BEFORE THE 2020 TAX POLICY STUDY COMMISSION OF THE OHIO GENERAL ASSEMBLY

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TESTIMONY
OF
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Mr. Chairman and members of the Committee, my name is Mark Engel. I'm the Partner in charge of Bricker & Eckler's Cincinnati-Dayton office; my practice is focused on taxation issues, with concentrated experience in all aspects of state and local taxation, including tax planning, compliance, and litigation in sales and use, income, commercial activity, public utility, and property taxation as well as economic development. I also serve as tax counsel for The Ohio Manufacturers' Association (OMA). I'm testifying today on behalf of OMA. The OMA was created in 1910 to advocate for Ohio's manufacturers. Its mission is to protect and grow Ohio manufacturing.

For Ohio to be successful in a global economy, the state's tax structure must encourage investment and growth and be competitive nationally and internationally. A globally competitive tax system is characterized by (a) certainty, (b) equity, (c) simplicity and (d) transparency. Economy of collections and convenience of payment also are important considerations.

Generally, manufacturers support efforts to broaden the business tax base, which enables lower rates. To preserve the integrity of the broad tax base and ensure fairness, credits and exemptions should be reduced and discouraged. The objects of taxation must be clearly defined. Where needed, government incentives are best structured as grants rather than as tax credits. And, in general, earmarking and dedicating general tax revenues to specific purposes should be discouraged.

It is poor tax policy to single out any one segment of the economy or group of taxpayers to bear the cost of tax relief for the general population. Similarly, except to resolve existing inequality, or in cases of other policy imperatives, Ohio tax policy should not create a windfall for any group of taxpayers at the expense of other groups of taxpayers.

Compliance and administration of any tax should be as simple and inexpensive as possible for taxpayers and tax administrators alike.

Good tax policy also generates necessary revenues to support the essential functions of government. To ensure transparency regarding the true cost of government and the rate of its growth, however, funding government programs with fee revenue instead of general fund revenue should be discouraged. Good budgeting and spending restraint at all levels of government are vital to ensure a competitive tax environment.

Major tax reforms approved by the Ohio General Assembly in 2005 and additional reforms from 2011-2015 have led to significant improvements to a tax system that was for many years widely regarded as outdated. Reforms included reducing overall tax rates, eliminating tax on investment, broadening the tax base, providing more stable and predictable revenues, and simplifying compliance.

The elimination of the tangible personal property tax, the corporate franchise tax, and the estate tax has strengthened the competitiveness of Ohio's tax system. So has the reduction of the personal income tax rate as well as the creation of a broad-based, low-rate commercial activity tax.

2005 Tax Reform

Prior to 2005, Ohio's tax structure was essentially unchanged since the 1930s. At that time, Ohio's economy was driven by agriculture and manufacturing. Its tax structure reflected that economy. The major taxes were the real property tax, the sales and use taxes, the tax on tangible personal property used in business, and the corporation franchise tax measured on net worth. However, the franchise tax and the tangible personal property tax, especially, both hit capital-intensive industries harder than others and had to be paid whether the entity made, or lost, money. Thus, the manufacturing sector paid an inordinately high level of state tax when compared with other segments of the economy.

As services made up a larger share of Ohio's economy over the years, the inequality in the state tax burden between manufacturing and other segments of the economy was exacerbated. Many service sector concerns operate without a significant investment in capital; hence, their tangible personal property and net worth franchise tax liabilities were minimal. Many of these services can manipulate their finances to minimize income; as a result, little income tax was generated. In addition, many of these new service entities were organized as pass-through entities that were not subject to the franchise tax. As the demand for state services grew, the only recourse was to raise existing tax rates on existing taxpayers. In many cases, that meant an increasing tax burden for Ohio manufacturers.

Paradoxically, Ohio continued to add exemptions from, and exceptions to, the various taxes during this time. As a result, Ohio was saddled with a number of taxes that had high nominal rates, but struggled to raise sufficient levels of revenue for governmental operations. The discrepancies between taxpayers and economic segments also increased and compliance with the existing taxes became more complicated.

Calls for Reform

During the 1960s, calls for reform in Ohio's tax structure began. Over the years, various band aids were applied to Ohio's tax structure in order to attempt to reduce its inequalities. At the same time, Ohio continued to enact exemptions from, or exceptions to, the various taxes, thereby creating increasing disparity and complexity.

With the dawn of a new millennium, calls for tax reform increased. Dr. Ned Hill of Cleveland State University independently conducted a study that examined the impact of state tax policy on Ohio's economy and called for the elimination of the tangible personal property tax and existing dual-based franchise tax, to be replaced with a broad-based, low-rate tax based on payroll. The study demonstrated how capital-intensive segments of the economy, such as manufacturing, construction, and mining, paid anywhere from three to 11 times more state taxes than did members of many service industries.

