Limiting Loopholes:
A dozen tax breaks Ohio can do without

A Report From

Policy Matters Ohio

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Policy Matters Ohio, the publisher of this study, is a nonprofit, nonpartisan policy 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

Ohio gives special tax treatment to payday lenders and mortgage brokers – they pay a lower state tax rate than banks under an outmoded tax unique to Ohio. Lobbyists and debt collectors don't have to bill their clients for sales tax. The state recently made it much easier for high-income retirees who spend part of the year out of state to avoid paying Ohio income tax. These tax breaks, which together cost the state more than $65 million a year, are among those that are squeezing the state budget even as it is feeling more stress from the weakening economy.

The state should conduct a broad review of the tax code to pinpoint tax loopholes that should be closed. In this report, Policy Matters Ohio begins that task by identifying a dozen tax breaks whose elimination or limitation would both make the state tax system fairer and generate up to $270 million annually in revenue for needed investments. Besides those above, these also include:

- Three property-tax reduction programs that should be limited to those who need them. These include the homestead exemption for seniors (which would save at least $118 million a year) and the 10 percent and 2.5 percent rollbacks for residential homeowners and owner occupants (which, together, would save at least $5.2 million a year). Both Gov. George Voinovich and Gov. Bob Taft unsuccessfully attempted to limit the latter rollbacks based on the value of the property. Taft would have limited it to property values under $1 million.
- Special-interest breaks on the Commercial Activity Tax. These favor giant distribution centers at a cost of $6 million a year. They also give special advantages to companies that lost tens of millions of dollars prior to the phase-out of the state's corporate income tax. These companies will be allowed to write off these losses over 20 years starting in 2010, costing the state up to $45 million a year. Lose a little, and the state can't help you. Lose a bundle, and you qualify.
- A recent loophole that allows certain trusts to choose which tax to pay, the income tax or the Commercial Activity Tax, cutting their taxes by up to $18 million this fiscal year.
- A newly created tax break for Avon Products, which won a sales-tax exemption on machinery and equipment at a new warehouse in Zanesville nine months after it broke ground (costing at least $3.7 million). The General Assembly extended this special break to Avon because the company had been mistakenly told by state officials that it would be eligible for another existing tax break. Rather than create a new loophole for Avon, the state should repeal the original one (costing $6.4 million this fiscal year).
- An exclusion from the main tax on banks that allows them to shift income into subsidiaries and avoid taxation.

These tax breaks are unwise in good times and unaffordable now, as the state budget faces a new period of stress. Gov. Ted Strickland has already ordered cuts and adjustments to the current biennial spending plan twice, by a total of more than $1.2 billion, amidst lower than expected tax revenues.

In the next two-year budget, beginning July 1, additional pressures will face the General Assembly, including the continuing phase-in of tax cuts approved in 2005. Reductions in the income tax alone are expected to slash more than $2 billion from state revenues each year starting in FY2010, compared to before the tax cuts. Yet Ohio has additional needs, such as handling the all-time record number of prisoners in state facilities, supporting additional spending called for in the higher education plan and providing insurance for rising numbers of Medicaid enrollees. And that excludes outlays for primary and secondary education, and other needed investments in Ohio's people and infrastructure.

Under Ohio's state and local tax system, like those in most states, low- and middle-income taxpayers pay a larger share of their income in taxes than upper-income taxpayers do. The tax breaks identified here further skew Ohio's taxes against individuals in general and low- and middle-income individuals in particular, in favor of businesses and higher-income individuals. This report is not comprehensive. Beyond eliminating or limiting the tax breaks described here, the state should review which services should be covered by the sales tax, as much of this sector falls outside the tax. It should conduct a regular review of all the tax breaks embedded in the revised code, as some states already do.

This report was prepared with financial support from The Center for Community Solutions. The conclusions and opinions do not necessarily represent those of The Center for Community Solutions. Community Solutions is preparing an update of its series on Ohio's tax system, Taxing Issues, which it plans to complete before the end of the year (For more information about the update, contact John Habat, Director, Public Policy and Advocacy, at 216-781-2944 or jhabat@CommunitySolutions.com).

Policy Matters Ohio has previously released a report making recommendations regarding the state income tax (see http://www.policymattersohio.org/StepTowardFiscalBalance.htm), and will be releasing additional tax research this year.

Ohio gives special tax treatment to payday lenders and mortgage brokers – they pay a lower state tax rate than banks. Lobbyists and debt collectors don't have to bill their clients for sales tax. The state recently made it much easier for high-income retirees who spend part of the year out of state to avoid paying Ohio income tax. These are among the tax breaks that are squeezing the state budget even as it is feeling more stress from the weakening economy.

