Ohio Governor Kasich's Tax Reform Proposal Introduced

Many Businesses to See a Tax Increase

This week, the Ohio House of Representatives introduced the new biennial budget bill, House Bill 64. The bill contains the language for Governor Kasich's *Blueprint for a New Ohio*, which includes major tax law changes which decrease taxes for some and increase taxes for others. The budget proposal also increases general revenue spending by 18% over FY2015. The tax proposal would reduce the income tax burden of individuals and small business owners, while increasing the tax burden of many medium and most large businesses, especially C corporations.

This SALT Buzz summarizes the tax provisions contained in the bill, which we expect will be debated in the House Ways and Means Committee. We have also placed a tax calculator on our website designed to help our clients evaluate the impact of these proposed tax law changes.

Commercial Activity Tax

Rate Increase. The bill proposes a 23% increase in the CAT rate, from 2.6 mills to 3.2 mills. If enacted, this tax rate increase would go into effect on July 1, 2015.

Small Business Exemption. The bill raises the gross receipts threshold for phasing out the $1 million exemption. Under current law, the $1 million exemption begins to be phased out once the taxpayer exceeds $1 million of taxable gross receipts. The bill provides that the exemption does not start to phase out until the taxpayer exceeds $2 million of taxable gross receipts. The increased threshold will save businesses with $2 million or less of taxable gross receipts $650. If enacted, this change would be effective for tax periods beginning on or after January 1, 2016.

Revenue Redirection. The bill proposes significant redirection of CAT revenue away from local government into state coffers. The following chart illustrates the new distributions:

	General Revenue Fund	School District TPP Tax Replacement Fund	Local Government TPP Tax Replacement Fund
2014	50%	35%	15%
2015	50%	35%	15%
2016 and after	75%	20%	5%

Sales and Use Taxes

The bill includes an 8.7% increase in the state sales and use tax rate, increasing the state rate from 5.75 cents per dollar to 6.25 cents per dollar, as well as a significant broadening of the tax base to a variety of services, including those provided by attorneys, accountants and other professionals. The expansion of the sales and use tax to these new services includes related party transactions, such as providing management services to other members of a consolidated group. Also, no business-to-business exemption is provided for these new services.

Cable Service. The bill adds "cable service" to the list of taxable services in Ohio. Cable service means the one-way transmission to subscribers of video programming, or other programming service, and subscriber interaction, if any, that is required for the selection or use of such video programming or other programming service. This service would become taxable on October 1, 2015.

Bad Debt Transfers. The bill subjects to sales tax all transactions by which a bad debt is or is to be transferred. Bad debt means any debt that has become worthless or uncollectible in the time period between a vendor's preceding return and the present return, has been uncollected for at least six months, and that may be claimed as a deduction under IRC section 166 or that could be claimed as such a deduction if the vendor kept accounts on an accrual basis.

Travel Service. Added to the list of taxable services are travel services, which are defined to mean acting as an agent in selling travel, tour, or accommodation services to the general public and commercial clients.

Professional and Other Services. The bill adds various professional and other services to the list of taxable services, including research and public opinion polling, public relations, lobbying, management consulting, parking, debt collection, and repossessions. These services are taxable regardless of the profession of the provider of the service, such as CPAs, attorneys, etc.

Research and Public Opinion. This service is defined to mean systematically gathering, recording, tabulating and presenting marketing and public opinion data. This also includes:

- Broadcast media rating services
- Political opinion polling services
- Marketing analysis or research services
- Statistical sampling services
- Opinion research services
- Economic research and analysis
- Sociological research and analysis

Public Relations. The definition of public relations includes designing and implementing public relations campaigns designed to promote the interest and image of one or more clients. Advertising and marketing services would almost certainly be caught up in this broad definition.

Lobbying. While "lobbying" is generally understood to refer to lobbying government agencies and officials, the bill broadens the definition to include any activity that serves to influence the behavior or opinion of an individual, an industry, or an organization. For example, payments to independent sales representatives would now be taxed as lobbying services.