Tax Reform Enacted

Finally, in early 2005, true tax reform was proposed. The goals of tax reform were:

- Eliminate tax on investment and shift to the taxation of consumption;

- Broaden the over-all business tax base;
- Reduce over-all business tax rates;
- Provide a more stable and predictable flow of revenue; and
- Simplify compliance.

The result was a comprehensive overhaul of Ohio's tax system by H.B. 66. As enacted, the bill:

- Eliminated the tangible personal property tax on new investment in manufacturing and phased out the tax on all general business property over 4 years;
- Phased out the corporation franchise tax for most corporations over 5 years;
- Phased in a 21 percent reduction in personal income tax rates ratably over 5 years (the last reduction was delayed 2 years in 2009 in an effort to balance the state budget, but was implemented in 2011); and
- Enacted the commercial activity tax ("CAT"), a broad-based, low-rate tax measured by gross receipts from virtually all business activities and entities.

H.B. 66 became law in June 2005. Although generally opposed to gross receipts taxes because of their compounding nature, the broad base due to limited exclusions and the low rate caused many skeptical taxpayers to warm to the tax as the net savings over the former franchise and personal property taxes became clear. In addition, compliance costs were slashed as taxpayers no longer had to undertake the arduous process of preparing personal property tax returns or corporation franchise tax reports.

Results of Tax Reform

Due to the phased implementation of the provisions of H.B. 66 and the general economic slowdown that has gripped the country over the past few years, questions have been raised regarding the effectiveness of the tax reform efforts. OMA has been at the forefront in demonstrating that, indeed, the effort was worthwhile.

- In 2009, Ohio won Site Selection magazine's "Governor's Cup" for an unprecedented fourth consecutive year. The Governor's Cup is awarded annually to the state having the most major business expansions in the nation.
- A January 2009 Ernst & Young study indicated that Ohio's business tax burden rated between 18th and 23rd best among states on three different scales of comparison. Another Ernst & Young study conducted for the Ohio Business Development Coalition showed that Ohio had the lowest effective tax rates on new capital investment in the Midwest.
- The Small Business & Entrepreneurship Council's Business Tax Index in 2008 rated Ohio's state tax system as 14th best nationally.

- In March 2010 the Federation of Tax Administrations released an analysis of new data from the U.S. Census Bureau showing that for FY 2009, Ohio's per capita state tax burden was the 16th lowest; as a percentage of personal income, the burden was the 18th lowest.
- In April 2011, Ernst & Young and the Council on State Taxation issued a report entitled "Competitiveness of State and Local Business Taxes on New Investment" in which they concluded that Ohio had the third lowest rate of state and local taxation on new business investment. The report laid this result directly at the feet of the 2005 tax reform law.
- In early 2013, Site Selection Magazine honored Ohio as having the 5th most favorable tax climate for mature firms and the 3rd most favorable tax climate for new firms for fiscal year 2012.
- Finally, according to the Ohio Department of Taxation, Ohio is one of only six states that do not tax corporate profits, and one of 10 that do not tax business personal property.

Commercial Activity Tax

Much has been debated regarding the commercial activity tax (CAT). For manufacturers, while the tax is not perfect, it has done much to spur growth and investment in Ohio's largest industry.

According to Ohio Department of Taxation Fiscal Year 2014 Commercial Activity Tax Returns data, manufacturers made up the second-largest group of CAT taxpayers, representing 10.2 percent of all taxpayers (retail trade is the largest).

And, manufacturers pay 26.8 percent of the state's total – far more than any other group (in terms of CAT revenues based only on the 0.26 percent CAT rate for gross receipts in excess of $1 million).

In addition, CAT filers with taxable gross receipts of $1 million or less accounted for 66.7 percent of all filers in fiscal year 2014, but only 0.7 percent of the total liability for that period.

As noted above, some of the most important aspects of the CAT are its broad base, its low rate, and its broad application to business entities. Those attributes can only be maintained when the state stands firm against pleas for individual carve-outs and exemptions.

When it was first enacted, there were few exclusions from the CAT and only four credits. The tax expenditure associated with those exclusions in 2009, the first year the tax was fully phased in, was approximately $300 million. Those exclusions were built into the tax as enacted and the 0.26 percent rate was established with those exclusions in mind.

In its fiscal year 2014 tax expenditure report, the Department of Taxation lists a larger number of exclusions and credits to the CAT. The total cost of those expenditures is over $600 million! Thus, in just 10 years, additional credits and exclusions were added to the tax that doubled the amount of the tax expenditure.