In this report, Policy Matters Ohio identifies a dozen tax breaks whose elimination or limitation would both make the state tax system fairer and generate revenue for needed investments. These also include:

- Three property-tax reduction programs that should be limited to those who need them. These include the homestead exemption for seniors (which would save at least $118 million a year) and the 10 percent and 2.5 percent rollbacks for residential homeowners and owner occupants (which, together, would save at least $5.2 million a year).
- Special-interest breaks on the Commercial Activity Tax. These favor giant distribution centers at a cost of $6 million a year. They also give special advantages to companies that lost tens of millions of dollars prior to the phase-out of the state's corporate income tax. These companies will be allowed to write off these losses over 20 years starting in 2010, costing the state up to $45 million a year.[1]
- A recent loophole that allows certain trusts to choose which tax to pay, the income tax or the Commercial Activity Tax, reducing their tax payments by up to $18 million this fiscal year;
- A newly created tax break for Avon Products, which won a sales-tax exemption on machinery and equipment at a new warehouse in Zanesville nine months after it broke ground (costing at least $3.7 million on a one-time basis). The General Assembly extended this special break to Avon because the company had been mistakenly told by state officials that it would be eligible for another existing tax break. Rather than create a new loophole for Avon, the state should repeal the original one (costing $6.4 million this fiscal year), and
- An exclusion from the main tax on banks that allows them to shift income into subsidiaries and avoid taxation.

The State of Ohio's budget is facing a new period of stress. Gov. Ted Strickland has already ordered cuts and adjustments to the current biennial spending plan twice by a total of more than $1.2 billion

[1] For additional description of these tax breaks beyond what is included in this report, see Zach Schiller, *Exempt from Scrutiny: Tax Breaks in Ohio*, Policy Matters Ohio, February 2007, available at http://www.policymattersohio.org/ExemptFromScrutiny2007.htm.

to try and ensure that the state ends the fiscal year in balance amidst flagging tax revenues. In the next two-year budget, beginning July 1, additional pressures will face the General Assembly, including the continuing phase-in of tax cuts approved in 2005. Reductions in the income tax alone are expected to slash more than $2 billion from state revenues each year starting in FY2010, compared to before the tax cuts.[2] Yet Ohio faces additional needs, such as handling the all-time record number of prisoners in state facilities, supporting additional spending called for in the higher education plan and providing insurance for rising numbers of Medicaid enrollees. And that excludes outlays for primary and secondary education, and other needed investments in Ohio's people and infrastructure.[3]

Under Ohio's state and local tax system, like those in most states, low- and middle-income taxpayers pay a larger share of their income in taxes than upper-income taxpayers do.[4] This is neither necessary nor desirable, particularly since upper-income Ohioans have seen their real wages rise even as most Ohioans have not.[5]

As a result, it is more appropriate than ever to examine the state's tax code to identify loopholes whose elimination or limitation would both make the tax system fairer and at the same time produce needed revenues. In this report, Policy Matters Ohio identifies a dozen such tax breaks (see Table 1). Some of these tax breaks date back decades, while others were approved by the General Assembly earlier this year. Ohio's most recent tax expenditure report lists 145 credits, deductions and exemptions that may be taken from state taxes.[6] This study reviewed a variety of sources, including that report, a summary of tax changes since FY1996,[7] and previous loophole-closing efforts to start

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[2] Ohio Office of Budget & Management, Executive Budget for FYs 2008 and 2009, Table B-1a, p. B8

[3] Richard Sheridan, a financial consultant for the Center for Community Solutions, summarized many of these issues in two commentaries earlier this year, "Is a State Tax Increase Inevitable?" State Budgeting Matters, Vol. 4, Issue 4, April 2008, and "Fiscal Year 2008 Ends While Fiscal Woes Worsen," Vol. 4, Issue 6, July/August 2008, available at http://www.communitysolutions.com/store/index.asp?DEPARTMENT_ID=38.

[4] Institute on Taxation and Economic Policy, "Who Pays? A Distributional Analysis of Tax Systems in All 50 States," January 2003. Policy Matters Ohio release of the study is available at http://www.policymattersohio.org/who_pays.htm. Since that study, Ohio has made changes to its tax system which have further accentuated the differences in tax load between income levels. See, for instance, "Wealthiest Ohioans Gain Most from Proposed Tax Changes," available at http://www.policymattersohio.org/Wealthiest_Ohioans_Gain_Most.htm. While the proposal analyzed in that release was changed somewhat in its final form, the major elements remained the same. Other changes in business taxes, such as the replacement of two existing business taxes with the Commercial Activity Tax, cannot be expected to have shifted taxes onto upper-income Ohioans from the less affluent.

[5] Hanauer, Amy, *The State of Working Ohio 2008*, Policy Matters Ohio, August 2008, accessible at http://www.policymattersohio.org/sowo_08.htm

[6] Overall, the 145 such expenditures detailed in the most recent state tax expenditure report would be worth an estimated $7.1 billion in FY2009 if they were repealed. See 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 127th General Assembly By Governor Ted Strickland March 2007. As useful as this report is, it does not cover all tax breaks.

[7] Cited in Gongwer News Service Ohio, "Ohio's Per-Capita Tax Burden Drops in Wake of 2005 System Restructuring, Report Finds," Volume #77, Report #51--Friday, March 14, 2008

compiling a list of tax breaks that should be limited. These dozen were selected because their limitation not only would generate additional revenue, it would improve the fairness of the tax system. This may involve eliminating special breaks for affluent Ohioans who are already favored by the state's tax system, doing away with a special edge for large businesses over small ones, or abolishing a special-interest break favoring a particular company or industry. This is hardly a comprehensive review. We invite interested Ohioans to do their own detective work and discover others, and we hope to add more to the list ourselves. An earlier Policy Matters Ohio review of such tax expenditures noted a number of others that should be scrapped.[8] Beyond eliminating or limiting the tax breaks listed here, the state should conduct a regular review of all the tax breaks embedded in the revised code, as some states already do. That way, special breaks can be reined in.