Management Consulting. Management consulting is broadly defined to mean any activity that provides advice and assistance to businesses and other organizations on business issues. For this purpose, "business issues" include, but is not limited to, the following:

- Financial planning and budgeting
- Equity and asset management
- Records management
- Office planning
- Strategic and organization planning
- Site selection
- New business startup
- Business process improvement
- Human resource management
- Marketing issues and planning
- New product development
- Pricing strategies
- Licensing and franchise planning
- Manufacturing operations improvement
- Productivity Improvement
- Production Planning and control
- Quality assurance and control
- Inventory Management
- Distribution and warehouse operations
- Materials management and handling
- Telecommunication management
- Utilities management

Attorneys and CPAs regularly give advice and assistance to their clients on business issues, which may now be subjected to tax under this broad definition. Further, many corporate groups centralize these functions and charge fees to brother-sister or subsidiary companies for the cost of providing these services. Such transactions would now be taxable under the proposal.

Debt Collection. The bill defines debt collection to mean collecting payments for claims and remitting payments collected to their clients including, but not limited to, account or delinquent account collection services, tax collection services on a contract or fee basis, and bill or debt collection services.

Repossession. Under the bill, repossession service means repossessing any tangible assets for a creditor as a result of delinquent debts.

Parking. Parking is defined to mean the service of parking a motor vehicle. While the proposed language seems to apply the tax only to valet parking, it is not clear that the definition was intended to be limited only to valet parking. Based on the revenue estimates and other changes, it seems the proposal was intended to apply tax to all parking, such as self-parking in parking garages and open lots.

Situsing of the New Services. The bill does not provide any unique rules for establishing the taxable situs of the services. Ohio's law for situsing services for purposes of sales and use tax does not provide an abundance of clarity for a taxpayer operating in a multistate or multinational capacity. For example, while the use tax is levied on the benefit realized in Ohio of any taxable service provided, the sales tax sourcing rules provide that all sales are to be sourced using the following cascading test:

> (1) If the consumer receives the service at a vendor's place of business, the sale shall be sourced to that place of business.
>
> (2) When the service is not received at a vendor's place of business, the sale shall be sourced to the location known to the vendor where the consumer receives the service, including the location indicated by instructions for delivery to the consumer.
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> (3) If (1) and (2) do not apply, the sale shall be sourced to the location indicated by an address for the consumer that is available from the vendor's business records that are maintained in the ordinary course of the vendor's business, when use of that address does not constitute bad faith.
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> (4) If (1), (2), and (3) do not apply, the sale shall be sourced to the location indicated by an address for the consumer obtained during the consummation of the sale, including the address associated with the consumer's payment instrument, if no other address is available, when use of that address does not constitute bad faith.
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> (5) If (1), (2), (3), and (4) do not apply, including in the circumstance where the vendor is without sufficient information to apply any of those divisions, the sale shall be sourced to the address from which the service was provided, disregarding any location that merely provided the electronic transfer of the service provided.

Although the sales and use tax are complementary taxes, the sales tax sourcing rules do not necessarily line up with the benefit realized methodology applied for imposition of the use tax.

<u>Exclusion of Trade-In Value from Price</u>. Current Ohio law allows the trade-in value of used vehicles and motor craft that is applied to reduce the purchase price of a new vehicle or motor craft to be excluded from the price for purposes of calculating sales tax due. The bill would only permit one-half of the value to reduce the purchase price of the new vehicle or motor craft.

<u>Sales of Services by the Government</u>. Current law provides a specific exemption from sales and use tax on any sale of a service by the state or any of its political subdivisions. The bill eliminates this

exemption, making taxable any sales by the government of services meeting the definition of any of the enumerated taxable services. An example of government services this change may be intended to include is parking (however, see the definition to parking above).