The CAT is a stable tax. Although it is a gross receipts tax that pyramids along the economic chain, it is tolerated because of its broad base and low, low rate. However, in less than 10 years, tax expenditures associated with the tax have doubled. One wonders how much longer chipping away at the base can continue before the calls to increase the rate become too loud to ignore. Ohio traveled down this path before with the franchise and personal property taxes. The trip was a disaster. Ohio should not venture down that path again with the CAT.

The CAT was enacted as a tax on commercial activity. All enterprises engaged in such activity should be paying the CAT; in fact, equality in the burden of taxation demands that they all remain subject to the tax.

Personal Income Tax

As noted earlier, sound tax policy dictates that any tax should have a broad base, a low rate, and few exclusions in order to minimize economic distortion. OMA applauds recent efforts to reduce Ohio's personal income tax rates. However, it is concerned that those efforts have typically been tied to a proposal to increase the sales tax, particularly on business consumption. This tax-shifting is not beneficial and may be counter-productive as businesses and consumers adjust to higher and higher sales tax rates. Rather, if income tax rates are to be reduced further, exclusions and exemptions from the personal income tax ought to be re-examined. If rates are reduced, the need for those exclusions and exemptions disappears. This would provide a broader base and a lower rate for all taxpayers, reduce overall taxes, and avoid the problems of tax-shifting.

Ohio currently relies upon a number of taxes of general application to fund its operations. Tax-shifting and other efforts to reduce or increase reliance on any of those taxes should be considered with great caution. One only needs to consider the crisis in Nevada in 2008, or the current crisis in Alaska, to recognize the problems of over-reliance on any one tax. Just as a broad base is important for any single tax, a broad base of general taxes is equally important for the fiscal welfare of Ohio.

Sales and Use Taxes

Ohio's sales tax was first enacted as a temporary measure in the depths of the Great Depression in the 1930s. At that time, it was conceived as a tax on final personal consumption of tangible goods. One year after initial enactment, the use tax was enacted; the two taxes were made permanent and the first exemption for machinery and equipment used to produce tangible personal property for sale by manufacturing was added. Similar exclusions were made for other activities that, similarly, resulted in the production of goods that would be subject to the tax upon final sale.

The rationale for these exclusions is simple: The taxes are intended to be imposed upon the final consumption of goods and, now, those selected services that are subject to tax. Intermediate transactions prior to the final sale of the product, including the acquisition of machinery and equipment and the raw materials that are incorporated into the final product, are not intended to be taxed. The basis for this is four-fold:

First, imposing the tax on intermediate transactions (sometimes called business inputs) causes the tax to be imposed at each step in the production of a good. This causes the tax to pyramid at each step of the economic ladder, resulting in an effective tax rate that may be much higher than the statutory rate. For example, in conjunction with the 1994 tax study commissioned by the General Assembly, the staff provided an example in which a sales tax rate of 6.5 percent applied to two stages of production resulted in an effective tax rate of 9.5 percent at the time of the final retail sale.[1]

Second, imposing the tax on business inputs increases the cost of doing business through the higher prices that result from the tax. Business generally will respond to higher costs in a combination of three ways: It may decide to charge higher prices; it may pay lower wages to workers (or expatriate those positions elsewhere); or it may provide a lower return on investment to owners.[2]

Third, direct inputs lead to the production of more valuable goods that are ultimately subject to the tax.

Fourth, the provision has economic development implications. Every single state that surrounds Ohio has a sales tax. Every one of those states has some sort of exemption from the tax for machinery and equipment used in the production of tangible goods to be sold by manufacturers. Moreover, the *1994 Study* also found that lower rates of taxation on business equipment increase the rate of business formation of smaller firms. Thus, imposing the sales tax on manufacturing machinery and equipment puts Ohio at a disadvantage from an economic development perspective.[3]

The application of sales and use taxes to business inputs has been the subject of comment on at least two prior occasions in Ohio. In 1982, the *Final Report and Recommendations of the Joint Committee to Study State Taxes* (114th General Assembly, December 1982), pp. 15-16 concluded that the taxes should be imposed broadly on consumer spending, but very selectively on business spending. Similarly, the *1994 Study* at p. 5-4 and the 1994 Staff Report at p. 27 both recognized that the sales tax should only be imposed upon the final consumer and that business inputs should not be taxed at all. The taxation of business inputs should be avoided because doing so leads to multiple levels of taxation and economic disadvantages. Moreover, the *1994 Report* concluded that if the sales tax is extended to services, there should be liberal exemptions for transactions between businesses.

