A Report from

Policy Matters Ohio

Ohio's Vanishing Corporate Franchise Tax

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Executive Summary

Ohio businesses are paying a far smaller share of the costs of state and local government than they did 25 years ago. One element in that decline has been the waning of the state's corporate franchise tax. That is Ohio's corporate income tax, which is actually paid on either on profits or net worth, depending on which produces a greater amount.

In the mid-1970s, the state's corporate franchise tax was a major source of revenue, accounting for 16 percent of the taxes supporting Ohio's General Revenue Fund, the main fund for state operations. That had declined to 4.6 percent by fiscal 2002. Though that is partly because of growth in other taxes, the amount of franchise taxes collected decreased in each of the last four fiscal years, contributing to Ohio's budget problems. In inflation-adjusted dollars, revenues from this tax have fallen below even the trough reached in the deep early 1980s recession. The drop began in fiscal 1999, well before the latest recession had started. Compared to gross state product, the measure of everything produced in Ohio, corporate franchise tax revenues are at their lowest level in decades.

Just over 100,000 non-financial businesses were liable for Ohio corporate franchise taxes for the tax year 2001. More than 44 percent of them were liable for the minimum $50, before credits. Another 36 percent were each liable for less than $2,000. Manufacturers pay a larger share of the total than any other industry.

Ohio's per capita state taxes on corporate income or net worth are below the average of all states taken together, or those of its neighbors. When Ohio municipal income taxes are factored in, Ohio's state and local corporate income taxes are closer to the national average.

A number of factors have contributed to the weakening in Ohio's corporate franchise tax, besides declining profits from the lethargic economy. One major reason is legal corporate tax avoidance. This is a national phenomenon. "We have a 'swiss cheese' state corporate income tax," said Dan R. Bucks, executive director of the Multistate Tax Commission. The current effective rate of state corporate income taxes is slightly over 5 percent, down from 9.6 percent in 1980. One common tactic involves shifting income to other states where it will not be taxed as heavily through the use of other companies there that sell goods or services to the company here. The Ohio Department of Taxation estimates that if the state required combined reporting, under which intercorporate transactions are eliminated and companies operating as a single business are treated as one taxpayer, it would take in roughly an additional $200 million a year.

Changes in U.S. tax law and aggressive tax sheltering at the federal level also have reduced the amount of Ohio taxes, since usually when federal tax liability drops, state tax liability drops with it. Changes in state law are another contributor. The state has diluted the net-worth component of the franchise tax, capping it in 1999 at $150,000. That helped lead to an especially large fall-off in collections when the economy weakened. The legislature also has cut tax rates and added tax credits. Altogether, the Legislative Budget Office estimated these changes would cost the General Revenue Fund $774 million in corporate franchise taxes between fiscal 1996 and fiscal 2003. Some credits are not well-targeted, such as job tax credits that were recently awarded for a Wal-Mart warehouse that was already being built.

The franchise tax also is declining because new businesses often are organized so that they escape the tax. Limited liability companies and others known as pass-through entities do not pay corporate franchise tax; tax on the income they generate is paid not by the business but under the personal income tax by their individual owners. The amount is substantial, and Ohio has started requiring these entities to withhold taxes on income paid to non-Ohio investors who otherwise might escape Ohio taxes. Limited liability companies offer new opportunities for multistate corporations to avoid taxes.

Ohio should take steps to curb corporate tax avoidance and fortify its franchise tax. Specifically, the state should:

- Consider requiring large corporations to disclose their corporate franchise tax returns. At the least, it should allow, as Wisconsin does, for citizens to be able to find out from the state whether a particular company is filing a return, and what its particular liability was in a given year. Ohio also should follow the lead of New Jersey and Alabama and report on overall corporate tax compliance.
- Require mandatory combined reporting. This has been used in California for decades, and 16 states in all require it.
- Repeal the $150,000 net-worth cap, which discriminates in favor of large companies. This would provide another backstop against corporate tax avoidance.
- Consider enacting what is known as a "throwback" rule, so that the Ohio corporate franchise tax would cover income from sales made by Ohio producers in other states where they are not subject to corporate income tax. Two dozen states currently have such rules.
- Adopt a moratorium on creation of new types of tax credits and create stricter standards for the award of existing ones.

Ohio also should track Alabama's new law curbing the use of contingency fees by tax preparation firms, and review whether more steps should be taken to ensure that pass-through entities are not abused by companies seeking to escape taxation.

Such steps are unlikely to harm economic growth. The franchise tax does not cover most new businesses, particularly high-technology businesses, so it is not a major barrier to business formation. Comparing overall business taxes among states is difficult, but Ohio's do not appear to be significantly out of line, and the corporate franchise tax accounts for only a fraction of total business taxes in the state. Moreover, the impact of business taxes on new investment is uncertain, at best. States that have throwback rules and combined reporting were disproportionately represented among those with strong manufacturing job growth between 1995 and 2000. Ohio needs to strengthen its corporate franchise tax, to provide the stable revenue the state needs and equity among taxpayers big and small.

Introduction

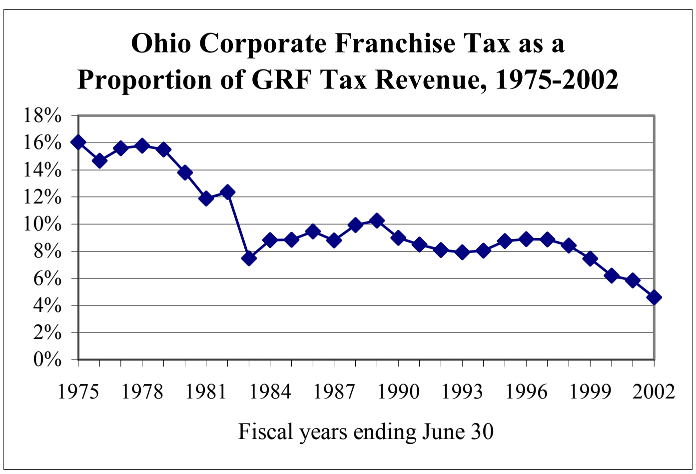
In a recent Wall Street Journal article entitled, "It's Time to Curb Corporate Tax Shenanigans,"[1] columnist David Wessel cited steps taken to curb abusive business practices, and wrote: "Next on the to-do list: Get companies – and lawyers, accountants and investment bankers – to stop treating taxes like a videogame in which the prize goes to the player who most cleverly avoids paying the government." Wessel was referring to taxes in general. But though most attention focuses on federal taxes, he could have been talking about state corporate income taxes as well. Amid state budget problems that almost certainly will require strong action from the next governor and General Assembly, it is well worth asking: How much are Ohio companies paying, and how well is the state's corporate franchise tax working?

This study examines that tax, Ohio's third-largest source of tax revenue. It reviews the status of the corporate franchise tax, including its importance as a source of state tax revenues, the reduction in collections from it, and who pays it. Next, it analyzes the reasons behind the tax's declining status. Finally, it proposes policy changes to bolster the tax and ensure that it is fairly paid.

The Business Share

Ohio businesses are paying a far smaller share of the costs of state and local government than they did 25 years ago. Prof. Edward W. Hill of Cleveland State University has shown that overall, business taxes fell from nearly 40 percent of state and local taxes in 1976 to 29 percent in the 1999 fiscal year.[2] One element in that decline has been the waning of the state's corporate franchise tax. Although the Ohio corporate franchise tax is what most people think of as the corporate income tax, it may be paid either on company profits or net worth, depending on which would produce a larger sum (See box, p. 4). Ohio is one of 47 states with a corporate income tax or something like it.