Vendor Discount is Substantially Reduced. Under current law, a vendor is able to retain 0.75% of all sales tax the vendor collects and remits to the state. The purpose of this discount is to compensate the vendor for collecting the sales tax on behalf of the state. The bill provides a $1,000 per month cap on the amount of vendor discount that may be claimed. The $1,000 monthly cap applies to each return filed by a vendor. While each vendor's license can constitute a tax return, many vendors with multiple vendor's licenses file a "master sales tax return" for all vendor's licenses. It is unclear whether the $1,000 monthly cap applies to master sales tax returns or on a vendor's license-by-vendor's license basis. If this proposal becomes effective, vendors that currently file a master sales tax return may want to reconsider their filing method in order to maximize the vendor discount.

Storage clarification. The bill provides an exception to the current sales tax on storage by clarifying that the impoundment of motor vehicles by the state or a political subdivision is not taxable storage.

Personal Income Tax

The bill contains many reductions, and a few increases, relating to personal income taxes. These changes, if enacted, would be first effective with respect to the 2015 taxable year (returns due in April, 2016).

Personal Income Tax Rates. The bill proposes a 23% across-the-board reduction of income tax rates, phased in over 2 years. The rate schedule would be as follows:

Adjusted Gross Income	Current Rates	Proposed 2015 Rates	Proposed 2016 Rates
$5,000 or less	0.528%	0.449%	0.407%
$5,000 - $10,000	1.057%	0.898%	0.814%
$10,000 - $15,000	2.113%	1.796%	1.627%
$15,000 - $20,000	2.642%	2.246%	2.034%
$20,000 - $40,000	3.169%	2.694%	2.440%
$40,000 - $80,000	3.698%	3.143%	2.847%
$80,000 - $100,000	4.226%	3.592%	3.254%
$100,000 - $200,000	4.906%	4.170%	3.778%
More than $200,000	5.333%	4.533%	4.106%

Small Business Income. The bill allows a business owner to effectively exempt from taxation the individual's Ohio "small business income" derived from each business that has gross receipts not exceeding $2 million. For those individuals whose business exceeds the $2 million threshold (even by one penny), the exemption is not available and the entire amount of Ohio small business income is subject to tax. However, the current law's deduction of up to $125,000 of Ohio small business income remains available to such taxpayers under the proposal. While the proposal's $2 million gross receipts threshold applies on a business-by-business basis (not an individual-by-individual basis), the current law's deduction of up to $125,000 applies to the business income of the individual, in the aggregate.

For example, if the 100% deduction is enacted, an individual that owns 25 different pass-through entities all with gross receipts of $2,000,000 could conceivably pay zero Ohio income tax, notwithstanding that the individual's businesses generated $50,000,000 of gross receipts in the aggregate. This is true because the new 100% deduction is measured at the business level (the $2 million gross receipts test), but the 100% deduction may be taken at the individual level (without a limitation for each individual owning a business that generated the income).

For purposes of calculating the $2 million gross receipts threshold, "gross receipts" generally means gross receipts for the taxable year reduced by returns and allowances made during such year.[1] The bill's $2 million threshold includes all gross receipts, not merely the Ohio sourced gross receipts.

If this provision becomes law, restructuring your small business could result in significant tax savings.

Personal Exemption. The bill provides an increase in the personal exemption for some taxpayers. For taxpayers with $40,000 or less of Ohio adjusted gross income (single or joint), the personal exemption is increased from $2,200 to $4,000. For taxpayers with Ohio adjusted gross income over $40,000, but not more than $80,000, the personal exemption is increased from $1,950 to $2,850.

Social Security and Railroad Retirement Deduction. Current law allows for the deduction of social security and railroad retirement benefits. The bill will disallow such deduction for any taxpayer with a federal adjusted gross income over $100,000. Note that this $100,000 limitation is measured by federal adjusted gross income, while other limitations discussed below are measured by Ohio adjusted gross income.

Old Age Credit. Current law provides a $50 credit for taxpayers that are age 65 or older, as well as an optional lump sum retirement distribution credit. The bill eliminates these credits.

