

BUSINESS TAX  
REVAMP:  
A DEFICIT IN THE MAKING

A REPORT FROM  
POLICY MATTERS OHIO

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**POLICY MATTERS OHIO**, the publisher of this study, is a nonprofit, nonpartisan research institute dedicated to researching an economy that works for Ohio. Policy Matters seeks to broaden debate about economic policy by doing research on issues that matter to working people and their families. With better information, we can achieve more just and efficient economic policy. Areas of inquiry for Policy Matters include work, wages, education, housing, energy, tax and budget policy, and economic development.

## Executive Summary

The Ohio General Assembly in 2005 approved an overhaul of the state's tax system. In addition to cutting the personal income tax and making other changes, the legislature phased out two of the state's most significant taxes on business: The Corporate Franchise Tax on nonfinancial companies, which is the state's corporate income tax, and the Tangible Personal Property Tax, a local tax imposed on machinery, equipment, inventories, furniture and fixtures used in business in Ohio. It replaced them with a new Commercial Activity Tax, based on gross receipts in Ohio.

This business tax overhaul has resulted in big savings for business – more than \$500 million last fiscal year alone, with further cuts still to come. Overall, when fully implemented, the business tax changes are likely to reduce total state revenue by \$1 billion or more a year.

The business share of Ohio's state and local taxes remains far lower than it was 30 years ago. This is partly because the two taxes being phased out had been weakened over the years or remained stagnant in real terms.

Though the business-tax changes cost Ohio substantial revenue, collections from the franchise and CAT taxes were stronger than expected during the FY06-07 biennium. This kept year-to-year revenue from the affected taxes from sinking in the first two fiscal years after the tax overhaul. In FY08-09 the changes really began to sting the state budget noticeably. The full effects will be felt in FY10-11, just as the state is walloped with the national recession.

The Commercial Activity Tax was billed as a broad, low-rate tax that would aid in-state industry and manufacturers in particular. The CAT indeed is a broader tax than the franchise tax, covering roughly three times as many corporate entities. Among the 272,029 entities registered to pay the CAT as of October 2008, more than two in five were limited liability companies or S Corporations that have proliferated in recent years and do not pay the franchise tax. However, the CAT still has numerous exemptions.

A previous study had estimated that when the tax changes were fully implemented, manufacturers would save about \$600 million a year. However, the record so far suggests that manufacturers may save somewhat more than expected. Manufacturers remain far and away the largest payers of the CAT, as they do with the franchise tax. In FY2008, manufacturing accounted for 30.8 percent of the \$929.7 million in CAT tax due. The next biggest payers of the CAT are the retail industry, at 17.9 percent of the total, and wholesalers, 14.6 percent. These two industries will pay a great deal more in CAT than they did in franchise tax, though they also benefit from the tangible property tax they no longer pay.

The limited data that exist on the location of companies paying the CAT tally the number of taxpayers by address, which does not necessarily provide an accurate picture of the amount paid by companies located in and out of Ohio. However, it shows that 85.8 percent of the 180,667

CAT taxpayers by street address are located in Ohio. Most of the rest are either in a neighboring state, or in one of the largest states in the U.S.

Economists and tax policy experts often criticize gross receipts taxes like the CAT because of what they call “pyramiding”: The tax may be paid multiple times as a product or service is resold, such as steel going into auto parts and then finished cars. A comparison of taxable gross receipts with Ohio gross state product provides a rough measure of pyramiding. Under this admittedly crude comparison, the CAT is being paid roughly 1.4 times on each dollar of economic output in Ohio, and more for some industries.

The tax overhaul has caused certain economic-development incentives to decline: For example, fewer new Enterprise Zone tax abatements are being created. Some other tax exemptions that were tied to the franchise tax will disappear. However, other franchise-tax incentives remain in place, or have been changed so they are applicable against the CAT. The amount claimed of job creation tax credits, a key state incentive, has remained flat or increased. Local tax abatement on real property has been growing at a double-digit pace, while the state continues to offer substantial incentives to businesses not only to locate in Ohio, but to stay here. The business-tax reductions have not fundamentally altered the state’s operating model for economic development away from offering tax incentives, despite the promise that the tax changes would make such inducements less necessary.

Revenues from the CAT could be sizably reduced in the next few years for two separate, unrelated reasons. A suit by the grocery industry claiming the CAT is an unconstitutional tax on food could cost hundreds of millions of dollars. Meanwhile, a trigger built into the tax could automatically reduce the CAT rate if collections exceed projections by more than 10 percent.

While the national recession clearly is a major cause of the state’s looming budget shortfall, the reduction in business taxes has been an important contributor. As another Policy Matters Ohio report indicates, there is little evidence the overall tax cuts have achieved the objective of improving the state’s economy. In addition to previous recommendations to restore the personal income tax and eliminate tax loopholes, Policy Matters Ohio recommends that the state:

- Retain and strengthen the franchise tax;
- Mandate that nonfinancial companies pay the franchise tax or the CAT, whichever is higher;
- Adjust the rate of the CAT, so these two business taxes bring in as much inflation-adjusted revenue as the franchise tax and the tangible property tax produced in 2005. This would provide significant revenue for the state, while leaving the business share of state and local taxes well below what it was in the past, and
- Require that grocers pay the franchise tax if the Ohio Supreme Court should rule in the industry’s favor. This would ensure that grocers and other sellers of food for off-premise consumption pay a general business tax, as other businesses do.

## Introduction

Ohio's tax overhaul of 2005 was the most sweeping in a generation. Besides its five-year, 21 percent reduction in personal income-tax rates, House Bill 66 included a dramatic makeover of business taxes. It phased out two of Ohio's major business taxes and replaced them with a new one, the Commercial Activity Tax (see box for description, p. 2).<sup>1</sup> This study reviews the effects to date of those changes on state and local government revenues, what the overhaul has meant for different types of companies and industries and how the effects have compared with how the reform was promoted. It analyzes available data on the size and industry of taxpayers paying the new CAT, their location, and the extent to which the tax overhaul has affected economic development incentives. These issues matter not only to business, but to Ohioans in general, as these taxes support public services that touch every resident of the state. A previous Policy Matters Ohio report examined how Ohio's economy has performed since the tax overhaul.<sup>2</sup>

## Corporate Franchise Tax

The corporate franchise tax is Ohio's corporate income tax. Described as a "swiss cheese" tax during the debate over House Bill 66 and accurately derided for companies' ability to avoid paying it, the tax was beginning to produce more revenue even as the debate was under way. Under HB 66, the tax rate was cut 20 percent each year for five years, beginning in 2006, so that in Fiscal Year 2010, non-financial Ohio companies will no longer pay a corporate income tax. Banks and other financial institutions were not included in the law and will continue paying the tax on their net worth. The phase-out of the corporate franchise tax for non-financial companies means Ohio will join just five other states – Nevada, South Dakota, Texas, Washington and Wyoming – in having no general tax on corporate profits.<sup>3</sup>

After the phase-out was approved, revenues<sup>4</sup> from the corporate franchise tax outstripped initial projections, to the point that they held level even when the rate was declining in 2006 and 2007 (see Figure 1).<sup>5</sup> The main reason was the increase in corporate profits during this time period. Corporate profits from nonfinancial domestic industries grew more than 17 percent in both 2005

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<sup>1</sup> This report examines the fundamental changes in Ohio's business taxes – the elimination of two major business taxes and their replacement by a new tax. It does not cover other changes made in the tax system at that time, such as the elimination of the 10 percent real-property tax rollback for commercial and industrial businesses and the reduction of individual income-tax rates, which included business income.

<sup>2</sup> Honeck, Jon, "The 2005 Tax Reform and Ohio's Economy," Policy Matters Ohio, January 2009, available at <http://www.policymattersohio.org/2005TaxOverhaul.htm>

<sup>3</sup> Richard A. Levin, "A View from the Tax Commissioner's Office," speech at the Ohio One-Day Tax Conference, Columbus, OH, July 18, 2008.

<sup>4</sup> This report generally uses overall revenue totals for the franchise tax and the CAT, not just those that go to support the state's General Revenue Fund. Currently, CAT revenues are used to reimburse school districts and local governments for lost tangible property tax and do not support the GRF.

<sup>5</sup> Enthusiastic analysts at the Legislative Service Commission wrote in July 2007: "The performance of the CFT was spectacular in the last biennium. Nonfinancial corporations had to pay only 80% and 60% of their full tax liability, yet CFT receipts increased 0.3% in FY 2006 and 2.0% in FY 2007." Budget Footnotes, Vol. 30, No. 11, p. 254, available at <http://www.lbo.state.oh.us/fiscal/publications/periodicals/bfn/V30N11.pdf>

### **Two Ohio business taxes, and the new tax that has replaced them**

The Commercial Activity Tax created by the Ohio General Assembly in 2005 replaces two taxes: the Corporate Franchise Tax on nonfinancial companies and the Tangible Personal Property Tax.

The CAT is levied on Ohio gross revenues of nonfinancial businesses, whatever their form of organization. Generally, it covers such businesses that paid the franchise tax, or whose owners pay personal income tax on income they receive from those businesses (Some industries that pay special business taxes, such as insurance, do not pay the CAT). When the tax is fully implemented in April 2009, the rate will be 0.26 percent. However, businesses pay only \$150 on their first \$1 million in Ohio receipts, and those with less than \$150,000 in receipts are exempt.

Ohio's Corporate Franchise Tax is the state's corporate income tax. It is computed on the basis of net worth or net income, with taxpayers owing tax on whichever computation yields the higher amount. Companies in Ohio have paid some form of franchise tax since 1902, but that will end after companies finish paying taxes on their 2008 income or net worth. That is the fourth year of the five-year phase-out, so companies are now paying tax at just 20 percent of the 2005 rate. As recently as the mid-1970s, the franchise tax accounted for 16 percent of taxes supporting the state's general operations.

