

# TAX ANALYSIS OF KASICH'S 2018 BUDGET

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THOMAS M. ZAINO, JD, CPA  
MANAGING MEMBER

## House Bill 49 Introduced – Will Cost Business \$1.2 Billion Over Next Two Years

Last week, Governor John Kasich introduced an overview of his biennial budget plan, which would lower personal income taxes by \$3.1 billion over the biennium, while increasing other taxes by over \$3.0 billion. We estimate that the tax shift would cost business \$1.2 billion over the next two years.

On Wednesday, the Ohio House of Representatives released the biennial budget legislative language in House Bill 49 (“Bill” or “H.B. 49”). The Bill is fairly consistent with Governor Kasich’s budget overview released the week before. However, there are some areas where the language may have a broader impact than initially described in Governor Kasich’s budget overview. Certain areas are so complicated, both politically and technically, that additional changes will be necessary. Finally, there are some administrative and other proposed changes that were not described in Governor Kasich’s budget overview that readers should know about.

## Personal Income Tax Rate Reductions and Reform

The language in H.B. 49 providing for the reduction of personal income tax rates is consistent with Governor Kasich’s proposed budget overview. The Ohio personal income tax on individuals, trusts, and estates is currently imposed using nine income tax brackets, ranging from 0.495 percent to 4.997 percent. The Bill would reduce

the existing income tax brackets from nine brackets to five brackets, lowering the top rate to 4.33 percent.

| Income                | 2017 Proposed Tax Rate | 2018 Proposed Tax Rate |
|-----------------------|------------------------|------------------------|
| Up to \$10,000        | 0.50%                  | 0.456%                 |
| \$10,000 - \$25,000   | 1.5%                   | 1.367%                 |
| \$25,000 - \$100,000  | 3.25%                  | 2.963%                 |
| \$100,000 - \$200,000 | 4.25%                  | 3.874%                 |
| More than \$200,000   | 4.75%                  | 4.33%                  |

The proposal also increases the benefit of the low income tax credit and increases the personal exemptions for many taxpayers. It is important to note that these cuts will not directly impact businesses because the first \$250,000 of business income is exempt and a flat 3 percent tax rate applies to business income above \$250,000.

### **Sales Tax Rate Increase**

Consistent with Governor Kasich's budget overview, H.B. 49 provides for an increase in the current state sales tax rate from 5.75 percent to 6.25 percent. If enacted, Ohio's state and average local sales tax rate (7.55 percent) would be higher than any of its neighboring states.

This 8.7 percent sales and use tax rate increase would generate approximately \$1.438 billion over the biennium. Past studies have determined that approximately 42 percent of the sales tax is paid by businesses in Ohio. As a result, this proposed increase could cost Ohio businesses approximately \$604 million over the next two years.

### **New Taxable Services Broadly Defined**

The Bill also adds a variety of services to the Ohio sales and use tax base. These new services will become taxable starting January 1, 2018. These services include: lobbying, repossession, cable television, landscape design, interior design and decorating, travel, and elective cosmetic surgery/procedures. Many of the definitions provided in H.B. 49 are broad and could encompass more services than the services specifically described in Governor Kasich's budget overview.

Lobbying Service. Lobbying service is defined broadly as any activity engaged in to influence the behavior or opinion of an elected official, an industry, or an organization. The person providing the services must be a “registered” lobbyist with Ohio, or with the United States (“U.S.”) Senate or House of Representatives. A service in which an attorney represents a client in a specific administrative or judicial matter or any form of advertising is excluded from the definition. Because the definition of a lobbying service is broad, and does not tie the registration to a specific service, the definition could be interpreted as applying to most services provided by a registered lobbyist. A trade association that handles legislative matters on behalf of its membership is often registered as a lobbyist and may be considered to be providing a “lobbying service,” which could cause all or a portion of the association’s membership dues to be subject to Ohio sales and use tax.

