

Written Testimony
The Ohio Society of CPAs
For
The Ohio 2020 Tax Policy Study Commission
June 20, 2016

Co-Chairmen Peterson and Schaffer, Director Keen, and members of the Ohio 2020 Tax Policy Study Commission, thank you for this opportunity to share The Ohio Society of CPAs (OSCPA) written testimony on our white paper report, "Driving a Pro-Business Tax Environment" issued by the Ohio Tax Reform Task Force. The report can be downloaded at www.ohiocpa.com. I'm J. Matthew Yuskewich, CPA, and I served as the Chair of the Task Force, comprised of 19 tax professionals throughout Ohio with a broad range of expertise. OSCPAs is a community of 22,000 members representing 85,000 CPAs and accounting professionals statewide, leading important initiatives that protect the public and create a healthy and sustainable business climate in Ohio.

Five elements are widely accepted as key tenets of a quality tax system: *competitiveness, simplicity, stability, equity/fairness and neutrality*. These principles of a quality tax system provide the basic standard for the consideration of reforming and modernizing Ohio's tax laws and each factor should be a key element as elected officials and other policymakers consider how best to design our state's tax structure for the future. Ohio's current tax climate is certainly better than where we were in 2010. Turning back to a focus on taxation, after careful evaluation by our Task Force and emphasizing the five elements of good tax policy, this white paper outlines OSCPAs's recommendations on each of the major forms of state and local taxation, and additional insights for consideration.

PERSONAL INCOME TAX

There are two main factors to consider with personal income tax: the tax rate itself, and the system used to collect revenue from taxpayers which includes allowable credits and deductions.

In 2015, forty-three states levied an individual income tax. Of those, forty-one states taxed wages and salary income, and two states exclusively taxed dividend and investment income. Of those states taxing wages, eight have a flat-tax structure whereby a single rate applies to all taxable income, including three of Ohio's neighbors (Indiana, Pennsylvania and Michigan). Thirty-three states have a multi-bracketed system, ranging from as few as two rates to as many as ten brackets. Ohio's graduated personal income tax system is on the high end with **nine** income tax brackets. The Task Force believes a straightforward, simple tax system with optimally three but no more than five brackets as opposed to the current nine brackets is even more beneficial. Reducing the number of brackets should bring greater simplicity to the personal income tax structure.

Flat Tax Considerations:

There is no doubt that having a single income tax bracket is even simpler than having three to five brackets. However, if pursued, moving to a flat tax in Ohio should be done with an acute awareness of the realities of the situation, and the strong likelihood of the financial challenges it will cause, especially during an economic downturn. OSCPAs has previously expressed significant concern about efforts to pay for a lower personal income tax rate by raising other

taxes paid by business owners (CAT rate increases) or through approaches that would impair Ohio's competitiveness through new sales taxes on services that can be easily purchased in another state without such a tax.

Income tax credits and deductions often are created to influence taxpayer behavior or to benefit one or more special interest groups. Many impact a limited-time event or limited number of people, and all reduce revenue that otherwise would have been generated by the personal income tax. A thorough review can determine if the credit or deduction can be eliminated or reduced, allowing more revenue to flow into the GRF and help pay for any income tax rate changes necessitated by bracket reductions. By reducing the number of brackets and the possible related changes in rate, many existing credits and/or deductions may not be necessary. It is important to examine whether the stated purpose of each credit and deduction has resulted in the intended goal.

Business Income Deduction (BID):

In Ohio, the tax on pass-through income has been largely mitigated by the new Business Income Deduction (BID) and for 2015 and thereafter the reduced 3% income tax rate that applies to pass-through entity business income above \$250,000. The Ohio General Assembly and the Administration should consider these questions: Is the BID and the accompanying 3% income tax rate—expected to cost Ohio well over \$500 million each year in foregone income tax revenue—spurring economic growth in Ohio? Alternatively, should the Legislature consider an overhaul of the entire personal income tax system for all taxpayers, not just for business owners?

While we strongly support the goal of helping small business owners in Ohio thrive, we also encourage a careful evaluation to determine if the desired economic growth is taking place with this important group of business owners. This recommendation to evaluate the results of the BID and the new 3% maximum income tax rate is consistent with OSCPA's past encouragement of our state leaders to carefully and periodically evaluate all tax expenditures to ensure they are meeting their intended goals.