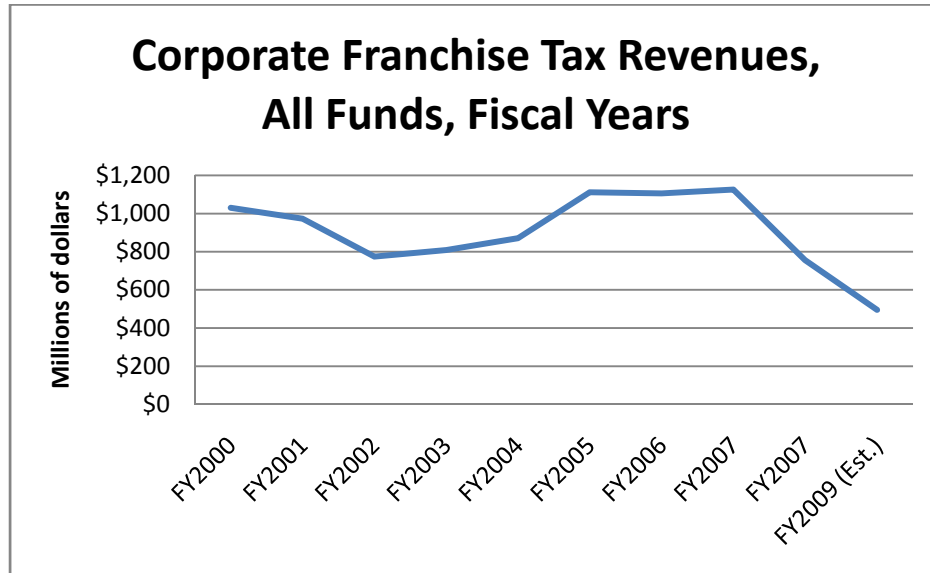
Prior to the phase-out, the franchise tax rate on general business corporations was 0.4 percent of net worth or 5.1 percent on the first \$50,000 in net income, plus 8.5 percent of net income greater than that. Nonfinancial companies also paid a small "litter tax." Such companies were liable for \$50, before refundable credits for which they might be eligible. The minimum was \$1,000 for companies with more than \$5 million in sales or at least 300 employees. Banks, savings and loans and other financial institutions were not affected by the phase-out of the tax. They pay under a net-worth formula, at a rate of 1.3 percent. Companies figure their tax using a formula based on the proportion of property, payroll and sales they have in Ohio (unlike the CAT, which is based strictly on Ohio receipts).

The tangible property tax, or TPP tax, was a local tax imposed on machinery, equipment, inventories, furniture and fixtures used in business in Ohio. The value of each was multiplied by an assessment percentage – 25 percent on most classes of property, less on inventories – to come up with a taxable value. The first \$10,000 of taxable value was exempt from taxation. A local millage rate was then applied. Prior to the general tax overhaul, the tax on inventories was scheduled to be phased out gradually by Tax Year 2018. In 2005, nearly \$1.7 billion was levied under the TPP tax. More than 70 percent of that went to school districts, with the rest going to counties, townships, cities and villages. After a four-year phase-out, this tax no longer exists. School districts as a whole are to receive 70 percent of the CAT on a continuing basis to make up for their revenue loss. Local governments are also being reimbursed, though that will be phased out between FY2012 and FY2018. Personal property taxes on telecommunications companies also are being phased out on a different schedule.

and 2006, according to the U.S. Department of Commerce.<sup>6</sup> Other factors could also have contributed, such as a federal law that loosened the restrictions on repatriating profits earned abroad, and the exhaustion of state tax credits for previous losses. Some analysts wondered if the increase in Ohio corporate franchise taxes might also reflect a move to shift profits to Ohio from other states by multi-state companies seeking to take advantage of lower rates here. However, analysts at the Ohio Department of Taxation have not been able to prove such a shift and do not believe it was a major factor in the increase.<sup>7</sup>

Based on more recent projections from last year, the corporate franchise tax has begun to fall below estimates, as have other taxes. That began in FY08, when the tax brought in less than budgeted, and is expected again this fiscal year, as corporate profits fall.<sup>8</sup> State corporate income tax revenues started declining nationally in the third calendar quarter of 2007, after almost continuous increases over the previous five years.<sup>9</sup>

**Figure 1.**



Source: Ohio Department of Taxation.

<sup>6</sup> See U.S. Department of Commerce, Bureau of Economic Analysis, National Economic Accounts, Selected NIPA Tables, Table 6.16D, Corporate Profits by Industry, available at <http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=Y> Most of the franchise tax paid in FY06 and FY07 was paid on profits in these years.

<sup>7</sup> Discussion with Mike Sobul and Chris Hall, Ohio Department of Taxation, Tax Analysis Division, Oct. 31, 2008

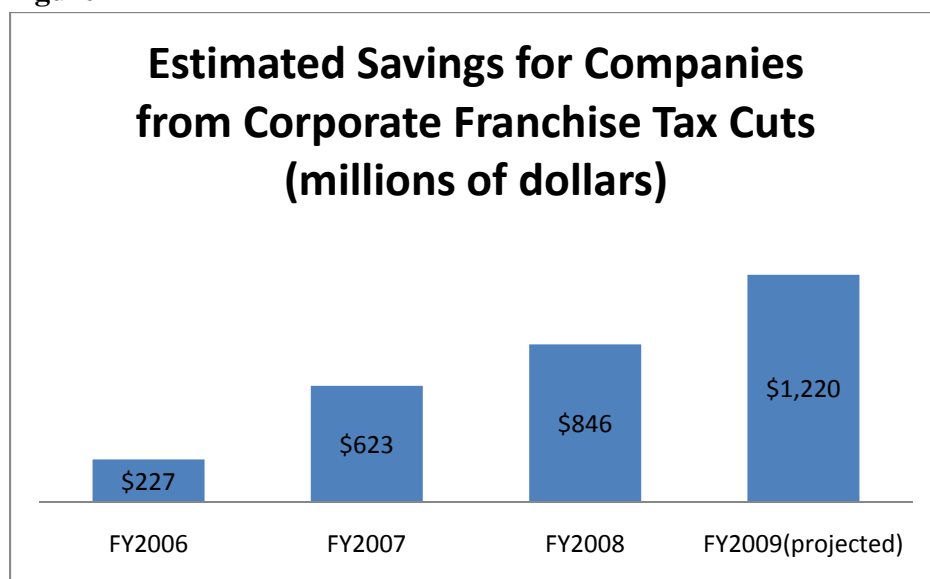
<sup>8</sup> J. Pari Sabety, Director, Office of Budget and Management, Budget Directive #6: Revised Revenue Estimates for FY 09, Sept. 11, 2008, <http://www.obm.ohio.gov/memos/2008/Budget%20Directive%20%20236.pdf>, accessed Dec. 2, 2008. However, the tax still brought in considerably more in FY08 than had been originally estimated at the time its phase-out was approved.

<sup>9</sup> Nelson A. Rockefeller Institute of Government, State and Local Finance, Revenue Data, See [http://www.rockinst.org/government\\_finance/revenue\\_data.aspx](http://www.rockinst.org/government_finance/revenue_data.aspx)

During the first three fiscal years after the tax changes were approved in 2005, the state collected \$483 million more in corporate franchise tax revenue than was initially projected. The majority of that came during FY07.

Even while the state was receiving more revenue than had been anticipated, this also meant that the benefit companies received from the phase-out grew as well. All else being equal, companies in Ohio now are receiving tax benefits of more than \$1 billion a year because of the phase-out of the corporate franchise tax, leaving aside other tax changes. Figure 2 shows estimates of how much companies saved in franchise tax each year because of the cuts:

**Figure 2**



Sources: Ohio Department of Taxation, Ohio Office of Budget & Management. FY09 uses current state estimate for franchise tax. Calculation of estimates uses tax years for financial institutions and fiscal years for total franchise tax.<sup>10</sup> A decline in corporate profits in the recession likely will reduce the FY2009 figure.

The above figures, like other such estimates in this report, are based on how much additional revenue would have been produced had the taxes and rates from before the tax overhaul in 2005 been in effect. While some may argue that the tax cuts increase economic growth and thus lead to higher tax revenues over time, this argument is flawed. For one thing, any such effects would be very modest at best. A consultant that modeled the 2005 tax changes as originally proposed by Gov. Bob Taft found that such “dynamic feedback taxes” would amount to only an additional \$216 million a year, compared to the \$3 billion plus in annual tax cuts.<sup>11</sup> And critically, that analysis did not include the very real economic effects of government spending reductions that

<sup>10</sup> This analysis excludes franchise tax paid by financial institutions, as they continue to pay the tax. It includes estimates for the effect on franchise taxes of refundable job creation tax credits between FY06 and FY08, since they were not subject to reduction each year with the phase-out of the tax. Since July 1, 2008, these credits have been applied against the CAT and do not affect the franchise tax.

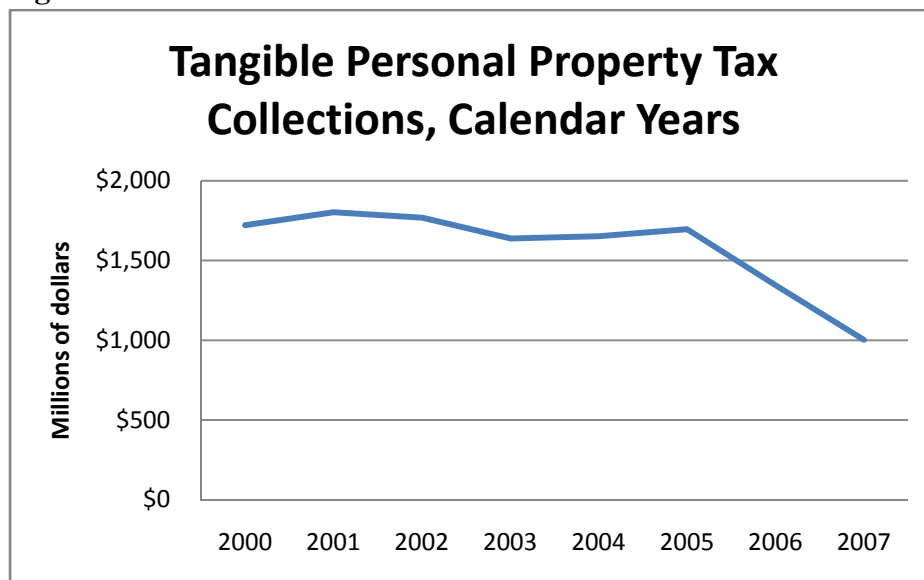
<sup>11</sup> See *The Dynamic Economic and Fiscal Impact of the Ohio Administration’s Proposed Changes to the Commercial Activity Tax, Corporate Franchise Tax, Personal Income Tax, Tangible Personal Property Tax, and Sales Tax*, Prepared for the Ohio Department of Development and the State of Ohio, REMI Consulting Inc, April 18, 2005).

are necessitated by the tax cuts. The economic effects of such spending cuts counter and often outweigh the economic stimulus provided by such tax cuts. Thus, even the \$216 million figure was a substantial overstatement, at best. In some other instances, researchers have found that increasing taxes and maintaining state spending may have a more positive economic effect than tax and spending cuts.<sup>12</sup> Moreover, as recent research has shown, there is little indication that the tax overhaul is having a positive effect on Ohio's economy.<sup>13</sup>

### Tangible Personal Property Tax

Under HB 66, the Tangible Personal Property Tax was phased out over four years. Traditionally, the tangible property tax has been less volatile than the corporate franchise tax. Data for taxes levied in 2008 are not yet available, but Figure 3 below shows how much has been collected in TPP tax and the decline since the reductions began taking effect in calendar 2006.

