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

**SENATOR BOB PETERSON AND REPRESENTATIVE JEFF MCCLAIN**
**CO-CHAIRMEN**

**TESTIMONY**
**OF**
**MARK ENGEL**
**BRICKER & ECKLER LLP**
**OMA TAX COUNSEL**

**FEBRUARY 24, 2016**

Senator Peterson, Representative McClain and members of the Commission, 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 regarding tax expenditures and the Commercial Activity Tax (CAT). The OMA was created in 1910 to advocate for Ohio's manufacturers; today, it has 1400 members. Its mission is to protect and grow Ohio manufacturing.

**Background:**

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.

Prior to 2005, Ohio's tax structure was essentially unchanged since the 1930s. 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 other industries 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 operate on more slender margins or 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.

The large and increasing number of exemptions and exclusions, added over the years in order to render the franchise, personal property and sales and use taxes less onerous, narrowed the bases of those taxes. Accompanied by the relentless rise in tax rates, the taxes were not only inefficient, but also discriminatory against businesses with heavy investment in capital.

**Tax Reform Enacted**

Over the years, calls increased to reform Ohio's tax system to render it more fair and competitive. Finally, in early 2005, true tax reform was proposed. The goals of tax reform were:

- Eliminate the taxation of investment and shift to the taxation of consumption;
- Broaden the over-all business tax base;
- Reduce over-all business tax rates;
- Improve fairness;
- 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% 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, taxpayers warmed to the CAT as the net savings over the former franchise and personal property taxes became clear due to the broad base, limited exclusions, and the low rate.[1] 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.

Many tax expenditures spring from the desire of policymakers to manage the economy, control economic behavior, or provide special favors through taxation. Regardless of how well-intentioned those efforts may be, tax expenditures can and do create undesirable consequences. They often reduce certainty, as many create questions as to who may benefit from them, and the extent of the benefit. They reduce equity, resulting in government picking winners and losers. Tax expenditures increase complexity and reduce transparency as taxpayers and tax administrators attempt to implement them. In short, they are bad tax policy and their use should be minimized. In fact, by minimizing them, the base is broadened and the need for special treatment is reduced.

[1] Manufacturers remain the largest category of CAT taxpayers. See Exhibit A, attached.

**CAT Tax Expenditures:**

Tax reform notwithstanding, Ohio has continued on its relentless march towards more tax exclusions, even as it enacted the CAT, raised sales tax rates and broadened the base, and continued to cut income tax rates. As noted many times, some of the most important aspects of the CAT are its broad base, its low rate, and its broad application to virtually all 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 approximately 25 exclusions from the CAT and only four credits. The tax expenditure associated with those exclusions in 2010, the first year the tax was fully phased in, totaled 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 CAT now lists approximately 36 exclusions and is subject to 7 credits. The total cost of those expenditures, without consideration of the credits, 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. Exemptions, exclusions and credits violate the rule of equality and render the tax less clear and more complicated.

**Sales and Use Tax Expenditures**

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 the 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 personal 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.[2] The economic basis for this principle 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.[3]

Second, imposing the tax on business inputs increases the cost of doing business through the higher costs that result from the tax. Business generally will respond to

---

[2] The exclusion for business inputs does not mean that manufacturers do not pay significant amounts of sales and use taxes. See Exhibit B, attached.
[3] Roy Bahl, Ed., *Taxation and Economic Development: A Blueprint for Tax Reform in Ohio* (Battelle Press 1994), p. 277-278 (the "*1994 Staff Report*").

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.[4] Such an impact by taxes on economic decisions should be minimized.

Third, direct inputs lead to the production of more valuable goods that are ultimately subject to the tax. Thus, the tax on the final product is maximized.

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 and may actually reduce small business formation.[5]

The application of sales and use taxes to business inputs has been the subject of comment on at least two prior occasions in which taxes in Ohio were studied. 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 sales and use 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.

---

[4] *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*").
[5] *Id.*, at p. 5-4.

The taxes are intended to apply to final, personal consumption. When the taxes were conceived, that meant primarily the purchases of tangible personal property by individuals. While some business purchases, such as office equipment and supplies, were subjected to taxation, business inputs that contributed to the production of a product, the sale of which would subsequently be subject to sales or use tax, were excluded. Other than the sale of food, few other exemptions existed.

Over the years, a number of exclusions have been added to the taxes. While many of them represent transactions involving business inputs, a majority of them represent exclusions of another nature. Today, R.C. 5739.02(B) contains 53 subdivisions providing for exclusions from the tax. One subdivision alone, subdivision (B)(42), contains 15 separate exclusions! Other exclusions are scattered throughout the Revised Code. And, this does not include the number of consumer services that are not even included in the tax base.

Business consumption is taxed under the CAT. The sales and use taxes are intended to apply to personal consumption of final goods and services. If the bases of those taxes are broadened accordingly, especially with respect to services, and exclusions and exemptions are limited, the rates can be lowered, further reducing the need for additional exclusions.

**Personal Income Tax Expenditures**

The personal income tax was enacted in the early 1970s as an additional, stable source of revenue. Over the years, the number of exclusions and credits has mushroomed as well, and the rates were driven upwards. Even though rates have dropped about 35 percent since the 2005 tax reform, R.C. 5747.01(A) still provides for about 22 deductions or exclusions for calculating Ohio taxable income. R.C. 5747.98 lists 38 separate credits that may be taken against the tax.