One of the biggest challenges with taxing professional services, such as lobbying, is determining whether the services are situated in or out of Ohio. If the service is received by the purchaser at the vendor’s location, the service is situated to the vendor’s location. If the service is not received at the vendor’s location, the service is situated to where the consumer receives the service, which can be difficult to determine in many situations. Lobbying services will probably be situated based on where the consumer received the service, but it may be unclear whether that location is the consumer’s headquarters or another location. The siting can become even more complicated depending on the location of the lobbying service. If a person is lobbying the Ohio legislature on behalf of an out-of-state company, is the service received at the company’s headquarters or in Ohio? If the service involves lobbying U.S. Congress, is only an Ohio headquartered company subject to the Ohio sales or use tax on such activity? These questions illustrate the difficulty with taxing professional services under the current law’s siting provisions.

Repossession Service. The definition of a “repossession service” includes “repossessing tangible assets for a creditor because of delinquent debts.” The term “repossession” is not specifically defined in H.B. 49, but the term is commonly understood to include reclaiming an item through judicial actions, foreclosures, etc. Thus, a repossession service could be broadly interpreted as applying to related legal and foreclosures services. The definition of price could also impact what is included in the taxable base for repossession services.

Cable Television Service. Cable television service is defined as a “one-way transmission to a subscriber of video programming or other programming service.” The broad definition may include services beyond traditional cable subscription services.

Most online video programming services are already subject to the Ohio sales and use tax as digital goods.

Landscape Design Service. Landscape design service is broadly defined to include “planning and design of exterior spaces, including consultation, research, supervision, preparation of general or specific design or detail plans, studies, or specifications, or any other similar service.” Some architecture and similar services may fall within the definition of these proposed taxable services.

Interior Design and Interior Decorating Service. Interior design and interior decorating service is broadly defined to include “planning and design of interior spaces, furniture arranging, design and planning of furniture, fixtures, and cabinetry, staging, light and sound design, interior floral design, selection, purchase and arrangement of surface coverings, draperies, furniture, and other decorations, or any other similar service.” Some architecture and similar services may also fall within the definition of these proposed taxable services.

Travel Service. Travel service includes acting as an agent to sell travel, tour, or accommodation services to the general public and commercial clients. The cost of the actual travel, tour, or travel accommodations are excluded from the definition. Online travel service companies should review the definition to determine the impact of this provision on their services.

Similar to the problem with situsing lobbying services, it will be a complex and somewhat ambiguous task to assign a situs for most of these services.

Affiliate Exception and Resale Exemption. The proposed language excludes these six services from the definition of taxable sales if provided between affiliated companies. While all of the services above should qualify for the existing resale exception, items consumed in providing these services will remain subject to use tax (except for items consumed in providing traditional cable television services).

Cosmetic Medical Procedure. Cosmetic medical procedures are also proposed to be included in the list of taxable services. Cosmetic medical procedure is defined as a medical procedure performed on an individual that is directed at improving the individual’s appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease. Cosmetic surgery, hair transplants, injections or fillers, laser treatments, and cosmetic dentistry would all be considered taxable.

Advertising and Direct Mail Exemption Certificate. H.B. 49 changes the original term “direct mail” to now be “advertising and promotional direct mail” and “other direct mail” and adjusts many of the related provisions. Similar to current law regarding direct mail, the Bill authorizes consumers of such “advertising and promotional direct mail” or “other direct mail” to provide vendors an exemption certificate. However, a major new requirement is added to the existing exemption certificate process. In order for a vendor to be relieved of collecting sales tax on the advertising and promotional or other direct mail, the vendor must accept the exemption certificate absent any bad faith. These provisions appear to be an attempt to codify the guidance outlined in Ohio Department of Taxation (“ODT”) Information Release ST 2013-01.

### **Commercial Activity Tax (“CAT”) Exclusions Modified**

H.B. 49 contains two changes in the existing exclusions from CAT.