Retirement Income Credit. Current law provides a retirement income credit of up to $200, depending on the amount of retirement income received. The bill disallows the credit for any taxpayer whose Ohio adjusted gross income for the taxable year (single and joint), less applicable exemptions, is $100,000 or more.

Lump-sum Distribution Credit. Current law allows taxpayers to elect to claim a lump-sum distribution credit. The bill disallows the credit for any taxpayer whose Ohio adjusted gross income for the taxable year (single and joint), less applicable exemptions, is $100,000 or more.

[1] Gross receipts has the same meaning as when used in IRC section 448(c), except that computation of the deduction for Ohio purposes is based on the gross receipts of the business for the current taxable year, rather than an average of the three prior taxable years.

"Related Member" adjustments affecting Ohio Pass-Through Entity tax and the Small Business Deduction. Current law requires certain "related member adjustments" that are intended to address aggressive tax planning by certain pass-through entities. The bill clarifies that the related member adjustments that apply for purposes of the Ohio pass-through entity tax and the Ohio individual income tax apply only when the recipient of the payment is not otherwise subject to Ohio income tax with respect to the receipt of the payment. The bill's provision appears to address, in part, some unintended consequences that apply under current law when measuring the "small business deduction" that may be taken by certain taxpayers, as well as a potential argument that the same income is taxed twice.

Cigarette Tax Increase

The cigarette tax is proposed to be increased from 62.5 mills on each cigarette ($1.25 per pack) to 112.5 mills on each cigarette ($2.25 per pack), generally effective July 1, 2015. As a result of this increase, a one-time floor tax is imposed on wholesale dealers to account for the increase on all stock existing at the beginning of business on July 1, 2015.

Cigarette Stamp Discount. Current law provides 1.125% to 10% discount on cigarette stamps, as a way of reimbursing wholesale dealers for placing the stamps on each pack. The bill would eliminate the discount.

Licensing to Sell Cigarettes. Any person desiring to manufacture or import cigarettes into Ohio must now provide the tax commissioner with the manufacturer's list price for each cigarette brand family listed in the applicant's annual certification. The tax commissioner is then required to publish on the Department of Taxation website the name of each manufacturer licensed to manufacture or import cigarettes, the brand families legal for sale in Ohio and the manufacturer's list price. The bill also imposes strict new guidelines on how prices may be advertised by retail and wholesale dealers.

Other Tobacco Products. The tax imposed on other tobacco products, such as cigars, chewing tobacco, etc., is also increased in the bill.

Vapor Products. The bill creates an entirely new chapter that imposes a cigarette-like tax on the sale of vapor products. Vapor products include any 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. Vapor product dealers are provided an exclusion from the CAT for the amount of the new vaping excise tax.

Severance Tax

The Governor is again proposing significant changes to Ohio's severance tax in an effort to gain a larger share of the economic activity being generated by the growing shale fracking industry in Ohio. The proposed tax increase only applies to the severance of crude oil, natural gas, and natural gas liquids through the use of horizontal drilling. The following chart illustrates the proposed new tax rates for horizontal wells:

Product	**Conventional Wells**	**Shale Fracking Wells (i.e., Horizontal Wells)**	
Crude Oil	20 cents per barrel	6.5%	N/A
Natural Gas	No tax for wells less than 10MCF/day; Otherwise, 3 cents/MCF	6.5%	4.5%
Natural Gas Liquids	Taxed as Natural Gas (unchanged)	N/A	4.5%

Kilowatt Hour (KwH) Tax

No increase in the Kilowatt Hour Tax is proposed. However, proceeds from the KwH Tax are currently earmarked for local government funding, including school districts, local park districts and public libraries. The bill provides that all KwH Tax revenue will now be deposited into the state's general revenue fund, rather than being used for school, local government, and library funding.

