirds of Ohio property taxes go to schools. One-fifth of Ohio property taxes come from the taxes on tangible personal property of business.

From 1977 until 1999, state and local property tax as a percentage of income in Ohio was below the national average. The gap narrowed and then closed in 1999, as the U.S. percentage fell, but the Ohio percentage held steady or slightly increased.

State and Local Property Taxes
as a Percentage of Income

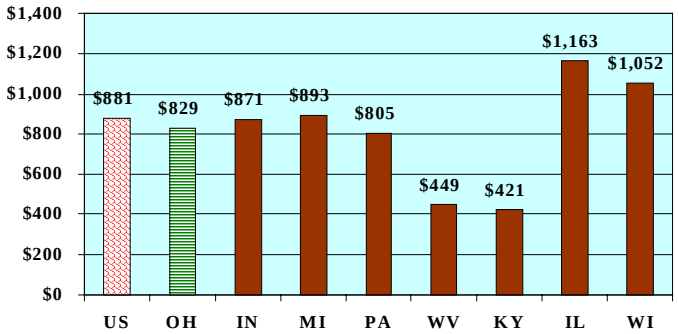


In comparing state-only property taxes, Ohio does not have a state-level property tax. However, U.S. census data does treat Ohio's Dealers in Intangibles tax as a property tax, which is a negligible amount.

When comparing state and local property taxes as a percentage of income, Ohio is equal to the U.S. average at 3.1%. Indiana is at 3.3%, Michigan at 3.2% (despite its big property tax reform), Pennsylvania at 2.8%, West Virginia at 2.1%, Kentucky at 1.8%, Illinois at 3.7% and Wisconsin at 3.8%.

This chart compares state and local property tax burdens on a per capita basis.

Per Capita State and Local Property Taxes, 1999



Rank		26	22	20	27	46	47	11	13

In examining the tax status of major categories of tangible personal property in all states and the District of Columbia, there are 12 states that fully tax inventory, including Ohio, while 35 states fully exempt inventory, and four states partially tax inventory. Ohio is among 24 states that fully tax commercial and industrial property, while 16 states partially tax such property, two states permit local taxes and nine states exempt such property.

General Tax Treatment of Selected Types of Personal Property

State	Intangible Personal Property	Household	Business Inventory	Business Depreciable Fixed Assets
California	Excluded	Excluded	Excluded	Tax
Florida	Excluded	Excluded	Excluded	Tax
Illinois	No Tax	No Tax	No Tax	No Tax
Indiana	Excluded	Excluded	Tax	Tax
Kentucky	Tax	Excluded	Tax	Tax
Michigan	Excluded	Excluded	Excluded	Tax
Minnesota	No Tax	No Tax	No Tax	No Tax
New Jersey	No Tax	No Tax	No Tax	No Tax
New York	No Tax	No Tax	No Tax	No Tax
Ohio	Excluded	Excluded	Tax	Tax
Pennsylvania	No Tax	No Tax	No Tax	No Tax
Texas	Excluded	Excluded	Tax	Tax
West Virginia	Excluded	Excluded	Tax	Tax

Source: Mikesell (1992)

Agriculture property is fully taxable in 12 states and partially taxable in 17 states. Three states permit local taxes on agricultural property and 19 states, including Ohio, exempt such property. A substantial number of states have some type of property tax on agricultural property, while Ohio does not. Household personal property is taxed in only one state and partially taxable in only four states. Ohio is one of 46 states that do not tax household personal property. Motor vehicles are exempt from property taxes in 32 states including Ohio, fully taxable in 12 states, partially taxable in three states and locally or specially taxed in four states.

Assessment levels are significantly different between the states and this is one of the complications in comparing property taxes among states. Further, tangible and real property taxes often have different rates and classification schemes. For example, Florida taxes real and intangible property at 100% of value, whereas Ohio taxes real property at 35% of value and tangible personal property at 25% of value. Ohio inventory is currently taxed at 23% and this percentage will decline to zero over the next 23 years. Assessment rates vary quite a bit from state to state.

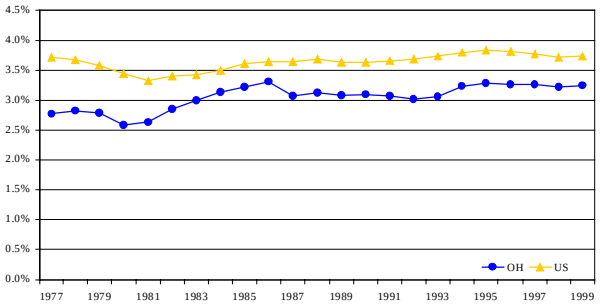
As a general impression, Ohio's property tax system is well regarded with respect to the administration of the property tax because it is a uniform system. Some other states have more local administration, which results in much more deviation from what the state law seems to say on the surface.

Sales and Use Taxes

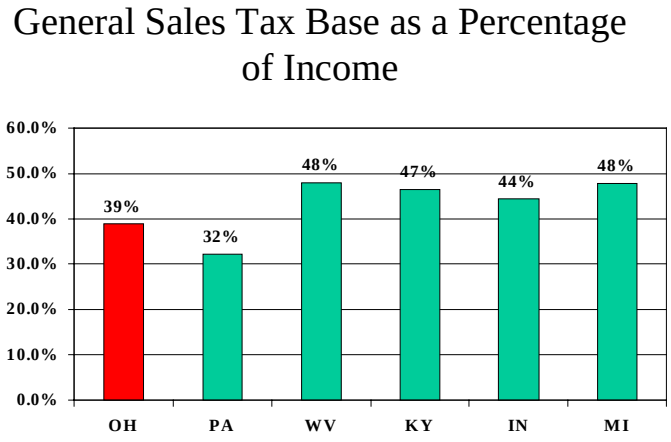
Five states are without a general sales and use tax, but usually have selective taxes or local taxes. These five are Alaska, Delaware, Montana, New Hampshire, and Oregon. Delaware is an outlier because 42% of its revenue is generated from other taxes. This is related to the unique Delaware laws that attract corporations to incorporate in Delaware. Another outlier state is Florida, which gets 52% of its revenue from the sales tax.

In reviewing the history of sales tax revenue as a percentage of income, Ohio has been consistently below the national average. The national average has been constant in the 3.5% range and Ohio has been about one-half percent below that over the last 20 years. Ohio ranks 38 out of 51 on the percentage of income used to pay state and local sales tax.

State and Local Sales and Gross Receipts
Taxes as a Percentage of Income



Looking at total state and local general sales taxes as a percentage of income, Ohio ranks 34th in the nation.

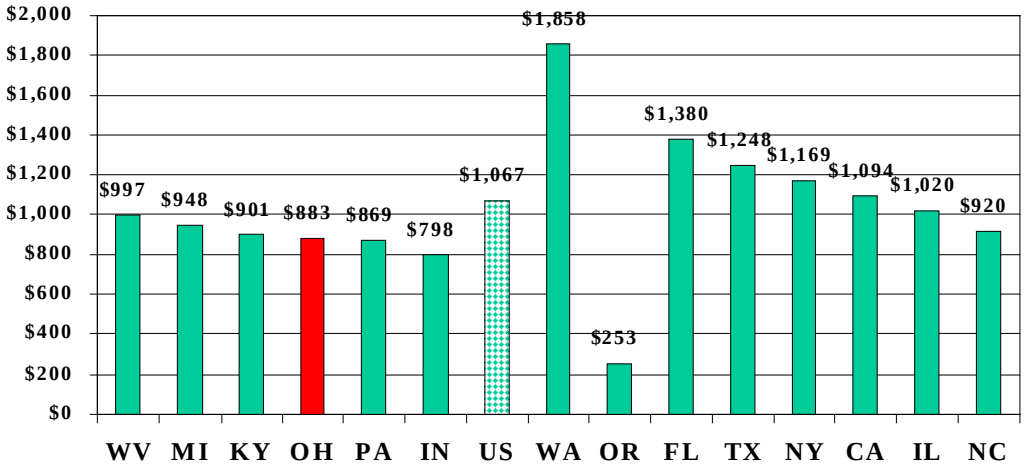


In states which have only a sales tax (and no income tax), the tax base as a percentage of income tends to be in the 50% and over range. If a state is getting most of its revenues from a general sales tax base, rather than both sales tax and income tax, then it must guard that base very jealously. As a result, Texas and Florida have large bases, which result in higher percentages of income. Hawaii's base is calculated at over 100% of income because of tourism. Another outlier is Washington state, which relies heavily on sales tax and has no income tax. Its state share was in the 75% range, which means Washington must be taxing a lot of intermediate purchases.

Another area that distinguishes state sales tax bases is the treatment of services. Ohio is basically in the mid-range of states that tax some services, but not as many as states like New Mexico, Hawaii and South Dakota. . Almost all of Ohio's competitor states exempt food. One exception is Illinois, which taxes food at a lower rate.

Looking at state and local sales and gross receipts taxes combined, Washington is over $1,800 per capita. Florida (at $1,380) and Texas (at $1,248) are also high. These states have broader tax bases and have no income tax. Ohio (at $883) and its neighbors (West Virginia - $997, Michigan - $948, Kentucky - $901, Pennsylvania - $869, and Indiana - $798) are all in a narrow range and a little below the U.S. average of $1,067.

Per Capita State and Local Sales and Gross Receipts Taxes, FY 1999



When viewing sales and gross receipts tax revenue as a percentage of income, the picture is basically the same. However, West Virginia jumps up because of its lower income levels. Washington's revenues, at 6.1% of income, are very high. Florida and Texas are around 5% of income and, also represent about half of their total state and local taxes. This results because Washington, Texas and Florida do not have income taxes. Nevada's sales and gross receipts taxes constitute 63% of total state and local tax collections. For Ohio, 30.8% of total state and local tax collections comes from the sales and gross receipts taxes. This is below the national average of 35.7% and below West Virginia (42.1%) and Kentucky (36.6%). Michigan (31.3%), Indiana (30.5%) and Pennsylvania (29.6%) are very close to Ohio.

The following chart provides a breakdown comparing state and local sales tax rates of Ohio and its competitor states. Of all its neighbors, only Pennsylvania permits local option sales tax rates. Ohio's average local sales tax rate is about 1%. Ohio's state rate of 5% combined with the local average rate of 1%, is higher than Indiana's total 5% rate and essentially equal to Kentucky, Michigan and Pennsylvania's tax rates.

State and Local Sales Tax Rates

	State Rate	Maximum Local Rate	Maximum State/Local Rate	Food Items*	Prescription Drugs	Non-Prescription Drugs
IL	6.25	2.50	8.75	T	1.00	1.00
IN	6.00	N/A	6.00	E	E	T
KY	6.00	N/A	6.00	E	E	T
MI	6.00	N/A	6.00	E	E	T
NY	4.00	4.50	8.50	E	E	E
NC	4.50	2.00	6.50	E	E	T
OH	5.00	2.00	7.00	E	E	T
PA	6.00	1.00	7.00	E	E	E
TX	6.25	2.00	8.25	E	E	E
WV	6.00	N/A	6.00	T	E	T
CA	6.00	2.50	8.50	E	E	T
FL	6.00	2.50	8.50	E	E	E

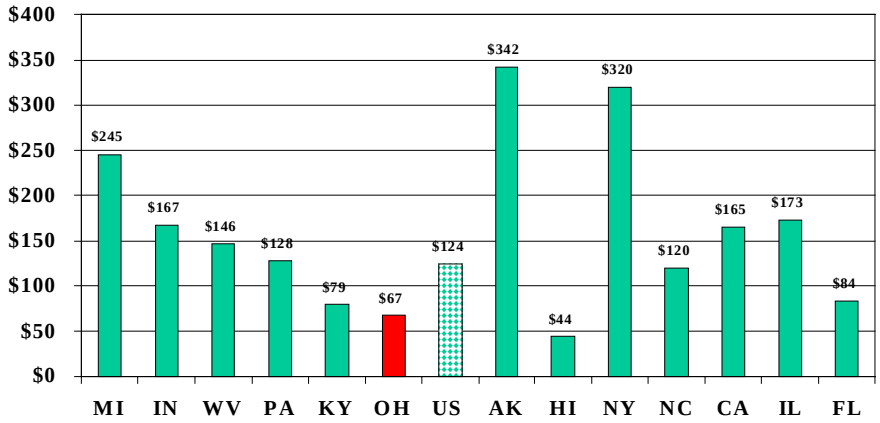
*Food purchased for consumption off-premises. IL taxes food at a lower rate than the general rate. Food subject to local rates in NC, although exempt from state sales tax. Some states tax food, but allow an income tax credit to poor households (e.g., ID, KS, SD, WY)

Looking at state and local selective sales taxes as a percentage of income, Ohio ranks 40th among the states. Ohio, at 1% of income, is below the U.S. average of 1.2%. States like Texas and Florida are pretty aggressive at 1.7% and 1.5%, respectively. Massachusetts is the low state at 0.7%.

Corporate Income Taxes

Per capita state and local corporate income tax collections in Ohio are $67 versus the U.S. average of $124. This federal statistic excludes the net worth base (if any) for all states. Even if only the Ohio net worth tax is taken into consideration, the per capita amount only increases to $96 and is still substantially below the U.S. average. Michigan (at $245), Indiana (at $167), West Virginia (at $146), Pennsylvania (at $128) and Kentucky (at $79) are all above Ohio's $67 per capita amount. Looking at state and local corporate income taxes on a percentage of income basis, Ohio is low at 0.25% versus the U.S. average of 0.43%. If the net worth base were included for Ohio, it would increase the Ohio percentage to 0.36%.

Per Capita State and Local Corporate Income Taxes, FY 1999

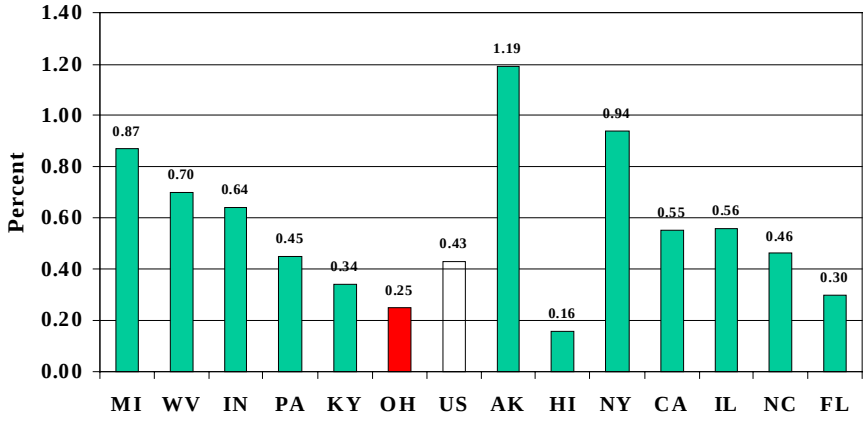


U.S. Census Bureau Data includes only Net Income taxes. If the net worth component of the franchise tax is included, **Ohio per capita corporate franchise tax would be about $96.**

Because the federal data do not include net worth taxes, Ohio's per capita taxes might appear lower because Ohio continues to subject financial institutions to tax under a net worth tax structure, while other states may tax them under an income tax structure. This could be one contributing factor to Ohio's low per capita amount relative to the other states. Other contributing factors include the ease with which tax planning can significantly reduce tax liability by shifting income to other states, as well as the expanded use of pass-through business entities (S corporations, partnerships, etc.).

When comparing total corporate income taxes as a percentage of total state and local tax collections, Ohio's 2.3% is below the national average of 4.2%. All of Ohio's neighbors and competitor states have a higher share of corporate income tax in the total state and local revenues than Ohio.

State and Local Corporate Income Taxes
as a Percentage of Income, FY 1999



If the net worth tax component of the franchise tax is included, Ohio franchise taxes as a percent of income would be 0.36%

Motor Fuel Tax

Ohio imposes a tax of $0.22 per gallon on the sales of motor fuel used for highway purposes. At first blush, Ohio has a higher tax rate than any of its neighbors, including Michigan at $0.17, West Virginia at $0.20, Pennsylvania at $0.12, Indiana at $0.15, Kentucky at $0.15 and Illinois at $0.19.

But Pennsylvania and West Virginia impose additional taxes on motor fuel, increasing their effective tax rates to $0.266 per gallon and $0.25 per gallon, respectively. Further, Illinois, Indiana and Michigan also include motor fuel in the sales tax base. Considering all taxes imposed on motor fuel, Ohio has a higher tax rate than Indiana and Kentucky, but a lower tax rate than all other neighboring states.

The average U.S. rate is about $0.20 per gallon, without including the extra taxes imposed by other states (such as those described above for Pennsylvania and West Virginia). But, this figure does include additional cents per gallon taxes imposed on commercial trucking (as imposed by Ohio and other states).

Ohio's tax rate has been $0.22 per gallon since 1993. The tax was initially imposed in 1926 at a rate of $0.02 per gallon. Between 1987 and 1993, the tax rate increased from $0.12 per gallon to $0.22 per gallon.