Marriage Penalty:

However, there is one area where an additional tax expenditure should be considered: fixing Ohio's marriage tax penalty. In Ohio, a married couple filing a joint tax return pays a higher income tax than a married couple filing separately or two single individuals with the same amount of income. Consideration should be given to either allowing a different filing status for Ohio from the federal status or creating a new tax table for married filing joint returns and eliminating the current Joint Filing Credit.

When comparing Ohio's personal income tax policy to other key states, it's important to remember that factors beyond the rate itself also impact total revenue collected. For example, each state treats standard deductions and personal exemptions differently, meaning the amount of income subject to taxation varies. Further complicating comparisons is the reality that not all states use federal adjusted gross income ("AGI") as their starting point. Simply having a stated low tax rate does not necessarily mean taxpayers will pay less tax, as the optics of a low tax rate with almost no offsets to income are far different than a higher tax rate with many offsets. In summary, you need to look beyond the gross marginal tax rates to find the actual effective tax rate to make a valid comparison.

MUNICIPAL INCOME TAX

As lawmakers evaluate Ohio's personal income tax system, recognition must be given to our state's unique role of having over 600 cities and villages that also assess an income tax in addition to the state income tax – the average local add-on income tax rate for all municipalities is 1.89%.

Ohio municipalities are allowed to assess an income tax in two ways: 1) on individuals living and working within its boundaries (individual income tax), and 2) on businesses providing goods or services within its boundaries (net profits tax). Therefore, it is important to note that there are two separate forms of municipal income taxation: the payroll withholding tax and related filing requirements processed by businesses for individuals they employ (plus any payments due directly from individuals who are self-employed), and the net profits tax assessed on business entities.

Ohio is at a significant disadvantage regarding municipal income taxes since only 10 other states have a system whereby cities and villages can assess tax both where you work and live. OSCPA's primary concern is not the amount of tax charged by cities and villages to their residents, but rather the compliance cost associated with filing in multiple jurisdictions, particularly since some municipalities are getting much more aggressive with their collection efforts.

Recommendations:

There are three specific recommended changes that Ohio CPAs believe would significantly improve the time, cost and effort involved with multiple net profit return filings: 1) adopt some form of centralized collection and administration for business filers; 2) eliminate municipal "throwback" rules, which states that sales of goods shipped to a customer in another tax jurisdiction where the seller does not have an employee that regularly engages in the solicitation of sales (e.g., internet sales companies likely do not have any employees that solicit sales at a physical location other than over the internet) are "thrown back" to the jurisdiction from which the goods are shipped; and 3) prevent double taxation by requiring all cities and villages to give 100% reciprocity credit for taxes already paid to the municipality where the employee works, OR charge non-residents a lower income tax rate, recognizing that the individual does not live in the jurisdiction and therefore does not use city services to the degree that residents do.

COMMERCIAL ACTIVITY TAX (CAT)

OSCPA has a longstanding position that the CAT is effective as long as the following criteria remain intact: the rate is low, the base is broad, the exemptions are few and compliance is simple. The primary benefit of Ohio's approach is the uniform, low rate of 0.26%, which mitigates the concern about pyramiding. If Ohio bifurcates or increases its rate, the effect would become even more burdensome. The higher the rate, the more dramatic the problem is with the CAT's pyramiding structure. A major reason why the CAT rate has remained low is that the base is very broad, as intended from inception. Therefore, exemptions must be limited because tax expenditures affect CAT revenues. OSCPA supports the commitment when the tax was first passed in 2005 to a broad base, limited exclusions and a low rate.

Recommendations:

The CAT is a simple tax to administer, yet improvements can be made in the areas of administration, compliance and enforcement: 1) simplify the definition of gross receipts by tying it to the definition of federal gross income; 2) eliminate or revise CAT exemptions; 3) reduce or eliminate the CAT administration earmark; 4) address the “estimation” procedures as they are inadequate for large multistate companies; 5) address the Research & Development (R&D) credit within the CAT as it has created complexity with filers; 6) amend the combined (mandatory) and consolidated (elective) filing methods for commonly owned persons; 7) adopt provisions that put private equity firms on par with commonly owned corporate groups; 8) add additional funding for the Ohio Board of Tax Appeals (BTA); and 9) pursue out-of-state companies more aggressively.

SALES & USE TAX

Like most taxes, Ohio’s sales and corresponding use tax can be divided into four main areas of discussion: (1) tax rate, (2) exemptions, (3) tax base and (4) compliance and enforcement.

