Executive Summary

Ohio stands on the brink of eliminating its corporate income tax for nonfinancial companies, known as the corporate franchise tax. Under the budget bill passed by the House of Representatives in April, the corporate franchise tax would be replaced, along with the tax on tangible personal property, with a new gross receipts tax called the Commercial Activity Tax. This would make Ohio one of only six states in the country without a corporate income tax. While the CAT has some positive features, it should not be used to replace the corporate franchise tax for a number of reasons.

Everyone agrees that the franchise tax has been weakened so that it does not produce the revenue it once did. Many of the state's largest companies are paying the yearly minimum of $1,000 because they are able to plan around the tax system, shifting their income to other states and reducing their liability for Ohio corporate franchise tax. A major reason for the weakness of the tax is state legislation that has allowed it to be legally circumvented. For example, the General Assembly in 1999 capped how much companies must pay on their net worth. As many as 19 of the state's top 50 companies benefited from this cap in tax year 2004, saving millions of dollars. It would be bad policy first to weaken a tax, and then eliminate it because it has been weakened. A better approach would be to strengthen it, which could be done easily enough through steps cited below. These include measures to keep companies from planning around the tax.

Even though many big companies manage to limit what they pay under the franchise tax, a number of others continue to pay a significant amount. In tax year 2003, the last year for which such data are available, 95 companies paid at least $1 million, or $204.5 million in total. Though collections remain hundreds of millions of dollars below late 1990s levels, they increased 30 percent in the first 10 months of fiscal 2005, to $774 million. This indicates that the tax remains viable.

Wiping out the corporate franchise tax would mean that highly profitable companies no longer would have any obligation to pay taxes based on their profits, violating a bedrock principle of fair taxation. Some companies would pay millions of dollars less than they do now. Yet it likely would add to the tax burden on low- and middle-income taxpayers, who already pay more of their income in state and local taxes than do affluent Ohioans. Manufacturers are not unduly burdened by the corporate franchise tax, so its abolition is not likely to spur manufacturing investment.

Perhaps most importantly, under the bill passed by the House, the CAT would not come close to substituting for the amount of taxes being collected under the levies that it would replace. When fully implemented in fiscal year 2011, the CAT would generate a projected $1.61 billion, without accounting for new exemptions in the House budget bill. That is far short of the $2.26 billion in estimated taxes that will be eliminated. This would reinforce the long-term trend in Ohio for taxes to shift from business to individuals, and leave a revenue hole of hundreds of millions of dollars a year for future legislatures to fill. If a Commercial Activity Tax is imposed, it should be at a considerably higher rate

than that proposed by Gov. Taft and approved by the House, to make up for all of the taxes it is replacing and the shrinking business share of the state and local tax load.

The CAT would sharply reduce the number of credits and exemptions that businesses may receive compared to those available on the corporate franchise tax, or the abatements companies receive on tangible personal property. However, it likely would be a magnet for business complaints about the unfairness of paying a tax unrelated to business conditions. In fact, legislators already are carving out exemptions, a point that the Taft Administration has criticized in the House-approved budget. A state tax department official has estimated three of the House changes would cost upwards of $100 million a year in revenue by fiscal year 2010. That is in addition to $100 million in annual credits included in the original proposal.

Critics argue that Ohio's corporate franchise tax should be eliminated because its relatively high rate discourages businesses from operating here. However, Ohio ranks well below average in how much revenue the tax brings in. Most companies are likely to review the taxes they would actually pay, not tax rates that may never be imposed in reality. In any event, taxes are a secondary factor in corporate location decisions. One recent report commissioned by the Ohio Department of Development found that the CAT would be better for the Ohio economy than the two taxes it is designed to replace. But the difference is tiny, and uncertainties such as which companies ultimately would pay the CAT make it hard to predict the effect one way or the other.

Ohio should adopt the following reforms to bolster the franchise tax while making it fairer to those who already pay, and to make sure business pays its fair share of state and local taxes:

- Require companies to report all of their related operations in a single, combined tax filing, cutting down tax planning that shifts income out of Ohio and artificially lowers corporate franchise taxes;
- Eliminate the cap on net worth payments, which discriminates against small businesses and costs the state close to $100 million a year;
- Eliminate or limit credits that are steadily weakening the tax;
- Add a throwback provision, under which Ohio would tax sales made by Ohio producers in other states where they are not subjected to tax.
- Consider bringing passthrough entities such as S Corporations and limited liability companies under the tax, as Kentucky has just done with its corporate income tax.