[8] Two of the tax breaks cited in this report were included in an examination of the state's tax expenditure report that Policy Matters Ohio released last year. See Zach Schiller, *Exempt from Scrutiny: Tax Breaks in Ohio*, Policy Matters Ohio, February 2007, available at http://www.policymattersohio.org/ExemptFromScrutiny2007.htm

Table 1

Tax	Loophole	Estimated foregone state revenue in FY2009	Approved
Individual Income Tax	Loosened residency test, allowing more people to avoid the tax	$25 million to $30 million	2006
Real property tax	Homestead exemption expansion allows even wealthy homeowners to qualify	At least $118 million	2007
Real property tax	Owners do not have to pay 10 percent of their tax; owners who occupy their properties receive an additional 2.5 percent rollback. The state reimburses schools and local governments for foregone revenue	At least $5.2 million (A)	1971, 1979
Dealers in Intangibles Tax	Payday lenders, mortgage brokers and others pay lower tax than banks	More than $10 million (B)	1931
Commercial Activity Tax/Individual Income Tax	Trusts formed before 1972 can choose which tax to pay	Up to $18 million	2006
Commercial Activity Tax	Companies with previous big losses can write them off against the CAT	Up to $45 million a year starting in 2010	2005
Commercial Activity Tax	Suppliers to certain distribution centers don't pay the tax (C)	$6 million	2006
Sales Tax	Machinery, equipment and software for a new Avon Products distribution center	At least $3.47 million (D)	2008
Sales Tax	Lobbying and public relations services are not covered	$11.6 million (E)	1935
Sales Tax	Debt collection is not covered	$21.5 million (E)	1935
Corporate Franchise Tax	Goodwill, appreciation and abandoned property excluded from net worth tax on financial institutions	NA (F)	1933

(A) -- Based on 2003 estimate by the Taft Administration of revenue gained in FY2005 if tax relief were limited to the first $1 million in market value of each property. A lower limit would produce more revenue. The 10% rollback was approved in 1971; the 2.5% rollback was approved in 1979.

(B) -- Based on an estimated $21 million in additional revenue if these companies were instead taxed under the corporate franchise tax, reduced by half based on possible exclusions they might claim

(C) -- Such distribution centers must have at least $500 million in sales and more than half of those must be shipped outside of Ohio

(D) -- This is a one-time amount for the outfitting of the warehouse. However, the 2007 Tax Expenditure Report estimates the cost of the ongoing exemption for retailers' warehouses at $6.4 million

(E) -- Based on $10.5 million for lobbying and $19.5 million for debt collection shown in Taft proposal for FY2005; the sales tax has been increased from 5.0% to 5.5% since then. The exclusion of these services from taxation is a function of the general definition of the sales-tax base, not an explicit exemption.

(F) -- The current Tax Expenditure Report estimates these exclusions are worth $112 million in FY09. While tightening this exemption could produce millions of dollars in additional revenue, the exact amount is not known

Dealers in Intangibles Tax. Each of the last two studies on Ohio's tax system recommended eliminating the dealers in intangibles tax (DIT) and making them subject to the same taxes as other businesses.[9] This obscure tax, a holdover from the days when the state taxed intangible assets like stocks and bonds, is unique to Ohio. It covers mortgage and securities brokers, payday lenders, finance companies and other financial companies that do not take deposits. It does not cover banks, which pay the corporate franchise tax. The DIT requires payment of 8 mills, or 0.8 percent, on the shares and capital of these financial companies. By contrast, the corporate franchise tax is set at a 13-mill rate.[10] Thus, Ohio's tax code favors payday lenders and finance companies over banks. Some banks still benefit, however, by having dealers as affiliates (see below).

In 2008, dealers in intangibles were assessed for taxes totaling $33.7 million.[11] If this tax were eliminated and the financial institutions that pay it were instead covered under the corporate franchise tax, they would pay the 13-mill rate. On the face of it, this would generate an additional $21 million in annual revenue. However, these entities also would be eligible then to use exemptions against the corporate franchise tax, reducing the new revenue. Even if they were able to use such exemptions to cut their new liability by half, it would still generate additional revenue of more than $10 million a year.

Until 2003, dealers in intangibles that were controlled by banks or insurance companies were able to claim under a court decision that they were excluded from paying any tax at all.[12] This turned the dealers in intangibles tax into an opportunity for financial institutions to avoid taxation, which is one reason that the studies of Ohio's taxes recommended its elimination. However, the General Assembly wiped out this loophole in 2003, requiring that such dealers pay the tax. In 2008, they accounted for almost 45 percent of the DIT paid.[13] That, together with the ongoing phase-out of the state's corporate franchise tax, means that the DIT isn't as much of a tax dodge as it once was. However, it still means that financial institutions do not compete on a level playing field. Why is it in Ohio's interest to favor payday lenders or mortgage brokers with lower tax rates? It is not. The tax should be eliminated, and these financial institutions should pay the corporate franchise tax as others do, at least for now.