**Figure 3**



Source: Ohio Department of Taxation.

In calendar 2006, the phase-out of the tangible property tax reduced the levy state-wide to \$1.35 billion, or about 22 percent (\$386 million) less than the estimated \$1.73 billion that otherwise would have been levied.<sup>14</sup> Figuring a similarly precise estimate of the revenue loss from the phase-out of the tax since then is not easily accomplished, because of other changes in the tax code that were due to take place prior to the 2005 tax overhaul and the unavailability of current

<sup>12</sup> See examples cited in Jon Honeck and Zach Schiller, "REMI Report Presents Just Half the Equation," Policy Matters Ohio, May 2005, p. 4, available at [http://www.policymattersohio.org/pdf/REMI\\_Report\\_Brief\\_May\\_2005.pdf](http://www.policymattersohio.org/pdf/REMI_Report_Brief_May_2005.pdf)

<sup>13</sup> Honeck, "The 2005 Tax Overhaul and Ohio's Economy," op. cit.

<sup>14</sup> This estimate is based on the percentage reductions in assessed valuations called for in the phase-out. Assessment rates on inventories were already set to decline under the law in effect when HB 66 was approved. See Ohio Department of Taxation 2007 Annual Report, Tangible Personal Property Tax, Tables 1 and 4.

data.<sup>15</sup> However, apart from the tax reduction, tangible property tax collections have been relatively stable. While a gradual decline could be expected under previous state law, in calendar 2009, the \$1.5 billion or more that this tax has been producing annually will disappear.

### Commercial Activity Tax

One of the chief attractions of the Commercial Activity Tax was that it was to be a broad tax, covering far more taxpayers than the Corporate Franchise Tax.<sup>16</sup> The CAT indeed is covering far more taxpayers.<sup>17</sup> As of October 2008, 180,667 entities were paying the CAT, double the 90,340 companies that have Corporate Franchise Tax liability in Tax Year 2007.<sup>18</sup> This understates the extent to which the CAT is covering more companies (see discussion on p. 12). However, these are the only numbers available to compare the number of CAT and franchise taxpayers, respectively, by industry. The biggest relative increase in the number of taxpayers came in management of companies (holding companies), agriculture, and arts and entertainment, respectively, but every category of industry with the exception of utilities showed an increase.<sup>19</sup> It is unclear why the number of utilities paying the CAT is smaller than those paying the franchise tax. Other industries in which the number at least doubled were construction; accommodation and food services; real estate and rental and leasing of property; and professional, scientific and technical services. Information was essentially flat.

That is not to say that the CAT takes in all businesses; far from it. From the outset, the new tax excluded not only financial institutions and insurance companies, but numerous others, including

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<sup>15</sup> Telecommunications companies started paying the general TPP tax in 2007 instead of the Public Utility Personal Property Tax and no data are available yet on how much of the tax they accounted for that year; assessment rates of different types of telecom property were changing under law in effect prior to HB 66, as were the assessment rates on inventories under the TPP. While estimates could be made of foregone tax, they would require numerous assumptions.

<sup>16</sup> In a recent court filing, Tax Commissioner Richard Levin stated that the CAT “seeks to meet the State’s revenue needs by employing a low-rate tax on all persons engaged in business in Ohio, and it measures the privilege of doing business by the amounts realized by those persons. In other words, it taxes more entities, but taxes them more lightly, for the privilege of doing business in Ohio.” Memorandum in Support of Jurisdiction of Defendant-Appellant, Richard A. Levin, Successor to William W. Wilkins, Ohio Tax Commissioner, Ohio Grocers Association et. al v. William W. Wilkins (Richard A. Levin), in his official capacity as Ohio Tax Commissioner, Ohio Supreme Court Case. No. 08-2018, Oct. 17, 2008, p. 3

<sup>17</sup> As noted below, an exact comparison of companies paying the two taxes is impossible because of differences in reporting.

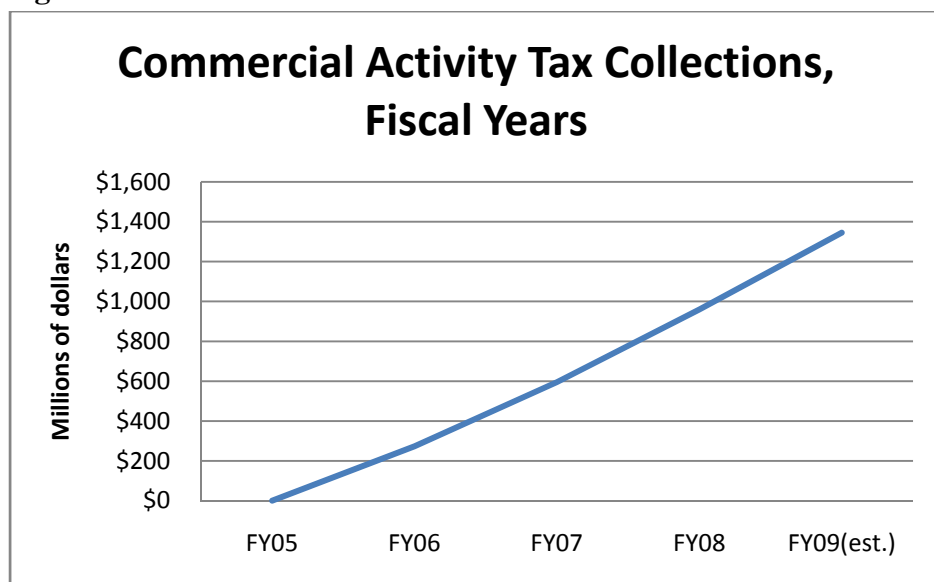
<sup>18</sup> Some companies that paid the tangible personal property tax may not have paid the franchise tax, so the actual number of CAT taxpayers compared to the number of those who paid the previous ones may not have actually doubled.

<sup>19</sup> See Ohio Department of Taxation, Tax Data Series, Commercial Activity Tax, Fiscal Year 2007 Commercial Activity Tax Returns: Number of Returns and Reported Financial Data by Industrial Classification, CAT-1, No. 13 (2008), April 1, 2008, and Corporation Franchise Tax, Number of Corporations by Tax Base and Industry, Tax Year 2007, Table CF-1A, No 42 (2008), August 1, 2008. Both of these reports are available at [http://www.tax.ohio.gov/channels/research/other\\_tax\\_statistics.stm](http://www.tax.ohio.gov/channels/research/other_tax_statistics.stm). The breakdown of the number of taxpayers by industry is based on companies’ reported liability. Actual revenues received usually have exceeded liabilities that taxpayers report.

affiliates of banks and insurance companies, nonprofits such as hospitals, and suppliers to very large distribution centers.

Over its first three years of existence, FY06-FY08, the CAT produced nearly \$1.83 billion in revenue, \$389 million or 27 percent more than what was anticipated soon after the tax was approved in 2005.<sup>20</sup> As with the franchise tax, revenues of the CAT continued to substantially exceed original projections in FY08, but fell somewhat below the administration estimate made in 2007. Revenues in FY09 outpaced recent estimates during the first six months by \$17 million, or 2.7 percent. However, the FY09 estimate might have been erroneously low because it wasn't adjusted for the end of an exemption on motor fuel. Payments in November fell 6 percent below expectations. The November tax payment covers receipts between July and September, so it reflects the weakening economy through only a portion of the financial crisis. The state has not yet updated its estimate for CAT revenue this fiscal year. If the CAT exceeds its originally projected level this fiscal year by more than 10 percent, its rate will be adjusted downward (see further discussion on p. 22) Figure 4 shows annual CAT collections:<sup>21</sup>

**Figure 4.**



Source: Ohio Department of Taxation

Comparisons of taxpayers between the Commercial Activity Tax and the franchise tax are admittedly imprecise. One difference is in the time period of the data – the CAT is shown for the fiscal year, while the CFT is for the tax year. Small companies with gross receipts under \$150,000 are not required to register for the CAT. And importantly, companies may choose to define themselves differently. Under the CAT, a corporation with more than one affiliate or

<sup>20</sup> Ohio Department of Taxation, Conference Tax Reform and Budget Revenue Plan – Preliminary Scoring, October 2005. As a new tax, it was difficult to predict how much revenue the CAT would generate. See below.

<sup>21</sup> The CAT will be fully implemented in the second quarter of 2009, when its rate reaches 0.26 percent of taxable gross receipts.

subsidiary can choose to file as a “consolidated group,” in which case it must include all of its various members and does not have to pay the CAT on any transactions between them. Alternatively, it can choose to file as a “combined group,” which only includes those affiliates that would have to pay the Ohio tax. In that case, it would pay the CAT on transactions between its member companies. As one might expect, more companies have chosen to file as consolidated taxpayers, given how it limits their liability.

However, this also means that far more companies are registered to pay the CAT than actually do so, since registration takes in all the various affiliates. One taxpayer filed a consolidated report for 3,004 different entities. While some taxpayers also file combined reports for many different units under the franchise tax, most file separate returns for each corporate entity that is covered by the Ohio tax.

