Testimony to the Ohio 2020 Tax Policy Study Commission

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Co-Chairs Senator Peterson and Representative Schaffer and Members of the Commission, I appreciate the opportunity to testify today on ways Ohio can improve its business climate. I will highlight several tax areas where the Council On State Taxation recommends improvements to foster a better business environment in Ohio.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of approximately 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. Many COST members do business in Ohio and are impacted by changes to Ohio's tax structure.

Municipal Income Tax Reform Opportunities

Ohio's municipal income tax system retains its complexity, with a plethora of separate taxing districts, despite the Legislature's efforts to provide greater uniformity and filing simplicity with 2014's House Bill 5. The COST Board of Directors has adopted a formal policy position with regard to tax administration. That position is:

> *Fair, efficient and customer-focused tax administration is critical to the effectiveness of our voluntary system of tax compliance. A burdensome, unfair, or otherwise biased administrative system negatively impacts tax compliance and hinders economic competitiveness.*

The State's municipal income tax system presents many issues for business taxpayers that the Legislature could address to improve the State's attractiveness to business. The ideal solution would be for the Legislature to find a way to eliminate the net profits portions of the municipal income tax. Barring that step, this Commission should consider enhancing the uniformity of the municipal income tax by requiring it to be centrally administered. Listed below are some other improvements COST believes this Commission should make to strengthen the reforms passed in 2014.

Net Operating Loss Provision. It is axiomatic that income-based taxes should account for the cyclical nature of business by allowing businesses to offset income in future years by losses from prior years. COST strongly believes the municipalities should follow the Internal Revenue Code's net operating loss rules, which provides a 20-year carryforward period (federal law also allows a taxpayer to carry back losses). To stress the importance of providing taxpayers with NOLs, the financial impact of a company with a large NOL was addressed by the Ohio General Assembly when it adopted the Commercial Activity Tax — see R.C. 5751.53.

"Throwback" Rule. Ohio's municipal income tax system should not embrace the "throwback" rule, which assigns sales to a municipality even though the sale would otherwise be properly sourced to another jurisdiction. As provided in COST's policy statement on the subject, throwback rules "seek to require companies to pay tax in one [tax jurisdiction] on income that another [tax jurisdiction] has chosen not to tax or is legally unable to tax. A company's tax liability in one [tax jurisdiction] should not be measured by its tax in another [tax jurisdiction]. Throwback (and throwout) rules also discourage investment in a [tax jurisdiction]." In sum, throwback rules tax "income at the wrong rate and direct the resulting revenue to the wrong [tax jurisdiction]." A municipality should only tax the activity occurring in its jurisdiction; how other taxing jurisdictions throughout the state (and world) tax a business is not relevant for apportioning the income of a business to a municipality in Ohio.

Uniform and Equalized Interest Rates with State Taxes. Ohio's municipal income tax system should require the municipalities to use the same interest rate that is used for most of the taxes administered by Ohio's Tax Commissioner. As it stands now, Ohio's municipal income tax system requires municipalities to impose an interest rate that is two percent greater than the state rate.

Nonresident Workers. H.B. 5 helped to clarify when Ohio's municipalities can impose their tax on nonresident workers, alleviating some of the administrative burdens facing employees, employers and tax agencies with *de minimis* tax return filing requirements. However, the bill only uses a 21-day threshold. COST is very supportive of proposed federal legislation, H.R. 2315 (the Mobile Workforce State Income Tax Simplification Act) and S. 386, which provides a 30-day threshold before a state can impose its income tax on certain workers, with exceptions for professional athletes and entertainers. This same 30-day threshold should be incorporated in Ohio's municipal income tax system.

Taxes Paid Credit. This Commission can also improve the State's municipal income tax system by requiring municipalities to provide taxpayers and their employees with a credit for taxes paid to other municipalities. Subjecting employees to municipal income tax based on both where they work *and*, where they live, without requiring a one-hundred percent credit for taxes paid at one of those locations makes Ohio a less attractive state to draw new employees. This Commission should recommend ending this bad tax policy.