**Interest Exclusion Narrowed.** The first change was described by the Administration as eliminating the interest exclusion for lenders, described as businesses that primarily produce interest income. The proposed language in H.B. 49 is much broader. It eliminates, “interest on loans made in the normal course of the taxpayer’s business” from the exclusion. During his testimony, Tax Commissioner Joe Testa explained that the change is intended to fix an inequity where lending entities subject to CAT are not paying any tax. The Bill does not require that the taxpayer be primarily in the business of making loans. Instead, the language requires that the lending be part of the taxpayer’s business. The Bill does not define the term “loan” nor does it define “normal course of the taxpayer’s business.”

The proposed language may be an issue for companies that have intercompany lending and have not elected to file as a consolidated elected taxpayer (“CET”) or that lend to entities not within its CET group, which is common with private equity groups and foreign-owned companies. The language could also be an issue for the lending entities previously subject to the Ohio Dealer in Intangibles Tax and now subject to CAT.

**Qualified Distribution Center Minimum Percentage.** The second change involves the existing exclusion for a supplier’s sales to qualified distribution centers (“QDCs”). Currently, CAT is only imposed on a QDC supplier’s receipts from goods that are ultimately distributed to Ohio purchasers. Consistent with Governor Kasich’s proposal, the Bill would require that each supplier calculate Ohio receipts based on the greater of the percentage ultimately distributed to Ohio purchasers or 10 percent of the supplier’s sales to the QDC. ODT posts the most recent Ohio sales percentage for

QDCs and this change would likely increase CAT paid by suppliers to all but three of the existing QDCs.

### **Cigarette and Other Tobacco Products Tax Increases; Vapor Products Expansion**

H.B. 49 proposes increases to the cigarette tax rate and other tobacco products tax rate, as well as extends the other tobacco products tax to vapor products, often referred to as e-cigarettes. Specifically, the proposal includes the following changes:

- ✓ Increases the cigarette tax rate from \$1.60 to \$2.25 per pack. A floor stock tax would also be imposed on current inventory when the tax increase takes effect.
- ✓ Increases the tax rate on other tobacco products from 17 percent to 69 percent, but also provides a cap of \$2.00 of tax on certain specialty cigars.
- ✓ Subjects vapor products to the tax on other tobacco products at the new 69 percent rate. Notably, there is an early payment credit for payment of the vapor products tax.
- ✓ Eliminates the 2.5 percent early payment discount for the other tobacco products tax.
- ✓ Reduces the cigarette stamping compensation paid to wholesalers by applying it to only 1.25 of the tax stamp value (ie per pack tax rate) rather than applying it to the full value of the tax stamp.

If enacted, Ohio would have the highest cigarette tax rate compared to all its neighbors except Pennsylvania.

From an administrative perspective, H.B. 49 would also change the filing frequency of the cigarette tax and other tobacco products tax (including the tax on vapor products) returns from semiannually to monthly.

Vapor Product. Vapor product is defined to mean a noncombustible product that contains or is made or derived from nicotine, that is intended and marketed for human consumption, including by smoking, inhaling, snorting, or sniffing, and that includes any component, part, or additive that is intended for use in a mechanical heating element, battery, or electronic circuit and is used to deliver the product. It also includes any product containing nicotine, regardless of concentration. “Vapor

product” does not include any product that is a drug, device, or combination product, as those terms are defined or described in 21 U.S.C. 321 and 353(g).

Currently, fewer than ten states impose a tobacco products type tax on vapor products. The tax would be due upon the “first invoice price” the first time the vapor product is received by a distributor in Ohio.

### **Increased Alcoholic Beverages Taxes**

H.B. 49 proposes to increase the tax rates on most kinds of alcohol (i.e., beer and wine) by approximately 70 percent. An additional tax rate increase would be applied to high alcohol beer. The proposal eliminates the deduction for early beer and wine payments and reduces the small brewers’ credit. Notably, there is no increase in the tax on liquor and other spirits, which are sold by the state of Ohio!