### **Revenue reductions from the business tax changes**

In Fiscal Year 2008, the state collected \$959.6 million in Commercial Activity Tax. Had rates not been cut, the CFT likely would have produced \$1.6 billion, compared to actual revenue generated of \$754.6 million. The TPPT would have generated roughly \$1.6 billion versus the actual amount of about \$927.2 million.<sup>22</sup> Thus, altogether, state and local governments generated \$2.64 billion in revenue compared to about \$3.2 billion had the old tax system remained in place. This is the bottom line on business tax reform from the vantage point of government revenue. Of course, that only reflects three years of the five-year tax changes. The shortfall will grow in the current fiscal year of 2009, the last year that the tangible property tax and the franchise tax are collected (the last payments under the TPPT were due in September, unless the deadline was extended locally). Current estimates for the FY09 CAT are nearly identical to the average annual amount of corporate franchise tax that without the phase-out would have been collected between FY04 and FY08, more than \$1.3 billion a year. While other changes in the tax code make an exact calculation difficult, the state taxation department estimated after approval of HB 66 that the tangible property tax would bring in \$422 million in FY09, about \$1.3 billion less than it would have otherwise.<sup>23</sup>

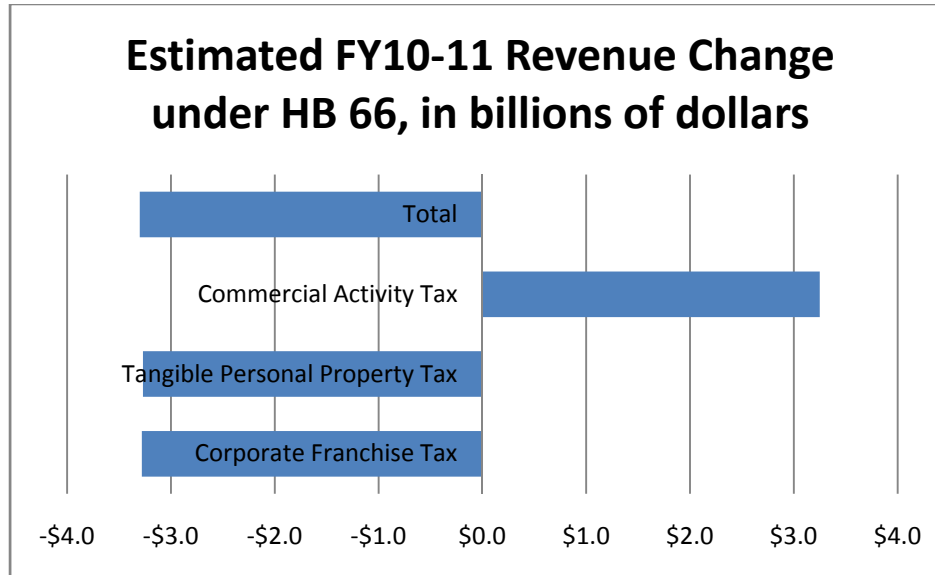
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<sup>22</sup> This is in all probability an underestimate. The tangible property tax, as noted, has been relatively stable, producing more than \$1.6 billion a year prior to its phase-out. While this amount was set to decline somewhat each year due to a decline in the assessment value of inventories, it does not include additional amounts of tax paid by telecommunications companies. In a 2005 estimate of TPP tax revenue that would have been generated without the approval of HB 66, the state tax department put the FY08 amount at \$1.74 billion, including payments by telecom companies.

<sup>23</sup> Both of these figures include personal property tax paid by telecommunications companies. As noted, such companies, which have paid the Public Utility Property Tax, started paying the general tangible property tax in 2007. They will continue paying both during a transition period, but ultimately will pay neither. “TPP Tax Revenue Estimates Derived at the Time of HB 66 Enactment,” Ohio Department of Taxation.

The revenue loss in FY2010 and continuing in FY2011 would be larger still. In early 2007, the governor's budget estimated revenue changes stemming from HB 66. Figure 5 shows the combined total for the change in the three business taxes, as estimated then, for FY10-11:<sup>24</sup>

**Figure 5**



Source: Executive Budget for FYs 2008 and 2009

Of course, with the recession, corporate profits are suffering, which would reduce the amount collected from the franchise tax. A review of the franchise tax in previous downturns suggests that it would continue to bring in close to \$1 billion a year, if not more, if restored to its 2005 status. Altogether, the tax cuts resulting from the business-tax changes once they are fully implemented will amount to \$1 billion a year or more during the state's FY2010-11 biennium beginning next July 1.

It is not surprising that the tax changes will result in a major reduction in business taxes. Authors of a 2007 review of the changes matter-of-factly note that "...the net result was a large business tax cut," which they estimated then at \$1.5 billion in FY2010.<sup>25</sup> The Ohio Business Roundtable told the Ohio Supreme Court in October: "The new business tax system substantially lowered the overall tax burden on business."<sup>26</sup>

<sup>24</sup> State of Ohio, Executive Budget for FYs 2008 and 2009, p. B-8. Under current law, the state reimburses school districts and localities for losses from the phase-out of the Tangible Personal Property tax. Schools are guaranteed 70 percent of CAT revenues, while reimbursements for localities are to be phased out during a period ending in 2018.

<sup>25</sup> Church, Frederick and Christopher Hall, "Ohio Tax Reform: Cuts and Repeals and that Darn CAT," *State Tax Notes*, Jan. 8, 2007, p. 34. Both Church and Hall are officials at the Ohio Department of Taxation. They note in the article, however, that the opinions in it are theirs and do not necessarily represent views of the taxation department.

<sup>26</sup> Memorandum in Support of Jurisdiction of Amicus Curiae Ohio Business Roundtable, Ohio Grocers Association et. al. v. William W. Wilkins (Richard A. Levin), in his official capacity as Ohio Tax Commissioner, Ohio Supreme Court Case. No. 08-2018, Oct. 17, 2008, p. 2.

While the national recession clearly is a major cause of the state's looming budget shortfall, the reduction in business taxes has been an important contributor. The state currently estimates that revenues from the franchise tax will fall from \$495 million in FY2009 – the last year of the tax on non-financial companies – to \$163 million in FY10 and \$169.7 million in FY11.<sup>27</sup> Excluding the \$40 million of this year's receipts that stem from a one-time settlement, just the final step of five eliminating the franchise tax will cost the state \$577 million in revenue over the next biennium. That assumes revenues would remain level with those estimated for FY09. Even if receipts from the tax were to fall drastically because of lower corporate profits, the state would still receive hundreds of millions of dollars in revenue over the two-year period if the last increment of the tax cut was deferred.

### **Business and individual shares of Ohio state and local taxes**

Ohio has seen a substantial long-term decline in the share of state and local taxes paid by businesses, compared to that paid by individuals. The changes in the tax code have not erased this change; in fact, the business share probably has declined slightly.

Between 1976 and 1999, according to a 2001 study by Dr. Edward W. (Ned) Hill of Cleveland State University sponsored by the Ohio Manufacturers' Association, the share of Ohio state and local taxes paid by businesses fell from 39.6 percent to 28.9 percent.<sup>28</sup> Policy Matters Ohio updated that study in 2004 and found that the business share had remained about the same.<sup>29</sup> A review of the business and individual shares using data mostly from Fiscal Year 2007<sup>30</sup> shows modest change since the 2004 study. The share paid by business was 28.7 percent and by individuals 69.4 percent, with the remainder in the motor vehicle license tax.<sup>31</sup> Thus, the business share was down slightly from the 30.3 percent found in the 2004 study.<sup>32</sup> While this analysis does not attempt to update the shares of each separate tax paid by business and individuals, respectively, from the 2004 study, it is clear that the business share remains far

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<sup>27</sup> Estimates of GRF tax revenue received from Ohio Department of Taxation, Dec. 8, 2008. As noted, the franchise tax on financial institutions will remain in place after the phase-out for most companies.

<sup>28</sup> Hill, Edward W., *Ohio's Competitive Advantage: Manufacturing Productivity*, Maxine Goodman Levin College of Urban Affairs, Cleveland State University, 2001.

<sup>29</sup> *Ohio's State and Local Taxes: The Dwindling Business Share*, Policy Matters Ohio, May 2004. Available at [http://www.policymattersohio.org/pdf/Ohio\\_Biz\\_Taxes\\_May2004.pdf](http://www.policymattersohio.org/pdf/Ohio_Biz_Taxes_May2004.pdf). Using a higher figure for the share of sales taxes paid by business, Policy Matters found business was paying 30.3 percent of the total, but using Hill's original methodology, the figure was actually 27.2 percent, or slightly below where it had been when Hill did his study. All of these figures exclude the percentage accounted for by motor vehicle license revenue, as in Hill's earlier report.

<sup>30</sup> For some taxes, data are only available on a calendar year basis. This analysis uses FY07 data or the most current year available so that the year covered remains comparable, if not exact.

<sup>31</sup> The business share shown here differs very slightly from the 28.9 percent calculated by the Center for Community Solutions in its recent report on taxes because of some small differences in figures used for tax collections and CCS's inclusion of the motor vehicle license tax, which this report does not estimate. See The Center for Community Solutions, "Taxing Issues Redux," January 2009.

<sup>32</sup> These percentages are based on business paying 34 percent of the sales tax, much higher than the 20 percent figure used in the Hill study though below the proportions used by some other researchers.

below what it was three decades ago.<sup>33</sup> One of the reasons is that, adjusted for inflation, both the franchise tax and the tangible property were generating considerably less before the tax overhaul than they had 30 years earlier.<sup>34</sup>

### **Taxpayers big and small**

Under both the franchise tax and the CAT, as with many taxes, most taxpayers pay very little and a relatively small number of taxpayers accounts for a large share of collections. Almost exactly half of the \$795.5 million in CFT liability for nonfinancial companies in Tax Year 2007 was paid by 177 taxpayers with more than \$1 million in liability, out of a total of 90,340 taxpayers.<sup>35</sup> By comparison, the 122 CAT taxpayers in Fiscal Year 2007 with Ohio taxable gross receipts of greater than \$500 million paid a collective \$179.9 million, or 31.9 percent of the total. While payment of the Corporate Franchise Tax appears to be slightly more concentrated among the biggest payers, the 60 companies with Ohio taxable gross receipts of \$1 billion or more were liable for \$136.8 million in CAT in 2007, or nearly a quarter of the total. That year, there were 171,160 companies liable for the CAT.<sup>36</sup>

The bulk of CAT taxpayers are businesses with between \$150,000 and \$1 million in annual taxable gross receipts, which pay only a flat \$150 a year.<sup>37</sup> In FY07, some 128,475 taxpayers with less than \$1 million in annual gross receipts, or three-quarters of the total paying the tax, were liable for the minimum.<sup>38</sup> When you add in those companies that do not have to pay tax

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<sup>33</sup> This analysis includes the Commercial Activity Tax, which did not exist at the time of the 2004 Policy Matters Ohio analysis. As noted, this analysis does not attempt to examine how shares of each tax might have changed since 2004. It does, however, reflect the relative business and individual shares in FY07 of the real property tax. Thus, the elimination of the 10 percent rollback on real property taxes paid by commercial and industrial businesses approved in 2005 is included in this analysis.

<sup>34</sup> Ohio Department of Taxation, Tax Data Series, Historical Time Series, available at [http://www.tax.ohio.gov/divisions/tax\\_analysis/tax\\_data\\_series/historical\\_time\\_series/publications\\_tds\\_historical.stm](http://www.tax.ohio.gov/divisions/tax_analysis/tax_data_series/historical_time_series/publications_tds_historical.stm) When adjusted for inflation, franchise tax collections in FY2005, just before the phaseout, were well below what they had been 10, 20 and 30 years before. Tangible Personal Property Tax paid in 2005 was modestly below payments in 1995 and 1985, and 22 percent below the levy in 1975.

<sup>35</sup> This analysis uses the taxation department's breakdown of franchise tax according to reported liability. As noted above, actual revenues received in recent years have been higher than the reported liability.