In comparing the sales and use tax rate to other states, the 5.75% state sales and use tax rate ranks Ohio in the middle of the pack of all states (27th). However, when the average county and transit authority local sales tax rate of 1.39% is added, Ohio jumps to the 19th highest combined sales and use tax rate in the country and the highest among our neighboring states.

As for exemptions, it is important that they are competitive so that businesses and consumers will not turn to other states for those services or goods, and they should apply to a broad base that has a real impact on driving economic development in our state, such as the manufacturing exemption, rather than granting carve-outs for small niche industries.

During the past two biennial budget proposals, OSCPA has strongly opposed the expansion of the Ohio sales and use tax base to include professional services. OSCPA applauds the General Assembly for declining to expand the tax base to include these services. The challenges are many when expanding the sales tax to include professional services: 1) the competitive disadvantage small businesses would face compared to larger companies since they typically cannot afford to have full-time legal, accounting or other professional staff and must hire firms to provide those services; 2) Ohio should avoid driving business away from our state because of the reality that many services are highly mobile in nature, meaning they can be easily provided digitally or electronically from virtually anywhere in the world; 3) sourcing rules present a significant challenge; and 4) sales between affiliated companies should always be excluded, which otherwise could cost millions of dollars for a single taxpayer.

Adding sales or use tax to sales on professional services or between affiliated companies will significantly drive up the cost of goods made in our state, as well as services provided by professionals in Ohio. Either of these changes will make Ohio-based business operations less competitive when compared to almost all other states.

Compliance is an issue for both sales and use tax, but especially use tax. There are opportunities for Ohio to significantly improve compliance and enforcement among businesses through the Business Gateway, sales or use tax reporting, remote sellers, refunds, and payment plans.

Recommendations:

OSCPA's sales and use tax recommendations are as follows: 1) explore expanding the definition of sin tax to allow for economic development purposes; 2) review the sales tax on business fixtures under R.C. 5701.03; 3) reduce or cap vendor discounts; 4) eliminate the exemption for tangible personal property used in storing, preparing, and serving food; 5) clarify the law concerning automatic data processing (ADP) and electronic information services (EIS); 6) streamline sales or use tax on employment services; 7) upgrade the Ohio Business Gateway (OBG); 8) report and collect sales tax for small business remittance on a cash (not accrual) basis; 9) collect tax that is currently due under existing law from out-of-state (or remote) sellers; 10) permit taxpayers to enter into a payment plan with the ODT; 11) reduce interest payments; 12) combine sales/use tax filing to one form; and 13) enact legislation to ban zappers.

SEVERANCE TAX

OSCPA's recommendations in the severance tax section are focused primarily on issues impacting administration of the tax in various approaches. We do not have a position on the rate that should be charged. Please see pages 29-32 of the report for those recommendations.

OTHER STATE TAXES

While Ohio's personal income tax, CAT and sales tax generate the majority of revenue for government operations, there are a number of other taxes in our state that result in increased government revenue, as well as increased compliance and financial cost to Ohioans. For all forms of taxation, there should be consistent treatment within each category, meaning that exemptions should be avoided, particularly when it benefits one class of business over other direct competitors. Highlighted below are additional taxes levied by the state and recommendations to keep Ohio competitive while maintaining economic fairness and stability.

Recommendations:

We encourage the legislature to take steps to ensure Ohio's Unemployment Compensation Trust Fund is fiscally solvent long into the future. Few if any would argue that the existing funding formula can properly prepare our state for future high rates of unemployment and the related drain on resources that will surely result during another downturn. Ultimately, compromises by both the business community (in terms of what they pay into the Fund) and by employees (on what they are eligible to receive) are necessary to address the funding issue.

Second, we encourage the Ohio General Assembly to consider equalization of our state's cigarette tax to other nicotine products. OSCPА believes the key factors at hand are fairness and consistency of treatment. Therefore, when using fairness as a best practice measurement, Ohio should not assess the tax on tobacco-oriented products that do not contain nicotine.

Third, we urge the Ohio General Assembly to make an apples-to-apples comparison to other states when examining the promotional spend issue for possible changes. Since Ohio casinos began operating in 2012, over \$383 million in tax-free promotional spend has been redeemed by casino customers. That figure climbs to \$807 million when Ohio's seven racinos are added. Casinos and racinos deduct the amount of promotional play used in their facilities from gross revenue before tax is assessed per current law. Roughly one-third of this amount is foregone tax revenue that otherwise would have been received by Ohio's primary and secondary schools and local governments.

