Ohio Department of TAXATION

To: Thomas Zaino, Tax Commissioner
From: Frederick Church, ODT
Date: April 4, 2003
Re: **Municipal Income Tax – Potential Revenue Gains from anti-PIC provisions**

Background

The State of Ohio

The state has had provisions that restrict the use of passive investment company (PIC) transactions since 1991. These provisions in the Revised Code generally prevent corporations from using transactions with affiliates to avoid Ohio corporate income tax, where the transactions are structured as payments of interest or as payments for the use of intangible property. These anti-PIC provisions were put in place to reduce the state tax revenue being lost through tax planning transactions where an Ohio corporation would make the payments described above to an affiliated company in another state – a state without a corporate tax, a state without a tax on portfolio or intangible property income, or a unitary tax state – in order to gain an Ohio tax deduction and yet not pay any additional tax in the state where the affiliated company received the payments as income.

When the anti-PIC provisions were put in place at the state level, ODT estimated that they would prevent revenue losses of approximately $75 million per year in the short run, but that the gains would erode somewhat over time as corporate tax planners found ways around the Ohio restrictions. An examination of tax return data over the intervening years suggests that the state is now gaining around $50 million per year (or slightly more) from these anti-PIC laws.

Anti-PIC Proposal for Municipalities in HB 95

The municipalities find themselves in a somewhat different situation than the state. In order to avoid Ohio corporate income tax, a multi-state group must structure its transactions so an Ohio corporation makes deductible payments to a member of the group that is in another state, where the income received will not have adverse tax consequences. To avoid Ohio's municipal income tax, a corporation or a flow-through entity could simply pay some of its operating income as intangible property expense to another entity that could be in Ohio, or that could even be in the same city. The key here is that Ohio municipalities cannot tax intangible property income, so that the act of taking operating income and "turning it into" intangible property income makes it disappear from the Ohio municipal income tax base. The company paying the expense gets a deduction, while the company receiving the payment earns income that the municipalities cannot tax.

HB 95 would require Subchapter C-corporations and flow-through entities to adjust their income tax base by adding back these expenses associated with intangible property and interest expenses, unless they can show that the expenses were paid to an unrelated entity in the same taxable year and that the transactions were not motivated by tax avoidance.

Overall Revenue Impact

The preceding section contains an estimate of the state gain from these disallowances of related member expenses of about $50 million per year. This translates into PIC addback income of 10 percent to 11 percent of the before PIC-addback corporate income tax base.

Based on data collected from Ohio municipalities for calendar year 2001, the municipal income tax base for that year was $194.7 billion. ODT projects that in FY 2004, the municipal income tax base will grow to $202.5 billion. ODT further estimates that eight percent (8%) of the municipal income tax base is from business net profits, which would put the net profits amount for FY 2004 at $16.20 billion. (ODT realizes that municipal officials have stated that business net profits are 10 percent to 15 percent of the municipal income tax base. However, ODT set the figure at eight percent because a 10 percent to 15 percent share would mean that the total municipal business profits tax base would exceed the state net profits tax base, using reasonable assumptions about the share of the state personal income tax that comes from business.)

If we assume that the municipalities would receive an increase in their business net income base of about 10 percent (similar to the state experience on its corporate tax) then the anti-PIC addback will add $1.62 billion annually to the municipal income tax base. Since the 2001 weighted average municipal income tax rate was 1.72 percent, this leads to a FY 2004 revenue increase of $27.9 million ($1.62 billion x 1.72%).[1] This revenue gain exceeds the gain estimated in ODT's preliminary spreadsheet analysis of HB 95 that was released at the time the executive budget was presented..

Revenue Impact for Large Cities

Analysis of income tax collections for Ohio's six largest cities shows that in calendar year (CY) 2001 they collected about 41% of all municipal income tax revenue. These cities had about 34% of the total municipal income tax base (this is a lower percentage than for collections because the largest six cities have higher rates than the statewide average).

ODT has no direct way of estimating how the anti-PIC addback revenue gain will be distributed among Ohio municipalities. That said, it is reasonable to assume that the businesses that are doing sophisticated tax planning are more likely to be large corporations or large partnerships (very likely multi-state entities) that are disproportionately concentrated in the larger cities. If

[1] The percentage increase in tax base for the municipalities might exceed the state-derived 10 percent, because the municipal disallowance can capture the same base that the state base does – minus any amounts paid by multistate corporations that are not located in Ohio municipalities that levy the income tax – **plus** additional amounts that may be paid to related entities **within** Ohio. Lacking any additional evidence about how much higher this figure might be, ODT chose to stay with a 10 percent estimate.

Ohio's six largest cities capture 50% (1.5 times their percentage of income) of the total anti-PIC municipal revenue, they will gain about $14.0 million annually; if they capture 70% (2 times their percentage of income) of the revenue they will gain about $19.5 million annually.

APPENDIX

CY 2001 Municipal Income Tax Data data for the "Big 6" cities

	Collections	Revenue: Percent of all cities w/ an income tax	Rate	Income	Income: Percent of all cities w/ an income tax
Akron	96,173,451	2.9%	2.00%	4,808,672,550	2.5%
Cleveland	296,965,406	8.9%	2.00%	14,848,270,300	7.6%
Cincinnati	265,492,155	7.9%	2.10%	12,642,483,571	6.5%
Columbus	453,378,864	13.5%	2.00%	22,668,943,200	11.6%
Dayton	116,181,986	3.5%	2.25%	5,163,643,822	2.7%
Toledo	150,131,452	4.5%	2.25%	6,672,508,978	3.4%
6-city total	1,378,323,314	41.1%		66,804,522,421	34.3%
Total municipal income tax	3,353,875,257			194,745,807,420	100.0%
weighted average effective tax rate, all cities with MIT			*1.72%*		