<sup>36</sup> See Ohio Department of Taxation, Commercial Activity Tax: Number of Taxpayers and Tax Return Data, Fiscal Year 2007, Tables CAT 1&2, Nos 13 and 14 (2008), March 26, 2008. See [http://www.tax.ohio.gov/divisions/tax\\_analysis/tax\\_data\\_series/CAT/cat12fy07.stm](http://www.tax.ohio.gov/divisions/tax_analysis/tax_data_series/CAT/cat12fy07.stm) Recently, ODT released data on FY2008, which showed the 136 companies with more than \$500,000 in taxable gross receipts accounted for 34.2 percent of the CAT liability due. A more detailed breakdown of FY07 CAT data for companies with \$500 million or more in gross receipts was provided to the author by the Ohio Department of Taxation.

<sup>37</sup> The law excludes the first \$250,000 in taxable gross receipts each quarter from having to pay more than the minimum, so some taxpayers with less than \$1 million in annual receipts still pay more than that.

<sup>38</sup> Since the actual state data categorize taxpayers as those with less than \$1 million in annual receipts, and the law excludes the first \$250,000 of each taxpayer's quarterly receipts from the tax over the flat rate, a portion of these 128,475 taxpayers have receipts in one or more quarters over the \$250,000 and thus pay a modest amount above the flat \$150 minimum per year. However, the total paid by such taxpayers altogether amounted to only \$932,000 in Fiscal Year 2007, 4.6 percent of the total tax due from these taxpayers. Fiscal Year 2007 Commercial Activity Tax: Number of Returns and Reported Financial Data, by Size of Taxable Gross Receipts, Tax Data Series, Ohio

because they fall below \$150,000 threshold for annual gross receipts, the overwhelming majority of Ohio businesses either pay no CAT or the minimum \$150. ODT estimated during discussion of the CAT in 2005 that there were about 85,000 entities with annual gross receipts between \$40,000 and \$150,000 that would not have to report and pay the tax, but it did not estimate the number with receipts below \$40,000.<sup>39</sup> Similarly, half the franchise taxpayers pay the minimum, and 71 percent pay \$1,000 or less.

### Who pays the CAT

Under Ohio law, the Corporate Franchise Tax covers what are known as “C corporations,” traditional companies that are known as such because they are classified that way in the Internal Revenue Code. Other businesses, from sole proprietorships to the S Corporations and limited liability companies that have proliferated in more recent years, are not covered by the Corporate Franchise Tax, another reason that this tax is not as broad as it once was.<sup>40</sup> The CAT, by contrast, covers all of these businesses, regardless of corporate form.<sup>41</sup> Thus, even with the exclusion under the CAT of companies with less than \$150,000 in Ohio receipts, the new tax covers far more companies than the franchise tax.

The Department of Taxation provided this breakdown of the CAT taxpayer registrations by type, as of October, 2008:

Sole Proprietor	38,403
Partnership	12,861
C Corporation	81,376
Association/Trust	1,036
Limited Liability Corporation	45,266
Limited Liability Partnership	3,451
LTD (Non-US)	1,659
S Corporation	70,875
Single Member LLC	3,454
Other	13,648
<b>Total:</b>	<b>272,029</b>

This total covers all those that registered. By contrast, 90,340 companies filed franchise tax returns in Tax Year 2007. While the comparison is not exact, this indicates that roughly three

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Department of Taxation, CAT-2, No. 14 (2008), March 17, 2008. Available at [http://www.tax.ohio.gov/divisions/tax\\_analysis/tax\\_data\\_series/CAT/documents/CAT12fy07.pdf](http://www.tax.ohio.gov/divisions/tax_analysis/tax_data_series/CAT/documents/CAT12fy07.pdf)

<sup>39</sup> Some companies that have less than \$150,000 in receipts pay the franchise tax.

<sup>40</sup> Business income received by Ohio residents from such “pass-through” entities is taxed under the individual income tax. Ohio also has a pass-through entity tax, which covers income received by non-resident investors from Ohio pass-through entities. Single-member limited liability companies and entities that are treated as corporations for federal income tax purposes also are subject to the state franchise tax.

<sup>41</sup> Financial institutions, insurance companies, nonprofit organizations, dealers in intangibles, affiliates of financial institutions and insurance companies, and certain receipts by public utilities were excluded.

times as many entities are covered by the CAT as have been by the franchise tax. It is important to note that the CAT figure reflects the number of entities; as noted above, many CAT taxpayers file as part of a consolidated or combined group.<sup>42</sup> This does not indicate what share of the CAT is being paid by companies that previously had not paid the franchise tax.

According to the taxation department, the CAT takes in about 32,000 C corporations that weren't covered by the franchise tax, probably because they are members of larger groups that pay the CAT. At the same time, about 33,000 C corporations that pay the franchise tax aren't covered by the CAT, probably because they have receipts of less than \$150,000 a year.<sup>43</sup>

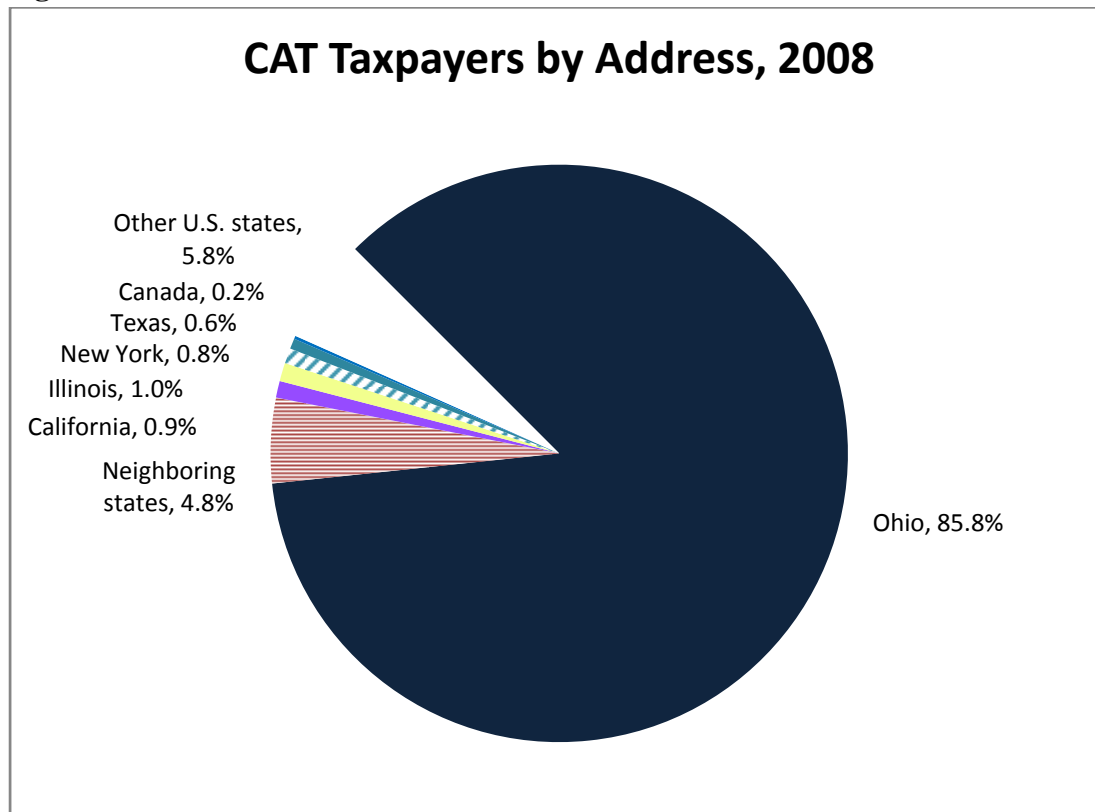
### **Out-of-state companies and how much of the tax they pay**

Proponents of the CAT also argued that it would promote investment in Ohio because companies producing here and selling most of their product or service outside the state would not pay the tax on what they exported out of Ohio (They did not so often mention that small, mom-and-pop companies selling only in-state would not receive such benefits, or that companies with major production but few sales in Ohio would pay little for all of the public services that help allow them to do business). Unfortunately, however, the state has not attempted to track the share of CAT being paid by out-of-state companies. Officials say that requiring companies to report gross receipts for each entity would be too burdensome for both taxpayers and the taxation department itself. Thus, the only measure available is a limited one that does not necessarily provide an accurate picture of the amount actually paid by companies located in and out of Ohio. It tallies the number of taxpayers by address, though it is impossible to know how much in gross receipts was generated in Ohio or another state. Figure 6 shows the number of CAT taxpayers by state:

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<sup>42</sup> As noted, there were 180,667 CAT taxpayers as of October 2008. Some franchise taxpayers also file as part of a combined group, so the 90,340 figure probably understates the number of entities covered by the franchise tax.

<sup>43</sup> Conversation with John Kohlstrand and Chris Hall of the Ohio Department of Taxation, Jan. 23, 2009

**Figure 6**

Source: Ohio Department of Taxation. As of October 2008. “Other U.S. states” include District of Columbia, Puerto Rico, Virgin Islands, Northern Mariana Islands and Palau.

As Figure 6 indicates, an overwhelming 85.8 percent of the 180,667 CAT taxpayers by street address are located in Ohio. Most of those outside Ohio are either in a neighboring state, or in very large states like California, Illinois, New York and Texas. CAT taxpayers are scattered across all 50 states, as well as other U.S jurisdictions and Canada. As noted above, while the data show Ohio taxpayers accounting for the lion’s share of the total, it is impossible to know if the goods and services of Ohio-based taxpayers were necessarily produced in Ohio, or if those of the non-Ohio taxpayers were produced outside Ohio. Thus, this is a relatively limited measure of the degree to which out-of-state companies are paying the tax.

The authors of the *State Tax Notes* article on the CAT cited previously noted that of 81,000 members of consolidated groups at that time, 27,000 or one-third were companies with non-Ohio addresses. While this data is subject to the same limitation as that cited above, it suggests that a larger proportion of the total CAT taxpayers are out of state.<sup>44</sup>

When the CAT was approved in 2005, state officials expected that there would be a court challenge to the requirement that companies with more than a specific level of receipts, payroll

<sup>44</sup> Church and Hall, *op. cit.*, p. 32

or property in Ohio pay the new tax.<sup>45</sup> While such a challenge seems inevitable in the long run – and may simply await enforcement action by the state that an out-of-state company chooses to contest – it has not surfaced yet.

## Pyramiding

Economists and tax policy experts often criticize gross receipts taxes like the CAT because of what they call “pyramiding”: The tax may be paid multiple times as a product or service is resold, such as steel going into auto parts and then finished cars.<sup>46</sup> This encourages companies to do more work in-house, since they won’t pay tax. Among the most vocal opposition to the CAT during the tax debate in 2005 came from oil marketers, who often resell their product a number of times before it gets to the ultimate customer. Proponents of the CAT, while acknowledging the issue, said the effects of pyramiding would be modest because the tax rate is low (a company with \$2 million in annual Ohio gross receipts will pay \$2,750 when the tax is fully implemented).