Further, we support the legislature continuing to cut red tape and expand efficiencies through consolidation. For example, one such area relates to payroll tax compliance audits with ODJFS and BWC. Because the ODT collects payroll taxes and has far more experience with the tax audit function, we suggest that ODJFS's unemployment tax division be transferred to ODT, and ODT work with BWC to find a more common sense approach to audit premium collections.

Finally, as previously discussed, credits and deductions need **independent** evaluation periodically as to their direct cost, utilization, and direct and indirect benefits to the Ohio economy. This information can then be used to determine the need to extend or renew them.

POTENTIAL SOURCES OF TAX REVENUE

While OSCPA is reluctant to call out any particular class of taxpayer, there are several areas where a closer look could be taken to determine if there should be more fairness in tax treatment and application. Some are areas where technology advances have opened the door for efficiencies; others where some industries have generous exemptions that may no longer make sense.

A few have already been mentioned, including promotional spend for Ohio's casinos and racinos, the sales tax vendor discount, and equalization of the cigarette tax to other nicotine products. In addition, with 52% of Ohio's budget dedicated to Medicaid expenditures, lawmakers should closely evaluate whether benefitting Ohio facilities are paying their fair share through health care provider taxes for the privilege of doing business in our state. Also, Ohio could join the many other states that place heavier emphasis on permanent user fee increases in place of taxes imposed on all, which burden those who do not even benefit from a given program, facility or service. Finally, the new Business Income Deduction (BID) merits additional study to ensure it is achieving its stated goal: largely, reinvestment of these tax savings by business owners into their operation(s). Changes could bring substantial revenue.

SUMMARY

Striving to make the state of Ohio a magnet for employers to locate and grow their businesses, and for skilled workers to live and raise their families, is critical to ensuring economic competitiveness. Reducing the tax burden on businesses and individuals alike is an important part of that equation, but is far from the only factor to be considered. Ohio's workforce is also of critical importance, both ensuring that our future workers are prepared to enter the job market and our state is attracting and retaining skilled workers for our key industries. A major concern expressed by employers is the lack of a ready workforce to fill the jobs that are available now.

Any efforts to update Ohio's tax system need to focus on the major tenets of good tax policy: competitiveness, simplicity, stability, equity/fairness and neutrality, and the recognition that there are two key cost components associated with tax policy: the tax rates themselves and the compliance costs impacting both taxpayers and government entities receiving tax dollars.

While every state is different, it is helpful to learn from successes and failures in other states. Significant research should first be done—particularly in view of recent major income tax reforms—to ensure that any further significant proposed tax changes likely will result in meaningful job and economic growth without hurting the state financially. Significant research should also be done on the dozens of Ohio tax credits, deductions and exemptions, including Ohio's new Business Income Deduction. One of the best ways to reduce a rate and simplify

compliance at the same time is to eliminate tax expenditures that are not critical to our state's economy.

Where the major taxes are concerned, OSCPA believes that moving to a reduction in the number of personal income tax brackets, coupled with relatively few credits and deductions, should be considered by policy makers to make Ohio's tax system appear more competitive with surrounding states. Optimally, Ohio would have no more than three brackets, as the fewer the better for simplicity. OSCPA also believes that moving to a flat rate likely is too financially challenging over the long term—depending on the rate, of course. Sustainable funding of key government services is crucial.

Moving to fewer brackets and/or lower rates likely will result in a loss of revenue to the state, giving rise to the related challenge of how to offset those losses. The fairest and most appropriate way to fund this shortfall, beyond cuts in government spending, is through the elimination of related personal income tax credits and deductions. Creating new revenue from a completely different source of taxation, such as the CAT or the sales tax, does not achieve the goal of reducing the Ohio tax burden—it simply reallocates it by increasing another tax, thereby picking winners and losers. We strongly discourage such an approach as it violates the fairness tenet of good tax policy.

Recognizing that reducing the cost of compliance is also important, we have recommended a number of possible changes to each of the major Ohio taxes. The Ohio Society of CPAs stands ready to work with members of the Ohio General Assembly and the Kasich Administration on the important, ongoing effort to make Ohio a destination state for employers, as well as the skilled workers they need to thrive.

Thank you again for this opportunity to offer testimony on Ohio's tax policies, and for your consideration of OSCPA's recommendations. I'm available to answer any of your questions.