Figure 1:



Source: Ohio Department of Taxation

In the mid-1970s, the state's corporate franchise tax was a major source of revenue, accounting for 16 percent of the taxes supporting Ohio's General Revenue Fund. That was three-quarters as much as the personal income tax and 40 percent as much as the sales tax. In fiscal 2002, which ended June 30, the $712.3 million it contributed was a tenth as much as the personal income tax and less than an eighth of what the sales tax collected.[3] As one might expect of a tax that depends

[1] David Wessel, "It's time to curb corporate tax shenanigans," *The Wall Street Journal*, Sept. 19, 2002, p. A2.
[2] Edward W. Hill, Ohio's Competitive Advantage: Manufacturing Productivity, Appendix Table 4-1. 2001.
[3] E-mail communication from Frederick Church, Ohio Department of Taxation. Figures have been adjusted by the Department of Taxation so that they are comparable over time. Figure 1 shows adjusted figures.

heavily on corporate profits, its share fell during recessions in the early 1980s and again in the early 1990s. Notably, however, that rate staged only a modest recovery during the long 1990s boom, and recently has plunged to its lowest level in decades. Figure 1 (above) shows how the corporate franchise tax has declined as a source of revenue for the General Revenue Fund.

How the Corporate Franchise Tax Works

Ohio's corporate franchise tax originated in 1902 as a tax on net worth (the assets of a business minus its liabilities). It was changed in 1971, so that it has two pieces. Companies must figure how much they would pay under two different methods, one based on their net income, the other on their net worth. They pay whichever is higher, although since 1999, the amount they pay under the net worth formula has been capped at no more than $150,000.

The net worth tax is calculated by applying a rate of 4 mills, or 4/10 of a percent, to the company's net worth. Under the income method, the amount is 5.1 percent of the first $50,000 in net income, plus 8.5 percent of net income greater than that. Non-financial companies also pay a small "litter tax," which varies according to whether they make such "litter stream" products as beverages, packaging, tobacco and gum.[4] Such companies are liable for a minimum of $50, before the litter tax and credits for which they may be eligible. Banks, savings and loans and other financial institutions pay the corporate franchise tax only under the net-worth formula, at the rate of 13 mills.

So who must pay the franchise tax, and what income must they include? The answers here are less obvious – and there may be room for artifice. Only those companies that have a presence in Ohio must pay the corporate franchise tax. Under U.S. law, that does not include companies that just take orders for products here, but approve the orders elsewhere and ship them in from another state.[5] Some companies, such as insurance companies, stock brokers, credit unions and certain public utilities, are exempt from the tax. Only some income is taxed; for instance, as Tax Commissioner Thomas M. Zaino explained, if a company based in Indiana with an Ohio operation sells a building in Indiana for a gain, that income is not liable under the Ohio corporate franchise tax.

As in other states with corporate income taxes, companies with Ohio operations figure their corporate franchise tax based on an apportionment formula, taking into account the proportion of their property, payroll and sales they have in the state. Most states used to weight the three factors equally. However, many, including Ohio, have weighted sales more; in Ohio, sales count for three times as much as property or payroll.[6] This move should favor companies with in-state property and payroll as opposed to those that largely sell in the state without owning property or employing people. However, it also reduces the amount of income that is taxed and, because most states have a different arrangement, allows multi-state companies to take advantage of the differences and reduce their liability

The state directs 4.8 percent of franchise tax collections to local governments. The rest goes into the General Revenue Fund, the main fund that supports state operations.

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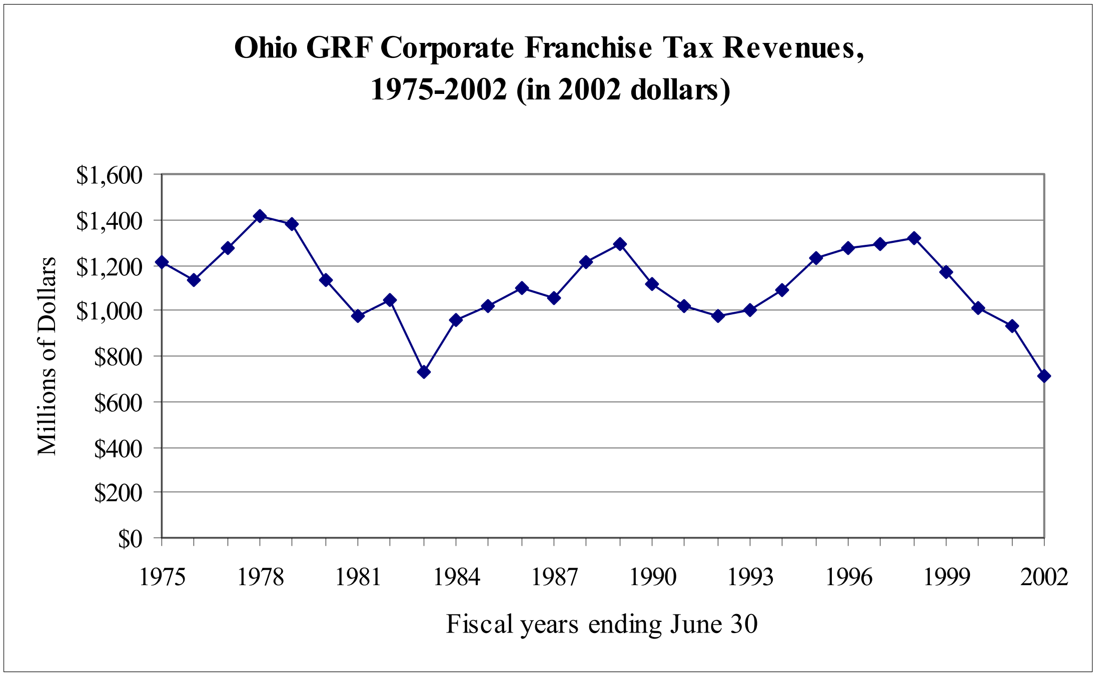
[4] Liability under litter-stream taxes totaled $13.3 million in tax year 2001. It is not discussed separately in this report.
[5] Though it restricts the levy of state corporate income taxes that way, the federal law does not keep the state from imposing its net worth tax on out-of-state companies that are just selling in Ohio.
[6] For financial institutions, sales count for 70 percent of the total, compared to 15 percent each for property and payroll.

Much of the relative decline stems not from an actual decrease in franchise tax collections, but from the growth in other taxes, especially the personal income tax. However, that is only part of the story. After increasing in real terms during the early years of the 1990s economic expansion, the actual amount of franchise taxes collected began to level off, and now has fallen for four fiscal years in a row. In real dollars, adjusted for inflation, such collections in fiscal 2002 fell below even the trough reached in fiscal 1983, during a much deeper recession:

Figure 2:



Sources: Ohio Department of Taxation, US Bureau of Labor Statistics

The plummet began in fiscal 1999, well before the latest recession had begun. Thus, while last year's decline in such receipts may have resulted largely from the slide in corporate profits, the franchise tax was losing its force when the economy was still thriving.[7] That is evident also when such franchise tax receipts are compared with Ohio's gross state product, the total value of goods and services produced in the state:

[7] Daniel Navin, director of legislative affairs and taxation for the Ohio Chamber of Commerce, told a committee studying state taxes in regards to claims that business tax planning is eroding the corporate franchise tax, "The fact of the matter is that the greatest contributor to lower franchise tax collections in the last few years, or during any period of recession, is lower or nonexistent corporate profits." (Navin testimony before the House Select Committee on Tax Reform, Sept. 24, 2002). However, speaking of the national picture and the declining proportion of state tax revenues coming from corporate income taxes, Nicholas W. Jenny of the Rockefeller Institute said: "There is certainly some connection between the recession in the economy and this decline in the corporate income tax. This decline however started before the recession and has been much deeper than either the general economic decline or the decline in other major taxes." Nicholas W. Jenny, "The Collapse of the Corporate Income Tax," The Rockefeller Institute State Fiscal News, Vol. 2, No. 4, April 2002

Figure 3:

*Gross State Product is for each calendar year; Corporate franchise tax revenues are for taxes paid the following year, on income or net worth from the same year as GSP. GSP figures include only private industry.
Source: Ohio Department of Taxation, US Bureau of Economic Analysis

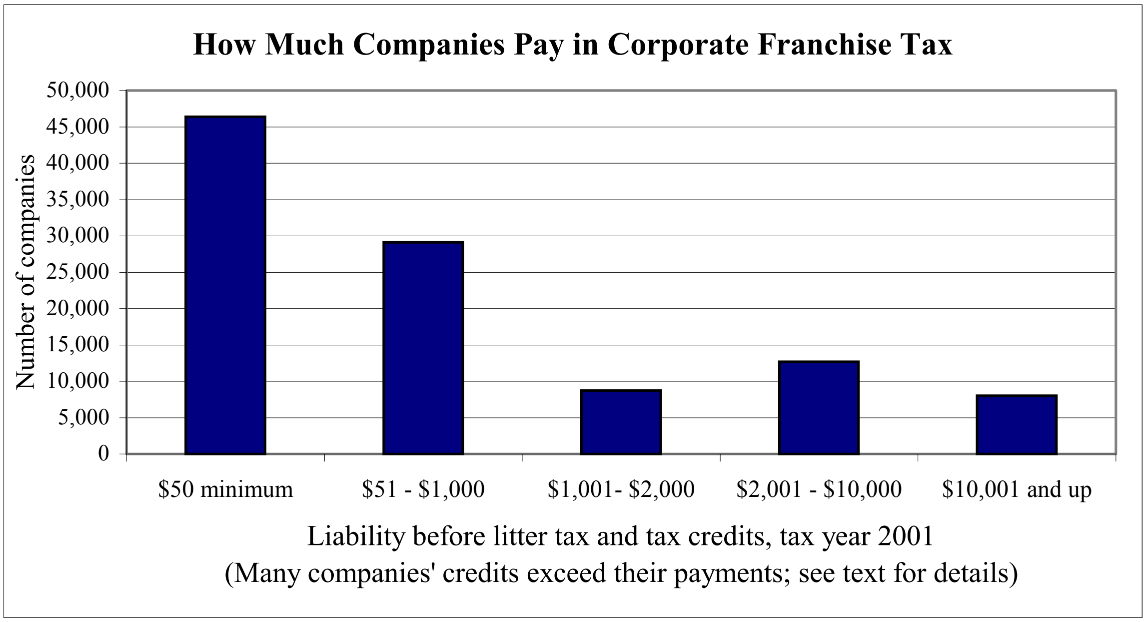
Obviously, the most meaningful statistic would measure corporate franchise taxes in proportion to Ohio corporate profits. Unfortunately, no direct measure of Ohio profits exists that is publicly available, so we must make do with the above.

Who Pays the Corporate Franchise Tax?

Altogether, 104,913 non-financial businesses[8] were liable for Ohio corporate franchise taxes for the tax year 2001. More than 46,000 of them – 44 percent of the total – were liable for the minimum $50, before credits. (As a group, these companies actually received almost $2.6 million in tax refunds, because of credits they were due.)[9] Most of the rest were liable for less than $2,000. At the other end of the scale, 544 companies together were liable for $400 million, or 64 percent of the total. Of these, 92 were liable for over $1 million. Figure 4 gives a breakdown of the number of non-financial companies liable for different amounts:

[8] Financial institutions such as banks and savings and loans are taxed differently. In tax year 2001, there were 392 of them.
[9] Ohio Department of Taxation, Tax Data Series, Table CF-2A, Nos 57 & 58 (2002), September 6, 2002. Other figures in this paragraph are before litter tax and tax credits. Overall, credits reduced the amounts companies were liable for to below the amounts listed above. However, Taxation Department data only disclose the number of companies liable for each amount before litter tax and credits.

Figure 4:



Source: Ohio Department of Taxation

Manufacturers continued to account for the largest share of corporate franchise taxes for the 2001 tax year, paying 27 percent of the total.[10] That share has declined recently. Financial institutions pay almost a fifth of corporate franchise taxes. Though that share was down from its peak in the early 1990s, it is a higher proportion than the industry had paid in the late 1980s.

The Department of Taxation also reported for the 2001 tax year that 32 percent of non-financial companies were liable under the net worth method while 24 percent were liable under the net income method.[11] As noted in the chart above, the remaining 44 percent were liable for the minimum. Although more companies pay under the net worth method, those that pay under the net income method pay far more of the total. Seventy-seven percent of the taxes liable are from those using the net income method, compared to 22 percent under net worth.[12]

[10] Figures in this paragraph reflect tax liability, not actual payments, after litter tax, surtax, and nonrefundable tax credits. Manufacturers were liable for as much as 42 percent of the total in 1995, but since then, there has also been a large increase in the proportion of taxpayers that do not indicate their industry in filing their tax forms. In tax year 2001, payors accounting for 11 percent of liabilities under the tax did not specify their industry, up from 2 percent in 1995. Many of these are undoubtedly manufacturers. Thus, manufacturers probably continue to pay somewhat more of the corporate franchise tax than their contribution to the state's goods and services, but the exact amount is uncertain. Figures are from the Ohio Department of Taxation.

[11] Ohio Department of Taxation, Tax Data Series, Table CF-2A, No 58 (2002), September 6, 2002.

[12] Ibid, Table CF-1B, No. 58 (2002), September 6, 2002. Figures reflect only non-financial institutions, before litter tax and credits. The other taxpayers, those companies responsible for paying the minimum tax, were liable for $2.3 million before litter tax and credits, or less than 1 percent of the total.

Below Average

Ohio's state taxes on corporate income or net worth are below the average of all states taken together, measured on a per person basis. They are also below those of its neighbors.[13] Figure 5 shows how Ohio's corporate franchise tax compares with corporate income taxes of nearby states and for all of the states, on a per-person basis[14]:

Figure 5:

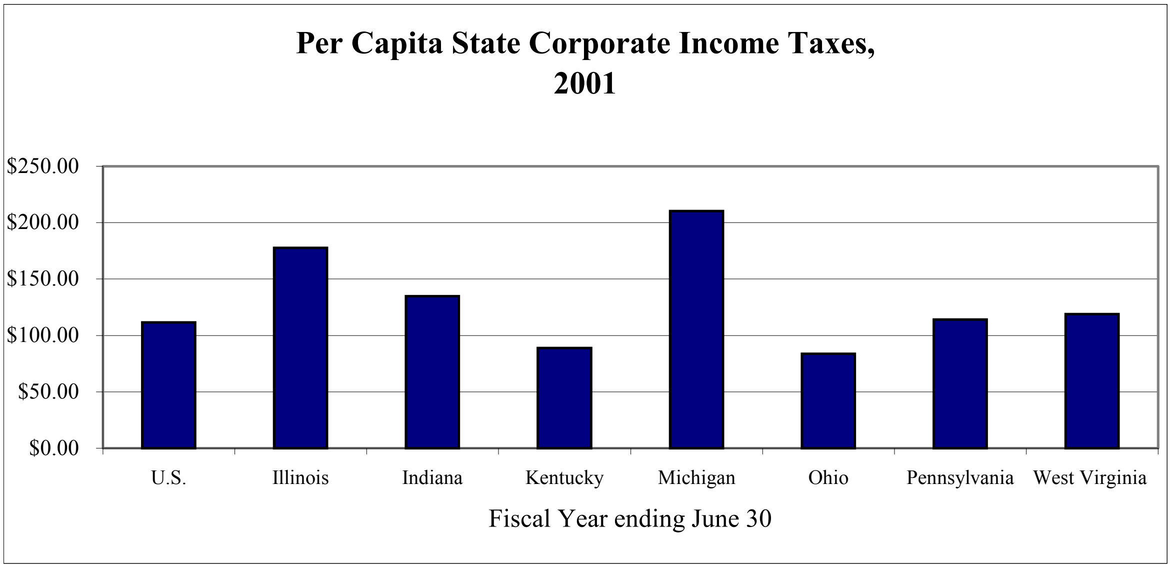


Figure 5: Policy Matters Ohio analysis of US Census Bureau data

Even when Ohio corporate franchise tax collections are adjusted further for personal income and tax rates, they are lower than in neighboring states, according to J. Donald Mottley, former chair of the state House Ways & Means Committee and an attorney in the tax department of the Cincinnati law firm Taft, Stettinius & Hollister LLP.[15]

However, as Mottley pointed out, Ohio municipalities that have income taxes levy them on corporations. The state, which does not collect these taxes itself, estimates that between 10 percent and 15 percent of municipal income taxes are paid by businesses.[16] In calendar 2000, $3.28 billion in such taxes were collected,[17] suggesting businesses paid roughly $410 million. When that amount is factored in, Ohio's state and local corporate income taxes are closer to the national

[13] The following chart does not include taxes that states levy on corporations, such as Kentucky's corporation license tax, that the Census Bureau does not classify as state corporate income taxes. However, it does include all of Ohio's corporate franchise tax. The Michigan figure is for its Single Business Tax, which is not directly comparable but replaced that state's corporate income tax, among others.

[14] David Brunson of the Legislative Service Commission presented additional data in his Aug. 27, 2002, testimony to the Committee to Study State & Local Taxes, illustrating that the same pattern holds true for state corporate income taxes as a percentage of income.

[15] J. Donald Mottley, "Thoughts on Ohio's Tax Structure." Testimony before the House Select Committee on Tax Reform, Aug. 27, 2002.

[16] Carol Bessey, Deputy Tax Commissioner, Interview, Sept. 27, 2002.

[17] Ohio Department of Taxation, Tax Data Series, Table LG-11, No. 65 (2001), Jan. 22, 2002.

average on a per capita basis. Municipal income taxes have risen since 1979, but the combined total of that with state corporate franchise taxes still declined in inflation-adjusted dollars.

Corporate Tax Avoidance

Why are corporate franchise tax collections in Ohio falling? A number of different factors have contributed, besides declining profits from the lethargic economy. Changes in U.S. tax law and aggressive tax sheltering at the federal level have reduced the amount of Ohio taxes as well, since with some exceptions Ohio starts with income as the federal government defines it.[18] Changes in state law, which have reduced tax rates and added credits, are another contributor. An additional reason has been the proliferation of new business entities such as limited liability companies, known as pass-through entities because taxes on the income they generate is paid not by the business but under the personal income tax by their individual owners. Thus, the state receives tax revenue, but not through the franchise tax.

Ohio's franchise tax also is wasting away because of legal corporate tax avoidance, known euphemistically as "tax planning." This has received ample attention at the federal level, such as the national controversy that erupted earlier this year over U.S. companies moving their headquarters offshore for tax benefits.[19] And now it is beginning to get an airing in Ohio as two official committees, the House Select Committee on Tax Reform and the Committee to Study State and Local Taxes authorized by the Ohio General Assembly, hold hearings on Ohio's tax system.

Prof. William F. Fox of the University of Tennessee told the study committee that Ohio's tax rates for business are "pretty high," yet taxes collected are "well below the national average."[20] At 8.5 percent after the first $50,000 in income, the top rate in Ohio is higher than most, though not among the very highest in the nation.[21] "Companies are getting very good at reducing their national tax burden," Fox said. David Brunson of the Legislative Service Commission also cited the low productivity from the tax.[22]

Ohio is not alone in seeing its corporate income tax shrink. Tax experts have been talking for some time about the decline of state corporate income taxes—at least one commentator recently referred to it as a "collapse."[23] During the 1990s boom, as U.S. corporate profits exploded, state

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[18] William F. Fox and LeAnn Luna estimated recently that a lower federal tax base may account for about 30 percent of the falloff in the effective state corporate income tax rate on the national level. "State Corporate Tax Revenue Trends: Causes and Possible Solutions," June 5, 2002, Paper prepared for the 32nd annual spring symposium of the National Tax Association, Washington D.C. and forthcoming in the September 2002 *National Tax Journal*, p. 10

[19] See for instance Masha Herbst, "Connecticut tool maker Stanley Works at center of tax haven debate," Associated Press, May 9, 2002.

[20] Lee Leonard, "Businesses Avoid Taxes, Expert Says," *The Columbus Dispatch*, Aug. 7, 2002, and William F. Fox, "Characteristics of a Good Tax System," Testimony before the Committee to Study State and Local Taxes, August 6, 2002.

[21] Range of State Corporate Income Tax Rates (as of Jan. 1, 2002), Federation of Tax Administrators. http://www.taxadmin.org/fta/rate/corp_inc.html

[22] David Brunson, Legislative Service Commission, "Ohio's Tax System in Comparison to Other States," Testimony before the Committee to Study State and Local Taxes, Aug. 27, 2002.

[23] See Nicholas W. Jenny, "The Collapse of the Corporate Income Tax," The Rockefeller Institute State Fiscal News, Vol. 2, No. 4, April 2002. The "primary finding" of a Congressional Research Service report Feb. 29, 2000, "Average

and local tax collections on this income did not rise in tandem. The current effective rate is slightly over 5 percent, down from 9.6 percent in 1980, according to Dan R. Bucks, executive director of the Multistate Tax Commission.[24] Observers have cited a number of reasons for the decline, including competition between states for business investment and the growth in pass-through businesses entities that are not taxed this way.

In his testimony to the study committee, Bucks said that the "vast majority" of this decline was not the result of rate cuts, tax credits or other legislative action. Rather, he estimated that as much as 80 percent of it is due to tax planning, or "weakened standards of income accountability." Whatever the exact percentage, it is significant. This occurs through shifting of U.S. income overseas, at the federal level, and similar moves at the state level to move profits where they will not be taxed. "We have a 'swiss cheese' state corporate income tax," Bucks said.

Tax minimization strategies, writes Richard D. Pomp, a law professor at the University of Connecticut, "typically involve pressing formal rules to their limits, aggressively exploiting weaknesses in state tax structures, shifting income and deductions among the states, identifying and capitalizing on gaps in the interfacing of state laws, restructuring corporate entities, and the use of pass-through entities."[25]

One tactic that has proliferated is the establishment of companies in other states, such as Delaware and Nevada, which tax corporate income at a lower rate than others or have special provisions that do not allow taxation of intangible income. The parent next transfers its trademarks or other intangible property to them. Then, the operating company pays a fee to the Delaware company for the use of the mark, reducing its income in its own home state and lowering the corporate income tax it would pay. The Delaware company may then loan the money back to the operating company, and the interest it pays on the loan may further reduce its taxes.