Conclusion

At least three primary areas of difference between Ohio and its neighbors and competitors stand out as follows:

1. The local income tax is a big difference. Ohio has it and uses it heavily, while most states do not have this tax;
2. Tangible property tax on inventory is substantial and most states do not tax inventory; and
3. Ohio's corporation franchise tax rate is relatively high, but the tax has low productivity.

V. "New Economy" Considerations

Ohio's tax system is a product of a bygone era. The basis of Ohio's real property tax dates back to 1799 and the Northwest Territory's first tax on land.[3] Ohio's corporation franchise tax was enacted in 1902.[4] The tangible personal property tax as it is known today became effective in 1931.[5] Ohio's sales tax became effective on January 1, 1935. One year later, Ohio's use tax became effective. Finally, in 1972, Ohio adopted a personal income tax and modified the corporation franchise tax to include an income measure.

The economy has changed significantly since these taxes were enacted. The Committee invited Dr. Robert Tannenwald, Assistant Vice President and Economist of the Federal Reserve Bank of Boston, to give a presentation entitled "Are State and Local Revenue Systems Becoming Obsolete?" (or "The Emerging Economy and Tax Structure Issues?"). Much of the discussion below is based on Dr. Tannenwald's presentation.

Dr. Tannenwald began his presentation by noting that throughout history, cities, states, and tribes have structured their tax systems so that they are designed to meter the stock of assets and flows of economic activity that are richest in their jurisdictions.

Five forces are eroding revenue productivity of state and local taxes. They include the following:

a) Households spend more on services and less on goods;
b) Businesses produce more services and fewer goods;
c) The nation is becoming an increasingly "knowledge-based" economy;
d) E-commerce is proliferating; and
e) Inter-jurisdictional tax competition is intensifying.

The nation is becoming more of a service rather than a goods economy. The nation's consumption and production are shifting in character dramatically and have been for some time. Services' share of U.S. consumer spending rose from 40% in 1959 to 58% in 2000. The increase was primarily in medical care services, financial services, recreation services, and education and research services.[6] Simultaneously, nondurable goods' share of U.S. consumer spending fell from 47% in 1959 to 30% in 2000.[7]

The shift to a service economy is a problem because services tend to be tax-exempt. When sales taxes were first established, the value of services was especially hard to measure. The typical service provider was small and didn't keep very complete records. Services were less important to the economy, and tax administrators decided the revenue was not worth going after. The services that kept better records also tended to be politically powerful (lawyers, accountants, consultants, etc.).

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[3] *Ohio Taxation*, Charles F. Glander, editor, 1967.
[4] *Ohio Corporate Franchise Tax – A Brief History*, G. Peter Angus, 1999.
[5] Source: Ohio Department of Taxation, Personal Property Tax Division (Rick Anthony, Administrator).
[6] *Survey of Current Business*, March 2001, Federal Bureau of Economic Analysis.
[7] Ibid.

As services, which tend to be tax exempt, are becoming a more important component of the economy, the sales tax base erodes relative to the size of the economy as a whole.

Five classes of items in the universe of all transactions are potentially subject to sales tax:

a) Generally taxed consumer purchases;
b) Tax-preferred consumer purchases;
c) Items purchased by generally tax sheltered industries (especially manufacturers);
d) Tax-preferred items purchased by unsheltered industries; and
e) Taxed items purchased by unsheltered industries.

Only two classes of potentially taxable transactions are generally taxed: taxed consumer purchases [(a) above] and taxed items purchased by unsheltered industries [(e) above]. As a percentage of potentially taxable transactions, these two have shrunk very little. Tax-preferred consumer purchases [(b) above] are growing as a percentage of consumer purchases. Purchases by generally sheltered industries (especially manufacturers) [(c) above] are shrinking as a percentage of all business purchases. Tax-preferred items purchased by unsheltered industries [(d) above] are growing as a percentage of total purchases by unsheltered industries. One of the sales tax's long-term problems, then, is that the ratio of total potentially taxable sales to GDP produced in the private sector has fallen sharply, because business-to-business purchases have become less important to the economy. The reason is that ours has become more of a knowledge-based economy. The evidence can be seen in the growing importance of intangibles. The consequence of this phenomenon is less sales tax revenues generated by pyramiding.

It is important to realize that even a comprehensive sales tax base (pure gross receipts tax) might continue to fall relative to GDP, and that including services in the base would mitigate, but not eliminate, erosion of the sales tax base relative to GDP.

The implications of a service-based and knowledge-based economy also apply to the property tax. The conventional wisdom is that the service economy erodes the property tax base. The property tax is a tax on capital. Services are less capital-intensive than manufacturing, so a shift to services erodes the property tax base. However, in practice, services and retail are generally more intensive in realty than manufacturing (office buildings, malls). This line of thinking would imply that a shift to services bolsters property tax. The ratio of realty to personalty nationwide has changed little in 25 years. Sectors relatively intensive in realty did grow relatively rapidly, and also inventories were pared (inventory management improved). On the other hand, all sectors have become more intensive in machinery and equipment. The growing importance of intangibles is also a major issue for property tax.

If a state got rid of every exemption in the sales tax, it would get a tremendous increase in revenue and could afford to lower rates and that would be a good thing. Generally, higher rates tend to introduce distortions in the economy. Any distortion of economic decisions reduces the overall efficiency of the economy.

Many problems are also created by the rise of e-commerce. E-commerce has been estimated to be the cause of the loss of one percent of total state revenues in 2001, with the percentage loss projected to rise to three percent by 2011. Federal law banning sales taxation of e-commerce only forbids taxes targeted on e-commerce alone or on the related telecommunications. One solution would be to minimize the inequity between "brick and mortar" retailers and remote sellers by means of a simplification and coordination of all state sales taxes, as intended in the Streamlined Sales Tax Project.

Another area of concern and change relates to the state taxation of financial institutions. Until recently, each type of financial institution tended to have a unique tax regime because of the unique role each used to play before deregulation. The resulting distortion and inequities were acceptable because different types didn't compete. Regulation segmented financial markets. With deregulation and intense competition, distortions and inequities intensified, leading to calls for change. In Massachusetts, each type of financial institution lobbied the legislature in separate campaigns to reform their tax regime, with little comprehensive planning. As a result, after reforms, winners and losers have changed positions, but the degree of inequity and distortion has changed little. There remains a wide dispersion in effective tax burdens. Comprehensive tax reform for formerly regulated industries is still needed.

Conclusion: The Committee finds that a broad tax base and lower tax rates are the best tax policy. It is generally agreed that broadening the sales tax base will mitigate the long-term decline of the sales and use tax. Further, if the tax base is broadened, then the result is a more level playing field and fewer decisions and choices of allocations based on taxes. Tax rates increase the amount of distortions by the square of the increase, as is often proven in public finance classes. Therefore, the best situation is to broaden the tax base and lower the tax rates.

VI. Economic Development Considerations

As defined by the International Economic Development Council, economic development is "the creation of jobs and wealth, and the improvement of quality of life. Economic development encompasses three major areas, including . . . [p]olicies and programs explicitly directed at improving the business climate through specific efforts, business finance, marketing, neighborhood development, business retention and expansion, technology transfer, real estate development and others."

Included among the generally accepted "Guiding Principles" of a quality tax system is Competitiveness, wherein a tax system should not impose excess burdens on taxpayers, particularly when compared to the tax systems of other states. The Committee recognizes, as it relates to economic development considerations and competitiveness, that tax reform must aim to maximize the state's ability to foster vibrant economic development and cultivate economic prosperity for all Ohio residents. The Committee agrees that a sound and competitive tax structure helps support business development and is likely to entice business decision-makers to locate and expand their operations in Ohio.

The Impact of Taxes on Economic Development

While there are many factors that drive business decisions**,** taxes also play a role in the business site selection process. The extent of this role has been debated for years, with conflicting conclusions. The range of opinions regarding the relative importance of taxes is reflected in the statements that have come to the attention of the Committee.

Placing taxes high in importance, Ohio University Professor Richard Vedder has concluded that high taxes minimize business growth. This conclusion is supported by his study on the subject of Ohio's tax system presented to the House Select Committee on Tax Reform. Professor Vedder found that relatively low-tax states grew nearly one-third faster than high-tax states.

Expressing more of a middle ground, the Committee also notes that according to Area Development Magazine's survey of corporate real estate managers, tax exemptions, corporate tax rates, and state and local incentives are more important factors in the selection process than the cost of land, proximity to major markets or even union profile. Similarly, in testimony before the Committee, the Ohio Chamber of Commerce stated, "…while we acknowledge that factors other than taxes influence the location/expansion/investment decisions of companies, there can be no doubt that the relative state and local tax burden is a significant, bottom-line factor in any economic development project competition with our neighboring states or other higher-growth states."

Finally, Professor William Fox, Director of the Center for Business and Economic Research at the University of Tennessee, indicated in his appearance before the Committee, "At the very least, tax burdens must be reasonable relative to Ohio's neighboring states."

A reasonable tax burden translates to one of the Committee's Guiding Principles: competitiveness. The competitiveness principle states that the tax system should not place an undue burden on taxpayers. In short, the competitiveness principle draws attention to those aspects of state tax structure that stand out unfavorably when compared to other states.

Ohio's Outliers

Property Taxes: 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. While capital-intensive businesses have heavy tangible personal property tax burdens, they also tend to have significant real property investments, pay high wages and constitute an integral part in the life of local communities. As Professor Edward Hill of Cleveland State University indicated in a recent report prepared for the Ohio Manufacturers' Association, "The problem is with the structure of taxation, the way it penalizes Ohio's demonstrated competitive advantage, and (most seriously of all) the way it provides disincentives for investing in both productivity-enhancing capital and new ventures – which are at the foundation of income growth in the state."

The manufacturing industry is one of Ohio's core industries. Ohio is known for its innovative advanced manufacturing. Yet some neighboring and other key states such as Pennsylvania, Illinois, Wisconsin, New Jersey, New York and Maryland either impose no tax on personal property or exempt manufacturing equipment from taxation. If Ohio wishes to foster growth in its manufacturing industry, the state has no choice but to address this aspect of its tax structure.

Within the tangible personal property tax, the inventory tax presents its own issues, in particular during a recession when inventories are high. Most states do not tax inventory. In fact, Ohio is one of only 16 states with an inventory tax. Of particular note from a competitiveness perspective, Michigan, Illinois, Pennsylvania and New York do not tax inventory.

Corporation Franchise Tax: At a minimum, Ohio's corporation franchise tax rates are perceived as high. This perception has an adverse impact on business site selection decisions. As indicated by Development Director Bruce Johnson, prospective companies often eliminate Ohio from further site selection consideration based solely on reported tax rates. To illustrate this point, material presented to the Committee by Professor Fox shows that among a list of 16 states (including Ohio neighbors West Virginia, Indiana, and Kentucky) only West Virginia has a corporate tax rate higher than Ohio.

Even though the Ohio tax rate is high, the state does not rely heavily on corporation franchise tax as a revenue source. The Legislative Service Commission reported in a 13-state comparison, which included six states from Professor Fox's chart, that only Hawaii collected fewer corporate taxes as a percentage of total tax collections. Also, the Department of Taxation testified that actual collections from Ohio's corporation franchise tax have declined

since 1998 – two years before the economy softened. This outcome is more related to the structure of the tax than the vagaries of the economy. Finally, data from the U.S. Census show that Ohio's corporation franchise tax raises $67 per capita, while the national average is $124 per capita. In short, Ohio's high tax rate disguises the evident weakness of the tax as a state revenue source.

The Committee recognizes that from an economic development perspective – high rates and low collections represent a serious problem. Making the tax more productive while lowering the corporation franchise tax rate would represent real progress in making this tax more competitive with other states' business income taxes.

Municipal Taxes: Ohio is one of few states to allow municipal corporations to impose an income tax on individuals and businesses. In fact, Ohio and Pennsylvania are the only two states that have such a broad–based local income tax system. In Ohio, 541 municipal corporations presently levy this tax. While some Ohio municipalities join together for administration of the tax, the sheer number of municipalities levying the tax creates a significant burden on businesses, particularly those that operate in many jurisdictions.

In addition to the sheer number of municipalities that levy the tax, the municipal tax structure itself is cumbersome and complicated, as was indicated by a variety of witnesses before the Committee. The lack of uniformity among municipalities in the definition of the tax base and in filing dates adds to the competitive issues raised by the very existence of the tax. According to testimony, businesses are forced to devote enormous time and money to compliance issues associated with Ohio's municipal income tax process. In fact, according to testimony before the Committee, the cost of complying with the tax (determining liability and completing and filing forms) can actually exceed the amount of tax owed.

The Committee notes the history of Ohio's strong municipal system of government as a net advantage to this state. The reliance on municipal income taxes has undoubtedly contributed to that strength. Still, the Committee believes that the state and municipalities ultimately will reap the benefits of a more uniform municipal income tax system.

Personal Income Tax: Personal income tax rates, when coupled with city income taxes, are high and also viewed as a non-competitive factor. States such as Florida, Texas, Tennessee and Nevada have no income tax. Others, including many of Ohio's neighbors, have lower tax rates than Ohio. These states are much more attractive to corporate executives responsible for making site selection decisions.

Incentives

To balance the non-competitive aspects of the state's tax climate, Ohio has relied on various incentive programs to level the playing field. Many companies have found that these added resources provide the stimulus to move their projects forward in Ohio. Kenney McDonald with Flour Corp. noted in the January issue of Area Development Magazine, "While there is always strong debate in both the public and private sectors about the incentive game, the fact

remains that incentives matter. A strong incentive package can substantially enhance the inherent advantages of a location; more important, it can reduce the risk of your capital investment."

Most states, if not all, provide some form of incentives to promote economic development. The National Association of State Development Agencies recently catalogued 1,105 business incentives from all 50 states. Of that total, 445 or 40% were tax-based.

Ohio provides key tax incentive programs such as enterprise zones and job creation tax credits to offset the competitive disadvantage of the tangible personal property tax. While there have been many debates over the need for tax incentive programs, they continue to be significant resources for communities engaged in promoting business development and expansion. For example, the total investment commitment for all active enterprise zone agreements as of December 31, 2001 stands at $38.5 billion, a 9.7% increase over 2000 reported agreements. Job commitments represent the creation of more than 11,000 jobs and the retention of more than 23,000. Of the 272 agreements entered in 2001, nearly 37% included some level of school compensation payment in conjunction with the project. Through the job creation tax credit program, companies have committed to invest more than $11.8 billion in fixed assets, while creating more than 92,000 jobs in Ohio.

Still, questions continue as to whether or not these resources are necessary to foster business growth, and whether Ohio should "unilaterally disarm" these programs. The Committee agrees with the earlier 442 Study Committee Report conclusion that Ohio is not ready to relinquish these incentive programs. These programs balance the equation by reducing the cost of capital expenditures. Until Ohio makes significant progress in reducing the burden of the personal property tax, these incentives will be needed to make Ohio attractive for business investment.

Conclusion

The Committee acknowledges that in working to establish a tax reform policy that fosters economic growth, Ohio must recognize the existence of national and international competition in the arena of business attraction and economic development. It is imperative that the state designs a tax policy that enhances Ohio's competitive position to create wealth and investment.

In his 2002 State of the State address, Governor Bob Taft proposed the Third Frontier Project, the most significant state investment ever, to generate and apply knowledge to high-wage, high-growth job creation and economic growth. In many ways the success of the Third Frontier Project, which has already initiated public focus on issues of economic development and global competition, is linked to tax reform insofar as tax policy is linked as a tool necessary for economic growth.

Fostering the state's business climate is a complex equation. There are nine essential components for a growing economy, according to the Ohio Business Roundtable: leadership,

customers, suppliers, infrastructure, talent, technology, capital, research and business climate. Ohio's ability to structure a sound, overall tax policy and positive business climate will only enhance growth prospects in the state. Perhaps an additional note from Professor Edward Hill is most fitting. He indicates, "The business tax code is a relic from Ohio's economic past, not a gateway to the future . . .. Changes should be strategic, tied to specific and economically viable economic development goals that benefit the residents of the state and encourage the long-term fundamentals of wealth creation."

VII. Identification of Obstacles and Options for Ohio Tax Reform

CORPORATION FRANCHISE TAX OBSTACLES

Simplicity: A major distinction between Ohio's corporation franchise tax and that of other states is Ohio's failure to conform to the Uniform Division of Income for Tax Purposes Act ("UDITPA"). Currently, most states adopt UDITPA's approach for determining apportionment and allocation of business income and nonbusiness income.[8] All Ohio's neighbors except Michigan use UDITPA, as does Illinois. Note though, that for business income taxed through the personal income tax (S-corporation income, partnership income, trust income, etc.), Ohio does use the UDITPA business/nonbusiness approach. This is a complicating factor that could be eliminated to achieve greater simplicity and uniformity in state taxation of business income.[9]

The tax includes a variety of special provisions targeted to certain activities or sectors. These provisions complicate the tax and may not serve purposes that are important enough to warrant the special treatment.