However, this does not mean that manufacturers do not pay sales and use taxes in Ohio. Manufacturers purchase and use many goods and services that are not included in the manufacturing exemptions. Those items include machinery and equipment that is used before manufacturing begins, or after it ends; cleaning equipment and supplies; maintenance and repair equipment and supplies; storage facilities; most safety items; and office supplies and

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[1] Roy Bahl, Ed., *Taxation and Economic Development: A Blueprint for Tax Reform in Ohio* (Battelle press 1994), p. 277-278 ("*1994 Staff Report*.").

[2] *Taxation and Economic Development in Ohio: A Blueprint for the Future*, final Report of the Commission to Study the Ohio Economy and Tax Structure (December 23, 1994), p. iii ("*1994 Study*").

[3] *Id*., at p. 5-4.

equipment and motor vehicles. As a result, manufacturers pay millions of dollars in sales and use taxes annually to the state of Ohio.

According to the 2014 Annual Report of the Ohio Department of Taxation, manufacturers as an economic segment paid more than $410,000,000 in sales and use taxes directly to the state of Ohio. This is in addition to the untold millions of tax dollars that were paid to, and reported by, vendors and retailers located in Ohio. It appears that in terms of tax directly owed to the state, as opposed to tax that is collected from others, manufacturing is one of the largest payers of sales and use taxes in the state.

Since 2005, Ohio has attempted to move away from the taxation of business investment. It eliminated the tax on business tangible personal property. It eliminated the net worth base of the corporation franchise tax. And, it excludes from the commercial activity tax, receipts in the nature of a return on investment. As noted earlier in my remarks, the purchase of machinery and equipment by manufacturers is not final consumption. Rather, it reflects an investment in the business. The sales tax exemption for manufacturing machinery and equipment is consistent with this policy.

Imposing the sales tax on business inputs, including manufacturing machinery and equipment (and labor) is contrary to sound tax policy. As previous tax study commissions have concluded,[4] good tax policy is based on simplicity, equity, stability, neutrality and competitiveness. Removing the exemption and subjecting those purchases to tax will render the tax more opaque, more complex, and less fair as final consumers who are less economically advantaged will pay an even higher proportion of their family income in sales taxes. Removing the exemption violates the principles of neutrality and competitiveness as it results in higher costs, which may influence economic decisions and competitiveness. Taken together, all these factors may in fact render the tax less stable.

Exclusion of Tax on Services as Manufacturing Inputs

There are two specific cases in which the sales or use tax should be amended to exclude specific manufacturing service inputs. I'll briefly describe the recommendations:

Ohio does not impose sales or use taxes (or the CAT) on the wages paid to employees. Just as wages are not subject to such taxes; and business inputs, such as ingredients, machinery and equipment, are exempted from the sales and use taxes, so too should amounts paid for temporary employees engaged in manufacturing activities that are otherwise exempt from the tax. Such employees are a business input; the sales tax should not apply to transactions by which such labor is obtained.

House Bill 343 currently pending in the House would address this issue for all employers. However manufacturers have especially solid policy reasons for this exclusion.

Effective January 1993 in order to fill a hole in the state budget, employment services were added as a taxable service by a conference committee facing a midnight deadline to reach

[4] *1994 Study*, p. 5-1; *Report of the Committee to Study State and Local Taxes* (March 1, 2003), p. 6.

agreement on a new budget. A taxable "employment service" includes any transaction in which a person provides personnel to perform work under the supervision or control of another, whether on a short- or long-term basis, where the personnel are paid by the person who provided them. The entire amount paid for the service serves as the base on which the tax is calculated.

Many manufacturers assumed that the existing manufacturing exemption, which exempted purchases of machinery and equipment used to produce tangible personal property for sale in a continuous manufacturing operation, would also cover workers on the manufacturing floor that operated the exempt equipment. Manufacturers and other purchasers of employment services also believed that in appropriate circumstances the services would be resold. After protracted litigation, they were disabused of both notions.

Another area that served fertile for litigation was the exclusion for employees that were "permanently assigned" to the purchaser. As noted previously, there were two conditions to this exclusion. First, the employees had to be provided pursuant to an agreement of a least a year in duration. Second, the agreement had to "specify" that the employees were provided to the purchaser on a "permanent" basis.

This provision likewise resulted in a flood of litigation.

The Department of Taxation continues to pursue employment services aggressively. It argues that employee turnover is a sign that the employees are not permanently assigned. It also takes the position that an agreement must set forth the name of every single employee covered by the agreement, and that if any of the employees provided under an agreement are not provided on an indefinite basis, then the entire agreement is tainted and none of the employees qualify for the exclusion.