### **Severance Tax on Fracking and Natural Gas Extracts**

H.B. 49 proposes significant changes to the current severance tax on oil and natural gas. Initially, the bill distinguishes four types of hydrocarbons rather than the two types, oil and natural gas, specified in current law. The additional types of hydrocarbons specified in the bill are condensate and natural gas liquids. These two types of hydrocarbons are split out because the new value-based tax proposed by the bill uses a base that is specific to each type and taxes them at different rates. The current severance tax is volume-based, whereas the bill proposes a tax based on the value of the specific hydrocarbon that is severed. The value of the products is based on the spot price for the specific type. A specific tax rate is then applied to each type of hydrocarbon. A 6.5 percent rate is applied to oil, gas that enters into the natural gas distribution system without further processing, and condensate. A 4.5 percent rate is applied to gas that requires further processing and natural gas liquids. The result of changing to a value-based tax using the specified rates will be a significant increase of the severance tax. The Governor’s budget proposal estimated that the changes would generate additional revenue of more than \$400 million in the biennium. Similar to prior years, the severance tax is expected to have little likelihood of enactment.

### **Municipal Business Net Profits Tax Reform**

A bright spot for business in Governor Kasich’s budget proposal has nothing to do with lowering taxes, but would go a long way to reduce business compliance costs and making Ohio’s municipal income tax system more competitive. Currently, each

municipality with an income tax also administers a net profits tax on businesses and individuals that generate business income. The Bill essentially centralizes the collection and administration of the municipal income tax on net profits and eliminates the throwback rule for most taxpayers.

Net Profits Tax Centralization. The Bill prevents a municipality from administering its net profits tax that is imposed on any person other than an individual starting January 1, 2018. It also deletes most of the existing references to business entities that exist in R.C. Chapter 718 and moves those provisions to a newly proposed R.C. Chapter 5718. Under the plan, individuals that generate business income will continue to be subject to municipal net profits tax as administered by each municipality and governed by R.C. Chapter 718. With a couple of limited exceptions, entities disregarded for federal income tax purposes will be disregarded for municipal purposes and any net profits will be required to be reported by the disregarded entity's owner.

R.C. Chapter 5718 would empower the ODT to administer all aspects of the municipal tax on net profits of non-individual taxpayers and require all net profits tax returns be filed through the Ohio Business Gateway ("OBG"). This approach would allow a business to file electronically and use a standard form across all Ohio municipalities. Likewise, the new R.C. Chapter incorporates similar administrative processes applicable to other Ohio taxes, including that all audits and assessments would be performed by ODT and appeals would be heard at ODT's Tax Appeals Division. Similar to current municipal tax law, appeals of Final Determinations would be made to the Ohio Board of Tax Appeals ("BTA") and then to the Ohio Supreme Court ("Court").

Individuals will continue to be governed by the administrative process administered by each municipality currently provided in R.C. Chapter 718. Also, to the extent that an individual is an owner of a pass-through entity, the individual will still need to comply with R.C. Chapter 718's provisions, while the pass-through entity would be governed by the new R.C. Chapter 5718. One area that may need clarified is the treatment of net profits generated by an S corporation in a city that has elected to tax S corporations at the individual level.

Centralized collection of municipal net profit taxes by the Ohio tax commissioner is not without precedent. In the early 2000s, electric light and local telephone companies became subject to the municipal income tax for the first time; electric light companies in 2001 and local telephone companies in 2004. Similar to H.B. 49's approach, a new R.C. Chapter 5745 was enacted and provided that the net profits tax

on electric light companies and local telephone companies would be administered and collected by the Ohio Tax Commissioner on behalf of the municipalities. Under the H.B. 49 plan, electric light companies and local telephone companies would continue to pay the municipal net profits governed by R.C. Chapter 5745, which provides a slightly different methodology than R.C. Chapters 718 or 5718 and is already administered by ODT.