Job Creation Tax Credit (JCTC) and Job Retention Tax Credit (JRTC)

The bill changes the base used to calculate the JCTC from Ohio withholding to what essentially amounts to employee payroll. Employee payroll is defined as total taxable income paid by the employer excluding amounts paid for retirement and other benefits paid or contributed by the employer to or on behalf of employees (e.g., medical expenses would appear to be excluded). The new methodology would apply upon the effective date of the bill, but allows certain taxpayers that had original agreements approved by the Tax Credit Authority in 2014 or 2015 to apply the new methodology.

The practical impact of these changes is that credits granted in future agreements (and selected prior agreements) will not be reduced by the bill's personal income tax reductions. All other agreements, which use Ohio withholding, will experience reductions in the JCTC available if the personal income tax reductions are enacted. Further, no language is provided to allow businesses that would have their JCTC reduced to correspondingly reduce their committed level of investment or their committed number of new the jobs.

The bill makes the same change in the base (to employee payroll) for the JRTC and removes the "refundable" credit alternatives enacted in the last few years.

The bill also adds language allowing the tax credit authority to recoup prior JCTC and JRTC if a taxpayer does not meet its obligations under the tax credit agreement or if the taxpayer files for bankruptcy.

Tax Expenditure Review Committee

Ohio has required the Department of Taxation to prepare a report describing the effect of tax expenditures on the general revenue fund. However, policy makers have generally not fully analyzed the tax expenditures listed in the report. The bill creates the Tax Expenditure Review Committee to review tax expenditures and make recommendations as to whether each such expenditure should be continued without modification, modified or repealed.

Revenue Estimates

The following chart shows the tax revenues associated with the various proposed changes as reported in the Governor's *Blueprint for a New Ohio*.

	FY2016 (in millions)	**FY2017** (in millions)	**Total** (in millions)
Elimination of Small Business Income Taxes	($338)	($358)	($696)
State Income Tax Rate Cut	($2,029)	($2,599)	($4,628)
Additional Tax Relief for Lower and Middle-Income Filers	($184)	($188)	($372)
Total Income Tax Cuts	**($2,551)**	**($3,145)**	**($5,696)**
Sales Tax Rate Increase	$651	$902	$1,553
Broadening Base of Sales Tax to More Services (including rate increase)	$471	$543	$1,014
Reduction of the Sales Tax Vendor's Discount	$26	$36	$62
Commercial Activity Tax Rate Increase	$290	$401	$691
Cigarette & Other Tobacco Tax Increases	$528	$463	$991
Oil and Gas Severance Tax Increases	$95	$230	$325
Reduction of the Used Car and Watercraft Trade-In Discount	$91	$125	$216
Means Testing Income Tax Credits & Deductions	$152	$166	$318
Elimination of Deduction for Early Beer & Wine Payment	$1	$2	$3
Total Tax Increases	**$2,305**	**$2,868**	**$5,173**
Total Tax Revenue Reduction to Ohio	**($246)**	**($277)**	**($523)**

If you would like to further examine how Governor Kasich's tax reform plan may impact your business, feel free to access our *Eight Step Estimated Business Tax Impact Tool,* which is available on our website at http://www.zhftaxlaw.com or contact one of our professionals.

Thomas M. Zaino, JD, CPA
(614) 349-4810
tzaino@zhftaxlaw.com

Stephen K. Hall, JD, LLM
(614) 349-4812
shall@zhftaxlaw.com

Richard C. Farrin, JD
(614) 349-4811
rfarrin@zhftaxlaw.com

Debora D. McGraw, JD, LLM, CPA
(614) 349-4813
dmcgraw@zhftaxlaw.com

John R. Trippier, CPA
(non-attorney professional)
(614) 349-4815
jtrippier@zhftaxlaw.com

Adam L. Garn, JD, CPA, MT
(614) 349-4814
agarn@zhftaxlaw.com

Charlotte B. Hickcox
(non-attorney professional)
(614) 349-4819
chickcox@zhftaxlaw.com

Jennifer R. Turner, CPA
(non-attorney professional)
(614) 349-4817
jturner@zhftaxlaw.com