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Municipal Income Tax "Fix" is a Flub

Legislators should cut tax avoidance, not invite it

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Key findings

- Proposed change in state law could cost cities significant money.
- The proposal ignores or even invites tax avoidance; preserves special carve-outs; and gives boutique arrangements to the wealthiest.
- Legislators should instead close current loopholes, prevent new tax breaks, and ensure that municipalities are not clobbered by a new round of tax cuts.

A major rewrite of the state law governing Ohio municipal income tax is being discussed in Columbus. A proposal to overhaul the tax – House Bill 601 – was introduced late last year, and the General Assembly will see a revised version after it convenes this month. A significant effort to overhaul Ohio's municipal income tax should crack down on tax avoidance, guarantee a broad tax base, and ensure that those most able to pay are in fact doing so. In some instances, however, House Bill 601 allows tax avoidance to continue, or even creates new avenues to avoid the tax. When this issue is taken up in the next General Assembly, this should be corrected.

Both recent and long-term changes in Ohio's tax system have treated business favorably. Over the last generation, the business share of state and local taxes has declined substantially.[1] The biggest overhaul of the state tax system in recent decades, House Bill 66 in 2005, eliminated two major business taxes, the tangible personal property tax and the corporate franchise tax (for most companies), while creating a new tax that generates far less revenue than the two it replaced. The bill's 21 percent reduction in the personal income tax reduced taxes by that amount on business owners who pay taxes on their businesses under that tax.

The municipal income tax raises more than $4 billion a year for Ohio cities and villages,[2] constituting the largest single source of municipal revenue.[3] Increasing the uniformity of municipal income taxes across the state is a laudable objective. Unfortunately, the legislation proposed so far leaves loopholes in the current law untouched. Rather than attempt a comprehensive examination of House Bill 601, this brief examines some of the ways that the proposal could restrain tax avoidance instead of ignoring or even inviting it.

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[1] See Zach Schiller, *Business Tax Revamp: A Deficit in the Making*, Policy Matters Ohio, January 2009, pp. 10-11, available at http://www.policymattersohio.org/business-tax-revamp-a-deficit-in-the-making.

[2] According to the Ohio Department of Taxation, the tax generated $4.05 billion in Calendar Year 2010. See Tax Data Series, Individual Income, Municipal Income Taxes, Tax Rates and Amounts collected, by Municipality, Calendar Year 2010, available at http://1.usa.gov/VSIkQX.

[3] Email from Kent Scarrett, Ohio Municipal League, Dec. 18, 2012.

One good example is the lack of restrictions on what are known as passive investment companies, or PICs. More than two decades ago, when George Voinovich was governor, the General Assembly restricted the practice of using these entities to avoid paying the corporate income tax. As described in a 2003 memorandum to then Tax Commissioner Thomas Zaino by Frederick Church, then an official with the Ohio Department of Taxation, these provisions restricted companies from arranging transactions structured as payments of interest or as payments for the use of intangible property to affiliated PICs in another state. Policymakers recognized that allowing them to be arranged that way permitted the companies to avoid Ohio tax (see appendix for a copy of the memo). An Ohio company might pay an affiliated passive investment company in Delaware or another state without a corporate income tax for the right to use a trademark, for instance, giving itself a deduction from Ohio tax. Yet the income of the Delaware corporation would not be taxed.[4]

The state never cracked down on such tax avoidance for the municipal income tax. Church described how this works in his 2003 memo:

> “To avoid Ohio’s municipal income tax, a corporation or a flow-through entity could simply pay some of its operating income as intangible property expense to another entity that could be in Ohio, or that could even be in the same city. The key here is that Ohio municipalities cannot tax intangible property income, so that the act of taking operating income and “turning it into” intangible property income makes it disappear from the Ohio municipal income tax base. The company paying the expense gets a deduction, while the company receiving the payment earns income that the municipalities cannot tax.”[5]

Church estimated then that municipalities could see a revenue gain of $27.9 million in Fiscal Year 2004 if such tax avoidance were restricted. This amount would be higher now.[6] An effort to eliminate this loophole in 2003 failed. As a result, even now, it is costing Ohio municipalities tens of millions of dollars annually, for no good reason. Inexplicably, House Bill 601 is silent on this.