While it is beyond the scope of this study to examine exactly how much pyramiding is occurring with the CAT, a comparison of taxable gross receipts with Ohio gross state product provides a rough measure. Under this admittedly crude comparison, CAT is being paid roughly 1.4 times on each dollar of value-added economic output in Ohio.<sup>47</sup> The CAT is being paid on average about twice on manufactured products, and more than three times on retail industry. This may overstate the extent to which the tax is pyramiding, since it does not take into account the CAT being paid on products imported into Ohio, or that CAT is not being paid on those products exported out of the state.

## How the shift has affected different industries

The tax changes in HB 66 were sold in part as a boon to manufacturing industry. They were supported by the Ohio Manufacturers’ Association and many large manufacturers for that reason (though others, such as the Detroit auto makers, were opposed, presumably because they would have been negatively affected). The tangible personal property tax, in particular, had been criticized in various studies of the state’s tax system as a hindrance to capital investment.<sup>48</sup> The Ohio General Assembly had previously approved a long-term phase-out of the inventory portion

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<sup>45</sup> The tax covers out-of-state businesses that have more than \$500,000 in taxable gross receipts in Ohio, more than \$50,000 in property in the state, spend more than \$50,000 on Ohio payroll, have more than a quarter of their property, payroll or receipts in Ohio, or are domiciled in Ohio.

<sup>46</sup> As noted in Church and Hall’s article in *State Tax Notes*, some provisions of the CAT keep the tax from applying to every dollar of receipts. “For example, those acting in an agency capacity are taxed only on their commissions, not on the entire receipts from those agency transactions,” it noted, p. 30.

<sup>47</sup> Tax data from Ohio Department of Taxation, Commercial Activity Tax: Number of Taxpayers and Tax Return Data, Fiscal Year 2007. Ohio Gross State Product statistics are from the U.S. Department of Commerce, Bureau of Economic Analysis Regional Economic Accounts, available at <http://www.bea.gov/regional/gsp/>

<sup>48</sup> Bahl, Roy, ed., *Taxation & Economic Development: A Blueprint for Reform in Ohio*, Battelle Memorial Institute, 1996, and Report of the Committee to Study State and Local Taxes, Created in Accordance with Am. Sub. Senate Bill 261 of the 124<sup>th</sup> General Assembly, March 1, 2003.

of the TPPT, which constituted about half of that tax. The end of the TPPT leaves Ohio as one of just 10 states without such a tax (Other states without a generally applied TPP tax include Delaware, Hawaii, Illinois, New Hampshire, New Jersey, New York, North Dakota, Pennsylvania and South Dakota). When Ohio's franchise tax is phased out, only South Dakota and Ohio will have neither a tangible personal property tax nor a corporate income tax.<sup>49</sup>

Authors of a 2007 article on the Commercial Activity Tax estimated that, when the tax changes were fully implemented, manufacturers would save about \$600 million a year. This was based on payments of about \$800 million a year under the TPPT and \$200 million under the CFT, versus predicted CAT payments of about \$400 million a year.<sup>50</sup>

The record so far suggests that manufacturers may save somewhat more than expected, because the franchise tax has been stronger and their share of it higher than it was a few years ago.<sup>51</sup> Between 2005 and 2007, manufacturers paid an average of \$256 million a year in Corporate Franchise Tax, and that does not adjust for the rate cuts in two of those years. In Tax Year 2007, manufacturers were liable for \$277 million in Corporate Franchise Tax, even after the 40 percent reduction in rates that HB 66 brought about.<sup>52</sup> The CAT, too, is delivering more revenue than expected from manufacturers, but not to the same degree. While the franchise tax is a volatile one that would be depressed anyway in the near term because of sagging corporate profits, it seems likely that manufacturers alone will be saving \$300 million or more a year from the elimination of the franchise tax, compared to the \$200 million estimate above.

One might imagine that the CAT, a broad tax levied on many companies that do not have to pay the franchise tax, would distribute the tax load more evenly across industries, reducing the share paid by manufacturers. However, manufacturers remain far and away the largest payers of the CAT, as they do with the CFT. In FY2008, as shown in Figure 7, manufacturers were liable for 30.8 percent of the CAT total. The next biggest payers of the CAT are the retail industry, at 17.9 percent of the total, and wholesalers, 14.6 percent. Together, retailers and wholesalers account for slightly more than manufacturing.

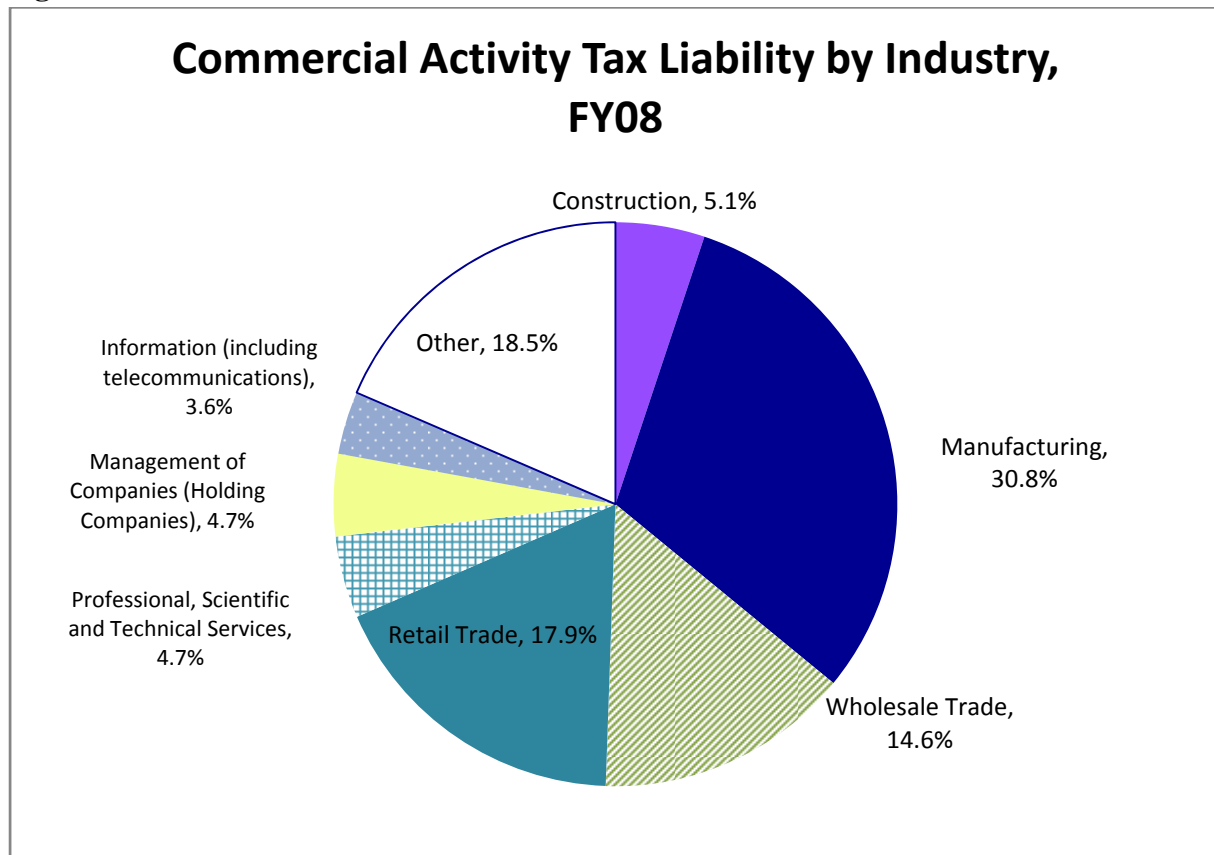
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<sup>49</sup> Information received from Ohio Department of Taxation.

<sup>50</sup> Church and Hall, *op. cit.*, p. 34

<sup>51</sup> Available data do not distinguish the location of the manufacturers paying the CAT compared to the franchise tax. Large, multi-state companies pay a large share of both taxes, and they do not necessarily report the CAT and the franchise tax in the same fashion. For instance, if a company chooses to consolidate many entities when paying the CAT, a unit that does manufacturing may not show up as a manufacturer but rather as part of its parent. And, of course, it's impossible to know exactly how much is being paid by Ohio companies compared to under the previous tax regime.

<sup>52</sup> Ohio Department of Taxation, Tax Analysis Div., "Corporation Franchise Tax, Reported Tax Liability by Tax Base and Industry Classification, Tax Year 2007," Table CF-1B, No. 43 (2008), Aug. 1, 2008

**Figure 7**

Source: Ohio Department of Taxation.

In order to compare how the CAT affects different industries, it is necessary to use data from 2007, since such a breakdown for 2008 is not yet available for the franchise tax. In FY2007, manufacturing accounted for 30.6 percent of the \$563.7 million<sup>53</sup> in CAT tax due; retail, 18.3 percent; and wholesale, 12.4 percent.<sup>54</sup> By comparison, during Tax Year 2007, manufacturers were liable for 34.8 percent of the \$795.5 million franchise-tax total, while retail accounted for 13.6 percent and wholesale trade 9.5 percent.

<sup>53</sup> This amount differs somewhat from the \$594.9 million reported in CAT revenue. As noted by the state taxation department, this is because the tables breaking down CAT by industry and size of gross receipts reflect reported tax liability, not actual payments made. In addition, later returns or corrections are not reflected in the table breakdowns. However, the overall difference is not great and no other information breaking down the CAT by industry and gross receipts exists. See Commercial Activity Tax: Number of Taxpayers and Tax Return Data, Fiscal Year 2007, Ohio Department of Taxation, available at [http://www.tax.ohio.gov/divisions/tax\\_analysis/tax\\_data\\_series/CAT/cat12fy07.stm](http://www.tax.ohio.gov/divisions/tax_analysis/tax_data_series/CAT/cat12fy07.stm)

<sup>54</sup> Church and Hall note in their 2007 article that compared to the taxation department's original analysis of how much different industries would shoulder in CAT liability, the FY06 liability of the wholesale trade industry fell short by the largest margin. The authors note, however, that that might be misleading because some wholesalers might be subsumed in larger entities; some might be reported under a manufacturing parent company, for instance. Church and Hall, *op. cit.*, p. 32

Apart from the huge increase shown by the category Management of Companies (Holding Companies), which probably is a result of different reporting standards under the CAT, retailers and wholesalers have seen the largest absolute increases in share of the CAT compared to the share paid under the CFT (such comparisons are not exact, because industry-level data for the CFT cover Tax Year 2007 while those for the CAT are for Fiscal Year 2007).<sup>55</sup> Together, the two industries were liable for nearly as much in CAT tax in FY07 (\$173.2 million) as they were for franchise tax in Tax Year 2007 (\$183.4 million). That suggests that when the tax changes are fully phased in, the industries might be paying more than \$100 million in additional tax a year under the CAT than they did under the franchise tax. This helps explain the lawsuit by grocers contesting the CAT for allegedly violating the Ohio Constitution by taxing gross receipts from wholesale food sales and food sold at retail for consumption off the premises.<sup>56</sup> Though there were other shifts among industries – construction was liable for a greater share, while utilities were liable for a smaller one – no other sector was liable for as much as 6 percent of the CAT in FY07 or FY08.