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[9] Bahl, Roy, ed., "Taxation and Economic Development: A Blueprint for Tax Reform in Ohio," Battelle Press, 1996, and Report of the Committee to Study State and Local Taxes, Created in Accordance with Am. Sub. Senate Bill 261 of the 124th General Assembly, March 1, 2003

[10] The corporate franchise tax on most companies is being phased out. However, banks, certain insurance-company affiliates and securitization companies will continue to pay the tax on their net worth.

[11] Intangible Property Taxes: Taxes Assessed on Dealers in Intangibles, by County, Calendar Year 2008, Ohio Department of Taxation, Table P-49, No. 28 (2008), June 12, 2008. Available at http://www.tax.ohio.gov/divisions/tax_analysis/tax_data_series/publications_tds_property.stm#IntangibleProperty

[12] See Bahl, op. cit., p. 587

[13] Such taxes accounted for $15.1 million in assessed tax in 2008, all of which goes to the state. The remaining $18.5 million was split between the state and localities. Five of the eight mills, or $11.6 million, goes to local governments, while the state gets the other three mills, or $6.9 million.

A loophole for banks. Over the longer term, the state should conduct a more comprehensive examination of its taxation of financial institutions, which were largely unaffected by the 2005 reform of business taxes. While the broad tax changes approved by the General Assembly in 2005 eliminated the corporate franchise tax for nearly all regular corporations, banks will continue to pay the 13-mill corporate franchise tax on their net worth. One loophole that bears close examination allows banks to exclude appreciation, goodwill and abandoned property from their net worth that is taxed. The size of this tax expenditure has grown substantially; the most recent tax expenditure report estimates it will cost the state $112 million this fiscal year.[14]

Under this exclusion, banks may be able to reduce their tax by shifting income-producing assets into out-of-state subsidiaries in exchange for stock in those subsidiaries. If the stock's value increases, the appreciation – which would normally be taxed – is exempt from Ohio taxation under this exclusion. That's just one way this exclusion may allow banks to avoid taxation; there are others. While the exact amount at stake is unclear, it could run into many millions of dollars a year. When the nation's financial markets stabilize, the state should examine this exclusion and consider taking steps to limit it.

High-income "snowbirds" avoid the income-tax. In a measure approved by the previous General Assembly in 2006, legislators substantially loosened the residency test for who has to pay Ohio income tax.[15] The net effect is to allow many high-income individuals who previously had to pay Ohio income tax and who would have to pay income tax in most other states to instead avoid state income tax. It is helpful to "snowbirds" who spend part of the year in Florida but still spend much of the year in Ohio.

Unlike most other states, Ohio uses what the state calls "contact periods" for measuring how much time individuals spend in the state and whether they are required to pay the income tax. A contact period is defined as an overnight stay, so someone coming to Ohio on a Monday and leaving Tuesday has one such period (not two). Under the new law, an individual who has less than 183 contact periods in a year is not considered an Ohio resident. This is a more liberal policy than most other states, which typically use a requirement of 183 days. Fred Church, deputy tax commissioner at the Ohio Department of Taxation, testified in a legislative hearing that, "*Under this bill, an individual could spend 45 full work weeks in Ohio and still be a non-resident.*"[16] (italics in the original) That's because someone coming to Ohio Monday morning and leaving Friday evening would have only four contact periods each week, and the total for the year would be 180.

Ohio's policy is also looser than the norm in other ways. Other states may examine aspects of people's lives such as where their bank accounts are, where they are registered to vote, and where they have

[14] 2007 Tax Expenditure Report.
[15] Sub H.B. 73, 126th General Assembly, available at http://www.legislature.state.oh.us/bills.cfm?ID=126_HB_73
[16] Testimony on HB 73, Frederick Church, Deputy Tax Commissioner, Ohio Department of Taxation, May 16, 2006

drivers' licenses, and use these to determine that they are indeed state residents even if they spend less than the requisite number of days in the state. Ohio, by contrast, is unique among states in saying that if people do not have more than 182 contact periods in the state and have a residence outside the state, they are nonresidents, regardless of any other factors.[17] This assures individuals they can escape taxation in a way that other states do not provide. Moreover, even those who spend more time in Ohio can still make a case that they are not residents based on other factors.

Prior to its passage, the state taxation department estimated that the bill would cost Ohio between $25 million and $30 million a year in revenue. Proponents argued that it would cause some individuals to spend more time in Ohio, where they would make purchases and pay sales tax. However the department's estimate of net lost revenue includes such additional sales taxes.

As Ohio Tax Commissioner Richard A. Levin noted in a letter last year, the bill "creates a large tax preference for those individuals, particularly retirees, who live in non-income tax states like Florida and have significant amounts of unearned income that will now escape Ohio income tax due to their nonresident status."[18] As Church mentioned in his testimony, many of these individuals are high-income taxpayers.

Before the new law, individuals were not considered Ohioans if they had 120 or fewer contact periods in the state. They could also spend another 30 contact periods here for medical or charitable purposes, for a total of 150. Then, as now, Ohio's "bright line" rule meant those individuals were not subject to other tests that might deem them to be state residents, as they might be in other states. And those who spent a greater number of contact periods in Ohio could still use other evidence to try and show that they were not residents. In short, Ohio's prior policy was generous – for many, more generous than those of other states. At a minimum, the state should return to that policy.