In recent audits, the Department takes the position that virtually any transaction involving personnel is a taxable employment service. Thus, transactions in which outside consultants are retained to provide services, such as computer and software design, engineering, or a skilled trade, are routinely picked up on audit as employment services.

The Tax on Employment Services Should Be Repealed

House Bill 343 proposes to do away with the tax on employment services completely. The bill deletes "employment services" from the list of taxable transactions in R.C. 5739.01(B)(3)(k); it deletes the definition of "employment services" found in R.C. 5739.01(JJ); and deletes reference to the provision in other statutes.

Repeal of this provision reflects sound policy.

First, repeal is consistent with the recent efforts of Ohio's tax policy to move away from the taxation of economic investment and towards personal consumption. Manufacturers invest in manufacturing machinery and equipment in order to expand or maintain their capacity to provide jobs and to produce a product for sale, a product that in most cases will be subject to the sales and use taxes when it is sold and used. Similarly, it invests in workers for the same reasons.

Since 2005, Ohio has attempted to move away from the taxation of business investment. It eliminated the tax on business tangible personal property. It eliminated the net worth base of the corporation franchise tax. And, it excludes from the commercial activity tax, receipts in the nature of a return on investment, including labor costs. Repealing the sales tax on employment services is consistent with this policy.

Second, imposing the sales tax on business inputs such as manufacturing machinery and equipment and labor is contrary to sound tax policy. As previous tax study commissions have concluded, good tax policy is based on simplicity, equity, stability, neutrality and competitiveness. Subjecting employment services to tax renders the tax more opaque, more complex, and less fair as final consumers who are less economically advantaged pay an even higher proportion of their family income in sales taxes. The tax on employment services violates the principles of neutrality and competitiveness as it results in higher costs, which may influence economic decisions and competitiveness. Taken together, all these factors may in fact render the tax less stable.

Just as wages are not subject to sales and use taxes; and business inputs, such as ingredients, machinery and equipment, are exempted from the sales and use taxes, so too should amounts paid for temporary employees engaged in manufacturing activities be excluded from the tax. Employees are a business input; the sales tax should not apply to transactions by which such labor is obtained.

Third, the provision has generated more and more litigation as the Department has taken increasingly aggressive positions with respect to it. The provision is neither clear, nor is it easy to administer.

An additional issue is that Ohio also taxes industrial janitorial and maintenance services. Manufacturers' production facilities and the equipment components of their production processes require continuous repair and maintenance. Without the required cleaning, repairs and maintenance the machinery breaks down and fails to produce acceptable products for sale to customers. Cleaning industrial assets is absolutely critical to the manufacturing process. It is a necessary business input and sales tax should not apply.

Severance Tax

While I am sure this commission will be taking a deeper dive into the severance tax issue, the OMA would like to take a couple of brief moments to touch on the issue.

The OMA recognizes that Ohio's current severance tax structure makes Ohio very competitive, one of the most competitive and drilling-friendly states according to provided data. We note the severance tax provisions in Ohio law, having first been enacted in 1971, are 40 years old and have not been materially updated. More extensive benchmarking of effective tax rates on the measure of energy severed would be helpful to inform policy decisions.

Even though new manufacturing investment does not qualify for cost recovery, the OMA recognizes the commonplace nature of cost recovery offered by other states to the oil and gas industry and does not object to some competitive level of cost recovery to spur new investment.

We note that a severance tax is an excise tax. An excise tax is typically upon a specified activity in order to help defray some special costs associated with that activity. In the case of the severance tax, those special costs might include regulatory, environmental, and health concerns, as well as infrastructure concerns for the communities in which the activity takes place. However, good tax policy demands that such a tax should not be used to fund a wide-scale reduction in some other tax of general application.

Conclusion

The OMA supports tax policy that supplies sufficient revenue for the execution of necessary state services in a manner that stimulates economic growth, investment and job creation. Tax policy should encourage growth of capital, and growth in jobs in Ohio.

Manufacturing is the largest contributor to the state's GDP, contributing more than 17.5 percent. The success of Ohio manufacturing – through its vast network of in-state customers and suppliers - large global firms and their local supply chains - enhances the economic vitality of all other Ohio industries and Ohioans' quality of life. Reducing tax rates in a manner that treats all taxpayers fairly should be encouraged.

Thank you very much for the opportunity to comment and provide input to this commission. Ohio's manufacturers are prepared to help improve the business climate in the state. We look forward to continuing our partnership with the administration and the General Assembly.

I'll be pleased to answer any questions you may have.