Equity: The failure of Ohio to follow the UDITPA business/nonbusiness distinction not only complicates Ohio tax calculations for multistate corporations, but also means that income that is allocated in other states (and wholly taxed by those states) is apportioned in Ohio (and partially taxed by Ohio), and vice versa. In short, Ohio may tax the same corporation income that is taxed by other states. One purpose of UDITPA is to minimize this possibility.

The Committee also found that some corporations, generally large ones, have the resources to plan their business transactions to minimize their Ohio corporation franchise tax liabilities. Planning techniques may involve the use of "transfer payments" where the Ohio corporation

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[8] When corporations do business in more than one state, any given state only taxes a portion of that corporation's income. Allocation and apportionment is the process of determining what or how much of the corporation's income is taxed by a particular state.

[9] Under the **"business income/nonbusiness income method,"** a company must apportion all types of trade or business income (e.g., profit or loss from selling goods and services, interest and dividends from working capital investments, gains and losses from the sale of assets used in the business, and profit or loss from rental activities—if such activities constitute an active trade or business). Under this method, only income derived from activities not constituting an active trade or business is nonbusiness income, which is allocated either entirely <u>into</u> the state (if the income comes from that state) or <u>out</u> <u>of</u> the state (if the income does not come from that state).
Under the current **"Ohio method"** of treating income, a company must allocate certain types of statutorily listed income, and must apportion everything else.
For further discussion of the business/nonbusiness income method and the Ohio method, see Appendix C.

makes payments to out-of-state related entities, thereby reducing Ohio income. The related entities may have corporate or non-corporate structures. The use of aggressive tax planning leaves smaller corporations bearing proportionally more of the tax burden than larger, more aggressive firms.

In regard to horizontal equity, the Committee found that some corporations are paying more or less than their competitors in similar industries. This is especially true in light of recent deregulation of certain industries. In Ohio, local telephone companies bear a greater tax burden than other corporations that are providing local telephone service and other related telecommunications services. Also, certain financial industry companies, such as dealers in intangibles, are treated more favorably than other businesses within the same industry.

The corporation franchise tax has both a net income and a net worth basis, with taxpayers computing tax both ways, and paying under the method that imposes more tax. The net worth tax provides a modest safety net to protect state revenues during economic downturns and from aggressive tax planning by large taxpayers (see **Stability**). It also helps ensure that all corporations, including large corporations that do not earn large Ohio profits, but significantly benefit from state services, pay their fair shares of tax. To address concerns that the net worth tax was a disincentive to investment and hurt non-profitable, highly capitalized businesses, in 1997 the General Assembly capped net worth tax liability at $150,000. While the net worth cap addresses these concerns, beneficiaries of the cap benefit from the provision of state services, and equity also calls for those taxpayers helping to pay for those services.

Stability: Any corporation income tax is subject to the fluctuations associated with the economy. Historically, in Ohio these fluctuations have been mitigated through the net worth tax base. The minimum tax calculation also provides extremely modest protection against economic fluctuations. As noted above, the net worth tax is now capped at $150,000, making the tax even more sensitive to economic fluctuations. Further, the minimum tax was at $50 in 1960 and, 43 years later, remains at $50 today. If adjusted for inflation, the minimum tax would be $300.

Aggressive tax planning has also affected corporation franchise tax revenues. The Committee found that while Ohio's combined state and local tax rate is high in relation to its competitors (see **Competitiveness**), the tax is not as productive as should be expected with such a high rate. For example, the Ohio corporation income tax raises approximately $67 per capita, while the national average figure is $124 per capita.[10] Clearly, this productivity issue is unrelated to the recent economic downturn, since all states have experienced this downturn, yet continue to collect more tax per capita with lower tax rates. Recent expansion of business tax incentives has also contributed to the tendency of the Ohio tax to raise less than other state's corporation taxes.

Neutrality: To the extent that tax planning opportunities encourage corporations to restructure operations, the tax could be viewed as non-neutral. Much of the restructuring

[10] Source: Legislative Service Commission testimony to the Committee, August 27, 2002, based on U.S. Census Bureau data.

may have little effect on actual business operations, but can dramatically reduce taxes. Also, certain tax incentive provisions have been added to the law specifically to encourage certain activities (for example, the new jobs credit and the manufacturing investment credit). These tax incentives were adopted with the understanding that the public policy goal of encouraging these actions outweighed the tax policy goal of neutrality. Finally, business may choose to organize in a non-corporate structure in order to avoid the corporation franchise tax, paying the personal income tax instead. Various differences exist in the calculation of tax on personal income as compared to the corporation franchise tax. For example, different tax rates and apportionment or allocation provisions apply.

Competitiveness: While the corporation franchise tax is not very productive as compared to other states, the highest corporation franchise tax rate on income of 8.5%, combined with the average municipal income tax rate of nearly 1.5%, creates the appearance of an unusually high tax burden. This can make Ohio appear unattractive in relation to its competitor states. This effect is often reflected in national comparisons of state taxes that focus on such factors as tax rates. The chart on the following page presents the maximum corporate income tax rates for all states.

Maximum Corporate Income Tax Rates for All States[11]

State	Max. Corporate Income Marginal Rate	State	Max. Corporate Income Marginal Rate
Alabama	6.5%	Montana	6.8%[12]
Alaska	9.4%	Nebraska	7.8%
Arizona	7.0%	Nevada	No tax
Arkansas	6.5%	New Hampshire	8.5%
California	8.8%	New Jersey	9.0%
Colorado	4.6%	New Mexico	7.6%
Connect.	7.5%	New York	7.5%
Delaware	8.7%	North Carolina	6.9%
Florida	5.5%	North Dakota	10.5%
Georgia	6.0%	**Ohio**	**10.0%**[11]
Hawaii	6.4%	Oklahoma	6.0%
Idaho	7.6%	Oregon	6.6%
Illinois	7.3%[13]	Pennsylvania	10.99%[11]
Indiana	8.5%	Rhode Island	9.0%
Iowa	12.0%	South Carolina	5.0%
Kansas	7.4%[14]	South Dakota	No tax
Kentucky	8.3%	Tennessee	6.5%
Louisiana	8.0%	Texas	4.5%
Maine	8.9%	Utah	5.0%
Maryland	7.0%	Vermont	9.8%
Massachusetts	9.5%	Virginia	6.0%
Michigan	1.9%[15]	Washington	No tax
Minnesota	9.8%	West Virginia	9.0%
Mississippi	5.0%	Wisconsin	7.9%
Missouri	6.3%	Wyoming	No tax

[11] Source for state rate is Commerce Clearing House (CCH) Multistate Charts - Tax Year 2002. Because Ohio and Pennsylvania are the only states with such broad local taxes on corporations, only the Ohio and Pennsylvania tax rate includes locally imposed taxes. For Ohio, the local rate is assumed to be the average municipal income tax rate of 1.5%. For Pennsylvania, the typical local rate of 1% is included. Other states with local taxes on corporations are generally limited to large, specific cities within those states.
[12] Rate is 7% for taxpayers making waters' edge election.
[13] Includes Illinois' Personal Property Replacement Tax rate of 2.5%, which is imposed on all businesses.
[14] Plus 3.35% surtax on income > $50,000.
[15] Michigan Single Business Tax starts with income, but is adjusted to eliminate payroll and depreciation, and to deduct capital expenditures. This tax is being phased out by Michigan.

CORPORATION FRANCHISE TAX OPTIONS

To overcome the obstacles described above, the Committee has identified the following options:

1. Adopt a Combined/Unitary Income Tax Base. The broadest tax base includes the use of a unitary theory of income taxation. Unitary taxation is a constitutionally sanctioned tax system that treats corporate groups as a single business enterprise for income tax purposes. The result is a more fair tax picture for a business enterprise. This approach reduces many of the tax planning opportunities that affect the current Ohio tax. Many states that have had significant economic development during the past decade utilize unitary taxation, including California, Colorado and Illinois. In all, 16 states[16] currently utilize unitary taxation.

The **"combined group tax"** approach means that affiliated companies combine their incomes. As such, inter-company profits and losses are eliminated as part of the combination of income. While income is allocated and apportioned with respect to the combined group, each corporation with nexus with the state files its own separate return.

As an alternative, the state could offer corporations the option to file a **"consolidated return"** with the same affiliates as participate in the filing of the U.S. consolidated income tax return. Under this approach, the group would allocate and apportion income as if one corporation had earned all the income, and the group will pay tax as a single unit. (The consolidated return group is not limited to those having "unitary" activities and profits.) Like the "combined tax returns" presentation, the impact of inter-company transactions are effectively neutralized as part of the consolidation of income process.[17]

2. Broaden the Tax Base, Eliminating a Substantial Portion of Special Interest Deductions and Tax Credits. Ohio currently provides 43 special deductions and tax credits[18] against the corporation franchise tax. Reducing the number of these special provisions would contribute to simplicity, stability and neutrality. Ohio should eliminate those deductions and credits that would not significantly harm the competitiveness or equity of Ohio's tax system. For example, under Ohio law businesses effectively deduct the amount of income taxes paid to other states from net income. This provision could be eliminated without substantially harming Ohio's competitiveness because Ohio is one of only 12 states that provide this benefit.

3. Adopt a Throwback Rule for Sales Factor Apportionment Purposes. While one purpose of allocation and apportionment is to ensure that more than one state does not tax the same income, under the Ohio system it is also possible that some income is not taxed at all. This occurs when a corporation makes sales into a state without an income tax or where the corporation cannot be taxed (because it does not have nexus). These sales are

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[16] Source: *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States*, Michael Mazerov, April 9, 2002.
[17] For further explanation of combined and consolidated reporting, see Appendix D.
[18] Source: Ohio Department of Taxation *Tax Expenditures Report*, January 2001.

often referred to as "no-where" sales. Sophisticated corporations can create no-where sales through transactions with related entities. Of the 46 states with a corporate income tax, 24 have adopted a throwback provision that treats these no-where sales as sales from the state of origin. A neighboring state with a throwback rule is Indiana. Other competitor states with throwback rules include California, Colorado, Illinois, and Texas.[19]

4. Increase the Net Worth Cap. The net worth tax has negative aspects, which the cap addresses, and for that reason Ohio should retain a net worth cap. However, the Committee does not believe $150,000 is the appropriate level of the cap. Large corporations with low incomes continue to benefit from the services provided by state and local governments. It is appropriate that the value of those services be more properly matched to taxes owed.

5. Adopt UDITPA Treatment of Business and Nonbusiness Income. This change will reduce the complexity of the Ohio corporate tax system, particularly for multistate taxpayers, and will make the taxation of business income under the Ohio personal income tax and corporation franchise tax more consistent.

6. Retain Net Operating Loss Deductions. In general, the allowance of a Net Operating Loss (NOL) deduction carryover better reflects the true economic results of a business enterprise over time and represents an appropriate tax policy. However, the Committee also recognizes that many NOLs can be artificially created through aggressive tax planning, particularly by shifting income from Ohio entities to related non-Ohio entities. Where NOLs have been created under planning strategies that the General Assembly has attempted to eliminate, the NOLs that arose from those planning strategies should not be permitted to continue. Overall, though, the Committee recommends against limiting the NOL deduction unless temporarily required to smooth the revenue impacts associated with the other recommended changes to Ohio's tax law.

7. Lower the Top Corporation Franchise Net Income Tax Rate and Eliminate the Brackets. The combined top state income tax rate of 8.5% and local average rate of 1.5% places Ohio's combined corporate income tax rate at 10% or more. On its face, this is a high tax rate, which can place Ohio at a competitive disadvantage. In addition to lowering the rate, the lower (5.1%) bracket should be eliminated. The most recent data show that only 14% of corporations pay at just the 5.1% rate. The other 86% of net income taxpayers will lose the benefit of this bracket, but they will benefit from the reduced tax rate. Most states have single tax rates for corporations. For example, Ohio's neighboring states with a single tax rate are Indiana (8.5%), Michigan (1.9%)[20], Pennsylvania (9.99%) and West Virginia (9%). Ohio's competitor states that have a single tax rate include California (8.84%), Colorado (4.63%), Florida (5.5%), Georgia (6%), Illinois (7.3%)[21], New York

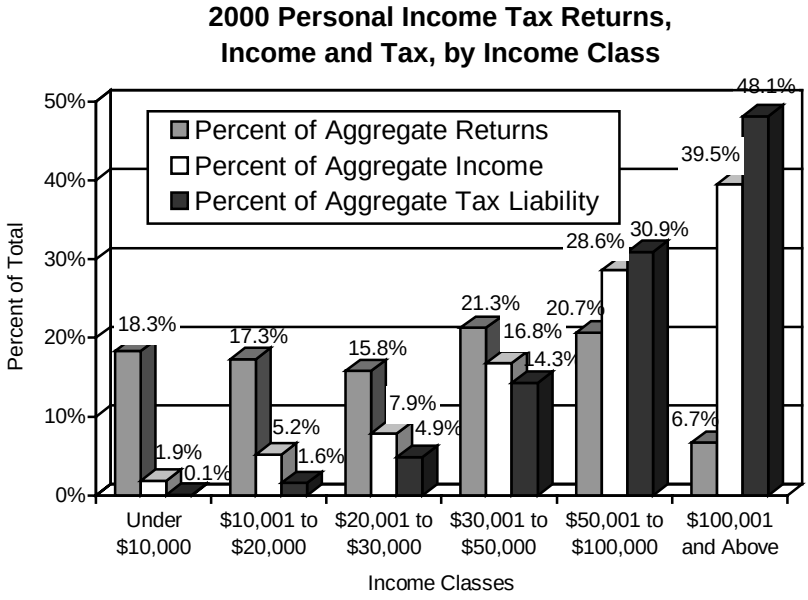
[19] Source: Panel Publishing, *2002 Multistate Corporate Tax Guide*.
[20] Michigan Single Business Tax, which generally includes income adjusted to include payroll and depreciation, but excluding capital investment.
[21] Rate includes the 2.5% rate for Illinois' personal property replacement tax, which is based on income.

(7.5%), Texas (4.5%) and Wisconsin (7.9%). (Elimination of the Litter Tax could also improve Ohio's competitiveness.)

PERSONAL INCOME TAX OBSTACLES

Simplicity: Ohio's personal income tax was first effective in 1972. At that time, both the long and short forms were contained on a single form about the size of a postcard. Today, those two forms are comprised of four full pages. (See Appendix B to compare the 1972 and 2002 tax returns). The primary reasons for this disparity are the number of exemptions, credits, deductions, add-backs and check-offs that have been added over the last 30 years. Further, the 1972 tax had six tax brackets, while today's tax has nine brackets. This evolution has increased the complexity of the personal income tax. As the tax becomes more complicated, the cost taxpayers incur to comply also increases, which effectively increases the cost of taxes. Further, the integrity of the tax comes into question by taxpayers who see all these credits and exemptions on the tax return, but never get to utilize them. When a tax's integrity is harmed, compliance also suffers.

Equity: The Ohio income tax uses a highly progressive tax rate schedule. In the eyes of many observers, progressive taxation appropriately addresses vertical equity, while in others' opinions, proportional taxation (as reflected in a flat tax) adequately addresses vertical equity. The following chart compares the personal income tax burden by income group.



Most taxpayers do not benefit from the many added exemptions, credits, deductions and adjustments that are a part of the current tax. While some of these contribute to vertical and horizontal equity, others can significantly detract.

Stability: The personal income tax provided 46.4% of total state revenue in FY 2001.[22] Therefore, it is an important revenue source. However, it is subject to fluctuations in the economy. For example, the recent fluctuations in the amount of capital gains realized have had a dramatic impact on the productivity of this tax, both a positive impact in the late 20th century and a negative impact in the early 21st century.

Neutrality: The personal income tax is generally neutral, and does not drive economic decisions among similarly situated taxpayers, except in limited circumstances. For example, prior to the passage of Am. Sub. S.B. 261 in 2002, trusts generally were exempt from taxation in Ohio. As a result, taxpayers established trusts to avoid the personal income tax. The taxation of trusts clearly contributes to the neutrality of the personal income tax. However, the tax only continues through 2004. As a result, taxpayers will change their behavior in anticipation of the expiration of the tax.

It is commonly asserted that higher income retirees move their residences from Ohio to a no-income-tax or low-income-tax state in order to avoid the high Ohio income tax rates. Short of eliminating the Ohio personal income tax, lowering the tax rate would mitigate the tax benefit of leaving Ohio.

Competitiveness: The highest marginal state income tax rate of 7.5%, combined with the average city income tax rate of 1.5%, and perhaps combined with the school district income tax in some areas, places Ohio at a competitive disadvantage in attracting high-paying jobs. The chart on the following page illustrates the state personal income tax rate for all states.

[22] Source: Ohio Department of Taxation, *2001 Annual Report*, Chart 3 – General Revenue Fund Tax Sources.