The Commercial Activity Tax

Three years ago, the legislature created a new tax on gross receipts called the Commercial Activity Tax. It was intended to be a tax with a broad base and few exemptions, unlike the corporate income tax it is replacing. From the very start, it was pockmarked with exemptions and credits, worth $141 million a year when the tax is fully implemented, ranging from anti-cancer drugs delivered in physicians' offices to affiliates of financial institutions and insurance companies.[19]

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[17] The bill also required that those claiming to be nonresidents file an affidavit verifying that they were not domiciled in Ohio during the year, that they had a residence outside the state all year and the location of that residence. The affidavit requirement, which was included in the new law, may help the state to reduce fraud, but such potential losses hadn't been included in the taxation department's revenue estimates for the bill.

[18] Letter to the Hon. Ron Amstutz from Richard A. Levin, Nov. 14, 2007, cited in Gongwer Ohio News Service, Volume #76, Report #231, Article #1, Monday, Nov. 26, 2007

[19] Schiller, Zach, *Exempt from Scrutiny: Tax Breaks in Ohio*, p. 10. See also Ohio Revised Code, Section 5751.01.

Distribution center exemption to the Commercial Activity Tax. CAT is not paid on products delivered to distribution centers that ship at least half their product out of state and have $500 million or more in annual supplier costs. Just two companies are using this exemption: Cardinal Health National Logistics Center in Groveport, and McKesson Corp., for a warehouse in Washington Court House.[20] Both of these warehouses predated the creation of the CAT. While this exemption was narrowed from its original version, the taxation department estimates the lost revenue this fiscal year at $6 million.[21] The state is favoring huge companies over small ones. This tilts the advantage to large companies and violates a tenet of sound taxation: That "businesses and persons with similar assets and income should be taxed alike."[22]

Net operating loss deductions. Another credit against the CAT that favors very large corporations over others is a credit for unused net operating loss deductions. This credit will allow companies that had more than $50 million in losses that they would have been able to deduct against the corporate franchise tax to write them off instead against the CAT, beginning in 2010. They will have 20 years to do so. This tax break allows companies to avoid taking write-downs against their earnings because they would no longer be able to take advantage of these tax breaks in the future. Companies filed more than $900 million in such credits, so the cost of them could amount to as much as $45 million each year starting in the second year of the next biennial budget (the cost could be less, depending on how taxation audits of company claims turn out). Given the $50 million threshold, only large companies are able to take advantage of this tax break; mom-and-pop companies are excluded.

Under the old corporate franchise tax that is now disappearing, the right to write off losses against future income was a benefit earned based on generating profits in the future that could be taxed. Now, of course, there will be no tax on such profits and no risk that they will be taxed. Thus, it no longer makes sense to allow such companies to write off those losses.

This is even more the case based on the huge business tax cut that came with the creation of the CAT. It replaced two other business taxes, reducing overall taxes on Ohio businesses by more than $1 billion a year. Ohio will be one of just a small minority of states without a corporate income tax when the phase-out of the corporate franchise tax is completed. Yet in 2025, companies will still be reducing their CAT payments because of this deduction. This revenue drain will have to be made up by other taxpayers, or through reduced services. Money-losing companies will have to pay the CAT, but those that lost money years ago won't.

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[20] See http://www.tax.ohio.gov/divisions/commercial_activities/qualified_distribution_centers.stm for the two companies' certificates.

[21] 2007 Tax Expenditure Report, p. 86. The value of this exemption is larger than $6 million a year, but the taxation department's estimate assumes that if the exemption were repealed, the owners would ship much of their product through distribution centers elsewhere in order to avoid CAT liability. That, of course, is uncertain.

[22] Sheridan, Richard G., David A. Ellis and Richard Marountas, "Implications of Tax Expenditures on Ohio's Revenue System," *Taxing Issues*, The Federation for Community Planning, October 2002, p. 10, available at http://www.communitysolutions.com/images/upload/resources/TAXINGISSUES7.pdf

A choice of taxes. In 2006, the General Assembly added another loophole. It allowed those trusts created before 1972 – essentially, before Ohio had a personal income tax – to choose whether to be taxed under the personal income tax or the CAT instead of both. As innocuous as this may seem, it will cost the state up to $18 million this fiscal year, according to the Ohio Department of Taxation.[23] The reason: For some of these trusts the CAT is a much friendlier tax. Some generate no receipts, so they would not pay any CAT tax at all. According to Columbus observers and an article in *The Plain Dealer*, this loophole was designed for a prominent Youngstown family, [24] though 1,432 trusts are now taking advantage of it and electing the exemption from the income tax.[25] When the break was first approved in the FY2006-2007 state budget, Gov. Bob Taft vetoed it, but he went along with it a year later. This measure was first proposed simply as an income-tax exemption for these trusts. And for many of them, that's what it amounts to. While it might appear as though the actual law is tougher, since they still have to pay the CAT, they would have been paying that anyway under existing law.