Two well-known companies based in Ohio have used such techniques in other states, where they sometimes have been challenged by state authorities. Limited Brands Inc., the Wall Street Journal reported in August, has seven subsidiaries in downtown Wilmington, Del., to hold its trademarks and transfer hundreds of millions of dollars to Delaware, where they pay no state tax. A company there called Delaware Corporate Management Inc. promised to provide Limited's subsidiaries with everything they needed to look like real corporate branches, from office space and stationery to mail forwarding and clerical support. "The rent, divided into tiny fractions by the hundreds of absentee corporate tenants that use DCM, worked out to a few hundred dollars a year for each of Limited's entities," the newspaper reported, based on findings from the North Carolina Tax Review Board.[26] The board last May upheld the case brought by the state, which the company is appealing.

Effective Corporate Tax Rates," by Steve Maguire, was "a decline in the average effective corporate tax rate at the state level over the last decade."

[24] Dan R. Bucks, "Trends and Issues in State and Local Taxation," Testimony before Committee to Study State and Local Taxes, Sept. 17, 2002.

[25] Richard D. Pomp, "The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer." In David Brunori, ed., *The Future of State Taxation*, The Urban Institute Press, 1998, p. 52.

[26] Glenn R. Simpson, "A Tax Maneuver in Delaware Puts Squeeze on States," *The Wall Street Journal*, Aug. 9, 2002, p. A1

The Massachusetts Appellate Tax Board ruled in 2000 that Cleveland-based Sherwin-Williams Co. was not entitled to deductions from corporate excise tax for royalty and interest payments made to two subsidiaries. The company formed the Delaware subsidiaries in 1991 to hold its trademarks, including "Sherwin-Williams" and "Dutch Boy," and license them back to Sherwin-Williams based on sales of particular products using those trademarks. Though the paint company said there were several business purposes for the transfer and leaseback, the board concluded that they were not supported by any valid business purpose other than tax avoidance.[27]

Ohio has protected itself against some of this gamesmanship, adopting a rule a decade ago under which certain expenses such as interest and royalty and trademark fees paid to out-of-state passive investment companies (PICs) must be added back into Ohio income for purposes of calculating corporate franchise tax. But this only protects against some of this sort of tax avoidance. As part of a budget-balancing proposal last year, Gov. Bob Taft proposed tightening up on this by making the addback apply to any related corporate entity. "Because the current law applies only to such payments which Ohio corporate taxpayers make to "PIC related members" (rather than to *any* related member), many Ohio corporate taxpayers are still able to shelter income from taxation by paying these expenses to non-PIC related members," said the governor's explanation of the proposal last year.[28] The Legislative Service Commission estimated the savings from this proposal at $50 million[29] this fiscal year – an indication that the revenues lost to the state because of tax planning are meaningful. The proposal, passed by the state House, did not go any further.[30]

Even that would not prevent other forms of tax dodging by multistate companies. Companies may carve up their operations in other ways to shift income out of Ohio to other states where it will not be taxed, or taxed to the same degree. One such strategy is to have subsidiaries in other states supply their Ohio operation at higher prices, reducing the income of the Ohio company and thus its corporate franchise taxes. This can be done not only with goods, but by having out-of-state subsidiaries charge consulting and other fees.[31] Because of such strategies, those companies located entirely within Ohio are at a disadvantage to multi-state corporations.

State corporate tax returns are private, so the specific tactics employed usually remain unknown. However, because Ohio does not force corporate taxpayers to consolidate all of their operations for tax-reporting purposes, it might permit a company that pays franchise taxes on its cable television systems in the state to avoid paying anything on the profits of cable networks that the

[27] Massachusetts Appellate Tax Board, The Sherwin-Williams Co. v. Commissioner of Revenue, No. F233560, July 19, 2000.

[28] Governor Bob Taft, Responsible Balanced Budget Solution, Tax Loopholes to be Closed, Oct. 16, 2001. Italics in the original. Material from the Department of Taxation explaining the proposal pointed out that, "These transfer strategies can only be utilized by larger, more sophisticated taxpayers that gain enough in tax savings from Ohio and other states to justify the cost of creating these corporate structures."

[29] Ohio Legislative Service Commission, Fiscal Note & Local Impact Statement, Sub. H.B. 405 as passed by the House, Nov. 1, 2001.

[30] Taft has included it among his current campaign proposals to close business tax loopholes (Randy Ludlow, "Hagan has fiscal plan; Taft says it's too early," *The Columbus Dispatch*, Sept. 19, 2002). Democratic candidate Tim Hagan has called for raising $500 million through closing business tax loopholes and ending tax exemptions ("The Hagan Plan for Ohio" cites Tax Expenditure Report estimates that corporate franchise tax exemptions will cost $479.8 million this fiscal year).

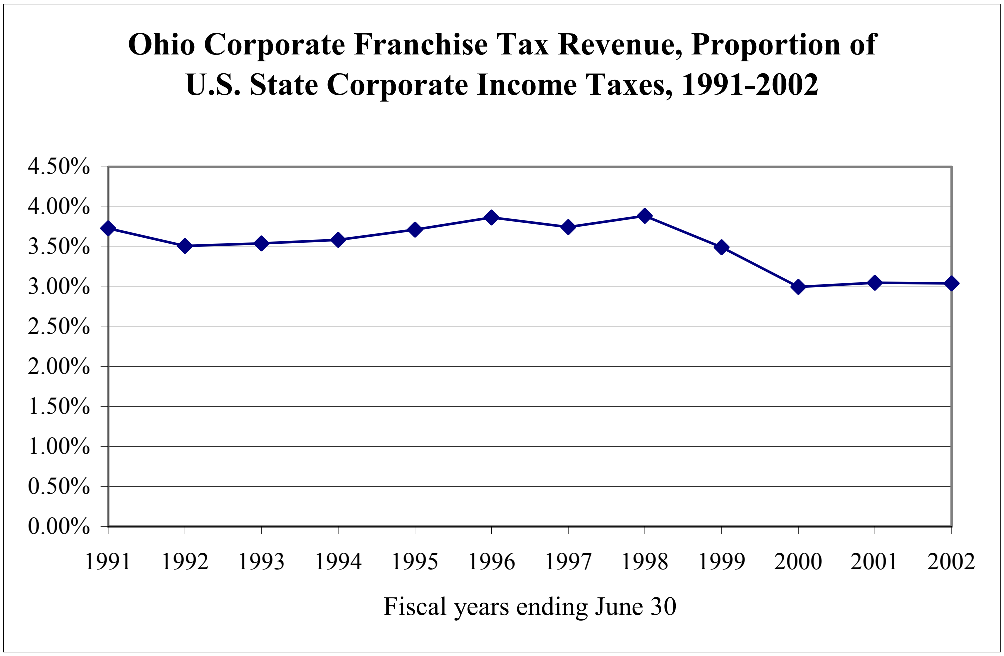
[31] Pomp, p. 61, and Bessey interview, Sept. 27. The addback proposal last year also would have covered management fees paid to related entities.

company also owns. The company could try to structure itself so its cable networks avoid crossing the threshold for taxability in Ohio, and that might be the more profitable part of the operation.

Ohio and the Nation

Ohio franchise tax revenues fell in absolute terms even in fiscal 1999 and 2000, when other states were seeing increases, or at least smaller declines, in such taxes.[32] Figure 6 depicts the recent relationship of corporate income tax collections in Ohio and for all states:

Figure 6:



Source: The Nelson A. Rockefeller Institute of Government, *State Revenue Report,* various issues.