Similarly, the bill says nothing about the use of related entities to avoid taxation, which the State of Ohio similarly restricted earlier. Related entities generally are entities that are at least 50 percent owned by the same owner. Suppose a group of Ohio car dealerships are all owned by the same individual, who says he lives in Florida. The dealerships contract with a partnership in Florida, owned by the same person, to provide accounting services. If the partnership charges a lot for those services, it can effectively transfer the profits from the Ohio companies to itself. Thus, the Ohio dealerships might even show losses. Meanwhile, Florida doesn’t tax this income. The loophole allows a company based in an Ohio city to reduce its municipal income tax. It should be eliminated.

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[4] Since the state cracked down on this avoidance of the corporate income tax, that tax has been phased out in favor of another business tax. However, a similar state law limiting this tax dodge with respect to state income tax does apply to limited liability companies, S corporations and other businesses known as “passthrough entities” whose income is taxed when it passes through to its owners. (See Ohio Revised Code, Section 5733.40(A)). The law requires that such payments made to out-of-state owners must be added back to income, so out-of-state owners pay Ohio state income tax on a larger amount.

[5] Frederick Church, ODT, draft memorandum to Thomas Zaino, Tax Commissioner, “Municipal Income Tax – Potential Revenue Gains from anti-PIC provisions,” April 4, 2003, p.1

[6] The taxation department has not updated the numbers since the 2003 analysis, however.

While aiming for uniformity, the bill also preserves special carve-outs for stock-option income and deferred compensation paid to residents of Cincinnati and Findlay. This allows wealthy executives of Procter & Gamble and Marathon Petroleum to pay less municipal income tax on their pay. This policy originated on the grounds that it allowed these cities to remain "competitive." What happened to the need for uniformity in this case? A bill seeking to make Ohio's municipal income tax more uniform should not allow special carve-outs for Ohioans who are among those most able to pay the tax.

At the same time, the bill preserves the right of Indian Hill and a handful of other municipalities to continue taxing unearned or intangible income, something that others in Ohio are not and will not be permitted to do. Unearned income includes income from dividends, interest, sales of stocks and bonds, and other sources. Indian Hill, in suburban Cincinnati, is one of Ohio's most affluent communities. According to testimony last June before House Ways & Means Committee by village officials, unearned income accounts for half of Indian Hill's tax base, while its budgeted income-tax revenue accounts for about 59 percent of operating revenues this year.[7] Residents there obviously are in a position to live wherever they choose, including townships with no local income tax—and they choose to live in a village that taxes unearned income, albeit at a relatively low rate. According to the most recent Ohio Department of Taxation annual report, the vast majority of the 181 Ohio school districts levying income taxes cover unearned income.[8] The General Assembly should consider allowing all Ohio municipalities to tax this source of income.

The warehouse loophole

The bill also would create a new loophole by prohibiting cities from taxing the profit a company makes when it ships a product or service outside the city where it is located to another place where it does not regularly solicit sales.[9] House Bill 601 eliminates this existing provision, known as a "throwback" provision because it "throws back" the income to the home municipality. If throwback is repealed, it means that tax will not be paid on those sales to *any* municipality.

This change in the law has been defended on the grounds that current law "has impeded Ohio's ability to attract Internet-based companies."[10] But is this in fact a serious problem? In general, taxes are not a top factor in economic development.[11] And taken together, state and local taxes in Ohio are in line with national averages.[12] Moreover, not only Internet-based companies would benefit from the creation of this loophole. Any business that ships products to places where it does not have sales agents would benefit. The consequences of this for city income-tax revenues are clear: Long-standing taxpayers will get a big tax break, hurting city revenues. The city of Columbus found that a single

