

Ohio Senate passes its version of Ohio's Budget Bill

On June 6, 2013, the Ohio Senate (“Senate”) voted to pass its version of Sub H.B. 59, Ohio's Budget Bill (“Budget Bill”). The Budget Bill was passed in the Senate with a vote of 23-10. The Senate’s version will likely be rejected by the Ohio House of Representatives (“House”) and then be sent to a conference committee which will provide a committee report to the House and the Senate to approve the final version of the Budget Bill. Under the Ohio Constitution, the budget must be in place by July 1, 2013.

Our previous issues of the *SALT Buzz* detailed specific aspects of Governor Kasich’s tax reform proposal. The focus of this *SALT Buzz* is to highlight the overall tax issues in the budget process and to contrast the version of the Budget Bill passed by the Senate to the version passed by the House and the original tax reform proposal offered by Governor Kasich.

Overview

In his original tax reform proposal, Governor Kasich proposed sweeping changes to the landscape of Ohio taxation. Governor Kasich proposed a reduction of income taxes for small businesses that operate as pass-through entities and sole proprietorships, a phase-in of a twenty percent across the board personal income tax cut, and a half cent reduction in the state sales tax rate. Similar to proposals made in several states recently, the tax cuts were to be paid for by significantly broadening the sales and use tax base to include nearly every service. The original tax reform proposal also created a new severance tax system. The House and Senate included some modest aspects of the Governor’s original tax reform proposal, but did not incorporate broadening of the sales and use tax base or the creation of a new severance tax system.

Several tax provisions that were previously included in the House-passed version of the Budget Bill were not included in the Senate’s version, including:

- Across-the-board seven percent reduction in Ohio personal income tax rates
- Required collection and remittance of sales and use tax by hotel intermediaries
- Bad debts removed from the definition of gross receipts for purposes of Casino Revenue Tax

The version of the Budget Bill passed by the Senate also did not include key tax provisions in Governor Kasich’s original tax proposal including:

- Expansion of the sales and use tax to apply to most services and digital goods
- Across-the-board twenty percent reduction in Ohio personal income tax rates
- Increase in the tax rates of Ohio’s severance tax

Small Business Tax Cut

The Senate adopted Governor Kasich’s small business tax deduction (the House did not include this provision in its version of the Budget Bill). This deduction reduces income taxes on business income generated by small businesses that operate as pass-through entities and sole proprietorships. The reduction is achieved by allowing a deduction from federal adjusted gross income equal to 50% of the taxpayer’s Ohio small business investor income. “Ohio small business investor income” is defined to mean the portion of a taxpayer’s adjusted gross income that is business income reduced by deductions from business income and apportioned or allocated to Ohio, to the extent not otherwise deducted or excluded in computing federal or Ohio adjusted gross income for the taxable year.

The deduction of such income is limited to \$375,000 for a single taxpayer or married taxpayers filing a joint return and to \$187,500 for a married taxpayer filing a separate return. The deduction is to be claimed by the small business owner, at the individual taxpayer level. As a result, Ohio small business investor income flowing from multiple pass-through entities and sole proprietorship activities would qualify for the deduction, thereby enabling the owners of multiple businesses to maximize the deduction available up to the \$375,000 cap. Small business owners may not benefit from this deduction to the extent the business’ income is paid out as wages to the owner.

The version of the Budget Bill passed by the House did not include the personal income tax small business tax cut.

Composite Returns are No Longer “Final Returns” for Certain Investors

Under Ohio’s current law, an individual with ownership in a pass-through entity is deemed to have satisfied his or her Ohio personal income tax filing obligation if the pass-through entity files a composite return on behalf of that individual. This treatment is available as long as that individual investor does not have any other source of Ohio income. If a composite return is filed by the pass-through entity on behalf of the investor, that investor is subject to the highest tax rate and is not able to file a separate individual income tax return claiming deductions for personal or dependent exemptions or any non-business credits. In addition, the investor is not able to take net operating loss carryforwards into consideration in the computation of Ohio taxable income for future tax years.