The reduction in Ohio corporate franchise tax collections starting in fiscal 1999, after some years when such collections had been increasing relative to all the states taken together, owes in part to changes in Ohio law. (The state's relative performance to the national economy could also have played some role.) Effective in 1999, the General Assembly capped the maximum liability for non-financial companies under the net worth tax at $150,000, reduced rates under both the net-worth and corporate-income means of calculating the tax, and lowered the rate for financial institutions as well.[33] The Legislative Budget Office estimated at the time that, taken along with other measures that would increase revenues, the net effect would be to reduce overall state revenues by $56 million a year starting in fiscal 2000.[34]

[32] The Nelson A. Rockefeller Institute of Government, *State Revenue Report*, and U.S. Census Bureau, United States State Government Tax Collections

[33] It also changed the apportionment formula, so that a company's sales in Ohio are weighted more heavily than they had been before when the corporate franchise tax is calculated. This was also expected to be a factor in the reduced revenue. Table 1-11, p.45

[34]Legislative Budget Office, Summary of Law Changes FY 1996-2003 – LBO Estimate of Tax Cuts and Tax Credits (Impact on GRF in millions of dollars).

The Legislative Service Commission noted last summer that, "The timing of the full impact of those net worth tax changes on franchise tax revenues was unfortunate. In the current environment of plummeting corporate net income and profits, the cushioning effect of the net worth tax base on franchise tax receipts may have been reduced by the changes in (the FY 1998-99 operating budget bill)."[35] Corporate franchise taxes flowing to the General Revenue Fund were off 22.2 percent in fiscal 2002 from the year before. That was the second largest percentage decline on record, the LSC said. The revenue decline of nearly $203 million contributed to Ohio's budgetary problems

In the past, the net-worth component has functioned as something of a safety net, a role which has been diluted by the change in the law. Typically, more is paid under the net worth formula during recessions, when profits decline. For instance, a committee studying Ohio's taxes in 1994 found in a simulation that without a net worth component there would have been a 21.2 percent decline in 1991 franchise tax liability, compared to the 10.7 percent decline that actually occurred.[36]

Figures are not yet available beyond taxes due in 2001 on the previous year's net worth. So it is not possible to say yet how much the weakening of the net worth tax contributed to the most recent plunge in corporate franchise revenues. However, it's clear that lower rates and the $150,000 cap contributed to the reduction in franchise tax collections last fiscal year. In 1999, when the changes became effective, non-financial institutions paid 47 percent less in net-worth taxes than the year before.

Credits and Exemptions

Before and since then, credits and exemptions have been passed which also have reduced franchise tax revenues. The Legislative Budget Office tallied up law changes between fiscal 1996 and fiscal 2003 and found that altogether, tax cuts and tax credits to the corporate franchise tax would cost the General Revenue Fund $774 million for those years combined.[37] For the tax year 2000, credits to non-financial institutions amounted to $105 million,[38] reducing collections by more than 11 percent. However, the amount of credits almost undoubtedly has grown substantially since then, with greater use of existing credits and the addition of new ones. According to the Tax Expenditure Report produced by the Department of Taxation, the estimated impact on state revenues for this fiscal year includes $30 million from the job creation credit, $86.3 million from a manufacturing investment credit, and $31.8 million for electric plants using Ohio coal, among others.[39]

Some of these incentives are not well targeted. For example, the Ohio Tax Credit Authority last year approved a job creation tax credit worth $2.6 million over 10 years to Wal-Mart Stores Inc.

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[35] Doris Mahaffey, Legislative Service Commission, "Status of the General Revenue Fund—Revenues," *Budget Footnotes*, July, 2002, p. 253.
[36] The 1994 study resulted in the volume "Taxation and Economic Development, A Blueprint for Tax Reform in Ohio," Battelle Press, 1996. Table 1-11, p. 45. See Chapter 1, "Taxation and the Economy: A Plan for Reform," by Roy Bahl.
[37] Legislative Budget Office, Summary of Law Changes.
[38] Ohio Department of Taxation, 2001 Annual Report, Table 17. Cited by J. Donald Mottley in Aug. 27, 2002, testimony to the House Select Committee on Tax Reform
[39] State of Ohio, Executive Budget, Fiscal Years 2002 and 2003. Book Two, Tax Expenditure Report, prepared by the Department of Taxation and Submitted to the 124th General Assembly by Governor Bob Taft, January 2001.

for a warehouse that was already under construction in Washington Court House.[40] It granted another such credit, worth nearly $1.4 million, to Kroger Co. for a new distribution center consolidating three other Ohio warehouses without properly notifying all the affected communities. Such credits do not add to jobs that would be created anyway.

Other types of credits or exemptions have been added by the General Assembly in the past year. Newly formed "high-technology" companies in certain fields such as biotechnology and information technology will be exempt from the net-worth provision for three years. And companies making capital investments of more than $200 million over three years at one site with more than 1,000 jobs may also be eligible for income-tax credits.

Not all of the changes have reduced collections from the franchise tax. The legislature also decoupled Ohio from federal depreciation schedules, keeping a sizeable revenue drain from occurring. And it made changes in the tax on dealers in intangibles (such as stock brokers, mortgage companies and finance companies), which should expand the base of financial institutions paying the corporate franchise tax. As a result of these changes relating to financial companies, the Department of Taxation has estimated, those two taxes should bring in an additional $41 million in revenue in this fiscal year.[41]

Pass-through Entities

Apart from corporate tax planning, rate cuts and tax credits, the franchise tax also is declining because new businesses often are organized so that they escape the tax. "We are increasingly seeing other forms of business structure being used, forms that do not get captured under the corporate franchise taxes,"[42] said Carol Bessey, deputy tax commissioner at the Department of Taxation. S Corporations, limited liability companies and other so-called pass-through entities do not pay franchise tax; instead, their owners pay individual income tax on their earnings from these businesses. More than 20,000 new limited liability companies registered with the Ohio Secretary of State last year, more than the number of new for-profit corporations that filed.

The state thus receives revenue, but not through the franchise tax—and probably less than it would have received, were that income subject to the franchise tax. Altogether, the Department of Taxation estimates that 11 percent of revenues collected through the personal income tax represent payments made on business income.[43] That would amount to $800 million, a sum larger than the amount of corporate franchise taxes collected last fiscal year. A major part of that, however, is income from partnerships and sole proprietorships that have been exempted from the franchise tax for many years.

S Corporations were exempted in 1987, and the Department of Taxation estimated in its most recent Tax Expenditure Report that the S Corporation exemption would result in $93.4 million in foregone revenue from the corporate franchise tax in the current fiscal year (that is money over

[40] Zach Schiller, Policy Matters Ohio, "Wal-Mart Special: Ohio Job Tax Credits to America's Richest Retailer," July, 2002
[41] LSC, Budget Footnotes, July 2002, pp. 253-4.
[42] Carol Bessey, Interview, Aug. 23, 2002
[43] Bessey interview, Sept. 27, 2002.

and above what the state actually did collect through the individual income tax).[44] In fiscal 2001, such revenue would have added 9 percent to corporate franchise tax collections.

Seeing pass-through entities sending some of their income out of state, the Ohio General Assembly moved in 1998 to require them to withhold taxes on income paid to non-Ohio investors who otherwise might escape Ohio taxes. The pass-through entity tax totaled $43.9 million in tax year 2000.