Some tax breaks are written into the tax code for individual companies, even if their names never appear. One of the most unusual such loopholes was written specifically for Convergys Corp., a Cincinnati-based provider of customer billing and service. In 2003, the company won a package of tax breaks worth $52.2 million from the city and other assistance from the state as part of an agreement to retain and expand its headquarters in downtown Cincinnati. One less well-known part of the deal protects the company if the Ohio legislature should decide to crack down on businesses that are shifting income out of state to avoid Ohio's corporate franchise tax. It says in effect that if the General Assembly tightens up its treatment of passive investment companies, forcing them to pay taxes on certain income that they don't now, Convergys will not be affected.[26]

A new legislature, of course, can overturn what its predecessors have done, so the protection granted to Convergys was far from iron-clad. Still, it would require that the legislature specifically take that away. As it turned out, the General Assembly decided two years later to eliminate the corporate franchise tax altogether. It is in the process of being phased out, and once it is, the very special break Convergys had will become meaningless. Even though at this point the tax break has no revenue implications, its existence is worth noting. It goes beyond the special-interest protection of other tax breaks in providing future protection against a yet-to-be-enacted law for a single company.

[23] Department of Taxation, State of Ohio, Executive Budget, Fiscal Years 2008 and 2009, Book Two, Tax Expenditure Report, March 2007. This number may turn out to be high, because a substantial number of trusts that initially elected not to pay the income tax later revoked that decision or were denied by the taxation department. The final status of this had not been determined when the taxation department made this estimate. A new estimate will be made for the next tax expenditure report, which will come out with the governor's proposed budget next year. E-mail from Christopher Hall, Ohio Department of Taxation, Tax Analysis Division, Aug. 28, 2008.
[24] Suddes, Thomas, "Sneaky tax break slithers through," *The Plain Dealer*, June 7, 2006.
[25] E-mail from Christopher Hall, Aug. 28, 2008.
[26] Ohio Revised Code Section 122.171(M)(1)

Sales-tax break for Avon Products. More recently, the General Assembly has granted special relief to Avon Products Inc. The capital bill approved in June exempted the company from having to pay sales tax on machinery, equipment and software for its new $117 million warehouse outside Zanesville. This will save the company at least $3.47 million in state sales tax, based on the $63 million in machinery and equipment that is going into the plant.[27] That doesn't count exempted state sales tax on software, or the savings from Muskingum County's 1.5 percent piggyback sales tax.[28] The five-year sales-tax exemption is in addition to an incentive package that included an eight-year Job Creation Tax Credit worth an estimated $1,615,483, a $500,000 roadwork grant, $150,000 for site grading and preparation, a $200,250 Ohio Investment in Training program grant and additional local incentives.[29]

The bill itself did not name Avon, but referred instead to a "qualified direct selling entity" using "a warehouse or distribution center primarily for storing, transporting, or otherwise handling inventory that is held for sale to independent salespersons who operate as direct sellers and that is held primarily for distribution outside this state."[30] It further specified that this entity had entered into a Job Creation Tax Credit agreement with the state since Jan. 1, 2007.[31]

Avon had announced in June 2007 that it would build the new distribution center, which will replace two others and be able to handle half the company's U.S. sales volume.[32] On Aug. 27, 2007, it broke ground for the new center.[33] Yet not until more than nine months later did the General Assembly approve this new tax break. Gov. Strickland agreed and signed the bill without vetoing this provision.

[27] State of Ohio Controlling Board, Operating Request, No. DEVA21, May 21, 2007.
[28] The Controlling Board request refers to another $14.5 million in "information technology" – if that is software, the sales tax exemption would be worth another $797,500.
[29] Ibid. See also Ohio Department of Development press release, "Job Creation Tax Credits Approved for Business Expansion," April 30, 2007, available at http://www.odod.state.oh.us/newsroom/2007PR/releases/1747.asp
[30] Ohio Revised Code, Section 5739.02(B)48
[31] By including such criteria, this special-interest legislation is unlikely to become an entitlement that any direct seller can use.
[32] "Avon to Build State-of-the-Art Distribution Center in Zanesville, Ohio," Earnings/News Release, June 1, 2007, available at http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/06-01-2007/0004600151&EDATE=
[33] "Avon Breaks Ground for New State-of-the-Art Distribution Center in Zanesville, Ohio," Earnings/News Release, August 27, 2007, available at http://www.avoncompany.com/investor/businessnews/index.html

Timeline for Avon tax breaks

March 2007 Ohio Department of Development (ODOD) makes preliminary offer of $650,000 in assistance for roadwork at a new Avon Products distribution center outside Zanesville

April 2007 Ohio Tax Credit Authority awards Avon a Job Creation Tax Credit worth an estimated $1,615,483 over eight years.

May 2007 State Controlling Board approves the $650,000 in roadwork assistance. Local authorities will also provide land and property tax abatement, while ODOD will support Avon with $200,500 in training funds.

June 2007 Avon announces it will spend $117 million to build the new distribution center.

August 2007 Company breaks ground for the warehouse

June 2008 Ohio General Assembly approves bill giving Avon a sales-tax break on machinery, equipment and software purchased for the warehouse, saving the company at least $3.47 million. This resulted from ODOD's incorrect interpretation that Avon would qualify for an existing sales-tax exemption.

Whatever this additional tax break accomplished, it did not bring the distribution center and its promised 450 jobs to Ohio. That had already happened when the bill was approved. So why was it passed? Because officials at the Ohio Department of Development had told the company that it would qualify for another sales tax exemption, one that covers equipment at warehouses handling inventory that mostly goes out of state, to retail stores or a mail order business. The officials failed to realize that Avon wouldn't qualify because it was a direct seller. Thus, the new break was a kind of "make-up" for the company, since it wasn't able to take advantage of the existing tax break.