Many exclusions and deductions to the sales and income taxes have a social basis. The personal income tax credit for retirement income and medical premiums are just two examples. Many exclusions serve laudatory purposes, but the result is a system of

taxes that is complicated, favors some taxpayers over others, and results in ever-higher tax rates on those who are left paying the bills. Ohio may be further ahead to lower the rates and let everybody help pay for the government services that they all use.

**Summary:**

Since the enactment of tax reform in 2005, OMA has maintained a principled, consistent approach to tax policy in Ohio. That approach insists on certainty, equity, simplicity, and transparency. The erosion of the tax reform legislation, in the form of carve-outs, exclusions, and ear-marks, reduces certainty, creates disparity by selecting winners and losers, renders the tax code more complicated, and reduces transparency as it becomes more difficult to determine who is entitled to which exclusions.

Everybody has a story; everybody has a reason why one tax or another is not fair to them. However, one cannot have an efficient and fair tax system that is different for every taxpayer. Nor is it fair to tax some segments of the economy at levels that are 10 times higher than those imposed on other segments. The 2005 tax reform legislation was directed at trying to reduce that inequity on a tax system-wide basis. Every time an exclusion or exemption from the CAT, the sales and use taxes, or the personal income tax is created, that increases the tax burden on everybody else. The solution isn't a tax system made of Swiss cheese; we tried that already, and it didn't work.

It is time to stop the madness. Rather than continuing to enact exclusions that render the taxes less and less fair, more and more complicated, and result in higher and higher tax rates for taxpayers, OMA suggests that a better approach may be to broaden the bases as appropriate, reduce the number of exclusions and reducing over-all tax rates. If rates are reduced, the necessity for the special tax treatment afforded by exclusions that are not economically based, and that are contrary to the very purpose of the tax, is reduced significantly. The result is a tax system that comprises one or more taxes with a broad base, a low rate tax, that is simple to enforce and simple to follow, and that treats all taxpayers the same.

Thank you very much for the opportunity to appear here today. I'd be pleased to answer any questions that any of you might have.

# EXHIBIT A

**CAT and Manufacturers:**

According to Ohio Department of Taxation Fiscal Year 2015 Commercial Activity Tax Returns data, manufacturers made up the second-largest group of CAT taxpayers, representing 10.5% of all taxpayers (retail trade is the largest).

And, manufacturers pay 26.1% of the state's total – far more than any other group (in terms of CAT revenues based only on the 0.26% 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 66.3% of all filers in fiscal year 2014, but less than 1% of the total liability for that period.

## EXHIBIT B

**Sales Tax and Manufacturers:**

Despite the exemption for machinery and equipment enjoyed by manufacturers, 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 equipment and motor vehicles. It also includes automatic data processing, computer and electronic information services, and temporary employment and employment placement services. As a result, manufacturers pay millions of dollars in sales and use taxes annually to the state of Ohio.

According to the 2015 Annual Report of the Ohio Department of Taxation, manufacturers as an economic segment paid more than $426,000,000 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 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.

## Foregone Revenue from CAT Exclusions, Deductions and Credits

Below are estimates of revenue foregone in FY 2017 by the state General Revenue Fund from various CAT exclusions, deductions and credits.[1] Dollar amounts are millions.

| | |
|---|---|
| Exclusion of first $1 million of taxable gross receipts | $267.8 |
| Qualified distribution center receipts exclusion | $164.6 |
| Job creation credit | $88.1 |
| Job retention tax credit | $29.6 |
| Credit for increased qualified research and development expenses | $28.6 |
| Agricultural receipts | $14.0 |
| Casino receipts in excess of "gross casino revenue" | >$10.0 [2] |
| Credit for net operating loss carry forwards and other deferred tax assets | $7.1 |
| Professional employer organization exclusion | $5.4 |
| State and federal cigarette tax exclusion | $3.5 |
| Consumer product integrated supply chain exclustion | $3.0[3] |
| Motor vehicle transfer exclusion | $2.0 |
| Exclusion of certain services to financial institutions | $1.9 |
| Exclusion of real estate brokerage gross receipts not retained | $1.5 |
| Research and development loan program credit | $1.5 |
| State and federal alcoholic beverage excise tax exclusion | $1.1 |
| Exemption for pre-1972 trusts | <$1.0 [4] |
| Anti-neoplastic drug exclusion | <$1.0 |
| Horse racing taxes and purse exclusion | <$1.0 |
| Receipts from sale of uranium from qualifying uranium enrichment zone | <$1.0 |
| Providing public services exclusion | No Estimate Available |
| Petroleum receipts [5] | No Estimate Available |
| Motion picture credit | No Estimate Available |
| **Estimated Total Foregone Revenues** | **More than $629.7 million** |

NOTE: Actual total foregone revenues will be higher than estimated total forgone revenues, which reflect indefinite revenues for casino receipts and undetermined revenues for the public services exclusion, petroleum receipts and motion picture credit.

[1] Unless otherwise noted, the source for the data listed above is the Ohio Department of Taxation Tax Expenditure Report (Fiscal Years 2016-2017).
[2] Ohio Legislative Service Commission estimates foregone revenue from casino receipts in excess of "gross casino revenue" will be "tens of millions of dollars."
[3] Ohio Legislative Service Commission, Senate Bill 208 Fiscal Note as Enacted, 2015.
[4] The Ohio Department of Taxation Tax Expenditure Report provides only general "less than $1 million" estimates for six items in this list (rather than precise estimates as provided for the other items). For this reason, we have chosen not to include any foregone revenue for the six items with estimated foregone revenues of less than $1 million each.
[5] Motor vehicle fuel dealers pay a one-time tax of 0.65% on their sales of petroleum products.