As meaningful as that step was, the proliferation of pass-through entities is likely to continue eroding the Ohio corporate franchise tax, as it is around the country. Limited liability companies "offer new means for corporations and other businesses to engage in tax avoidance," Fox and Luna pointed out in their recent paper.[45] One way they noted is that, "the LLC structure potentially permits multistate corporations to shift income to non-taxing or lower-taxing jurisdictions." For instance, by creating an LLC 99-percent owned by a company in Delaware but operating in another state, nearly all of its income would go untaxed. Delaware does not tax such investments.

Structuring the Franchise Tax

It is impossible to know how much Ohio's top employers are paying in franchise taxes. In Wisconsin, a citizen can request from the state revenue department whether a particular corporation is filing a return in the state, and what its particular liability was in a given year. Though the Ohio Department of Taxation reports how much different industries are paying each year in franchise taxes, it does not regularly report how much is paid by big or small companies as a group. The 1994 study of Ohio's tax system tallied data on how much companies with more than $1 billion in net worth paid.[46]

New Jersey recently went further. The state disclosed that 30 of the state's 50 largest employers paid only the $200 minimum tax.[47] Among them were 10 companies with a combined $2 billion in New Jersey profits in 1999, which would have produced $177 million in taxes at the regular rate**.** In Alabama, 619 companies doing business in the state in 2000 paid no state income taxes on a total of $850 million in profits. Such corporate tax avoidance cut by $135 million funds that would have been used for school programs.[48]

Last year, Alabama approved legislation curbing the use of contingency fees by tax preparation firms.[49] The statute establishes that use of improper contingent fees is evidence of tax evasion.[50]

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[44] State of Ohio, Tax Expenditure Report, January 2001, p. 17.
[45] Fox and Luna, pp. 15-16.
[46] *Taxation and Economic Development, A Blueprint for Tax Reform in Ohio*. It found that in 1993, firms with net assets of over $1 billion represented 0.17 percent of all filers, but accounted for 19.22 percent of all liabilities. These companies also claimed 22.7 percent of new investment tax credits and 33.8 percent of all other tax credits.
[47] Robert S. McIntyre, "Jim McGreevey: Working Class Hero," *The American Prospect*, Sept. 9, 2002.
[48] Shailagh Murray, "Business-Friendly Alabama Puts Brakes on Tax Breaks," *The Wall Street Journal*, Sept. 30, 2002.
[49] Bucks testimony, Sept. 17, 2002, and interview with Michael E. Mason, Director of Tax Policy, Alabama Department of Revenue, Sept. 20, 2002.
[50] Code of Alabama 1975, Section 40-2A-17. http://www.ador.state.al.us/incometax/01act1088.pdf. The statute defines improper contingent fees according to the Code of Professional Conduct of the American Institute of Certified Public Accountants.

That takes away the incentive for accounting firms and others to hawk tax-cutting schemes in which they get fees based on how much is saved. The state has sent letters to accounting firms, informing them that this is improper.

Combined Reporting

Sixteen states require what is called "combined reporting," which cuts down on income-shifting schemes designed to avoid taxes. As Michael Mazerov of the Center on Budget and Policy Priorities explains, "If a state requires combined reporting, all related corporations that are operated as a single business enterprise, any part of which is being conducted in the state, are essentially treated as one taxpayer for apportionment purposes."[51] Intercorporate transactions between parent and subsidiary are eliminated, so a company could not set up subsidiaries in other states and reduce Ohio tax liabilities by attributing costs from these out-of-state entities; all of its operations would be included. Combined reporting has been used by California for many decades, and has been upheld by the U.S. Supreme Court.

"A state that does not require related corporations conducting a unitary business to file a combined report is at the mercy of its corporate taxpayers," wrote Pomp. "Transfer pricing, holding companies, and more subtle and less notorious strategies exist for exploiting separate entity states. Once the province of only the most sophisticated practitioners, these tax minimization approaches are now so widespread as to constitute orthodox planning tools."[52]

Roy Bahl, writing in the report of the most recent committee to study Ohio taxes, said that one of the ways in which the Ohio tax system was arguably obsolete was in "the failure to adopt combined income reporting to close off avenues for large corporations to use transfer pricing to avoid Ohio tax liability."[53] Ohio currently gives companies the opportunity to choose combined reporting. However, as the report of the most recent study committee pointed out, "The present approach of giving the option to file with combined income reporting when some minimum requirements are met almost certainly guarantees that the only groups of corporations filing combined reports are those that can reduce their tax liability by doing so."[54]

No law will eliminate clever schemes to avoid taxes. However, some experts also suggest that states should structure their tax systems so that it is harder to use untaxed entities such as partnerships to bury income where it will not be taxed. Bucks pointed in his testimony to the extreme example of Enron, which used offshore entities to shift income into foreign tax havens and did not pay U.S. corporate income taxes in four out of five years. Some 30 percent of its earnings one year came from one-time tax shelters. Such earnings are unsustainable, and distort the economy by driving up stock prices compared to others who do not use such devices. While obviously much of this issue cannot be dealt with at the state level, Mottley proposes that the state

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[51] Michael Mazerov, "Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenues for Many States," Center on Budget and Policy Priorities, April 9, 2002.
[52] Pomp, p. 62
[53] Taxation and Economic Development, A Blueprint for Tax Reform in Ohio, in the chapter by Bahl, "Taxation and the Economy: A Plan for Reform," p. 47.
[54] Ibid, in the chapter by Jorge Martinez-Vazquez and Martin Grace, "Corporate Taxation: The General Franchise Tax," p. 551.

require greater disclosure of transactions with related entities of any kind to help avoid Enron-style deals with partnerships that are not themselves taxed.

The Net Worth Tax

The net worth tax was the only way companies paid corporate franchise tax in Ohio until 1971, when the corporate income tax was added. The net worth tax in the past has provided more stable revenues, and a bedrock against tax avoidance. The 1994 tax report noted that it "serves as a revenue floor when profitability is down, and as protection against transfer pricing practices which might otherwise drive corporate tax liability to zero."[55] However, the committee recommended the elimination of the net worth tax, along with the approval of combined reporting.[56] It argued that the tax reduces profit rates for investment in the state, and is especially burdensome to capital-intensive manufacturers and start-up companies, hurting new business formation and economic development.[57] Among a long list of reasons, it also cited complaints from business taxpayers that the tax burdens them just when they are suffering from low income or losses, and that it amounts to double taxation, because the same assets are taxed under the property tax.

The General Assembly has not gone so far as to eliminate the net worth tax, but it has watered it down. Capping payments under the net-worth formula, as the legislature did in 1999, added to the volatility of state revenues. The cap discriminates in favor of large firms: Companies with a net worth of more than $37.5 million do not pay any more than the $150,000 cap.

The cap also reduced the state's ability to tax out-of-state companies doing business in Ohio. The existence of the net worth tax ensures that out-of-state companies just making sales in Ohio, which might be out of reach under federal law if the state had only a corporate income tax, can be taxed here.

Throwback Rules

That federal law is known as Public Law 86-272, and under it, states are not allowed to tax income from many companies that are just taking sales orders there.[58] If a company produces a product in one state, but sells it in another state where it is protected by the law, the income it receives from selling there will not be taxed by any state. This is called "nowhere income." Two dozen states, ranging from Texas to Illinois, have adopted "throwback" provisions, so that in these cases the income will be assigned (or "thrown back") instead to the state from where the product was shipped. If Ohio had such a provision, it would tax sales made by Ohio producers in other states where they are not subjected to such a tax.