Yet while the CAT is hitting retailers and wholesalers harder than the Corporate Franchise Tax has, many of these companies also are benefiting from the elimination of the Tangible Personal Property Tax. Current data are not available for the share of that tax paid by industry. However, in Calendar Year 2000, retailers and wholesalers accounted for 12.6 percent and 5.9 percent, respectively, of the total assessed valuation under the tax.<sup>57</sup> Both of these sectors have significant merchants' inventory, which is one of the kinds of property that has been covered by the Tangible Personal Property Tax. Though the tax on inventories was being gradually reduced under existing law prior to the 2005 tax cuts, that slow phase-down was due to take more than a decade.

The effect of the reduction in property taxes on inventories of individual companies will vary substantially, depending on their distribution systems and whether they hold their own inventories. Small retailers that have only store inventory may not pay much in TPP tax, while large retailers with warehouses have paid more in the past and thus have gotten larger tax cuts as the tax has been phased out.

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<sup>55</sup> Shares of the tax paid by different industries also change year to year, in part because major changes by one or two large companies can increase or decrease an industry's share. For instance, the share paid by the retail trade industry soared in 2006, but came back down in 2007 to a level more in line with its history. Caution must be taken not to read too much into these changing figures. Also, FY2007 CAT data excludes oil marketers, which were exempted from the tax until FY2008.

<sup>56</sup> Ohio Grocers Association, et al. v. Wilkins, Ohio Supreme Court Case No. 08-2018

<sup>57</sup> The total share of these industries is undoubtedly somewhat higher, since 18.5 percent of the property was not classified by industry. These totals include only taxpayers with property in more than one Ohio county, but there is no reason to believe the numbers would be different if single-county taxpayers were included. See Ohio Department of Taxation, 2001 Annual Report, Table 75, p. 142. Available at [http://www.tax.ohio.gov/divisions/communications/publications/annual\\_reports/2001\\_Annual%20Report/publications\\_annual\\_report\\_2001.stm](http://www.tax.ohio.gov/divisions/communications/publications/annual_reports/2001_Annual%20Report/publications_annual_report_2001.stm)

Separate from inventories, another sizeable percentage of the tax that is also being eliminated under the 2005 act covers furniture and fixtures. Retailers, in particular, pay a sizeable portion of this, too.

## Tax incentives

Proponents of the 2005 business-tax overhaul argued that another benefit would be a reduction in loopholes and tax abatements that were so common with the Corporate Franchise Tax and the Tangible Personal Property Tax.

Obtaining overall information on the amount of tax credits, deductions and abatements at both the state and local level is not easy. According to the Ohio Department of Development, overall direct assistance to business increased from \$215.5 million in 2004 to \$268.2 million in 2006 and \$269.8 million in 2007, though this included not only financial assistance but also some money spent on workforce training, roadwork, Third Frontier and other programs.<sup>58</sup>

The disappearance of the Corporate Franchise Tax for non-financial companies will mean that most of the 34 tax exemptions or credits (known as “tax expenditures”) that went with it will disappear or be sharply reduced. One large tax credit, available to manufacturers for making investments in machinery and equipment, was converted to a grant program and is being eliminated under the tax reform; in Tax Year 2005, prior to the reform, \$112.2 million of such credits were claimed. Grants, which are only available on investments made prior to July 1, 2005, declined to just \$5.1 million in Tax Year 2007, after including the effect of reduced rates from the phase-out of the tax.<sup>59</sup>

However, tax expenditures accounting for most of the \$245.4 million in lost revenue from the franchise tax that the taxation department estimated from them in FY2009 will remain in place, or are being extended against the CAT instead.<sup>60</sup> The largest single such tax exemption, a break worth \$112 million in FY09 for goodwill, appreciation and abandoned property of financial institutions, remains on the books (Banks and other financial institutions were not covered by the 2005 tax changes and will continue paying the Corporate Franchise Tax on their net worth).<sup>61</sup> The second-largest, involving net operating loss deductions, was worth \$31.7 million in FY09 and is being phased out. However, companies with at least \$50 million in net operating loss

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<sup>58</sup> See Ohio Department of Development annual Loan-Grant Reports, available at

[http://www.development.ohio.gov/research/Other\\_Reports\\_in\\_departmental\\_Reports.htm#x100](http://www.development.ohio.gov/research/Other_Reports_in_departmental_Reports.htm#x100)

<sup>59</sup> Ohio Department of Taxation, Corporate Franchise Tax: Reported Refundable and Nonrefundable Tax Credits and Nonrefundable Manufacturing Grant, Claimed in Tax Year 2007, Table CF-Credits, No 51 (2008), August 1, 2008. Available at

[http://www.tax.ohio.gov/divisions/tax\\_analysis/tax\\_data\\_series/corporation\\_franchise/cfcredit/cf-credits\\_07.stm](http://www.tax.ohio.gov/divisions/tax_analysis/tax_data_series/corporation_franchise/cfcredit/cf-credits_07.stm)

<sup>60</sup> State of Ohio, Executive Budget, Fiscal Years 2008 and 2009, Book Two – Tax Expenditure Report, Prepared by the Department of Taxation and Submitted to the 127<sup>th</sup> General Assembly by Governor Ted Strickland, March 2007, pp. 5-6

<sup>61</sup> See p. 6 of *Limiting Loopholes*, a Policy Matters report available at <http://www.policymattersohio.org/pdf/LimitingLoopholes2008.pdf>, for a description of how this loophole may cost the state millions of dollars in tax revenue.

deductions prior to the tax change will be allowed to write them off against the CAT over a 20-year period beginning in 2010. This could cost the state \$45 million a year starting in the second year of the next biennial budget.<sup>62</sup>

Four tax breaks that had been applied to the Corporate Franchise Tax now can be used against the CAT instead. These include the job creation tax credit (JCTC), the job retention tax credit, the credit for increased research expenses and the credit for research and development loan repayments. While anecdotal reports suggest that terms of job creation tax credits have been reduced in recent years and the number of such credits claimed fell substantially between Tax Year 2005 and Tax Year 2007, the amount of such credits claimed has remained flat or even increased.<sup>63</sup> The number of credits for increased research expenses has grown, and the amount of such credits grew significantly in 2007 even after the effects of the phase-out in the franchise tax, which reduced the value of such credits.<sup>64</sup>

Ohio's enterprise zone (EZ) program, a local tax abatement program covering both tangible and real property, was originally aimed at bringing businesses to distressed areas but turned into a business entitlement.<sup>65</sup> New enterprise zone agreements, which averaged 266 a year between 2001 and 2005 and numbered 243 in 2005, fell to just 110 in 2006.<sup>66</sup> The Ohio Department of Development's 2006 annual report on the program noted that "tax reforms instituted during 2005 have reduced the importance of the program as a local tax incentive tool." It further noted that the Community Reinvestment Area (CRA) tax abatement program operates with less complexity than the EZ program.

However, as shown in Figure 8, taxation department data through 2007 shows that the overall amount of tax abatement on all real property continued to increase apace through that year. The double-digit percentage growth in 2006 and 2007 was equal or greater to that in the previous three years. These include not only Enterprise Zone abatements, but also those under the CRA, tax increment financing, and other abatement programs. The amount of real property exempted

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<sup>62</sup> Ibid, p. 8. According to the taxation department, 53 companies have qualified for this tax breaks; altogether, they have filed for roughly \$900 million. They will be audited, but the vast bulk of this amount is likely to be eligible for credits.

<sup>63</sup> Companies claimed 198 job creation tax credits in Tax Year 2007 worth \$42 million, compared to 280 claims worth \$42.4 million in Tax Year 2004 and 240 claims worth \$36.9 million in Tax Year 2005. The JCTC and the other three credits continued to be taken against the franchise tax through FY08, so data do not yet exist regarding their application to the CAT. Data through Tax Year 2007 are from the Ohio Department of Taxation, Tax Data Series, Table CF-Credits, No 51 (2008), Aug. 1, 2008, and data for previous years are available at [http://www.tax.ohio.gov/divisions/tax\\_analysis/tax\\_data\\_series/corporation\\_franchise/publications\\_tds\\_corporate.stm](http://www.tax.ohio.gov/divisions/tax_analysis/tax_data_series/corporation_franchise/publications_tds_corporate.stm)

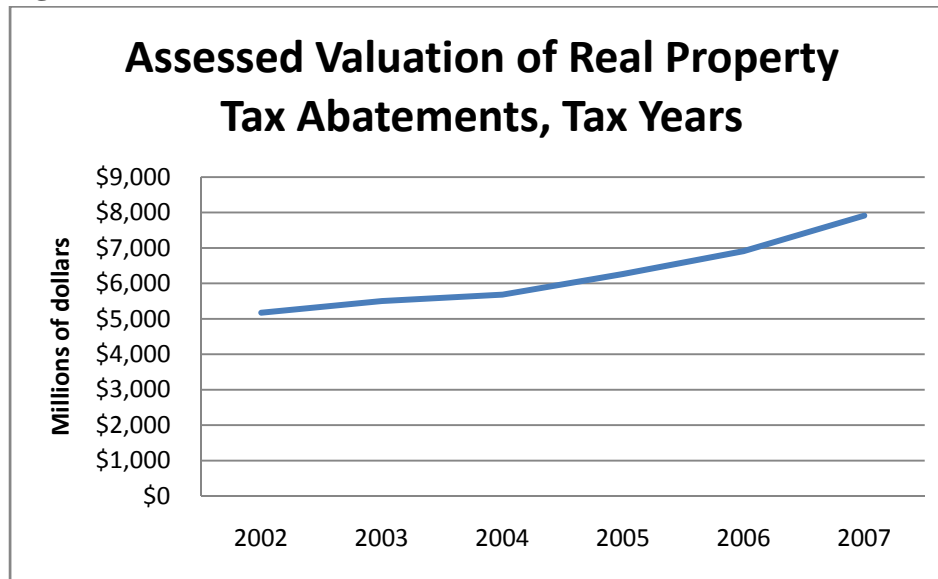
<sup>64</sup> Ibid. Companies claimed 206 research credits in Tax Year 2007 worth \$12.29 million after the phase-out factor, compared to 56 credits worth \$3.64 million in Tax Year 2004 and 125 credits worth \$8.56 million in Tax Year 2005. Companies claimed 179 research credits in Tax Year 2006 worth \$6.99 million after the phase-out factor, which began that year.