Sales Tax Reform

In a perfect world, sales taxes imposed by states would fall entirely on consumers. The COST Board of Directors has adopted a formal policy statement on sales taxation of business inputs. COST's policy position on the imposition of sales tax on business input is:

> *Imposing sales taxes on business inputs violates several tax policy principles and causes significant economic distortions. Taxing business inputs raises production costs and places businesses within a State at a competitive disadvantage to businesses not burdened by such taxes. Taxes on business inputs, including taxes on services purchased by businesses, must be avoided.*

Unfortunately, Ohio's sales/use taxes are imposed on numerous business-to-business transactions. Currently, approximately 42% of Ohio's sales/use tax revenue is derived from business-to-business transactions, increasing to 52% if the CAT is included.[1] The State's imposition of such a heavy tax burden on business-to-business transactions does not foster a positive environment for businesses to locate or remain in Ohio.

Ohio targets its sales/use tax on automatic data processing, computer services, and electronic information services exclusively on the business sector. Other services, such as janitorial services and employment services, also predominantly fall on the business sector. Further increases in the State's sales/use tax rate, without eliminating the tax on business inputs, will not make Ohio more attractive as a business location. In fact, such taxes would likely be borne disproportionately by small businesses, since larger businesses would be incentivized to provide these services in-house to avoid the tax, a strategy small businesses typically cannot afford.

Ohio can take a step toward ameliorating these issues by coming into compliance with the Permanent Internet Tax Freedom Act, federal legislation (H.R. 644) passed in February 2016 that prohibits states and localities from levying taxes on internet access. While the federal law permits states until June 2020 to phase-out their existing taxes on internet access, Ohio should immediately comply with the Act to reduce the State's business tax burden. COST also encourages this Commission to recommend passage of Ohio House Bill 343, which would repeal the application of sales tax to employment services.

CAT Rate Increases Exacerbates Problems with Gross Receipts Taxes

This Commission should seek ways to improve Ohio's Commercial Activity Tax (CAT) by keeping the base broad and rates low, though it should also seek ways to mitigate the detrimental rate pyramiding effects inherent with gross receipts taxes like the CAT.

The COST Board of Directors has adopted a formal policy statement on gross receipts

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[1] Robert Cline, Andrew Phillips, and Tom Neubig, "What's Wrong with Taxing Business Services," Ernst & Young in conjunction with COST, April, 2013; Daniel Mullins, Andrew Phillips, and Daniel Sufranski, "Analysis of Proposed Changes to Select Ohio Taxes Included in The Ohio Executive Budget and Ohio House Bill Number 64," Ernst & Young in conjunction with the State Tax Research Institute, March 2015.

taxes. COST's policy position is:

> *Gross receipts taxes are widely acknowledged to violate the tax policy principles of transparency, fairness, economic neutrality and competitiveness; generally, such taxes should not be imposed on business.*

Despite the well-known policy shortcomings of gross receipts taxes,[2] two mitigating factors noted during adoption of Ohio's CAT were its combination of a "broad base and low rate" and the elimination of the personal property tax (a tax that is also not based on profit) on general businesses. Ultimately, these factors drove the State's 2005 tax reform package that phased in the CAT and phased out the State's corporate income tax and personal property tax.[3] COST and others have remained concerned that increasing the CAT rate, even by a small amount, would in turn exponentially increase its pernicious effects as a gross receipts tax. The base of a gross receipts tax is so broad (many times greater than the State's gross domestic product) that even small rate increases will negatively impact businesses selling their products to customers in the State and conducting their operations within Ohio. The burden of the CAT varies based on:

1) An entity's gross receipts (*e.g.*, those under $150,000 pay no CAT);
2) Profit margin (*i.e.*, higher margin businesses do better than low margin businesses because of their profit differentials); and
3) The length of the supply chain it takes to get a good to an Ohio consumer (the longer the supply chain, the greater chance of "pyramiding").