Under Governor Kasich’s original tax proposal and the versions of the Budget Bill passed by the House and the Senate, an investor whose Ohio source income is limited to an ownership interest in a pass-through entity that filed a composite return on behalf of the investor will now have the ability to file a separate individual income tax return. This change in law will allow these investors to claim personal or dependent exemptions and any non-business credits if the individual investor chooses to file a separate individual income tax return. Also, these investors will be able to carryforward net operating losses into future tax years on the separate individual income tax returns.

Remote Sellers and Click-Through Nexus

A constitutional precedent set by the United States Supreme Court in *Quill v. North Dakota*, 504 U.S. 298 (1992) prevents a state from requiring sales tax collection by vendors unless the vendor has a physical presence in the state. However, states across the country have aggressively adopted provisions to require the collection of sales tax from

vendors whose physical presence is limited to an independent contractor who establishes an in-state website link to a website soliciting sales on behalf of that vendor. These vendors are typically referred to as remote sellers. A remote seller is a vendor that sells products to customers in a state using the internet, mail order, or telephone without having a physical presence in that state. Many states have adopted statutory provisions targeting remote sellers under the theory of “click-through” nexus. “Click-through” nexus laws are generally targeted at the following scenario:

Remote seller has no physical presence in State X. Joe Smith resides in State X and owns and operates a website in State X. Smith’s website has a link on it for users to access remote seller’s website. Remote seller pays a referral fee whenever a customer accesses the Remote Seller’s website through a link provided on Smith’s website.

Under both the House and Senate versions of the Budget Bill, Ohio is proposing to join the battle against remote sellers by statutorily adopting “click-through” nexus provisions. If enacted, substantial nexus with Ohio would be presumed to exist (i.e. a remote seller would be required to collect and remit sales tax) if:

- The business enters into an agreement with one or more residents of Ohio under which the resident, for a commission or other consideration, directly or indirectly refers potential customers to the seller, whether by a link on a web site, an in-person oral presentation, telemarketing, or otherwise, provided the cumulative gross receipts from sales to consumers referred to the seller by all such residents exceeded ten thousand dollars during the preceding twelve months.

The presumption of substantial nexus may be rebutted if the remote seller can submit proof that each resident engaged by the seller did not engage in any activity within Ohio during the preceding twelve months that was significantly associated with the seller’s ability to establish or maintain the seller’s market in Ohio during the preceding twelve months.

The remote seller and “click-through” nexus provisions included in the House and Senate versions of the Budget Bill are similar to “click-through” provisions that other states have adopted. However, since *Quill* has not been overturned by the United States Supreme Court and Congress has not adopted legislation allowing this treatment of remote sellers, there are potential constitutional challenges that can be made by remote sellers if the industry is ultimately required to collect and remit sales tax to Ohio. Correspondingly, if an independent contractor’s establishment of an in-state website link constitutes a physical presence for the remote seller, then statutory adoption of this provision is likely unnecessary.

Governor Kasich’s original tax reform proposal did not include any provisions relating to the taxation of remote sellers or “click-through” nexus. This provision was likely added to help pay for individual income tax cuts included in the House-passed version of the Budget Bill.

Excise Tax on Motor Fuel Suppliers

The Senate’s version of the Budget Bill creates a new excise tax on motor fuel suppliers. Beginning July 1, 2014, a motor fuel supplier will no longer be subject to the Commercial Activities Tax (“CAT”) on certain gross receipts but will be subject to a similar excise tax based on the gross receipts of the supplier. A supplier of motor fuel is defined as a person

that sells, exchanges, transfers or otherwise distributes motor fuel from a terminal or refinery rack to a point outside of the distribution system in the state or a person that imports or causes the importation of motor fuel from a point outside of a distribution system to the state.

Gross receipts of the supplier will include the total amount received by the supplier without a deduction for cost of goods sold or other expenses incurred from the first sale of motor fuel within the state. Gross receipts will include amounts accrued by the supplier on the accrual basis of accounting. Gross receipts do not include receipts from the sale of motor fuel when sold for export to another state, federal and state excise taxes paid by the supplier on motor fuel, bad debts from receipts reported on previous tax periods, or amounts realized from the sale of accounts receivables if the receipts were previously included in the gross receipts of the motor fuel supplier.