State Personal Income Tax Rates for All States[23]

State	Max. Personal Income Marginal Rate	State	Max. Personal Income Marginal Rate
Alabama	5.00%	Montana	11.00%
Alaska	No Tax	Nebraska	6.68%
Arizona	5.04%	Nevada	No Tax
Arkansas	7.00%	New Hampshire	See Note[24]
California	9.30%	New Jersey	6.37%
Colorado	4.63%	New Mexico	8.20%
Connect.	4.50%	New York	6.85%
Delaware	5.95%	North Carolina	8.25%
Florida	No Tax	North Dakota	5.54%
Georgia	6.00%	**Ohio**	**9.0%[25]**
Hawaii	8.25%	Oklahoma	7.00%[26]
Idaho	7.80%	Oregon	9.00%
Illinois	3.00%[27]	Pennsylvania	3.80%[28]
Indiana	3.40%	Rhode Island	See Note[29]
Iowa	8.98%	South Carolina	7.00%
Kansas	6.45%	South Dakota	No Tax
Kentucky	6.00%	Tennessee	See Note[30]
Louisiana	6.00%	Texas	No Tax
Maine	8.50%	Utah	7.00%
Maryland	4.75%	Vermont	See Note[31]
Massachusetts	5.30%[32]	Virginia	5.75%
Michigan	4.10%	Washington	No Tax
Minnesota	7.85%	West Virginia	6.50%
Mississippi	5.00%	Wisconsin	6.75%
Missouri	6.00%	Wyoming	No Tax

[23] Source: CCH Multistate Charts - Tax Year 2002. Only the Ohio and Pennsylvania tax rate includes locally imposed taxes (see Footnotes 25 and 28). Other states with local taxes on individuals are generally limited to large, specific cities within those states.
[24] An income tax is imposed on interest and dividends at a rate of 5%.
[25] Includes highest state rate of 7.5%, plus the 1.5% average city tax rate. Does *not* include typical School District Income Tax rate of 0.75%.
[26] For taxpayers that itemize, maximum rate is 10%.
[27] Additional Personal Property Replacement Tax rate of 1.5% is also imposed on business income.
[28] Includes typical city tax rate of 1%.
[29] Tax liability is calculated as 25% of federal income tax liability.
[30] An income tax is imposed on interest and dividends at a rate of 6%.
[31] Tax liability is calculated as 24% of federal income tax liability.
[32] Special rate is imposed on capital gains.

PERSONAL INCOME TAX OPTIONS

To overcome the obstacles described above, the Committee has identified the following options:

1. Reduce the Number of Low-Income Taxpayers. The Committee recommends that the brackets be adjusted to increase the number of low-income taxpayers that have no tax liability under the tax system. This change would increase simplicity by eliminating from the tax rolls those taxpayers who pay a relatively low amount of tax. For example, only 1.7% of tax receipts are generated by taxpayers with incomes below $20,000, but this represents 35.6% of the total number of Ohio taxpayers.

2. Remove Trust Tax Sunset. Eliminating the 2005 sunset on trust taxation would maintain a broader tax base and significantly contribute to equity, stability and neutrality. Further, competitiveness is not significantly impaired by doing so because every state with a broad-based income tax also imposes that tax on trusts.

3. Lower Personal Income Tax Rates. The Committee recommends that the state personal income tax rates, especially the highest rate, be reduced to make Ohio more attractive for high-paying jobs and economic development. However, the reduction should not be achieved by shifting the tax burden to low- or middle-income taxpayers. The Committee recommends eliminating deductions and credits to broaden the tax base and delaying indexing of the brackets scheduled to begin in 2005 in order to finance the lowering of all tax rates. Reducing the top tax rate in particular would significantly contribute to competitiveness.

MUNICIPAL INCOME TAX OBSTACLES

Simplicity: Ohio's municipal income tax system is cumbersome and complicated for taxpayers, especially businesses with multiple locations in Ohio. Businesses must comply both with respect to the tax on corporate profits and with respect to withholding for employees. The absence of uniform definition of taxable income and a uniform withholding tax base among the 541 Ohio cities and villages imposing the tax is the primary source of complication for businesses. While some municipalities use centralized administrators, such as the Regional Income Tax Authority or the Central Collection Agency, no overall central filing capability exists for businesses to file in all municipalities on one form, and to pay with one check. Often, the cost of complying can exceed the actual tax liability.

Equity: The Committee observes that some horizontal inequity exists within the municipal income tax system for businesses that are in the same industry, but not always subject to the tax. For example, some telecommunications companies are subject to the municipal income tax, while others are not.

Stability: No critical obstacles.

Neutrality: No critical obstacles.

Competitiveness: Ohio's municipal income tax is an obstacle to attracting out-of-state businesses to locate in Ohio. The tax rate is not the primary obstacle to competitiveness. The primary source of this obstacle is the non-uniformity of the tax among the 541 tax jurisdictions and resulting costs of compliance. Ohio is unique in giving municipalities such broad authority both to enact an income tax and to define the tax base. Only Pennsylvania has more municipal income tax jurisdictions than Ohio. However, Pennsylvania's municipal income tax has a uniform tax base, withholding base and filing provisions. The Committee also received testimony that the cost of complying with this tax can often exceed the actual tax liability, and even exceed the cost of complying with Ohio's state-level income tax. Some businesses have left Ohio to avoid the impact of this tax, primarily in border areas.

MUNICIPAL INCOME TAX OPTIONS

The Committee received substantial testimony regarding the municipal income tax from both taxpayers and from cities and villages. Further, a subcommittee of the Committee had extensive separate and joint discussions with city officials and business taxpayers regarding improvements to overcome the above obstacles. While no broad consensus between city officials and business representatives could be reached in the limited time available, the Committee learned a significant amount from these discussions and was able to refine the available options to improve the simplicity and competitiveness of the municipal income tax.

1. Create a Uniform Tax Base for Net Profits Tax Purposes. Ohio law should establish a single definition of taxable income for purposes of taxing business profits. A uniform definition of taxable income is absolutely critical to making Ohio's overall tax system competitive and attractive for economic development. The General Assembly has constitutional authority to limit local taxation.[33] The base should be broad enough that it would not reduce the revenue of municipalities. The uniform definition should be designed to avoid significant revenue impacts on local revenue. The Committee recognizes that some base-broadening would reduce any adverse revenue impact on municipalities due to a uniform tax base. For example, a required add-back of any interest or royalty expense paid to related parties would expand the tax base. Further, this "anti-Passive Investment Company (PIC)" provision would eliminate the benefit of aggressive city tax planning by businesses. Another important characteristic would be the uniform treatment of federal bonus depreciation.

2. Create a Uniform Withholding Base. Ohio law should establish a uniform withholding tax base. Again, this is critical to making Ohio's overall tax system competitive and attractive for economic development. Based on discussions with city officials, either of the following tax bases would be substantially revenue neutral:
   a. Medicare wages (Box 5 of Form W-2), excluding non-qualified deferred compensation and adding IRC Section 125 cafeteria plan contributions; or
   b. Medicare wages, including non-qualified deferred compensation.

[33] Ohio Constitution, Article XVIII, Section 3, Section 7 and Section 13.

While these alternatives would not create a simple tax base, most municipalities substantially use one of these two tax bases. Further, they are substantially revenue neutral. Any reductions will be offset by a broader tax base resulting from the adoption of anti-PIC language in the business profits tax as described above and the options for special industries identified below.

3. Provide Appeals to the Board of Tax Appeals and the Ohio Supreme Court. In order to preserve the integrity and purpose of uniform municipal income tax provisions, a centralized and specialized appeal process should be provided, as is done for other state and local tax purposes in Ohio. Therefore, following an administrative appeal at the city level, the next level of appeal should be to the Board of Tax Appeals, followed by an appeal of right to the Ohio Supreme Court or the Court of Appeals. Without a central body interpreting the uniform provisions, decisions by common pleas courts could lead to a wide variety of interpretations of uniform provisions. Finally, taxpayers have found the appeal to the local court of common pleas to be expensive and prohibitive.

4. Create Uniform Net Operating Loss ("NOL") Carryover Treatment. A uniform net profits tax base is meaningless without uniform treatment of NOL carryovers. It is appropriate tax policy to permit the carryover of NOLs by businesses.

5. Provide Uniform Treatment of Pass-Through Entities. Current treatment by municipalities of pass-through entities (S corporations, partnerships, etc.) is inconsistent, with some municipalities taxing the business income at the entity level and others taxing the business income at the owner level. This often results in double taxation. Further, current law requires different treatment of S corporations by different municipalities.[34]

6. Provide a Centralized, Web-Based Filing and Payment Option on *Ohio Business Gateway*. Beginning in calendar year 2005, an electronic centralized municipal income tax filing and payment system should be made available through the *Ohio Business Gateway*.[35] Business taxpayers advocate a mandatory centralized filing and compliance system, but municipalities have expressed concern over the ability of a central authority to enforce and administer this large tax system, as well as cash flow issues. An electronic filing and payment alternative avoids many concerns and issues raised by the municipalities. The municipalities can retain their own enforcement and compliance efforts, and the tax will be quickly deposited directly into their bank accounts. Further, any business wishing to file its business profits' estimated payments and final return may voluntarily use the *Ohio Business Gateway* to comply with the municipal income tax system by filing on one electronic form and with one payment. The *Ohio Business Gateway* will peel the tax payment apart and send it to each jurisdiction, along with all necessary tax return data. The state should fund the

[34] See provisions of S.B. 180, 124th General Assembly.

[35] The *Ohio Business Gateway* is a proven and secure web-based tax filing and payment system currently used by various state agencies, including the Department of Taxation, Bureau of Workers Compensation, Department of Job and Family Services and Department of Commerce.

development and ongoing operation of this added feature of the *Ohio Business Gateway*. The intent of the Committee is that the state should not charge a fee to municipalities for their use of the *Ohio Business Gateway*. The delayed date of implementing this option permits for development of the program and gives municipalities time to adjust to this new filing option. Note that this is merely a filing and payment option and businesses will still be permitted to file using the traditional filing options currently available.

7. Provide a Centralized Web-Based Tax Return Extension Site for Business. Beginning in calendar year 2005, an electronic centralized bulletin board should be made available for businesses to notify municipalities that a federal extension was filed with the IRS. Currently, while municipalities accept a federal extension for purposes of extending the municipal income tax due date, a copy of that form is required to be also filed with most municipalities. This increases the costs of compliance and headaches associated with this tax. At the same time, knowing that a firm has filed a federal extension is important information for municipalities in running their delinquent taxpayer programs. Permitting a business to notify all municipalities of their federal extension at one time (at a single web site), simplifies tax compliance and yet provides all municipalities this valuable information.

8. Revise the Due Date of Municipal Income Tax Returns and Extensions. Based on testimony and discussions with both municipalities and businesses, the Committee recommends that the municipal income tax return for individuals be set at April 15th for all cities and villages. The currently permissible April 30th due date is generally confusing and often creates problems for taxpayers because many often forget to file their municipal tax returns when due on April 30th. Further, the initial due date for net profits tax returns should be set as the 15th day of the fourth month following the end of the taxpayer's taxable year. The extended due date for all municipal tax returns should be set as the last day of the month following the month in which falls the extended due date for federal tax purposes.

9. Eliminate Three-Year Requirement for Reporting for Withholding Tax Purposes. Current law requires that an employer must withhold municipal income tax from its employees if the total withheld amount for all employees reaches $150 of tax in that municipal corporation for a taxable year. As a result of exceeding that threshold, the employer's withholding responsibility is locked-in for three years, even if the tax withheld for all future tax years is less than $150. The purpose of the $150 threshold is to decrease compliance costs of employers. Therefore, the three-year lock-in should be eliminated.

SALES & USE TAX OBSTACLES

Simplicity: Complexity exists for non-Ohio based companies that need to comply both with Ohio's unique definitions of various taxable goods and services and the definitions of other states. One reason that many "remote sellers"[36] give for not voluntarily collecting the tax is that it is too burdensome to do so. When the remote seller does not collect the tax at the time of the sale, the customer is supposed to pay the tax directly to the state. The Department of Taxation has attempted to facilitate this payment, permitting the customer to make payment through the filing of an individual use tax return, or by reporting the information on the annual personal income tax return. Even so, this system is highly inefficient and very cumbersome for customers. It is much easier and cost effective for customers if vendors collect the tax at the time of purchase.

Some of the specific terms of the sales tax can cause confusion and may warrant simplification. For example, the definition of "food" includes coffee and candy bars, but excludes Snapple and Hi-C. These distinctions are burdensome to the various vendors that sell food and snack products.

Equity: The sales tax is often considered a regressive tax, placing more burden on low-income taxpayers than on high-income taxpayers. In fact, the law's exemption of many necessities from the sales tax base (groceries, housing costs, medical costs, etc.) actually reduces the validity of this claim. However, the failure of many remote sellers to collect tax on their sales into Ohio is probably a greater "benefit" to higher income individuals who are more likely to make these remote purchases, particularly via the Internet. (Note, however, that tax is owed on these transactions. The problem is in the ability to collect the tax, not in the structure of the tax itself.)

Further, horizontal inequity exists when comparing Ohio brick and mortar businesses to remote sellers. Brick and mortar companies are required to collect the sales tax, while remote sellers can avoid collection responsibilities. This creates an uneven playing field for Ohio-based businesses, yet these Ohio businesses are providing jobs and other benefits to Ohio's economy.

Finally, aggressive tax planning techniques, used by larger taxpayers, can distort horizontal equity since firms that use these devices pay less tax than similar firms that do not. Because these techniques are more likely to be used by larger corporations, this planning also exacerbates vertical equity.

Stability: The sales and use tax does fluctuate with the economy, but is generally more stable than the personal income tax and the corporation franchise tax. However, when examining the long-term stability of the sales and use tax, significant concerns come to light. The sales tax was first effective in 1935. The use tax was added in 1936 to protect Ohio-

[36] As used here, "remote sellers" generally refers to out-of-state companies that are not constitutionally required to collect Ohio tax because they do not have sufficient presence or nexus with the state. This includes mail order companies, catalog companies, and Internet businesses. There are also Ohio remote sellers who must collect Ohio tax, and non-Ohio remote sellers that do have nexus with the state and who must collect Ohio tax.

based businesses by eliminating the incentive for Ohio consumers to make purchases in neighboring states without paying a sales tax. The use tax serves as some protection against the erosion that would otherwise have been experienced due to the growth of remote sales, but it is not a perfect solution to the problem.

The sales and use tax applies to all sales of tangible personal property (with certain exceptions), and to certain limited services as specifically enumerated in the statute. The growing importance of the service sector results in the need to expand the tax to include additional services. The Federal Bureau of Economic Analysis (BEA), in a paper in the March 2001 issue of the *Survey of Current Business*, reported that services' share of U.S. consumer spending rose from 40% in 1959 to 58% in 2000. The increase was primarily in medical care services, financial services, recreation services, and education and research services. The BEA also found that nondurable goods' share of U.S. consumer spending fell from 47% in 1959 to 30% in 2000.

Tax planning strategies, noted above, and the expansion of remote sales, particularly Internet sales, pose a definite threat to stability.

Neutrality: Because the tax rate and tax base is similar to or even more narrow than those of neighboring states, Ohio's sales and use tax system is generally neutral to economic decisions. However, the Committee observed that tax planning strategies have emerged where businesses have attempted to expand the application of existing exemptions, including restructuring traditional operating structures, to obtain the benefit of these exemptions and exceptions.

Competitiveness: Ohio's sales and use tax is generally competitive with its neighboring states. In general, Ohio's state rate is very competitive. Even adding the average permissive tax rate of 1% keeps Ohio's sales tax average with other competitor states. It also appears that the tax base is either less comprehensive than the surrounding states or comparable. The chart on the following page illustrates the state sales and use tax rate for all states.

State Sales and Use Tax Rates for All States

State	State Sales And Use Tax Rate[37]	Highest Combined Rate[38]	State	State Sales And Use Tax Rate[37]	Highest Combined Rate[38]
Alabama	4.00%	9.00%	Montana	No tax	
Alaska	- 0 -	6.00%	Nebraska	5.50%	7.00%
Arizona	5.60%	8.60%	Nevada	6.50%	7.25%
Arkansas	5.125%	8.125%	New Hampshire	No tax	
California	6.00%	8.60%	New Jersey	6.00%	6.00%
Colorado	2.90%	7.40%	New Mexico	5.00%	7.19%
Connecticut	6.00%	6.00%	New York	4.00%	8.50%
Delaware	No tax		North Carolina	4.50%	6.50%
Florida	6.00%	8.50%	North Dakota	5.00%	7.00%
Georgia	4.00%	7.00%	**Ohio**	**5.00%**	**7.00%**
Hawaii	4.00%	4.00%	Oklahoma	4.50%	9.75%
Idaho	5.00%	7.00%	Oregon	No tax	
Illinois	6.25%	8.75%	Pennsylvania	6.00%	7.00%
Indiana	6.00%	6.00%	Rhode Island	7.00%	7.00%
Iowa	5.00%	7.00%	South Carolina	5.00%	6.00%
Kansas	5.30%	8.30%	South Dakota	4.00%	6.00%
Kentucky	6.00%	6.00%	Tennessee	7.00%	9.75%
Louisiana	4.00%	9.50%	Texas	6.25%	8.25%
Maine	5.00%	5.00%	Utah	4.75%	6.75%
Maryland	5.00%	5.00%	Vermont	5.00%	6.00%
Massachusetts	5.00%	5.00%	Virginia	3.50%	4.50%
Michigan	6.00%	6.00%	Washington	6.50%	8.80%
Minnesota	6.50%	7.50%	West Virginia	6.00%	6.00%
Mississippi	7.00%	7.00%	Wisconsin	5.00%	5.60%
Missouri	4.23%	8.23%	Wyoming	4.00%	6.00%

[37] Source: CCH Multistate Charts, as of January 1, 2003.
[38] Source: Federation of Tax Administrators, web site information as of October 18, 2001.