[7] Mayor Mark Tullis, Council Member Mark Kuenning, City Manager Michael Burns, Village of Indian Hill, Testimony Re: Municipal Income Tax Reform, the Ohio House of Representatives, Ways & Means Committee, June 13, 2012
[8] Ohio Department of Taxation, 2011 Annual Report, p. 72, available at http://1.usa.gov/Uz10sC.
[9] See Ohio Revised Code, Section 718.02(B)(3) for the existing provision
[10] Reps. Cheryl Grossman and Michael Henne, Memorandum to All House Members, "H.B. 601 – Municipal Income Tax Uniformity," November 1, 2012, p. 4
[11] See Peter Fisher, with Greg LeRoy and Phil Mattera, "Selling Snake Oil to the States: the American Legislative Exchange Council's Flawed Prescriptions for Prosperity," A joint publication of Good Jobs First and the Iowa Policy Project, November 2012, Chapter 3.
[12] Altogether, state and local taxes per capita in Ohio amounted to $3,762 in Fiscal Year 2010, less than the national average of $4,105. Such taxes amounted to 10.8 percent of personal income, compared to the national average of 10.7 percent. Federation of Tax Administrators, State and Local Tax Burdens, available at http://bit.ly/YFwzzT.

company in that city would reduce its municipal tax liability by $385,000 if the rule were eliminated.[13] If Ohio wants to support Internet-based companies, we should invest in education so they will have the workers they need, not create a new, untargeted tax break that will benefit any number of companies that happen to operate warehouses.

Snowplows before snowbirds

The bill would also allow municipalities to tax individuals only if they are Ohio residents for the purposes of the state income tax. That may seem logical, but if this is to be the rule, then the definition of who is covered by the state income tax should be overhauled and broadened.

For this purpose, Ohio defines a resident more narrowly than most states. Ohio uses what the state calls "contact periods" for measuring how much time individuals spend in the state. A contact period is defined as an overnight stay, so someone coming to Ohio on a Monday and leaving Tuesday has one such period (not two). Under a law approved in 2006, an individual who has less than 183 contact periods in a year is not considered an Ohio resident. This is a more generous policy than is used by most other states, which typically use a requirement of 183 days, not contact periods. In addition, other states may examine aspects of people's lives such as where their bank accounts are, where they are registered to vote, and where they have drivers' licenses, and use these to determine that they are indeed state residents even if they spend less than the requisite number of days in the state. Ohio, by contrast, is very unusual among states in saying that if people do not have more than 182 contact periods in the state, have a residence outside the state, and attest that they were not domiciled in Ohio, they are nonresidents, regardless of any other factors.

This definition of residency must be tightened before we consider adopting it for cities and villages, too.[14] Under the 2006 law, many high-income individuals who previously had to pay Ohio income tax and who would have to pay income tax in most other states are able to avoid state income tax. It is helpful to "snowbirds" who spend part of the year in Florida but still spend much of the year in Ohio. This should not be simply applied at the local level. Snowplows should come before snowbirds as a priority for the General Assembly.

One of the three guiding principles used in drafting the bill, according to sponsors Rep. Cheryl Grossman and Rep. Michael Henne, was to "Achieve substantial revenue neutrality."[15] That is not how the Legislative Service Commission reads the bill, however. While the LSC says that the effects on individual municipalities will vary, it said in its fiscal note that, "LSC economists believe that, on balance, the bill will probably decrease statewide revenues to municipalities. Due to a lack of detailed statewide data on municipal income tax revenue in Ohio, revenue losses to municipalities are

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[13] Conversation with Melinda Frank, Income Tax Division Administrator, City of Columbus, Dec. 14, 2012

[14] The Legislative Service Commission notes that, "Current state law does not address qualifications for municipal income tax residency. Residency is determined under municipal ordinances, many of which employ common law determinations of domicile depending on various indications of where a person intends to stay (e.g., maintaining a home, voting records, motor vehicle registration)." See Botomogno, Jean J., Legislative Service Commission, Fiscal Note & Local Impact Statement, H.B. 601 of the 129th G.A., As Introduced, Nov. 27, 2012, available at http://bit.ly/12SUKzF. The Regional Income Tax Agency says that it is difficult to quantify overall, but that 12 domicile cases over the last year and a half generated revenue of $425,000 for 8 of its member municipalities. This would be lost revenue for the local governments. Regional Income Tax Agency, HB 601 analysis.