Any increase in the CAT rate, even if limited to select industries, undermines the original intent of the CAT being a simple tax with a "broad base and low rate." As addressed in more detail below, increases in the CAT to select industries complicates the CAT, increases pyramiding of the CAT, and exacerbates the burden of the tax being imposed regardless of profitability.

Complexity: As the saying goes, the "devil is in the details," and any CAT rate differentiation between industries would require very precise language. Different rates, similar to the pyramiding concern addressed below, also create winners and losers. Differing rates also increase the difficulty of calculating the tax. Businesses will legitimately seek to use more tax planning to minimize the tax they would have to pay at the higher rate, inevitably leading to increased litigation. Texas and Washington are two states with a state-based gross receipts tax that have different rates, and tax administrators from both of those states have said it increases controversy, a direct result from businesses seeking to utilize a lower tax rate.[4] Other problems with using different tax rates for the CAT include, but are not limited to, the following:

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[2] John Mikesell, "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance," Indiana University School of Public and Environmental Affairs, January, 2007.
[3] Personal property tax was not eliminated for all businesses; certain public utilities are still subject to a personal property tax.
[4] *In re Nestle USA, Inc.*, 387 S.W.3d 610 (2012) is an example of litigation over the tax rate in Texas; and *Bowie v. Washington Dep't of Rev.*, 248 P.3d 504 (2011) is an example of a tax rate dispute in Washington.

1) Converting the CAT into a transactional tax could create problems with the CAT applying to food for off-premise consumption;[5]
2) More business-to-business transactions would likely be taxed at a higher rate;
3) Ohio businesses would be encouraged to minimize CAT exposure by transacting business with out-of-state companies that are not subject to the CAT;
4) Ohio businesses would be encouraged to locate operations outside of Ohio to minimize the CAT; and
5) Small Ohio businesses are hurt as they no longer get work from companies that have elected to insource some operations (or outsource outside the State) to avoid the CAT.

Pyramiding: Businesses that are both horizontally and vertically integrated can buffer the effects of the pyramiding of the CAT better than non-integrated businesses. Thus, businesses that cannot exclude related-entity receipts (*i.e.*, not part of a consolidated elective taxpayer group) are hit much harder than those businesses in control of the distribution chain (manufacturer to wholesaler to retailer, and on to the ultimate consumer). The effects of pyramiding within the CAT can be seen in the resulting 0.65% tax rate of Ohio's Petroleum Activity Tax (PAT), a tax rate to be revenue neutral when applied to only one distribution point as compared to the CAT which is applied to multiple points within the distribution chain, clearly proves the effect of pyramiding. That rate is 2.5 times the CAT rate. While the level of pyramiding varies industry by industry, increasing the CAT rate compounds the problems with the pyramiding effect of the CAT.

Imposes Tax Regardless of Profitability: The CAT is imposed on gross receipts regardless of whether a business is profitable. Businesses operating at a loss or at minimal profitability, such as a capital-intensive business at start-up, will incur a much higher tax burden with the CAT increase (*i.e.*, higher effective tax rate on profit) than those businesses with higher profit margins.

Real Property Tax Appeals

This Commission should recommend ending third-party appeals of real property valuations. The County Auditor is the entity vested with determining the fair market value of real property. Allowing school districts and other governmental entities to independently dispute property owners valuations, primarily targeted towards business properties, is unfair. The vast majority of the states do not allow this practice and it should be eliminated in Ohio. To that end, COST supports the passage of Senate Bill 85, which would prohibit school districts or other third-parties from filing Board of Revision complaints if the taxpayer has not filed a complaint on the property.

Conclusion

COST appreciates the opportunity to testify today. COST shares the same goal as the Ohio General Assembly – to grow Ohio's economy and create jobs in Ohio. I would be pleased to answer any questions.

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[5] *See* Ohio Constitution Article 12, § 3(C) and *Ohio Grocers Assn. v. Levin*, 123 Ohio St.3d 303 (2009).