<sup>65</sup> See for instance Cassell, Mark, *Zoned Out: Distribution and Benefits in Ohio's Enterprise Zone Program*, Policy Matters Ohio, October 2003, available at [http://www.policymattersohio.org/pdf/EZ\\_report.pdf](http://www.policymattersohio.org/pdf/EZ_report.pdf)

<sup>66</sup> 2006 Annual Report, Ohio Enterprise Zone Program, Ohio Department of Development, Economic Development Division, available at <http://www.odod.state.oh.us/cms/uploadedfiles/EDD/OTI/EZReport.pdf>

from taxation by local governments under each of the biggest abatement programs showed double-digit growth in 2007. While some of this tax-abated property is residential and thus unaffected by changes in business taxes, these figures indicate that the business-tax overhaul has not caused a significant downshift in local real property tax abatement.

**Figure 8**



Source: Ohio Department of Taxation

Moreover, despite the reductions in business taxes from HB 66, the state continues to offer substantial incentives to businesses not only to locate in Ohio, but to stay here. During 2008, for instance, the state offered major incentive packages to NetJets of Columbus, Goodyear and Bridgestone in Akron, and Eaton for its move from Cleveland to suburban Beachwood, among others. “I have learned that global companies like Eaton have multiple choices about where to locate their headquarters,” Lt. Gov. Lee Fisher told *The Plain Dealer*. “We can’t afford to take any company for granted, especially one of the largest and most important companies in Ohio.” The newspaper reported that Fisher “said that Ohio must offer “generous” benefits to Eaton or risk losing the company to another state.” Yet Fisher also said that he did not believe Eaton was seeking deals outside Ohio.<sup>67</sup>

The General Assembly also has created new incentives since the 2005 tax reform. These include a new exclusion from the sales tax for repair of small aircraft, an expansion of the job retention tax credit, a sales-tax exemption on the purchase of flight simulators and a special exemption on sales tax paid by Avon Products Inc. on machinery, equipment and software for a new

<sup>67</sup> Breckenridge, Tom, “Eaton gets \$71 million from state to move from Cleveland to Chagrin Highlands,” *The Plain Dealer*, Oct. 27, 2008. The story also said a state document said the company had called other states about tax breaks.

warehouse outside Zanesville.<sup>68</sup> Clearly, while certain loopholes and abatements have been eliminated because the taxes they avoided no longer exist, the business-tax reductions have not fundamentally altered the state's operating model for economic development away from offering tax incentives.

### **The CAT Trigger**

As noted above, under current estimates, the Commercial Activity Tax for FY09 will slightly exceed the amount under which, according to state law, it will be automatically reduced. Because of the uncertainty about how much revenue the CAT would produce, legislators approved "triggers" under which the CAT rate would automatically be increased or decreased if CAT revenue was more than 10 percent above or below certain thresholds during three established time periods. However, the General Assembly later eliminated the upward trigger. Based on the current estimate of CAT revenues for this fiscal year, the tax rate would be reduced by about 12 percent, or roughly \$200 million in calendar year 2010.

### **Court cases**

As noted, the Ohio Grocers Association and others have brought a lawsuit alleging that the CAT violates the Ohio Constitution when it is applied to wholesale food sales and food sold at retail and consumed off the premises. The plaintiffs lost in trial court but won on appeal last September, so the state has now appealed the case to the Ohio Supreme Court. According to the Ohio Department of Taxation, the state will lose approximately \$188 million a year in revenue if the decision is upheld, along with an estimated \$355 million in refunds covering the period between FY06, when the tax began, and FY09. The state further said in its appeal that the appeals court decision would bring out-of-state businesses to challenge whether they have to pay the CAT.<sup>69</sup> And it would likely affect the CAT's applicability to sellers of motor fuel, the state said. That industry has launched a separate lawsuit, saying that the CAT is an excise tax on motor fuel and such proceeds are not being dedicated to highway purposes, as they must be under the Ohio Constitution.<sup>70</sup> The Supreme Court case is unlikely to be decided prior to approval of the next biennial budget. But the General Assembly will need to make some provision for it in case the court upholds the decision, since it could knock the budget out of whack.

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<sup>68</sup> See Schiller, Zach, *Limiting Loopholes: A dozen tax breaks Ohio can do without*, Policy Matters Ohio, September 2008, for more details. Gov. Strickland also vetoed a motion-picture tax credit approved by the General Assembly.

<sup>69</sup> The state says that out-of-state retailers could claim they do not have a physical presence in Ohio and hence don't have to pay the CAT under a U.S. Supreme Court decision. See p. 6 of the state's appeal.

<sup>70</sup> See p. 6 of the state's appeal. The motor fuel case is *Beaver Excavating Co. v. Levin*, Franklin County C.P. 08CVH03-3921. The taxation department previously has estimated that oil companies will pay \$139 million a year when the CAT is fully phased in.

## Conclusions and recommendations

The swap of the franchise tax and the tangible property tax for the CAT has resulted in big savings for business – more than \$500 million last fiscal year alone, with further cuts still to come. Yet initial collections from the franchise and CAT taxes after the 2005 overhaul were stronger than expected. This kept year-to-year revenue from the affected taxes from sinking in the first two fiscal years after the tax overhaul. In FY08-09 the changes really began to sting the state budget noticeably. The full effects will be felt in FY10-11, just as the state is walloped with the national recession. Overall, when fully implemented, the business tax changes are likely to reduce state revenue by \$1 billion or more a year.

The business share of Ohio's state and local taxes remains far lower than it was 30 years ago. In fact, this is partly because the two taxes being phased out had been weakened over the years or remained stagnant in real terms.<sup>71</sup> While Ohio's looming state budget deficit is certainly a product of the economy, it is far worse because of the tax cuts. The main rationale for the 2005 tax overhaul – to reverse Ohio's poor economic performance relative to the nation – has not been validated.<sup>72</sup> Instead, there has been a continuing decline and a more severe budget crisis. As a result, we make the following recommendations:

Ohio should maintain and restore its Corporate Franchise Tax. This tax can be strengthened so that it is harder for multi-state businesses to shift income from Ohio to other states, reducing their Ohio tax liability. Twenty-two states require that companies report the earnings from all of their related units as a single entity. Combined reporting, as it is known, prevents many of the most common ways that companies avoid tax liability by shifting income to other states. In the past four years, six other states, including neighbors Michigan and West Virginia, have adopted one form or another of this key reform.<sup>73</sup> Gov. Bob Taft proposed a measure with some of the same features in 2003, though it was not adopted by the General Assembly. In short, the franchise tax is a viable tax, one that the vast majority of states use so that companies pay tax based on their income, as individuals do.<sup>74</sup>

In addition to retaining and strengthening the franchise tax, the state should mandate that companies calculate both their franchise tax and the CAT, and pay whichever is higher. This uses the same concept as the now-expiring franchise tax: Nonfinancial companies pay either based on their profits or net worth, whichever produces a higher amount (see box, page 2).<sup>75</sup>

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<sup>71</sup> See *Ohio's State and Local Taxes: The Dwindling Business Share*, Policy Matters Ohio, 2004, available at <http://www.policymattersohio.org/OhioBizTaxes.htm> See also below.

<sup>72</sup> Honeck, op. cit.

<sup>73</sup> In Michigan, this covers the corporate-income tax portion of the state's new business tax. Other measures can also be taken to strengthen the franchise tax. See *Strengthen, Don't Scrap, Ohio's Corporate Franchise Tax*, Policy Matters Ohio, May 2005, available at [http://www.policymattersohio.org/Ohio\\_CFT\\_Study\\_2005\\_05.htm](http://www.policymattersohio.org/Ohio_CFT_Study_2005_05.htm) .

<sup>74</sup> See also *Strengthen, Don't Scrap, Ohio's Corporate Franchise Tax*, 2005.

<sup>75</sup> Under this proposal, there would not be a need for a net-worth tax for nonfinancial corporations, as the CAT would function as the alternative to the corporate income tax.

At the same time, the rate of the Commercial Activity Tax should be adjusted so that, together with the Corporate Franchise Tax, the two taxes produce as much inflation-adjusted revenue as the franchise tax and the Tangible Personal Property Tax produced prior to their phase-out. This was not a large amount, by historical standards. Adjusted for inflation, both taxes were generating considerably less in 2005 than they had 30 years earlier. In the mid-1970s, the Corporate Franchise Tax accounted for 16 percent of the taxes supporting Ohio's General Revenue Fund. By FY05, prior to the tax overhaul, that share was just 4 percent.

A dual tax of this kind bases at least some of the payment on income, but also ensures that under the CAT companies pay tax because they continue to receive public services even when their profits dip. It also continues to ensure a broad tax base, covering pass-through entities like S Corporations and limited liability companies. Both Kentucky and New Hampshire currently use a dual-tax arrangement like this for businesses, though the details differ. Profitable companies with a large presence in Ohio but only a small amount of Ohio sales would pay based on their earnings; under the CAT, they are not subject to significant taxes now.

The General Assembly also should ensure that grocers and other sellers of food for off-premise consumption pay a general business tax, as other businesses do. As Tax Commissioner Levin noted in his brief in the court case, the appellate court's decision threatens "to cordon off an entire industry from the State's power to tax. Under the Tenth District's flawed logic, the State will find it all but impossible to tax businesses engaged in the sale of food, whether at the producer, wholesaler, or retailer level."<sup>76</sup> One way to ensure that this industry pays taxes if the court should rule in its favor is to mandate that grocers pay the franchise tax, including the net worth portion. Business representatives have noted that a significant reduction in the CAT tax base will require an increased CAT rate, or the restoration of previous business taxes.<sup>77</sup>

Together, these proposals would revitalize Ohio's business taxes and provide needed revenue while leaving the business share of state and local taxes well below what it was in the past.

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<sup>76</sup> Ohio Grocers Association, et al., v. William W. Wilkins (Richard A. Levin), Memorandum in Support of Jurisdiction of Defendant-Appellant, op. cit., p. 5.

<sup>77</sup> Ohio Grocers Association, et al., v. Wilkins, Memorandum in Support of Jurisdiction of Amicus Curiae Ohio Business Roundtable, op. cit., p. 2



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