SALES & USE TAX OPTIONS

To overcome the obstacles described above, the Committee has identified the following options:

1. Broaden the Sales and Use Tax Base in Order to Capture the Broader Economy. By expanding the tax base to include more services, vertical equity and the long-term stability of the sales and use tax system will be enhanced. To broaden the tax base, the tax should be applied to more services, a growing part of today's economy. However, in order to avoid harming the competitiveness of the tax, only those services that are not mobile should be taxed. By mobile, the Committee refers to services that could be easily performed outside Ohio in order to avoid the tax. Examples of extremely mobile services include legal services, accounting services and consulting services. In addition, in the case of personal service items, the base expansion should focus on the purchase of nonessential services in order to avoid vertical equity issues. Examples of services, the taxation of which would not harm Ohio's competitiveness or the vertical equity of the tax, would include pet grooming, dry cleaning, and design and decorating services.

2. Ohio Should Participate in the Streamlined Sales Tax Project. Participation in the Streamlined Sales Tax Project ("SSTP") will improve simplicity, vertical and horizontal equity, and stability. Further, it will lower the cost of compliance for Ohio-based businesses, thereby improving their competitiveness. While significant confusion exists among the public about the consequences associated with SSTP, the Committee found that participation will not cause a dramatic increase in Ohio taxes or tax collections. Rather, it will ensure the fairness of the sales tax system in Ohio, facilitate collection of taxes already owed, and protect the state from erosion of the tax base as remote selling grows in relative importance. Furthermore, full implementation of the system will undoubtedly require some adjustments to Ohio law, which could actually narrow the tax base. (Adopting a more uniform definition of "food" is one example.) Small and medium-sized Ohio businesses will find participation in SSTP important for their abilities to compete effectively with remote vendors. Under the current system, these brick and mortar Ohio companies are at a competitive disadvantage to the remote sellers that are not based in Ohio and not providing Ohio jobs or otherwise contributing to the Ohio economy and communities.

3. Broaden the Sales and Use Tax Base by Eliminating Special Carveouts to the Tax. While many of the exemptions and exceptions are necessary to preserve vertical equity (such as exemptions for food, housing rents, etc.), others are little used and of benefit to only a small portion of Ohio's taxpayers. These little-used exemptions and exceptions should be eliminated. In addition, the law should be amended to prevent related member entities from adjusting structures and transactions in order to inappropriately exploit exemptions and exceptions.

4. Do Not Increase the County Permissive Tax Rate Authority. Many local authorities are seeking the ability to increase their authority to impose additional permissive taxes. Currently, a county may impose a permissive tax of up to 1.5%. Twenty-seven counties currently impose the highest rate. The average permissive tax rate imposed by all counties across Ohio is 1%. The local officials would like their permissive tax authority increased to 2%, which would provide them with the ability to fund their important government functions. However, the Committee believes that the base-broadening proposed above will provide sufficient new revenue to the county governments, thereby eliminating the need for higher tax rates.

5. Lower Tax Rates. Clearly, high tax rates are anti-competitive. While Ohio's sales and use tax rates are not anti-competitive, Ohio's personal income tax and corporation franchise tax rates are high. By lowering personal income and corporation franchise tax rates, Ohio becomes more attractive for business investment and the creation of high-wage jobs, which benefits all Ohioans. The increased revenue resulting from the broader sales tax base could alternatively be used to help fund elimination of the tangible personal property tax.

TANGIBLE PERSONAL PROPERTY TAX OBSTACLES

Simplicity: The tangible personal property tax is not simple. The Committee found that the requirement to track the location and determine the value of each and every piece of equipment is a very expensive and costly task, especially for larger businesses with multiple locations. Further, small businesses are also significantly burdened by the tax's complexity. Specifically, while a $10,000 exemption applies to eliminate liability of approximately 280,000 small general businesses, these 280,000 taxpayers are still required to file tax returns showing the value and location of their property. The Department of Taxation uses this information to reimburse the local jurisdictions for the impact of this exemption. Small businesses can incur significant costs in order to claim this exemption. For example, if Ohio small businesses incur an average cost of $100 to file their annual report of exempt property, then Ohio businesses incur approximately $28 million to comply with this reporting, yet pay zero tax. (By statute, the exemption is forfeited if a return is not filed.)

A separate tangible personal property tax is levied on public utilities as opposed to general businesses. The differences in the taxes as they apply to these different categories of taxpayers is a significant complication, particularly as the idea of what constitutes public utility service continues to evolve.

Equity: The various tax abatement programs create inequities among taxpayers, since some pay less tax under abatement agreements than comparable businesses that do not have such agreements, or whose agreements do not have as favorable terms. It is also possible that larger, more sophisticated taxpayers can take better advantage of abatement programs than smaller, less sophisticated taxpayers. In short, the abatement programs, while considered essential to maintaining Ohio's competitiveness, create vertical and horizontal equity issues.

The tangible property of public utilities is taxed under a different set of rules than the tangible property of general businesses. The general effect of the differences is that the public utility property is more heavily taxed. The distinctions between public utilities and general businesses have begun to break down, particularly in certain areas (telecommunications, for example) creating horizontal inequities between businesses in the same line of business, but operating under different tax classifications.

Stability: The tangible tax is generally very stable. Since 1980, in only one year did the statewide tax collection experience negative growth and that was the year the $10,000 exemption law took effect (1984)[39]. Exceptions occur if and when large businesses close or move, and when tax issues are litigated, creating refund exposure to local taxing districts. These exceptions can have dramatic destabilizing impacts on local jurisdictions, especially school districts.

Neutrality: Distinctions in the listing percentage of public utility versus general tangible property has led to the creation of non-utility businesses to own certain property used by the utility (for example, inventory) in order to take advantage of the lower listing percentage for general business.

Competitiveness: The Committee received significant testimony from business taxpayers that the general tangible personal property tax poses a significant obstacle to Ohio's competitiveness. While 44 states have tangible personal property taxes, only 16 include inventories in the tax base.

Every major study of Ohio's tax system performed since 1967 has described the anti-competitive aspects of this tax. Each time, the study has called for adjustments or elimination of this tax. Each time, adjustments have been made to improve the competitive issues surrounding this tax. For example, the listing percentage has been reduced from 1967 through 1997 on merchant inventories and furniture and fixtures from 70% to 25%, and on manufacturing equipment and inventories from 50% to 25%.[40]

TANGIBLE PERSONAL PROPERTY TAX OPTIONS

To overcome the obstacles described above, the Committee has identified the following options:

1. <u>Eliminate the Tangible Personal Property Tax and Replace It with a Broad-Based, Low Rate Tax</u>. The "personal property replacement tax" should be based on one of the following tax bases:
    a. A simple tax base consisting of Ohio sales, property and payroll as reported for income tax apportionment purposes. Businesses already compute this information. Further, the tax should apply to all business organizations, whether a regular corporation, S corporation, partnership, etc.; or

[39] Source: Ohio Department of Taxation. The Committee did not request review for years prior to 1980.
[40] Note: See slide on page 31 for further detail.

b. A simple tax base consisting solely of Ohio gross receipts. Again, businesses already compute gross receipts. Further, the tax should apply to all business organizations, whether a regular corporation, S corporation, partnership, etc.

Each of these tax bases would require a very low rate to replace the $2.5 billion of tangible personal property tax (including utility tangible property). As a result of the low rate, tax planning to avoid this tax would be significantly mitigated. Further, this broad-based tax would also be applied to all business entities evenly, without regard to whether the business is a service provider (with a very low tangible personal property tax) or a manufacturer (with a very high tangible personal property tax).

The broad tax base will cause a shifting of tax liabilities between businesses, but will provide a much more competitive tax system with taxes being spread across all industries. Out-of-state businesses making sales into Ohio and having payroll in Ohio will now share this tax liability, whereas they currently avoid any tangible personal property tax liability. Finally, elimination of the tangible personal property tax could result in elimination of personal property tax abatements granted through Ohio's enterprise zone program (see discussion in Options Related to Tax Administration and Ohio's Budget, below).

2. Accelerate Elimination of the Inventory Tax Base. If the tangible personal property tax is not altogether eliminated and replaced, the inventory tax elimination should at least be accelerated. This will substantially enhance Ohio's competitiveness. No longer will Ohio be one of only 16 states to fully or partially tax inventory (while 44 states have tangible personal property taxes).[41]

3. Eliminate Filing Requirements Associated with the $10,000 Exemption. The requirement that taxpayers exempt from the tax must still file property tax returns is burdensome and costly.

4. Phase Out Reimbursement of the cost of the $10,000 Exemption. The state should also phase out reimbursement to local governments for the impact of the exemption, for example over a 10-year period. The payments during the phaseout period would be based on the last year such information is filed.

5. Expand Abatement of Penalty Circumstances. The powers of county auditors and the Tax Commissioner to abate penalties for underpayment of the tangible personal property tax should be expanded to be equivalent with other taxes. For example, with most state-administered taxes, the Tax Commissioner may abate penalties for "good cause."

[41] Commerce Clearing House, *2001 U.S. Master Property Tax Guide*.

REAL PROPERTY TAX OBSTACLES

Simplicity: Ohio's real property tax system is so complicated that it is not understood by taxpayers. This leads to frustration with the tax. Tax relief initiatives, particularly the tax reduction factor law (H.B. 920), have broken down the relationship between the tax rates approved by the voters and the taxes actually due. The tax reduction factor law, with its many complications and ramifications, is difficult even for experts to fully comprehend. Other examples of areas of confusion are the use of "mills" rather than percentages for tax rates, the difference between fair market value and assessed value, the existence and purposes of the 2.5% and 10% rollbacks, the current agriculture use valuation law, and the difference between replacement levies, continuing levies, and renewal levies.

Equity: While the tax reduction factor law has its shortcomings, it does limit tax increases arising out of appreciation of property values. This has been a key public policy of the state for many years. The 20-mill floor, below which the tax reduction factor law cannot cause school tax levies to fall, can cause taxes to increase with appreciation. In effect, the tax reduction factor law does not provide the same protections from tax increases for taxpayers in areas where the 20-mill floor has been reached that it does in other areas. This may be perceived as a horizontal equity issue if the primary policy objective is limiting tax increases arising from increased property values.

As a tax relief measure, the state pays 10% of every real property tax bill. For homesteads (owner-occupied housing), the state pays an additional 2.5% of the bill. This tax relief applies without regard to the financial circumstances of the property owner, and may be viewed as a violation of vertical equity. That is, the state assumes responsibility for 12.5% of every homesteader's property tax bill, whether that homesteader is a retiree on a fixed and limited income or whether the homesteader clearly has the financial means to pay the tax.

Stability: Ordinarily a stable tax source will provide for some expansion over time. The tax reduction factor law affects this potential expansion, by limiting the amount of revenue expansion arising from property value appreciation. Even so, the real property tax is a very stable and vital revenue source, with about two-thirds of the tax going to local school districts and the balance going to county and other local jurisdictions. Some exceptions to this general conclusion warrant mention. In areas where few additions are being made to the tax base, the tax reduction factor law may be thought to severely restrict revenue growth.

At the same time, the Committee has observed a recent trend of school districts to reduce their millage down to the 20-mill floor. As noted above, the result of this phenomenon is to short-circuit the impact of the H.B. 920 reduction factor limits on real property tax growth so that it has no impact in those districts. It is estimated that 314 school districts are currently at the 20-mill floor and that 113 more will be at the 20-mill floor within the next six years, barring passage of a new levy.[42] When the tax reduction factor law does not apply, the increases in taxes on real property can be quite dramatic, and can outstrip the amount of growth considered reasonable in order to maintain stability.

[42] Based on 2001 data available from the Ohio Department of Taxation.

Closely tied to stability is the impact of the revaluation process every six years, with the intervening three-year update. As a result of this process, taxpayers can experience large and unexpected jumps in their tax liabilities upon revaluation.

Neutrality: Significant variations in local tax rates do exist and may affect decisions regarding where to live, although decisions may be equally driven by the level of service provided, as by the amount of tax charged. That is, taxpayers may choose to pay additional tax in order to have more services.

Competitiveness: Ohio's real property tax does not pose any significant competitiveness issues. While many Ohioans feel that the real property tax rates are very high and burdensome, Ohio's average effective tax rates are generally lower than the effective rates of its competitor states. For example, Ohio was ranked 21st when comparing effective tax rates on $100 of value in each state's largest city.[43] Neighboring states with higher effective real property tax rates include Indiana, Michigan, and Pennsylvania. Other competitor states with higher effective real property tax rates include Florida, Georgia, Texas, and Wisconsin.

REAL PROPERTY TAX OPTIONS

To overcome the obstacles described above, the Committee has identified the following options:

1. Establish a Special Committee to Examine the Real Property Tax. The real property tax system in Ohio is uniquely complicated. Further, it is inextricably tied to the funding of primary and secondary education, which is beyond the scope of the Committee's statutory duties. While the Committee received testimony regarding the real property tax, a more focused examination of this tax is deserved. A bi-partisan committee can focus solely on this tax and also consider the implications any change will have on school funding.

2. Expand Abatement of Penalty Circumstances. The powers of county auditors and the Tax Commissioner to abate penalties for underpayment of the real property tax should be expanded to be equivalent with other taxes. For example, with most state-administered taxes, the Tax Commissioner may abate penalties for "good cause".

[43] Source: District of Columbia Report, *Tax Rates and Tax Burdens in the District of Columbia: A Nationwide Comparison*, 2000.

OBSTACLES RELATED TO SPECIAL INDUSTRIES

General Public Utility Taxation Obstacles

Public utilities were at one time easily identifiable as businesses that provided specialized services or products under specially regulated conditions. The importance of the product, its predictable delivery, and unusual market conditions contributed to the public interest in regulation and oversight. This regulation often involved the creation of state-authorized monopolies and the imposition of special or heavier taxes than apply to other businesses. In some ways these issues may have been related: in return for a monopoly franchise, the state may have imposed heavier taxes. Also, the existence of rate regulation may have made it easier to levy higher taxes on these businesses since they were theoretically guaranteed full recovery of taxes through the rate-making process. For whatever reason, a system developed that did impose heavier and different tax burdens on the public utility industry than on general businesses.

The discussion below reviews obstacles as they apply to public utilities in general. Immediately following the general discussion, the obstacles are reviewed in more detail with respect to the telecommunications industry.

Simplicity: Public utility taxes apply to a class of taxpayers—those defined as "public utilities." Public utility status affects tax liability of both the utility and its customers. In the era of deregulation and re-regulation, the term "public utility" has lost its bright-line meaning. Determining whether an entity meets the definition of a particular public utility can be difficult. It is also possible for a particular business to meet the definition of a public utility one year, but not the next. On the customer side, the taxes paid by the consumer will differ based on whether the provider of the service or product is a public utility or not.

Equity: To tax the same product or services differently depending on whether or not it is provided by a public utility is not only confusing, it is inequitable. To tax two companies differently when they provide products or services in competition with each other is also inequitable.

Stability: The public utility taxes, once a hallmark of stability, have become less reliable as public utilities have moved out of the monopoly environment and into a more competitive situation. Competitive pressures have affected both the rate-making processes and prompted legal challenges to the statutes that impose differing tax regimes than apply to general businesses. Legal challenges have already led to some refunds, and they create uncertainty for the future.

Neutrality: The disparities between general business taxation and public utility taxation have led to the creation of non-utility related entities to assume some portion of the traditional public utility role, but at a lower tax cost. An historical example best illustrates this. Formerly, electric companies were subject to higher listing percentage on inventory (like coal to be used in generating electricity) than general businesses. By transferring

ownership of the inventory to a non-utility, the electric company could significantly reduce its tax.

Competitiveness: The uncertainty associated with Ohio's current tax treatment of public utilities and their competitors makes investment in these ventures risky. In some cases, businesses may defer investment until the tax questions are resolved. The central roles of these industries, once regulated in part due to their critical importance, argues for the elimination of these artificial and troubling differences in tax treatment.

Telecommunications Taxation Obstacles

The telecommunications industry stands out among utilities as needing change. This industry has undergone significant changes over the last two decades. Changes in this industry make the issues related to public utility taxation, as it applies to some but not all sectors of the industry, particularly stark.