[15] Reps. Cheryl Grossman and Michael Henne, Memorandum to All House Members, "H.B. 601 – Municipal Income Tax Uniformity," November 1, 2012, p. 1.

undetermined; however, they may be significant, potentially totaling millions of dollars annually."[16] This takes into account the provisions of the bill that may produce more revenue.

The Ohio Municipal League (OML) has expressed grave concerns about the revenue effects of the bill. Municipalities and agencies that collect taxes for them, such as the Regional Income Tax Agency, have not been able to pinpoint the full effect of all the proposed changes. However, while noting they are not able to assign a dollar figure to many revenue-reducing items, cities from Franklin in Southwest Ohio to Bedford in Northeast Ohio each have estimated annual losses of hundreds of thousands of dollars.[17] Central Collection Agency estimated that Cleveland would lose $1.5 million annually, excluding more than a dozen provisions – most of them negative for the city – that CCA could not immediately quantify.[18]

The consequent reduction in municipal spending and local public services would affect both residents and businesses. The OML noted in a white paper earlier this year, "Employers expect and depend on strong but basic services provided by municipalities such as adequate police, fire and EMS forces, safe and dependable transportation infrastructure and communities that can attract a workforce able to meet the demands of a global economy, to mention just a few. The inability of municipalities to adequately pay for these requirements for the pillars of a successful community will cause local businesses and the overall economy of the State to suffer."[19]

Discussions about the municipal income tax are continuing. But before such a major overhaul of the tax is approved, we must be certain that it will not negatively affect cities and villages. They have already been hammered by cuts in the Local Government Fund (LGF) and tax reimbursements, with effects from the repeal of the estate tax still looming.[20] Altogether, local governments are receiving more than $1 billion less from the state in the current two-year budget than they did in the previous biennium from reductions in the LGF and reimbursements for property taxes that had been eliminated and the state had previously promised to pay. The estate tax, which was repealed effective Jan. 1, had provided more than $200 million a year to localities.[21] The General Assembly should ensure that municipalities aren't clobbered again. It should close current loopholes that allow tax avoidance and prevent the creation of new ones.

Appendix A

2003 memo from Frederick Church of the Ohio Department of Taxation to Tax Commissioner Thomas Zaino regarding potential revenue gains from anti-PIC provisions.
Available online at www.policymattersohio.org/mit-jan2013.

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[16] Botomogno, Jean J., Legislative Service Commission, Fiscal Note & Local Impact Statement, H.B. 601 of the 129th G.A., As Introduced, Nov. 27, 2012, available at http://www.lsc.state.oh.us/fiscal/fiscalnotes/129ga/hb0601in.pdf
[17] See HB 601 Analysis, City of Franklin and City of Bedford Ohio, Loss Analysis of HB 601, As of 12/13/2012
[18] Lynch, Nassim M., Tax Administrator, CCA Memorandum to CCA Members, HB 601 Impact Analysis, Nov. 14, 2012
[19] "Municipal Income Tax Uniformity Achieved Through a Balanced Approach," attached to testimony before the House Ways & Means Committee of Kent Scarrett, director of communications, Ohio Municipal League, May 23, 2012
[20] See Wendy Patton and Tim Krueger, *Intensifying Impact,* Policy Matters Ohio, November, 2012, available at http://www.policymattersohio.org/county-budgets-nov2012, and Wendy Patton, *A Thousand Blows: State Budget Slashes Funding for a Wide Swath of Local Government Services*, Policy Matters Ohio, September 2011, available at http://bit.ly/RlzX23.
[21] Ohio Department of Taxation, 2011 Brief Summary of Ohio's Taxes, p. 33, available at http://1.usa.gov/TBD5r7.