This special-interest loophole was approved in 1994 and is sometimes called the "Les Wexner" tax break because it benefited the operations of the retailing magnate, founder of The Limited. Rather than create a new loophole for Avon, the state should repeal the original one. The taxation department estimated last year that repeal of this tax break would save the state $6.4 million in FY09.[34] Owners of distribution centers use state services – roads, public safety, education – whether or not most of their products are shipped out of state.

The expansion of such loopholes for business also means that a greater share of taxes is being paid by individuals. This reinforces the long-term shift of Ohio's state and local tax system in that direction.[35]

[34] Tax Expenditure Report, March 2007, p. 71
[35] Schiller, Zach, "Ohio's State and Local Taxes: The Dwindling Business Share," Policy Matters Ohio, May 2004, available at http://www.policymattersohio.org/OhioBizTaxes.htm

Too often, states are responding to calls for tax breaks from industries or individual companies based on the siren call that they will see new jobs. As increasing numbers of states offer the same breaks, however, this becomes a zero-sum game. Moreover, substantial evidence exists showing that financial incentives are relatively ineffective in bringing investment.[36]

No sales tax on lobbying and debt collection. Though services account for an increasing share of the economy, Ohio's sales tax does not automatically cover them; they must be explicitly included in the tax code.[37] In 2003, Gov. Taft attempted to broaden the sales tax by covering a variety of services. While Taft succeeded in adding some services to the sales-tax base, such as dry cleaning and taxi service, others were not approved by the General Assembly. Among those that he proposed but remain tax-free are lobbying and public relations services and debt collection services, respectively. The Taft administration estimated that adding lobbying and public relations would bring in $10.5 million in FY05, while debt collection would generate $19.5 million. Since that time, the state sales tax has been raised from 5.0 percent to 5.5 percent, so it's reasonable to assume these would generate 10 percent more in sales tax than they did then, even without any growth in these businesses. Together, that would total $33 million. It would also take away a state preference for these industries that is undeserved. Lobbyists, moreover, are particularly unlikely to move out of state if their clients have to pay sales tax.

Economists often argue that it is problematic to tax business services, since such taxes are incorporated in the price of the ultimate product and may affect economic decision-making. However, many lobbyists, public relations practitioners and debt collectors work for businesses that aren't taxed under the sales tax. A 2004 survey by the Federation of Tax Administrators indicated that Pennsylvania covers lobbying and consulting with its sales tax, as do six other states, and that West Virginia, Pennsylvania and six others collect sales tax on check and debt collection.[38]

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[36] See for instance "Geographic Redistribution of U.S. Manufacturing and the Role of State Development Policy," by Yoonsoo Lee, Federal Reserve Bank of Cleveland, Working Paper 04-15, December 2004, p. 5. http://www.clevelandfed.org/Research/Workpaper/2004/WP04-15.pdf "Overall, the results of this study support previous findings that the use of public funds for tax incentives to attract large industrial plants is not very effective," Lee stated (p. 37). See also Sheridan, Richard G., David A. Ellis and Richard Marountas, op. cit., p. 9

[37] In years gone by, the state's tax expenditure report used to attempt to estimate the value of the sales-tax exemption for many services. In the 1997 report, the last time such estimates were made, the exemption for various professional and business services, recreation and amusements, and personal and other services covered was estimated at $3 billion for FY1999, and this was not comprehensive. For a variety of reasons – changes in the methodology in how such estimates are constructed, as well as concerns about how artfully they were done and a few instances where those services are now taxed – that number should be viewed with great caution. However, it indicates that these exemptions are very substantial. See State of Ohio, Executive Budget, Fiscal Years 1998 and 1999, Book Two, Tax Expenditure Report, Prepared by the Department of Taxation and Submitted to the 122nd General Assembly by Governor George V. Voinovich February 1999, p. 46

[38] Federation of Tax Administrators, Sales Taxation of Services, Updated 2004, http://www.taxadmin.org/fta/pub/services/services.html

Beyond expanding the sales tax to cover lobbying, public relations and debt collection, the state should revisit the general issue of which services should be covered by the sales tax. Among the reasons Gov. Taft gave when he proposed to broaden the scope of the tax were:

- This matches the changes in the economy since the sales tax was first enacted during the Great Depression. A greater share of consumer spending goes toward services today. [39]
- The current set-up distorts economic decision-making by favoring services over goods.
- Including more services reduces the regressivity of the state's tax structure, "because services generally comprise a higher percentage of spending for higher income households."[40]
- It will help forestall additional increases in the tax rate, and help local governments.

Property-tax reductions for the affluent. Ohio has three state programs that provide reductions in taxes to property owners. In each case, the state reimburses school districts and localities for the revenue they would otherwise not receive. One program rolls back the property tax by 10 percent from what non-commercial owners would otherwise pay; another provides a 2.5 percent rollback for owner-occupied properties. As the Taft administration noted in a 2003 release, "While the rollbacks are tax relief mechanisms, they are not limited to taxpayers that necessarily need tax relief."[41] Gov. Taft proposed at that time to limit these two tax-reduction programs to the first $1 million in market value of each property. At that time, the administration estimated that it would save $5.2 million in FY05 from such a change.