Simplicity: Telecommunications businesses now offer a wide variety of services, including cellular service, pay phone service, high-speed Internet connections, e-mail, voice mail, paging, call waiting, three-way calling, call forwarding, caller identification, call blocking, cable television, and others in addition to the traditional dial tone and long-distance services. These services may be provided by traditional "public utilities" or by any one of a variety of emerging telecommunications businesses. The determination of when to apply public utility versus general business taxes is becoming more and more difficult.

Equity: Ohio's tax structure treats similar telecommunications services and business entities differently. For example, if one person calls another person locally on a "regular" telephone, the local telephone company must pay a tax on the gross receipts received for handling that local service. If the same person makes the same call on a cellular telephone or through a long distance company that also provides local service, a sales tax applies to that cellular call and that local service. However, the cellular or long distance company does not pay the gross receipts tax; instead it pays the corporation franchise tax (if it is a corporation) to the extent that its business realizes a profit. The equipment used to handle the call also can receive different tax treatment.

On a local taxation basis, the telephone company does not pay the municipal income tax, but the cellular company does. The local telephone company will pay a higher rate of tangible personal property tax than the cellular company to the extent the local telephone company uses equipment placed in service before 1994.

Stability: The long-term stability of revenues from telephone taxes has the potential to deteriorate as other telecommunications options enter the market and qualify for different tax treatment compared to local telephone companies. In addition, at some point differences in tax treatment for companies providing similar services may result in successful legal challenges, thereby undermining revenue stability.

Neutrality: The gross receipts tax and the 88% assessment rate for certain personal property single out public utilities for different treatment compared to other telecommunications providers. This disparity encourages public utilities to use related, non-utility businesses to provide what was once part of the package of utility services. The production of telephone directories provides a good example.

Competitiveness: Ohio's different treatment of telecommunications services, and the related complexities and the instability of the law and its application, discourages participation in telecommunications businesses to the disadvantage of Ohio's competitive position.

General Public Utility Tax Options

- Explore Eliminating the Differences in the Taxation of Public Utilities as Compared to Other Businesses as the Barriers to Competition Break Down. The process may need to be approached in steps, addressing different issues at different times.

Telecommunications Taxation Options

- Tax Local Telephone Companies in the Manner of Other Telecommunications Companies. To move local telephone companies to regular business taxation, it is necessary to do the following:
    a. Repeal the gross receipts tax for local telephone companies;
    b. Impose the corporation franchise tax and municipal income tax on local telephone companies;
    c. Phase-in a reduction of the assessment rate on pre-1994 property from 88% to 25%;
    d. Impose the sales and use tax on all local telephone services; and
    e. Provide protection for small telephone companies from the above options.

General Financial Services Industry Obstacles

The various service providers within the financial services industry have traditionally been subject to different taxes. As the economy and marketplace have evolved, the lines between these various industries have begun to blur, and the rationales for the traditional distinctions have weakened. Key players in this field are financial institutions (including banks and savings and loans), insurance companies, and dealers in intangibles.

None of these entities pay the general corporation franchise tax that applies to most corporations in Ohio. Financial institutions pay tax under the corporation franchise tax, but only on net worth, which is specially defined, and at a special rate of 13 mills. Insurance companies generally pay a gross receipts tax based on premiums paid for insurance against risks in Ohio. Finally, dealers in intangibles pay the dealers in intangibles tax, which is also a net worth tax, with a rate of eight mills. While many variations exist in taxation of these

entities, they do have some taxation characteristics in common. None of these entities pay tangible personal property taxes. Nor do dealers in intangibles or insurance companies pay municipal income taxes. The financial institutions and dealers in intangibles taxes are administered by ODT. The Department of Insurance administers the insurance tax.

Simplicity: The existence of specialized taxes applicable to different industries complicates the tax law. These specialized taxes not only raise simplicity issues among those special industries, but also as those industries compare to the general businesses.

Equity: To the extent that financial institutions, dealers, and insurance companies compete with each other and with other businesses outside of those categories, differences in taxation can create inequities. For example, because insurance companies generally are taxed on the basis of premiums paid for policies, they may be attractive places for related businesses to shelter net income or net worth.

Stability: The stability of each of these taxes is threatened to the extent that evolving regulatory changes make the definitions of the categories less meaningful and subject to manipulation for tax advantages.

Neutrality: As with stability, as the distinctions between these industries blur, it may be possible to restructure in order to take advantage of the varying tax bases. Some of this activity has already been observed among financial institutions and dealers in intangibles.

Competitiveness: No other state levies a Dealers in Intangibles tax. Instead, these entities are taxed as general businesses. Some states tax financial institutions as general businesses on profits, and others use a net worth methodology, similar to Ohio. Most states apply a premiums-type tax to insurance companies, although other business taxes may apply as well. Given the variations in taxation among these industries and between the states, it is difficult to reach conclusions regarding Ohio's competitiveness with the financial services industry in general.

Dealers in Intangibles Tax Obstacles

The Dealers in Intangibles tax generally applies to businesses engaged in the business of lending money, or discounting, buying or selling bonds, stocks, or other investment securities. Financial institutions are not dealers, even when engaged in these activities. Numerous issues have already been identified that call for special attention to this area of tax law.

Simplicity: Ohio is the only state to have a tax of this type. This creates complexity for taxpayers that operate in an interstate environment. The definition of what constitutes a dealer is also subject to interpretation, which can lead to taxpayers taking aggressive positions regarding their qualifications as dealers in order to take advantage of the potential for tax savings.

Equity: The dealer tax is based on net worth and ignores profitability. Consequently, it is possible for very profitable dealers to pay little tax because they have little net worth (see Neutrality). Under these circumstances, dealers operate in a more favorable environment than other businesses in the state.

At the same time, the dealer tax applies to all businesses regardless of business form. This means that unincorporated dealers pay tax at the dealer or entity level and also at the personal income level as earnings "pass through" to owners. This runs counter to the state's general tax policy concerning pass-through entities.

Dealers do not pay personal property taxes, nor do they pay municipal income taxes.

Stability: To the extent the dealer tax presents a tax planning opportunity, the stability of other taxes may be affected.

Neutrality: The dealer definition provides opportunities for various businesses to claim dealer status. This is most likely to occur when the business is highly profitable, but with relatively low net worth. Aggressive taxpayers have adjusted operations so that they can argue that they are dealers in order to shelter income from taxation.

Competitiveness: This unique tax does not provide an important competitive edge to the state. Nor would the repeal of the tax harm Ohio's competitiveness, since repeal would bring Ohio taxes on these entities into alignment with the rest of the country.

General Financial Services Industry Options

- Perform Industry-by-Industry Examination for Change. The state should undertake a comprehensive examination of the financial services industry to determine whether or when all of these businesses should be subject to the same basic tax structure. This study should take into account all of the obstacles described above and should include a comprehensive analysis of the taxation of these businesses by other states.

Dealers in Intangibles Tax Options

- Eliminate the Dealers in Intangibles Tax. Dealers should be subject to the same taxes as other businesses, including the corporation franchise tax, personal income tax, municipal income tax, personal property tax, and sales and use tax, as applicable.

OPTIONS RELATED TO TAX ADMINISTRATION AND OHIO'S BUDGET

1. Rebuild Ohio's Rainy Day Fund. The recent economic downturn illustrates the benefit of a significant rainy day fund. In reviewing recent history, an economic downturn occurs approximately every ten years in Ohio. Each downturn has resulted in significant new taxes, which do not expire once the downturn is over. By building up a significant rainy day fund sufficient to ride out an economic downturn, new taxes can be avoided, thereby ensuring Ohio's ongoing competitiveness. The Committee received testimony that a significantly more stable rainy day fund balance would be as high as 15% of the state budget.

2. Increase Funding of the Department of Taxation to Ensure Fair Compliance by All Taxpayers. Since 1991, the Ohio Department of Taxation has lost 25% of its personnel. Last year alone, ODT lost 105 employees and only hired four. In spite of this reduction, however, many new taxes have been added to ODT's responsibility, including the Kilowatt-Hour Tax, the Mcf Tax, and the Municipal Income Tax on electric companies. Under-funding the Department significantly harms stability and equity. It also reduces taxpayer service, which is important to ensure compliance and reduce taxpayer frustration with the tax system. The Committee received testimony that, due to limited resources, most compliance resources are focused on only Ohio's largest businesses. This creates inequity among business taxpayers. Further, underlying integrity and stability of the tax system is reliant upon an appropriate level of oversight and service.

3. Enhance Enterprise Zone Agreement Enforcement Provisions and Tools. Limited enforcement provisions and tools exist to ensure compliance by businesses with enterprise zone agreements. Further, lack of enforcement creates confusion and harms the integrity of the program. Local Tax Incentive Review Councils (TIRCs) are the primary tool for enforcing enterprise zone agreements. The ability of TIRCs to ensure proper review and compliance needs to be enhanced. The Committee recommends the following enhancements:
   a. Establish the county auditor as statutory chairperson of each TIRC;
   b. Require legislative authority to take a vote on TIRC recommendations;
   c. Require businesses to provide requested information to TIRCs or face significant penalties;
   d. Strengthen language to define "normal business fluctuations"; and
   e. Expand TIRC oversight to include pre-1994 enterprise zone agreements.

4. Limit Enterprise Zone Benefits to New Investments Involving Interstate Competition. The enterprise zone program was originally designed to attract new investment into economically depressed areas of the state. Today, nearly every part of the state is either a designated enterprise zone or can be designated a zone rather easily. The reason for this evolution is to mitigate the anti-competitive aspects of the tangible personal property tax and to attract new economic development. As a result, in some instances the program has been used by local Ohio jurisdictions to attract new business investments away from other Ohio jurisdictions. This is not an appropriate

policy for Ohio to support. Therefore, the enterprise zone law should be modified to ensure that benefits are only granted as a result of attracting economic development from interstate competition, not intrastate competition.

APPENDIX A

Member Letters

Ohio Senate
Senate Building
Columbus, Ohio 43215
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Committees:
Reference, Chairman
Education, Vice Chair
Finance and Financial Institutions
Economic Development,
Technology & Aerospace
Agriculture
Rules

Controlling Board
Joint Legislative Ethics Committee
Ohio School Facilities Commission
Legislative Committee
on Education Oversight
Ohio War Orphans
Scholarship Board

Senator Bill M. Harris
19th District

February 13, 2002

Committee to Study State & Local Taxes
Tom Zaino, Commissioner
Ohio Department of Taxation
30 East Broad Street, 22nd Floor
Columbus, Ohio 43215

Dear Commissioner Zaino and CSSLT Members,

When the Committee to Study State and Local Taxes (CSSLT) was created in Sub. Senate Bill 261 of the 124th General Assembly, Ohio was in the midst of one of the most difficult economic recessions in recent history. The recession, which has hit industrial and manufacturing states especially hard, was undoubtedly worsened by the terrorist attacks of September 11, 2001. As a result of the recession and slow economic recovery that has beset the entire nation, coupled with rapidly rising Medicaid costs, record-level spending on Primary & Secondary education and other budgetary strains, Ohio is currently in one of its most challenging fiscal situations since the Great Depression.

Keeping in mind the many challenges our state is facing, the initiative of the CSSLT was to examine Ohio's tax structure with five key principles: simplicity, equity and fairness, stability, neutrality and competitiveness. For years, Ohio has seen slow growth in economic development and its complex, burdensome tax structure is constantly cited as one of the major obstacles to attracting new business and industry.

Prior to the CSSLT, there have been three other legislative studies to examine Ohio's tax system: the Ohio Tax Study Commission (1967), the Joint Committee to Study State Taxes (1982) and the Commission to Study the Ohio Economy and Tax Structure (1995). While the committees or commissions all reached slightly different conclusions, the respective final reports all cited a common theme: Ohio's tax code failed to meet the guiding principles of a quality tax system.

Regardless of the reasoning behind past policy decisions, it has become apparent that Ohio's tax system needs to be modernized. Many aspects of our current structure have been in existence since the 1930's and 1970's. With the transformation of America's economy in the last quarter of the 20th Century, Ohio now finds its tax code out of sync with the rest of business, industry and individual taxpayers.

The CSSLT heard during many hours of public testimony that failure to implement major tax reform would continue to negatively impact Ohio's economic development initiatives. The committee heard from business leaders, policymakers, elected officials and economists who clearly stated that Ohio has transitioned from primarily a manufacturing-based to a services-oriented economy. Business and industry officials cited the cumbersome regulations that Ohio's tax system places on them: the complex structure, assorted state and local rates and various penalties and compliance requirements. All of these have lead to a competitive disadvantage for the state.

As a result of the evolution of Ohio's economy, we heard testimony that suggested Ohio's Sales & Use Tax was placing unfair rates on tangible goods while placing virtually no tax burden on a majority of services. The CSSLT was told that a broader tax base could lead to a reduction in rates since the tax burden would be more equitably distributed. The committee learned that the state's Personal Income Tax was relatively low. Yet, as a result of the local government's "piggybacking" on the state's income tax, there is a very high burden placed on Ohio's individual taxpayers. Administrative confusion, different rates in the hundreds of taxing jurisdictions throughout the state and the heavy reliance on unpredictable taxes have put Ohio in not only a competitive disadvantage, but also in violation of essentially every guiding principle for a quality tax system.

Although it is clear that Ohio's rates are relatively high, the revenue continues to erode the equity, stability and competitiveness of the tax code. If Ohio is to maximize the development of its economic base, it is essential that major tax reform be initiated as soon as possible. For too long major reform has often been replaced with political modifications. As the 1995 Blue Ribbon Commission warned: "Had it [politics] been our principle concern, we likely would have recommended little change in the tax system." Just as with the previous studies, the CSSLT's main charge is to think about the long-term economic growth of Ohio.

In my opinion, this reports puts political judgment aside and offers at least a vision of where our tax system needs to go in order to help ensure economic prosperity for future generations. I recommend, without hesitation, that the legislative leaders initiate immediate hearings to develop legislation to implement the recommendations set forth in this report. The proposal deserves further study, additional testimony and more information through the legislative process so that recommendations can be further analyzed.

There is little doubt that Ohio's archaic tax structure is a result of the state's manufacturing history. I am confident that if the legislature moves forward with the principles that have guided this report, the tax reform will be a major factor in once again making Ohio an innovative and economic leader. The time has arrived for Ohio to evaluate the guiding principles of a tax structure that will lead to competitiveness, fairness and equity, stability, simplicity and neutrality. Approving this CSSLT report for further legislative consideration is just one step to achieve this goal.

Sincerely,

Bill Harris

Bill Harris
State Senator
19th Senate District

SENATOR Eric D. Fingerhut
25th District

February 20, 2003

Thomas M. Zaino, Commissioner
Ohio Department of Taxation
30 East Broad, Street, 22nd Floor
Columbus, OH 43215

Dear Commissioner Zaino:

Thank you for the opportunity to submit comments on the final report of the Joint Committee to Study State and Local Taxes. Representative Jerse and I would like to add the following points.

For over a decade, the General Assembly has been under a court order to revise the state's system for funding primary and secondary education. The Ohio Attorney General has repeatedly asked the Ohio Supreme Court to reconsider this decision, and the court has repeatedly reaffirmed its core findings. Among the core findings is that the state's over-reliance on local property taxes to fund primary and secondary education does not produce a thorough and efficient system as required by the Ohio Constitution. Though the General Assembly may continue to resist the implications of the decision, it is clear that any reduction in the use of local property taxes to fund education requires replacement revenue coming from taxes of statewide application.

We understand the difficulties inherent in addressing this question, but still believe that it is wrong to complete a report purporting to study all state and local taxation without making recommendations in this area. This omission makes this report incomplete and ultimately far less useful to the General Assembly than it would be if we had tackled the issue of school funding.

Additionally, the final report does not address the effects of previous changes to local government's tax base. Increasingly, local governments in Ohio face severe financial challenges due to the current economic downturn, reductions in Local Government Fund assistance, and a decline in revenues due to changes in the estate tax. It has been suggested that the phase out of the state's reimbursement to local governments for exemption of certain businesses from the tangible personal

(Cont'd)

State House
Columbus, Ohio 43215
614-466-4583
Fax 614-466-4120

SenatorFingerhut @ hotmail.com

District Office
22675 Fairmount Blvd
Cleveland, Ohio 44118
Ph/Fax 216-397-0357

property tax will cost local governments an additional $100 million over 10 years. Given the mandate of the Committee to make "revenue neutral" recommendations and the challenges local governments now face, both in terms of current revenues and the capacity to raise additional revenues, we believe the state should endeavor to hold local governments harmless from this projected loss. We understand that this loss is expected to be offset somewhat by increased sales tax revenues, but the state should monitor the situation to ensure local governments are, in fact, held harmless.