Critics of throwback provisions argue that they would inappropriately tax companies on income that does not reflect economic activity in Ohio. However, such a rule would make up for

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[55] Ibid, in the chapter by Bahl, "Taxation and the Economy: A Plan for Reform," p.44.
[56] Ibid, p.53. "These reforms should be adopted together, or not at all," Bahl said.
[57] Ibid. See pp. 27 and 53-55 and in Martinez-Vazquez and Grace, pp. 548-550.
[58] The law "essentially prevents a state from taxing the income of a corporation whose only business activity in that state consists of the solicitation of orders for tangible goods, provided that the orders are sent outside the state for approval and that the goods are delivered from outside the state." Pomp, p. 58.

restrictions on the state's ability to tax corporations that do business in Ohio and do not pay franchise taxes here. If every state had a throwback rule, these would cancel each other out.

Recommendations

Ohio should take a number of steps to restore the vitality of its corporate franchise tax and ensure that it extends as much to multistate companies as to small businesses:

- Ohio should consider requiring large corporations to disclose their corporate franchise tax returns.[59] At the least, it should allow, as Wisconsin does, for citizens to find out from the state whether a particular company is filing a return, and what its particular liability was in a given year. Ohio also should follow the lead of New Jersey and Alabama and report on overall corporate tax compliance.
- To cut down on tax-shifting flimflams, the Ohio General Assembly should approve Gov. Taft's proposal from last fall to expand the addback so that not just passive investment companies but all related entities are covered.[60] Ohio needs to go beyond that, however. Mandatory combined reporting is a necessity if Ohio's corporate franchise tax is to remain viable. The Department of Taxation estimates that instituting combined reporting would generate roughly $200 million in additional annual revenue.[61]
- The state should eliminate the $150,000 net-worth cap. At a time when tax avoidance is becoming a bigger and bigger problem, we need a backstop to make sure that companies are paying tax for the privilege of doing business in Ohio.[62] Money-losing companies still use public services, from roads their trucks use to deliver goods to public schools and colleges that educate their workers. The tax should apply equally to companies large and small.
- The General Assembly also should consider adding a throwback rule to help ensure that Ohio companies are taxed on income that stems for Ohio production and now is untaxed by any state.
- Adopt a moratorium on creation of new types of tax credits and create stricter standards for the award of existing ones.

New solutions to corporate tax avoidance will probably emerge as more states realize how their corporate income taxes are eroding in the face of it. Ohio should track Alabama's new law on

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[59] Columnist Alan Murray urged in *The Wall Street Journal* recently that publicly traded companies should be required to make their federal tax returns public, so that shareholders can analyze the differences between the income figures companies report to shareholders and those they tell the government. He noted that U.S. Senators Charles Schumer of New York and Charles Grassley of Iowa were pursuing the idea. Alan Murray, "Narrowing the Gap Should be Priority of Next Congress," *The Wall Street Journal*, Oct. 8, 2002, p. A4.

[60] Gov. Taft also proposed eliminating the dealers in intangibles tax in favor of the corporate franchise tax, another sensible idea. The dealers in intangibles tax "allows some taxpayers to avoid a higher tax liability under the corporate franchise tax as either a financial institution or a general corporation," said material explaining the proposal.

[61] Interview with Carol Bessey and Frederick Church, administrator, Tax Analysis & Research Division, Ohio Department of Taxation, Oct. 8, 2002.

[62] New Jersey legislators recently came to the same conclusion. They approved an alternative minimum tax on gross profits or gross receipts over certain amounts, which companies will pay if it exceeds what they would pay under the regular tax on net income.

contingency fees, and review whether more steps should be taken to ensure that pass-through entities are not abused by companies seeking to escape taxation.

Franchise Taxes and Economic Growth

If Ohio's corporate franchise tax were to look less like swiss cheese, what would it mean for the state's economy? Would it harm economic growth? A number of factors indicate otherwise.

For one thing, the franchise tax does not cover most new Ohio businesses, particularly high-technology businesses, so it is not a major barrier to business formation. Most new businesses in Ohio incorporate as entities such as limited liability companies that are exempt from the franchise tax. And the break passed last year by the General Assembly in effect exempts money-losing high-tech businesses from the tax for three years.

Franchise taxes, in any event, account for only a fraction of overall business taxes in the state. According to Prof. Hill of Cleveland State, overall state and local business taxes amounted to nearly $9.2 billion in fiscal 1999. The corporate franchise tax accounted for $1.15 billion, or an eighth of the total. Though some of the total comes from special-purpose taxes on particular industries, corporate franchise taxes, even when one adds the income taxes businesses pay to municipalities, do not represent a large share of the business tax burden.[63] Nor does that even take into account unemployment insurance taxes or workers' compensation costs.

Studies comparing overall taxes on business in Ohio with other states have produced mixed results.[64] This is a trickier topic than one might think, since tax rates vary from city to city and industry to industry. However, Prof. Peter Fisher of the University of Iowa used a model of hypothetical firms in 16 manufacturing sectors. He concluded that Ohio's 1998 tax rates on such new manufacturing investment, including incentives, were lower than 16 of 19 other states.[65] The consulting firm McKinsey & Co., which studied factors in state economic growth in 2000 for the Ohio Business Roundtable, found that that Ohio's average tax burden was lower than some of its competitor states and lower than places that are growing.

Moreover, the impact of business taxes on new investment is uncertain, at best. Robert Tannenwald, an economist at the Federal Reserve Bank of Boston, found modest differences in business tax climate among most states, and that the impact of state and local tax burdens on business investment is small and statistically insignificant. "This finding buttresses existing empirical evidence that the effectiveness of state and local tax policy as an instrument of economic development is uncertain," Tannenwald said. "While tax characteristics may affect a state's competitiveness, policymakers should view with caution claims that changes in tax policy will

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[63] Hill, Table 4-1, p. 12, and Appendix Table 4-12.

[64] For instance, Barents Group found that the average industry tax burden in Ohio was second-highest among the 15 states it examined in 1999 (Cited in Fox testimony, Aug. 6, 2002). On the other hand, the *Economic and Demographic Trends Newsletter* found that in fiscal 1999, Ohio's state and local business taxes as a share of its Gross State Product were lower than all of its neighboring states (*The Economic and Demographic Trends Newsletter*, Vol. 14, No. 3 April 2002).

[65] Peter Fisher, "Tax Incentives and the Disappearing State Corporate Income Tax," Table 6. *State Tax Notes*, March 4, Vol. 23, No. 9.

dramatically improve their state's economy. Enhancing public services valued by businesses may be a more effective economic development strategy."[66]

Mazerov of the Center on Budget and Policy Priorities points out that states that have adopted throwback rules and combined reporting are disproportionately represented among those with high manufacturing job growth between 1995 and 2000.[67] These include California, Colorado, Kansas, Oregon and Utah. Fox likewise testified that states that have combined reporting show no corresponding slowdown in economic growth.

Some seem ready to chase the very uncertain prospect that reductions in business taxes will result in greater investment. Others have spoken of tax reforms that would broaden bases while lowering rates.[68] But given the weakened status and plunging revenue from the corporate franchise tax, we must first make sure that we are broadening the base, before giving thought to additional rate reductions. Ohio needs to strengthen its corporate franchise tax, to provide the stable revenue the state needs and ensure equity among taxpayers big and small.

[66] Robert Tannenwald, "State Business Tax Climate: How should it be measured and how important is it?" New England Economic Review, January/February 1996. Fisher found in the 20 states his model covered that between 1990 and 1998, "Tax rates on manufacturing investment after incentives were actually higher among the states *gaining* manufacturing share…" (Italics in the original) Fisher, pp. 9-10. The 20 states in his model account for 75 percent of U.S. manufacturing.
[67] Mazerov, p. 8
[68]Gongwer News Service, Ohio Report No. 184, Volume 71, September 25, 2002

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