That wasn't the first time in recent memory that such a cap on eligibility has been proposed. In 1995, Gov. George Voinovich put forward in his executive budget a plan to limit the two rollbacks to just the first $200,000 in value. The $33 million in savings over the biennium was to be used to increase funding for primary and secondary education. Neither Taft nor Voinovich's proposals were approved.[42] The General Assembly should enact a cap of no more than $1 million, and consider a lower cap of $500,000.

Property-tax relief for affluent seniors. The third property-tax relief measure is the state's homestead exemption for seniors. Last year, agreeing to a proposal made by Gov. Strickland, the General Assembly approved an expansion of this exemption. It provides a local property-tax exemption on the

[39] Between 1959 and 2000, the share of consumer spending on services increased from 40 percent to 58 percent. Larry R. Moran and Clinton P. McCully, "Trends in Consumer Spending, 1959-2000," *Survey of Current Business* (2001): pp. 15-21, U.S. Bureau of Economic Analysis, https://www.bea.gov/scb/pdf/national/nipa/2001/0301pce.pdf.

[40] Tax Reform Fact Sheet, Governor's Press Conference, Jan. 30, 2003, p. 4

[41] Tax Reform Fact Sheet, Governor's Press Conference, Jan. 30, 2003, p. 10.

[42] Executive Budget for Fiscal Years 1996 and 1997, Prepared by the Office of Management and Budget and Submitted to the 121st General Assembly, Gov. George V. Voinovich, January 1995, Book One, "Tax Relief Programs," p. H29.1

first $25,000 of market value for all homeowners 65 or older.[43] The state reimburses local taxing authorities for the loss of revenue. While the old homestead exemption was available only to senior homeowners with incomes of $27,000 or below, the new program expands eligibility to all senior homeowners. The new exemption also differs from the old one in providing an equal reduction in taxable value for all those participating; the old exemption was tiered so that those with the lowest incomes were eligible for the largest credits. The new exemption also has a "hold-harmless" provision so that some of the lowest-income homeowners would not see their exemptions reduced under the new plan.

During the budget debate last year, House Speaker Jon Husted called for the homestead exemption to be means tested.[44] That way, affluent Ohioans would not receive the tax benefit, saving funds that could be used for other purposes. An analysis by the Institute on Taxation and Economic Policy released by Policy Matters Ohio last year found that targeting the homestead exemption would save at least $118 million a year while directing the same or greater tax reductions to low- and moderate-income Ohioans.[45] Specifically, ITEP looked at two alternatives to the Strickland plan. One would have imposed an income eligibility limit of $40,000, while the other would have increased the credits and the income limits under the old plan so that they were worth the same as they were in 1980 after inflation. Each would save at least $118 million compared to the Strickland plan, which was enacted with modest changes.[46] Just as with the other property-tax relief programs, the homestead exemption should be limited based on need.

Conclusion

Altogether, ending or limiting these dozen tax breaks would generate up to an additional $270 million a year in revenue while making Ohio's tax system fairer. That does not include a review of which services the sales tax should cover. And it in no way covers the full extent of tax loopholes that should be closed or preferences that should be ended. As described in Policy Matters Ohio's 2007 report, *Exempt from Scrutiny*, other states have gone further than Ohio in examining their tax expenditures. Some, such as New Jersey and Rhode Island, have taken recent steps similar to those described in this report, limiting property tax rebates based on income and capping the use of some credits.[47]

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[43] The exemption also covers permanently and totally disabled homeowners.
[44] Niquette, Mark and Jim Siegel, "Tobacco Money Plan Debated," *The Columbus Dispatch*, May 27, 2007, and "Penny wise," *The Plain Dealer*, editorial, June 12, 2007.
[45] "Targeting homestead exemption would save Ohio $118 million a year," Policy Matters Ohio, June 6, 2007, available at http://www.policymattersohio.org/pdf/HomesteadExemptionRelease2007_0606.pdf
[46] Based on data from the 10 largest Ohio counties, the homestead exemption delivered a slightly smaller tax reduction than originally predicted, but estimates were very close to the actual reduction.
[47] Sheridan, Richard, "Options to Stave Deepening State Budget Hole," State Budgeting Matters, Vol. 4, Issue 7, September 2008, p. 5, available at http://www.communitysolutions.com/store/index.asp?DEPARTMENT_ID=38

The General Assembly should enact legislation closing the loopholes identified in this report and review which services the sales tax should cover. It should authorize a regular review of all the tax breaks embedded in the revised code, as some states already do. This should include the necessary funds for the Ohio Department of Taxation to thoroughly explore the issue.

Policy Matters Ohio is a non-profit, non-partisan research institute dedicated to researching an economy that works for all in Ohio. Policy Matters seeks to broaden debate about economic policy by providing research on issues that matter to Ohio's working people and their families. Areas of inquiry for Policy Matters include work, wages, and benefits; education; economic development; energy policy; and tax policy. Generous funding comes from the Joyce, Gund, Cleveland, Public Welfare, KnowledgeWorks, New World, Annie E. Casey and Sisters of Charity Foundations, the Economic Policy Institute, and Greater Cleveland Community Shares. To those who want a more fair and prosperous economy... Policy Matters.

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