This committee's task was to study the state and local taxation system in Ohio and make recommendations for improvement. It was not our task to suggest how those recommendations be implemented. However, the history of tax reform in the United States makes clear that broadening the base of any major tax is an extraordinarily difficult thing to accomplish. The only real hope for systemic reform of the type suggested by this committee is to *simultaneously* broaden the base and reduce the rate of that tax. In this way, those who benefit from the rate reductions become a factor in the debate, in addition to the taxpayers affected by the broadening of the tax base.

The Taft Administration has proposed a significant broadening of the sales tax base in order to generate revenue. They have called this proposal tax reform, and have cited this committee's report in support of their position. This is a misuse of the term tax reform and of this committee's report. Further, the Taft Administration's current strategy is likely to undermine the chances of true tax reform, not enhance those chances.

This report justifies many tax changes as efforts to enhance Ohio's competitiveness. This is an appropriate yardstick, but it is not sufficient. Ohio's economic growth has lagged behind the rest of the nation for most of the last decade. Residents of many of Ohio's cities have actually seen their income decline in real terms. Ohio needs tax reform that accelerates the rate of economic and real income growth. This report contains many valuable changes in the state and local tax system, but it is not, in our opinion, sufficiently focused on economic growth.

Sincerely,

Senator Eric D. Fingerhut Representative Edward S. Jerse

APPENDIX B

1972 and 2002 Personal Income Tax Forms – A Comparison

Front of 1972 Tax Return

1972

STATE OF OHIO
DEPARTMENT OF TAXATION

FORM IT-1040

INDIVIDUAL INCOME TAX RETURN
FOR THE CALENDAR YEAR 1972 OR OTHER TAXABLE YEAR

Beginning _____, 19____ ending _____, 19.

SOCIAL SECURITY NUMBER(S)

TAXPAYER	SPOUSE	COUNTY

First name(s) and initial(s) Last name

PLEASE PRINT OR TYPE

Address (number and street including apartment number or rural route)

City, town or post office, state Zip code

(attach State copy of IT-2 or W-2 on back)

I DECLARE UNDER THE PENALTIES OF PERJURY THAT TO THE BEST OF MY KNOWLEDGE AND BELIEF THIS IS A TRUE, CORRECT AND COMPLETE RETURN.

SIGNATURE – If joint return, both husband and wife must sign Date

Signature of Preparer other than Taxpayer based on all information of which he has any knowledge

SHORT FORM

1. FEDERAL ADJUSTED GROSS INCOME (From IRS Form 1040 or 1040A) ..... $ _____ | ____
2. EXEMPTIONS ($500.00 each) ..... _____ | ____
3. OHIO TAXABLE INCOME ..... $ _____ | ____
4. TAX (see tax table) ..... $ _____ | ____
5. OHIO INCOME TAX WITHHELD ..... $ _____ ____
6. OHIO EST. INCOME TAX PAYMENTS _____ ____
7. TOTAL PAYMENTS ..... $ _____ | ____
8. TAX DUE (attach check or money order made payable to. Treasurer of State of Ohio) ..... $ _____ | ____
9. OVERPAYMENT ..... $ _____
   Check one: Refund ☐ Credit to 1973 Tax ☐

THIS RETURN MUST BE FILED ON OR BEFORE APRIL 15, 1973. MAKE CHECK OR MONEY ORDER PAYABLE TO TREASURER OF STATE OF OHIO AND MAIL TO: OHIO DEPARTMENT OF TAXATION, BOX 2679, COLUMBUS, OHIO 43216

Back of 1972 Tax Return

LONG FORM (To be used only by taxpayers with adjustments and/or credits)

1. FEDERAL ADJUSTED GROSS INCOME (From IRS Form 1040 or 1040A) ..... $ _____ | ____
2. ADJUSTMENTS (see instructions)
   A. ADD – (1) _____ ..... $ _____ | ____
   (2) _____ ..... _____ | ____
   (3) Total Additions ..... _____ | ____
   B. SUB TOTAL ..... $ _____ | ____
   C. DEDUCT – (1) Intangible income reported on 1972 Ohio Intangible Personal Property Tax Return $ _____ | ____
   (2) Retirement income (Not more than $4,000.00 per return) _____ | ____
   (3) _____ ..... _____ | ____
   (4) Total Deductions ..... _____ | ____
3. OHIO ADJUSTED GROSS INCOME ..... $ _____ | ____
4. EXEMPTIONS ($500.00 each) ..... _____ | ____
5. OHIO TAXABLE INCOME ..... $ _____ | ____

TAX (see tax table) ..... $ _____ | ____

CREDITS (see instructions)

A. Credits for income taxed by another state (attach schedule) $ _____ | ____

B. Senior Citizens Credit (Limit $25.00 per return) ..... _____ | ____

C. Other (explain) ..... _____ | ____

D. Total Credits (not to exceed Line 6) ..... _____ | ____

TAX BEFORE PAYMENTS ..... $ _____ | ____

PAYMENTS

A. Ohio income tax withheld ..... $ _____ | ____

B. Ohio estimated income tax payments ..... _____ | ____

C. Total Payments ..... _____ | ____

TAX DUE (attach check or money order made payable to: Treasurer of State of Ohio) ..... $ _____ | ____

OVERPAYMENT ..... $ _____ | ____
Check one: Refund ☐ Credit to 1973 Tax ☐

IT 1040 OHIO Income Tax Return 2002

For the year Jan. 1-Dec. 31, 2002 or other taxable year ending _____, 20___

Social Security Numbers must be filled in below.

Please Clip Your Check or Money Order Here.

Your first name	Initial	Last name	Your social security number	Filing Status–check only one
If a joint return, spouse's first name	Initial	Last name	Spouse's social security number	☐ Single or Head of Household ☐ Married filing joint return ☐ Married filing separately, enter spouse's SS#
Home address (number and street) — PLACE LABEL HERE OR PRINT/TYPE INFORMATION		Apt. Number	Ohio county	
City, town or post office, state and ZIP code			Ohio Public School District Number (See pages 33-35.) ▶	

Ohio Residency Status (see instructions)

☐ Resident ☐ Part-Year Resident from: / /02 to / /02

☐ Nonresident _____ state of residence

Ohio Political Party Fund

	Yes	No
Do you want $1 to go to this fund?		
If joint return, does your spouse want $1 to go to this fund?		

Note: Checking "Yes" will not increase your tax or decrease your refund.

INCOME

1. Federal Adjusted Gross Income (from Federal Form 1040, line 35; or 1040A, line 21; or 1040EZ, line 4; or 1040TEL)	1		00
2. Ohio Adjustments (from line 45 on back of this return)	2		00
3. Ohio Adjusted Gross Income (line 2 subtracted from or added to line 1)	3		00
4. Multiply your personal and dependent exemptions ☐ times $1,200 and enter the result here	4		00
5. Ohio Taxable Income (subtract line 4 from line 3)	5		00

TAX AND CREDITS

6. Tax on line 5 (see tax tables, pages 26-32)	6		00
7. Credits from Schedule B (line 54 on back of this return)	7		00
8. Ohio Tax less Schedule B Credits (Subtract line 7 from line 6. If line 7 is more than line 6, enter zero.)	8		00
9. Exemption Credit: Number of personal and dependent exemptions ☐ times $20	9		00
10. Ohio Tax less Exemption Credit (Subtract line 9 from line 8. If line 9 is more than line 8, enter zero.)	10		00
11. Joint Filing Credit (see instructions and attach documentation) ☐ % times line 10 (limit $650)	11		00
12. Ohio Tax less Joint Filing Credit (subtract line 11 from line 10)	12		00
13. Resident/Nonresident/Part-Year Credits (Sch. C or D) & Nonrefundable Business Credits (attach Sch. E)	13		00
14. Ohio Income Tax (Subtract line 13 from line 12. If line 13 is more than line 12, enter zero).	14		00
15. Interest Penalty on Underpayment of Estimated Tax: Check ☐ if Form IT-2210 is attached	15	00	
16. Unpaid Ohio Use Tax (please see worksheet on page 24) The amount you show on this line is part of your total income tax liability for this year.	16	00	
17. Total Ohio Tax (add line 14, line 15, and line 16)	17		00

PAYMENTS

18. **Ohio Tax Withheld** (box 17 on your W-2) (attach W-2's to the back of this form) AMOUNT WITHHELD ▶	18	00	
19. Ohio Estimated Tax, IT-40P Payments for 2002, and 2001 Overpayment Credited to 2002	19	00	
20. Refundable Business Jobs Credit 20a ☐ Refundable Pass-through Entity Credit 20b ☐ Total of 20a & 20b	20	00	
21. Add lines 18, 19, and 20 TOTAL PAYMENTS ▶	21	00	

Electronic Filing can speed up your refund by 6 weeks!

REFUND OR AMOUNT YOU OWE

22. If line 21 is LESS than line 17, subtract line 21 from line 17. Attach payment made payable to Treasurer of State of Ohio. Check here ☐ if you have paid or will pay with a credit card (see instructions) AMOUNT YOU OWE ▶	22		00
23. If line 21 is GREATER than line 17, subtract line 17 from line 21 AMOUNT OVERPAID ▶	23		00
24. Amount of line 23 you wish to DONATE for conservation of endangered species and wildlife diversity: $3 ☐ $5 ☐ $10 ☐ Other ☐ Check box and enter amount on line 24	24		
25. Amount of line 23 you wish to DONATE for nature preserves, scenic rivers, and endangered species protection: $3 ☐ $5 ☐ $10 ☐ Other ☐ Check box and enter amount on line 25	25	00	
26. Amount of line 23 to be credited to 2003 estimated tax liability CREDIT ▶	26	00	
27. Amount of line 23 to be refunded (subtract amounts on lines 24, 25, and 26 from line 23) YOUR REFUND ▶	27		00

IF THE BALANCE DUE IS LESS THAN $1.01 PAYMENT NEED NOT BE MADE, AND IF THE OVERPAYMENT IS LESS THAN $1.01, NO REFUND WILL BE ISSUED.

I have read this return. Under penalties of perjury, I declare that to the best of my knowledge and belief, the return is true, correct, and complete.

SIGN HERE

▶ Your signature	Date
▶ Spouse's signature (If filing jointly, BOTH must sign)	Phone number (optional)
Preparer's signature	Preparer's phone number
Preparer's address (including zip code)	

FOR DEPARTMENTAL USE ONLY

		18a.	U

NO Payment Enclosed–Mail to:	Payment Enclosed–Mail to:
Ohio Department of Taxation P.O. Box 2679 Columbus, OH 43270-2679	Ohio Department of Taxation P.O. Box 2057 Columbus, OH 43270-2057

Schedule A Adjustments to Income (Additions and Deductions)

Additions – Add to the extent not included in federal adjusted gross income (Line 1)

28. Add non-Ohio state or local government interest and dividends ..... 28 ● 00
29. Add Pass-through Entity addback ..... 29 ●
30. Add income from an Electing Small Business Trust (ESBT–see instructions) ..... 30 ● 00
31. Other. Check if from:
    a. ☐ Federal interest and dividends subject to state taxation
    b. ☐ Reimbursement of college tuition expenses and fees deducted in any previous year(s) NEW
    c. ☐ Losses from sale or disposition of Ohio Public Obligations
    d. ☐ Non-medical withdrawals from an Ohio Medical Savings Account
    e. ☐ Reimbursements previously deducted but not included in federal adjusted gross income
    f. ☐ Non-education expenditures from College Savings Account
    g. ☐ Add back 5/6ths of the depreciation expense adjustment for IRC section 168(k) bonus depreciation NEW
    Total ..... 31 ● 00
32. Total Additions (add lines 28, 29, 30, and 31) ..... 32 ● 00

Deductions – See Limitations in Instructions

33. Deduct federal interest and dividends exempt from state taxation ..... 33 ● 00
34. Deduct compensation earned in Ohio by full-year residents of neighboring states ..... 34 ● 00
35. Deduct state or municipal income tax overpayments (see instructions) ..... 35 ● 00
36. Deduct disability and survivorship benefits (does not include pension continuations) ..... 36 ● 00
37. Deduct qualifying social security benefits and some railroad benefits ..... 37 ● 00
38. Deduct contributions to a variable college savings account and/or purchases of tuition credits ..... 38 ● 00
39. Deduct tuition expenses paid to a qualified Ohio educational institution ..... 39 ● 00
40. Deduct unsubsidized health insurance/long term care insurance and excess medical expenses (see worksheet) ..... 40 ● 00
41. Deduct funds deposited into & earnings of a Medical Savings Account for eligible medical expenses (see worksheet) ..... 41 ●
42. Deduct losses from an Electing Small Business Trust (ESBT–see instructions) ..... 42 ● 00
43. Other. Check if :
    a. ☐ Wage & salary expense not deducted due to the federal targeted jobs or the work opportunity tax credits
    b. ☐ Interest income from Ohio Public Obligations and Ohio Purchase Obligations and gains from the sale or disposition of Ohio Public Obligations
    c. ☐ Refund or reimbursements of prior-year federal itemized deductions (from line 21 of Federal 1040)
    d. ☐ Repayment of income reported in a prior year
    e. ☐ Amount contributed to an Individual Development Account
    f. ☐ Deduct 1/5th of the depreciation expense adjustment for IRC section 168(k) bonus depreciation NEW
    Total ..... 43 ● 00
44. Total Deductions (add lines 33 through 43) ..... 44 ●
45. Net Adjustments–If line 32 is GREATER than line 44, enter the difference here & on line 2 as a positive amount.
    If line 32 is LESS than line 44, enter the difference here & on line 2 as a negative amount ..... 45 ● 00

Schedule B Credits

46. Retirement Income Credit (see instructions for credit table) (**Limit–$200**) ..... 46 ● 00
47. Senior Citizen Credit (**Limit–$50 per return**) ..... 47 ● 00
48. Lump Sum Distribution Credit (you must be 65 years of age or older to claim this credit) ..... 48 ● 00
49. Child and Dependent Care Credit (see instructions and worksheet) ..... 49 ● 00
50. Lump Sum Retirement Credit ..... 50 ●
51. Job Training Credit (see instructions & worksheet) (**Limit–$500 single; $1,000 joint, if both spouses qualify**) ..... 51 ●
52. Ohio Political Contributions Credit ..... 52 ● 00
53. Ohio Adoption Credit (**Limit–$500 per adoption**) ..... 53 ● 00
54. Total Credits (add lines 46 through 53) – enter here and on line 7 ..... 54 ● 00

Schedule C Ohio Resident

55. Enter the portion of line 3 subjected to tax by other states or the District of Columbia while an Ohio resident ..... 55 ● 00
56. Enter Ohio Adjusted Gross Income (line 3) 56 00
57. Divide line 55 by line 56 [%] Multiply by the amount on line 12 ..... 57 00
58. Enter the 2002 income tax less all related credits other than withholding and estimated tax payments and carry-forwards from previous years paid to other states or the District of Columbia ..... 58 ● 00
59. Enter the smaller of line 57 or line 58. This is your Ohio Resident Tax Credit. Enter here and on line 13 ..... 59 00

List the state(s) other than Ohio with which you filed 2002 Income Tax Returns

[ ] [ ] [ ] [ ]

Schedule D Nonresident/Part-Year Resident

60. Enter the portion of Ohio Adjusted Gross Income (line 3) that was not earned or received in Ohio ..... 60 ● 00
61. Enter the Ohio Adjusted Gross Income (line 3) 61 00
62. Divide line 60 by line 61 [%] Multiply by the amount on line 12. Enter here and on line 13. ..... 62 00

Attach W-2 and 1099R Forms Here

IT 1040 EZ

2002

OHIO Income Tax Return

For Full Year Ohio Residents

Please clip your check or money order here.

Your first name	Initial	Last name
If a joint return, spouse's first name	Initial	Last name
Home address (number and street)	PLACE LABEL HERE OR PRINT/TYPE INFORMATION	Apt. Number
City, town or post office, state and ZIP code		Ohio County

Social Security Number(s) must be filled in below

Your Social Security No. ☐☐☐ ☐☐ ☐☐☐☐

Spouse's Social Security No. (if joint filing) ☐☐☐ ☐☐ ☐☐☐☐

Public School District Number ▶ ☐☐☐☐
(See pages 33-35.)

Filing Status (check only one) Single or Head of Household ☐ Married Filing Joint ☐ Married Filing Separate ☐

Ohio Political Party Fund Checking "Yes" will not increase your tax or reduce your refund.