A motor fuel supplier will be required to file a return on a quarterly basis and initially will be subject to a tax rate of .65% of the supplier's gross receipts derived from the first sale of motor fuel. On its quarterly return, a motor fuel supplier will be required to indicate the portion of gross receipts from the sale of motor fuel used for propelling vehicles on public highways and waterways and the portion of gross receipts from the sale of motor fuel used for other purposes. It is unclear of the methods that a motor fuel supplier is able to use to determine the use of its customers to properly report gross receipts.

Motor fuel suppliers that derive gross receipts other than from the first sale of motor fuel in Ohio will remain subject to the CAT on those gross receipts.

The language as currently drafted does not allow a supplier subject to the new excise tax on motor fuel to apply any tax credits issued by the Tax Credit Authority against the new excise tax liability.

Commercial Activity Tax Review Committee

The versions of the Budget Bill passed by the House and the Senate included the creation of the CAT Review Committee (“Committee”). The Committee would review and make recommendations for reforming and improving the CAT. Under the Senate's Budget Bill, members of the Committee would include four legislators from the House, four legislators of the Senate, the Tax Commissioner, and Director of Budget and Management. The Committee would be co-chaired by the chairs of the standing taxation committees of the House and the Senate. The Committee would begin monthly meetings beginning in July, 2013 and would cease to exist after October 31, 2013.

The original tax proposal of the Governor did not include the creation of the Committee.

Qualified Distribution Center Penalties

Under the commercial activity tax currently, suppliers to a qualifying distribution center may exclude gross receipts from the computation of taxable gross receipts to a qualifying distribution center based upon the non-Ohio delivery percentage. Amended Senate Bill 28 of the current General Assembly imposed a \$500,000 penalty against the operator of a qualifying distribution center if the Tax Commissioner later determines that the distribution center failed to satisfy

the requirements of the Revised Code to be classified as a qualifying distribution center. Under the law prior to the passage of Amended Senate Bill 28, the operator of a distribution center was liable for the tax, penalty, and interest of the supplier if the distribution center failed to satisfy the requirements of a qualified distribution center under the Revised Code.

Under the House and Senate versions of the Budget Bill, a distribution center initially granted the status of a qualifying distribution center that is later determined to not meet the requirements of a qualifying distribution center will now be subject to a penalty equal to the amount of the CAT that would have been owed by the suppliers of the distribution center had the distribution center not been improperly issued a qualifying distribution center certificate. Amounts owed by the supplier required to be paid as a penalty by a non-qualifying distribution center operator do not currently include any interest or penalties and would be limited to actual CAT amounts that would have been due.

Current law also provides that a supplier to a qualified distribution center is liable for additional CAT and interest if it is determined that the Ohio delivery percentage as originally published by the Ohio Department of Taxation ("ODT") is incorrect. The Senate's version of the Budget Bill removes this potential additional CAT liability for suppliers to a qualified distribution center. According to ODT, to the extent that a dispute exists on the Ohio delivery percentage between the operator and ODT and the operator files a timely appeal to the final determination of the Ohio delivery percentage, ODT would issue the operator a qualifying certificate while the appeal is pending but would issue the qualifying certificate at the percentage ODT believes to be correct. This percentage would likely be higher than requested by the operator. To the extent it is determined that the operator was ultimately correct, potential refund opportunities would exist for suppliers to a qualified distribution center subject to the normal statute of limitations.

Sales and Use Tax Exemptions

The Senate's version of the Budget Bill also allows additional exemptions from sales and use tax for the following:

- Goods and services used in aerospace vehicle research and development activities;
- Purchases of computer data center equipment used by multiple businesses operating as a single data center;
- Tangible personal property or services purchased by a non-profit corporation that leases a recreational facility used by a professional athletic team or minor league affiliate from an eligible county. Currently, the only eligible county is Lucas County.

Next Steps

H.B. 59's tax language raises many opportunities and issues for Ohio taxpayers, including the potential of either increasing or decreasing the cost of having business operations in Ohio. Every business and industry should weigh the benefits and costs of the Budget Bill. ZHF is uniquely positioned to assist you in evaluating the Budget Bill and guiding you through the legislative process. If you have any questions about Budget Bill and how it may impact you or your business, feel free to contact any member of our team.

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