Elimination of the Throwback Rule. The Bill would eliminate the throwback rule for purposes of the net profits tax on non-individuals. Under the current R.C. Chapter 718 throwback rule, sales of tangible personal property that are shipped from an Ohio municipality to a location at which the seller does not have employees soliciting the sales must treat those sales as if delivered within the originating city for apportionment purposes (i.e., the seller must “throw-back” the sales to the originating municipality by including those sales in the numerator of the sales factor for the originating municipality). Under the proposed R.C. Chapter 5718, there would be no throwback rule.

Although it may be inadvertent, the Bill retains the throwback rule for purposes of individuals with net profits under R.C. Chapter 718. As a result, there are some differences between the net profits tax set forth in R.C. Chapter 718 applied to individuals and the proposed net profits tax set forth in R.C. Chapter 5718 on businesses. Thus, a business owned by a sole proprietor would continue to be subject to the throwback rule, but a business that is a pass-through entity or a corporation will not be subject to the throwback rule.

Other Observations. The Bill allows a taxpayer to claim job creation and job retention tax credits (“JCTC” and “JRTC”) that were previously awarded by a municipal corporation(s) against the taxpayer’s net profits tax in the same municipal corporation(s) as administered pursuant to R.C. Chapter 5718. However, the Bill requires that each municipal corporation provide a copy of the underlying agreement with each taxpayer and a copy of each municipal ordinance or resolution granting each credit awarded by January 31, 2018. For JCTC or JRTC grants, the municipal corporation(s) must provide the same information by January 31, 2018 of the year a credit may be claimed.

We anticipate that there will be significant debate regarding the proposed municipal tax reforms provisions of the Bill. While the proposed approach will be applauded by businesses, the application of the two R.C. Chapters will require some fine tuning. For example, the Bill deletes a provision that allowed an employer to forgo the deduction of stock options in order to allow its employees to exclude the same

income. The language was deleted, perhaps inadvertently, because businesses will no longer be subject to R.C. Chapter 718. However, the change may also prevent the individual from excluding the stock option income from the individual's municipal net profits tax. This was likely not intended and could be addressed.

Governor Kasich's municipal tax plan is bold, but will need strong support from the business community in order to succeed. Taxpayers should closely review the proposed changes to evaluate the impact on their municipal obligations and to identify areas of further improvement.

### **Medicaid MCO Sales Tax Eliminated and Replaced**

Governor Kasich's budget proposal eliminates the existing Medicaid managed care organization (MCO) sales tax and replaces the revenue with a new franchise fee imposed on all health insuring corporations, generally referred to as MCOs or HMOs. The amount of the franchise fee is graduated and will be based on the MCO's number of member months, with different rates being applied to Medicaid and non-Medicaid members.

The proposed franchise fee will not provide any relief to local jurisdictions for the lost sales tax revenue resulting from elimination of the Medicaid sales tax. However, the budget proposal does contain a transition plan to mitigate the impact of these revenue reductions on local taxing authorities. The amounts provided under this plan are rather limited compared to the revenue generated by the lost sales tax.

### **Administrative Provisions**

The Bill also contains several administrative changes not described in Governor Kasich's budget overview including:

- ✓ Requires that a person have a tax certificate, in the case of a negotiated tax credit such as the Ohio JCTC and JRTC, or a form issued by ODT in order to claim a credit against a tax imposed in R.C. Chapter 5700. ODT will prescribe a form for tracking credits and a person must complete that form and the attachment on or before the due date of the return. The provision allows ODT to deny the credit until the completed tax certificate or form is provided. The proposed language appears to codify ODT's existing policy of requiring that a tax certificate or the prescribed form be attached to a taxpayer's return. The proposed language may also prevent a taxpayer from claiming a credit on its original return where a tax certificate is not issued

timely.