Do you want $1 to go to this fund? ..... Yes ☐ No ☐

If joint return, does your spouse want $1 to go to this fund? ..... Yes ☐ No ☐

		Dollars	Cents
1.	**Federal Adjusted Gross Income** from Federal Form 1040, line 35; or 1040A, line 21; or 1040EZ, line 4; or 1040TEL	1.	00
2.	**Enter the amount from Worksheet A on the back of this return**	2.	00
3.	**Ohio Adjusted Gross Income** (line 1 minus line 2)	3.	00
4.	**Personal and Dependency Exemption Deduction** – Multiply the number of your exemptions _____ times $1,200 and enter the result here *(See TIP on back of return for children who are claimed on their parents' tax return.)*	4.	00
5.	**Ohio Taxable Income** (line 3 minus line 4)	5.	00
6.	**Tax on line 5** (see tax tables, pages 26-32)	6.	00
7.	**Exemption Credit** – Multiply the number of your personal and dependent exemptions _____ times $20 and enter the result here	7.	00
8.	**Tax Less Exemption Credit** (line 6 minus line 7)	8.	00
9.	**Joint Filing Credit** (see instructions) _____% times line 8 **(Limit $650)**	9.	00
10.	**Ohio Income Tax** (line 8 minus line 9)	10.	00
11.	**Unpaid Ohio Use Tax** (from Worksheet B, line e on back of this form) *The amount you show on this line is part of your total income tax liability for this year.*	11.	00
12.	**Total Ohio Tax** (add lines 10 and 11)	12.	00
13.	**Ohio Tax Withheld** Enter the amount of Ohio income taxes withheld (box 17 on your W-2) (Indicate the number of W-2's attached ____) **WITHHOLDING** ▶	13.	00
14.	**Refund** (if line 13 is more than line 12, subtract line 12 from line 13). This is your refund. **YOUR REFUND** ▶	14.	00
15.	**Amount You Owe** (if line 13 is less than line 12, subtract line 13 from line 12). This is the amount you owe. Attach payment made payable to: Treasurer of State of Ohio. Write your social security number on your check or money order. Check here ☐ if you have paid or will pay with a credit card (see instructions) ..... **AMOUNT YOU OWE** ▶	15.	00

Attach W-2's to backside.

If the amount you owe is less than $1.01, payment need not be made. And if your refund is less than $1.01, no refund will be issued.

Wildlife Donations and Natural Areas (These will REDUCE your refund.)

16. Amount of line 14 you wish to **donate** for conservation of endangered species and wildlife diversity: $3 ☐ $5 ☐ $10 ☐ other ☐ ..... 16. ☐☐☐ . 00

17. Amount of line 14 you wish to **donate** to nature preserves, scenic rivers and endangered species protection: $3 ☐ $5 ☐ $10 ☐ other ☐ ..... 17. ☐☐☐ . 00

Do not complete lines 16 and 17 unless you want to donate all or part of your refund on line 14 to Wildlife and Natural Areas. Your refund will be automatically reduced by the amount donated.

I have read this return. Under penalties of perjury, I declare that, to the best of my knowledge and belief, this return is true, correct, and complete.

Sign Here

Your Signature	Date
Spouse's Signature (if joint return)	Phone No. (optional)
Paid Preparer's Name and Signature	Preparer's Phone No.
Paid Preparer's Address (including zip code)	

FOR DEPARTMENTAL USE ONLY

13A U

No Payment Enclosed – Mail to:
Ohio Department of Taxation
P.O. Box 182294
Columbus, OH 43218-2294

Payment Enclosed – Mail to:
Ohio Department of Taxation
P.O. Box 182850
Columbus, OH 43218-2850

2002 Ohio Form IT 1040EZ
Additional Instructions and Worksheets

TIP:
Line 4 and Line 7–Personal Exemption Deduction and Exemption Credit

Every taxpayer who files an Ohio income tax return is entitled to a personal exemption of $1,200 (line 4) and a $20.00 exemption credit (line 7). You are entitled to this deduction and credit even if you can be claimed on another taxpayer's tax return. Some taxpayers (mostly working students) are not taking advantage of this deduction and credit because they are claimed on their parents' return and believe they are not entitled to the personal exemption deduction or exemption credit provided on the Ohio return. By taking advantage of this deduction and credit, you will increase your refund or decrease the amount you owe.

Worksheet A for Line 2

If you filed a **federal Form 1040** tax return, you may be entitled to a deduction on your Ohio tax return this year for state or municipal income tax refunds you received in 2002. You are **not** entitled to a deduction this year if you filed a **federal Form 1040EZ, 1040A, or federal Form 1040TEL**. Complete this worksheet to determine if you are entitled to a deduction on line 2 of this return.

a) Did you file a **2002 *federal Form 1040EZ*?** ***or*** Did you file a **2002 *federal Form 1040A*?** ***or*** Did you file a **2002 *federal Form 1040TEL by telephone*?** ☐ **Yes**. **STOP** and enter -0- on line 2 of this return. ☐ **No**. **Complete line b.**	
b) Enter the amount from line 10 of your 2002 federal Form 1040 here and on line 2 of this return. This deduction is for state and/or local income tax refunds that you claimed as an itemized deduction (Schedule A) on your 2001 federal Form 1040 and added back as income on your 2002 federal Form 1040.	**$ .00**

Worksheet B for Line 11

If you made any out-of-state purchase(s) during 2002 (e.g., Internet, television/radio ads, catalog purchases or purchases made directly from an out-of-state company) and if you paid **no** sales tax on that purchase(s), you are required to complete this worksheet to determine what tax you owe on that purchase(s). Please complete the following worksheet to determine if you owe any Ohio use tax (which is the sales tax on those purchases).

a) Did you make any of the purchases described above during 2002? ☐ **No–STOP –You do not owe any Ohio use tax.** Enter -0- on line e, below, and on line 11 of this tax return. ☐ **Yes**–Complete line b of this worksheet to determine if you owe Ohio use tax on your purchase(s).	
b) Did the retailer charge you sales tax on your out-of-state purchase(s)? ☐ **Yes–STOP–You do not owe any Ohio use tax**. Enter -0- on line e, below, and on line 11 of this tax return. ☐ **No**–You owe Ohio use tax on your purchase(s). Complete lines c, d, and e of this worksheet.	
c) Enter your total out-of-state purchases on which you paid ***no*** sales tax or Ohio use tax.	**$ .00**
d) Enter your county use tax rate (see page 24 in the instruction booklet if you do not know your county's sales/use tax rate). Please use the rate decimals on page 24 to calculate your tax.	**X . _ _ _ _**
e) Multiply line c by line d. This is the amount of Ohio use tax that **you owe** on your out-of-state purchase(s). Write the amount here (round to nearest dollar) and on line 11 of this return. This amount is part of your income tax liability.	**$ .00**

APPENDIX C

A Comparison of the Business/Nonbusiness Income Reporting Method and the Ohio Method

Appendix C

A Comparison of the Business/Nonbusiness Income Reporting Method and the Ohio Method

Business Income/Nonbusiness Income Method

Under the business income/nonbusiness income method,[44] a company must apportion all types of trade or business income (e.g., profit or loss from selling goods and services, interest and dividends from working capital investments, gains and losses from the sale of assets used in the business, and profit or loss from rental activities—if such activities constitute an active trade or business. Under this method, the only income which is not business income is that income derived from activities not constituting an active trade or business. The nonbusiness income, if any, is allocated either entirely into the state (if the income has some connection with the state) or out of the state (if the income has no connection with the state).

The key to the business income/nonbusiness income distinction is that income is "business income" if it is derived from the conduct of a trade or business. Income is "nonbusiness income" only if it does not qualify as business income. As a general rule, under the "business income/nonbusiness income method," all income is presumed to be business income (which is apportioned using a ratio of the business' property, payroll, and sales in Ohio versus its property, payroll, and sales everywhere).[45]

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[44] Divisions (B) and (C) of ORC section 5747.01 – the section which defines terms and phrases in connection with Ohio's income taxation of non-corporate business entities – define "business income" and "nonbusiness income," respectively, as follows:

(B) "Business income" means income, including gain or loss, arising from transactions, activities, and sources in the regular course of a trade or business and includes income, gain, or loss from real property, tangible property, and intangible property if the acquisition, rental, management, and disposition of the property constitute integral parts of the regular course of a trade or business operation. "Business income" includes income, including gain or loss, from a partial or complete liquidation of a business, including, but not limited to, gain or loss from the sale or other disposition of goodwill.

(C) "Nonbusiness income" means all income other than business income and may include, but is not limited to, compensation, rents and royalties from real or tangible personal property, capital gains, interest, dividends and distributions, patent or copyright royalties, or lottery winnings, prizes, and awards.

[45] See Multistate Tax Commission Apportionment and Allocation Regulations @Reg. IV.1.(a) available at http://www.mtc.gov/UNIFORM/Genla&a_72701.PDF:

In essence, all income which arises from the conduct of trade or business operations of a taxpayer is business income . . .. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the

Example #1:

Facts: An Ohio company manufactures and sells shoes. Over the years the company has accumulated excess cash and currently has no plans for using the cash. The company invests the cash in two apartment buildings—one in Ohio and one in another state.

Tax results: Under the business income/nonbusiness income method, the profit (or loss) from the shoe business would be apportionable business income. The profit (or loss) from the apartment buildings would be allocable nonbusiness income: the profit or loss from the Ohio apartment building would be allocated entirely to Ohio; the profit or loss from the non-Ohio apartment building would be allocated entirely outside Ohio.

Example #2:

Facts: An Ohio company's sole "line of business" is purchasing, maintaining, renting, and selling apartment buildings in Ohio and elsewhere.

Tax results: Under the business income/nonbusiness income method, the profit or loss from the apartment buildings would be apportionable business income: the profit or loss from the Ohio apartment buildings would be apportioned within and without Ohio; the profit or loss from the non-Ohio apartment buildings would also be apportioned within and without Ohio.

The Ohio Method

Under the Ohio method of treating income, a company must allocate certain types of statutorily-listed income (such as income from rental properties)—whether the property generating that income is part of (or not part of) the company's active trade or business. Furthermore, under the Ohio method all remaining types of income are apportioned—even if the property generating that income is not part of the company's active trade or business. The key to this method is that trade or business activities are irrelevant: the statute lists several types of income which are always allocated (whether the income is or is not derived from a trade or business), and all other types of income—that is, income not specifically listed—is always apportioned (whether that income is or is not derived from a trade or business).[46]

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transactions and activities which are the elements of a particular trade or business. In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will be integral parts of, a trade or business.

[46] However, under the U.S. Constitution, some items of income not required by statute to be allocated must, nevertheless, be allocated outside Ohio if such income is not related to (that is, not unitary with) the business conducted in Ohio. Example: A corporation operates a shoe business in Ohio and operates a peanut farm business in Georgia. Each business has its own separate management group, separate pension plans, separate health insurance plans, etc. There are no economies of scale; there is no functional integration. While Ohio law would require that both the shoe business profit and the peanut farm profit be added together and then apportioned, the U.S. Constitution would most likely allow the company to allocate entirely out of Ohio the peanut farm profit since the corporation's two business operations are not unitary.

Example #3:

Facts: Same facts as in example #1—an Ohio company manufactures and sells shoes. Over the years the company has accumulated excess cash and currently has no plans for using the cash. The company invests the cash in two apartment buildings—one in Ohio and one in another state.

Tax results: Same tax results as in example #1—under the Ohio method the profit or loss from the shoe business would be apportionable income (just "apportionable income," not "apportionable *business* income"). The profit or loss from the apartment buildings would be allocable income (not "allocable *nonbusiness* income;" just "allocable income"): the profit or loss from the Ohio apartment building would be allocated entirely to Ohio; the profit or loss from the non-Ohio apartment building would be allocated entirely outside Ohio.

Example #4:

Facts: Same facts as in example #2—an Ohio company's sole "line of business" is purchasing, maintaining, renting, and selling apartment buildings in Ohio and elsewhere.

Tax results: Not the same tax results as in example #2—the profit or loss from each apartment building would be allocable income (just "allocable income," not "allocable *nonbusiness* income"). The profit or loss from each Ohio apartment building would be entirely allocated to Ohio, and the profit or loss from each non-Ohio apartment building would be allocated entirely outside Ohio.

Summary

The two methods (business income/nonbusiness income method and the Ohio method) differ regarding a presumption and a "default." Under the business income/nonbusiness income method, the presumption is that (1) all income is apportionable business income and (2) income "defaults" to allocable nonbusiness income only if the income is not business income. On the other hand, under the Ohio method there is no presumption: certain income is, by statute, always allocable income, and the remaining income "defaults" to apportionable income if that income is not statutorily listed as allocable income.

APPENDIX D

Combined and Consolidated Reporting for Taxing Corporate Income

Appendix D

Combined and Consolidated Reporting for Taxing Corporate Income

There are generally three different filing status "presentations" for the corporation income tax return: (1) "separate tax return" presentation, (2) "combined group tax return" presentation,[47] and (3) "consolidated tax return" presentation.

Separate Tax Return Presentation

The separate tax return presentation means that each corporation must file its own income tax return and cannot file in combination with or in consolidation with any affiliate (parent, subsidiary, brother-sister). As such, the corporation's own income cannot be "sheltered" with losses generated by affiliates. Furthermore, the corporation's income cannot be "diluted" based upon affiliates having little or no apportionment factors in the state.

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[47] The "combined group tax return" presentation has several variations or methods. The two most common methods are (i) combinations of (and limited to) all members of the "unitary" group and (ii) combinations of only those corporate affiliates which the taxpayer elects to be part of the combination.

The first method, combinations of (and limited to) all members of the unitary group, is commonly employed in several states, most notable of which is California. If the state requires a combination of income, the U.S. Constitution – as interpreted by the U.S. Supreme Court – limits the state's authority: the state's requiring a combined tax return will apply only to members of the unitary group. In general, a group of business activities or a group of corporations are unitary only if three conditions are present: centralized management, economies of scale, and functional integration. While volumes have been written on what constitutes – and what does not constitute – these three conditions, the following example illustrates the concept.

Assume a parent holding company—with no significant operations of its own—owns two subsidiaries and at least one of the subsidiaries is doing business in a state having a "required combination" statute (with a "required combination" statute it is irrelevant if the second subsidiary does—or does not—operate in the same state). Further assume that one of the subsidiary corporations operates a shoe business and that the other subsidiary operates a peanut farm business. Each subsidiary has its own separate management group, separate pension plans, separate health insurance plans, etc. There are no economies of scale (no group purchases, for example); there is no functional integration (neither business contributes to or is part of the other business).

In this example, the two subsidiaries are not operating a unitary business. Thus, while the state's required combination law could mandate that these brother-sister corporations must file a combined group income tax return, most likely the U.S. Constitution would allow the corporations to avoid filing a combined group income tax return since in this example the two corporations are not unitary.

The second method of combination, the elected combination, is often not limited to those corporations comprising a unitary group, and, in fact, the combination may exclude one or more members within the unitary group. Many call this combination variation the "cherry picking" method since the corporate group will elect a combination of only those affiliates resulting in the lowest state income tax imposed on the group as a whole. Ohio law provides for such "cherry picking."

Example: Under this method of filing, XYZ Motor Company (the manufacturer) and XYZ Credit Company (the wholly-owned lending and leasing company) are considered to have no relationship at all, and for state income tax purposes, they are treated as two separate, distinct, and totally unrelated taxpayers.

Combined Group Tax Return Presentation

The combined group tax return presentation means that affiliated companies combine their incomes. As such, inter-company profits and losses are eliminated as part of the combination of income. After the income is combined, the group then ascertains (1) the portion of the combined income which is allocable and (2) the portion of the combined income which is apportionable. The combined allocable income is then assigned to each corporation which generated the allocable income; each corporation then allocates the assigned allocable income either within or without the state.

The combined apportionable income is then assigned, based upon some statutory pro-rata method, to each corporation – regardless of which corporation actually generated the apportionable income. Each corporation then apportions its pro-rata share of the combined apportionable income.

After completing these above-described procedures, each corporation prepares its own separate return setting forth the results of the above-described procedures. Only those members of the combination which are "taxpayers" pay tax on their share of (1) the combined allocated income and (2) the combined apportioned income. Those members of the combination which are not "taxpayers" pay no tax on their share of (1) the combined allocated income and (2) the combined apportioned income.

Example: XYZ Motor Company (the manufacturer) and XYZ Credit Company (the wholly-owned lending and leasing company) file in Ohio as a combined group. In this example each corporation will file a separate Ohio tax return reflecting each corporation's share of (1) the combined allocated income and (2) the combined apportioned income. XYZ Motor Company will pay Ohio income tax based upon its share of (1) the combined allocated income and (2) the combined apportioned income. However, because XYZ Credit Company is exempt from the franchise tax as a dealer in intangibles, that company will pay no Ohio income tax on its share of (1) the combined allocated income and (2) the combined apportioned income.

Consolidated Tax Return Presentation

A consolidated tax return presentation means that the corporate affiliates – generally the same affiliates participating in the filing of the U.S. consolidated income tax return – allocate and apportion income as if all the income had been earned by one corporation (that is, the return reflects the consolidated income of the group as a whole).[48] The consolidated return group is not limited to those corporations having unitary activities and profits. Like the combined group tax returns presentation, inter-company profits and losses are eliminated as part of the consolidation of income process. However, unlike the combined group tax returns presentation, the consolidated income is not assigned to the various corporate members of the group; rather, the group files only one tax return: a return reflecting the entire group's consolidated income which is allocated and apportioned to the state.

[48] Generally, although only one tax return is filed, each corporation having nexus with the state is jointly and severally liable for the consolidated income tax.