- ✓ Makes several changes to the Ohio Development Services Agency (“DSA”), including expanding the DSA Small Business office to also include entrepreneurship. The Bill also removes a requirement that DSA receive complaints from small businesses on regulations and other government activity that is impeding business. However, DSA would still be required to periodically make recommendations on such matters. The Bill adds a requirement that DSA provide information to individuals on job resources available on Ohio-MeansJobs.
- ✓ The Bill grants the Tax Commissioner authority to inspect records of a person involved in the sale of oil, gas, condensate, or natural gas liquids, and examine individuals of those persons, for the purpose of ensuring compliance with R.C. 5749.02(A)(5) to (8).
- ✓ Authorizes the Ohio Division of Liquor Control to provide information to ODT, likely to administer audit and compliance programs.
- ✓ Requires ODT to provide an online system for the county auditors to provide vendor licenses.
- ✓ Allows ODT to cancel vendor and similar licenses where fraudulent or incorrect returns are filed.
- ✓ Provides that applications for exemption for property of or held by the state for the use of state universities are to be filed with the Tax Commissioner and not with the county auditor.
- ✓ Changes the process for review of a denial of the remission of the late payment penalty by a county auditor. Under current law, the property owner can apply to the Tax Commissioner requesting a review of the denial. Under the Bill, the Tax Commissioner’s review process is eliminated. Instead, the Bill provides that if the county auditor denies remission, the auditor shall present the application for remission to the county Board of Revision (“BOR”). The BOR shall review the auditor’s denial and determine if remission is warranted. The original purpose of the tax commissioner’s review of penalty appeals was to ensure uniform decisions across the state on penalty abatements.

- ✓ Requires notification be given to the Tax Commissioner prior to the transfer of a liquor license and payment of any outstanding Ohio state taxes before the license transfer is approved.

### **Next Steps**

All businesses will be impacted by the sales and use tax rate increase and the addition of new taxable services. Further, retailers are likely to experience lower sales revenues due to the increases in the sales tax rate, tobacco tax rate, and new tax on vapor products, especially in areas along Ohio's border. Each business should quantify the impact of the sales tax and other tax rate increases on their business and consider lobbying (on a tax-free basis) policy makers to reject this tax shifting plan.

Also, the proposal to centralize the administration of municipal net profits tax and eliminate the throwback rule can be a great benefit for businesses. However, the proposal is expected to generate major resistance from local governments and lawmakers. As a result, business taxpayers that like this proposal may want to consider ways to support this dramatic proposal.

If you would like to discuss how the biennial budget process may impact your business, please contact one of our tax professionals.

# ZAINO HALL & FARRIN LLC

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A T T O R N E Y S   A T   L A W

**WWW.ZHFTAXLAW.COM**

**614-326-1120**

**855-770-1120 (toll-free)**

**STEVE AUSTRIA**

(non-attorney professional)

614-349-4820 (Direct)

937-609-8355 (Mobile)

saustria@zhftaxlaw.com

**THOMAS R. FAGAN**

614-782-1541 (Direct)

330-607-7103 (Mobile)

tfagan@zhftaxlaw.com

**STEPHEN K. HALL**

614-349-4812 (Direct)

614-284-1253 (Mobile)

shall@zhftaxlaw.com

**DEBORA D. MCGRAW**

614-349-4813 (Direct)

614-595-5560 (Mobile)

dmcgraw@zhftaxlaw.com

**JOHN R. TRIPPIER**

(non-attorney professional)

614-349-4815 (Direct)

614-203-4173 (Mobile)

jtrippier@zhftaxlaw.com

**RICHARD C. FARRIN**

614-349-4811 (Direct)

614-634-3130 (Mobile)

rfarrin@zhftaxlaw.com

**ADAM L. GARN**

614-349-4814 (Direct)

agarn@zhftaxlaw.com

**CHARLOTTE B. HICKCOX**

(non-attorney professional)

614-349-4819 (Direct)

614-537-4339 (Mobile)

chickcox@zhftaxlaw.com

**BRAD W. TOMLINSON**

(non-attorney professional)

614-349-4818 (Direct)

btomlinson@zhftaxlaw.com

**THOMAS M. ZAINO**

614-349-4810 (Direct)

614-598-1596 (Mobile)

tzaino@zhftaxlaw.com